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International Economic & Energy Weekly (U)

6 February 1987

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DI IEEW 87-006
6 February 1987

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International Economic & Energy Weekly (U)

Synopsis

1 **Perspective—OPEC: Following the Saudi Lead** (b)(3)

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3 **Indonesia: Countdown to Rescheduling?** (b)(3)

We believe Indonesia will reschedule some of its $40 billion foreign debt in 1987 unless there is a sufficient increase in world oil prices. The timing of rescheduling negotiations with commercial creditors probably will be dictated more by Jakarta's schedule for parliamentay and presidential elections than by the deteriorating state of the country's external finances. (b)(3)

7 **China: Reassessing the Role of Foreign Technology** (b)(3)

After several years of rapidly—and haphazardly—increasing its imports of Western technology, Beijing is reassessing the role of foreign technology in China's industrial modernization effort. Nonetheless, total expenditures on foreign technology will continue to rise and market opportunities for foreign suppliers remain bright in some sectors. (b)(3)

11 **Mexico's Parastatals: The High Price of Domestic Politics** (b)(3)

Although pressure to divest the largely inefficient parastatals has mounted in the last year with the dramatic decline in oil prices and the burgeoning of the federal deficit, President de la Madrid has for the most part responded with only vague promises to open the sector to private control. (b)(3)

15 **Jordan: A Gamble on West Bank Development** (b)(3)

King Hussein's first formal economic development program for the West Bank and Gaza is intended to improve the quality of life, and, more important, to establish Jordan—in place of the PLO—as the representative of Palestinians in the two occupied territories. Without rapid and visible progress on the program, Jordan risks losing its bid to become the Palestinian's major negotiator in the peace process. (b)(3)

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Perspective

OPEC: Following the Saudi Lead [redacted] (b)(3)

OPEC has reduced oil output substantially following its decision in December to limit production and raise prices. These production cuts by OPEC, combined with public announcements of support for higher prices from many non-OPEC producers, have buoyed price expectations. The average world price for crude oil has risen by $3 per barrel since December to about $18 per barrel. [redacted] (b)(3) [redacted] OPEC output has declined by about 2 million b/d to about 16.5 million b/d since December, with the Saudis accounting for more than one-half of the decline. Riyadh has canceled its netback contracts and switched entirely to a fixed-price basis. Moreover, the former Aramco partners recently agreed to purchase 1.25 million b/d at official Saudi oil prices through June, [redacted] (b)(3) (b)(3)

Other OPEC members are following the Saudi lead, [redacted] (b)(3) (b)(3) They reportedly have phased out market-related pricing schemes and are changing fixed prices. Most have also reduced output, although some countries—Kuwait, the UAE, and Nigeria, for example—are apparently still producing above their quotas. [redacted] (b)(3)

Nevertheless, considerable doubt remains whether OPEC can sustain compliance with the accord over the next several months. Some customers are likely to search for lower priced supplies before purchasing oil at higher, official prices. Although OPEC members have been able to sell oil at these prices initially, many customers have balked at signing longer term contracts. OPEC producers could come under pressure to offer discounts when companies renew contracts amidst a seasonal decline in oil demand. Also, continued overproduction by Kuwait and the UAE and higher Iraqi output could prompt other members to begin producing above quotas. Baghdad may be able to increase exports by as much as 850,000 b/d in several months because of pipeline expansion projects in Turkey and Saudi Arabia. Finally, over the course of the year non-Communist oil demand growth is expected to be below last year's 2-percent increase, which could complicate the group's efforts to sustain higher prices. [redacted] (b)(3)

Saudi Arabia's production policies will be crucial to the accord. In our view, its near-term strategy is to stabilize prices near $18 per barrel, a level Riyadh believes will still ensure a longer term market for its oil. Last year, lower oil prices reversed market trends and raised OECD dependence on Persian Gulf oil supplies from 16 percent of total consumption in 1985 to 20 percent. [redacted] (b)(3)

This price support strategy is risky, however, because continued budget deficits may force a sharp drop in Riyadh's liquid reserves—now estimated at about $50 billion. For example, if Riyadh holds government expenditures at last year's level of about $40 billion, the Saudis would need to boost exports by an additional 2 million b/d at prices of about $18 per barrel to balance the budget. But world demand is unlikely to increase by this amount for at least two to three more years, and Riyadh cannot be sure other producers would allow it to capture the bulk of this demand. [redacted] (b)(3)

Widespread cheating by other OPEC members or faltering oil demand could cause the Saudis to abandon their current strategy and boost output to generate increased revenues. It is more likely, however, that Riyadh will tolerate some moderate cheating and rally enough OPEC support for the agreement to keep prices above last year's $15 per barrel average. Under these conditions, prices, while remaining volatile, would probably average in the $15 to $18 per barrel range for the year. Stricter compliance or an escalation of the Iran-Iraq war could push the average price above $18. [redacted] (b)(3)

[redacted] (b)(3)

Indonesia: Countdown to Rescheduling? [redacted] (b)(3)

We believe Indonesia will reschedule some of its $40 billion foreign debt in 1987 unless there is a sufficient increase in world oil prices. The timing of rescheduling negotiations with commercial creditors probably will be dictated more by Jakarta's schedule for parliamentary and presidential elections than by the deteriorating state of the country's external finances. In our judgment, the Soeharto government will delay any rescheduling request until after the parliamentary elections are completed in April 1987. From the regime's perspective, this would allow time for some of the public's concern about the government's ability to manage the economy to dissipate before it stage-manages the election of President Soeharto to a new five-year term in March 1988 [redacted] (b)(3)

Rescheduling Jitters

Anemic export revenues are making it difficult for Indonesia to sustain economic growth, generate employment opportunities, and restrain its foreign debt, which we estimate reached $40 billion by January 1987. Since 1981, the country's external accounts have reeled following oil price declines amounting to about $18 per barrel through the end of 1986. In addition, prices for Indonesia's primary commodity exports—rubber, tin, palm oil, and copper—have also fallen. As a result of the drop in export revenues, Jakarta recorded cumulative current account deficits exceeding $20 billion in just five years—an estimated $6 billion in 1986 alone. [redacted] (b)(3)

The deficit last year was financed through a variety of sources, including about $1 billion in commercial credits, approximately $3 billion in foreign development assistance, and the rest from drawdowns in international reserves—which totaled about $10.5 billion last April—and new private borrowings. According to our estimates, if Indonesian oil prices average $14 per barrel and the prices of other commodity exports stay depressed, Indonesia could suffer a $4-5 billion current account deficit in 1987. [redacted]

Assessing the Likelihood of Rescheduling

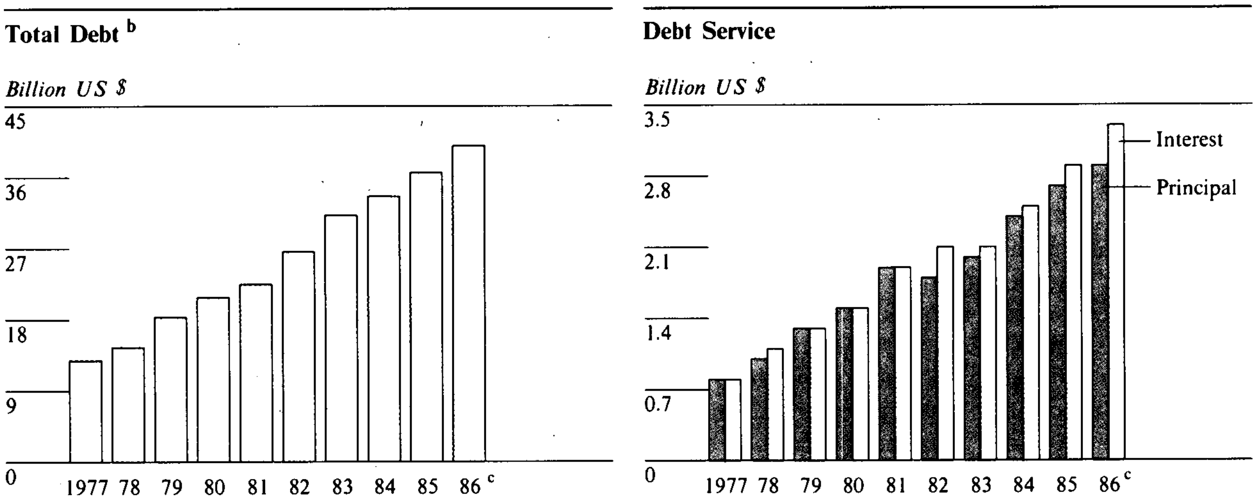
On the basis of a variety of techniques to evaluate a country's repayment ability, we believe that, at current low oil prices, debt rescheduling is only a matter of time for the Soeharto government. One such methodology is logit analysis, an econometric technique quantifying the likelihood that Indonesia will seek multilateral debt relief rising from declines in oil prices and export revenues. Judging from prior rescheduling cases for 19 countries, including Indonesia, covering the period 1979-84, we believe that a rescheduling probability above 40 percent warrants serious concern. In Indonesia's case, the probability reached this level in 1986, and is projected to reach 50 percent this year. [redacted] (b)(3)

Liquidity analysis—which measures liquid assets and access to commercial credit versus current payments—indicates Jakarta began to encounter liquidity problems after oil prices peaked in 1981 at roughly $35 per barrel. The problem worsened steadily as service payments on external debt rose faster than Indonesia's cash and credit account. The problem started to become especially acute in 1986 following the sharp decline in world oil prices early last year. Our analysis suggests that, unless Jakarta can come up with quick and cheap sources of foreign credit, or unless there is a sustained turnaround in oil prices, the government could be forced to reschedule its foreign debt before the end of 1987. [redacted] (b)(3)

Many US commercial banks are already reluctant to make additional financing available because of Indonesia's dire short-term economic prospects, despite the recognition that Jakarta is publicly committed to repaying its debt to foreign commercial banks. For its part, the Soeharto government in recent months has been making a concerted effort to ingratiate itself with foreign bankers by repaying as many short-term

(b)(3)

Indonesia: Foreign Debt Situation, 1977-86[a] *Note scale change*



[a] Yearend data.
[b] Includes long- and short-term debt. Short-term debt includes short-term trade financing and short-term borrowing by the central bank and commercial banks to finance international reserves.
[c] Estimated.

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[redacted] (b)(3)

loans as possible. [redacted] this is to enhance future borrowing power in international credit markets. At the same time, some foreign bankers are concerned that Jakarta is not moving vigorously enough to avail itself of standby credits from the IMF. According to US Embassy reporting, however, it is very doubtful that the government could secure $3 billion in standby credits that US banking sources believe necessary to restore Indonesia's previously excellent access to new commercial borrowings. The bankers believe that IMF standby loans, and the economic policy adjustments they would entail, would send a positive signal to the financial community and help bolster Indonesia's sagging commercial credit rating [redacted] (b)(3)

If Jakarta Reschedules

As Indonesia's largest commercial creditors, with about $7 billion outstanding, Japanese banks probably would take the lead in a rescheduling and provide fairly reasonable terms if their recent financial dealings with Jakarta are any guide. Through the end of 1986, Japanese banks had been willing to provide new credits to Jakarta even though it was apparent that Indonesia's economy was deteriorating. Even if these banks were not inclined to treat Indonesia leniently in rescheduling negotiations, we expect they would be under pressure from Tokyo to do so. The Japanese Government is sensitive to the long-term economic importance of Indonesia as a vital and relatively secure source of strategic resources—especially oil and gas; last year, for example, Indonesia provided about 15 percent of Japan's oil requirements. All told, we believe, Tokyo would view a rescheduling exercise as a unique opportunity to strengthen Japan's overall economic relationship with Indonesia and perhaps push Jakarta to make some economic policy changes. [redacted] (b)(3)

US commercial banks, with about $3 billion in loans outstanding to Indonesia, would have to decide whether to go along with an accommodating Japanese approach or, as in recent debt reschedulings with other LDCs, be hard bargainers. For its part, we believe that Jakarta, in exchange for favorable treatment from US banks, might be willing to offer some concessions in other areas of the bilateral economic relationship, such as easing foreign investment regulations and redtape. [redacted] (b)(3)

Indicators To Watch

As Jakarta wrestles with its financial problems, there are a number of indicators that, in our judgment, could signal that a rescheduling is at hand:

- Substantial activity and deep discounts in the secondary market for Indonesian medium- and long-term loans. [redacted] (b)(3) last November an international banker reported that such a market was growing. He noted (b)(3) that most Indonesian loans are being swapped for 83 to 85 cents on the dollar, and estimates this could drop to 70 to 75 cents per dollar early this year.

- Demands by bankers for a sharp decrease in loan maturity and a sharp increase in interest spreads above the London interbank offer rate (LIBOR) for new loans. [redacted] several international bankers have indicated that they would not increase their outstanding loans to Indonesia on any terms.

- Imposition of the exchange controls that have been rumored in Jakarta since the 31-percent devaluation of the rupiah last September. [redacted] despite repeated government announcements to the contrary, Jakarta is considering another devaluation soon along with exchange controls to halt the drain on its international reserves.

- Increased capital flight, which would also compel the government to impose foreign exchange controls. [redacted] some bank depositors were shifting their funds overseas for fear that Jakarta might freeze bank deposits. [redacted] (b)(3) Chinese businessmen—some con- (b)(3) nected with Soeharto and his family—are getting their money out of the country before another devaluation is announced.

- Significant drawdowns in international reserves and commercial credit lines. [redacted] (b)(3) rumors are circulating within (b)(3) the international financial community that drawdowns of credit lines are "substantial." [redacted] (b)(3)

The Political Dimension

The government's current economic difficulties coincide with a particularly sensitive period for the Soeharto regime. Despite its public optimism, the government is undoubtedly aware that oil prices could remain depressed for at least several more years. We believe the regime, therefore, must weigh the consequences of doing nothing in the hope that oil prices will firm soon, or move decisively to remedy the present financial crisis. Among other things, a major goal would be to restructure principal and interest payments on official debt—which we estimate at about 30 percent of government budget expenditures—to avoid further budget cuts in economic and social services. Whatever Jakarta's policy response, it will be made with elections on the horizon. Parliamen- (b)(3) tary elections this April will set the stage for the (b)(3) presidential election in March 1988 and Soeharto has already said that he intends to run for a fifth five-year term. Because of the election timetable, we believe Jakarta will probably move to reschedule some of its foreign debt soon after the April elections. This will allow time for some of the public's concern about the (b)(3) deteriorating economic situation and the govern- (b)(3) ment's ability to manage the economy to dissipate before the presidential election, which Soeharto is assured of winning. [redacted] (b)(3)

[redacted] (b)(3)

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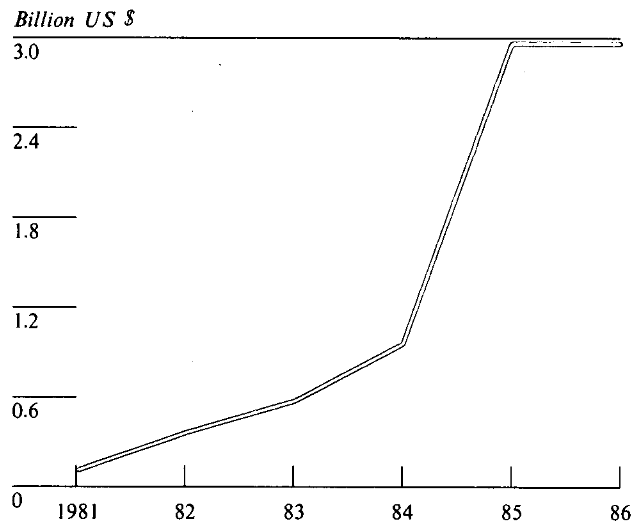
China: Reassessing the Role of Foreign Technology [redacted]

(b)(3)

After several years of rapidly—and haphazardly—increasing its imports of Western technology, Beijing is reassessing the role of foreign technology in China's industrial modernization effort. Growing concerns about the costs of foreign technology, its disappointing impact in a number of economic sectors, and the disruptions it has caused in some fledgling domestic industries have led to tighter controls over the acquisition of foreign technology—both equipment and know-how—as well as closer scrutiny of its use. These changes will probably, over time, contribute to a strengthening of Chinese industrial capabilities and export competitiveness. Nonetheless, total expenditures on foreign technology will continue to rise and market opportunities for foreign suppliers remain bright in some sectors. [redacted] (b)(3)

China: Technology Imports by Central Authorities, 1981-86 [a]



[a] Data reflect contracts signed, not actual shipments. Data on technology purchases by provincial, municipal, or semi-independent trade authorities are spotty.
[b] Projected, based on data for the first six months.

[redacted] 311809 2-87 (b)(3)

Emerging Problems

Three main concerns have prompted Beijing's reassessment:

- ***The decline of foreign exchange holdings.*** Duplicate and unnecessary technology imports contributed to the dramatic drop in China's foreign exchange holdings from $17 billion in December 1984 to $10.3 billion in September 1986. Chinese traders, for example, imported more than 100 color television production lines and dozens of washing machine and refrigerator assembly lines. Many of these deals committed China to massive expenditures of foreign exchange well into the future for components needed for assembly.

- ***Disappointing results from using imported equipment.*** Widely publicized Chinese reports last year indicated that only a fraction of the imported equipment was being used effectively—even in priority areas such as computers, microelectronics, and scientific instrumentation.

[redacted]

- ***The harm to infant industries.*** Many factories are strapped because their products cannot compete with lower priced, higher quality imported goods while purchases of duplicate production lines have created additional surplus production capacity. Chinese press reports have also been critical of the fact that many of the foreign-equipped production lines have kept China dependent on imported components. [redacted] (b)(3)

New Initiatives

To correct these problems, Beijing aims not to curb total expenditures on foreign technology, but rather to reduce unnecessary purchases and find ways to increase the benefits from the technology it must import. Beijing still believes that foreign technology can (b)(3) provide a cost-effective shortcut to the country's industrial and technological advancement. Beijing also views foreign technology as vital to its export competitiveness as well as its goal of eventually substituting domestic products for imports. [redacted]

(b)(3)

Beijing, however, is seeking a middle ground between the import legislation adopted by Brazil and India to protect their infant electronics industries from foreign competition and the liberal policies of Taiwan and South Korea, which have nearly eliminated government controls over technology acquisition in order to speed industrial development and export growth. Beijing has implemented a combination of direct administrative controls, economic levers, and worker and manager incentives to control the purchase and improve the use of foreign technology, and to encourage greater use of domestic technologies. Beijing has, for example:

- Centralized import decisionmaking, and charged industrial ministries with checking domestic availability and ensuring that imports are not redundant.
- Issued regulations linking equipment purchases to transfers of know-how, and offered preferential treatment to foreign partners that help China produce for export.
- Encouraged trade corporations and factories to seek the advice of technical consultants and to make use of feasibility studies.
- Raised tariffs and cut domestic prices to shore up sales of domestically produced goods.
- Sponsored technology exhibits and fairs to make Chinese buyers aware of indigenous technologies that could substitute for foreign ones. [redacted]

(b)(3)

More Bang for the Import Buck

We expect China's progress in rationalizing technology import decision making and in improving technology utilization to be gradual. Bureaucratic boundaries—both provincial and ministerial—will continue to result in duplicate or unnecessary purchases. Moreover, basic infrastructural weaknesses—including shortages of technical personnel, energy supplies, raw materials, spare parts, and funds—will continue to hinder technology absorption. Nonetheless, we believe that China will, over time, substantially reduce the

Beijing Debates Technology Import Policies

In the aftermath of Hu Yaobang's dismissal, Chinese reformers and conservatives will probably intensify their debate over a wide range of issues related to economic policy. China's "open door" to Western technology could become one of the focal points for challenges to recent reform policies. [redacted] (b)(3)

Throughout 1986, even when reformers generally had the upper hand, Chinese officials expressed a variety of opinions on the relative merits and drawbacks of foreign technology, as well as on the policies most likely to yield maximum economic benefits from technology introduction. The debate has centered on several issues:

- *To make or buy needed technologies.*
- *To centralize import decision making or to increase the factory voice in the decisionmaking process.*
- *To regulate imports by administrative means or through greater use of market mechanisms.*
- *To direct purchases toward mature sectors such as textiles and machine building or to high-tech industries such as electronics.*
- *To purchase state-of-the-art or less advanced, but more easily assimilated, items* [redacted] (b)(3)

We believe that a push this year by conservative Chinese leaders would result in greater use of indigenously developed technologies and equipment, closer central supervision and greater use of administrative mechanisms to regulate technology imports, and stronger emphasis on less sophisticated but possibly more easily assimilated technologies for established industries. Soviet technology would probably meet the requirements of many Chinese conservatives. Reformers, however, will also try to promote their policies, which include greater use of market mechanisms to regulate technology import choices and to encourage effective technology use, greater involvement by factory-level decisionmakers, and emphasis on imports of sophisticated Western technology for high-tech industries. [redacted] (b)(3) incidence of duplicate imports and the purchase of equipment China can supply domestically. Some successes are already evident. Last year, for example, China's Ministry of Machine-Building Industry canceled 88 import projects that did not meet the new criteria. [redacted]

We also believe Beijing will improve the match between imported technology and the needs and capabilities of users, gradually boosting the economic payoffs to factories introducing foreign technology. Import decisions made by central agencies such as the State Economic Commission or the Ministry of Foreign Economic Relations and Trade will begin to reflect what these agencies have learned from surveys undertaken in 1986 about why past import projects succeeded or failed. Factories will make better use of imported technology as they gain experience using feasibility studies to guide both equipment selection and related adjustments in factory conditions, resource supplies, and training. Managers will probably become increasingly sensitive to the benefits of technology introduction—and the costs of poor technology use—as a result of factory management reforms adopted in recent years. Political uncertainties in Beijing following Party Chairman Hu Yaobang's ouster last month have put related changes in labor and price policy on hold, and will limit the effectiveness or delay the widespread implementation of managerial reforms. [redacted]

We believe the sectors likely to benefit most from improved use of foreign technology are textiles, food processing, household appliances, consumer electronics, packaging, metallurgy, printing, and plastics. Because Beijing is aggressively promoting exports—and has tied the use of foreign technology to the promise of export earnings, rather than solely to improved production for the domestic market—we expect Chinese goods in these sectors to be increasingly competitive in international markets. Foreign technology will help China improve quality control and upgrade packaging, factors that have limited China's penetration of many export markets. [redacted]

Consequences for Technology Suppliers

Despite Beijing's attempts to cut back duplicate purchases, many foreign technology suppliers will find improved opportunities to sell to China during the next five years. Overall spending on foreign technology is slated to increase, accelerating in the latter years of the 1986-90 Plan. The focal areas for technology imports will be the energy, transport, telecommunications, raw materials processing, textile, light (b)(3) industry, machine-building, and electronics sectors. We also expect China to make greater use of foreign experts to conduct feasibility studies, consult on technology import needs, and provide managerial and financial advice. We believe Chinese buyers will also look for ways to acquire foreign technology without making large outlays of foreign exchange—for example, buying used equipment or the rights to dated technology processes, or leasing equipment instead of purchasing it outright. [redacted] (b)(3)

Beijing's new policies will probably create additional layers of bureaucracy, prolonging negotiations with foreign suppliers. Foreign technology suppliers also will face greater pressure to engage in cooperative production projects, such as joint ventures and license agreements. The ability of foreign firms to secure government-backed concessional financing—already a decisive factor—will become increasingly important. [redacted] (b)(3)

Beijing will continue to find Western technology—especially from Western Europe and the United States—more desirable than that from the Soviet (b)(3) Bloc, in our judgment:

- The market position of West European technology suppliers will remain strong, but will probably decline slightly from 1985 levels, which were most likely skewed by a small number of large contracts awarded to West German and French firms.

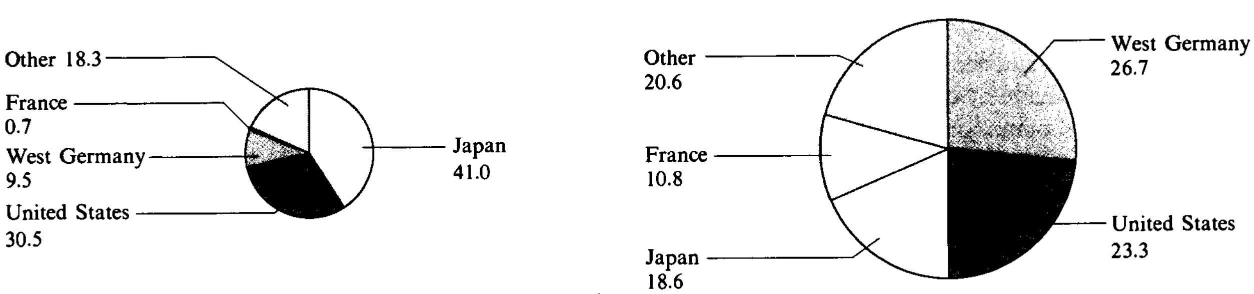
- We expect the US share of China's technology imports at least to stabilize—and probably to increase—over the next five years. US firms will benefit from policies linking equipment purchases to cooperative production, but will face keen competition from European firms, which often include (b)(3) attractive financing with their bids to supply equipment and production technology.

- Japan's share of China's technology purchases will probably continue to erode, as China's central trade

China: Sources of Technology Imports by Central Authorities, 1983 and 1985[a]

Percent

1983 Total=US $ 0.6 billion	**1985** Total=US $ 3.0 billion



[a] Data reflect contracts signed, not actual shipments.

[redacted] 311810 2-87 (b)(3)

corporations enforce Beijing's instructions to direct imports away from Japan—a policy first formulated in 1985 out of frustration with a ballooning bilateral trade deficit and the relatively low level of Japanese investment. Japanese sales figures will also begin to reflect China's suspension of imports of consumer goods production lines through 1990 and the effect of the yen's appreciation.

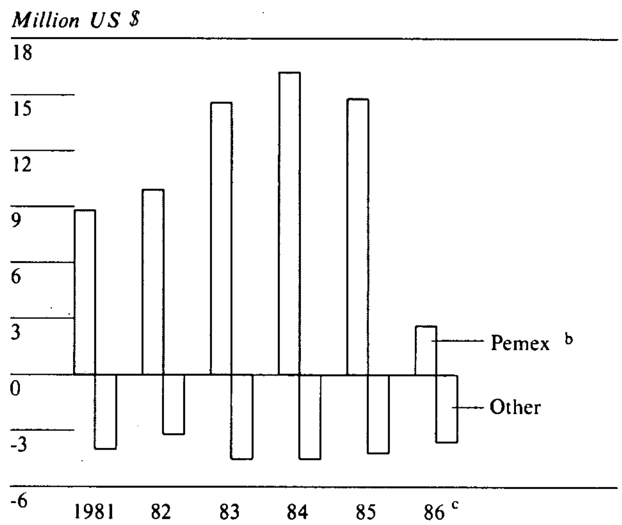
Beijing considers Soviet technology generally to be inferior, and—unless there are sharp shifts in the direction of economic and foreign policy in Beijing following Hu Yaobang's resignation—the Soviet Union will remain a relatively minor source of the foreign technology China seeks. China will receive Soviet equipment and assistance in at least two dozen projects under a bilateral technical cooperation agreement signed in July 1985, however. Most are in the energy or heavy industry sectors; Beijing welcomes Soviet assistance for the former because its technology—particularly in coal and electric power—is relatively advanced, and for the latter because it is a sector that Western investors generally avoid. Most of the joint projects under consideration involve renovation of sites built with Soviet help in the 1950s. [redacted] (b)(3)

[redacted] (b)(3)

Mexico's Parastatals: The High Price of Domestic Politics [redacted] (b)(3)

The Mexican Government uses its system of state-owned enterprises, or parastatals, to great advantage to create jobs, administer subsidies, exert leverage over private business and organized labor, and keep the political system functioning relatively smoothly. These political benefits, however, come only at a substantial economic cost: excessive spending, massive debt, unnecessary inventory accumulation, reduced international competitiveness, and higher inflation spurred by the sector's generous labor contracts. Although pressure to divest the largely inefficient parastatals has mounted in the last year with the dramatic decline in oil prices and the burgeoning of the federal deficit, President de la Madrid has for the most part responded with only vague promises to open the sector to private control. [redacted] the onerous conditions attached to many sales, the domestic liquidity crunch, and the poor state of most public-sector firms' ledgers have choked off privatization efforts and probably will continue to do so through the end of de la Madrid's term in 1988. In addition, new lenient foreign financing agreements have dulled much of the fiscal incentive for reform. Any piecemeal progress de la Madrid is able to make could provide limited opportunities for US business in the near term, but, at the same time, Mexico City is likely to squeeze US banks for further concessions on parastatal debt. [redacted] (b)(1) (b)(3)

Mexico's Controlled Parastatal Sector: Operating Surpluses and Deficits,[a] 1981-86



[a] Those enterprises subject to congressionally approved budget.
[b] The national oil company.
[c] Estimated.

[redacted] 311775 2-87 (b)(3)

A Problem Sector

US Embassy reporting indicates that, without key market forces, operational inefficiencies are rampant in many parastatals, quality control often is lacking, and modern management techniques are sometimes ignored by supervisors and middle-level managers who owe their positions to political factors rather than business acumen. Among examples reflected in [redacted] press reporting are the following: (b)(3) (b)(3)

[redacted] (b)(3)

- [redacted] DINA, the state-owned truck manufacturer [redacted] trying to persuade Mexico City to allow a US firm 100-percent control of a DINA plant as [redacted] overall effort to restructure the parastatal and bring an end to heavy annual losses. [redacted], the director has identified a history of poor Mexican management as the company's major problem, and believes that US management techniques can help produce a profit. (b)(3) (b)(3) (b)(3) (b)(3) (b)(3) (b)(3)

- Engineers at the electric power parastatal, CFE, reportedly fear that the country faces brownouts or blackouts unless various spare parts are received soon. For example, many turbines already have been shut down and "cannibalized" for spare parts to keep other units running.

- [redacted] inefficiency and overstaffing in Mexico's steel sector allows the public sector to produce only 70 tons per worker compared with the 170 tons that workers produce in Mexico's private steel firms.

- The state-owned sugar company, AZUCAR, has announced that it has no plans to scale back its operations or work force even though there is a massive surplus of sugar in the country.

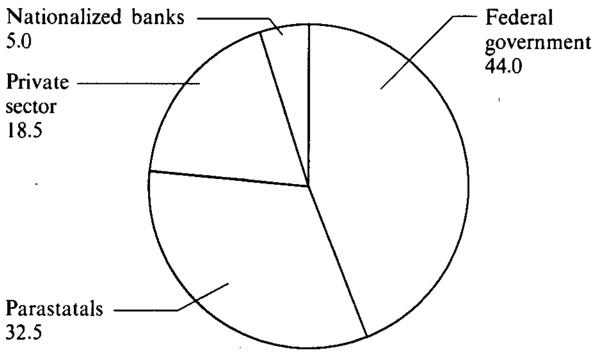
- Despite heavy subsidization, we have found that government food stores, CONASUPO, sell their goods at prices only slightly lower than their private-sector competitors. In addition, press reports indicate that CONASUPO store managers employ high degrees of discretionary pricing with little regard to market conditions.

- Generous labor agreements at AeroMexico and Mexicana, Mexico's state-owned airlines, reportedly were scaring off potential private-sector investors, although there are rumors that Mexicana soon will be sold. Meanwhile, Mexican pilots publicly blamed poor maintenance for recent airline disasters. (b)(3) [redacted]

Mexico: Debt Profile, 1986 (b)(3)

Total=US $ 97.5 billion

Percent



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[redacted]

Dim Prospects for Improvement

De la Madrid is now faced with a dilemma: financially, he finds it nearly impossible to allow the parastatal sector to maintain its size; politically, he finds it equally difficult to scale it back. In recent years, the oil revenues and heavy foreign borrowing that masked the losses incurred by most parastatals have been harder to come by, and the subsequent strain on government coffers has been intense. We believe the President recognizes the need for a contraction of the state-run system, but he lacks the political capital required to take decisive steps in that direction. As a result, he has largely backed off on his promises to divest the sector and is now placing more emphasis on making "priority" state-owned firms more efficient. [redacted]

In his 1 September 1986 State of the Nation speech, de la Madrid announced that his government would take steps to prevent nonstrategic and lower priority enterprises from depleting the Mexican budget so that the strategic and priority enterprises might be saved. This formulation apparently was intended to indicate that his government would continue to operate some firms, but was willing to divest others. The list of sacrosanct firms was divided into the following categories:

- Those put under exclusive state jurisdiction by the Constitution, including petrochemicals, electric utilities, railroads, the nuclear industry, post, telephone and telegraph, and public banking.
- Essential social services such as social security, public housing, and CONASUPO.
- Priority enterprises that, among others, include steel, fertilizer, sugar, and shipbuilding.

The President also stated that 205 parastatals have been transferred, liquidated, merged, or sold, and that some 261 others are in the process of being divested. (b)(3) According to de la Madrid, there now are about 700 parastatals, compared with 1,155 in 1982. The US Embassy reports that it has been unable to confirm the numbers cited by the President, and points out that the inclusion of the caveat "among others" in the last category is a typical Mexican Government loophole. [redacted]

Last May's closing of the Fundidora Steel complex was a bold gesture by de la Madrid, but we believe that the political fallout from the move will hinder further progress. Moreover, we are skeptical of recent government announcements that the number of parastatals has been reduced:

- In their announcements, Mexican officials refer to the number of parastatals whose sale or liquidation have been "authorized," rather than actual transactions, which are far fewer.
- Although some firms have been eliminated, our analysis of government data reveals that the sector's total output and employment levels actually have increased.

We conclude that the de la Madrid administration is convinced the political benefits the parastatals generate make them worth their economic cost. Thus, despite the President's relatively conservative market-oriented economic philosophy and his promises to Mexico's creditors to privatize the sector, his hands are tied by a system that rests on the ruling party's monopolistic control of economic resources. As the economy deteriorates, de la Madrid now depends more than ever on the state-run sector to buy him time by delaying or softening the impact of austerity-driven economic reforms. [redacted] (b)(3)

Outlook

Between now and the end of his term in 1988, we believe de la Madrid's administration will enjoy a temporary respite from its immediate financial problems as a result of the lenient IMF agreement signed in September 1986 and the $12 billion financial bailout by the country's creditors. Rather than use this break to begin economic reform, however, we believe the Mexican leadership will direct most of the money toward foreign interest payments and, with an eye on national elections in 1988, domestic spending that favors the ruling party's major constituencies. In our view, the leverage for change does not exist: domestic advocates of reform are without strength and foreign creditors have lost the influence they once

The Fundidora Closing

The closing in May of the Fundidora Steel Company in Monterrey, the country's third-largest city, resulted in significant political costs in addition to immediate financial losses. The company—one of the three largest state-owned steel complexes that comprise the SIDERMEX conglomerate—clearly was a financial disaster. In 1985 alone, according to press reports, Fundidora lost $48 million and increased its total outstanding debt to $380 million. Workers responded angrily with large-scale demonstrations to the closing, which eliminated some 10,000 jobs directly and will affect another 60,000. Layoffs are costly to the government: under Mexican law, severance pay covers three months' salary and an additional 20 days' salary for each year of service. [redacted] *Fundidora employees would receive sufficient severance pay to support their families for six to eight months. Beyond that, their prospects look bleak. Because of inefficiency and overcapacity, Mexican steel is uncompetitive in international markets, while the slowdown in economic activity has reduced domestic demand for steel. Moreover, private business in the area is in no position to absorb any of the newly unemployed, according to US consular officials in Monterrey.* [redacted]

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For its part, Mexico City points to the decision to close the steel plant as evidence that it is taking the painful steps needed to reform the economy. We believe there is some validity in drawing a parallel between the closing of the plant and the decision in 1985 to allow IBM 100-percent ownership of a Mexican subsidiary. In both cases, Mexico City acted while intense negotiations with creditors were taking place amidst increasing pressure to adopt economic reform. Although financial realities were more pressing in the Fundidora decision than in the IBM case, we believe that the timing of the decision was influenced by the creditor negotiations. More important, rather than signaling similar moves elsewhere, we believe that the negative political fallout from the closing dampened the administration's resolve to eliminate other inefficient state firms. [redacted] (b)(3) held by agreeing to new loans and new terms on old debt without conditioning them on reform. [redacted] (b)(3)

Implications of these domestic economic and political strains for the United States over the near term will be limited largely to adverse effects on US firms doing business with Mexico's parastatals and to US commercial creditors that have lent them money. Payment delays and declining markets can be expected for US businessmen, but investors may find new opportunities if Mexico puts some of the smaller, less politically sensitive parastatals on the market. Mexico City will be hard pressed to honor parastatal debt obligations once the current financial rescue package expires. US bankers will increasingly be pushed to offer concessions and creative solutions for their parastatal loan exposures. Banks also are concerned about the status of outstanding debt to a parastatal that is sold. In most cases, creditors view foreign governments as better risks than private firms and fear that the new owners may shirk their responsibility to repay old debts [redacted] (b)(3)

As oil prices remain depressed, Mexico's population balloons, and rapid urbanization continues, the ruling party will find it increasingly difficult to continue satisfying its constituencies by relying on parastatals. Over the long term, we believe these pressures will force de la Madrid's successors to search for new means to buffer the pain of austerity policies. A number of alternatives may be pursued, but the most likely scenario of a muddle-through approach carries risks: given the mounting strains, the eventual trauma associated with economic reform will be more pronounced the longer the adjustment is postponed. The Mexican reluctance to reform, in our view, will accelerate the erosion of the economy and contribute to broader problems that will spill across the US border. For example, we expect illegal emigration to increase, because we do not believe that the public sector can absorb the increments in the labor force. In addition, as long as the parastatal sector fails to contract, US banks will face increasing pressure for further loans or face payment suspensions [redacted] (b)(3)

[redacted] (b)(3)

Jordan: A Gamble on West Bank Development

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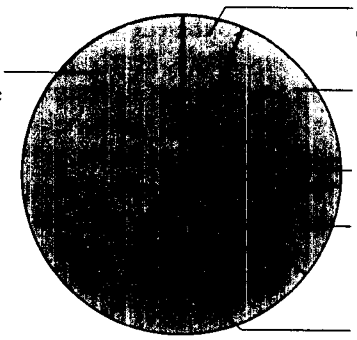
King Hussein's first formal economic development program for the West Bank and Gaza is intended to improve the quality of life, and, more important, to establish Jordan—in place of the PLO—as the representative of Palestinians in the two occupied territories. Severe cash shortages, PLO opposition, and skepticism on both banks, however, challenge Jordan's ability to implement the plan. Without rapid and visible progress on the program, Jordan risks losing its bid to become the Palestinians' major negotiator in the peace process. (b)(3)

Jordan: West Bank and Gaza Development Plan, 1987-90
Cumulative total=US $ 1.3 billion

Percent



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Hussein Bets on Development

Rather than engage in head-to-head political competition with the PLO, Hussein has opted for a long-term strategy designed to capitalize on disarray within the PLO and its problems providing economic and social support to the Palestinians. Hussein hopes that by providing economic and municipal development aid he can reestablish a Jordanian political presence among the Palestinians in the West Bank and Gaza. Ultimately, he believes improving economic conditions is the best way to win Palestinian acceptance of Jordan—and not the PLO—as the representative in negotiations with Israel, according to the US Embassy.

The development program, which Jordanian planners expect to have a price tag of about $1.3 billion through 1990, focuses on social projects that will give maximum benefit to the general populace. About three-fourths of the planned investments are earmarked for education, social welfare, and construction, according to the US Embassy. Spending in these areas is designed to improve the quality and skills of the West Bank and Gaza work force and to stimulate employment opportunities.

No Cash in Hand

The key obstacle to the development plan's success is Jordan's inability to pay the bill. Worker remittances—Jordan's most important source of foreign exchange—tourism, and merchandise exports continue to perform poorly, saddling Jordan with the problem of financing another foreign payments gap this year. Foreign exchange reserves of about $360 million—the equivalent of less than two months' imports at current rates—are woefully inadequate to cover the revenue shortfall. Despite holding expenditures at last year's level, the 1987 budget calls for a deficit of at least $188 million, according to the US Embassy. (b)(3)

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Without foreign assistance, Jordan has no hope of making the development plan work. As a result, senior Jordanian officials are scrambling to obtain critically needed financial aid, according to US Embassy reports. Last September, Prime Minister Rifa'i traveled to West Germany, France, and the United Kingdom seeking money for the plan, followed the next month by a stop in Kuwait. Emphasizing the importance the government places on the program, King Hussein subsequently visited Middle Eastern and West European capitals to make a pitch for funds. Jordan's drive to attract international financial support for the program culminated in November at the Development Conference held in Amman.

Donor response has been unenthusiastic. Although participants at the Development Conference gave guarded endorsement to the concept of Jordanian aid to the West Bank and Gaza, nearly all countries evaded financial commitments to Amman. The US Embassy reports several EC members, particularly France, Spain, and Greece, continue to believe that funneling aid through Jordan would compromise their neutrality on the legal status of the occupied territories. Some European countries probably are also concerned about the possibility of Arab retaliation.

The EC Commission has, instead, elected to channel part of its $3.1 million commitment directly to the West Bank and Gaza—a decision that Amman vehemently opposes. Only the United Kingdom has pledged direct assistance—about $7.3 million through 1990—which London intends to disburse with minimal fanfare to avoid political controversy that might jeopardize implementation of its projects. West Germany intends to follow the UK lead, but German assistance is only at the planning stage.

A greater disappointment for Jordan has been the tepid response from its traditional Arab benefactors. Saudi Arabia, Qatar, and Oman—some of Jordan's most important donors—sent only low-level representatives to the Development Conference and have not committed additional funding beyond their scheduled payments agreed to at the 1978 Baghdad summit. Even the Baghdad grants are likely to decline this year to about $450 million from the 1986 total of $560 million. Saudi Arabia also still is insisting that Jordan pay $195 million for Saudi oil deliveries in the second half of 1985.

Views From the West Bank and the PLO

Yasir Arafat has denounced Jordan's development plan, declaring it would lead to a de facto normalization of relations between Amman and Tel Aviv, according to Palestinian media reports. He has cautioned Arab countries not to support the plan, contending that such assistance would prolong the Israeli occupation. Arafat instead has called for adherence to (b)(3)
the Baghdad summit resolutions, a clear signal for a return to the PLO-Jordan Joint Committee as the official conduit of development funds to the occupied territories. For now, Arafat probably wants to avoid risking a more direct confrontation with Jordan and concentrate on reconciling with rival Palestinian factions in Syria and Lebanon. (b)(3)

Most Palestinians apparently are willing to accept Hussein's money, but even the staunchest supporters of the plan are skeptical of long-term Jordanian objectives and capabilities. Many Palestinians object to Jordan's veiled strategy to supplant the PLO as the (b)(3)
legitimate representative of the Palestinians in the occupied territories.

(b)(1)

Views From the East Bank and Israel

Israel, in principle, supports the development program, including quality-of-life improvements for the (b)(3)
Palestinians. Tel Aviv much prefers an increase in Hussein's moderate influence to the PLO's continued sway in the occupied territories. Reflecting its common interests with Jordan, Israel has cracked down on PLO militants, closed radical newspapers, and deported some activists, according to the press and US Embassy reporting. Much to Jordan's irritation, however, Israel has attempted to link itself publicly to the implementation of the development plan. Moreover, Tel Aviv has insisted on a strong hand in vetting proposed development projects and would veto any

(b)(3)

initiative that threatens Israeli economic and security interests in the occupied territories. [redacted]

Although most key officials in the Jordanian Government support the plan, some East Bank political conservatives argue that the country's scarce financial resources should be used at home and are pressuring Amman to abandon the plan. Moreover, they have allies in the government who share their concerns about the security implications of closer ties to the occupied territories, according to the US Embassy. [redacted]

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An Uncertain Payoff

Jordan's chances are not good that it will be able to keep the development plan on schedule or gain political advantage in the territories at the PLO's expense. Any failure to make rapid and coordinated progress will make Jordan appear too weak to represent Palestinian interests. So far, Amman has allocated only about $25 million for the plan. These funds, however, will help quiet criticism from many Palestinian leaders on the West Bank who are complaining about the lack of discernable progress, according to the US Consulate in Jerusalem. [redacted]

(b)(3)

Foreign donors will continue to be tightfisted. The Arab states will be most reluctant to provide assistance to a perceived Jordanian-Israeli strategy to circumvent the PLO. Riyadh told Hussein its own cash problems preclude more aid to Jordan for now, according to the US Embassy. Other Arab oil states are echoing the same theme. As a result, we estimate total Persian Gulf aid in 1987 will continue last year's decline and fall to about $540 million from $600 million in 1986. EC members also probably will drag their feet until they are certain they can avoid negative political fallout. [redacted]

The best we believe Jordan can expect is enough money to start a few small projects that demonstrate to the Palestinians the program is still a viable solution to improve their standard of living. This might give the Jordanians some breathing room to line up additional funding, especially from the EC. Jordan also is likely to launch an aggressive public relations campaign, touting existing projects in an effort to maintain Palestinian confidence in the program. Still, Amman has promised much and faces an uphill battle to maintain the momentum of the program. New money probably will come too late to give Jordan the opportunity to make much headway on large projects this year. [redacted] (b)(3)

(b)(3)

Regardless of the financial outcome, Jordan cannot discount the prospect that the PLO will take countermeasures to undermine the plan if Arafat or local supporters believe they are losing political ground. The Embassy reports some evidence that pro-PLO Palestinians are taking notice of the threat the Jordanian strategy presents to Arafat and themselves. A PLO counteraction almost certainly would include increased violence and acts of intimidation against any Palestinian participants in the development plan. [redacted] (b)(3)

Jordan knows the constraints on US foreign aid this year and, as a result, will look to the United States for support principally on the diplomatic front. Amman believes that a US lead could spur EC countries to boost their assistance to the development effort. Jordan also will look to the United States to continue to intercede on its behalf with the Israelis and perhaps the Saudis. If Hussein's plan is unsuccessful, Amman may well lose the opportunity to create a Jordanian-Palestinian negotiating team that eliminates the PLO—and thereby forfeit the chance to remove a major obstacle to the peace process. [redacted] (b)(3)

[redacted] (b)(3)

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Approved for Release: 2018/08/22 C05743475

Briefs

Energy

Results of Saudi Oil Minister's Trip

Saudi Oil Minister Nazir's recent visits to Egypt, the USSR, Norway, and the United Kingdom as an OPEC emissary strengthened perceptions of solidarity among oil producers and helped reestablish Saudi Arabia as the primary architect of OPEC's oil policy. Nazir succeeded in gaining commitments for production cuts from most countries he visited, but the cuts were minor and OPEC still must hammer out policies to achieve stability in the international oil market. Non-OPEC oil production, including cuts by Norway and Oman, will be pared by less than 200,000 b/d. Even proposed cuts by Egypt, Mexico, and the USSR are probably more the result of technical constraints, declining capacity, seasonal fluctuations in consumption, or interest in scoring propaganda points. London reiterated its longstanding policy of not cooperating with OPEC. Renewed competition among oil producers—especially within OPEC—is still likely as oil demand declines during the spring and summer. With little prospect for additional non-OPEC cuts, growing pressure on government revenues will put OPEC's solidarity to the test. The Saudis may have to make stronger overtures to non-OPEC oil producers and put pressure on the other OPEC members—particularly Iraq—to abide by the OPEC agreement. [redacted] (b)(3)

Iranian Attempts To Protect Refinery Operations

Since April 1986, Iraqi air attacks have damaged all six of Iran's operating petroleum refineries, substantially reducing the production of petroleum products—especially heating and motor fuels. Refining output for 1986 reached its lowest level in September when total daily production dropped to 130,000 b/d, or 20 percent of capacity. By January 1987, however, much of the damage had been repaired and imports needed to satisfy national demand were down to a near-normal 200,000 b/d. The Iraqi attacks have apparently forced Tehran to construct walls around some of the critical refining components such as the furnaces, distillation towers, pump and control buildings, steam plants, and major pipeline bundles. Walls have also been built around gas storage tanks, the bases of stacks and flares, and around some administration buildings. [redacted] (b)(3)
[redacted] wall construction is continuing. Although the walls will (b)(3)
provide some protection for refinery workers and components such as pump and control buildings, they offer little protection for other critical components such as furnaces and distillation towers. Iran is also constructing crude oil storage tanks at the Esfahan and Tabriz refineries that will increase storage capacity at the two refineries to a 10-to-15-day supply in the event pipeline supplies were cut off. However, given the high vulnerability of oil storage tanks to air attacks, Iraq could probably easily negate Iran's effort. [redacted] (b)(3)

Vietnam Plans Oil Exports

Officials from Japanese trading firms expect that later this year Vietnam will begin exporting crude oil produced from its joint venture with the Soviets off the southern Vietnamese coast, [redacted] The Japanese officials project initial exports of about 40,000 b/d, with increased volumes expected if the world price of crude stabilizes between $16 and $18 per barrel. They say the crude oil will be shipped to Singapore in exchange for refined petroleum products from the Middle East. Vietnam is counting on these oil exports to spearhead the recovery of its economy; it is deeply in debt, depends on the USSR for economic and military aid, and is isolated from Western assistance because of its occupation of Cambodia. Tests by Western oil firms in the 1970s indicated that recoverable amounts of oil in the area might be only 20,000 to 40,000 b/d. Even at the higher estimate, the exports would only marginally benefit the Vietnamese economy, although Hanoi's dependence on Soviet aid would be reduced. [redacted]

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Ethiopian Oil Discovery Reported

Soviet drilling teams in Ethiopia claim to have discovered the country's first commercially exploitable oil deposit in the Ogaden. [redacted] the claimed potential of the field is 1.5 billion barrels of oil and petroleum byproducts. The Soviets have been drilling in the area since 1983. Ethiopia is now totally dependent on imports of Soviet oil, and a field of this size could eventually make Addis Ababa self-sufficient. Moscow, however, may have exaggerated the field's potential in order to please Ethiopian leader Mengistu, who has been disappointed with Soviet oil exploration efforts. News of the find almost certainly will heighten tension with neighboring Somalia, which has long claimed the Ogaden and still supports sporadic guerrilla operations there. [redacted]

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[redacted]

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International Finance

Japanese Banks Accept New Debt Proposal

[redacted] Japanese banks have agreed in principle to a Finance Ministry proposal that would have far-ranging implications for Japan's relations with troubled LDC debtors. Under the proposal, the Japan Center for International Finance (JCIF)—now a private clearinghouse for up-to-the-minute country risk information—would purchase new LDC loans from Japanese banks at a discount. The banks, in turn, could claim the discount as a tax loss while still earning interest on the loans. Moreover, the banks would receive a taxable dividend from the JCIF if the LDC repays the principal. In addition to the near-term tax benefits, individual banks are apparently attracted to the proposal because it spreads risks of LDC loans among financial institutions. It also transfers some risk to the government because both Tokyo and the banks will provide capital to the JCIF, although the amounts have yet to be decided. For its part, the Finance Ministry hopes the proposal will spur lending to high-risk LDCs as well as give Tokyo more leverage over such lending, including deciding which countries will be permitted to receive the discounted loans. [redacted] (b)(3)

Philippine Request for New Financing Facility Rejected

The Consultative Group of key bilateral and multilateral aid donors refused in late January to endorse a $7 billion "growth facility" requested by the Philippines to finance economic recovery. It did agree to provide $1.5 billion in new economic assistance this year—$500 million less than Manila sought. Manila probably will continue to seek support for the facility, arguing that it is necessary to meet development goals. Under the proposal, Manila's major aid donors and commercial banks would provide matching funds. Although the aid donors are receptive to the concept of shared funding, they contend that private banks would only lend to the Philippines once political and economic conditions stabilized. Philippine officials, however, claim that commercial banks would consider the facility if the Consultative Group gave its approval first. [redacted] (b)(3)

Mexico's First-Quarter IMF Target

Mexico City and IMF officials seem likely to settle on a first-quarter target growth rate that will enable the Mexicans to draw on a $500 million contingency fund. According to the terms of Mexico's agreements with the Fund and international bankers, commercial banks will disburse the contingency fund if an index of manufacturing production grows more slowly during the first quarter of 1987 than a target negotiated with the IMF. [redacted] (b)(1) (b)(3) If the contingency fund is released, as is likely, the de la Madrid administration is constrained to allocating the money to public-sector investment projects identified by the World Bank. [redacted] (b)(3)

Ecuador's New Debt Problems

Ecuador may be headed for a confrontation with its major creditors over terms for rescheduling its debt and growing international concern about its uncertain political future. The Central Bank claims Quito cannot pay $30 million in interest due this month to foreign banks. [redacted] President Febres-Cordero may default rather than exhaust his country's foreign exchange reserves, according to sources of the US Embassy. [redacted] Under Febres-Cordero, Ecuador has been one of the most financially responsible nations in honoring its foreign debt obligations. Quito appears to be dragging its feet on its monthly interest payments now, however, to obtain better terms in negotiations for a rescheduling package of $300 million. Ecuador's current cash reserves—estimated to be $144 million—are probably sufficient to cover Quito's interest payment this month, but future payments may be in jeopardy. [redacted] (b)(3) (b)(3) (b)(1) (b)(3)

Sudan and the IMF

Sudan has made a token payment of $6.7 million on its arrearages to the IMF, seeking to improve relations before its annual Article IV consultations in February. The payment will enable Sudan to participate in new SDR allotments, but is not sufficient to reinstate Sudan's eligibility to borrow from the general fund—Sudan is still approximately $585 million in arrears. The Sudanese Finance Minister may be building false hopes within the Cabinet and the public that wrinkles between the IMF and Sudan are being ironed out. The IMF claims no decisions are planned for the coming meeting and no change in the Fund's relations with Sudan is likely. [redacted] (b)(3)

Kuwait's New Investment Policy

The Kuwait Investment Company is selling off some of its dollar-denominated securities because of concern about the US budget deficit, depreciation of the dollar, fear of renewed inflation, and uncertainty about US tax legislation. [redacted] Kuwait, however, probably will continue to keep much of its estimated $50 billion in foreign securities investment in US dollars—at least 35 percent—because of the security and size of US financial markets while it continues to diversify its investments in the West as well as in the Third World and Communist Bloc. Because the Kuwait Investment Company has a reputation among the Persian Gulf states for prudence, its move away from the dollar—if discovered by other Gulf investors, especially Saudi Arabia—might cause them to alter the composition of their own foreign investment portfolios. [redacted] (b)(3) (b)(1) (b)(3)

Threat to Zambian IMF Program

President Kaunda announced last week that he will end Zambia's year-old system of determining foreign exchange rates through a weekly auction—the centerpiece of an ambitious IMF-supported economic reform program that also included significant relaxation of price controls and improved producer incentives. What system will replace the auction is still uncertain, but according to Embassy and press reporting, the exchange rate apparently will be fixed at 11 cents per kwacha, a significant appreciation from last week's auction rate of 7 cents. According to

Embassy reporting, the decision to change the exchange rate system was made by a limited circle of senior advisers without consultations with the IMF and World Bank. Riots in December triggered by IMF-recommended increases in food prices probably heavily influenced Kuanda's decision. The departure from using a market-based system to determine the exchange rate will clearly jeopardize external financing. Disbursement of about $200 million under an existing IMF standby agreement already is threatened by the country's inability to pay arrears before the end of February, when new payments become due. Kaunda's new Prime Minister, who has additionally assumed the finance portfolio, will seek to schedule another consultative group meeting later in the year, convene a Paris Club meeting, and pursue negotiations with bilateral donors. [redacted] (b)(3)

Eastern Europe's Foreign Borrowing Down

Eastern Europe's syndicated loans from Western banks dropped to $1 billion last year from $3.3 billion in 1985 despite favorable conditions, but borrowing by creditworthy countries in the area probably will revive this year. Bulgaria, Czechoslovakia, East Germany, and Hungary—the region's creditworthy countries—sought fewer syndicated loans in 1986, in some cases because they had borrowed heavily two years ago to restructure debts. In addition, they resorted increasingly to less publicized and less costly bank-to-bank loans. Cash-rich Japanese banks became the dominant lenders, partly because they offered more attractive rates than US and West European banks. Eastern Europe's troubled debtors—Poland, Yugoslavia, and Romania—remained out of the syndicated loan market in 1986. Many banks, pessimistic about receiving payment on existing loans, are hesitant to offer them new money. Borrowing by East European countries probably will increase this year, although not to 1985 levels, because of reduced hard currency earnings and continuing debt obligations. Banks may raise rates or limit additional exposure if borrowers' creditworthiness deteriorates or if East-West tensions rise. [redacted] (b)(3)

Hungarian Financial Problems

Hungary's hard currency current account deficit in 1986 reached $1.5 billion, and GDP stagnated, according to a source of the US Embassy. The source implied Budapest will seek assistance from the IMF if the financial situation does not improve. Hungary probably will avoid a liquidity crisis in the short term because it has encountered only mild resistance to its recent borrowing efforts and its foreign exchange reserves remain substantial. Budapest is likely to come under increasing pressure to seek IMF assistance this year, however, to convince Western bankers it is acting to resolve its economic troubles. The IMF has been dissatisfied with the slow pace of Hungary's reform efforts and probably will demand tougher adjustment policies and broader reforms. Negotiations could prove difficult because the regime fears greater austerity would lead to domestic unrest [redacted] (b)(3)

International Trade

Key LDC Debtors' Poor Trade Performance in 1986

Most key debtors recorded substantial export declines in 1986. Oil exporters were hard hit by the sharp drop in oil prices. Lower commodity prices and reduced grain sales cost Argentina nearly $2 billion in export earnings while high domestic demand in Brazil reduced the quantity of goods available for export, lowering export earnings by more than $3 billion. The Philippines—the one exception—benefited from a modest rebound in prices for traditional exports such as coconut products. For the debtors as a group, import cutbacks in 1986 did not match export declines. As a result, the cumulative trade surplus was cut nearly in half, aggravating financial woes and further delaying sustained economic recovery. In fact, Argentine efforts to boost real GNP growth led to an import surge. Mexico and Nigeria slashed imports in response to lower oil exports, and Brazil was forced to cut imports in order to limit reductions in its trade surplus. [redacted] (b)(3)

Key LDC Debtors: Exports and Imports, 1985-86 [a]

Billion US $ (except where noted)

	Exports			Imports			Balance		
	1985	1986	Change (*percent*)	1985	1986	Change (*percent*)	1985	1986	Net Change
Total	**90.4**	**67.6**	**−25**	**53.0**	**47.8**	**−10**	**37.4**	**19.8**	**−17.6**
Argentina	8.4	6.9	−18	3.8	4.6	21	4.6	2.3	−2.3
Brazil	25.6	22.4	−12	13.2	12.9	−2	12.4	9.5	−2.9
Ecuador	2.9	2.1	−28	1.6	1.7	6	1.3	0.4	−0.9
Mexico	21.9	15.8	−28	13.5	11.4	−16	8.4	4.4	−4.0
Nigeria	12.8	6.5	−49	8.5	5.5	−35	4.3	1.0	−3.3
Philippines	4.6	4.7	2	5.1	4.7	−8	−0.5	0	0.5
Venezuela	14.2	9.2	−35	7.3	7.0	−4	6.9	2.2	−4.7

[a] 1986 figures are estimated.

[redacted] (b)(3)

Global and Regional Developments

Airbus Competition With US Aircraft

The West European aircraft consortium Airbus Industrie is trying to win over the airlines that were the first customers for the new McDonnell Douglas MD-11 long-range wide-body aircraft. According to the US Embassy in Stockholm, Airbus Industrie has offered a 25-percent discount on its new A340 long-range aircraft to entice Scandinavian Airlines to switch its order. The US Embassies in Rome and Bangkok report similar offers to Alitalia and Royal Thai Airlines—including free use of substitute aircraft between the MD-11 delivery date in 1990 and that of the A340 in 1992. These initiatives are causing governments and airlines to reevaluate their choices. The apparently successful marketing of the MD-11 has forced the consortium to adopt this aggressive strategy of trying to reverse the purchase decisions of the airlines. The design and development costs of the A330/A340 would add another $2.9-3.1 billion in subsidies to the $7.5 billion provided by member governments in support of Airbus Industrie since its inception in 1970. [redacted] (b)(3)

[redacted]

(b)(1)
(b)(3)

Kuwaiti-Soviet Petroleum Cooperation

Kuwaiti and Soviet officials will meet in Moscow early next week to continue talks on joint energy projects. The discussions, the first since September, will center on oil swap arrangements, technical production cooperation, and development of joint ventures in Iraq, the USSR, Greece, and Morocco, according to the US Embassy in Kuwait. The talks follow an agreement signed last summer between the two states to expand economic cooperation. Potential deals would provide an important outlet for Kuwait's oil industry during the oil market slump and help the government balance its relationship with the United States. Moscow probably views economic cooperation as an effective way to improve Soviet-Kuwaiti relations, to obtain access to Western oil technology and Kuwaiti financing, and to improve their image in the Arab world. Although immediate progress is unlikely, enhanced economic ties between Moscow and Kuwait could encourage other Gulf states to expand ties to the Soviet Union. [redacted] (b)(3)

Major Chinese Investments in Hong Kong

Beijing is paying $256 million for a 12.5-percent share of Hong Kong's Cathay Pacific Airways, according to press reports. The deal is the third major investment in Hong Kong made by the China International Trust and Investment Corporation during the past year. Since last January, it has bought out a failing bank and invested in Hong Kong's second cross-harbor tunnel project. Beijing is making these large, well-publicized investments to demonstrate it intends to maintain Hong Kong's vibrant capitalist economy. China now estimates that its total investment in Hong Kong exceeds $5 billion, a 25-percent increase since the Chinese-British accord was signed in 1984. Cathay Pacific probably hopes the investment will give it access to Chinese cities beyond Shanghai and Beijing, which it now serves. It wants to compete with a new Hong Kong airline, which is owned by entrepreneurs with close ties to China and is already serving several secondary Chinese cities. [redacted] (b)(3)

Economic Problems Spur Omani-UAE Border Agreement

Oman has traded territory for cash to end a longstanding border dispute with the United Arab Emirates and to relieve growing economic problems. [redacted] (b)(1) (b)(3) (b)(3) Oman ran a budget deficit of about $1.4 billion last year because of a decline in oil revenues, according to the US Embassy in Muscat. [redacted] (b)(1) (b)(3) (b)(3) Oman and the UAE probably agreed not to publicize the deal to avoid renewed Saudi pressure to settle their border disputes and because of Muscat's concern about a domestic backlash. Oman has managed its economy fairly well over the past five years, but the additional cash will relieve pressure resulting from lost revenues. Despite its economic troubles, Muscat is unlikely to agree to a similar arrangement with Riyadh, whose border claim overlaps up to 200 kilometers. [redacted] (b)(3)

National Developments

Developed Countries

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New Bank of France Governor

After earning wide respect for his handling of the LDC debt crisis during an eight-year term as IMF head, Jacques de Larosiere returned to Paris in January 1987 to become governor of the Bank of France (BOF). [redacted] de Larosiere will probably try to make the BOF—traditionally only an administrative arm of the Treasury—a more independent institution. [redacted] De Larosiere's efforts to increase BOF independence may also be constrained as the government slows reform in anticipation of the 1988 presidential election. In the interim, de Larosiere may be able to use recently instituted interest-rate-based monetary policy as a tool for more day-to-day operating control. Nonetheless, we expect de Larosiere will eventually become an influential voice, particularly in international monetary policy. [redacted]

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Danish Wage Agreement

The unexpectedly swift agreement on a four-year wage pact will help improve labor relations. The unions achieved their main goal in obtaining a 37-hour workweek—to be phased in over a four-year period—without a reduction in compensation. In addition, labor won some wage increases and the right to reopen negotiations halfway through the contract period. Management is pleased because employers will have four years of labor stability in which to modernize their facilities. The conservative government is also pleased because the private-sector settlement facilitated a public-sector agreement and helped maintain its thus far successful efforts to balance the budget. Government officials are hailing both agreements, but Danish economists are more skeptical: some say that the settlement will cause a 5-percent deterioration in Danish competitiveness in 1987 and add to the current account deficit. Economists are more sanguine that future productivity gains—coming from a surge in investment—will offset the pact's damage to overall competitiveness. [redacted]

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Less Developed Countries

Nicaragua Allows Repatriation of Oil Refinery Profits

Nicaragua recently signed an agreement permitting the US-owned oil refinery in Managua to repatriate earnings blocked since 1981, [redacted] Under the new accord—reached after 18 months of negotiations—Managua agreed to release $40 million in embargoed profits. Past earnings are to be paid off over 12 years in $2 million semiannual installments, although the agreement permits the payments to be rolled over at maturity if the refinery is unable to export enough fuel oil to cover the costs. In addition, the refinery's owners are promised a minimum of $5 million in annual earnings repatriation for 1986 and future years. While the agreement limits the refinery to a very low return, if honored by the Sandinistas the deal probably would be sufficient to keep the owners from abandoning the operation and forfeiting their investment. [redacted]

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The Downside of Peru's Economic Boom

GDP grew a robust 9 percent in 1986, according to official estimates, but the economy may soon begin overheating, causing President Garcia problems with business and labor. Lima expects 6- to 7-percent growth in 1987, although local private forecasters foresee only about 5 percent as the economy slows later in the year. After seeing inflation fall from 160 percent in 1985 to 60 percent last year, the government expects another sharp drop to 40 percent this year. Local independent forecasters, however, project inflation in the 50- to 100-percent range. We expect several factors to push inflation to the upper end of this range, including the relaxation of price controls, a planned series of devaluations, and a budget deficit that the Central Bank anticipates will reach nearly 12 percent of GDP this year—double the share it held during the first nine months of 1986. Production costs will probably rise as firms approach capacity, leading to demands for greater price concessions. Once labor sees inflation pick up, unions probably will increase strike activity to press Garcia to make good on his promise of a 6-percent real wage increase in 1987. Inflationary pressures added to worsening foreign payments problems could undermine confidence in Garcia, forcing major policy readjustments. [redacted] (b)(3)

Labor Strife in Suriname

Attempts by disgruntled bauxite workers to close the US-owned Suralco refining facilities on Monday and periodic sabotage by insurgents may prompt the company to pull out of Suriname. The police dispersed workers, but a US official reports the refinery was damaged extensively. Workers were angered after the company laid off at least 500 workers last week when sabotage of powerlines by the rebels forced closure of the smelter. According to the US Embassy, the company, which accounts for 50 percent of Suriname's hard currency earnings, has demanded major financial concessions from the Bouterse regime to stay in Suriname. This is the first significant labor strife in Suriname since 1984, when militant bauxite workers won tax concessions from the Bouterse government. Continuing insurgent activity, coupled with labor violence, probably will cause the company to cease operations for an extended period—or possibly to close down entirely—even if it receives additional concessions. [redacted] (b)(3)

[redacted] (b)(1) (b)(3)

Communist

Damage to Soviet Winter Grains

Record cold temperatures early last month caused moderate to severe damage in major winter grain regions of the USSR. Soviet press reports and weather data indicate that cycles of intense freezing and thawing caused severe ice crusting in the southern Ukraine and in parts of the northern Caucasus. The prolonged cold period occurred after a very dry fall in the Ukraine—a vital grain-producing area—thus preventing optimal winter grain development. Winterkill as a result of plant freezing or suffocation averages 18 percent a year in the USSR, but probably will be greater this year. Even if the weather is normal for the rest of the winter, the harvested winter grain crop—which usually is about 60 million metric tons—may be reduced by as much as 4 million tons. High levels of soil moisture this spring will spur growth and partially compensate for losses, but damaged areas can be replanted only with spring crops, which yield less than winter grains. Even so, if at least average weather conditions prevail through the spring grain-growing season, the overall harvest could equal last year's 210 million tons. [redacted] (b)(3)

Rapid Growth in Soviet-Romanian Trade

A sharp increase in bilateral trade last year has increased Romania's economic dependence on the USSR and may undermine its attempts to pursue a nonconformist foreign policy in coming years. Total bilateral trade for the first three quarters of 1986 grew 30 percent, as compared with the same period in 1985, according to sources of the US Embassy in Bucharest. Romanian exports of food and agricultural products accounted for much of the gain and contributed to dire food shortages in Romania this year. They were largely in payment for the increase in Soviet oil deliveries, which rose from 42,000 b/d in 1985 to 129,000 b/d in 1986. The Soviets reportedly also agreed to more favorable trade terms for 1987 by raising prices for Romanian agricultural and food goods and by lowering prices for Soviet raw materials. The Soviets' new willingness to increase oil deliveries and to give Bucharest better price terms reflects their satisfaction with the rapid rise in Romania's deliveries of foodstuffs and their desire to increase trade within CEMA. The expanded trade relationship with the Soviets undermines Romania's longstanding effort to diversify its international trade to help maintain its relatively independent position in the Soviet Bloc. Some additional increases in trade are likely this year and could eventually give the Soviets additional leverage.

[redacted] (b)(3)

East German Economic Growth Slows in 1986

According to official statistics, national income growth slowed last year—to 4.3 percent versus more than 5 percent in 1984 and 1985—but remained strong by East European standards. We estimate this translates into GNP growth of 2.1 percent compared with a 1984-85 annual average of 2.8 percent. We calculate that industrial production increased 2.2 percent. High-tech sectors, including computers, electronics, and robotics, grew rapidly, but several important industrial ministries, including chemicals, did not meet their targets. Agriculture turned in another good year with grain production a record 11.6 million metric tons. Foreign trade, however, was a disappointment. East Berlin's reported hard currency trade surplus declined to about $500 million from an estimated $746 million in 1985, we believe largely as a result of lower prices for exports of refined petroleum products. Trade performance with the USSR may also have worsened. Although Soviet statistics show a sharply higher East German bilateral deficit through September—caused largely by a 9.3-percent decline in East German deliveries—the East German claim that bilateral trade rose 1.5 percent for the year suggests that East German exports may have rebounded considerably in the fourth quarter. Continuing trade problems, January's severe cold, and the explosion at the country's largest power plant last month indicate a poor start for 1987. The lower 1986 hard currency trade surplus will further inhibit purchases of much-needed Western capital goods and retard investment. As a result, East Berlin may have trouble meeting its 1987 growth target of 4.5 percent. [redacted] (b)(3)

China Appoints New Science Academy Leaders

The appointment of new leaders for the Academy of Sciences (CAS), the organization responsible for China's elite science research institutes, suggests Beijing is interested in continuing S&T reforms and scientific ties to the United States. Zhou Guangzhao, a 58-year-old physicist who replaced Lu Jiaxi as president, has been involved in international activities since becoming a CAS vice president in 1984. Teng Teng, an advocate of reform while a vice chairman of the State S&T Commission, takes over Yan Dongshan's position as vice president; Teng also was just named president of the University of S&T, a site of recent student demonstrations. A joint interview with Lu, Yan, and Zhou last week appears designed to stress the normal retirement of elderly scientists. At the same time, however, Teng's background in the party's propaganda department and the timing of the announcement—shortly after the ouster of the S&T university's previous leaders for poor handling of the demonstrations—is probably a signal that Beijing intends to strengthen control over ideological issues within the scientific community. Teng has reinforced Beijing's recent conservative rhetoric by stating that his most important task at the university is to criticize ideological errors. [redacted] (b)(3)

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