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# International Economic & Energy Weekly (U)

30 October 1987

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*30 October 1987*

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# International Economic & Energy Weekly (U)

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# International
# Economic & Energy Weekly (U)

iii **Synopsis**

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1 **Perspective—South Korea: Aftermath of Labor Unrest** [redacted] (b)(3)

In our view, recent labor turmoil has had a substantial but manageable short-term impact on the South Korean economy. For the longer term, we believe the 20-percent average wage gains won by striking workers by themselves probably will have little impact on South Korean competitiveness. [redacted] (b)(3)

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3 **Poland: Second Stage of Economic Reform** [redacted] (b)(3)

Polish leader Jaruzelski this month launched a broad program of economic and administrative reforms to revitalize Poland's economy and dig it out from a crushing $35 billion foreign debt. Similar reform measures of this and previous regimes have failed, but the timing may be ripe for what appears to be a genuine reform initiative. Jaruzelski has succeeded in emphasizing a commitment to reform, but implementation may prove another matter entirely. [redacted] (b)(3)

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9 **Israel: Dealing With Bank Share Redemptions** [redacted] (b)(3)

Increased spending from the scheduled redemption this week of $1.2 billion in bank shares—equal to about 5 percent of Israel's GNP—will put pressure on the government's successful economic stabilization program. Looming on the horizon is the much larger October 1988 redemption totaling $3.7 billion, which will swell the budget deficit and further complicate long-term reform efforts. [redacted] (b)(3)

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13 **South Asia: Growing Economic Dependence on Japan** [redacted] (b)(3)

South Asian countries are increasingly looking to Japan for financial and technical resources to assist in their economic development. Tokyo's economic assistance to the region—although not explicitly tied to purchases from Japan—probably will give Japanese companies a major advantage when competing for markets in South Asia. [redacted] (b)(3)

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17 **Eastern Europe–Japan: Economic Ties Still Weak** [redacted] (b)(3)

Meetings earlier this year between East European leaders and Japanese Prime Minister Nakasone have not resulted in a significant increase in trade or joint venture activity because of Eastern Europe's financial problems, the mismatch in tradable goods, and Eastern Europe's relatively close ties with Western Europe.
[redacted] (b)(3)

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# International
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**Perspective**

***South Korea: Aftermath of Labor Unrest*** [redacted] (b)(3)

In our view, recent labor turmoil has had a substantial but manageable short-term impact on the South Korean economy. [redacted] the work stoppages by some 650,000 striking workers—about 5 percent of the labor force—who demanded higher wages, ouster of promanagement labor unions, and improved working conditions: (b)(3)

- Sliced industrial production by $1.5 billion. Hardest hit was the automobile industry, which lost about $800 million in output.
- Slowed South Korea's export growth. Exports expanded 18 percent in August—the peak month of the strike—down from a 45 percent growth rate in July.
- Reduced projected real GNP growth for the second half of the year from 10.7 percent to about 9 percent, steepening the cyclical decline that already had begun. Nonetheless, we expect real GNP growth for 1987 will still reach 12 percent. [redacted] (b)(3)

For the longer term we believe the 20-percent average wage gains won by striking workers by themselves probably will have little impact on South Korean competitiveness. Our analysis—which utilized a version of South Korea's input-output model and a forecasting model of manufacturing productivity—shows that:

- Wages account for less than 11 percent of the final cost of goods produced in South Korea. Modest cost cutting could offset much of the impact of higher wages. Moreover, profits—which account for a 7-percent share of the cost of goods—were excellent this year, giving firms a cushion to fall on.
- Productivity gains will almost match the growth of workers' pay increases this year, hence unit labor costs will remain steady in 1987. During 1988-89, however, we believe wage hikes will outstrip increases in workers' output and force about an 8-percent rise in unit labor costs. [redacted] (b)(3)

Seoul can avoid a wage-induced slowing of export growth by adjusting its exchange rate. For instance, a private forecasting firm estimates that a 4.2-percent appreciation, rather than the actual 6.8-percent rise, would have maintained South Korea's 1987 export growth rate despite the wage cost push. If Seoul maintained its current exchange rate—voiding its planned 3.8-percent rise—South Korean exports would grow by 15 percent next year, the same as the firm's prestrike forecast. [redacted] (b)(3)

Several developments could reverse our upbeat outlook for continued export-led growth. Domestic factors will play a key role in shaping the growth path of South Korea's economy. If productivity does not rise, or if labor becomes embroiled in political turmoil during the presidential succession this winter, exports could stumble badly and the economy deteriorate. A lack of experience in negotiating with management and the possibility that the eager young leadership of the new unions will press their demands too far could foster new strikes. Moreover, workers could launch new job actions if management does not keep its promises to workers. Some labor pacts already have unraveled because firms have failed to make good on wage payments. [redacted] (b)(3) (b)(1)

External factors, however, remain the most important variables in South Korea's economic growth equation. Protectionism in major markets, a slowdown in developed countries' economic growth, or an oil price runup, could prevent South Korea from achieving the 7-percent annual real GNP growth we now expect over the next two years. In addition, a reversal of the substantial appreciation of the yen and the new Taiwan dollar against the South Korean won—which has boosted Seoul's competitiveness relative to these rivals—could seriously hurt South Korea's economic prospects. [redacted] (b)(3)

The adjustment to higher wages will bolster some key items on Seoul's economic agenda but will also pose some risks. Higher wages will boost consumer spending in South Korea, which will further the government's long-term goal of reducing dependence on exports for growth. Better labor-management relations would bring these longstanding rivals closer together and perhaps boost productivity by improving cooperation. According to the US Embassy, however, economic technocrats acknowledge that higher wages threaten price stability—key policy objective of Seoul's economic policy makers. In addition, Seoul claims that labor problems have limited its ability to meet Washington's trade demands, particularly appreciation of its currency, which will further strain bilateral economic relations. [redacted] (b)(3)

[redacted] (b)(3)

## Poland: Second Stage of Economic Reform

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Polish leader Jaruzelski this month launched a broad program of economic and administrative reforms to revitalize Poland's economy and dig out from under a crushing $35 billion foreign debt. The ambitious package follows months of intense public debate in the party and government—Warsaw's decision on implementing austerity measures awaits a binding public referendum slated for 29 November. Similar reform measures of this and previous regimes have failed in the past, but the timing may be ripe for what appears to be a genuine reform initiative:

- Moscow's own policies create a favorable atmosphere.
- Western creditors encourage similar or identical measures.
- The church is more conciliatory to government economic policies.
- Jaruzelski can now draw on six years' experience in pushing his reform agenda.

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Jaruzelski's efforts will face stiff resistance from an entrenched bureaucracy and a restive, cynical workforce. Many of the 129 proposals outlined this month are likely to fall by the wayside or be circumvented; the timetable for achieving various objectives is overly optimistic. Nonetheless, Jaruzelski's plan of attack for the reforms gives him some chance of laying groundwork for long-run improvements in Poland's living standards and hard currency debt situation. In the meantime, Warsaw is making it clear it believes reform success depends on attracting new credits from the West to finance Polish industrial modernization.

### New Reform Initiatives

Since the imposition of martial law and a sharp economic decline in the early 1980s, the economy has come back to about the level of production reached in the late 1970s, although per capita income still is about 10 percent lower than it was in 1979. Agriculture—including a large private sector—has shown creditable performance in recent years, but industry remains inefficient and wasteful of investment funds, and overly focused on obsolescent heavy equipment production. Major disequilibrium pervades domestic markets, the result of excessive consumer subsidies to placate workers and chronic market shortages.

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The latest measures are a renewed effort to carry out reforms legislated in 1981 that were not implemented or were reversed in subsequent years. In pursuing these changes, Jaruzelski hopes to revitalize Poland's economy, improve living conditions, promote exports, and improve Poland's international trade and debt situation. Influenced by both Gorbachev's bold economic initiatives and China's gains from reform,

***Calendar for Second Stage-Reform Goals***

| | |
|---|---|
| 1987 | • Restructure the government (October 24).<br>— Consolidate 26 ministries into 19.<br>— Abolish 3,000 government positions (25 percent of central bureaucracy).<br>— Eliminate half of roughly 200 deputy ministers.<br>• Referendum on the pace of reform (November 29). |
| 1988 | • Create market initiatives to stimulate production, exports. |
| 1989 | • Stabilize the zloty exchange rate.<br>• Make wage structure systematic. |
| 1990 | • Bring inflation below 9 percent annually. |
| 1991 | • Achieve current account balance.<br>• Lay groundwork for debt reduction. |
| Beyond: | • Debt normalization.<br>• Zloty convertibility. |

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Jaruzelski has pressed hard this year for implementing a second stage of reforms. We believe he sees a unique chance to use the climate for change spawned by current Soviet policies as the basis for change in Poland. Increased confidence in his own abilities stemming from six years as president probably are also a factor. [redacted]

The draft program for implementing the second stage of reform is extremely ambitious, striving for fundamental change in the structure and operation of Poland's economy. In all, the program includes 129 wide-ranging measures to be put in place from late 1987 through December 1991. Patterned after reform efforts in other socialist states—Hungary in particular—the new program attempts to decentralize economic decision making, create incentives for factory and worker productivity, encourage entrepreneurial activity, and allow market forces to help adjust prices to reflect true costs of production and labor. [redacted]

In drawing up his reform agenda, Jaruzelski has first targeted the main sources of opposition to reform. His program begins with a major restructuring and reduction of the bureaucracy, announced this past week, followed by an unprecedented public referendum on reform, now scheduled for 29 November. Jaruzelski hopes that progress in these efforts will convince critics abroad that the reforms are genuine, and will prepare Poles for more unpalatable measures—wage controls and price increases—that will probably begin next spring. [redacted]

**Restructuring the Government...**

To set the stage for later reform initiatives, Jaruzelski's first objective is to reduce the interference of the bureaucracy in the operation of Poland's economy. The restructuring of the government's Council of Ministers is meant to create a central body that will focus on macroeconomic concerns while delegating day-to-day operating authority to the factory level, introducing profit and efficiency incentives, and eliminating the present heavy industrial ministries' ability to grab the lion's share of the state investment budget. [redacted]

The restructuring of Poland's Council of Ministers, approved this past week by the Sejm, Poland's parliament, eliminates or downgrades seven of 26 ministerial-level organizations. It replaces three industrial ministries that have been forceful opponents of reform during this and previous regimes with a single Ministry of Industry. The communications, (b)(3) transport, and maritime economy ministries are combined, and other ministries will absorb several formerly autonomous committees. The Polish press claims that these moves will cut the size of the central economic bureaucracy by one-fourth, abolishing some 3,000 jobs. [redacted] (b)(3)

**... and Bringing in Reformers**

In restructuring the Council of Ministers, Jaruzelski hopes to turn 16 ministers and committee heads out of office by the end of the year; only two of the seven (b)(3) reorganized ministries will be headed by current ministers. Replacements at key positions announced last week include some old-line politicians, but also several non-Communists and technocrats that already are stumping for the reform program. [redacted] (b)(3)

To head the Planning Commission, a chronic opponent of decentralization and enterprise autonomy, Jaruzelski has appointed his reform architect, Deputy Premier Sadowski, to replace Chairman Gorywoda, a party member and strong advocate for the industrial ministries. Sadowski, not a party member, has borne (b)(3) the brunt of moving the reform program through government and party review, apparently keeping it relatively intact. [redacted] (b)(3)

In a particularly shrewd move, Jaruzelski's choice for Minister of Industry is Jersy Bilip, manager of a factory using US-licensed technology. Bilip's appointment not only plays up Jaruzelski's effort to overhaul the bureaucracy, but also signals his intention to promote further economic and technical cooperation with the West. Jaruzelski undoubtedly also hopes to

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**Ministerial Restructuring and Personnel Replacements**

| Existing Ministries/Committees | Future Ministries/Committees |
|---|---|
| Mining and Energy<br>Chemical and Light Industry<br>Metallurgy and Machine Industry | Industry [a] |
| Construction, Land Use Management and Municipal Services | Land Use Management and Construction [a] |
| Communications<br>Transport<br>Maritime Economy | Transport, Shipping, and Communications |
| Labor, Wages, and Social Affairs | Labor and Social Policy [a] |
| Foreign Trade<br>Committee for Economic Cooperation with Foreign Countries | Foreign Economic Cooperation [a] |
| Internal Trade and Services<br>Materials and Fuel Economy | Home Market |
| Education and Upbringing<br>Science and Higher Education | National Education [a] |
| Physical Culture and Sports Committee<br>Youth affairs | Youth and Physical Culture Committee (downgraded from ministry level) |
| **Ministries not subject to restructuring:**<br>Agriculture<br>Culture and Art<br>Environment [b]<br>Finance<br>Foreign Affairs<br>Health [b]<br>Internal Affairs<br>Justice<br>National Defense<br>Planning Commission [b]<br>Religious Affairs<br>Science and Technology | |

[a] New minister/committee head is not a former minister/committee head.
[b] New minister announced this past week.

This table is Unclassified.

favorably influence the West regarding Poland's efforts to regain access to hard currency loans through the IMF and official credits, in its bid to modernize through imports of Western technology. [redacted] (b)(3)

Restructuring and restaffing the Council of Ministers is a significant first step, but some opponents of reform remain. For example, Deputy Premier Szalajda, an ardent supporter of heavy industry, has retained his post. While Jaruzelski's appointment of new faces to the Council of Ministers is unlikely to guarantee the success of upcoming reform policies, it does increase the potential for achieving at least part of his reform objectives. [redacted] (b)(3)

**Selling Reforms at Home**

Jaruzelski's next step is an unprecedented public referendum, now scheduled for 29 November, that asks the people to vote on reforms. The two referendum questions—one economic, one political—were published this week. Couched in general terms, they are worded to make a favorable impression; and, by asking for support for "full implementation" of the second stage of reform, Jaruzelski can use a positive response—which could be rigged if necessary—as the rationale not only to effect price and wage reform but also to blunt resistance to reforms from within the bureaucracy. [redacted] (b)(3)

In promoting the importance of the upcoming referendum, Warsaw hopes to condition the Poles to accept with minimal unrest the inevitability of coming hardships, including price and wage measures. Warsaw will try to soften resistance by portraying these measures as temporary hardships agreed to by a majority of the people. Jaruzelski can also cite the willingness of the government to cut the bureaucracy before asking the people to make sacrifices. Warsaw will point out that these measures had been encouraged by international institutions—the IMF, World Bank, and official creditors—who can later be blamed for the severity of these policies. [redacted] (b)(3)

The response to the referendum is hard to predict. Poles realize reforms are necessary to restore the economy, but also fear wage controls or the risks associated with linking wages and employment to productivity or introducing bankruptcy for poorly performing enterprises. Most are cynical about the current reform offensive being any different than earlier efforts, and the novelty of having a chance to express an opinion in a referendum may not prove inspiring. It is also hard to predict how strongly inclined is the man on the street to make a futile but symbolic gesture of defiance: Solidarity—on the defense and increasingly portrayed by the government as uncompromising and unwilling to participate in reform efforts—has asked the people to boycott the referendum or write "Solidarity" on the ballot. (b)(3)

The US Embassy notes that the populace is not uniform in its attitudes toward reform; Polish press articles provide evidence that the campaign to soften opposition from various sectors has already begun:

- We expect the church's position on the referendum will weigh heavily on its outcome. The church has not yet taken a stand on reforms, but may support encouraging private enterprise and worker incentives, especially if accompanied by political reforms. While supporting the spirit and objectives of Solidarity, the church in recent months has hinted that Solidarity as an organization is losing relevance.

- Pensioners, the disabled, those earning minimum wage are most fearful of price increases. Warsaw has announced this month, however, that the minimum wage would be indexed for inflation, and that sharp price hikes in consumer goods would be offset by subsidies.

- Blue-collar workers have been able to keep wage growth above inflation in the 1980s and are resistant to change.

- Independent farmers are discriminated against, relative to collectives, and face government attempts to consolidate less-efficient farms. They are suspicious of reforms but attracted by possible banking policies that would provide new sources of credit. (b)(3)

On the other hand:

- Urban white-collar workers believe their incomes have been eroded, relative to heavy industry workers, and may welcome a more flexible, market-oriented economy. Intellectuals are suspicious of reforms, but like white-collar workers may support changes that reverse the relative decline in their incomes.

- Frustration and hopelessness among young couples—who now face a 20-year waiting list for apartments—could galvanize reform support in desperation from a presently apathetic sector of society. (b)(3)

**Reforms and the West—Seeking Support**

Jaruzelski admits that for his reform package to have any chance of success he must attract greater cooperation—economic, technical, and financial—from the West. Warsaw wants new hard currency loans that would enable Poland to modernize and expand industrial capacity through increased imports of technology, equipment, and materials. To get new loans, however—Poland has received only token amounts of new credits since 1981—Warsaw must reschedule existing private and official debts and implement a standby program negotiated with the IMF. (b)(3)

Poland has made some progress in debt rescheduling this year. A new commercial agreement that includes some requirement to pay principal as well as interest has been initialled, with signing expected by the end of the year. Poland has also discussed rescheduling with official creditors and negotiations continue despite Poland's claim it can only pay half of what creditors are seeking in 1987. (b)(3)

Poland hopes concurrent progress in its reform efforts and in IMF negotiations will reinforce each other. Jaruzelski expects success in restructuring and conducting a referendum will increase Poland's chances at IMF loans; at the same time, Warsaw probably hopes to legitimize reform efforts in sensitive areas such as price hikes and wage controls by labelling them as recommended or required by the IMF. [redacted] (b)(3)

**Outlook**

Jaruzelski has succeeded in emphasizing a commitment to reform, but implementation may prove another matter entirely. According to the US Embassy Warsaw, the government restructuring—although it passed the Council of Ministers themselves as well as the Sejm—has been bitterly opposed by the line ministries most affected, especially the Ministry of Mining and Energy. The staffing of new larger ministries and the planning commission with reform advocates will create a protracted struggle to redefine the roles of these organizations in a more market-oriented economy. [redacted] (b)(3)

Jaruzelski's success in implementing other reforms will depend, in large part, on maintaining stability during a difficult adjustment period. A crucial factor will be the balance Warsaw strikes between expanding incentives and encouraging private enterprise on one hand, and controlling wages while raising prices on the other. Poland's debt situation will remain serious into the next century, but with movement on reforms Poland may be able to speed growth and modernization via renewed access to substantial hard currency loans. [redacted] (b)(3)

[redacted] (b)(3)

## Israel: Dealing With Bank Share Redemptions [redacted] (b)(3)

The scheduled redemption this week of $1.2 billion in bank shares—equal to about 5 percent of Israel's GNP—will put pressure on the government's successful economic stabilization program. Ministry of Finance officials fear that a decision by bank share holders to spend their redemptions instead of reinvest them will destabilize the economy and rekindle inflation. Our econometric model of the Israeli economy suggests that increased public spending would lead to a surge in the current account deficit and spur growth in real private consumption and real imports. The increased spending would likely lead to higher inflation and would apply pressure on the government to adjust exchange rates. Looming on the horizon is the much larger October 1988 redemption totaling $3.7 billion. While this redemption will put pressure on next year's government budget, it will not be a threat on the consumption side since the shares are held by banks, other institutional holders, and households with large holdings who will undoubtedly reinvest the money. [redacted] (b)(3)

### Government Redemption Fears

Ministry of Finance officials, not surprisingly, are more worried about the imminent $1.2 billion redemption than the $3.7 billion that falls due next October, according to the Embassy and press reports. Next year's big payout is mostly held by financial institutions—banks, mutual funds, and others. Together, these institutions hold about $2.2 billion, but they will be looking to reinvest their shares. [redacted] (b)(3)

Of the remaining $1.5 billion, companies hold about $500 million and private households hold $1 billion. According to Embassy reporting, the government believes the companies will simply roll over their holdings into other investment channels. From the households faced with redemption in 1988, one-third of the owners hold an average of about $150,000 in bank shares, and the remaining two-thirds have an average of about $20,000 in holdings. According to the US Embassy, the Ministry of Finance believes these households are sufficiently well-to-do that they have no need to spend the cash. These households will likely roll over their holdings into other saving schemes. [redacted] (b)(3)

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***Bank Shares and the Stock Market Collapse***

*The first signs of stock market trouble appeared in January 1983. Confidence in the continuation of the stock boom had eroded and Israelis began to sell off their holdings of nonbank shares. As nonbank share prices dropped, panic set in and the prices of these stocks collapsed. Bank shares, however, continued to climb even after January, partly fueled by nervous investors trying to get into the last supposedly safe alternative in the stock market. These investors did not know bank share prices were being propped up by the major banks with the government's blessing, according to Embassy reporting.* [redacted] (b)(3)

*The timing of the stock market's collapse in October resulted directly from Finance Minister Aridor's defunct program of suppressing inflation through slow depreciation of the shekel. The shekel's value steadily became more unrealistic, and the foreign payments situation deteriorated. As part of the movement back into foreign currencies, the public sold off bank shares to buy dollars as a hedge against inflation. To forestall the drop in bank share prices, the banks borrowed massively abroad to prop up their own share prices. The end to the bank share mania came in October 1983 when the government announced it was closing the stock market and would bail out bank share holders, who had suffered an estimated $5 billion capital loss by their investments in bank shares.* [redacted] (b)(3)

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While next year's big payout is not likely to end in higher consumption expenditures, it will have a large impact on the government budget. Without further spending cuts, the government's budget deficit next year is likely to swell to between 15 and 20 percent of GNP from the current level of about 4 percent. A deficit surge of this magnitude almost certainly would undermine the government's stabilization program. [redacted]

This month's scheduled $1.2 billion redemption, on the other hand, is held entirely by individual investors, who hold between $5,000 and $15,000 in bank shares per household. The fear that a large proportion of this money will be spent immediately thereby destabilizing the economy and rekindling inflation—currently around 20 percent annually compared with the 185 percent inflation rate for 1985—has long been the nightmare of Ministry of Finance officials. [redacted]

Government estimates point to the public spending at least 25 percent of this month's redemption for immediate consumption. Our econometric model of the Israeli economy suggests that higher public consumption would increase this year's current account deficit from $144 million to $317 million. The higher consumption also would increase real import growth by 11.2 percent this year—compared with our baseline forecast of 9.9 percent. [redacted]

### Households—Options to Immediate Redemption

Faced with the difficult decision of what to do with their bank shares besides redeeming them now, many households may simply do nothing. By doing nothing they would automatically retain their shares and could hold them until redemption in October 1989, thereby accepting the government's payback scheme. Beginning on 1 November, bank share holders also will have the option of selling the shares due for 1989 redemption on the Tel Aviv Stock Exchange. The last option available to share holders would be to explore various saving offers from Israel's commercial banks. [redacted]

Israel's commercial banks have undertaken major campaigns to attract additional holders of bank shares. Bank Hapoalim, Israel's largest commercial bank, has embarked on the most ambitious effort, moving in mid-August to disseminate information on numerous saving options for its 110,000 customers holding bank shares. In a similar effort to attract bank share holders, Mizrahi Bank has offered bridging loans to allow customers to deposit their money early in saving schemes. Bank Leumi, Israel's second-largest commercial bank, has yet to formulate a bank share campaign, but according to press reports probably will have undertaken a major publicity campaign before the 31 October redemption to attract bank share redemption funds. [redacted] (b)(3)

### Outlook

Barring significant spending cuts—which seem unlikely—the Israeli Government will face a budget deficit next year totaling an estimated $3.7-5.0 billion—equal to 15 to 20 percent of GNP—to absorb the 1988 redemption. The government made only

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***Generous Redemption Terms***

*Under terms of the government's bailout stemming from the October 1983 stock market collapse, bank share holders were given a choice when they could redeem their holdings. Bank share holders who placed their shares in a frozen saving scheme are eligible to redeem them now. Under this option, for each $100 originally frozen in the scheme in October 1983 dollar terms, the holder would receive $112. Bank share holders can, however, choose not to redeem the shares, postponing redemption until October 1989. If the holder chose this option, he would receive $134 in October 1989 for each $100 originally frozen. By offering a lower yield in the period 1983-87 as compared with the 1983-89 period, the government clearly hopes to postpone individual redemptions until 1989. According to the US Embassy in Tel Aviv, however, most Israeli economists believe that, no matter which period is chosen for redemption, bank share bailouts will prove costly for the government.* [redacted]

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limited progress in trimming this year's budget deficit to about $900 million, which fully incorporated the October 1987 redemption. A drastically higher budget deficit in 1988 would force the government to step up domestic borrowing or to print additional money, both highly inflationary. [redacted] (b)(3)

Increased government borrowing to finance a much higher budget deficit also would undercut government attempts to give the private sector—already nearly crowded out by the government's need for financial resources—a greater role in the capital market. The public's redemption of bank shares to the government also might result in the government's holding a majority of the stock of Israel's commercial banks. Such a de facto nationalization, however, would further complicate capital market reform efforts. [redacted] (b)(3)

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# South Asia: Growing Economic Dependence on Japan

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South Asian countries are increasingly looking to Japan for financial and technical resources to assist in their economic development.[1] South Asians are seeking more concessionary economic assistance from Tokyo, tariff relief for South Asian exports, access to high technology, more direct investments, and greater exposure to entrepreneurial expertise. South Asian countries are anxious to increase economic cooperation with Japan in part because the Japanese generally do not require political and economic reforms. Japanese Foreign Minister Kuranari in August affirmed Japan's intent to promote political dialogue and increase economic cooperation with the region, but South Asians will remain wary of new promises without more action on Tokyo's part. Many South Asians believe that Japan is still primarily interested in quick sales of manufactured goods and will continue to require lengthy negotiations before buying more goods from the region, transferring technology, or concluding major aid agreements. Tokyo's economic assistance to the region—although not explicitly tied to purchases from Japan—probably will give Japanese companies a major advantage when competing for markets in South Asia.

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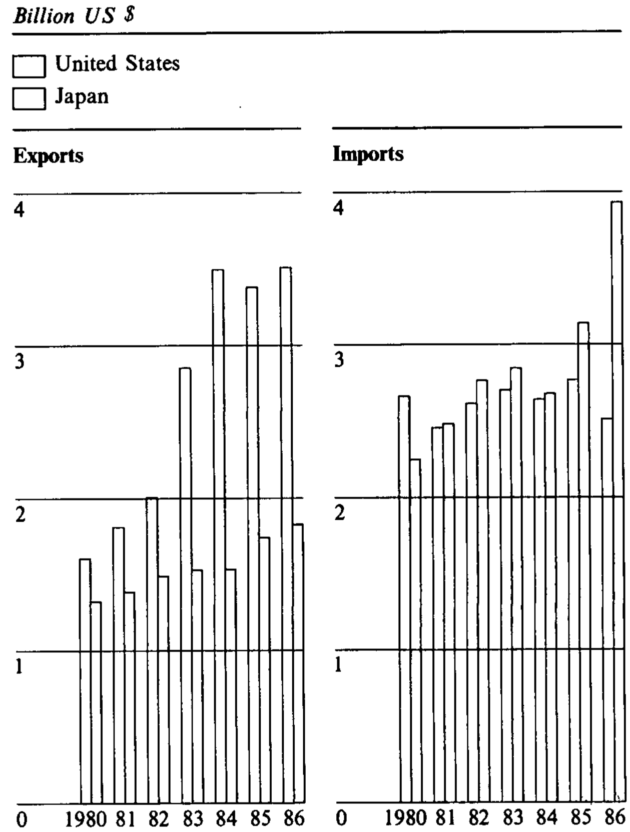
**South Asia: Trade With the United States and Japan, 1980-86**

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## The Economic Relationship

South Asian economic relations with Japan over the past decade have focused primarily on trade. South Asia sells mostly raw materials and food—iron ore, cotton, and marine products—and buys manufactured goods. The total value of trade between the two areas grew by 18 percent in 1986 to nearly $5.8 billion. Japan currently is the largest commercial exporter to the region and the second largest in overall trade, slightly behind the United States.

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Direct Japanese investment and industrial collaboration are beginning to show signs of growth. Japanese joint ventures in the region have increased from an

[1] The South Asian countries covered in this article include Bangladesh, India, Nepal, Pakistan, and Sri Lanka.

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investment of about $5 million in 1980 to nearly $15 million in 1985. While total Japanese investment in the region still remains small, Japan probably has become the third-largest foreign investor after the United States—US investment in the region totalled $40 million in 1985—and the United Kingdom. Japanese direct investment has been oriented toward the domestic markets, especially the automobile industry in India and Pakistan and the tourist industry in Sri Lanka. These countries want more new Japanese investment in export-oriented industries and joint ventures that would help them compete in the export market. [redacted]

**Growing Financial Assistance**

Japan already is the largest Free World bilateral aid donor in each of the South Asian countries, except Pakistan, and is likely to increase its disbursements this year. In 1986, Japanese loans, grants, and technical assistance exceeded $800 million. During his visit to the region in August, Kuranari pledged additional assistance for economic development. In India, for example, he pledged a loan of $470 million for the fiscal year that ends in March 1988—more than double the amount disbursed last year—to finance nine industrial projects, including the construction of a fertilizer factory, a telecommunications facility, and an electric power plant. [redacted]

Tokyo also has been in the forefront of providing relief for the natural disasters that have plagued the region this year:
- It was the first major contributor to the relief effort following the devastating floods in Bangladesh during August, donating 100,000 metric tons of rice and wheat.
- Earlier this month Tokyo offered India a $200 million long-term, low-interest loan for drought relief. [redacted]

While Tokyo has expressed a willingness to increase economic assistance to South Asia, it appears unsure of how to respond to all the requests from the area and is interested in finding a mechanism to facilitate aid disbursements.[2] During his trip to the region Kuranari announced that Tokyo would convene a symposium between Japan and the South Asian Association for Regional Cooperation (SAARC) some time before next April. According to the US Embassy in Tokyo, Japan would like to coordinate its aid activities through the SAARC if the organization becomes active in regional cooperation. [redacted] (b)(3)

We believe Tokyo's increased bilateral assistance will pave the way for greater trade and investment. While only a small portion of the Japanese aid is explicitly tied to imports from Japan. Tokyo uses concessionary loans to promote purchases of Japanese goods. Goods brought from LDCs, however, are not tied to Japanese aid although most of the equipment needed for large-scale protects is not produced by LDCs. [redacted] (b)(3) (b)(3)

**Pitfalls in the Relationship**

A major expansion of economic relations between Japan and South Asian countries faces obstacles. South Asians remain wary of becoming a dumping ground for Japanese manufactured goods. Relations between South Asia and Japan before the late 1970s focused on bilateral trade that was nearly balanced. By the early 1980s, however, the South Asian trade balance with Japan moved into deficit, reaching $2 billion in 1986. South Asia's imports from Japan, including major purchases of capital goods, parts for use in assembling automobiles, and consumer electronics equipment, have nearly doubled in the 1980s. Regional exports to Japan, which are still primarily raw materials, have grown by less than 40 percent during the same period. [redacted] (b)(3) (b)(3)

Tokyo has shown little interest in opening its markets to a wider variety of South Asian goods despite frequent complaints and meetings designed to address

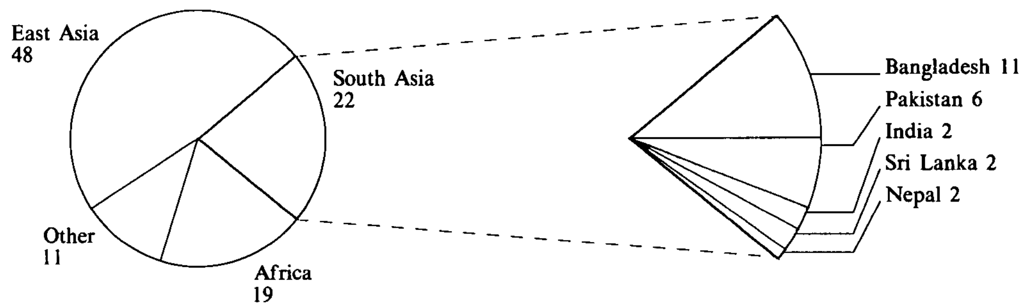
[redacted]

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

**South Asia: Japanese Official Development Assistance, 1980 and 1986 [a]**

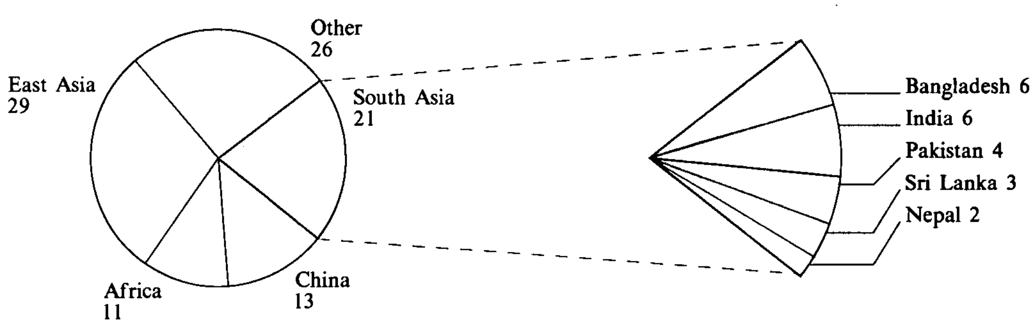
*Percent*

**1980 [b]**




**Total = US $2.0 billion**

**1986 [b]**



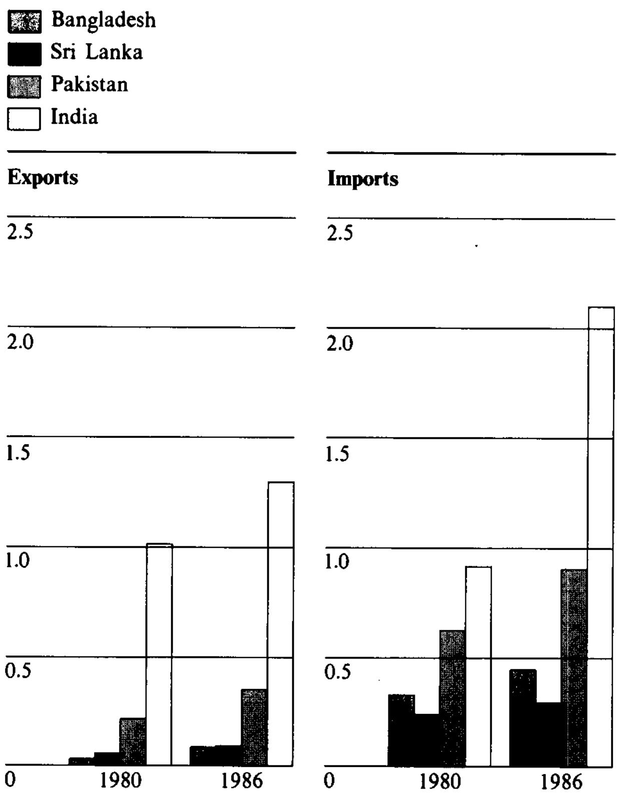

**Total = US $ 3.8 billion**

[a] Includes only bilateral disbursements.
[b] Data for fiscal period beginning April of stated year.

314694 10-87 (b)(3)

**South Asia: Trade With Japan, by Country, 1980 and 1986** [a]

*Billion US $*




[a] Data excludes Nepal.

[redacted] 314695 10-87

the problems. Japanese businessmen are still unwilling to relinquish their control in favor of an equitable relationship and continue to drag their feet on increasing the South Asian domestic content of joint ventures, thus aggravating the regional payments deficit. Many of their business ventures continue to serve primarily as markets for Japanese exports. [redacted]

Japan has found it difficult to deal with South Asian bureaucracies on issues such as aid projects, in part because of its own understaffed aid bureaucracy. Aid appropriations have sometimes gone unused because of delays and inefficiencies in the programs designed to receive the assistance and because of problems coming up with the large-scale projects Tokyo requires for most loans. We believe these problems leave some doubt that all the aid promised this year will actually be disbursed. We also believe it will be several years, if ever, before SAARC could play the regional role the Association of Southeast Asian Nations currently plays in coordinating economic relations with Japan. [redacted] (b)(3)

## Outlook and Implications

We believe Japan will continue to make major economic inroads in South Asia and could become the region's largest commercial trading partner in a few years. The prospect of a large new market opening as a result of liberalization efforts undertaken by countries in the region has prompted a major influx of Japanese seeking new business ventures and markets for exports. Growing aid disbursements, even though not explicity tied to sales of Japanese products, will facilitate Tokyo's activities, possibly at the expense of the United States. [redacted] (b)(3)

South Asian countries are wary of Japanese business and trade practices but nevertheless will seek a closer economic relationship with Japan. They will continue to reluctantly accept a large trade deficit with Japan because much of it can be balanced by inflows of capital from Tokyo. Loans and grants from Japan also are often politically more palatable than those from other bilateral or multilateral donors because they (b)(3) normally are not tied to political and economic reforms. Japan also is generally less stringent than the United States in controlling the level of technology in equipment exported. Moreover, some South Asians have expressed concern that the region is too dependent on the United States for high-technology equipment. [redacted] (b)(3)

[redacted] ((b)(3)

# Eastern Europe–Japan: Economic Ties Still Weak [redacted] (b)(3)

Meetings earlier this year between East European leaders and Japanese Prime Minister Nakasone have not resulted in a significant increase in trade or joint venture activity because of Eastern Europe's financial problems, the mismatch in tradable goods, and Eastern Europe's ties with Western Europe. The most recent effort to expand cooperation took place in January, when Prime Minister Nakasone visited Eastern Europe and Polish leader Jaruzelski subsequently visited Japan. We believe the Nakasone visit, however, was intended to demonstrate to Moscow Japan's growing global, political, and economic presence rather than to generate new business. Eastern Europe wants additional Japanese financing and technology for modernization efforts and increased exports to Japan to earn hard currency. Japan, for its part, is looking for creditworthy outlets for surplus capital and customers for industrial plant exports. [redacted] (b)(3)

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

**Limits to Expanding Trade Ties to Japan**

Eastern Europe's expanding technology needs have resulted in a number of purchases from Japan—particularly in microelectronics, machine tools, and robotics technology—but similar products available from West European suppliers limit prospects for stronger trade ties to Tokyo. Bulgaria's joint venture with a Japanese firm has proved successful in engineering and producing numerically controlled machine tool systems. Recently, East European countries also have shown some interest in Japanese assembly plants to produce consumer durables. In 1985 Berlin negotiated the first of two contracts with the Mitsui trading firm and the Toshiba Corporation for color television and picture tube assembly plants that are scheduled for completion this year. [redacted] (b)(3)

Western Europe, however, continues to satisfy most East European needs for products and technology, and East European enterprises remain oriented toward West European export markets. Romania has sought West European integrated circuits, and Bulgaria is interested in fiber optic products from French and West German as well as Japanese suppliers. Moreover, East European–West European trade ties were recently strengthened when Poland signed a cooperation agreement to produce small cars with Italy—not Japan—although Warsaw is continuing negotiations with the Japanese on a contract to manufacture medium-size cars. [redacted] (b)(3)

***Japan and Italy Vie for Polish Car Deals***

*After months of deliberations, Japan lost out to Italy when Poland signed a contract with Fiat early this month for the production of small cars in Poland.* [redacted]

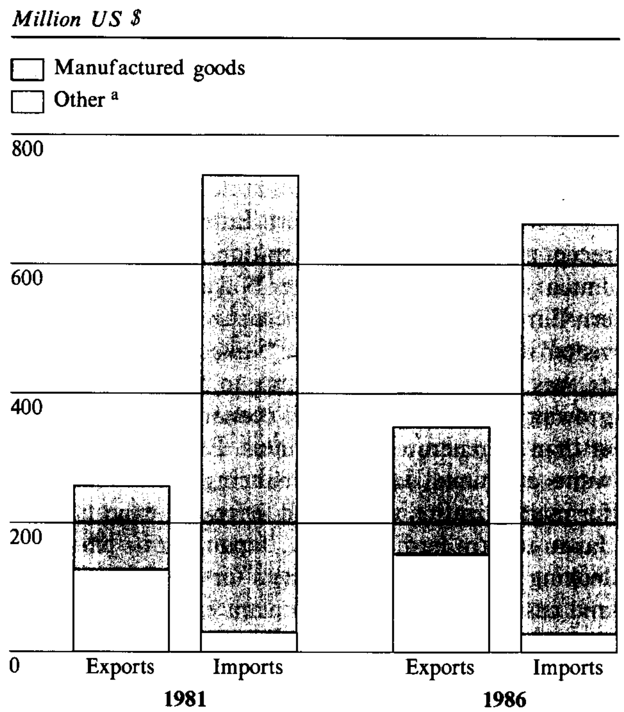
(b)(3)
(b)(1)

*Japan and Italy are now competing for a plant to construct medium-size cars. Warsaw appears to be considering more seriously the contending Japanese offer* [redacted] *If the contract is signed, the plant in Poland would be the first Japanese automobile assembly plant to be opened in an East European country.* [redacted]

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

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

**Eastern Europe: Trade With Japan, 1981 and 1986**




a Includes raw materials and foodstuffs.

[redacted] 314641 10-87

(b)(3)

Despite the low volume of trade between Japan and the region, cash-rich Japanese banks are a key source of credit for some East European countries as West European and US banks limit their exposure to the region. Hungary has moved aggressively to acquire Japanese loans, and Poland has sought new credits to support the possible production plant for medium-size cars. Japanese banks took sizable shares of almost all new commercial loans to Hungary, Bulgaria, and Czechoslovakia in 1986, although most banks remain cool to problem debtors Yugoslavia, Poland, and Romania. [redacted]

[redacted]

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

(b)(3)

### Obstacles to Growing Economic Ties

***COCOM Regulations.*** Some Japanese firms, fearing US criticism, are pulling out of deals with Eastern Europe. [redacted]

***Restrictions on Joint Ventures.*** Japanese businessmen maintain that shop-floor control over production processes is key to successful joint ventures, but Poland, East Germany, and Czechoslovakia appear unwilling

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

to grant enough latitude to foreign firms to attract Japanese managers. Even when East European countries try to be accommodating, the market opportunities for Japanese firms are too small to attract major interest. The Japanese see little incentive for export-oriented joint ventures in Eastern Europe because their output would compete against exports from Japan or with goods produced by Japanese direct investments elsewhere. [redacted]

*Tougher Financial Terms.* Bulgaria and Czechoslovakia still have access to Japanese banks, but Hungary's recent loan requests have encountered some resistance. Given Hungary's imminent request for an IMF standby program, we expect Japanese banks to temporarily curtail new lending to Budapest and demand higher interest rates on new loans until its financial situation is clarified. Still the Japanese, probably holding over half of Hungary's projected yearend debt of $16 billion, have expressed confidence in Budapest's central bankers, and probably will resume lending, albeit on somewhat tougher terms. [redacted]

The Japanese Government is one of the leading official creditors of Bulgaria, East Germany, and Hungary, but, like other Western governments, Tokyo has not extended large new credits in recent years. The amount of official debt as compared to Japanese commercial bank exposure is small partly because commercial banks are in some cases offering better terms than the Japanese Export-Import Bank. [redacted]

**Playing Politics With Eastern Europe**

Nakasone's sudden decision to visit the region last January was billed as a step to promote increased commercial ties to Eastern Europe, but, in our view, it was a stopgap decision made after efforts to persuade Soviet General Secretary Gorbachev to visit Tokyo collapsed. We believe Nakasone's objective was to remind Moscow of Japan's growing political importance worldwide. Visits by key Japanese officials to Poland, Bulgaria, Yugoslavia, and Romania last year apparently had similar motives although yielded no trade or joint venture agreements. [redacted] (b)(3)

**Outlook**

The East European regimes will remain interested in Japanese technology as they try to modernize their economies, but they have little to offer in return. Trade in high-technology fields such as semiconductor production could be stunted by Japan's current efforts to tighten enforcement of COCOM-related export controls. [redacted] (b)(3)

Japanese industry, facing trade restrictions elsewhere, may seek to expand export markets in the region, but Eastern Europe's debt problems and limited Japanese demand for its goods will hamper expansion of conventional trade. We see little prospect for joint ventures and exports of industrial plants becoming key elements of East European ties to Japan. For ties to grow, Japanese businessmen and East European managers will have to find mutually beneficial ways to promote licensing agreements, joint ventures, and innovative countertrade arrangements. [redacted] (b)(3)

[redacted] (b)(3)

***Trade Remains Modest***

*East European trade with Japan is small compared with the region's trade with West Germany, Italy, Austria, and the United States. Eastern Europe imports Japanese chemicals, machinery, and equipment and exports chemicals, textiles, and foods. The region has increased sales of chemicals and steel manufactures since 1981 and appears to want to increase food exports, but boosting exports to Japan has been difficult because of the poor quality of its goods and competition from the newly industrializing countries. Eastern Europe's hard currency shortages and Tokyo's reluctance to extend large, officially backed credit lines also have prevented rapid expansion of sales to Eastern Europe.* [redacted] (b)(3) (b)(3) (b)(1) (b)(3)

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# Briefs

## Energy

*Saudi Arabia Opposes Oil Price Change*

King Fahd earlier this week indicated his opposition to any increase in OPEC's official oil prices—which average $18 a barrel—through the end of 1988 and said that demand for OPEC oil would have to rise before higher prices could be considered even after next year. Fahd's comments were probably prompted by concern about weak oil demand and by OPEC's inability to hold down output. OPEC crude oil production this month is probably close to 20 million barrels per day, well above its self-imposed quota of 16.6 million b/d. Statements by Fahd have been a reliable indicator of future Saudi policy and will dampen any prospects for an increase in official prices at OPEC's December meeting, despite lobbying from a few cartel members—notably Iran. It is more likely that Saudi Arabia and other members will be forced to trim output to prevent an oil price decline if oil demand is sluggish in coming months. (b)(3)

*Greece To Import Soviet and Algerian Natural Gas*

Athens is moving forward with long-deliberated plans to import natural gas, with an eye to reducing its dependence on oil imports and improving the environment. Under an agreement reached earlier this month, the Soviet Union will supply 1-2 billion cubic meters (BCM) of natural gas annually for 25 years beginning in 1992. The required 700-kilometer pipeline from Bulgaria and the gas distribution network will cost roughly $2.2 billion to construct. Athens is also close to signing an agreement with Algeria to provide about 0.5 BCM of liquefied natural gas annually for 21 years. These preliminary accords follow years of difficult negotiations, particularly with Moscow, and still leave several critical issues unresolved—including the price of the gas, the payment terms, and financing for the construction projects. The gas will be used mainly in industry and for generating electricity, and is expected to cover 12 percent of total Greek energy requirements by 2002. Athens probably decided to go with two suppliers to avoid undue dependence on the Soviet Union and to improve its negotiating position when haggling over price and payment terms. (b)(3)

*Revisions on Energy Content of Soviet Coal*

The recently released Soviet economic handbook for 1986 shows a major adjustment downward—by roughly 10 percent—in the energy content of raw coal produced. Until this year, Moscow did not take proper account of the growth in production of lower quality coal from the Ekibastuz and Kansk-Achinsk coal basins and did not adjust the factor used to convert raw coal tonnage into standard fuel. Coal from these basins is low in energy value, comprising lignites or subbituminous coals with a high ash content. In the 1985 handbook, raw coal production for 1985 was equated to 487 million tons of standard fuel; in the new handbook, this has been reduced to 440 million tons standard fuel. Moreover, the 1986 record output of 751 million tons of raw coal (35 million tons higher than in

1980) is converted to 455 million tons of standard fuel—22 million tons below the output listed for 1980. Plans to increase coal production substantially during the next decade—primarily through increases in production from the Ekibastuz and Kansk-Achinsk basins—can now be more clearly viewed as running in place rather than achieving real growth in energy output. [redacted] (b)(3)

## International Finance

*Credit Ratings of Multilateral Development Banks at Risk*

Increasing multilateral development bank (MDB) exposure to troubled debtors could gradually undermine the MDBs' high credit standings, making it more difficult for these institutions to finance their lending operations. With the sharp cutbacks in commercial bank lending, the MDBs—including the World Bank, the African Development Bank, and the Inter-American Development Bank—have become an increasingly important source of funds for LDCs. World Bank disbursements, for example, rose to a record $11.4 billion in the last fiscal year, which ended 30 June. At the same time, however, debtor arrearages to MDBs have also increased. Total arrears to the World Bank, for example, currently total $656 million. Growing arrearages and sustained MDB loan expansion to troubled debtors could reduce the quality of the MDBs' loan portfolio and impact adversely on these institutions' commercial borrowings. The World Bank, for example, finances its lending operations mostly by selling bonds and securities in capital markets; it currently is the largest nonsovereign borrower of money in the world, owing investors over $82 billion. While the recent turmoil in international stock markets may cause investors to look with renewed interest at the MDBs' "triple-A" rated bond offerings, the investors may demand higher interest rates to compensate for the MDBs' riskier financial positions. [redacted] (b)(3)

*Venezuela's New Economic Team*

President Lusinchi's appointment of well-respected economic advisers Hector Hurtado and Mauricio Garcia to head the Finance Ministry and the Central Bank may lead to much-needed policy reforms and pave the way for new foreign loans. Former Finance Minister Azpurua resigned last week after he failed to secure foreign financing that Lusinchi and ruling party officials had said had to accompany the $21 billion public debt rescheduling agreement that Venezuela signed last month. Hurtado, who has broad political support, may be able to persuade the government to approve a highly controversial increase in domestic interest rates to improve Caracas's financing prospects with major lenders. [redacted] (b)(3)

*Costa Rica Making Progress in IMF Negotiations*

The IMF is close to approving a $65 million standby agreement for Costa Rica, but an accord probably will not deflect mounting domestic criticism of President Arias's handling of the economy. [redacted] the agreement has tough (b)(3) economic guidelines, and approval is contingent on Costa Rica making $15 million in delinquent interest payments to commercial banks. Failure to pass a controversial tax package will jeopardize Costa Rica's ability to meet the standby program's December economic targets and would delay release of funds, according to the US Embassy. The press is criticizing Arias for pursuing tax increases to satisfy the

IMF while neglecting promised social programs. Opposition politicians oppose austerity measures that do not reduce the public budget, and they are likely to block or delay tax legislation. In addition, vocal labor factions and business groups remain critical of Arias's failure to improve education and health services and build more housing. If the IMF accord is approved, however, private creditors and the Paris Club probably will renegotiate, and the debt rescheduling and new loans eventually would give Arias greater flexibility to stimulate growth and meet his social program obligations. [redacted] (b)(3)

*Hong Kong Futures Exchange Still Threatened*

Local and foreign investors are watching closely as the Hong Kong futures exchange faces crippling defaults. The main futures insurance firm has filed suit against 39 brokers unable to meet $230 million in commitments, with more defaults expected. The Hong Kong Government initially created a guarantee fund of $256 million—later doubled—to prevent a large-scale default of the futures exchange. Beijing's Bank of China, along with several prominent Hong Kong banks, contributed heavily to the fund. Nevertheless, the licenses of 40 of the 182 futures brokers were revoked after they were unable to meet their margin-call requirements, and brokers estimate that a guarantee fund of nearly $800 million will be needed to cover potential defaults. Western investors, already wary following last week's suspension of the market, could begin to withdraw investment capital from Hong Kong if the futures market fails to stabilize. [redacted] (b)(3)

*Delay in SWIFT Capacity Expansion*

SWIFT—the primary electronic global financial communications network—has announced another delay, until early 1989, in introducing its new system. The delay of this new system, which would double message capacity, increases concern among bankers that SWIFT service could be interrupted, constricting global financial activities. SWIFT officials hope that the addition of another processing computer to the existing system—adding nearly 200,000 messages to its capacity—in early 1988 will reduce this risk. SWIFT now transmits almost 1 million financial information messages and payment instructions daily to about 2,400 banks in 60 countries. Operating near its 1.15 million message-per-day capacity, SWIFT service has been interrupted more than usual in recent months, and we believe this will probably continue as growing demands tax the system's capabilities. [redacted] (b)(3)

*Cuba Losing Finnish Trade Credits*

Havana's failure to repay previous Finnish loans on schedule and its poor creditworthiness have led Helsinki to cut off any further credit to Cuba for the import of Finnish technology and equipment [redacted] (b)(3)
Helsinki's move will undercut Cuban economic development plans generally and, in particular, delay port modernization efforts and the construction of a textile school. Finland provided Havana with about $6 million worth of intermediate and capital goods in 1986. Helsinki's decision, which follows similar moves by many of Havana's larger Western trading partners, is yet another signal that Cuba's stagnant economic performance will continue. [redacted] (b)(3)

## Global and Regional Developments

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

*Brazilian-US Informatics Dispute Sours Trade Relations*

Brasilia's recent hardline decisions to prohibit US computer firms from introducing their products into the Brazilian market have greatly increased bilateral tensions over Brazil's informatics policies and are symptomatic of a souring of overall trade relations. A high-level Brazilian official, recognizing that the Special Secretariat for Informatics' recent denial of a US firm's petition for market access may trigger trade retaliation by Washington, advised US Embassy officials that Brazil will respond in kind if sanctions are imposed. He continued that, in addition to Brasilia's immediate reaction, nationalistic groups in the Constituent Assembly probably will seize on US trade policies to justify highly protectionist, xenophobic measures being prepared for the new constitution, which it is currently drafting. We expect that other US software firms will face more difficulties. Moreover, Brasilia may be less flexible on other bilateral commercial talks on issues such as pharmaceutical patents and may increasingly charge the United States with protectionism in international forums such as the GATT. (b)(3)

*Taiwan Trade Surplus With US Grows*

Despite an 18-percent appreciation of the Taiwan dollar since the beginning of the year, Taiwan's trade surplus with the United States for the first nine months of 1987 reached $12.5 billion—a 26-percent increase over last year's level. After record exports in August and September, moreover, overall foreign exchange reserves have surpassed $69 billion. Taipei believes that, if trends continue, foreign exchange reserves will top $150 billion by 1992. To counter this, Taiwan has reportedly mapped out a five-year plan to diversify exports and expand imports. Although details are lacking, efforts would be likely to center on policies such as continued gradual reduction of import restrictions, encouraging domestic firms to buy American products, and increased direct investment in overseas markets. Past efforts to diversify export markets, however, have had limited success; the US share of Taiwan's exports has only declined by 3 percentage points this year, and US markets still absorb close to half of Taipei's overseas sales. (b)(3)

[redacted]

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

### *Soviets Purchasing Grain From the United States*

The USSR has entered the US grain market for its first major purchase of US corn—1.5 million metric tons—in the fifth and final year of the US-USSR Long-Term Grain Agreement (LTA), which runs from 1 October 1987 to 30 September 1988, according to the US Department of Agriculture. This purchase follows an earlier, small Soviet purchase of 65,000 tons of subsidized US wheat, which reportedly will be fumigated in transit as a means of trying to solve wheat infestation problems. Even if the Soviets make additional US grain purchases, Moscow probably feels no compulsion to meet the terms of the LTA this final year because it has not done so the last three. Moreover, because Moscow came into the US wheat market in the 1986/87 LTA year only after the US agreed to subsidize its wheat at some $40 per ton, Moscow is likely to push for wheat subsidies again this year. These subsidies, while beginning to recapture lost grain markets, are generating resentment of the United States for contravening the spirit of the Punta del Este Agreement, which called for a halt to increased use of subsidies. Australia—angered by increased use of the US Export Enhancement Program in selling 4 million tons of subsidized wheat to Moscow during the 1986/87 LTA year and by increased subsidized sales to other markets—has recently filed a protest at GATT of the expanded US use of agricultural export subsidies. [redacted] (b)(3)

### *Indochina May Face Major Food Shortages*

Vietnam, Laos, and Cambodia have been hit by severe drought and expect substantial shortfalls in the current rice crop. [redacted] Laos (b)(3) and Cambodia will be hardest hit, as rice production is likely to fall at least 20 percent from last year. Hanoi is anticipating a 5-percent drop in grain production, the first decline since 1982. The Indochinese countries have no reserves to fall back on. Moreover, limited foreign exchange and poor credit ratings make importing large quantities of grain impossible. As a result, the countries would have to rely on foreign aid and austerity measures to bridge the gap. Moscow will probably continue supporting Vietnam by providing rice purchased on the international market. [redacted]

(b)(3)

*Kuwait-USSR Economic Cooperation Talks*

The recent visit of Kuwait's Oil Minister to Moscow has built on the closer economic and political ties developed between the two countries over the past year. The US Embassy reports that Kuwait and the Soviet Union agreed to create a permanent Soviet-Kuwaiti commission that will consider projects in oil and gas industries, health care, banking, and construction in Kuwait, the Soviet Union, and Third World countries. Kuwait will probably move ahead on several energy-related projects with the Soviets, but the extent of the relationship will be constrained by the poor rate of return on such arrangements and the relative inferiority of Soviet goods. [redacted] (b)(3)

*Indo-Soviet Power Project Under Fire*

New Delhi will probably continue to support the Tehri Dam project, although the Soviet-financed project has come under fire from Indian ecologists for safety reasons. The power project is the cornerstone of the bilateral economic cooperation agreement negotiated during Gorbachev's visit to India last November. After completion, the dam—which will be located in India's most populated state of Uttar Pradesh—is expected to increase the state's total power generating capacity by 50 percent, irrigate 270,000 hectares of land, and store water during peak discharge season to control flooding. Indian ecologists, supported by international surveys, claim that the project is a high-risk venture because it is situated in a seismic-sensitive area. The project was dropped in the 1960s for safety considerations. The generous financial assistance offered by the Soviet Union combined with India's rapidly increasing power needs are prompting New Delhi's decision to support the project. Although Moscow shares some of the reservations expressed by Indian environmentalists about the project's difficulty, the Soviet Union will continue with the construction plans, viewing the project as an opportunity to compete with the West and display Soviet technical know-how. [redacted] (b)(3)

[redacted]

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

## National Developments

### *Developed Countries*

*Mixed Signals on Japanese Monetary Policy*

Recent decisions by Japan's financial authorities provide mixed signals about the direction of monetary policy. The Bank of Japan early last week moved to increase liquidity—and thus lower interest rates—to cope with the plunge on the Tokyo Stock Exchange, but by week's end the Finance Ministry approved a 0.4-percentage point rise in the interest rate paid on postal savings and national pension premiums. The postal savings rate hike, which took effect on 27 October, also increases the base loan rate charged by government financial institutions such as the Japan Development Bank and the Housing Loan Corporation, which could dampen investor enthusiasm for some of the infrastructure and housing projects included in last spring's stimulus package. Moreover, commercial banks are likely to push for similar increases in the rates they can pay depositors in order to prevent a loss of deposits to the $780 billion postal savings system. We suspect the Finance Ministry probably agreed to the higher rates because it feared that without it the funds received from the postal savings system would be insufficient to finance the increased public works spending and recycling of funds to LDCs that Japan has promised in recent months. However, the decision will be difficult to reverse and may limit Tokyo's maneuvering room if the volatility in financial markets continues. [redacted] (b)(3)

*French Government To Write Off Renault Debt*

The US Embassy reports the French Government plans to write off up to $2 billion in Renault debt it holds as part of a restructuring of the troubled finances of the state-owned car company. Legislation will also be introduced to change the company from a state agency—which protected the company against bankruptcy and virtually guaranteed it unlimited state aid—to an ordinary limited-liability company, although it will remain state owned. The plan could run into opposition from the EC and the private Peugeot-Citroen car group, who see any state bailout as risking serious distortion of competition in the car market. Renault is expected to show a profit on operations this year after six years and $5 billion of cumulative losses. If accepted, the government's refinancing plan could eventually lead to partial privatization of the company. [redacted] (b)(3)

*French Privatizations Delayed*

French Finance Minister Balladur announced last week that the sale of the government's 51-percent share of the defense and electronics group Matra would be delayed by the recent stock market turmoil. While the conservative government's entire privatization program has come under severe criticism by the opposition socialists, Balladur stressed that the delay would only be for a matter of days or a few weeks, depending on market conditions. So far the privatization program has been one of if not the most successful of the government's economic programs. In less than a year, 23 of the 65 companies slated for privatization have been sold, earning the government about $8.5 billion in net proceeds. The money has been used to reduce government debt and to inject capital into some of the weaker nationalized companies. Prime Minister Chirac is counting on the success of the privatization program to help him in the presidential election next spring and will be interested in having further successful sales before then. [redacted] (b)(3)

*Less Developed Countries*

[redacted]

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

*Strains in Egypt's Foreign Exchange Regime*

According to the US Embassy, a significant share of the estimated $3-4 billion workers remit annually is now accumulating outside Egypt, possibly because of the government disruption last May of the private, or unofficial, foreign exchange market. Meanwhile, the lack of an effective interbank exchange market to distribute existing foreign exchange more equitably is preventing many importers, primarily in the private sector, from obtaining letters of credit. Government plans to go ahead with accommodating debt obligations and private individual requirements for foreign exchange within the existing bank pool may only exacerbate the current credit crunch. A sizable devaluation of the existing bank-pool rate may be needed to balance supply and demand for foreign exchange. Despite government assertions that it will allow market forces to determine the bank-pool rate, we believe the potential inflationary impact of such an action on Egyptian living standards may dissuade Cairo from acting. Unless some steps are taken, however, Egypt's normally vibrant private-sector economy may experience a recession and the viability of the IMF standby accord may be eroded. [redacted] (b)(3)

*Thailand Revises Economic Forecast Upward*

Led by strong growth in manufactured exports and Bangkok's aggressive export diversification program, Thailand's Central Bank expects real GDP to rise by 6 percent in 1987, compared with its earlier projection of 5.5 percent. Although the economy is on the road to recovery from last year, when growth slowed to a mediocre—by Thai standards—4 percent, the Bank's upbeat forecast may be timed to restore business confidence following the Bangkok stock market's crash last week. The Bank is projecting a $400 million current account deficit for 1987—imports are likely to be one-third higher than in 1986—after a modest $222 million surplus last year, but increasing capital inflows may boost international reserves to an unprecedented $5 billion. [redacted] (b)(3)

*Tunisia's Current Account Deficit Improves*

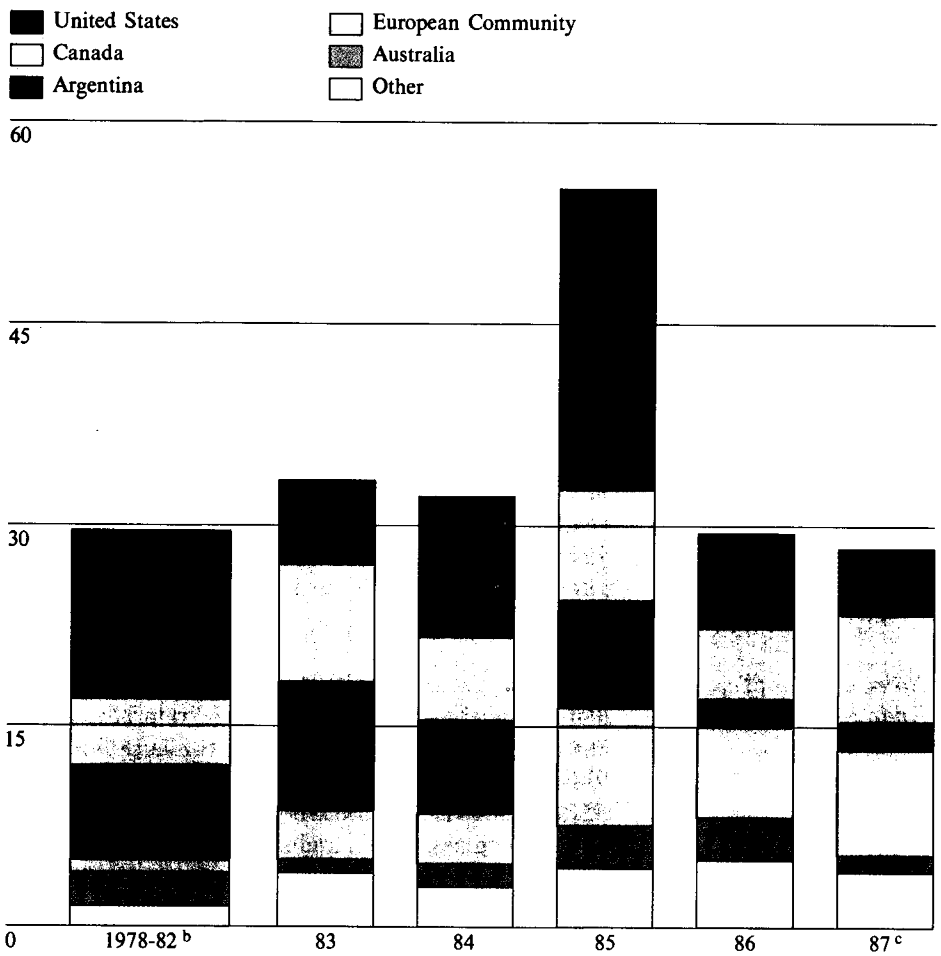
Tunisia's current account deficit for the year will be approximately $340 million, equal to about 4 percent of GDP and approximately one-half the level in 1986, according to projections by the US Embassy in Tunis. During the first eight months of the year nonoil exports were up 39 percent, tourism receipts increased 37 percent, and worker remittances increased 51 percent compared with the corresponding period last year. Import growth was limited to about 6 percent, mainly because of a near-record grain harvest and lower prices for food imports. We believe the increase in exports and tourist earnings—tourism is one of the sectors stressed in the development program—largely reflects the progress Tunis has made in implementing its structural adjustment program. As a result of the improvements and greater access to long-term borrowing, foreign exchange reserves have increased to about two months of import coverage. [redacted] (b)(3)

*Botswana To Mine Soda Ash*

Botswana's plans to mine and export natural soda ash from a large deposit at Sua Pan are likely to succeed following Pretoria's recent assurances of preferential tariff treatment for soda ash sales to South Africa. According to press and US Embassy reports, about 15 percent of Sua Pan's projected annual output of 150,000 metric tons probably would be marketed in Zambia and Zimbabwe for use in the glass, paper, and steel industries. The remainder would be exported to South Africa, which imports all of its nearly 300,000-ton annual consumption, one-half of it from US producers. Gaborone believes that it has deflected Pretoria's attempt to obtain political and security concessions in exchange for South African protection of soda ash imports under a customs union agreement between the countries. Gaborone remains concerned, however, over efforts by a US export cartel—that now provides one-half of South Africa's soda ash imports—to block the Sua Pan project. Pretoria has publicly accused the US producers of waging "economic war" on Botswana and challenged the United States to prevent the cartel from interfering with Botswana's development. [redacted] (b)(3)

**USSR: Grain Imports, 1978-87** [a]

*Million metric tons*




[a] Data based on marketing periods ending in June of the stated year. Includes wheat and coarse grains.
[b] Annual average.
[c] Estimated.

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(b)(3)

## *Communist*

### *Good Soviet Grain Crop*

The USSR had its second consecutive good grain harvest this year. Improved growing conditions throughout most of the country from late spring through summer made it possible for farmers to overcome earlier weather problems. The grain crop will be about 205 million metric tons, 5 million tons below 1986 but about 15 million tons above the average of the last 10 years. A crop of this size would reduce Moscow's import needs for the 1987-88 marketing year to about 20 million tons, compared with roughly 30 million tons purchased in each of the last two marketing years. If the Soviets opt to take advantage of low world grain prices, however, imports could reach 25 million tons. Moscow can satisfy most of its import requirements from non-US sources, and is not likely to buy any US wheat without a substantial price subsidy. The United States is in a good competitive position, however, to supply the major share of Soviet corn needs. [redacted] (b)(3)

### *East European Harvest Results Mixed*

Smaller harvests this year will add to economic strains in the southern countries of Eastern Europe, while most of the northern countries will benefit from increased grain production. Harvests in Yugoslavia, Bulgaria, and Hungary are likely to be slightly below average because of drought and reduction of sown areas. In Romania, grain output probably will be about average, but cold weather and dry conditions reduced other crops, such as potatoes. Grain production in Poland, East Germany, and Czechoslovakia was above average, but the harsh winter damaged fruits and vegetables, particularly in Poland, leading to some consumer shortages much of the year. Already poor food supplies in Romania will worsen and may lead to local demonstrations if Bucharest continues to export food at current high levels. Yugoslavia and Bulgaria probably will need to import more grain than last year and reduce agricultural exports; this course will damage Belgrade's already weak hard currency position. In Hungary, grain exports will also be down, although supplies are sufficient for domestic needs. Better harvests in recent years for Poland reflect increased incentives for private farmers, a trend that may be strengthened by President Jaruzelski's reform program. [redacted] (b)(3)

### *Rapid Growth for Chinese Electronics Industry*

Chinese officials credit structural reforms and investment in new technology for the boom in the country's electronics industry. The Chinese press reports the industry's output reached $8.4 billion for the first nine months of 1987, and officials expect annual production to register a 33-percent increase over last year, with exports quadrupling. [redacted] placing enterprises under (b)(3) local rather than central government control and introducing financial accountability proved to be powerful incentives on the heels of large investments in new production technology during 1984 and 1985. Earlier plans, however, to refocus the product mix on capital goods in order to curb the overheated growth of consumer goods—currently about 70 percent of the total—apparently have yet to take effect. [redacted] (b)(3)

*Cambodian Currency Devaluation*

Phnom Penh, for the second time in less than two years, has implemented a major devaluation of its currency. According to press reports, the riel was recently devalued by almost 70 percent against the US dollar, apparently in an effort to counter black-market trading and encourage international donor organizations into providing more financial assistance. The new official rate of 100 riels per dollar is much closer to the black-market rate of 130 riels to the dollar. Although the devaluation may stimulate some exports, Phnom Penh—unlike its patron Hanoi—shows no sign of introducing the kind of reforms needed to reverse the country's downward economic spiral. In addition, Cambodia is almost certainly worse off than Vietnam to the extent that it lacks the managerial skills to carry out reforms. [redacted] (b)(3)

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

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(b)(3)

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