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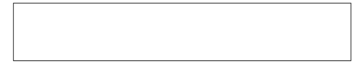

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International Economic & Energy Weekly

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21 February 1986

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International Economic & Energy Weekly

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International Economic & Energy Weekly

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Synopsis

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Mexico's handling of its growing financial difficulties runs the risk of sparking action on the part of other Latin American debtors. 25X1

3 **Italy: Worsening Budget Deficit** 25X1

Italy's continuing huge public-sector deficit, which is likely to top 16 percent of GDP in 1986, is placing strains on the economy and the five-party ruling coalition. In any event, economic growth is likely to slow this year, making early elections some time this summer a likely possibility. 25X1

7 **EC Institutional Reforms Make Slow Progress** 25X1

EC efforts to remove barriers to intra-EC trade and facilitate decisionmaking following the entry of Spain and Portugal have been delayed by the Danish Parliament's rejection of reforms adopted at the EC summit meeting in Luxembourg last December. Once the Danish objections are resolved, these reforms could be an important step in addressing the problems in EC trade and competitiveness. 25X1

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15 **Poland: The Status of Foreign-Owned Firms** 25X1

Over the past several years, Warsaw has promoted the establishment of Western-owned companies in Poland—so-called Polonia firms—as a way to increase market supplies and generate hard currency earnings. Nonetheless, tighter regulation has dealt a setback to government efforts to attract large-scale Western investment. 25X1

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19 **Key LDC Debtors: Limited Progress on Tax Reform**

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Large government budget deficits are impeding needed tax reforms in the 15 countries targeted by the Baker initiative. Although a major concern is that tax reform can reduce government revenues and worsen the deficit problem, these efforts are also being stalled by substantial political opposition.

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21 February 1986

Perspective

Latin America: Potential Fallout From Mexico's Financial Problems

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At the request of the presidents of Mexico and Venezuela, the 11 Cartagena Group countries have scheduled an emergency meeting of finance and foreign ministers in Uruguay on 27-28 February to discuss the current Mexican crisis and measures to deal with it. Following a preparatory session on 10 February, Uruguay's Foreign Minister Iglesias told the press that the Cartagena countries will focus on the new problems created by falling oil prices.

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Although the other Latin debtors are being publicly circumspect about Mexico's financial plight, we believe that at the very least Mexico will draw moral support from other Latin American countries in negotiations for interest rate concessions and new funds. Although we judge few other Latin governments would automatically demand the same terms should foreign banks grant the de la Madrid government interest payment relief, all debtors clearly would view the development as an irreversible change in the debt servicing ground rules.

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The debt policies of Latin American governments are also being driven by each individual country's financial self-interests. These, in turn, depend on the country's balance-of-payments position and the status of its relations with foreign creditors. Nevertheless, the same deflationary pressures that are plaguing Mexico are also affecting other Latin American debtors such as Venezuela and Chile. These pressures coupled with the recent precedence for unilateral action set by Peru and Nigeria could increase the chances for other countries taking steps on their own.

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The financial crisis presently is concentrated in Mexico, but we believe it could again engulf the region. We are particularly concerned about the consequences if Mexico's financial predicament again causes creditors to "cut and run" by reducing trade credits, withdrawing interbank deposits, and suspending disbursements of medium-term credits to the region's other debtors. In that event cash-flow problems will ensue throughout the region. Such actions would almost certainly play into the hands of populists throughout Latin America who believe that the current debt strategy is condemning their countries to slow growth. A stronger voice for the nationalist forces in the region would not only result in major financial setbacks for US banks but would also seriously hurt US investment and commercial interests in the region.

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Italy: Worsening Budget Deficit

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Italy's continuing huge public-sector deficit, which is likely to top 16 percent of GDP in 1986, is placing strains on the economy and the five-party ruling coalition. Last-ditch efforts by the government to reduce the deficit failed earlier this month when the lower chamber of the Parliament rejected many of the modest spending cuts proposed in the 1986 budget. To finance the deficit, Rome will probably have to boost monetary growth and/or raise already-high interest rates. Either action will worsen Italian economic prospects. The first would fan inflation, hurting Italy's international competitiveness, while the second would cut back private investment. In any event, economic growth is likely to slow this year, intensifying strains within the governing coalition over how to reduce the deficit and making early elections some time this summer a more likely possibility.

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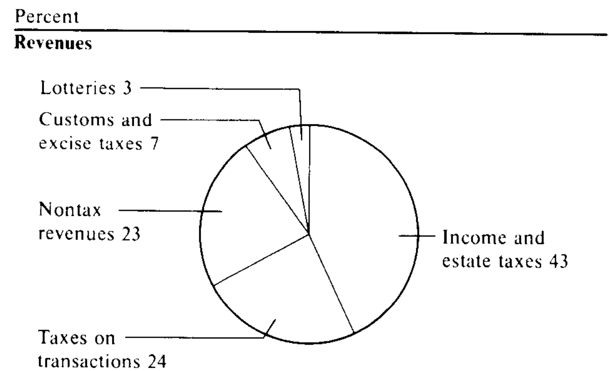
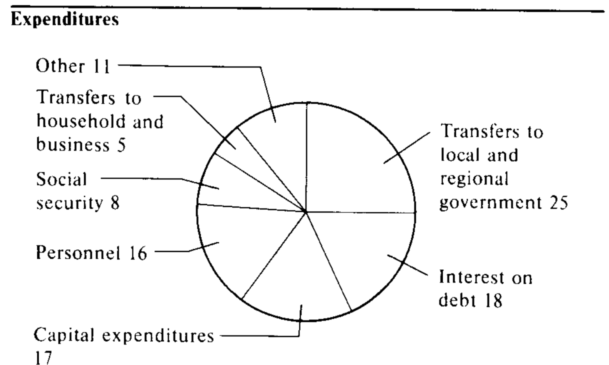
The 1985 Italian Budget: Revenues and Expenditures, by Type





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Sources of Deficit Growth

The Italian expanded public-sector deficit [1]—estimated at $66 billion or 15.8 percent of GDP in 1985—is one of the largest in the OECD. The deficit first rose above 10 percent of GDP in the mid-1970s, reflecting the impact of the 1974/75 recession. Since then, the deficit has tended to drift upward mainly because of soaring expenditures. Government outlays last year equaled about 48 percent of GDP, more than double the level in the early 1970s.

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Interest payments on the public debt are the fastest growing element of government outlays. Total public debt currently equals GDP, and is growing at an average of about 6 percent annually. Interest payments on the debt have increased from 12 percent of budget expenditures in 1979 to over 18 percent last year.

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[1] The expanded public-sector deficit comprises the borrowing requirements of general government; autonomous agencies; municipal enterprises; and ENEL, the state-owned electricity monopoly. At the request of the IMF in 1976, Italy began using this definition of the deficit—which is somewhat greater than the gap between revenues and expenditures—as the target deficit because it provides a better picture of how the government's borrowing affects the financial markets.

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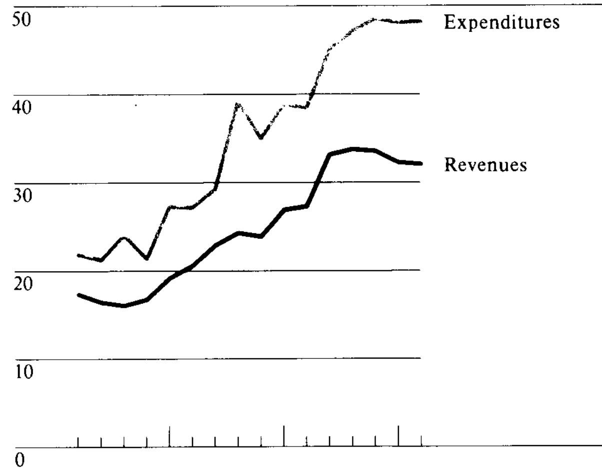
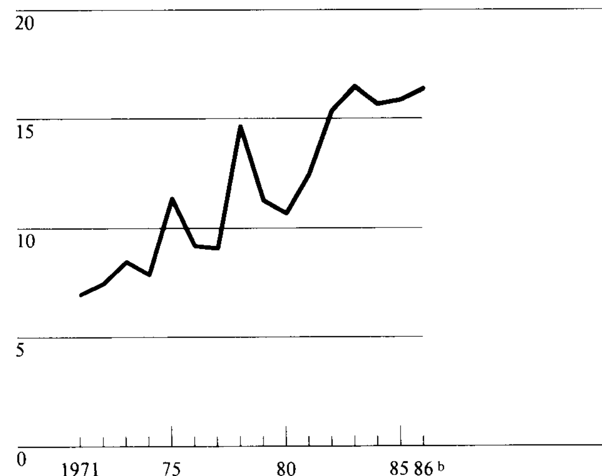
Italy: Government Revenues, Expenditures, and Expanded Public-Sector Deficits, 1971-86

Government Revenues and Expenditures
Percent of GDP



Expanded Public-Sector Deficits[a]
Percent of GDP



[a] This measure includes the borrowing requirements of the general government, autonomous agencies, municipal enterprises, and ENEL, the state-owned electricity monopoly and results in a deficit that is somewhat greater than the gap between revenues and expenditures.
[b] Projected.

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More sluggish economic growth in the 1980s also has contributed to the deficit by slowing revenue growth and increasing outlays for unemployment compensation—the unemployment rate has jumped from 7.7 to 10.6 percent over the past six years. According to our econometric model, every percentage point increase in the unemployment rate raises the budget deficit by $6 billion. 25X1

Probably the most pervasive cause of growth in public expenditures, however, has been legislated increases in social outlays such as pensions and medical programs. The government's contribution to pensions, for example, has been increasing by an average of 9 percent annually in real terms over the past 15 years. 25X1

The 1986 Budget

Although the final touches are still being put on the 1986 budget, it looks as though it will call for a deficit target of $67 billion, or about 14.6 percent of GDP—1.2 percentage points less than in 1985. Spending is to be restrained by very modest cuts in pension contributions, transfers to local governments, and other social expenditures. Cabinet members were reluctant to propose any significant cuts to the welfare system because that would hurt their party's chances in the next election, but even the small savings included in the cabinet's proposal met heated opposition in the lower chamber of Parliament. The government several times had to resort to open votes of confidence to get measures passed. The larger governing parties were divided internally on such controversial issues as raising medical fees and reducing family allowances, enabling even the smallest party to block legislation that would reduce spending. As a result, the lower chamber added about $1.2 billion in spending to the cabinet's original proposal. 25X1

The difficulty in implementing spending cuts has forced the government to look to enhanced revenue collection, concentrating on measures to make the tax system more equitable. Although some reforms have been enacted, tax collection continues to be

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hampered by poor enforcement, and we estimate that possibly as much as half of Italy's potential value-added taxes go uncollected. Reforms are particularly difficult to achieve because the main offenders—small businessmen and professionals—make up a significant part of the large Christian Democratic Party's base of support. In fact, the 1986 budget includes a revision of the personal income tax system to compensate for recent inflation, leading to a $3.9 billion reduction in tax revenues rather than an increase. [ ]

We believe that the estimate of the budget deficit is too low and that the actual figure will be about $73 billion—over 16 percent of GDP. The government's ambitious target of a $12 billion reduction in current spending probably cannot be achieved. It includes about $3.9 billion in spending cuts that have not been specifically determined, as well as some other savings, such as changes in bank reserves and methods of calculating interest payments, that are probably superficial at best. In addition, projected revenues are based on an overly optimistic forecast of 3-percent real GDP growth in 1986 and on the implementation of some one-time tax changes that have already been delayed by the Parliament for over two years. [ ]

Implications for the Economy

We believe the budget deficit has become a serious drag on the economy. Partly because of Rome's borrowing requirements, domestic credit expansion has consistently exceeded targets set by the central bank, and this has contributed to the current 8.6-percent inflation rate. Moreover, since 1976 the state share of domestic credit has grown from 42 to 74 percent—and these figures do not include borrowing by many of the state-owned companies. The Bank of Italy has repeatedly warned that government borrowing is reducing the amount of credit available to the private sector. Over the past decade, private investment's contribution to GDP has dropped from nearly 18 percent to just over 14 percent in 1984. [ ]

The large public-sector deficit also has prevented Rome from lowering interest rates as much as other industrialized countries. In fact, interest rates on three-month and six-month treasury bills were recently increased because the government has been unable to sell enough bills to meet its maturing debt. Rome is relaxing many controls on Italy's financial markets, thus creating attractive new investment opportunities and making it more difficult to sell government debt to the public without raising interest rates on treasury bonds. Real interest rates—now at 7 percent—are a major factor in sluggish economic growth. [ ]

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The impact of the 1986 budget deficit on the economy will depend to a large extent on how much of it is financed through money creation—currently the subject of heated debate within the government. Since 1980 the Bank of Italy generally has been able to limit the share of the deficit funded by money creation and is unhappy that it has been forced to step in recently when the Treasury could not sell enough bonds. The governor of the central bank has therefore called for interest rates to be raised in order to attract new investors. Many government officials, however, strongly oppose raising interest rates because it would increase considerably the government's interest payments on the public debt. They also fear that it might slow the economic recovery that has depended to a large extent on strong investment spending—although the investment boom has been largely financed by increased profits. [ ]

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The result is likely to be a compromise involving some increase in interest rates, but not enough to take all of the pressure off the money supply. Consequently, while factors such as falling oil prices and lower real wage gains will help hold down price increases, inflation is unlikely to come down to the government's target of 6 percent. The continuing inflation differential between Italy and its major trading partners will further erode Italy's international competitiveness. Unless offset by periodic devaluations, the decline in competitiveness

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will considerably negate anticipated improvements in the trade deficit resulting from lower oil prices and a falling dollar. Devaluations would probably be resisted by the other members of the European Monetary System, who admonished Italy to shape up its financial house when the currencies were realigned last July. Raising interest rates, on the other hand, will almost certainly slow investment spending. Our econometric model suggests that every percentage point increase in interest rates leads to a 0.5-percent decline in the level of investment spending. 25X1

Higher interest rates and the inability to reduce the inflation differential with its trading partners will contribute to the expected slowdown in Italy's economic growth this year. While real GDP advanced by 2.4 percent in 1985, it probably will grow only 1.9 percent in 1986. As a result, the unemployment rate—at a historic high of 11 percent in the fourth quarter—is not likely to come down much, if at all, this year. 25X1

The slowdown in economic growth will put increased pressure on the government to reduce the budget deficit and will intensify existing strains within the coalition over economic policy. There is little agreement among the coalition parties on how to reduce the budget deficit—the Prime Minister, for example, opposes raising taxes, the Treasury Minister claims new taxes are probably necessary, and the Finance Minister refuses to consider tax hikes until deep spending cuts are instituted. To attenuate the differences, Prime Minister Craxi is likely to shuffle the cabinet later this month, but the move may not be sufficient to reduce the tensions, making early elections sometime this summer a possibility. 25X1

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EC Institutional Reforms Make Slow Progress

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EC efforts to remove barriers to intra-EC trade and facilitate decisionmaking following the entry of Spain and Portugal have been delayed by the Danish Parliament's rejection of reforms adopted at the EC summit meeting in Luxembourg last December. Danish Prime Minister Schlueter has called for a referendum in his country on the reforms for 27 February. If it fails and Denmark thus is unable to sign the reform act, the rest of the Community would be forced to renegotiate the reforms in light of the Danish objections. Other EC states are firmly committed to reforms because of their potential to make EC decisionmaking more efficient, considered essential for revitalizing lagging West European competitiveness.

The Reform Package

The institutional reform package—the first changes proposed to the EC Treaty of Rome since its signing in 1957:

- Allows greater use of majority voting, though it does not guarantee faster decisionmaking.

- Defines new areas concerning creation of the internal market in which majority voting would apply, but leaves intact the ability of one member to block EC decisions on the basis of "vital national interests."

Under the reform package, however, members and the EC Commission would be given the right to sue states abusing the veto, which should enhance the use of the majority vote. In contrast, another element of the reforms—granting the European Parliament additional powers to review Council decisions—could even slow decisionmaking on some issues. Moreover, the package also specifies certain policy areas in which members retain the right of demanding unanimity.

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The Reforms

The main elements of the institutional reform package agreed to by the EC summit meeting last December include adding European Political Cooperation and the European Monetary System—both currently informal arrangements—to the Treaty of Rome, but focus on improving the EC decisionmaking process. The Single European Act:

- *Sets the goal of establishing a totally free internal market—defined as an area in which the free movement of goods, persons, services, and capital is ensured—by 31 December 1992.*
- *Establishes that all measures harmonizing national laws and regulations for the purpose of setting up the internal market will be decided on the basis of majority vote in the EC Council of Ministers and no longer by unanimity, except for matters concerning indirect taxation, the budget, free movement of persons, and the rights of employed persons.*
- *Allows member states to exempt themselves from harmonization because of major national needs—including environmental protection—but requires that notification be given to the EC Commission, which in turn must confirm that the exemption is not a means of arbitrary discrimination or disguised restriction of trade; the Commission or any member may sue before the EC Court of Justice if it believes another member is abusing this right.*
- *Permits the European Parliament to review Council of Ministers decisions—a so-called second reading. If the Parliament rejects a Council decision, the Council can override the rejection by unanimous vote. The Act also encourages cooperative efforts on R&D, environmental protection, and social policy, and incorporates intra-EC economic development aid under the Treaty. The explicit goal of such resource transfers is the eventual convergence of member state economies.*

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Referendum on EC Reform: The Internal Danish Situation

The minority government's failure to win parliamentary approval for the Luxembourg reform package on 21 January has endangered not only the progress of the reforms, but also has created a hot debate in Denmark. The Schlueter government contends that majority voting on internal market issues will benefit Denmark economically, and that wider powers for the European Parliament and the formalization of foreign policy cooperation will have little practical effect. The opposition Socialist parties disagree, arguing that these measures dilute the principle of national sovereignty—a particular Danish concern as one of the smaller countries in the Community. The opposition also fears that environmental protection—an emotional issue in Denmark—might not always take precedence over the removal of trade obstacles.

Anticipating last month's unfavorable parliamentary vote, Schlueter took a gamble and called a consultative referendum for 27 February to resolve the issue. The referendum vote is likely to be a victory for Schlueter and strengthen his center-right coalition. Polls indicate the electorate supports the reforms 48 percent to 33 percent. A yes vote could also help the government put through many unpopular economic measures necessary to address Denmark's chronic balance-of-payments problems.

The prime minister and other supporters of the reforms, including industry and many trade unions normally loyal to the opposition Social Democratic Party, are equating a no vote to a question of continued Danish EC membership, hoping to sway votes from the Social Democrats. Although none of the political parties takes much interest in the wider ideals of European integration that inspired the EC's founders—in fact, most Danes feel a greater attachment to the Nordic region and its institutions—there is little incentive for a Danish withdrawal.

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The total financial benefit that Denmark derives from EC membership is difficult to quantify, but in 1983 and in 1984 direct net benefits—largely from the Common Agricultural Policy—amounted to about $260 million a year. Community membership brings Denmark substantial economic advantages. Agriculture and fisheries, both crucial to Denmark's economic well-being, would be hardest hit if the Danes withdrew. Agricultural exports in 1985 accounted for more than two-thirds of agricultural production and more than one-fourth of total Danish exports, of which roughly half went to EC markets. Denmark received about $625 million in agricultural subsidies in 1983-84, which, if lost, would force a major economic restructuring. According to the US Embassy, foreign exchange earnings would drop by a projected $1.5 billion, severely damaging Denmark's credit rating and its ability to pay off its large foreign debt. In the fisheries sector, direct subsidies are limited, but if Denmark were excluded from EC waters the Danish catch would shrink by as much as 60 percent. The direct cost would be almost $250 million in sales, and 5,000 jobs, with more employment losses in other related sectors.

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If the reform package succeeds, it would be an important step toward improving the Community's ability to dismantle the myriad nontariff barriers to intra-EC trade that are a drag on European competitiveness. The political commitment to remove these barriers by 1992 depends on a detailed timetable of over 300 highly technical harmonization measures, all requiring member state approval. Even with increased use of majority voting, it will be difficult for the EC to meet this schedule, but virtually impossible without it, especially with the addition of Spain and Portugal.

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The reform effort has had the support of all the member state governments. Italy—instrumental in

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launching the effort at the Milan Summit in June 1985—and the Benelux countries have been most supportive, but even the United Kingdom, Greece, and Denmark, who initially opposed amending the Treaty of Rome and holding a special intergovernmental conference as the mechanism for reform, contributed constructively to the four-month-long reform conference. [ ]

All the member states except Denmark, Greece, and Italy signed the Single European Act reform package amending the Rome Treaty on 17 February. Greece and Italy, while in basic agreement with the Act, will withhold their signatures until Denmark is ready to sign. The Act cannot legally take effect until signed and ratified by every member state, giving the Danish Parliament an effective veto. [ ]

Should Denmark Not Sign

Although considered unlikely, rejection of the reform package by Danish voters in the 27 February referendum would prevent the government from signing the Act and thus block the reforms for the entire Community. In that event, the EC would be thrown into one of its periodic crises. Foreign policy initiatives and the resolution of pending trade disputes with the United States would almost certainly be given secondary priority. The initial inclination of the members would probably be not to reopen reform negotiations—as, indeed, EC foreign ministers have recently told Danish Foreign Minister Ellemann-Jensen in prereferendum consultations—for fear of shattering the complicated compromises the reform package is based upon. [ ]

In the end, the rest of the EC would probably agree to reopen negotiations and seek to modify the aspects of the reform package objected to by Denmark. If that proved too difficult, the members might seek an informal agreement instead of a formal treaty amendment. The Netherlands, the current president of the Council of Ministers, already plans to persuade members on a case-by-case basis to use majority voting before the reforms take effect. Italy, because of strong domestic pressure to strengthen the European Parliament, probably would block any attempt by Denmark or any other EC member to dilute the reform measure that gives limited new powers to the Parliament. In any case, a no from Denmark on reforms could further isolate it politically within the Community, ensuring that Danish concerns on key matters of self-interest—the environment and agriculture—would be heard much less sympathetically by the other members. [ ]

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Jordan: Keeping Its Head Above Water

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Jordan's abrupt economic slowdown—and the realization that renewed rapid growth is unlikely—has prompted the government to take a more serious look at its economic strategy. Rising unemployment and uncertainty about the levels of foreign aid and worker remittances are Amman's greatest concerns. The government's efforts over the past year suggest it is willing to lower its own sights on what it can accomplish and look to the private sector for help. Jordan's moves to date have been cautious, however, and the country's economic fortunes will remain for some time largely dependent upon foreign assistance.

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Arab Recession Hits Home

Resource-poor Jordan relies heavily on the generosity of the Gulf states to keep its economy afloat. Arab aid and remittances from the approximately 300,000 Jordanians working abroad—equivalent to 40 percent of the total labor force—account for nearly two-thirds of the country's hard currency receipts. The oil price boom of the 1970s increased these flows sharply and spurred annual GNP growth of almost 10 percent. The recession spreading through Gulf states as oil revenues fall is taking its toll on Jordan:

- Gross worker remittances dropped about 10 percent in 1985 and are not expected to pick up soon. In fact, the increase in 1984 remittances appears to have been an anomaly as returning workers brought home savings. On the plus side, the Jordanian Government is not expecting a rapid return of the remaining workers abroad given their high skills and education vis-a-vis other guest workers.
- Arab aid totalled $640 million last year, less than half that received during the peak year of 1980. Only a successful barnstorming trip by King Hussein last summer prevented still another decline: He was able to drum up some Baghdad accord payments from recalcitrant donors Kuwait and Qatar and also secured a hefty gift from Oman.

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Jordan: External Economic Indicators, 1981-85

Million US $

	1981	1982	1983	1984	1985 [a]
Current account balance	−42	−335	−389	−269	−170
Trade balance	−2,435	−2,488	−2,456	−2,027	−1,910
Exports (f.o.b.)	735	751	580	757	780
Imports (c.i.f.)	3,170	3,239	3,036	2,784	2,690
Net services	1,088	1,093	1,254	1,044	980
Net worker remittances	875	907	909	983	920
Unrequited transfers	1,305	1,060	813	714	760
Arab aid	1,197	953	712	593	643
Official foreign exchange reserves	1,049	848	798	500	423
Medium- and long-term external debt	2,005	2,411	2,942	3,400	3,900

[a] Estimated.

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The poor record of these two major hard currency sources was offset somewhat by an improved trade balance over the past three years. Exports—consisting largely of phosphates, chemicals, fruits, and vegetables—have picked up following a severe slump in 1983, primarily on the strength of increased sales to Iraq. Even some of these gains are more illusory than real—as Amman has been forced to extend government-guaranteed credits to enable Baghdad to make the purchases. Imports have dropped the past three years, but most of the

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fat has been cut. The Jordanian economy still relies heavily on imports of foodstuffs, raw materials, and machinery, and further cuts could prove more costly to overall economic performance.

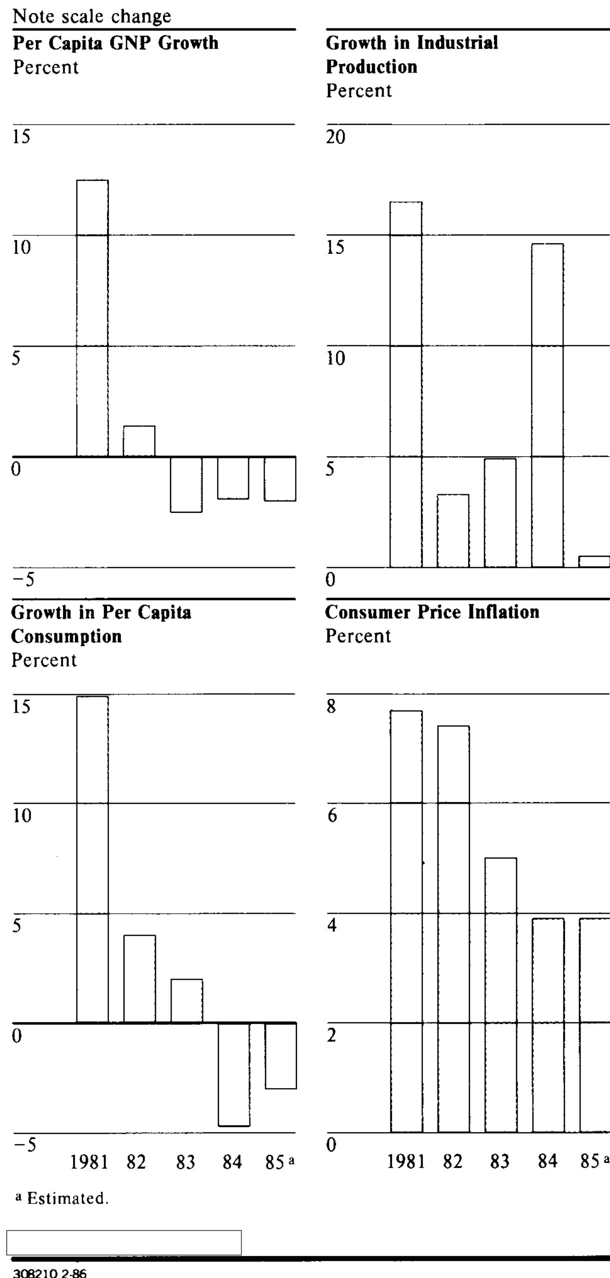
Over the past few years, Jordan has drawn down its official foreign exchange reserves to help close its financial gap. Reserves fell sharply in both 1984 and 1985, and the current level of about $420 million covers only about two months' worth of imports. Jordan's credit rating has not suffered unduly during the recent crunch, however. A $200 million syndicated loan—the third large syndication in three years—was oversubscribed last year. Nonetheless, Amman is concerned about relying on borrowing because its external debt has nearly doubled since 1981 and debt-service obligations continue to climb.

Domestic Impact

Slowing GNP growth reflects Jordan's problems with its external accounts. Recently revised statistics put annual GNP growth at about 2 percent for the last three years—a negative per capita rate given Jordan's population growth of almost 4 percent per annum. Amman had hoped growth would be spurred as new industrial projects came on line in 1984. But poor world markets, in general, and the leveling of sales to Iraq, in particular, quickly burst that bubble. Investment, too, has suffered, falling well short of planned levels over the past three years.

The public is only now beginning to feel the pinch. Much of the past decline in consumption is largely the result of reduced imports of luxury items and therefore has not been a significant burden. Consumers also have been helped by the low inflation rate, which shows few signs of increasing in the immediate future. Rumors are circulating in Amman of a possible devaluation of the dinar, which, if proved true, would eventually lead to price hikes.

Jordan: Economic Indicators, 1981-85



[a] Estimated.

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The Jordanian public is worried, however, about creeping unemployment. According to the US Embassy, Jordanian officials have put the unemployment rate at about 8 percent, a high figure for a country that traditionally prides itself on no employment problems. One Jordanian official believes the rate could double by the end of the decade, while a recent World Bank study projects a possible rate as high as 30 percent because of returning workers and an influx of new graduates. Moreover, these rates fail to consider the large and growing number of idle workers kept on the payrolls of numerous government-operated enterprises.

The Government's Strategy

The government is aware that it must take a more serious look at its economic prospects. Indeed, the appointment of a more activist Prime Minister last April may have been, in part, a move to help stimulate the economy. The new government appears to recognize its financial limitations—for example, this year's budget essentially shows no growth—and is actively seeking help from the private sector:

- The government rescinded a scheduled law that would have required Jordanian majority ownership of all banks, because some foreign banks were threatening to leave.

- Amman is planning to sell some government businesses. Talks have been under way for some time regarding the telecommunications company, and the government hopes some time this year to offer the public the opportunity to buy shares in ALIA, the government-run airline.

- Last summer the parliament approved a variety of measures aimed at protecting local industries and stimulating exports. Duties on luxury goods also were increased, restrictions imposed on the importation of many goods also produced locally, and tax exemptions hiked for export-oriented industries.

- The government is continuing with its plans to have Amman replace war-torn Beirut as the major center for services in the the region. Current efforts focus on developing the infrastructure needed to support such operations.

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Jordan is also making job creation a high priority. Last month the government began cracking down on illegal workers, who constitute about one-fourth of Jordan's estimated 150,000 foreign workers. Among the new measures are deportation for nonregistered workers, higher fees for work permits, increased fines on firms hiring illegal workers, and improved monitoring at immigration points. Although Jordan's 1986-90 five-year plan has yet to be published, the Embassy reports that job creation will be a major component. The government projects that increased investments and fewer foreign workers will enable it to lower unemployment to an acceptable 5 percent by 1990.

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Outlook

The government's economic plans are tempered by political realities. Amman's location in the volatile Middle East makes it hard enough to encourage Jordanians to keep funds home, let alone entice new foreign capital. The threat of violence already has slowed efforts to bring service operations to the capital. In addition, the unwillingness of many Jordanians to invest in domestic projects will hinder privatization efforts.

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In the near term, Jordan will continue to look outside its borders for financial help. Moves to increase self-sufficiency are costly, and human capital remains Jordan's principal asset. The King has proved to be an adept fundraiser and the Jordanians reasonably sound money managers. Without any unexpected external shocks, the country should be able to keep its head above water.

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Poland: The Status of Foreign-Owned Firms

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Over the past several years, Warsaw has promoted the establishment of Western-owned companies in Poland—so-called Polonia firms—as a way to increase market supplies and generate hard currency earnings. As their numbers have grown, so has criticism of some Polonia firms and the high wages paid their employees. Despite the controversy and the resulting tighter government regulation, we expect this highly productive sector of the Polish economy to remain active for the next several years. Nonetheless, tighter regulation has dealt a setback to government efforts to attract large-scale Western investment.

A Productive Sector

Polonia firms account for a very small share of total Polish economic activity—the approximately 640 Polonia firms produced 0.4 percent of Poland's 1984 output and employed about 42,000 workers or 0.2 percent of the labor force. These enterprises, however, provide about 10 percent of the total output of Poland's private industrial sector. Most of these enterprises produce consumer goods such as clothing, furniture, cosmetics, or leather goods, which, though generally more expensive, are widely preferred to the shoddy state-produced goods. In addition, Polonia firms provide almost 25 percent of Poland's medical and laboratory supplies, produce mine safety, environmental, and electronic equipment, including computer components, and many chemicals and construction services in short supply in Polish markets.

Warsaw initially sought Polonia businessmen for their contacts in Western markets. Polonia enterprises later came to be viewed as a source of "costless" investment capital and Western technical and managerial skills. Polish officials hoped that the firms would prod state enterprises into more efficient production while producing consumer goods using scrap or surplus materials, vacant buildings, and underutilized machinery. Polonia firms were also expected—although not legally required—to use their own funds to import raw materials in short supply, thus saving Poland's resources and hard currency.

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Government promotion of Polonia enterprises began in the late 1970s, and culminated in the legislation of July 1982, which offered foreign entrepreneurs tax advantages and legal autonomy far exceeding those enjoyed by private Polish-owned firms. Provisions of the 1982 law granted new Polonia enterprises:

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- Exemption from taxation for three years.
- A 50-percent ceiling on the income tax rate thereafter.
- Freedom to set prices and use material incentives to increase production.

Partially offsetting these generous terms, the law required that 50 percent of hard currency export earnings and all domestic zloty profit remain in Poland until the enterprise's liquidation.

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Western entrepreneurs were enticed by the availability of a skilled, low-paid work force, a high demand for consumer goods, and the prospect of gaining access to markets in other socialist countries. During 1981-82 the number of new permits mushroomed from 68 to 230, the number of Polonia employees more than tripled, and the combined sales revenues of all Polonia firms increased almost fivefold. Perhaps most significant, the export revenues of Polonia firms in 1982 were over 500 percent larger than the previous year.

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Retrenchment in 1983

Success brought problems, however. In late 1982 the Ministry of Finance charged some Polonia firms with earning "excessive" profits, transferring

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their profits abroad illegally, luring skilled workers from the public sector, bidding up the prices of scarce domestic inputs, charging "designer" prices for their products, and neglecting their investment obligations. Premier Jaruzelski, who had encouraged the formation of Polonia firms in 1982, criticized them in February 1983 for ignoring their responsibilities and said they would have to learn to operate in accord with the social and economic interests of Poland.

Consequently, new restrictions were enacted in late July 1983. The three-year tax holiday was made contingent on a firm's investing annually at least one-third of its earned income. The 50-percent ceiling on corporate taxes was raised to 85 percent—although in practice reductions of up to 20 percent were allowed when the firm produced "socially desirable goods" such as medical and agricultural equipment. The government also ordered the Polonia firms to exchange 50 percent of their hard currency earnings for nonconvertible zloty.

The legislation apparently was accompanied by closer scrutiny of Polonia applications. The government granted only 117 new permits in 1983 and 142 new permits in 1984. According to Polish statistics, the rejection rate in 1984 was nearly 50 percent. Consequently, about 700 Polonia firms were authorized to operate in Poland by the end of 1985 compared with 1982 predictions of 1,000 such firms by that date.

Impact

The government seems to have been successful in channeling Polonia firms into sectors it considers essential, such as the medical and computer fields. Although some advocates of Polonia claim that the new rules encourage entrepreneurs to liquidate their operations after three years and then start wholly new endeavors, Polish officials claim that such behavior is acceptable since they want Polonia firms to be temporary instruments for filling market shortages.

Restrictions on the entrepreneurs' use of hard currency earnings probably has, on balance, worked against Poland's interests by reducing imports of Western goods. Many state enterprises previously obtained Western machinery and spare parts by collaborating with Polonia firms that had hard currency. Moreover, Polonia firms have also been compelled to rely as much as possible on domestic inputs, thus increasing the competition for the country's meager resources.

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The hard currency restrictions also have dampened incentives to export to the West at a time when Warsaw needs to maximize its hard currency earnings. Thus the value of Polonia firms' exports to the West increased only 44 percent in 1984 over 1983 levels, while the value of exports to socialist countries grew more than 450 percent. The "typical" Polonia firm now seems to produce its main line of output for the Polish market while exporting to the West small quantities of unrelated goods in order to finance imports. One good example is a firm that produces roach traps for Polish consumers and exports machine tool subassemblies to the United States to finance imports of insecticide and glue.

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Continued Controversy and More Regulation

Despite restrictive regulations, the controversy over Polonia firms has continued. The frank admission in the Polish press that Polonia firms are five times more productive and pay wages twice as high as state enterprises has raised the ire of political hardliners and workers in the large socialized sector. In addition, some foreign investors who choose to reside in Poland use their zloty earnings to support a conspicuous lifestyle. Members of parliament cited Polonia firms as a "serious social problem" in late 1984, and trade union representatives declared their opposition to Polonia firms in September 1985.

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In defense, Polish officials have publicized some "success" stories. A recent press article credited Polonia companies with breathing life into the microcomputer industry, calling them the main source of microcomputer components in Poland, and lauding instances of cooperation with state enterprises. Last August, the party daily contained an article about the Polonia firm Plastomed, which produces medical equipment and chemical diagnostic reagents, and noted its contribution in meeting health service needs both in Poland and in many other socialist countries. Polish officials also paid tribute, at a school dedication ceremony, to the renovation services provided by a US-owned construction firm last September.

Nonetheless, the government has further tightened the reins. Over the past two years 40 foreign firms have had their licenses taken away and more than $2 million worth of zloty fines and extra taxes have been levied. Further regulations in January 1985 increased to $50,000 the hard currency deposit required to start a Polonia firm and also required that the first $50,000 in profits be reinvested in the company. A government directive issued last August requires Polonia firms to use official government channels to hire Polish workers—a measure designed to prevent workers from quitting solely to seek higher paying jobs with foreign-owned firms.

Local government authorities have further complicated the Polonia business environment. Some provincial governments require that local residents be given priority in hiring, have imposed age restrictions on Polonia's employees, or have tried to ensure that local markets have a priority claim on the firms' output. Polonia firms could probably lose their licenses for failing to fulfill such additional obligations.

Outlook

Despite the controversy and the shifting regulatory climate, Polonia firms are likely to remain part of the Polish economy for at least the remainder of this decade. Although the government will continue to fiddle with the rules, it probably will not be under strong pressure to make dramatic changes. Tighter regulation has partially disarmed critics by minimizing flagrant abuses and channeling firms into more highly valued endeavors. Polonia businesses can still be very profitable because of tax breaks in the first three years and because Polish authorities have a great deal of discretion to reduce a firm's financial obligations after the grace period, particularly for entrepreneurs who undertake priority investments. Even many of those who dissolve operations at the end of three years opt to remain in Poland to start up a new venture. The lure of profits is key, but many probably also decide to stay because of their considerable zloty holdings and their hard-earned familiarity with Poland's regulatory peculiarities.

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Nonetheless, the controversial environment and the regulatory instability of the past few years have undoubtedly had some negative impact on the investment climate. The Polish parliament is considering a joint-venture law aimed at encouraging large-scale Western investment, but the Polonia experience may dissuade some potentially valuable investors.

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Key LDC Debtors: Limited Progress on Tax Reform

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Large government budget deficits are impeding needed tax reforms in the 15 countries targeted by the Baker Initiative.[1] Although a major concern is that tax reform can reduce government revenues and worsen the deficit problem, reform is also being stalled by substantial political opposition. These two constraints to tax reform could be substantially eased if, as in the Baker plan, increased donor assistance is made conditional upon the implementation of meaningful tax reform. Tax reforms can increase efficiency and equity in the economies of key LDC debtors, stimulating economic growth over the longer term.

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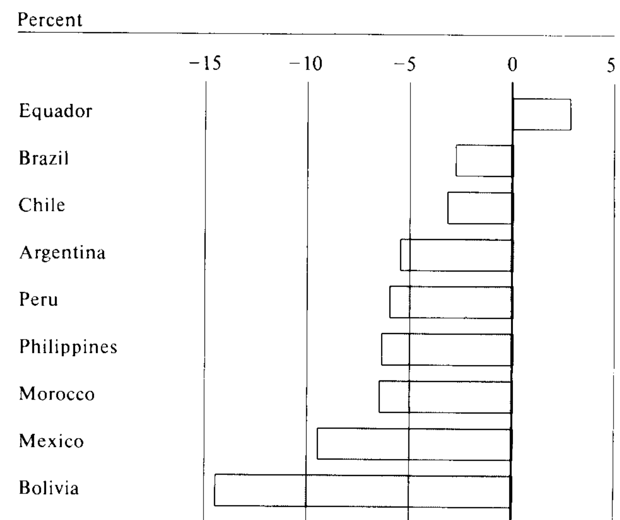
The Current Status of Reform

Several of these key LDC debtors have recently introduced, or are presently considering, meaningful tax reforms:

- ***Colombia*** has adopted major tax reforms over the past three years. A 1983 tax reform lowered rates, broadened the tax base, increased the revenue-generating power of local governments, tightened enforcement mechanisms, and introduced a limited tax amnesty. A value-added tax (VAT) was introduced in 1984.

- After more than four years of IMF prodding, ***Morocco***'s proposed tax reform package is scheduled to begin in April with a new VAT. This is the first of three new taxes that will replace the existing intricate and outmoded tax system. A corporate income tax is to be debated in parliament this spring, followed eventually by a personal income tax. Concern over the inflationary potential of the VAT could delay its implementation. Some government officials fear local retailers may use the VAT as a pretext to raise prices, an outcome that could spark civil unrest.

Selected LDC Debtors: Budget Balances as a Share of GDP, 1985



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- In ***Chile***, austerity has delayed reforms of personal and corporate income taxes. Although Santiago began annual phased tax rate reductions in 1984, it announced last fall that the personal income tax reductions scheduled for 1986 will be suspended for two years in an attempt to meet IMF deficit targets.

[1] Candidates for the Baker plan, which increases IMF lending to LDCs undertaking important economic reforms, are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

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- ***Peru*** announced tax rate reductions last December aimed at promoting economic growth while striving to minimize revenue losses. The government reduced top marginal rates from 65 to 45 percent on personal income and from 57 to 40 percent on corporate income. Since then, it has also lowered the VAT from 11 to 6 percent. Business deductions were tightened substantially to offset the revenue loss.

Another group of these countries has introduced limited tax reforms while pursuing revenue increases:

- ***Argentina*** imposed a forced savings scheme upon producers in 1985. The government also introduced progressive new taxes on transfers of stocks, bonds, and real estate. Tax revenues increased by 2.5 percent of GDP.

- ***Brazil***'s 1986 economic package closes some corporate loopholes and makes individual income taxes more progressive while seeking tax increases equal to 1.4 percent of GDP.

- ***Mexico***'s 1986 budget increases tax progressivity through a special tax on upper- and middle-income groups and higher taxes on nonessential goods. The government also promises to combat tax evasion while attempting to halve the budget deficit to 4.9 percent of GDP.

- ***Nigeria*** made minor changes in its income tax in 1985. Revenue from this source, however, remains minuscule.

- ***The Philippines***, under IMF pressure to reduce its deficit, is working to simplify its tax structure. A variety of minor tax changes announced in December will probably raise revenues slightly without introducing meaningful reform.

- ***Venezuela***, in a recent crackdown on widespread tax evasion, has substantially broadened withholding to apply to professionals and company subcontracting. Faced with falling oil prices, the government has also raised domestic gasoline taxes by 30 percent.

- In ***Yugoslavia***, where federal expenditures equal only 12 percent of all government outlays, Belgrade is likely to reduce taxes on earned income in 1986 and to increase taxes on unearned income such as interest and rent.

- In ***Bolivia***, the US Embassy believes this year's most likely tax innovation may be a heavy tax on individuals and corporations that had access to highly overvalued central bank foreign exchange during the Siles presidency. Because of heavy opposition to more taxation, the government is using nontax mechanisms to reduce sharply its deficit as a share of GDP. One mechanism likely to be abrogated in the Senate is the very unpopular "forced loan" that funds the retirement benefits of 15,000 government workers who will be displaced this year.

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In the other LDC debtors targeted by the Baker Initiative—Ecuador, Ivory Coast, and Uruguay—there is little or no evidence of government interest in tax reform.

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Outlook

We believe that, in response to donor pressure and economic necessity, growing numbers of LDC governments will seek over the next two years to implement significant tax reform. Nonetheless, the need to increase revenues to reduce budget deficits may severely limit the pace of tax reform. Additional external assistance tied to reform efforts, as proposed in the Baker plan, could accelerate tax reform by alleviating the revenue constraint and mollifying local political opposition.

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The progress of tax reform that we foresee among key LDC debtors may falter if economic growth in these countries slows before their budget deficits are brought under control, even if reform is tied to donor assistance. In that event, a deteriorating revenue picture would probably doom LDC tax reform for the next several years and reduce Third World economic prospects even further over the longer term.

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Briefs

Energy

Boom in Angolan Oil Exploration

The director of production for Angola's state oil company expects exploration in Angolan offshore waters to continue to boom during 1986 and 1987, [redacted]. Six foreign oil companies are leading the expansion:

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- Chevron-Gulf (US) will complete a two-year, $500 million expansion program by the end of 1986 and is beginning seismic studies to expand its area of production in 1987.
- Texaco (US) plans to lease an additional drill ship in April to develop a field discovered last November.
- Conoco (US) probably will sign an exploration agreement with Angola this month. It has released tenders for offshore seismic work and expects to drill six exploration wells beginning in October-December of this year.
- AGIP (Italy) will employ three offshore drilling rigs to develop a field discovered in late 1985 and approved by Angola for development in January.
- ELF-Aquitaine (France) will add two drilling rigs this summer to carry out the second phase of an exploration program begun in 1984.
- ESPA (Brazil and Belgium) is continuing a 12-well exploration program.

Largely on the basis of this exploration, some industry experts forecast a near-doubling of Angolan production by 1990 to 400,000 to 500,000 b/d.

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Mozambican Oil Agreement With Iran

Maputo probably will accept a recent Iranian offer of crude oil, despite its reluctance to accede to Iran's pressure for political support in the Iran-Iraq war. Mozambique has been desperately seeking new sources of oil since Iraq cut off shipments in 1981, according to US Embassy reporting. The Soviet Union has supplied 3,000 b/d—about 20 percent of requirements—since 1984. The agreement with Iran calls for deliveries of 10,000 b/d, with payment on easy, no-interest terms after a one-year grace period. These credit terms probably will prove irresistible to Maputo in light of its severe foreign exchange shortage and heavy foreign debt.

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Zimbabwean Interest in Oil Refinery Development

The government is moving forward with plans to either build a new oil refinery or refurbish its nonoperational refinery at Feruka [redacted]. Kuwait reportedly has offered to assist in developing a new refinery, while estimates place the cost of modernizing the Feruka refinery at $100-120 million. The government believes that high operating costs will be more than offset by substantial long-term foreign exchange savings. The US Embassy reports that Zimbabwe at present imports only refined petroleum products and spent 16 percent of its total export earnings—$185 million—on petroleum imports in 1984.

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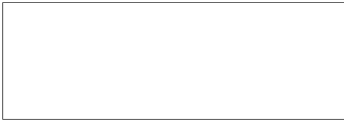
Albania Seeking Algerian Aid for Oil Industry



Foreign Minister Malile traveled to Algeria last week—the first bilateral official visit by an Albanian foreign minister since 1967—to request help for the nation's troubled petroleum industry. Tirane last month reported another drop in petroleum production during 1985 following an 18-percent decline from 1981 to 1984. Malile's meeting with Algerian oil officials coincided with a visit by Algerian petroleum experts to Albania. New Albanian leader Alia has given top priority to the petroleum sector. Oil products are Albania's leading hard currency export, accounting for 25 percent of earnings, and provide over half the country's energy needs. Tirane apparently hopes that Algeria, which has helped it obtain oil equipment in the past, will provide expertise and Western technology, probably on barter terms. Albania probably also views Algeria as an acceptable partner ideologically.

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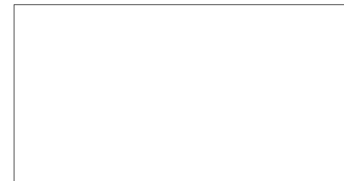
International Finance

Venezuelan Debt Rescheduling Set



Venezuela and its creditor banks are on track to sign accords in New York on 26 February to reschedule $21.2 billion in public-sector debt, . Maturities originally due in 1982-88 will now be repaid over the period ending in 1997. Another $4.1 billion in public debt—mainly owed to official lenders and bond holders—is not a part of the refinancing and is being repaid on schedule. There remains concern that the deal could misfire. implementation would be blocked if banks holding 5 percent of the rescheduled amount refused to go along. Some banks—mainly US regionals—are upset because the government has not guaranteed the foreign obligations of certain private Venezuelan debtors. A longer term threat to the accords is posed by the collapsing oil market. Venezuela is already negotiating an eleventh-hour amendment postponing $923 million in principal payments due this year under the original terms.

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New Threat to Moroccan Rescheduling

The refusal of a US bank to participate in the revamped 1983-84 London Club debt rescheduling could sabotage the entire accord. The bank reportedly wants more favorable terms for repayment of its $10 million loan. Embassy reporting indicates efforts are currently under way to convince the bank to reconsider its position, but that success is far from imminent. According to Moroccan Minister of Finance Jouahri, if the bank persists, Rabat will take back the $83 million paid to London Club donors to inaugurate the program and will force a complete renegotiation. Collapse of the 1983-84 rescheduling would aggravate Morocco's already precarious financial position and further strain relations with commercial creditors. Moreover, it could well derail the country's $200 million IMF standby and would almost certainly postpone discussions to reschedule debt obligations for 1985 and 1986.

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East Germany Moves To Cut Borrowing Costs

East Germany has requested "technical adjustments" to three loans syndicated in 1984-85 for $1.5 billion. [ ] the East German Foreign Trade Bank in late January asked creditors to convert the loans, much of which has not yet been drawn, to revolving credits for the entire terms of the loans, and to reduce annual fees and interest rates. Under the original terms, availability of undrawn funds expires next month. [ ] most lenders will accept the revised terms and that other syndication members will take the shares of banks electing to drop out. While East Berlin had been accepting comparatively costly terms in order to obtain large, oversubscribed loans, the East Germans apparently have concluded that their improved financial health puts them in a strong position to renegotiate better terms. Success in the effort will solidify East Germany's reputation as the most creditworthy East European country. [ ]

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Taiwan's Asian Development Bank Membership

Taiwan's leaders apparently have agreed on a strategy for staying—at least for now—in the Asian Development Bank. Recent articles in the party-controlled press indicate that Taipei will continue publicly to reject any name change while tacitly agreeing to the "Taipei, China" formula supported by the Bank. Taipei will not participate in any Bank meetings but will not formally withdraw. The Bank cannot expel members, and Taiwan's leaders appear to have decided that Taiwan's continued participation in the Bank outweighs any domestic gains it would make by withdrawing to protest China's admission. Because Taipei remains wary of appearing to have "negotiated" with the mainland over its membership, it may still withdraw from the Bank after Beijing becomes a member at the annual meeting of the Bank Board of Governors in April. [ ]

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International Trade

Japanese Trade Policy Study Group Report

The report of Prime Minister Nakasone's special advisory commission on trade policy—due in late March—will contain no major trade initiatives, according to our preliminary analyses. The US Embassy expects general policy guidance rather than specific "how to's." Recommendations will probably include tax incentives for consumption and investment, support for international efforts to limit exchange rate fluctuations, continued financial liberalization, and domestic demand expansion. Any reference to economic stimulus, however, will be tempered by the study group's strong support for Tokyo's five-year-old fiscal austerity effort. The Embassy also anticipates short-term measures, such as additional LDC financial assistance, to improve good will toward Japan in a time of increasing trade imbalance. The Japanese press has speculated that the group may recommend reducing the share of the current account surplus from 3.6 to 2 percent of GNP by 1990. Although Nakasone has made statements favoring a current account target, MITI and the Finance Ministry still strongly oppose numerical targets. [ ]

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Growing Chinese–Hong Kong Trade Ties

Hong Kong will open a trade promotion office in Beijing later this month, the colony's first official representation in China. A second office is scheduled to open in Shanghai before yearend. The opening of the trade office reflects the substantial growth in economic ties since the Sino-British accord to transfer the territory was signed in late 1984. Last year Hong Kong's exports to China increased 77 percent in the first 10 months of the year, counteracting a slump in exports to other markets. We estimate that two-way trade exceeded $15 billion in 1985, about 25 percent of Hong Kong's total trade. China displaced the United States last year as the colony's largest trading partner. Beijing has actively pursued closer economic links to promote the territory's stability and prosperity, but much of the increase in Hong Kong's exports has stemmed from China's trade decentralization, which has allowed localities to deal directly with foreign firms. China's recent efforts to cut its trade deficit may cause Hong Kong's exports to China to fall off in 1986.

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Global and Regional Developments

British and Soviets Renew Trade Accord

Moscow and London initialed a new five-year trade accord earlier this month, signaling a mutual desire to improve bilateral relations. The pact—a 1975 agreement expired last December—presumably will be formally signed when Foreign Minister Shevardnadze visits London this spring. The accord offers few specifics, emphasizing instead broad areas where trade could increase, such as construction projects. Although British trade officials do not expect any boom in trade as a result of the agreement, they hope at least to reverse the recent decline. According to UK statistics, bilateral trade in 1985 fell 20 percent from the previous year to roughly $1.8 billion. British firms also calculate that the accord will help them win bids for such Soviet projects as chemical plant construction, modernization of a textile factory, and a role in gas treatment and coal gasification projects.

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Swaziland To Quit Monetary Union With South Africa

Mbabane has negotiated a revision to the 1974 trilateral agreement with South Africa and Lesotho that effectively will remove Swaziland from a monetary union with those countries. Although retaining special access to South African capital and foreign exchange markets, Swaziland will no longer be required to back its currency 1 to 1 with the South African rand nor to accept the rand as legal tender. Swazi officials have stated that the move—which will allow some freedom to set interest rate policies—was prompted by the sharp decline of the rand last year. Lesotho probably will stay in the union.

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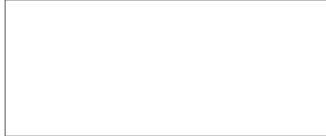
National Developments

Less Developed Countries

Salvadoran Austerity Protests



Both the far left and the far right are attempting to discredit President Duarte's administration by attacking his economic initiatives. Despite the government's efforts to cushion the impact of austerity on workers, Marxist labor leaders have called for demonstrations today that the Embassy expects will draw as many as 10,000 participants—organizers hope to mobilize well in excess of that number. [ ] the guerrilla leaders hope to foment a general strike by spring. Conservatives have also been vocal in their attacks on Duarte's economic policies, [ ] Despite pressure from economic advisers and international creditors to stand firm, Duarte will be hard pressed to ignore public demands as living standards are further eroded by austerity measures and escalating guerrilla destruction of economic targets. [ ]

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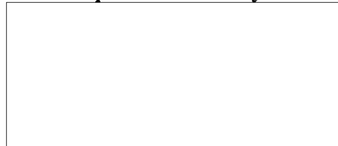
Guatemalan President Reluctant To Impose Austerity



President Cerezo is challenging his economic advisers to come up with imaginative policies that will not require further sacrifices by the poor, [ ]. Despite earlier indications, Cerezo now flatly refuses any devaluation or cuts in public services. In contrast, he supports lowering gasoline prices because of lower world oil prices. Cerezo hopes to meet financial requirements by hiking luxury taxes, improving tax collection, and relying on possible increases in foreign aid. Cerezo's populist leanings are splitting the cabinet and have encouraged the emergence of a "social group" that is increasingly opposed to the social costs of the austerity proposals, [ ]. Cerezo's efforts to protect the poor may win him temporary public favor, but they are likely to discourage business leaders and international creditors, and make future economic adjustments more painful. [ ]

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Libyan Agriculture Hurt by Sanctions

Libya has been forced to cancel at least one major seed order with a US supplier because of US sanctions. [ ] Libya cannot arrange legal payment under US trade restrictions for 800 metric tons of seed for the Kufra agricultural project. The delay probably precludes planting during the spring cycle at the desert project, which accounts for about 20 percent of Libya's annual production of beans and onions. Libya has no domestic seed production capability and prefers US seed, which has superior germination and yield compared with European stock. The anticipated shortfall will exacerbate already serious food shortages in Libya, [ ] a recent food riot in Banghazi involving 10,000 angry women resulted in substantial damage to state-operated facilities. [ ]

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Moroccan Phosphate Strike Fading?

Senior management at the Youssoufia mine maintains the five-week-old strike by some 5,000 miners is winding down. Mine officials report more than 70 percent of the workers have already returned to their jobs—at a rate of 100 to 200 daily—and that the majority are now indifferent to union demands. Union leaders, however, insist the strike is far from over and are continuing to mobilize support in country and abroad. Embassy reporting indicates that, even if management's claims are exaggerated, it now appears unlikely that a settlement involving any kind of union recognition—the primary objective—will emerge. Moreover, although most detained workers will probably be released after the strike ends, few are likely to be reinstated as the union has demanded. With sizable stocks of phosphate on hand, the company can probably outlast even a prolonged strike.

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Pakistani-Islamic Banking

Falling dividends on non-interest-bearing savings accounts pose new problems for Pakistan's Islamic banking system. The US Consulate in Karachi reports that earnings on deposits in domestic banks were a maximum 7.8 percent during June-December 1985 compared with 8.5 percent for the preceding six months. Foreign banks in Pakistan, in contrast, are offering rates of up to 12 percent. The lower domestic bank returns probably reflect higher operating costs and loss of funds to government bonds that pay as much as 15 percent. A sustained dropoff in dividend rates will probably discourage new savings and embarrass Islamabad's efforts to showcase its Islamic banking program. The government could be forced to subsidize domestic banks in order to keep returns competitive and maintain the viability of Islamic banking.

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China Controlling Electronics Trade

Beijing's concern over excessive reliance on imported electronics goods and its inability to absorb foreign technology is growing.

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Reportedly, of 33 imported production lines, only one is partially usable; the rest cannot be used at all. In the future only traders subordinate to the Ministry of Electronics Industry may import finished microelectronics goods, and purchases of foreign production lines must include provisions for training and technology transfer. Greater central control over some electronics imports will enable China to purchase more selectively—protecting the domestic industry and curtailing substandard imports. Attention to training personnel to operate and service imported production lines will improve technology absorption and help China to approach its stated goal of self-sufficiency in microelectronics production by 1990.

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