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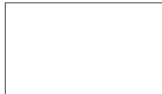

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Synopsis

1 **Perspective—*Persian Gulf Oil: The Dependency Issue*** 25X1

Despite their varied levels of dependence, all industrialized countries have a stake in the continued flow of oil from the Persian Gulf. Past supply disruptions were complicated by a number of factors, including panic reactions by dependent consumers that prompted a scramble among competing governments and imposition of price and export controls. Averting panic buying in the future will require that market players—including governments and companies—have reliable information both before and during a crisis. 25X1

15 **The Oil Market Outlook Through 1985** 25X1

Barring an oil supply disruption because of the Iran-Iraq war, the oil market probably will remain soft. 25X1

25 **Kuwait: Reverberations of the Stock Market Crash** 25X1

The crash of Kuwait's unofficial stock market in August 1982 continues to have adverse financial, political, and social effects in a country that is trying to cope with declining oil revenues, the Iran-Iraq war, recent bombings, and an increasingly restive Shia population. 25X1

29 **Pakistan: Economic Downturn Appears Manageable** 25X1

Pakistan's economy is likely to grow more slowly in the fiscal year ending 30 June than in any year since President Zia came to power in 1977. Despite deterioration in the economy's performance, we believe that it is unlikely that the economy by itself will cause serious political problems for Zia, and he has already taken steps to demonstrate he is dealing with the situation. 25X1

33 **International Financial Situation: Private Capital Flows to Asian NICs** 25X1

This article in our series on the economic and political aspects of the international financial situation examines the favorable outlook for private capital flows to Hong Kong, Singapore, South Korea, and Taiwan. 25X1

35 **Second-Tier LDCs: Potential NICs** 25X1

The emergence of new LDC exporters of manufactured goods over the longer term is likely to increase competition in several industries and could spark complaints by industrial-country producers. 25X1

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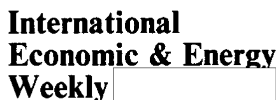

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Perspective

Persian Gulf Oil: The Dependency Issue

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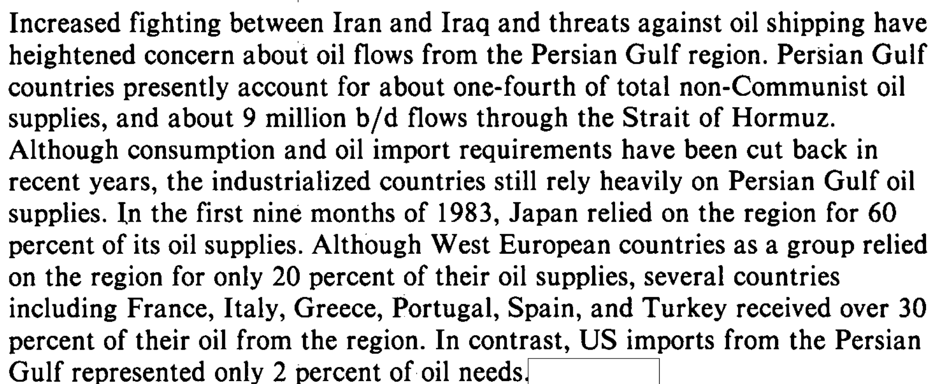

Increased fighting between Iran and Iraq and threats against oil shipping have heightened concern about oil flows from the Persian Gulf region. Persian Gulf countries presently account for about one-fourth of total non-Communist oil supplies, and about 9 million b/d flows through the Strait of Hormuz. Although consumption and oil import requirements have been cut back in recent years, the industrialized countries still rely heavily on Persian Gulf oil supplies. In the first nine months of 1983, Japan relied on the region for 60 percent of its oil supplies. Although West European countries as a group relied on the region for only 20 percent of their oil supplies, several countries including France, Italy, Greece, Portugal, Spain, and Turkey received over 30 percent of their oil from the region. In contrast, US imports from the Persian Gulf represented only 2 percent of oil needs.

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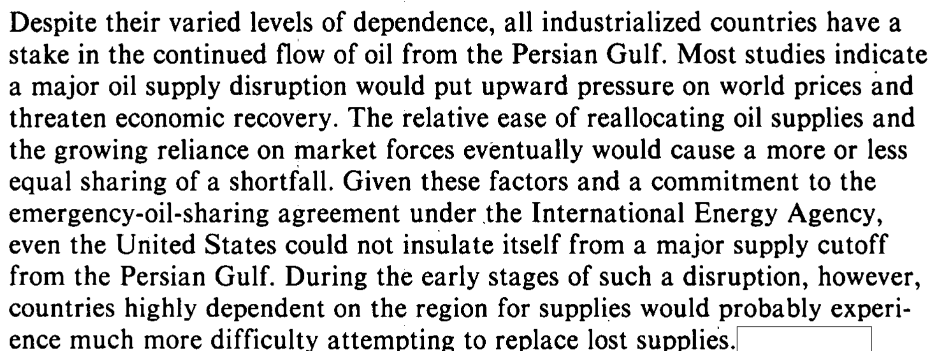

Despite their varied levels of dependence, all industrialized countries have a stake in the continued flow of oil from the Persian Gulf. Most studies indicate a major oil supply disruption would put upward pressure on world prices and threaten economic recovery. The relative ease of reallocating oil supplies and the growing reliance on market forces eventually would cause a more or less equal sharing of a shortfall. Given these factors and a commitment to the emergency-oil-sharing agreement under the International Energy Agency, even the United States could not insulate itself from a major supply cutoff from the Persian Gulf. During the early stages of such a disruption, however, countries highly dependent on the region for supplies would probably experience much more difficulty attempting to replace lost supplies.

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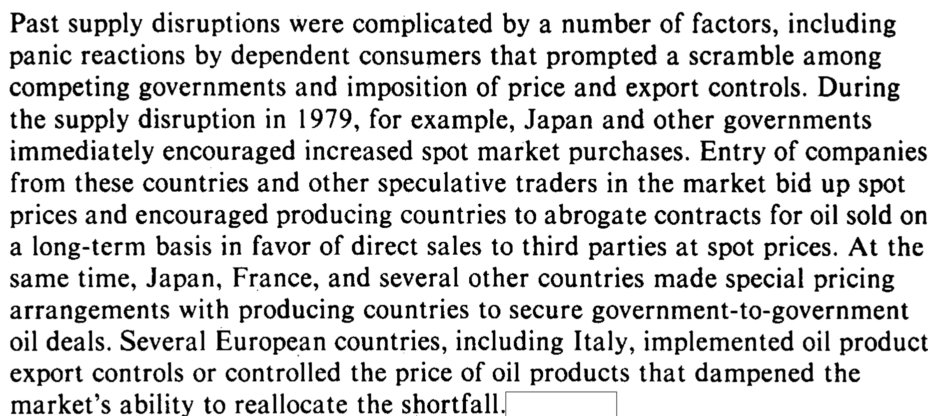

Past supply disruptions were complicated by a number of factors, including panic reactions by dependent consumers that prompted a scramble among competing governments and imposition of price and export controls. During the supply disruption in 1979, for example, Japan and other governments immediately encouraged increased spot market purchases. Entry of companies from these countries and other speculative traders in the market bid up spot prices and encouraged producing countries to abrogate contracts for oil sold on a long-term basis in favor of direct sales to third parties at spot prices. At the same time, Japan, France, and several other countries made special pricing arrangements with producing countries to secure government-to-government oil deals. Several European countries, including Italy, implemented oil product export controls or controlled the price of oil products that dampened the market's ability to reallocate the shortfall.

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Uncertainty over the magnitude and duration of an oil supply disruption frequently encourages speculation and panic among market participants. In our view, developments in recent years indicate these general reactions are more likely to be amplified because of a lack of reliable information. Reduced company access to producing countries—especially in the Iran-Iraq region—adds to market uncertainty because many companies no longer have personnel in the field to report on developments. Moreover, as demonstrated in the current Iran-Iraq war, there are an increasing number of attacks that are directed against oil facilities, and accurate information on the extent of damage and its consequences is often not immediately available. In addition, countries with a high level of dependence on disrupted supplies frequently have limited access to reliable information and may be forced to act solely on the basis of rumors. Speculators in search of profits tend to aggravate market conditions by reacting to similar rumors about damage or attacks. Although compulsory or government-owned stocks and the IEA oil-sharing scheme could dampen these pressures, the market may not be convinced either would be used in a disruption. Commercial oil stocks, which might also be used to help dependent countries mitigate an oil cutoff, presently are reported to be near the low end of the normal operating range,

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Averting panic buying will require that market players—including governments and companies—have reliable information both before and during a crisis. Public access to information about the magnitude of a supply cutoff, the extent of any damage, and the availability of surplus productive capacity, energy substitutes, and stockpiles, would help the market react effectively. Moreover, consultations among producing and consuming countries as well as oil companies to evaluate and exchange information would help to minimize panic reaction. A major accomplishment of the International Energy Agency, for example, has been its role as a source of information during past disruptions. In addition, recent statements by the United States that it will use its strategic petroleum reserve in the early stages of a disruption probably will ease market uncertainties.

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Briefs

Energy

Developed Countries' Dependence on Persian Gulf Supplies

The industrialized countries have cut oil consumption and imports particularly from the Persian Gulf region. Despite reductions in imports from the region—from nearly 15 million b/d in 1979 to approximately 6 million b/d last year—several industrialized countries rely on the Persian Gulf for more than one-third of their oil needs.

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Major Developed Countries: Estimated Dependence on Persian Gulf Oil Imports, January-September 1983

Thousand b/d

	Iran	Iraq	Kuwait	Qatar	Saudi Arabia	United Arab Emirates	Total Persian Gulf Oil	Total Developed Country Supply [a]	Persian Gulf Oil as a Share of Supply (*percent*)
Total	**1,282**	**407**	**363**	**208**	**2,716**	**948**	**5,924**	**36,627**	**16**
United States	59	10	9	NEGL	252	26	356	15,061	2
Japan	352	12	105	144	1,264	604	2,481	4,160	60
Canada	34	0	5	0	8	0	47	1,893	2
Western Europe	837	385	244	64	1,192	318	3,040	15,513	20
West Germany	47	26	27	6	145	30	281	2,290	12
France	88	25	19	20	294	128	574	1,860	31
Italy	229	111	90	10	227	66	733	1,880	39
United Kingdom	11	17	13	0	114	22	177	3,060	6
Austria	1	0	0	0	27	0	28	195	14
Belgium/Luxembourg	8	37	1	3	38	0	87	723	12
Denmark	3	0	18	0	4	0	25	266	9
Finland	7	0	0	0	11	0	18	243	7
Greece	8	24	0	0	97	0	129	339	38
Netherlands	118	3	67	3	47	9	247	1,591	16
Norway	0	0	0	0	5	0	5	684	1
Portugal	25	19	0	0	49	7	100	208	48
Spain	163	45	0	22	99	54	383	1,096	35
Sweden	16	0	0	0	1	0	17	476	4
Switzerland	1	0	0	0	10	2	13	255	5
Turkey	112	78	9	0	24	0	223	347	64

[a] Production plus imports.

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Shipping Markets Respond to Persian Gulf Tensions

Iraq's recent air attacks on ships in the Persian Gulf have led to increases in both charter rates for tankers loading in the Gulf and war risk insurance premiums for oil tankers and cargoes coming out of Khark Island. These costs will add as much as 60 cents per barrel to the delivered cost of Iranian crude. According to the shipping press, charter rates for shipments from Khark to Western Europe have risen 65 percent since 29 February from 66 cents per barrel to $1.09 per barrel; this is close to the level reached last October following Iraq's acquisition of Super Etendards. Rates out of Arab ports on the Gulf have risen as well, but only by 32 percent. [ ] [ ] war risk premiums on cargoes shipped from the Khark terminal have gone up from their October level of 14 cents per barrel to 21 cents per barrel. Premiums on tankers themselves have doubled from their 1983 level last fall of 4 cents per barrel to 8 cents per barrel as of this week. The premium boost for this coverage, which is payable by the tanker owners, probably will be passed on in further charter rate increases. [ ]

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Iranians Occupy Iraqi Oilfield

[ ] confirms recent press reports that the Iranians now occupy Iraq's Majnoon oilfield north of al Basrah [ ] [ ] Iranian engineering unit building a pontoon bridge across the marshy area and traveling across the oilfield area in boats. There is no visible damage to the 28 oil wells. The Majnoon field was under develoment by Petrobras of Brazil, but work had halted last summer because of the field's proximity to the war-torn border. Iran may try to retain control and produce oil from Majnoon, whose potential reserves have been reported as high as 10 billion barrels. Parliamentary Speaker Rafsanjani claims that revenues as high as $150 billion would accrue from exploiting Majnoon, and Tehran would use the revenue as war reparations. Iranian officials expect fierce fighting at Majnoon as Iraq seeks to regain its territory, according to press reports. Should Iran damage the wells, this could become a contributory factor provoking Iraq to attack Iranian oil facilities. [ ]

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Delay in Iraqi–Saudi Arabian Pipeline Agreement

Negotiations to complete the agreement for construction to connect the Iraqi export pipeline with the Saudi Petroline have stalled, [ ] [ ] Late last month, petroleum officials from the two countries discussed Saudi concerns about the proposed project. The Iraqi Second Deputy Petroleum Minister refused after the meeting to comment on the reason for the delay but reaffirmed Iraq's interest in moving ahead. [ ]

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Riyadh continues to have apprehensions despite having agreed in principle last year to the Petroline link. With the recent intensification of the war, the Saudis may fear more visible cooperation with Baghdad would increase the risk that Iran would attack Saudi oil facilities. The delay in completing the Iraqi-Saudi agreement also may be caused in part by recent reports that Iraq and Jordan are near agreement on an Iraqi export pipeline to Al Aqabah—an alternative that bypasses Saudi territory. [ ]

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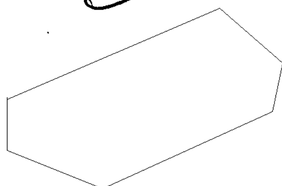
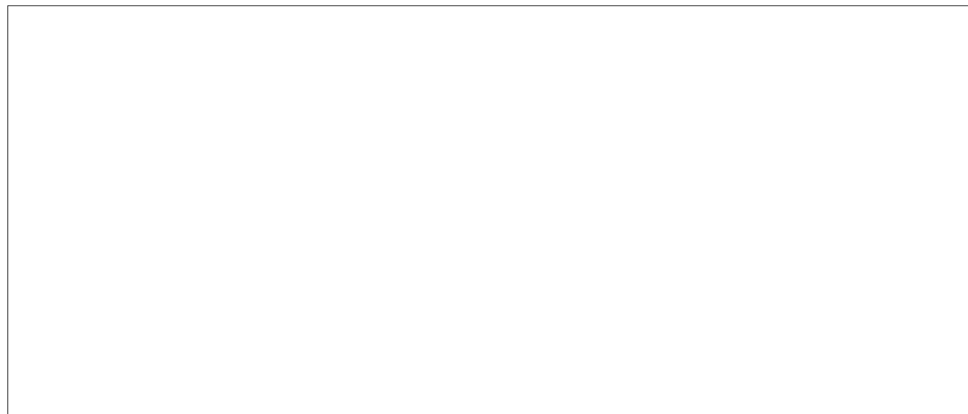
Nigerian Production Exceeds Quota





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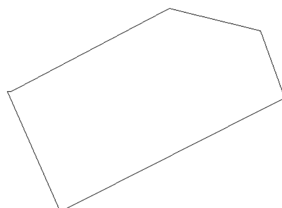
Nigeria Rescinds Ban on Gas Flaring



In a recent meeting with oil company executives, Nigeria's new Minister of Petroleum and Energy, Dr. Tam David-West announced suspension for one year of Nigeria's ban on natural gas flaring that was intended to become effective at the start of 1984. Oil companies have been forced to flare about 30 million cubic meters of gas a day, worth an estimated $2 billion per year, because Nigeria lacks an extensive domestic gas market, gas reinjection plans, or a commercially viable gas export project. Royal Dutch Shell—Nigeria's largest oil and gas producer—has argued against the ban, claiming gas reinjection would cost the firm $1.7 billion annually, 80 percent of which would have to be paid by Nigeria's national petroleum company

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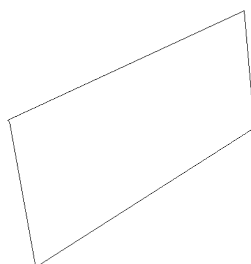
Projected Rise in EC Energy Consumption



Energy consumption in the European Economic Community is expected to rebound this year after four years of decline, according to a recent study by the EC Commission. Overall consumption is expected to rise by 1.3 percent in response to a nearly 2-percent rise in real GNP. Natural gas and nuclear power are expected to account for most of the rise in energy demand. Nuclear

EC Energy Consumption, 1983-84 *Million b/doe*

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	1983	1984 (Projected)
Total	**17.4**	**17.6**
Oil	8.2	8.2
Coal	4.1	4.1
Natural gas	3.2	3.3
Nuclear	1.6	1.7
Hydro and other	0.3	0.3

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consumption is expected to increase 11.5 percent as new reactors come on line, while growth in gas demand is projected at 2 percent. Oil use is expected to remain fairly steady at about 8.2 million b/d after falling from 10.8 million b/d in 1979.

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Results of Norway's Eighth Licensing Round

Norway recently completed its eighth licensing round, which resulted in awards for 14 offshore blocks. In a departure from the last three rounds when only Norwegian oil companies were named as operators, foreign oil companies were made operators on almost half of the blocks awarded this year. Most of the interest centered on block 34/7—also known as the Diamond Block—which is believed to contain up to 2 billion barrels in oil reserves. Saga Petroleum, a Norwegian company, was named as primary operator on 34/7, and Esso was named as co-operator and technical assistant. Although the Norwegian Petroleum Directorate appears satisfied with the industry response to this latest licensing round, a growing number of oil companies believe that Norwegian taxes soon will have to be modified for Oslo to continue to attract foreign oil investors.

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United Kingdom Announces Ninth Offshore Licensing Round

In an effort to increase the pace of exploratory drilling on the UK continental shelf, the UK Department of Energy has announced that this spring it will offer about 180 offshore blocks for licensing. About 80 of these blocks are expected to be awarded in early 1985. Many new areas are expected to be offered, including blocks in the English Channel, Celtic Sea, West Shetlands Basin, and far north areas. Most of the block awards will be made on a discretionary basis, but about 15 blocks in the northern North Sea area will be auctioned. Energy Department officials have stated that awards for blocks considered most promising will take into account the willingness of bidders to take shares in higher risk concessions. Officials reportedly plan to encourage industry interest in "frontier" areas by including more acreage per block and allowing additional time to assess seismic data. Given the current positive climate in the United Kingdom for petroleum investment, we expect a high degree of industry interest.

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British Petroleum Announces New Gas Find

The British Petroleum Company (BP) has announced the discovery of four gasfields with estimated total recoverable reserves of about 70 billion cubic meters. The fields are located in the southern sector of the United Kingdom's North Sea area and are near existing facilities at BP's West Sole gasfield. The company estimates development costs of the new finds at $1.9 billion and is currently negotiating a sales agreement with the British Gas Corporation and other buyers. According to a spokesman for the firm, production could begin in 1987 and peak in the early 1990s at about 4 billion cubic meters per year. Given current industry projections of growth in UK gas demand over the balance of the decade and the expected decline in output from other domestic gasfields, we expect BP will successfully market the gas in the United Kingdom.

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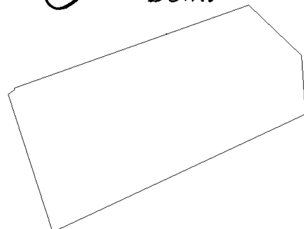
Austrian Gas Consumption Down



Austrian natural gas consumption is unlikely to grow sufficiently through 1987 to use contracted levels of Soviet gas. Demand for gas has declined nearly 15 percent since 1978 and has caused the Austrian State Oil Company to reduce domestic production and delay acceptance of the first Soviet deliveries under a 1982 contract until later this year. Under earlier contracts, the USSR is providing 2.5 billion cubic meters (m^3) annually—almost 60 percent of Austrian consumption. The 1982 contract calls for delivery this year of an additional 500 million m^3, rising to 1.5 billion m^3 annually during 1987-2008. Austria will have to curtail domestic gas production further if it is to fulfill its Soviet purchases.

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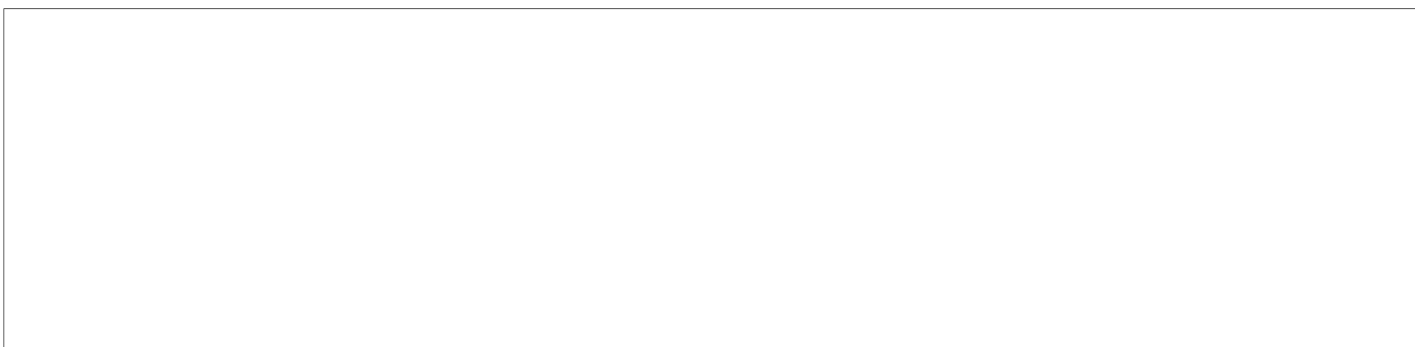

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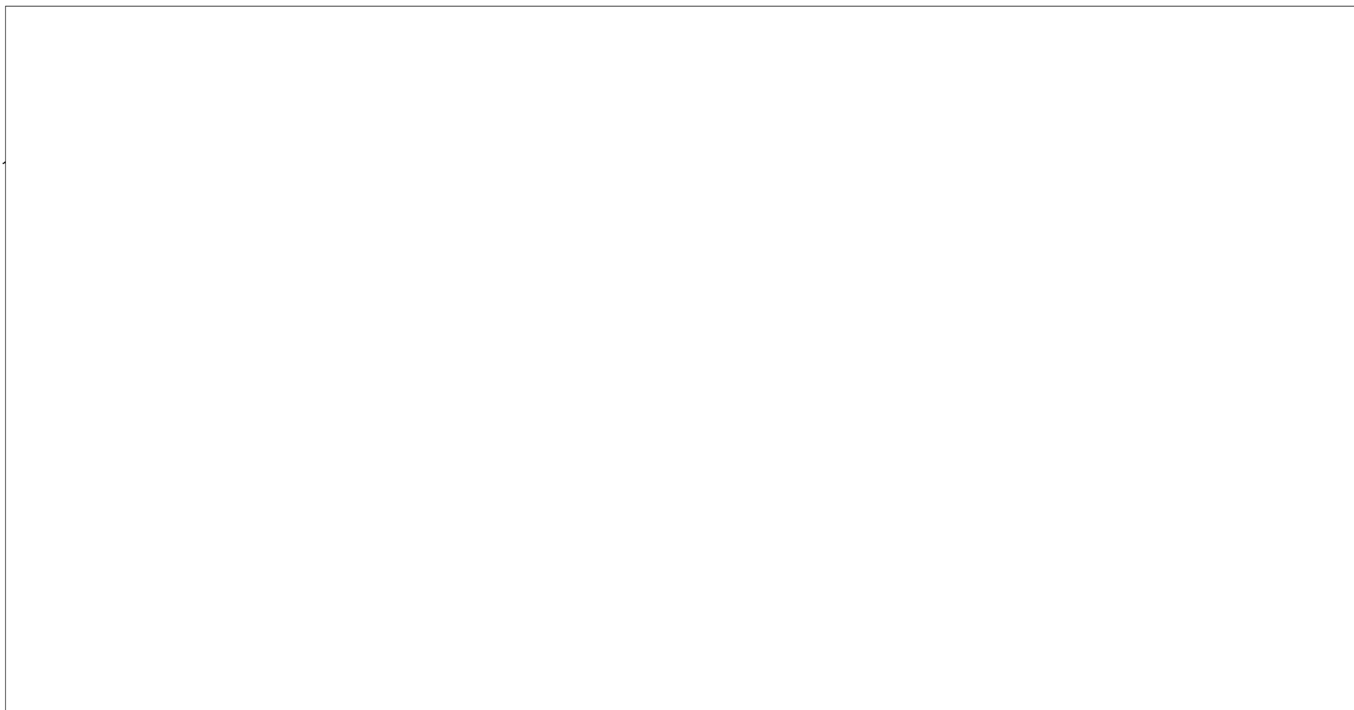
International Finance



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France and Saudi Arabia Aid Iraq

France and Saudi Arabia recently made new financial commitments to Iraq, possibly as a result of the recent increase in fighting. Press reports state that the Iraqi First Deputy Prime Minister, during his visit to Paris last week, secured a promise of about $1 billion in new credits. Last year Iraq failed to pay all its debts incurred to France, which included about $1 billion in loans for civilian contracts. As Iraq's largest Western arms supplier, France views its support of Iraq as essential to prevent an Iranian victory. The French also want to protect their already sizable financial stake and political influence in Iraq. The new loan probably is intended to pay for civilian contracts rather than military equipment, for which Paris insists on cash payments. 25X1

25X1 The Saudis, along with Kuwait, also are selling about 250,000 barrels per day of their oil for Iraq's benefit. The Saudis probably hope their money will help restrain Iraq from attacking Khark Island or shipping in the Gulf and prevent a widening of the war. 25X1

Saudi Arabia's New Financial Instrument

The 91-day debt instrument issued by the Saudi Arabian Monetary Agency (SAMA) in mid-February is a first attempt to establish monetary tools, but was met with a mixed reception by local bankers, according to the US Embassy. SAMA is offering $100 million of the Bank Security Deposit Accounts each week, with the subscription limited to Saudi commercial banks. The first issue was only about 80 percent subscribed, but sales subsequently increased. Bankers have been reluctant to participate because the yield is about one-half percentage point below the Bahrain Interbank Offer Rate. Moreover, some bankers probably are uneasy because the new issue violates the Islamic prohibition against usury; the government has not publicized the interest-earning securities. 25X1

SAMA's main goal in the new issue is to increase control over the Kingdom's money supply. The government also intends to use the debt instrument to offer local investment opportunities and draw riyals out of Bahraini banks. The SAMA issue follows the sale of $600 million in shares by the Saudi Arabian Basic Industries Corporation, and we expect other government-controlled companies also will begin to issue stock. These measures, however, are unlikely to produce sufficient revenue to ease significantly Riyadh's current budget squeeze. 25X1

Bankers Signal Confidence in Indonesia

International bankers have increased Jakarta's latest syndicated loan from $600 million to $750 million because of Indonesia's successful implementation of austerity policies during the past year, according to financial press reports. Jakarta originally sought a loan of $500 million to further strengthen its international reserve position and maintain confidence in the rupiah. The bankers, however, have been attracted by Indonesia's ability to boost official reserves from about $3 billion in March 1983 to $4.5 billion by yearend

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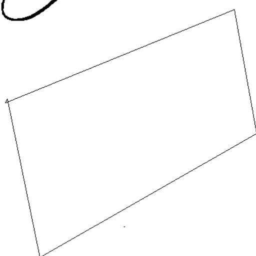
without incurring serious domestic social problems as a result of austerity. Jakarta, however, is paying slightly higher spreads this year; about three-fourths of the new loan will be priced at 0.75 percentage point over LIBOR and one-fourth at 0.2 percentage point over US prime. Although the increase in the syndication will push Jakarta's borrowing for its fiscal year ending 31 March above the $2.5 billion Jakarta originally planned, bankers expect the Indonesians to accept the larger amount. 25X1

Argentine Financing for Nicaragua

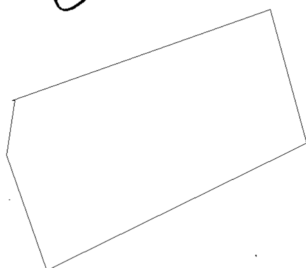
Argentina reportedly will open a $40 million line of credit for Nicaragua, primarily for the purchase of Argentine foodstuffs, and will donate $5 million in commodities, probably grains. If Nicaragua makes full use of the credit, it would represent a substantial boost in Argentine financing; we calculate that last year Buenos Aires committed only $17 million in funds to the Sandinistas. Argentina probably hopes to strengthen Nicaragua's ties with the West and ensure that Argentina's support for political pluralism will get a hearing in Managua 25X1 25X1

Costa Rica Requests Paris Club Rescheduling



Faced with the prospect of exhausting its foreign exchange within three weeks, Costa Rica has announced that it will not pay any of the $100 million falling due this year on its debt to foreign governments, and has requested a meeting of the Paris Club to reschedule these obligations. San Jose's attempts to secure temporary bridge financing from foreign commercial banks until IMF and US aid disbursements are made later this year are meeting resistance. According to the US Embassy, one leading US bank believes that such financing would merely defer the crisis a few months. Although San Jose's failure to devalue the colon as much as the IMF had recommended last year is largely responsible for the current crisis, a devaluation now would not cut import spending significantly before May. The government probably will resist a further devaluation anyway because of union pressures to ease austerity measures. 25X1 25X1

Ecuadorean Debt Negotiations at Impasse



Quito will seek to renegotiate the terms of its recent agreement in principle with creditor banks to reschedule debt repayments due in first-half 1984, This decision is motivated by more favorable terms received by other Latin debtors in recent negotiations with bankers. Ecuador now would like its debt rescheduled over a 10-year period at an interest rate of 1.5 percentage points over LIBOR and with a more than four years' grace period. Currently the terms offered by the banks are eight years at 2 percentage points over LIBOR with four years' grace. Moreover, Quito plans to seek $250 million from bankers and an equal amount from multilateral organizations and Western governments to close its projected $500 million foreign financing gap for 1984. creditor banks are refusing to provide new funds until a new IMF austerity program is in place. This will not occur until after the next government takes office in August. 25X1 25X1 25X1 25X1 25X1

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Ivorian Debt Reschedulings Awaiting IMF Agreement

Ivory Coast is seeking to alleviate some of its foreign payments strains, but current negotiations with bankers are stalled until Abidjan and the International Monetary Fund agree on a $90 million one-year standby program. A decision by the IMF is expected next month. Bankers are discussing rescheduling $300-400 million; another $600 million in government-to-government debt is under consideration for rescheduling through the Paris Club. Even if all the reschedulings are approved, Ivory Coast still may seek new loans this year.

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Global and Regional Developments

Canada Drops Airbus A320 Negotiations

Ottawa has abandoned its 18-month effort to negotiate Canadian participation in the Airbus A320 consortium because it was unable to secure a "meaningful" amount of production for Canadian companies. In his announcement on 28 February, Industry Minister Ed Lumley expressed his dissatisfaction with the package offered by the European Airbus consortium, stating specifically that it failed to provide Canadian firms with high-technology work. Ottawa had been seeking a 10-percent share of A320 production, but existing allocations to the European members precluded that level of Canadian involvement. Ottawa had hoped that participation in the Airbus consortium would improve the financial position of Canada's two airframe manufacturers—Canadair and De Havilland—which together lost $1.4 billion in 1982. Although efforts to involve these two companies in the Airbus project have been discontinued, Lumley said that other firms would continue to seek subcontract work on the aircraft. Given European demands for domestic production, however, Canadian prospects are dim. Ottawa's present pique at being excluded from the project is likely to send Air Canada's future orders for narrow-bodied, medium-sized aircraft to Airbus competitors because Ottawa had stated early in negotiations that purchase of the A320 would hinge on Canadian participation.

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West German Government Moves To Fund A320

The West German Cabinet has decided to provide DM 1.5 billion ($575 million) in loans over the next six years to help fund development of the German portion of the 150-seat A320 Airbus. The German consortium partner, Deutsche Airbus, will have a 28-percent share of the $2.4 billion cost of launching the aircraft, somewhat lower than the 37.9 percent originally foreseen. Doubts about A320 profitability delayed the Cabinet decision for nine months, and the commitment was made only after Deutsche Airbus concessions limited Bonn's exposure to potential losses by reducing the German share and increasing risk sharing by industry. A decision to support the FRG aircraft industry probably was the decisive consideration. The main German firm, Messerschmitt-Boelkow-Blohm (MBB), is financially weakened because of low demand for the earlier A300 and A310 models and needs another project to maintain its work force. After the losses suffered on earlier models, the Federal Economics Ministry questioned both the market potential of the A320 and the wisdom of public support. Ministry qualms apparently were overcome by industry champion Franz Joseph Strauss, Chairman of

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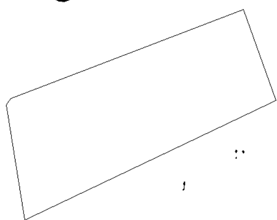
Deutsche Airbus and Minister-President of the state of Bavaria, where most construction will take place. Strauss has pointed to the need to have suitable aircraft in production to meet expected replacement demand at the end of the decade and thus prevent a US aircraft monopoly. 25X1

Honda's Plans for US Investments



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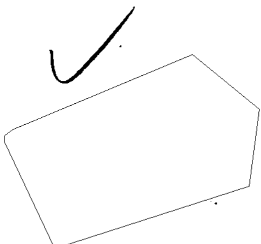
Honda Motor Company is considering new investments in the United States because the firm expects domestic content laws. the company plans to build a new facility in 1986 to produce both automobile and motorcycle engines near its Marysville, Ohio, auto assembly plant. With engines built in the United States, the domestic content of the cars to be manufactured at the Ohio plant could exceed 80 percent. In addition, company executives believe the motorcycle engine production will allow Honda to sell motorcycles without voluntary restraints. Honda also is investigating new auto production sites 25X1 25X1 25X1

South Korean Plans To Expand Auto Production

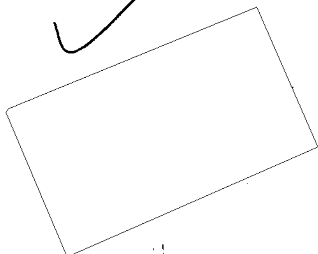


According to press reports, Daewoo and General Motors are near final agreement on a major expansion of their joint-venture facility in South Korea. General Motors reportedly will invest about $100 million to expand by 1986 the facility's annual productive capacity to 167,000 units, of which about half will be sold abroad—primarily in the United States. GM dealers in the United States will market the automobiles. We believe the expansion project will strengthen South Korea's auto industry through the acquisition of more advanced technology and increased economies of scale. In addition, the agreement probably will improve South Korea's foreign investment image, which has been tarnished by the withdrawal of several major investors in recent years. In the early 1980s, disagreements between GM and the Korean Government were widely publicized and contributed to investor concerns about doing business in Korea. 25X1 25X1

National Developments

Developed Countries

Turkey Selling State Enterprises



A new law allowing the government to sell inefficient state enterprises to private firms carries potential political liabilities for Prime Minister Ozal. The new legislation is consistent with other moves by Ozal to make the economy more responsive to market forces. It is likely to please organizations, such as the World Bank, which have long advocated reforming the state-owned firms. The firms account for nearly half of Turkey's industrial production and are widely viewed as a major impediment to improved economic performance. Ozal wants to funnel the proceeds into development projects he believes eventually will reduce Turkey's high unemployment. 25X1

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The law could become the most controversial part of Ozal's economic program and an issue in the local elections later this month. It is a dramatic departure from the tradition of heavy state involvement in the economy. Opposition

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leaders on the left and the right of the governing Motherland Party have criticized the measure. Ozal could suffer politically if private investors buy state firms and then fire workers. Layoffs would anger the labor unions, which are already asking for large wage increases and will soon be allowed to strike. Moreover, Ozal may have difficulty selling some of the firms, particularly those that are overstaffed and poorly managed.

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Less Developed Countries

Philippine Sugar Reforms Inadequate

The dismantling of the government monopoly on sugar trading late last month probably will not restore free trade to the domestic or export market any time soon. Planters must decide by the end of March whether to sign five-year contracts that allow the National Sugar Trading Corporation (Nasutra), Manila's official trading arm, to continue to represent them in the sale of sugar in the Philippines and abroad. Planters who do not sign with Nasutra will lose access to the US market—which took approximately $180 million in Philippine sugar last year—and to favorable long-term contracts negotiated in 1980 at almost four times the current spot-market price. They also will risk foreclosure or losing crop financing from sugar czar Roberto Benedicto's Republic Planter's Bank—the principal source of crop loans.

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Restoring free trade to the sugar industry has long been a demand of sugar planters and the business community. They charge that President Marcos's close friends have enriched themselves at their expense through the control of key domestic and foreign markets. Recently these critics have been joined by the World Bank, which is calling for abolishing the state agricultural monopolies as part of a loan package aimed at reforming the agricultural sector. Under the restructuring conditions imposed by Manila, we believe most planters have little choice but to sign contracts with Nasutra, thereby placing real reform of the sugar industry on hold.

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Tunisian Economic Problems Could Cause Cabinet Changes

Continued unrest since the bread riots in January has prompted President Bourguiba to consider key cabinet shifts in an effort to placate the populace.

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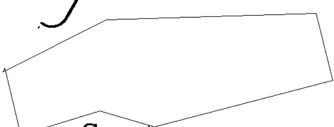

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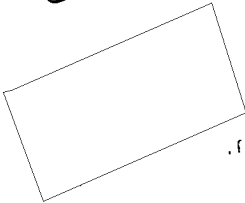
The riots unleashed the frustration of workers who are angry with the government's procrastination in addressing labor demands. Union leaders, who supported the government during the riots, have begun to lose control of workers. Over the past three weeks, strikes by bank, postal, and communications workers as well as teachers and other public employees have disrupted city services. Labor leaders are unlikely to reassert discipline unless the government agrees to costly wage increases. Moreover, the US Embassy reports the government may be backing away from the phased 20-percent increase in the price of bread it announced after the riots. Instead, it is now considering a single symbolic increase of 5 to 10 percent. 25X1

Strikes Continue in El Salvador



Public-sector workers have rejected the government's offer of a 10-percent wage increase, and more organizations may join the unions that are on strike. According to the US Embassy, a general strike could develop, paralyzing the capital and other urban centers. Waterworkers are among those on strike, and water is being cut off in some sections of the capital and in other cities. To prevent sabotage, Army units are guarding water facilities. 25X1

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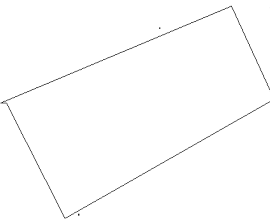
The insurgents reportedly have been planning to use leftist labor unions to disrupt the presidential election, and the striking unions are unlikely to accept any new proposals offered by the government. To maintain public services during the crucial election period, the government may detain strike leaders and place utilities under military control. 25X1

Communist

Criticism of Economists in USSR



Pravda recently published a decree—the first under General Secretary Chernenko's leadership—that criticizes the Institute of Economics in Moscow for superficial analysis of economic problems. The Institute is instructed to focus its research on current problems and to prepare recommendations for economic experiments that are acceptable under the Soviet system. 25X1

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The decree almost certainly is intended as a general criticism of Soviet economists for not producing politically, ideologically, and bureaucratically satisfactory proposals. At the plenum of the Central Committee last June, Chernenko criticized economists for dragging their feet in preparing realistic solutions. Publication of the decree underscores the leadership's intention to redirect economic research toward analyses that are politically more practical and to introduce and evaluate economic experiments before producing the draft plan for 1986-90. 25X1

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Additional Soviet Loan Syndications

Moscow has followed its recent successful foray into the Euroloan market with additional syndications. A French bank recently managed a $100 million syndication, which was to have been drawn down by mid-February, and in late February the Soviet Foreign Trade Bank requested that a Bahraini bank syndicate a $100 million loan from other Arab banks. An Austrian banker expects the USSR to seek at least one more Euromarket loan this year.

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Although the individual loans are modest in size, the return of the USSR to the commercial syndicated loan market after a four-year absence is noteworthy for the change in Soviet borrowing behavior. Since 1979, the USSR has limited its commercial borrowing largely to shorter term supplier credits. Improvement in the USSR's credit standing among bankers—reflecting an apparent easing of East-West political strains—may have encouraged the Soviets to test the receptivity of the syndicated loan market

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Drought Hits East European Winter Grain Crops

The continuing drought in several East European states has worsened prospects for winter grain production, according to reports from US Embassies. The region will need abundant precipitation over the coming weeks to avert serious losses. Winter grains normally account for almost half of total grain production in Czechoslovakia, Hungary, Romania, and Bulgaria. Production shortfalls would intensify food supply difficulties, particularly in Romania. Moreover, efforts to improve trade balances in Hungary and Bulgaria would be hindered by a reduction in grain available for export

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The Oil Market Outlook Through 1985

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Despite the recent escalation of the Iran-Iraq war and Iraqi threats to mount attacks against shipping in the Khark Island area, the oil market remains relatively calm. Barring an oil supply disruption because of the Iran-Iraq war, we expect the oil market to remain soft. A seasonal decline in demand this spring probably will again test OPEC's resolve to maintain oil prices, but we believe that Saudi Arabia will defend the current benchmark price as long as other producers generally adhere to their production guidelines. We expect oil market conditions will remain soft in 1985, and OPEC countries will be forced to maintain production controls to prevent a price decline. In addition, OPEC will face new challenges to crude oil price stability, including increasing spot transactions and some members' growing volume of oil product exports, whose prices are not fixed by the cartel. The volatile situation in the Middle East, however, could cause a rapid turnabout.

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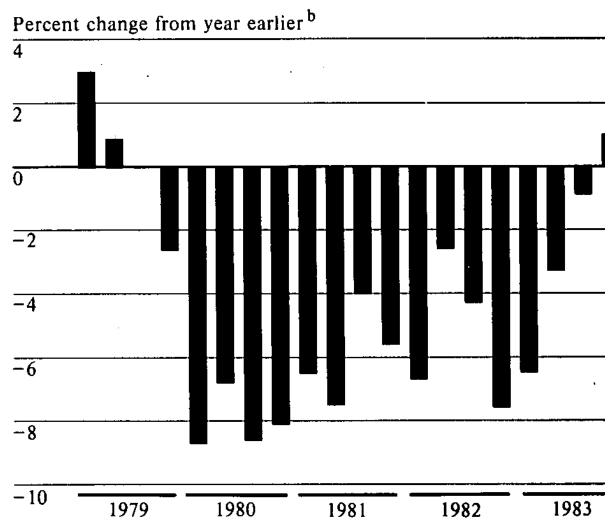
OECD Oil Consumption Trends, 1979-83[a]



[a] Inland sales.
[b] By quarter.

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The Outlook for 1984

We expect non-Communist oil consumption to rebound slightly in 1984 in response to the economic recovery, lower real oil prices, and a return to more normal weather patterns. In our base case scenario—which assumes continued growth in the US economy and sustained economic recovery in Western Europe—we forecast a modest increase to about 44.8 million b/d, approximately 2 percent above a year earlier. OECD countries, principally the United States, are expected to account for almost all of the 800,000-b/d increase. Under the base case, we expect consumption during the peak winter quarters to approximate 46 million b/d, compared with low seasonal requirements of 43 million b/d during the spring and summer quarters.

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The existence of surplus capacity worldwide and prospects for continued price weakness will encourage companies to attempt to maintain inventories at minimum levels. Our base case forecast assumes that total oil stocks decline by about 300,000 b/d in 1984. We assume that most of the excess commercial inventories—about 100-200 million barrels—will be depleted during first-half 1984. We anticipate a first-quarter inventory drawdown of approximately 2.5 million b/d, followed by little or no stockbuilding during the second quarter.

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Non-Communist Primary Oil Stocks on Land, End of Period

	Billion Barrels				Days of Forward Consumption [a]			
	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr
1978	3.6	3.7	3.9	3.9	74	76	74	70
1979	3.5	3.8	4.2	4.3	72	78	81	82
1980	4.3	4.6	4.8	4.6	91	99	97	93
1981	4.5	4.6	4.7	4.6	102	105	100	96
1982	4.3	4.2	4.3	4.3	97	98	97	95
1983	4.0	4.0	4.1	4.1	94	94	93	90 [b]

[a] Estimates include government-owned stocks in Japan, West Germany, and the United States, which have increased from 62 million barrels in first-quarter 1978 to about 520 million barrels at the end of fourth-quarter 1983. The increase amounts to about 11 days of forward consumption.
[b] Estimated.

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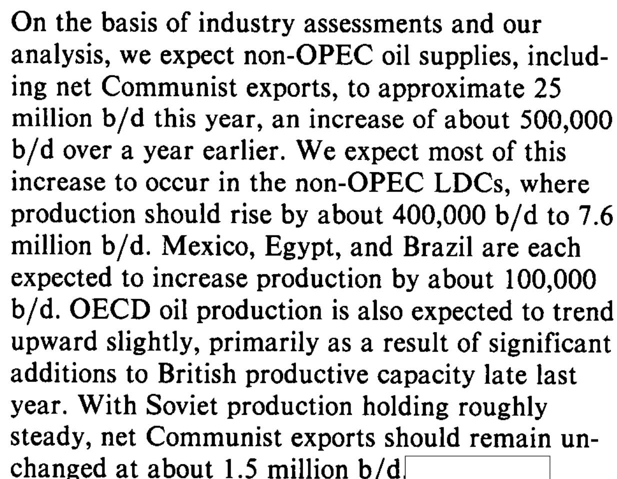

On the basis of industry assessments and our analysis, we expect non-OPEC oil supplies, including net Communist exports, to approximate 25 million b/d this year, an increase of about 500,000 b/d over a year earlier. We expect most of this increase to occur in the non-OPEC LDCs, where production should rise by about 400,000 b/d to 7.6 million b/d. Mexico, Egypt, and Brazil are each expected to increase production by about 100,000 b/d. OECD oil production is also expected to trend upward slightly, primarily as a result of significant additions to British productive capacity late last year. With Soviet production holding roughly steady, net Communist exports should remain unchanged at about 1.5 million b/d.

If consumption, inventory, and non-OPEC production developments materialize as we expect under our base case scenario, demand for OPEC oil should average 19.5 million b/d in 1984, or about 1 million b/d higher than 1983.[2] We estimate demand for OPEC oil will average about 19 million b/d during the first half of 1984 and begin to trend upward in the third quarter. If the economic recovery in Western Europe takes hold and the US business expansion remains robust, demand should reach about 20 million b/d during the fourth quarter. This forecast is in line with most recent industry estimates.

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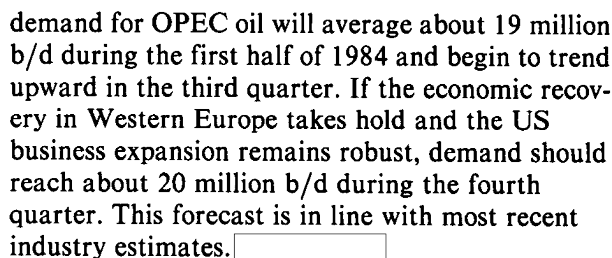

Factors Supporting Market Stability

We believe underlying market conditions—including increasing oil consumption, a more normal winter weather pattern, and a lower level of inventories—are working in favor of price stability in 1984. Nevertheless, given projected demand conditions, the key to maintaining prices this year—assuming a supply disruption is avoided—will be producer cooperation. Under our base case scenario, we expect OPEC to control production to defend nominal oil prices, and, in our view, Saudi Arabia will play the major role in determining oil price

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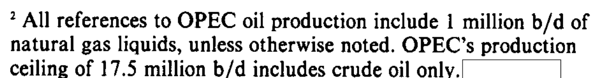

[2] All references to OPEC oil production include 1 million b/d of natural gas liquids, unless otherwise noted. OPEC's production ceiling of 17.5 million b/d includes crude oil only.

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1983 Non-Communist Oil Supply [a]

Million b/d

	Quota	I	II	III	IV	Year
Total		**40.9**	**41.9**	**44.5**	**44.8**	**43.0**
OPEC		16.7	17.6	19.8	20.0	18.5
Natural gas liquids		0.8	0.8	0.9	1.0	0.8
OPEC crude	17.5	15.9	16.8	18.9	19.0	17.7
Algeria	0.7	0.7	0.6	0.8	0.8	0.7
Ecuador	0.2	0.2	0.2	0.2	0.2	0.2
Gabon	0.2	0.2	0.2	0.2	0.2	0.2
Indonesia	1.3	1.1	1.4	1.4	1.4	1.3
Iran	2.4	2.6	2.3	2.5	2.4	2.4
Iraq	1.2	0.8	0.9	1.0	1.0	0.9
Kuwait	1.1	0.8	0.7	1.0	1.0	0.9
Libya	1.1	1.3	1.1	1.1	1.2	1.2
Neutral Zone [b]		0.2	0.4	0.5	0.3	0.4
Nigeria	1.3	0.8	1.4	1.4	1.3	1.2
Qatar	0.3	0.2	0.3	0.3	0.4	0.3
Saudi Arabia [c]	5.0	3.9	4.4	5.6	5.9	5.0
UAE	1.1	1.1	1.2	1.2	1.2	1.2
Venezuela	1.7	2.0	1.7	1.7	1.7	1.8
Non-OPEC		24.2	24.3	24.7	24.8	24.5
United States		10.3	10.2	10.2	10.2	10.2
Canada		1.6	1.5	1.7	1.7	1.6
Norway		0.6	0.7	0.6	0.7	0.7
United Kingdom		2.4	2.3	2.4	2.5	2.4
Other OECD		0.9	0.9	0.9	0.9	0.9
Non-OPEC LDCs		6.9	7.2	7.2	7.3	7.2
Of which:						
Mexico		2.8	3.0	3.0	3.0	2.9
Egypt		0.7	0.7	0.7	0.7	0.7
Net Communist exports		1.5	1.5	1.5	1.5	1.5

[a] Excluding refinery gain. Data for Non-OPEC countries include NGLs.
[b] Neutral Zone production is shared equally between Saudi Arabia and Kuwait and is included in each country's production quota.
[c] Saudi Arabia has no formal quota; it acts as swing producer to meet market requirements.

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Non-Communist Oil Supply and Demand [a]

Million b/d

	1983					1984					1985
	I	II	III	IV	Total	I	II	III	IV	Total	
Consumption	45.0	42.9	43.0	45.3	44.0	46.5	43.2	43.5	46.0	44.8	45.4
Inventory change	−4.1	−1.0	1.5	−0.5	−1.0	−2.4	0.1	1.4	−0.5	−0.3	0.2
Supply	40.9	41.9	44.5	44.8	43.0	44.1	43.3	44.9	45.4	44.5	45.6
Non-OPEC	24.2	24.3	24.7	24.8	24.5	24.9	24.7	25.0	25.3	25.0	25.1
OECD	15.8	15.6	15.8	16.0	15.8	16.0	15.7	15.9	16.1	15.9	15.8
United States	10.3	10.2	10.2	10.2	10.2	10.2	10.2	10.2	10.2	10.2	10.1
Canada	1.6	1.5	1.7	1.7	1.6	1.6	1.5	1.6	1.7	1.6	1.5
United Kingdom	2.4	2.3	2.4	2.5	2.4	2.6	2.4	2.5	2.6	2.5	2.6
Norway	0.6	0.7	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Other	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Non-OPEC LDCs	6.9	7.2	7.2	7.3	7.2	7.4	7.5	7.6	7.7	7.6	7.9
Mexico	2.8	3.0	3.0	3.0	2.9	3.0	3.0	3.1	3.1	3.0	3.3
Net Communist exports	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.4
Implied Demand for OPEC Oil	16.7	17.6	19.8	20.0	18.5	19.2	18.6	19.9	20.2	19.5	20.5

[a] Excluding refinery gain.

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developments from the producer side. Unlike last year, the Saudis have stated their support for the current price, and we feel Riyadh views defense of OPEC's $29-per-barrel marker price as the best available option. Saudi production has fallen gradually from its September 1983 peak of 6.2 million b/d to 5.2 million b/d in January. If demand follows the first-half 1984 pattern as we now expect, Riyadh probably will be well positioned to defend prices.

A Saudi decision to allow output to stay at or below 5 million b/d would allow other OPEC producers to increase their production by 1 million b/d. Based on current prices, an increase of 300,000 b/d in Nigerian production to 1.6 million b/d in 1984 would provide Lagos with an additional $3.3 billion in oil revenues—enough to cover more than 30 percent of the total cost of projected Nigerian imports in 1984. A 200,000-b/d increase in production for both Venezuela and Indonesia would provide each of these countries with an additional $2 billion. Nonetheless, OPEC countries as a group will register a current account deficit of about $20 billion this year, under our base case scenario.

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The Price Decline Scenario

Although we expect OPEC to cooperate to maintain oil prices this year, the absence of a sustained economic recovery in Western Europe or a drop in US growth prospects could make the situation very difficult for OPEC to manage. Demand for OPEC crude oil could be 1-2 million b/d less than we now expect if the business cycle weakens or if inventory

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drawdowns are greater than we anticipate. We believe OPEC would be hard pressed to accommodate such a sharp drop in demand, and several OPEC countries probably would ignore their production ceilings. Under these conditions, Saudi output could be forced to unacceptably low levels, and Riyadh might abandon attempts to support the existing price structure.

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It is difficult to predict how far prices would fall if OPEC becomes unable or unwilling to defend the current $29-per-barrel benchmark. Because a

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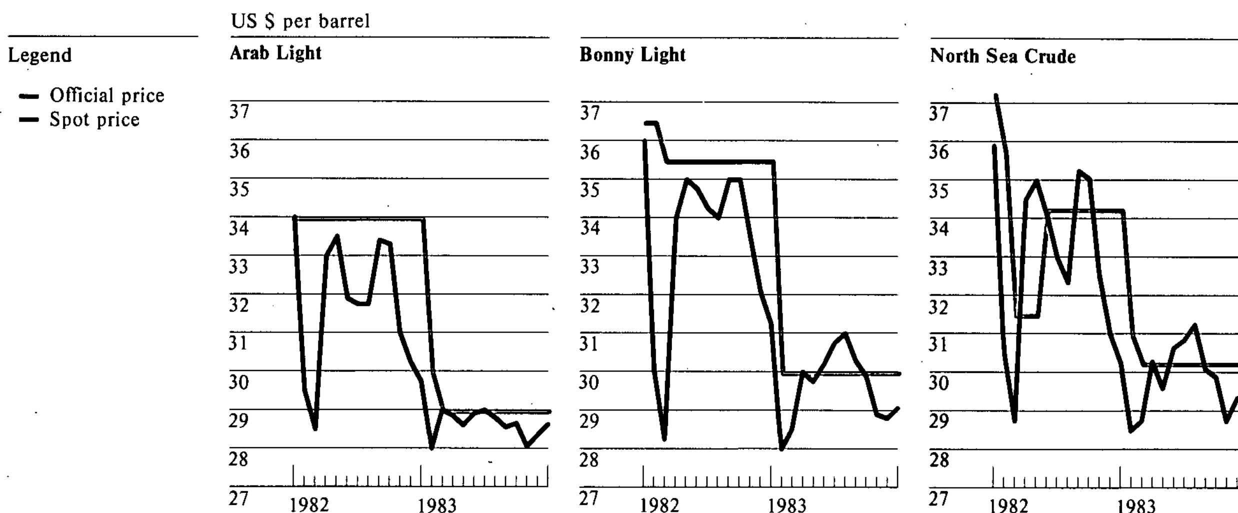
Oil Price Trends, 1982-January 1984[a]



[a] End of month.

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modest cut in oil prices would not increase demand for OPEC oil significantly in the short term, the financial situations of OPEC's hardest pressed members are likely to deteriorate further if prices decline. We estimate that for every $1 per barrel annual average decline in nominal prices, OPEC's current account deficit would increase by $6 billion.

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The 1985 Market Outlook

Even if OPEC members get through 1984 with stable prices, the outlook for oil consumption in 1985 indicates OPEC will continue to face challenges to its cohesion. Building on our 1984 base case demand scenario, we expect only a modest increase in non-Communist oil consumption of about 500,000 b/d in 1985.[3] On the basis of this consumption estimate and the expectation that inventory levels and non-OPEC oil supplies will hold relatively stable, we estimate demand for OPEC oil will approximate 20-21 million b/d. Under this demand scenario, we expect supplies will be ample and OPEC will have to restrain output with few, if any, countries able to produce at desired levels. If demand for OPEC oil is below our baseline scenario and OPEC fails to experience an upturn in market share, the cartel could have a difficult time maintaining the price structure. Indeed, some economists are now predicting an economic downturn in 1985 that could depress demand for OPEC oil.

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Iraq and Iran—Increased Production Possible

Constraints imposed by the war will limit the likelihood of any major increase in production from Iran and Iraq in 1984. On the basis of recent initiatives by the Iraqis to expand export outlets,

[3] Assumptions underlying this 1985 forecast include OECD real GNP growth of 2.7 percent, a continued slight decline in the energy-to-GNP ratio, constant nominal oil prices, and an increase of about 1 million b/doe in nonoil energy demand in OECD countries.

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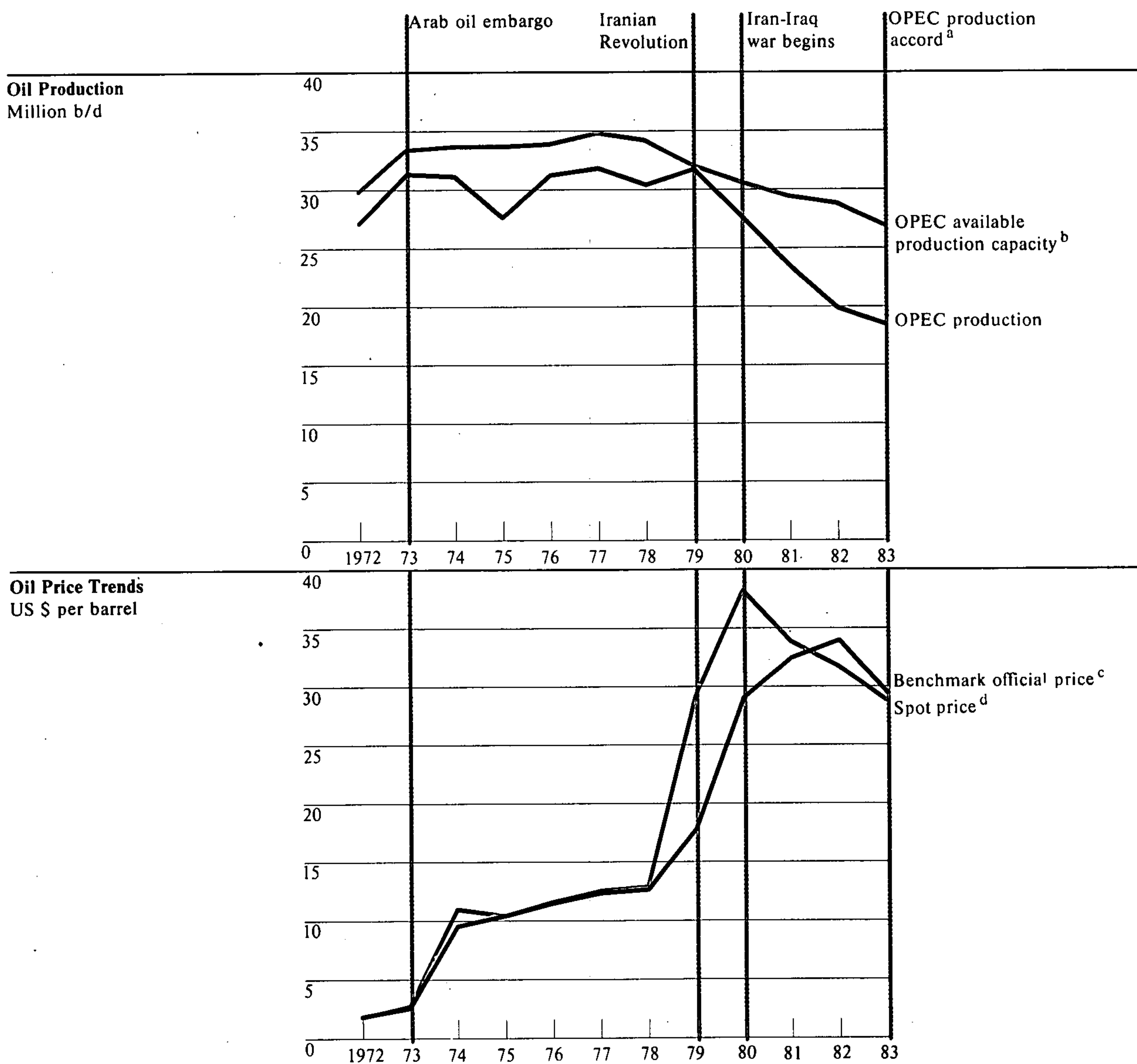
Oil Production and Price Trends, 1972-83



[a] Benchmark price falls five dollars per barrel.
[b] Reflects government production ceilings.
[c] Actual contract sales prices for Arabian Light.
[d] Annual average.

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however, we believe developments in Iraq and Iran will play a crucial role in determining market conditions in 1985. If the war continues and Iraq and Iran maintain exports at or near current levels, other OPEC members will be able to share any increase in oil demand among themselves. Iraq's current attempts to increase oil export capacity and revenues, however, could place Baghdad in a position to boost production and demand a higher quota. Should Iran match any increase in Iraqi oil exports—as Tehran has threatened—an additional 1 million b/d of exports would offset the expected increase in demand and keep the oil market soft. Should hostilities end, Iraq could increase its export capacity by 2 million b/d or more by reinstalling offshore loading facilities in the Persian Gulf and building a new pipeline link. If Iran also raises its exports by nearly 1 million b/d, substantial cuts by other producers would be needed to maintain price stability.

In our judgment, OPEC countries such as Nigeria, Venezuela, and Indonesia probably would be unwilling to lower output to offset higher production from Iraq and Iran. Indeed, these countries—especially Nigeria—are eager to increase production and revenues. Even if these and other OPEC members were to agree to limit output to current quotas for 1985, an additional 3 million b/d of oil from Iraq and Iran could only be accommodated by lowering Saudi production to less than 4 million b/d. Because of their own internal needs, we believe such an outcome would give the Saudis pause and increase the risk of an oil price slide.

Other Market Pressures

We expect several factors to grow in significance over the next few years, making it even more difficult for producers to control oil prices. For example, increasing spot market sales have added to buyer flexibility and reduced the volume of oil sold on a traditional contract basis. Some industry analysts estimate that the spot market now comprises 20 to 25 percent of total non-Communist oil trade, compared with 5 to 10 percent in the 1970s.

Another new factor is that oil producers are expanding downstream operations. According to the International Energy Agency, OPEC will add 2 to 3 million b/d to refining capacity over the next several years—about half of this in the Persian Gulf. As a result, product export capacity in OPEC could approximate 3.5 million b/d in 1985 or 1986, roughly 20 percent of expected total OPEC oil exports. Purchases of existing European capacity by OPEC members—Kuwait and Venezuela—will also increase OPEC's role in downstream operations. In recent years these producers have purchased or are partners in about 350,000 b/d of refining capacity in Western Europe, and, according to press reports, purchases by private Saudi companies total an additional 170,000 b/d.

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OPEC countries' growing role in product markets may cause additional problems for the organization as it struggles to control oil prices and production in the next few years. Product prices are not included in the cartel's official price structure, and OPEC currently has little recourse if producers choose to discount product prices, despite the fact that such discounts tend to erode crude oil prices. We believe increasing OPEC penetration into product markets may also be cause for increasing tension between these countries and consuming countries in Europe. Because of the substantial surplus refining capacity in Western Europe, these countries have already made significant reductions to their refining capacity in recent years. These countries may decide to impose import fees on oil products to protect their remaining domestic industry and jobs, according to one industry source. Thus far, OPEC has no strategy for coping with these problems.

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The Iran-Iraq Risk

The Iran-Iraq war could cause a rapid turnabout in the market. Iraq's deterioriating economic situation and stepped-up attacks by Iran have prompted Baghdad to threaten to attack oil shipping near Khark Island in an effort to end the conflict. Such action by Iraq might induce Iran to retaliate by

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attempting to close the Gulf to shipping or striking out against Iraq's oil facilities or its Persian Gulf allies.

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Under these conditions, the world oil market could tighten quickly and cause a runup in spot prices because of uncertainty regarding the extent of damage to the oil industry in the Gulf and the length of any supply disruption. Furthermore, only about 3 million b/d of the current 8-million-b/d surplus in available productive capacity in non-Communist countries is outside the Gulf, and commercial stocks have been drawn down to near normal levels. As a result, there is little surplus to offset a disruption; government-held stockpiles might not be used initially to prevent price runups. We cannot predict how high prices would rise or how long such increases might be sustained. We believe industry and public perceptions and the magnitude and duration of the supply loss would be key factors

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Kuwait: Reverberations of the Stock Market Crash [1]

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The crash of Kuwait's unofficial stock market in August 1982 continues to have adverse financial, political, and social effects in a country that is trying to cope with declining oil revenues, the Iran-Iraq war, recent bombings, and an increasingly restive Shia population. Kuwaitis will probably continue to blame the government for the collapse,

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Although we believe Kuwait will muddle through, barring further shocks to the economy, the Kuwaiti leadership's failure to prevent the crash or to deal fairly and decisively with its aftermath adds to the instability in an area vital to US interests.

The Market's Growth and Crash

Although Kuwait's enormous oil earnings have been used by the ruling Sabah family to build a welfare state at home and an investment portfolio—estimated at $67 billion—abroad, a large number of local inhabitants also have become wealthy. Initially, individuals invested abroad, but the excesses of oil wealth eventually led them to seek internal investment opportunities. Most investments have been in financial service enterprises—banks, insurance companies, and security houses.

Over time two stock markets developed around these investment ventures. The Kuwait Shares Market was established in 1977 with governmental approval and oversight. The Gulf Shares Market, or Suq al-Manakh, also sprang up in 1977, but it did not have government approval. This unofficial market was viewed by many Kuwaitis and expatriates—who make up 60 percent of the country's population—as a sign that Kuwait had reached a level of financial sophistication that allowed investors to diversify their portfolios with both foreign assets and local stocks.

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Fueled by revenues from the second oil price boom, more individuals entered the stock market, trading became increasingly active, and speculation intensified. Local observers estimate that in 1981 the average value of stocks on the Manakh more than doubled. According to US Embassy reporting, during one week in late 1981 an estimated 400 millionaires were created on paper.

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This hectic pace on Kuwait's unofficial stock market was fed by:

- A rapid expansion in domestic liquidity—17 percent in 1979, 25 percent in 1980, and 36 percent in 1981.
- Development of an unofficial credit-creating system in the form of postdated checks incorporating sizable premiums.
- A belief that the government would not allow a market collapse.

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The speculative bubble burst in August 1982 when lower oil earnings finally forced a cutback in internal credit, and concerns over Middle East stability caused many investors to withdraw from the market. Within a period of days, according to Embassy sources, about $100 billion worth of stocks were wiped out, and as many as 6,000 investors saw their financial positions crumble. After sorting out who owed whom, the net debt was still more than $20 billion.

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The Government Response

The initial Kuwaiti Government reaction to the stock market collapse was swift:

- The Amir suspended dealings in postdated checks and established an arbitration committee.
- A recording committee was set up to register postdated checks and to determine the magnitude of the problem.
- According to Embassy reporting, the government discreetly began supporting stock prices in the official market to limit the crisis.

Establishment of the arbitration committee was a key element in the government's plan for resolving the financial crisis. From the beginning, however, the group proved to be a lightning rod. According to Embassy sources, committee sessions were marred by threats, violent arguments, and histrionics of the traders who had lost money on the market.

After these initial moves to calm the situation, the government implemented the first of several plans to bail out investors. the key ingredients during the first six months of 1983 included:

- A Ministry of Finance (MOF) injection of $3.1 billion into the commercial banking system in January 1983 to maintain the banks' liquidity.
- A public law specifying that the interest of small investors was to be protected by the use of a $1.7 billion rescue fund.
- An MOF disbursement of $6.9 billion in bonds to small investors in exchange for their worthless stock certificates.
- Establishment of a special clearinghouse where commercial banks could redeem MOF bonds cashed in by individual investors.

We believe these moves were intended by the MOF to gain time to resolve the financial difficulties generated by the stock market debacle. The government expected much of the $12 billion injected through its rescue efforts to find its way into deposits or loan reductions at commercial banks. Apparently this did not happen. According to aggregate banking data, deposits and loan balances in local banks remained essentially unchanged through mid-1983. Moreover, there seems to have been a slight decline in deposits during September and October.

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Instead, a substantial portion of the government funds allocated to neutralize the financial disruption of the stock market collapse has probably left Kuwait. Kuwaiti dinars are being sold in Europe at a substantial discount. It is impossible to gauge the exact level of capital flight, but Bank of Kuwait officials estimate the outflow at between $5 billion and $10 billion worth of dinars.

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Strains in the Rescue Program

Failure to solve the stock market problem has contributed to the economy's decline. According to Embassy reports, sources of credit for Kuwaiti companies, both international and domestic, are drying up. Even firms with strong international ties are being affected as foreign bankers, unable to assess anyone's financial condition in Kuwait, are cutting back their exposure. Local merchants complain that sales have slowed to a trickle. The situation could get worse. We believe more business failures, additional credit restrictions, and increasing personal bankruptcies are possible.

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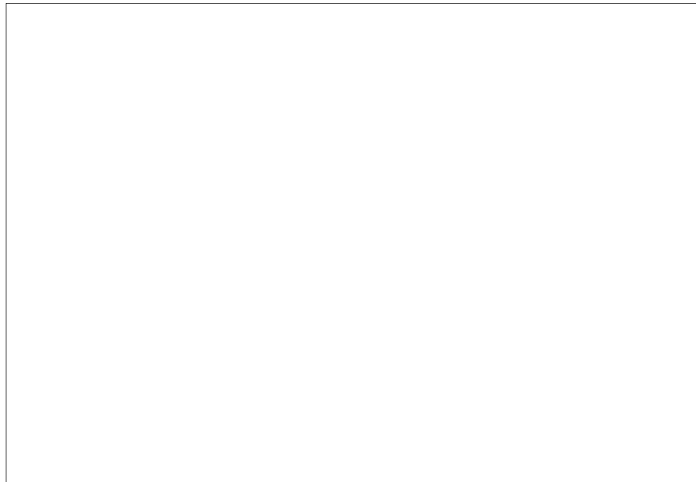

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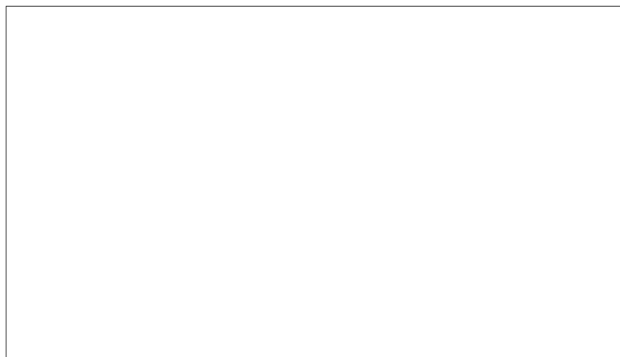
Kuwaitis Moving Money and Treasure Abroad



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According to the US Embassy, bankers in Kuwait believe capital is leaving the country in increasingly large amounts, much of it from Manakh settlements. The Embassy reports an increasing concern—but not yet a sense of panic—among local bankers about the large outflow of funds. In addition to fears about political stability and the Iranian threat, Kuwaitis are uneasy about lower oil revenues and the effects of the Manakh collapse. Kuwaitis may have moved as much as $10 billion abroad over the past two years.

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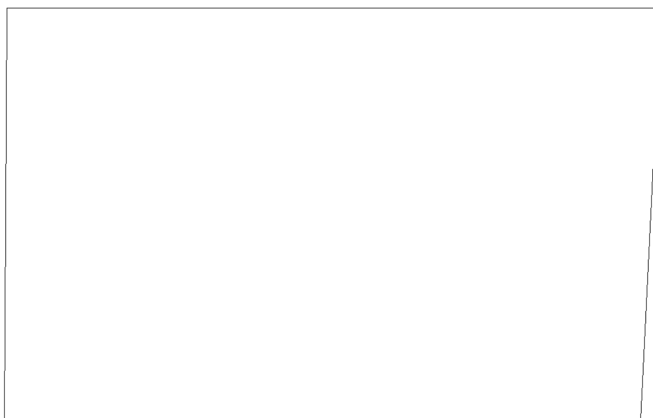

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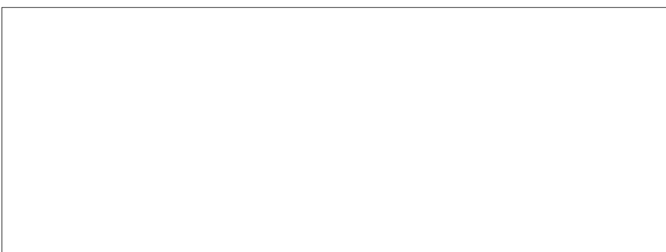

The Social Fallout

We believe the most profound social impact of the market collapse has been on Kuwait's growing middle class. The Manakh, because it was open to all residents, had become Kuwait's economic melting pot. Despite high expectations and growing incomes, the new middle class, according to press reports, often found their economic interests blocked by the 20 or so traditional Nejdi merchant families who largely control the banks and the official stock market and wield extraordinary influence on Kuwait's rulers. The status that came with rapid stock market profits made many feel equal to the established rich. The collapse of the market, however, and the perceived unwillingness of the Sabah-controlled government to step in have only intensified deep-seated tensions between the middle class and the Nejdi merchant families.

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For expatriates the Manakh offered a chance for the good life. Having made a major contribution to Kuwait's growth, they resented the discrimination that prevented most of them from becoming citizens or sharing equally in Kuwait's prosperity. After the collapse, many expatriates felt they would never recoup their losses, which reinforced the view that Kuwait's ruling elite would forever block any chance for equal treatment.

Clouds Over the Horizon

In an attempt to prolong the adjustment to the Manakh collapse, the Government of Kuwait has laid the foundation for yet another financial crisis. The Iran-Iraq war, for example, could prompt foreigners holding dinars, as well as Kuwaiti investors, to shift to hard currencies. If the estimate on the size of foreign dinar sales—$5-10 billion—is in the ballpark, the government would be hard pressed to meet such a sudden inflow of dinar holdings. Because of the slowdown of oil earnings—$9.3 billion in 1983 compared with $18.7 billion in 1980—the government only has about $10 billion in highly liquid short-term accounts. Should a crunch occur, the Government of Kuwait would have to devalue the dinar or consider imposing currency controls to limit the loss of hard currency.

The impact of the Manakh collapse and the prospects for continued financial and social spillover add another element of risk to an already troubled Persian Gulf region. Financial setbacks are of major concern to the Kuwaiti Government, whose foreign policy depends largely on placating potential adversaries with monetary support. The economic downturn has made Kuwait's large expatriate community, particularly the Palestinians, more restive as they face possible deportation in a dwindling job market. Kuwaitis seeking a return to fundamentalist Islam may view the crash as further evidence that a policy of modernization and Westernization has failed. Because of these pressures, Kuwait may be more inclined to appease these groups and less likely to cooperate with other moderate Arab states on issues of importance to the United States.

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Pakistan: Economic Downturn Appears Manageable

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Pakistan's economy is likely to grow more slowly in the fiscal year ending 30 June than in any year since President Zia came to power in 1977. A disastrous cotton crop has already taken its toll, and higher inflation, mounting budget deficits, and sluggish remittances are adding to Pakistan's concerns. Despite deterioration in the economy's performance, we believe that it is unlikely that the economy by itself will cause serious political problems for Zia, and he has already taken steps to demonstrate he is dealing with the situation. If conditions worsen significantly, we believe Zia quickly would solicit additional financial assistance from the United States and other donors.

Strong Performance in Zia's First Six Years

The Pakistani economy recorded six consecutive years of rapid growth through FY 1983—increasing by almost 6 percent annually, according to Pakistani statistics and US Embassy estimates. We believe that last year's civil disobedience campaign in Sind Province did not elicit broad popular support, because most Pakistanis have benefited from economic prosperity:

- Agriculture, the cornerstone of the economy, has maintained steady growth because of favorable weather and increases in government procurement prices. Pakistan is self-sufficient in all major food categories except edible oil.
- Industrial performance has been strong because of output from new public-sector plants in the fertilizer and steel sectors. Although industrial output still represents less than 20 percent of GNP, industrial growth is critical if Pakistan is to provide new jobs for a rapidly growing population and expand exports.

The Zia government's most impressive recent economic achievement has been the improvement in its foreign payments. Last year the current account deficit was reduced to the lowest level since the early 1970s, primarily because of growth in worker remittances, reduced import costs because of lower oil prices and import substitution, and expanded exports of manufactured goods. Pakistan doubled its foreign exchange reserves to a record $2 billion, the equivalent of about four months of imports.

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Slower Growth This Year

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Poor weather and other unfavorable economic developments have caused increased government concern in recent weeks. In a rare move, President Zia called a special meeting of the National Economic Council—Pakistan's highest economic policy making body—in early February to discuss the performance of the economy. Following this meeting the government announced GNP projections for FY 1984 of 4.5 to 5 percent compared to the earlier target of 6.4 percent. We believe that even this estimate is overly optimistic, and growth may be as low as 4 percent.

25X1

The agricultural sector is unlikely to register gains in output despite growth targets of 4.9 percent:

- Untimely rains and pest infestation reduced this season's cotton output to 2.9 million bales—down from a target of 5.2 million bales—according to official estimates. Embassy sources in the cotton trade place the size of the crop even lower—2.5 million bales.
- The winter wheat crop is being jeopardized by the lack of rain since mid-December. The US agricultural attache estimated in early February a

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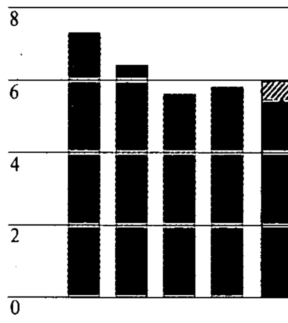
Pakistan: Economic Indicators, 1980-84[a]

Note scale change

Real GDP Growth

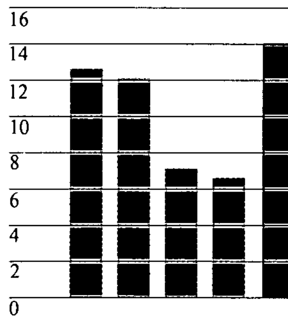
Percent



Shaded portions indicate range

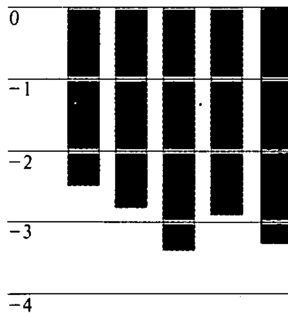
Consumer Price Growth

Percent



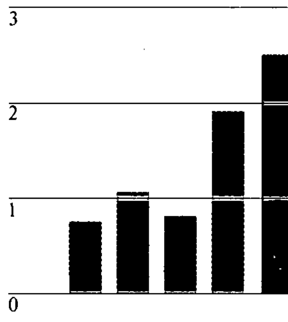
Trade Balance

Billion US $



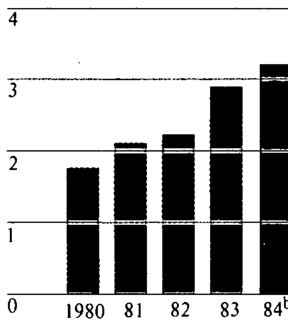
Foreign Exchange Reserves

Billion US $



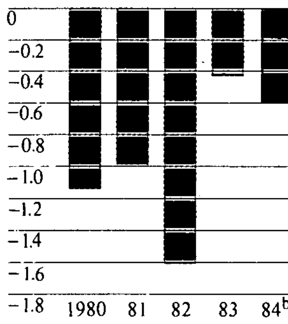
Worker Remittances

Billion US $



Current Account Balances

Billion US $



[a] Data are for fiscal year ending 30 June.

[b] Projection based on six months reporting and government plans.

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harvest of 12.5 million metric tons, slightly above last year's record of 12.4 million tons, but continued drought conditions could reduce output below last year's level. 25X1

Industrial production is expected to expand this year by about 10 percent, slightly above the government projection. Growth in output of cotton yarn, steel products, and cement has been particularly strong thus far this year. 25X1

Inflationary pressures are much greater than last year. The official consumer price index indicates prices are increasing at an annual rate of at least 10 percent compared to less than 7 percent last year. Price increases for sugar, cotton, energy, cement, fertilizer, onions, and vegetable oil have been contributing to public concern. 25X1

The Pakistani Government's budgetary problems and increases in the money supply are contributing to inflationary pressures. After several years of moderate monetary expansion, the money supply increased by 26 percent last year, largely because of government spending. The budget deficit this year is likely to be only slightly less than the $1.9 billion of last year. Sluggish imports are inhibiting growth in import duties that comprise the bulk of government revenues. At the same time, the government is facing unexpected expenditures for edible oil and cement subsidies because of higher world prices for soybean and palm oil and greater losses by the state cement corporation. 25X1

Foreign Payments

Pakistan probably will not add to foreign exchange reserves this year as the government had hoped. The current account balance is likely to show some deterioration from last year. A shortfall in earnings from raw cotton exports, an expected increase in prices for imported edible oil, and unanticipated imports of raw cotton will be only partially offset by strong performances from other exports. 25X1

Slumping worker remittances are now becoming a concern of the government. Remittance flows

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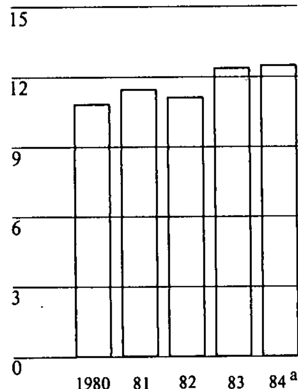
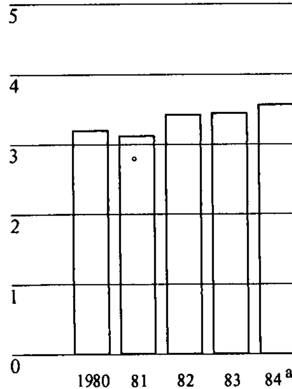
Pakistan: Agricultural Reform

Note scale change

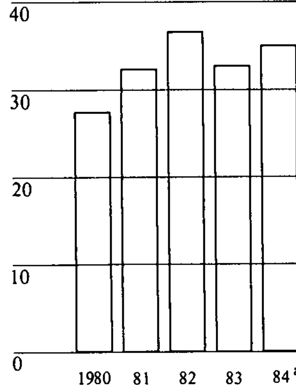
Wheat
Million metric tons



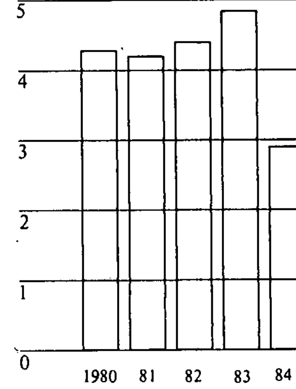
Rice
Million metric tons



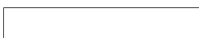
Sugar Cane
Million metric tons



Cotton
Million bales



[a] Projected.



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began to slow in August and registered a decline in November and December. For the first six months of the fiscal year, remittances were only up about 3 percent compared to a government projection of 10 percent. The decline may only be temporary:

- Workers may be holding back funds for family members planning to apply for the pilgrimage to Mecca.
- The rupee-dollar exchange rate was relatively high during the last quarter but has since depreciated.
- Last fall's civil agitation campaign by the Pakistani opposition may have prompted some of the more affluent expatriate workers to hold back remittances until the outcome was determined.

Although the decline in remittances may be temporary, there is a possibility that Pakistan is experiencing the end of a decade of growth in worker remittances. Reporting from the Persian Gulf states indicates that the economic and political pressure to cut the size of the expatriate work force is increasing. Many construction workers are being laid off because of the slowdown in spending for development projects. Wage rates for those with jobs are being moderated by increased competition for jobs. A Pakistani newspaper in early January reported a net decline in Pakistani workers in the United Arab Emirates. 25X1

We also foresee a reduction in capital inflows in the current fiscal year. This will result from the termination of the Extended Fund Facility with the IMF, some difficulties finalizing World Bank loans, and a slowdown in receipts of project aid and refugee assistance from foreign donors. 25X1

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Implications for Political Stability

The Zia regime has acted to assure the population that it has the economic situation under control.

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Pakistan: Balance of Payments [a]

Million US $

	1981	1982	1983	1984 [b]
Current account	**−991**	**−1,610**	**−554**	−800 to −1,100
Trade balance	−2,765	−3,450	−2,989	−3,500
Exports (f.o.b.)	2,798	2,319	2,627	3,000
Imports (f.o.b)	5,563	5,769	5,616	6,500
Net services and transfers	1,774	1,840	2,435	2,400 to 2,700
Worker remittances	2,095	2,224	2,886	2,900 to 3,200
Capital account	**581**	**746**	**1,264**	**800**
Gross official disbursements	956	1,092	1,301	1,250
Amortization	−516	−492	−389	−450
Other [c]	141	146	352	
Other short-term capital [d]	771	629	401	
Change in reserves	361	−235	1,111	0 to −300

[a] Fiscal year ending 30 June.
[b] Projected.
[c] Including private, long- and short-term capital.
[d] Including errors and omissions.

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The government quickly banned cotton exports and arranged for imports of raw cotton to protect the domestic textile and yarn industries from the full effects of the bad crop. Onions were imported to bring down prices, and the government has shielded consumers from the full extent of higher costs for imported cooking oil.

President Zia has displayed his sensitivity to the inflation issue in other ways as well. During the National Economic Committee meeting, he ordered a continuous review of prices. Local papers have given prominent attention to this directive, and regional government administrators are setting up local monitoring committees. According to Planning Minister Mahbubul Haq, Zia will intervene in the marketplace to keep a lid on prices by releasing commodities from government stocks and importing basic items in short supply, even if these actions result in greater budget deficits and a loss of foreign exchange.

We do not believe that agricultural conditions or remittance payments will deteriorate enough over the next year to make economic problems a serious campaign issue in the elections, reportedly planned for later this year or early next year. Foreign exchange reserves, near the all-time high, are sufficient to finance imports of essential consumer goods. If a large drawdown in reserves becomes necessary, we expect Zia to solicit additional assistance from the United States, as well as other donors.

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International Financial Situation: Private Capital Flows to Asian NICs

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This article is part of our series on the economic and political aspects of the international financial situation.

Despite the recession and LDC debt problems, the Asian newly industrializing countries (NICs)—Hong Kong, Singapore, South Korea, and Taiwan—largely have been successful in attracting private foreign capital. These countries have benefited from international bankers' efforts to direct their lending to more creditworthy developing countries. We believe their favorable investment climate, good-to-excellent international credit ratings, and continued strong growth potential will encourage future foreign capital inflows. As the recovery proceeds, the Asian NICs will be the first choice of many foreign investors and lenders and will receive far better terms than most other developing countries. The Asian NICs' success in upgrading their manufacturing capabilities with these capital inflows will increase further the gap between these countries and the financially troubled LDCs.

Recent Developments by Country

Foreign investment in **Hong Kong** declined in 1983 because of the slump in the world economy and uncertainty concerning Hong Kong's future. According to US Consulate reporting, the current OECD economic recovery and calm in the Sino-British talks on Hong Kong's future status are reviving investors' interest. Foreign manufacturers are beginning to add capacity or replace existing equipment to meet orders for expanding export markets and to focus their attention on the market in China. Much of this recent investment is concentrated in electronics, electrical appliances, machinery, and textiles—industries that have relatively short payback periods in Hong Kong. The US Consulate also reports that a small portion of the increased foreign investment is coming from China. Hong Kong's improved market conditions and China's efforts to ensure greater confidence in Hong Kong's future are cited as reasons for the increased Chinese investment. We believe foreign investment in Hong Kong will accelerate unless there is serious short-term political uncertainty

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Foreign investment has played an important role in the capital formation of **Singapore**'s manufacturing sector. Government statistics indicate that foreign investment grew at an average annual rate of 16 percent between 1978 and 1982 and currently accounts for almost three-fourths of Singapore's total capital inflows. Although actual investment inflows experienced a moderate decline in 1983, statistics released by Singapore's Economic Development Board indicate that new foreign investment commitments increased during the first half of 1983 by more than 10 percent over a year earlier. This suggests a potentially larger inflow of investment in 1984. Singapore's success in weathering the effects of the world recession and strong growth potential enhance its attractiveness to foreign investors. Consequently, we believe the inflow of foreign investment probably will regain the pace that it established prior to 1983

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More than 95 percent of **South Korea**'s total capital inflows come from foreign borrowing. According to the IMF, over 60 percent of this total is from private sources. Despite closer scrutiny by the international financial community, South Korea has maintained a good credit rating among international bankers and has had little difficulty in arranging recent syndicated loans. South Korea's record of sound economic and financial management as well as the country's diversified export base are the principal reasons cited by many bankers for this good credit rating. We believe that, over

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the next two to three years, South Korea will need to borrow about $4 billion in new funds annually from private sources and maintain ample short-term trade financing. In our judgment, Seoul has a good chance of obtaining this financing, although it probably will have to pay slightly higher spreads on its loans because of international banks' high exposure in South Korea.

In a bid to attract more investment capital, US Embassy reporting indicates that South Korea's National Assembly recently passed legislation, effective 1 July 1984, to substantially liberalize foreign investment policy. By streamlining approvals and lifting restrictions, Seoul is attempting to attract foreign capital to develop its electronics, auto, computer, machinery, and chemical industries. During the past three years, Seoul has relaxed several restrictions on foreign investment; yet, approvals have lagged behind planned investments and have not been comprised of the high-technology investments needed to upgrade manufacturing capabilities. Moreover, according to US Embassy and press accounts, foreign investors are hesitant to invest in Korean industry because of the gap between official policy and actual implementation, the inadequate protection for patents and trademarks, and frequent violation of licensing agreements for manufacturing processes.

Foreign lending is critical in **Taiwan**, providing roughly three-fourths of the country's total capital inflows. According to the American Institute in Taiwan (AIT), Taipei maintains an excellent international credit rating and will have little difficulty in obtaining future credit. several West European commercial banks to compete aggressively for Taipei's Mass Transit project loans, once they are announced. The reduction in foreign direct investment since 1980—principally because of Taiwan's restrictive policies and world recession—may soon be reversed. According to AIT reporting, planning officials have indicated that increased foreign investment is needed to upgrade high-technology export industries and attract foreign managerial and technical expertise. Taipei is considering reducing restrictions on foreign investment, opening the stock market to foreigners, and forming a venture-capital company with a major Western partner.

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Second-Tier LDCs: Potential NICs

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Industrial-country producers of manufactured goods are concerned that exports from second-tier LDCs will add to existing competition from the newly industrializing countries (NICs).[1] The number of LDCs exporting more than $100 million worth of manufactured products (in 1975 prices) has steadily increased from 18 in 1965 to 22 in 1970 to 47 in 1980. We believe that, as these LDCs overcome obstacles to growth in manufactures exports, they will alter market prospects in a number of industries. In the process, this could spark political debate in industrial countries.

Identifying Second-Tier LDCs

To identify a second tier of LDC exporters who may become NICs, we applied two NIC criteria—the value and rate of growth of manufactures exports. Manufactures exports of the country had to:

- Exceed $200 million in value in 1980.
- Grow at a real average annual rate of at least 18 percent during 1976-80.

According to these criteria, we have identified 11 developing countries as second-tier exporters of manufactured products.[2] This list includes one low-income country—Sri Lanka—and 10 middle-income countries—Chile, Cyprus, Indonesia, Jordan, Malaysia, Peru, the Philippines, Thailand, Tunisia, and Uruguay. Of these countries, Malaysia, the Philippines, and Thailand account for 60 percent of the second-tier LDCs' total exports of manufactured products. Three countries that are excluded from this list but considered in the analysis are Argentina, India, and Pakistan. Each has had lower than NIC-average growth in manufactures exports but nonetheless has substantial exports of manufactured products and registered some gains in the growth of these exports during 1976-80.

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UN trade data reveal the dynamic nature of these newcomers' manufactures exports. Between 1975 and 1980, the second-tier LDCs' exports of manufactured products grew at an average real rate of almost 25 percent per year, far outpacing the 6-percent rate sustained by industrial countries and the 18-percent rate for the NICs. In spite of this rapid manufactures export growth, a considerable gap exists between the second-tier LDCs and the NICs. The most salient difference is in the size of their manufactures exports. In 1980, the second-tier LDCs exported, on average, $800 million of manufactures, which accounted for 15 percent of their total exports. This is well below the average $11.6 billion of manufactures exports and 63-percent share registered by the NICs.

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Obstacles Ahead

Like the NICs, the second-tier LDCs have a mix of economic conditions that facilitate industrial growth—a skilled labor force, an entrepreneurial class, low labor costs, and adequate domestic financial markets, transportation, and communications. The second-tier LDCs, however, face several obstacles to the rapid growth of their manufactures exports. Included among these are:

- The partial rather than comprehensive implementation of export-led growth policies.

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[1] The NICs are Brazil, Hong Kong, Mexico, Singapore, South Korea, and Taiwan.

[2] Six developing countries, other than the NICs, that met the criteria were excluded from the analysis: five countries where oil dominates the economic structure (Kuwait, Nigeria, Saudi Arabia, Trinidad and Tobago, and Venezuela) and Lebanon, for lack of comprehensive data.

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Major LDC Exporters of Manufactured Products [a]

1980 Manufactures Exports in 1975 Prices	Real Growth of Manufactures Exports, Average Annual Increase, 1976-80		
	Less Than World Average (6.7 Percent)	Between World and NIC Average (6.7 to 17.8 Percent)	Greater Than NIC Average (17.8 Percent)
$200 million to $1 billion	Colombia Egypt El Salvador Ivory Coast	Bangladesh Costa Rica Guatemala Kenya Morocco	*Chile* *Cyprus* *Indonesia* *Jordan* *Peru* *Sri Lanka* *Tunisia* *Uruguay*
$1 billion to $2 billion	**Mexico**	Argentina Pakistan	*Malaysia* *Philippines* *Thailand*
$3 billion to $10 billion		**Brazil** India	**Singapore**
More than $13 billion		**Hong Kong** **Taiwan**	**South Korea**

[a] Second-tier LDCs are shown in italics, and newly industrializing countries are shown in boldface type.

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- Foreign financial problems that have required austerity measures and slowed the implementation of their outward-looking development strategies.
- Sluggish global economic growth, protectionist pressures, and heightened trade competition in textiles and other labor-intensive industries.
- Country-specific factors, such as political instability, that limit the growth of manufactures exports.

Second-Tier LDC Prospects

Given these obstacles, we believe that only Malaysia and, to a lesser extent, Thailand have the potential to vie for a position among the NICs in the next 10 years. Malaysia has already established itself as a large exporter of semiconductors and electronic products. We believe its extensive financial, communications, and transportation networks, combined with favorable investment incentives and a good international credit rating, will help attract foreign investment and will assist Prime Minister Mahathir in diversifying industry into skill- and capital-intensive industries. Thailand's abundant natural resources, its political stability during the past four years under Prime Minister Prem, its available supply of technically skilled low-cost workers, and its access to a large Asian market make it attractive to foreign investors.

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Eventually, contenders for a position among the NICs are likely to emerge from Latin American countries rather than Asia. Argentina, Peru, and Uruguay, in particular, are building a foundation for strong growth in export-oriented industries.

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Obstacles to Rapid Growth in Manufactures Exports [a]

	Lack of Commitment to Outward-Looking Growth Policies	Financial Constraints	Other Factors				
			Political Instability	Insufficient Infrastructure	Shortage of Skilled Labor	Narrow Export Market	Limited Natural Resources
Argentina	M	H	M				
Chile		M	L				
Cyprus				L		L	
India	M			M			
Indonesia	M	M			H		
Jordan						L	M
Malaysia					L		
Pakistan	L	L	L	M	M		
Peru		M					
Philippines		H	M				
Sri Lanka			L	M	L		
Thailand			L				
Tunisia	M				M		
Uruguay			L			L	

[a] The severity of each factor is indicated by an *H* (High), *M* (Medium), or *L* (Low). If no indicator is given, the factor is not considered an obstacle to the growth of the country's manufactures exports.

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Implications

Like the NICs in their early stages of export-led growth, the second-tier LDCs will focus on narrowly defined product lines in which they have a comparative advantage. These will largely consist of yarn, fabrics, leather, plywood, cement, assorted chemicals, and other labor-intensive, standardized, intermediate goods.

Over the longer term, the focal point of the second-tier LDCs' competition with industrial-country producers probably will spread beyond textiles and clothing exports as these LDCs attempt to develop more sophisticated lines of manufactures exports. Because of recent advances in manufacturing techniques, there are a number of mature, technologically stable industries that are suitable for these LDCs. These include such labor-intensive consumer and leisure goods as toys, printed materials, and small electrical appliances as well as electronic components. As in the case of textiles and clothing, their movement into the production and export of these manufactures will pose an additional challenge to US and other industrial-country producers of these goods.

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The emergence of the second-tier LDCs will generate export-market opportunities for industrial countries, particularly capital equipment and management services. Moreover, as second-tier LDC incomes rise, demand for industrial-country consumer goods will likely rise. Although it is impossible to prejudge whether market gains in some

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sectors will outweigh losses elsewhere, the emergence of these second-tier LDCs will alter market prospects in a broad range of industries and probably will spark political debate in industrial countries.

As the second-tier LDCs increase their manufactures exports during the 1980s and beyond, we believe this will lead to a substantial increase in the competition between the second-tier LDCs and NICs as they compete to capture a greater share of a slowly expanding world market for manufactures. As the second-tier LDCs move into the low- and medium-technology area, this could force the NICs to push more aggressively into high-technology industries. In the process, such developments could weaken industrial-country control over sales of high-technology items.

An upswing in inter-LDC competition could enable the industrial countries to play off the needs of one group of LDCs against those of another in future international negotiations. This tactic could prove useful in splitting common LDC positions in the GATT, UNCTAD, and other international economic forums as well as in the negotiation of such trade agreements as the Multifiber Arrangement.

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