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International Economic & Energy Weekly

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8 February 1985

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Comments and queries regarding this publication are welcome. They may be directed to [redacted] *Directorate of Intelligence,* [redacted] 25X1 25X1

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Perspective

South Korea: Emerging Industrial Giant? 25X1

An aggressive private sector aided by government support and a low-paid but productive work force have propelled South Korea in 25 years from an underdeveloped agrarian society to the position of the world's 15th-largest exporter and perhaps its most advanced LDC. South Korea has become a keen competitor in several highly visible industries important to the economies of the developed countries, prompting some commentators to call Korea the next Japan. South Korea's growing industrial strength is reflected in:

- *Shipbuilding.* South Korean shipbuilders captured 20 percent of worldwide orders in 1983—second only to Japan. Although expansion plans have been scaled back, Korean shipyards continue aggressively to add capacity.
- *Steel.* South Korea has become the world's most competitive steel producer by combining low wages with technologically advanced plants. Plans to increase capacity by 75 percent in the next decade are being implemented.
- *Overseas construction.* Orders grew an average of 28 percent annually between 1975 and 1983. In 1981, South Korean firms accounted for over one-half of the world's 25 largest general building contractors. 25X1

Building on these successes, South Korean economic planners have targeted rapid expansion into knowledge- and technology-intensive industries:

- *Automobiles.* Seoul plans to boost automobile exports from 43,000 units in 1984 to 800,000 by 1991. Hyundai plans to begin selling cars in the US market later this year, and Daewoo, strengthened by a technical and equity tieup with General Motors, is tripling its capacity.
- *Semiconductors.* Samsung and other leading electronics firms intend to begin producing 64K and 256K random-access memory chips. The South Koreans could apply this technology in the production of other advanced electronics. 25X1

Seoul's track record for astute economic planning, its aggressive private sector, and its well-disciplined and educated work force are pluses for its ambitious industrial strategy. The many underemployed college graduates and Koreans residing overseas also are sources of talent that can be tapped. Seoul will be better able to encourage the inflow of new technology and to foster domestic as well as foreign investment because of its ongoing liberalization of foreign investment, technology transfer, imports, and the financial system. 25X1

Despite these advantages, South Korea must cope with hurdles to growth not faced by the Japanese two decades ago:

- *Small domestic market.* With a population of only 40 million and its $2,000 per capita income, South Korea's domestic market does not provide economies of scale that would be a springboard for many emerging industries, forcing reliance on foreign markets.

- *Dependence on foreign inputs.* Lacking a mature R&D infrastructure, South Korea depends upon foreign technology and capital for even rudimentary development of new industries.

- *Protectionism.* Forays into technology-intensive exports will result in head-to-head competition with developed trading partners. Trade frictions will inevitably increase in areas such as intellectual property rights, trade in services, and strategic trade controls.

- *Security issues.* A relatively heavy defense burden—nearly 6 percent of GNP impedes South Korea's climb up the technology ladder.

- *Foreign debt.* Unlike the Japan of 1960, South Korea must manage a $43 billion debt—equivalent to half its GNP. Additional capital inflows could be at risk if foreign bankers become more concerned over South Korean political stability [redacted] 25X1

Given these factors, we believe South Korea will emerge as a strong competitor in world markets for many knowledge- and technology-intensive products but is unlikely to succeed on the same scale as Japan. Seoul is aware that its very success could lead to increased strains in its leading export markets and it faces stiff competition from other NICs. [redacted] 25X1

In our judgment, serious political instability is unlikely in the near term, but the recent confrontational note struck by opposition candidates underscore the potential for political turbulence. Transient episodes of political tension and scandal could erode foreign confidence in Korea's stability and prompt a cutoff in crucial capital and technology inflows. In addition, uncertainty about an anticipated leadership transition in 1988 raises questions among many observers about prospects for longer term political stability. [redacted] 25X1

[redacted] 25X1

Briefs

Energy

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Iran Set To Begin Shuttling Crude to Southern Gulf

[redacted]

Iran has chartered four tankers to shuttle crude oil from Khark Island to the southern Persian Gulf near its Sirri Island terminal and two VLCCs to store and offload the crude, according to the US Consulate in Dhahran [redacted] Tehran hopes to boost exports from recently depressed levels by enabling buyers to avoid the added cost and danger of calling at Khark. If operated efficiently, the shuttle system is capable of transshipping at the 1.5-2.0-million-b/d level maintained at Khark over the past few years. Because of storage limitations, the flow rate will also depend heavily on a regular timetable for customers' tankers—about one a day to maintain peak rates. Larger discounts will be a key factor in the scheme's success, but Tehran's resistance was largely responsible for erratic exports over the past six months, and customers—particularly the Japaneses—have been pressing hard for lower prices. [redacted]

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[redacted]

Soviet Oil Deliveries to Western Europe Suspended

[redacted]

The shortage of Soviet oil supplies evidently is severe, as the USSR recently informed numerous West European customers that it will not export any oil during the rest of this month. According to West European press services and an industry spokesman, the Soviets told some customers that the stoppage was because of the "national emergency." The West Europeans indicate that they are not concerned, because alternative supplies are plentiful due to the soft oil market. It is not yet clear how long the suspension of deliveries will last and how this will affect the USSR's hard currency situation. During nearly every winter in recent years, harsh weather at Soviet ports and oilfields has made it

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difficult for the USSR to meet all of its oil commitments and has caused some stoppage in oil exports. The present conditions, however, clearly are more serious than last year's, as domestic oil production has fallen in recent months. [redacted]

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Iraqi-Saudi Pipeline Construction Lags

[redacted]

Work on the 500,000-barrel-per-day spur line from Iraq to the Saudi Red Sea pipeline is well behind schedule, and Iraq will not make the September completion date, according to US Embassy sources in Baghdad and Riyadh. Progress has been slowed by defective pipe and difficult trenching conditions as well as by contractor manpower limitations imposed by Iraq. Meanwhile, [redacted] construction is under way near the spur's junction with the Saudi's Petroline link to export terminals on the Red Sea. Additional construction delays are likely, and Iraqi oil probably will not flow through the line this year. The maximum flow rate probably will not be reached until mid-1986. [redacted]

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Oil Slump Hits Ecuador

[redacted]

Falling oil exports will reduce Ecuador's prospective trade surplus and budget revenues, thereby jeopardizing economic gains. According to the US Embassy, CEPE—the state oil company—recently lost contracts with two US oil firms because Ecuadorean crude became overpriced relative to the spot market. CEPE's exports dropped 17 percent during the last quarter of 1984 to 142,000 barrels per day (b/d), and export revenues could fall by $140 million this year. Quito is selling oil on the weakening spot market, dropping the effective export price to $26.25 per barrel—compared with the $27.50 official price for Ecuadorean crude. Quito also will probably offer discounts to entice its oil customers, and may be forced to devalue every few months to boost nonoil exports. If oil income is not replaced, Quito's 1985 budget revenues will suffer, impeding its ability to achieve the 3-percent budget surplus called for under the new IMF agreements. [redacted]

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New French Nuclear Technology

[redacted]

Framatome and Electricite de France have demonstrated a new technology that will allow France to rely more heavily on atomic power and reduce its consumption of imported oil. The new technology improves the ability of a nuclear reactor to increase or decrease its output rapidly, reducing the need for conventional power generation to satisfy peak load demands. Existing reactors can be retrofitted when refueled. The new technology would also increase the competitiveness of Framatome, even though it may license the technology to other firms. [redacted]

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Premature Announcement of Turkish Nuclear Reactor Purchase

[redacted]

Officials of the Canadian firm AECL last week informed the US Embassy in Ottawa that they have not signed a contract to build Turkey's first nuclear reactor, despite a Turkish announcement three weeks ago. According to the officials, AECL has only received an invitation to continue negotiations within the proposed "joint venture" framework. The offer is nonexclusive, indicating that the West German firm KWU, as well as Westinghouse, are still in the

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running. The original ambiguous announcement by the Turkish Energy Minister may have been aimed at putting last-minute pressure on the other bidders to sweeten their proposals. [redacted] 25X1

Japanese Gas and Electricity Demand Rising

Japanese imports of liquefied natural gas (LNG) through the first 10 months of 1984 were running at an annual rate of 36.4 billion cubic meters (bcm), a 30-percent increase from the 1983 total of 28 bcm. Imported LNG accounts for close to 95 percent of Japan's gas consumption. The increase is due in large part to a 40-percent rise in LNG-fueled generating capacity to meet rising electricity demand. Additional electrical capacity currently under construction 25X1 is expected to push Tokyo's LNG imports to an annual rate of 45 bcm by the end of 1986 and 52 bcm by 1990. Japan has sufficient LNG supplies already under contract, primarily with Indonesia and Malaysia, to meet these increased requirements until well into the 1990s. [redacted] 25X1

International Finance

Mexican Debt Rescheduling Update

Mexico is meeting this week with the Bank Advisory Committee in New York to hammer out final details of its $48 billion multiyear debt rescheduling, [redacted] The agreement has taken longer than 25X1 expected because of lengthy negotiations with European and Japanese banks on switching dollars to their home currencies. [redacted] 25X1 the agreement should be in the hands of Mexico's 530 creditor banks by mid-February. Final ratification probably will take another two to six months because of the complexity of the documentation and the large number of signatories. [redacted] 25X1

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The rescheduling agreement, which allows lending banks to convert about 25 percent of the rescheduled debt into currencies other than the dollar, could lead to repayment difficulties for Mexico if the dollar drops sharply [redacted] 25X1 About 90 percent of Mexican revenues are received in dollars, and the current agreement does not insulate repayments from 25X1 fluctuations in the US dollar. Mexico, however, is attempting to protect itself by diversifying its foreign exchange reserves, [redacted] 25X1

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Philippine Aid Donors Focus on Economic Reforms

Manila's lackluster approach to long-term economic policy reform led some donors to withhold or reduce new aid pledges at the annual meeting last week of the Philippine donors. The donors—believing Manila's recently announced revisions in coconut marketing perpetuate pricing disincentives for producers and exporters—pledged less than $1 billion, compared with the $1.2 billion Manila expected. To underscore their concern with policy reforms, a subcommittee of the group will meet with Philippine officials in a few months to review progress on structural adjustments. Particular attention will be given to institutional, marketing, and price reforms in agriculture as well as reforms of 25X1 the weak public-sector financial institutions. Many of the reforms, however, would require President Marcos to eliminate some major economic benefits enjoyed by his strongest supporters. [redacted] 25X1

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[redacted]

Somalian Economic Reforms

[redacted]

Mogadishu has implemented several economic reforms over the past month, but the fate of its IMF standby program remains in doubt. The government has devalued the shilling and established a dual foreign exchange market to encourage exports and discourage imports. Mogadishu also has ended price controls and abolished almost all export and import licensing. Tax reforms, reductions in civil service payrolls, and changes in public enterprises are to follow. Mogadishu has undertaken the politically risky measures to gain IMF approval for a crucial one-year, $22 million credit. Pledges from the recent World Bank's donor conference covered only $80 million of Somalia's projected $100 million payments gap this year, and the Fund is requiring Somalia to obtain the full $100 million this month. Moreover, Somalia will have to reschedule much of its $350 million in current and past-due debt service payments to meet IMF financial targets. Mogadishu probably will ask the IMF to reverse its current stand and allow proposed funding for export shortfalls to be applied to the payments gap. In addition, Somalia almost certainly will seek more aid from past donors—particularly Arab countries that were conspicuously absent from the recent list of pledgers. Mogadishu also might pressure the United States for emergency food aid. Even if the Fund approves the standby, domestic political pressures may soon cause President Siad to back away from the program—as he did last year—or to push for modifications. [redacted]

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Global and Regional Developments

EC Farm Price Proposals

[redacted]

The EC Commission has called for an overall 0.3-percent cut in Community farm prices—in terms of European Currency Units—for the marketing year beginning in April. Support levels for grains and butter would be reduced by almost 4 percent, but prices for some commodities—including some edible oils and cheeses—may increase by more than 2 percent. In national currencies,

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driessen, in presenting the proposals to the press, claimed that US-EC trade relations would be helped, presumably because export subsidies could be cut on wheat and butter sales outside the Community. Lower grain prices also probably would reduce EC demand for feed substitutes, but Andriessen ruled out dropping efforts to limit imports of US corn gluten. EC governments, which have yet to discuss the proposals formally, face strong agricultural lobbies and almost always adopt higher farm prices than those proposed by the Commission. [redacted] 25X1

EC-Pakistan Economic Cooperation

The European Community (EC) and Pakistan last month negotiated a new cooperation agreement to strengthen economic ties between the Ten and Islamabad. Approval by the EC Council and Parliament is expected before summer. The agreement extends the nonpreferential trade provisions of the 1976 cooperation pact for a minimum of five years and calls for more frequent consultation on bilateral and multilateral trade issues. Since 1976, EC exports to Pakistan—largely machinery and manufactures—topped an estimated $1.1 billion last year compared with EC imports—dominated by textiles—of only about $500 million. New aspects include EC aid to Pakistan's industrial development through financial support and technical exchanges; no amounts were specified. Islamabad, in return, promises to promote and protect investments by the Community and its members. These provisions are similar to EC agreements with India and the ASEAN countries, and Pakistan probably wanted to raise the status of its arrangement with the EC principally for political reasons. [redacted] 25X1 25X1

Europe's Esprit Project Receives Major Funding

The Esprit information technologies program, Western Europe's response to large increases in computer-related research—such as the Japanese Fifth-Generation Computer Project—has received $126 million in Community funding for 1985 research. Additional industry funds will bring the total to nearly $200 million—approximately four times the amount of Japanese expenditures over the entire three-year initial stage of their project. We believe that the West Europeans, drawing on their well-developed research base in advanced architectures and artificial intelligence, could well make some research progress. Efforts will be aided, moreover, by the inclusion of several major US high-tech firms. Nonetheless, longer term prospects remain clouded by likely coordination problems between participants and by Western Europe's historical weakness in turning high-technology research results into marketable products. [redacted] 25X1 25X1

Italian-Soviet Trade Problems

Prime Minister Craxi intends to complain about Italy's widening trade deficit with the Soviet Union when Foreign Minister Gromyko visits Rome in late February, according to the US Embassy in Rome. The deficit for the first 10 months of 1984 stood at about $2 billion, up from $1.7 billion for all of 1983. Although Moscow pledged to redress the imbalance last year when it signed the new Siberian gas accord with Italy, Soviet purchases from Italy have declined. Italian officials also complain that the Soviets hold Italian firms to 25X1 dollar-denominated contracts while accepting nondollar contracts with leading West European competitors. These officials point out that higher interest costs on dollar export financing place Italian firms at a competitive disadvantage. Unless Craxi wins some concessions, he may feel politically compelled to increase pressure on the Soviets, perhaps by cutting back purchases of Soviet oil on the spot market [redacted] 25X1

Petroleum Purchases Sustain Indian-Soviet Trade

[redacted]

Moscow has agreed to sell India 111,000 b/d of crude oil and petroleum products in 1985—only slightly less than in each of the last two years. Although no details of the 2 February contract have been announced, we believe that most of the crude oil will come from the Middle East. Moscow has been pushing New Delhi to diversify its purchases of Soviet goods—still 70 to 75 percent petroleum—and probably hopes to increase sales of machinery to private Indian businessmen. India would like to balance payments with the Soviets—last December's agreement calls for a 24-percent increase in two-way trade over 1984 levels—by selling more consumer goods, machinery, and wheat. [redacted] 25X1 25X1

No Changes Expected at Coffee Meeting

[redacted]

Proposals by Brazil for a decrease in the International Coffee Organizations's global export quota to prevent a price drop are likely to be rejected at next week's ICO executive board meeting. Importing members cite high market prices—about $1.45 a pound, the ICO upper limit—as an argument against a quota cut and are more concerned about ICO-member coffee sales to nonmember countries. Such sales have created a two-tier market in which prices to nonmembers are nearly half those paid by ICO members. Concern about crop prospects in Brazil and Colombia—the two largest exporters—along with harvesting and shipping problems in Africa, Asia, and Central America have boosted coffee prices 10 percent since the ICO quota was raised last October. Traders expect prices to soften somewhat in the near term as previously delayed shipments come onto the market. Beyond that, prices will depend on the weather in Brazil and Colombia as the frost season approaches. 25X1
[redacted] 25X1

National Developments

Developed Countries

Thatcher and the Pound

[redacted]

Prime Minister Thatcher will face an intensifying political and economic dilemma if the pound weakens further, a situation that might cause her to demand more direct US action to control the value of the dollar when she visits Washington later this month. London has tried to arrest further depreciation of the pound, primarily by raising interest rates. The base lending rate has risen 4.5 percentage points in two weeks to 14 percent, pushing real interest rates to the highest level in 150 years. This threatens an economic recovery already

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weakened by the coal strike and opens Thatcher to renewed complaints even from her own party that she is not doing enough to reduce unemployment. The pound's weakness also will make it more difficult for the government to stay within its budget because of increased costs of dollar-denominated purchases, particularly for defense. Slower economic growth, moreover, will reduce tax revenues and increase social welfare spending. The government thus will find it difficult to make tax cuts promised for March without increasing perceptions that its resolve to hold down inflation is weakening. Meanwhile, worries about the future of British oil prices are likely to continue downward pressure on the pound. [redacted] 25X1

Madrid Focusing on Export Control Problems

The Spanish may be close to a decision to negotiate with the United States over export controls on sensitive technology. Spanish officials have told the US Embassy they are increasingly aware that lack of an agreement will limit Spain's ability to develop its electronics industry and to create new jobs. They are particularly concerned that a joint venture with a US firm to produce microchips in Spain is in jeopardy. A high-level official said the Cabinet has discussed the year-old issue twice, and an options paper is to go to Prime Minister Gonzalez this week. Options will include joining COCOM or negotiating a bilateral agreement. We think Gonzalez will lean toward the latter. Some officials in the Ministry of Commerce, however, are attempting to make any solution conditional on settlement of a US case against a Spanish semiconductor firm for diverting material to Cuba. This would further complicate the issue. [redacted] 25X1 25X1

Italian Wage Indexation Referendum

Italy may hold a national referendum this spring on last year's six-month limitation on wage indexation. Rome's cap on wage indexation was a key element in bringing inflation down from 15 percent in 1983 to 10.6 percent last year. The referendum results from a successful suit begun last year by the Communist Party (PCI) before the Italian Constitutional Court. Most labor leaders, concerned that the referendum will further split the labor movement, oppose it, but the rank and file may ignore their views. [redacted] the Communists believe the indexation cap would be defeated by a wide margin. The PCI, however, is now concerned that the referendum may backfire on the party in May's nationwide elections. As a result, Rome may be able to work out a legislative compromise that avoids a referendum. [redacted] 25X1 25X1 25X1 25X1

New Israeli Measures To Combat Falling Reserves

The Israeli Cabinet this week approved new measures to stem a continuing drain on foreign currency reserves, which have dropped by nearly $1 billion since June to $2.85 billion. The new measures will double the foreign travel tax, impose a temporary duty on overseas airline tickets, and raise taxes on privately owned cars, boats, and planes. In addition, required deposits on 35 import items will increase, and the linkage of interest on bank deposits to exchange fluctuations will end for accounts held less than one year. These stopgap measures probably will not significantly reduce foreign currency

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losses, but the government hopes to avoid another devaluation that would intensify inflationary pressures, making adherence to the new wage-price accord more difficult. 25X1

Less Developed Countries

Bolivia's Economic Situation Worsening

Strikes, food shortages, and runaway inflation have pushed Bolivia even closer to economic chaos. A prolonged walkout by factory workers has caused production to plummet. Food shortages are more pronounced, and a nation-wide shutdown by private banks has prevented cashing of end-of-month salary checks. Meanwhile, the country's largest labor confederation is threatening to declare an indefinite general strike. President Siles's prospects for remaining in office until his term ends in August have been temporarily bolstered by the increasing dominance of prodemocratic forces in the military. 25X1 His failure to halt the economic slide, however, leaves him vulnerable to a coup. 25X1

US-Thai Textile Settlement Could Unravel

Bangkok will find it difficult to eliminate subsidies to textile exporters by 4 March, as called for in last week's agreement with the US Department of Commerce. Attempts to end subsidies will provide fresh ammunition to business and political groups who oppose Prime Minister Prem's austerity policies and will intensify the political debate prior to April's National Assembly session. If Bangkok maintains the subsidies and Washington again proposes countervailing duties on Thai textiles, Prem will probably face pressure from some Thai Cabinet members to link future purchases from the United States to the outcome of the case. 25X1 Further problems over textiles would undoubtedly lead the Cabinet to reject Boeing's bid to sell 737s to Thailand's domestic airline—a deal that already is in jeopardy. 25X1

Communist

Poland Steps Up Agricultural Barter Trade

Poland has increased barter trade with CEMA partners and Western suppliers to augment inadequate domestic meat supplies. Warsaw recently concluded a $20 million exchange with New Zealand for 18,000 metric tons of frozen lamb for heavy industrial equipment, believed to be largely mining equipment. In early January, a deal with West Germany was completed involving 80,000 tons of Polish rye for 10,000 tons of German pork. The two trades would supply roughly one-third of Poland's estimated meat import needs in 1985. With cash and credit resources tight, additional barter deals for meat and 25X1 other agricultural commodities are likely. Last year's above-average harvest of rye and record output of rapeseed exceed domestic processing and storage capabilities, providing a ready surplus for barter. 25X1

Hungarian Social Tension Blamed on Reform

Public reaction to recent consumer price hikes appears to be greater than Budapest expected. The government raised prices last week as much as 25 to 30 percent for dairy products and household heating and imposed even stiffer hikes on postage and transportation. Although the 1985 plan provides for a small gain in real wages—the first since 1981—the US Embassy reports that many are skeptical that the average 8-percent wage increase for public-sector employees will cover the price increases. Moreover, this lastest round of price reform hits people in the fixed-income public sector much harder than those in the increasingly lucrative private sector. As a result, social tensions are 25X1 growing over wage differentiation, inflation, and conspicuous consumption by the newly emerging entrepreneurial class. If discontent increases despite government efforts to mollify the public sector, the leadership may decide to slow the pace of reform. [redacted] 25X1

China's Civil Aircraft Buying Spree

Over the last three months, China has ordered over 50 commercial aircraft worth about $2 billion, [redacted] Beijing could spend 25X1 some $12 billion over the next few years upgrading its aviation sector. To date, China has committed nearly $1.4 billion for 25 Boeing aircraft, including 767s, 747s, and 737s. China is also turning to other suppliers with smaller orders for three Airbus A-310s, eight Shorts 360 from Ireland, nine Soviet TU-154Ms, and three De Havilland DHC-7s and five DHC-6s from Canada. Most of the aircraft are scheduled for delivery by 1987 leaving little time to 25X1 prepare flight and maintenance crews—both already in short supply. In fact, the Soviet purchase may be an effort to shorten crew retraining time. China plans to retire 15 older Soviet aircraft, probably IL-14s, which will free their Russian-speaking crews to man the new Soviet aircraft. [redacted] 25X1

China Promotes Technology Research Links With Enterprises

As part of its effort to overcome a longstanding failure to transfer research results from the laboratory to factories, China is promoting the formation of technology markets—places where research institutes, universities, factories, and S&T personnel can discuss problems, display results and negotiate sales of research results. Over 1,000 of these technical development and exchange centers reportedly have been formed. The Beijing Technology Market, one of the few permanent centers, sets selling prices for technology transfers, operates a job-locator service for S&T personnel, and is involved in developing inducements for S&T personnel to relocate. In promoting these markets, 25X1 China apparently has been influenced by its study of technology-exchange centers in East Germany and other Eastern Bloc countries. [redacted] 25X1

China Boosting Fertilizer Capacity

China is upgrading and expanding its phosphate fertilizer capacity to reduce dependence on imports. Emphasis is on increasing China's currently small output of diammonium phosphate (DAP), a multipurpose fertilizer. With assistance from US, Japanese, Kuwaiti, and Tunisian firms, China will

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construct at least five new DAP plants with a total annual capacity of 1.2 million metric tons. In 1984, China imported about 1.6 million metric tons of DAP, two-thirds from the United States. [redacted] 25X1

Increasing Overseas Remittances to Vietnam

New incentives have boosted hard currency remittances to Vietnam in the past few months and may allow Hanoi to settle its $19 million in overdue debt to the IMF. Overseas remittances, about two-thirds from the United States, fell to only $30 million last year. In response Hanoi adopted a more favorable exchange rate for remittances and increased the amount of cash that families could receive from abroad by 50 percent. [redacted] 25X1
remittances increased substantially in the last two months of 1984. The inflow may reach $50-60 million this year and possibly $100 million by 1987 if Hanoi demonstrates it can guarantee its citizens will receive the funds intended for them. Vietnam will need a substantial portion to pay for rice imports in the next few months and probably will use any remaining foreign exchange to reduce overdue debts to the IMF in the hope of lifting the unprecedented suspension the Fund imposed in January. [redacted]

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South Korea: Financial-Sector Liberalization [redacted] 25X1

South Korea's liberalization of its financial sector will provide foreign bankers with increased opportunities for financial services in trade and foreign exchange transactions. Economic policy makers are taking steps to attract additional capital, technology, and management skills, to allow the market to determine interest rates, and to expand the use of equity markets. These measures are part of a broader effort to open the economy that includes easing regulation of imports and direct foreign investment. We believe that the domestic economy will be strengthened by more efficient mobilization of capital, more equitable allocation of credit between large conglomerates and small firms, and shrinking of the illegal curb market. Seoul recognizes, however, that it must proceed slowly to avoid shocking the private sector as banks and businesses are weaned from government-directed, subsidized credit. [redacted]

Controls on Commercial Banks Loosened

Seoul, which has been loosening controls on the financial sector since 1982, has accelerated the pace in the last year. This activity reflects a growing concern with scandals linked to the "curb lending market," renewed pressure from foreign bankers, and countermeasures being applied abroad against South Korean exports produced with subsidized credit. Liberalization efforts vary from one financial market to another, as do the prospects for future deregulation, but Seoul has crafted its program to benefit all sectors by promoting competition and reducing government intervention in the routine management of financial institutions, particularly commercial banks. [redacted]

The Ministry of Finance (MOF) is gradually reducing the Bank of Korea's (BOK)—the central bank—direct control over the day-to-day management of the banking sector, relying instead on general guidelines and standards of performance:

- In early 1983, the BOK, formerly the majority stockholder in South Korea's commercial banks, completed a nine-year divestiture program.
- The government has replaced direct credit controls for each bank with indirect measures such as reserve requirements, rediscount operations, and open market operations.
- The BOK's Office of Bank Supervision and Examination is now concentrating on monitoring the financial performance of individual banks.
- The government is phasing out its special treatment of specific industries by eliminating preferential interest rates and forced lending (that is, loans dictated by government policy). [redacted] 25X1

Government influence over the financial system, however, remains extensive. The MOF, for example, controls interest rates to affect inflation and to avert a slowdown in economic growth. The major result has been a continual credit shortage caused by low deposit rates that discourage savings and a strong demand for loans at these below-market interest rates. As a result, the MOF must allocate credit among sectors: domestic banks must reserve a specified percentage of loanable funds for small- and medium-sized firms and other high-risk borrowers. Beginning in 1985, foreign banks will also be required to hold similar reserves. Seoul also continues to monitor credit flows to the largest firms and to restrict them if they absorb too large a percentage of total credit. [redacted] 25X1

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Interest Rate Decontrol 25X1

The government has taken a few cautious steps to loosen its control over interest rates, but we believe

The Curb Market in South Korea

The curb money market, which operates outside the formal financial sector, provides an estimated 10 percent of total domestic credit. Though the market is not illegal, nearly all curb market transactions violate tax laws and are made by unlicensed brokers. The existence of the curb market is explained, in part, by a lack of diversified financial instruments for savers and borrowers and by a rigid system of interest rates that are a constraint in a dynamic economy such as that of South Korea.

The curb market is a relatively simple system in which a broker collects savings from households for consumer loans or for short-term credit to primarily small- and medium-sized firms. Savers receive higher than official interest rates with no tax liability and borrowers are willing to pay high loan rates for scarce capital. The official financial sector participates in the curb market as bankers funnel funds between curb market brokers and borrowers.

South Korea's curb market is periodically rocked by scandals that paralyze this important source of short-term financing. A 1982 scandal resulted from a loss of confidence in a major curb market broker who blatantly displayed government connections, whereas a 1983 scandal was caused by the bankruptcy of a major curb market borrower. These scandals have had only temporary effects on the curb market, which rebounds with renewed vigor once order is restored.

The government has tolerated the curb market because it helps to ease the liquidity problems caused by its tight money policies, but major scandals are prompting a harder line. The recent liberalization of interest rates and laws discouraging the use of aliases that cloak curb market participants are intended to dry up these resources and bolster the formal financial sector.

near-term prospects for comprehensive decontrol are dim. Since last year, the MOF has been phasing out its rigid schedule of loan and deposit rates in favor of a more flexible system that allows bankers to charge loan rates—within MOF-imposed limits—that reflect the demand for credit and the risk. At present, however, even the most creditworthy firms usually pay rates at the upper limit because of scarce credit. In November 1984, interest rates in the call money market and in the unguaranteed bond market were completely decontrolled. 25X1

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Although some progress has been made, Seoul has not been responsive to rapidly changing interest rate market signals and continues to set rates in the largest credit markets. Moreover, deposit rates, particularly for small savers, are substantially below market levels. As a consequence, the curb market still is more efficient at mobilizing savings than the organized money market. Even so, we believe the freeing of interest rates in important financial markets may accelerate if the experimental call money and unguaranteed bond rates are not unusually high or volatile. 25X1

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Better Treatment for Foreign Banks

We believe the new regulations that provide near-equal treatment for foreign banks in the competition for won-denominated deposits and lending to domestic firms will help alleviate criticism from overseas bankers. Foreign banks can now compete with domestic banks in the public bond market and can gain domestic bank status through joint ventures with Korean partners. This year the government also will give foreign banks partial access to the BOK rediscount window for preexport financing, followed by full privileges in 1986.[1] Although 25X1

[1] Loans to South Korean firms are typically made by banks discounting commercial bills or promissory notes, which are then rediscounted by the BOK at a preferential interest rate. The rediscounted note or bill is a low-interest loan to the bank, which then can make a new loan at the official loan rate with the proceeds. 25X1

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access to the rediscount window will open new business opportunities—essentially by relieving chronic shortages of won—it will also require foreign banks to phase out the use of profitable swap transactions.[2]

Despite the progress toward providing full "national treatment" for foreign banks, several contentious barriers remain. Restrictive definition of foreign banks' capital base—the basis of their lending limits—puts them at a disadvantage with domestic banks in offering large, single-borrower loans, opening new branches, or providing high-profit, nonlending services. The prohibition against foreign banks' holding title to real estate and other property, including ships and aircraft, denies their use of such collateral to secure loans. Foreign banks must still gain MOF approval to enter newly opened markets through a lengthy process with obscure regulations. Moreover, continued depressed profits among domestic banks may prompt Seoul to close the door to new foreign banks.

Equity Market Restrictions Relaxed

Seoul is also gradually easing restrictions on foreign participation in the private securities market to provide alternative corporate financing and to attract foreign equity investment, thus reducing foreign borrowing. The Korean Stock Exchange (KSE) is being opened to foreign investment in several measured steps:

- Two $15 million trust funds of KSE-listed stocks were privately placed with foreign institutional investors in 1981.
- The Korea Fund, started in 1984 as foreigners' first chance to participate in the Korean securities market, has been well received and plans are being discussed for a second fund.
- A limited number of foreign investors will be allowed to purchase shares directly in prescribed industries in 1986.
- Restrictions on repatriation of profits and on areas where foreign investment is permitted will be lifted in 1988.

In addition, foreign securities dealers, on a reciprocal basis, may open representative offices and, since 1983, establish joint ventures with South Korean securities firms.[3] Seoul plans to lift restrictions on Korean securities firms in 1988, and Koreans will be free to make investments in foreign securities by the mid-1990s, when liberalization is scheduled to be completed. 25X1

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Outlook

We believe that the long-term prospects for an international, market-based financial system in South Korea are favorable. The key argument of the liberalizers—including many members of President Chun's Cabinet—that greater reliance on market forces will benefit the Korean economy is gaining wider acceptance within the bureaucracy. Nonetheless, progress will come in fits and starts because of domestic political considerations and economic conditions, and trading partner pressures for reforms: 25X1

- The pace of financial-sector liberalization could slacken if policy disputes exacerbate rifts within the ranks of the liberalizers—evidenced by a 10-month delay in interest rate reform caused by this group's infighting. We believe that the liberalizers will continue to have Chun's ear, but greater caution and his belief that liberalization and the economy are progressing may well curb its pace.

- Greater reliance on market forces carries a variety of risks and uncertainties, and, if economic conditions deteriorate, criticism of government policy would put heavy pressure on Seoul to retake control of the economy. 25X1

[2] Swap transactions occur when foreign banks acquire currency from their home office (usually in the form of a short-term loan) that is converted into won at the BOK. Swap funds offer a guaranteed profit of 1 percent and freedom from foreign exchange risk—advantages not available to domestic banks.

[3] Representative offices are authorized to provide only market information services and cannot conduct securities transactions.

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- The 1984 US Trade and Tariff Act links Generalized System of Preferences (GSP) benefits to progress in economic liberalization, and South Korean exports to the United States could be sharply curtailed if these benefits were withdrawn. 25X1

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Sudan: A Balancing Act [redacted] 25X1

The Sudanese Government is under intense pressure to initiate economic reforms while coping with shortages of food and energy and a growing insurgency in the south. President Nimeiri probably is giving greater weight to the immediate requirements for political stability than to the need for major adjustments in economic policy. In our judgment, Nimeiri's disinterest in, or aversion to, coherent economic decision making—together with his conviction that foreign benefactors, especially the United States, ultimately will rescue him—may preclude a systematic and sustained approach to solving Sudan's economic difficulties. [redacted] 25X1

To obtain renewed financial assistance from disenchanted international donors, we believe that Khartoum soon will announce an economic reform package, albeit one likely to fall short of donors' expectations. Nonetheless, reforms such as devaluation and price increases, even if only temporarily or partially implemented, may exacerbate economic hardship in the cities and fuel growing political dissent. Barring a resurgence of foreign assistance, the Nimeiri regime probably will resort to increasingly desperate measures to avert economic collapse, including unorthodox trade agreements with unscrupulous middlemen and perhaps even overtures to Libya or the USSR [redacted] 25X1

Sudan: Economic Assistance From Major Donors *Million US $*

	1981	1982	1983 [a]	1984 [b]
Total	**698.3**	**680.7**	**568.5** [c]	**124.5** [c]
Western donors	369.3	400.0	300.7	80.1
United States	140.0	175.0	165.0	67.0
France	62.0	130.1	40.0	2.1
W. Germany	79.2	41.3	55.0	13.9
Netherlands	34.8	26.4	30.0	5.5
United Kingdom	53.3	27.2	10.7	13.5
OPEC	200.0	130.0	178.0	0
Saudi Arabia	160.0	80.0	178.0	0
Kuwait	NEGL	0	NEGL	0
U.A.E.	40.0	50.0	0	0
Multilateral	129.0	150.7	NA	NA
World Bank	64.8	84.9	70.0	16.0
EC	45.5	40.9	19.8	6.5
United Nations	18.7	24.9	NA	NA

[a] Estimated.
[b] Reflects assistance received up to June 1984.
[c] Minimum estimate.

[redacted] 25X1

The Current Financial Crisis

In common with many other Third World countries, Sudan's current economic disorder stems largely from profligate borrowing during the last decade, coupled with economic mismangement and adverse shifts in its terms of trade. Despite generous debt rescheduling agreements, Sudan remains unable to meet its debt service obligations. According to the most recent data, Khartoum was $124 million in arrears to international creditors at midyear 1984. Over 80 percent of these obligations represented payments to multilateral institutions, and technically cannot be rescheduled. Most important, arrears of $84 million have put Sudan out of compliance with its standby agreement with the IMF [redacted] 25X1

Unless the IMF arrearages are resolved, the Fund is not likely to extend further standby financing to Khartoum, largely because of the unfavorable precedent it could create with other Third World debtors. The IMF reportedly is willing to accept a "reasonable payment" toward arrears as long as full payment is made during 1985. The confrontation with the IMF has also caused a slowdown in disbursements of financial assistance from most major donors. From January to June 1984, only $168 million in official aid was transmitted to Sudan, out of commitments of $625 million made for the entire year. Although we lack accurate information on disbursements during the second half of 1984, we strongly suspect the slowdown has continued. Most donors reportedly are extremely displeased with Khartoum's economic policies—the Saudis totally halted disbursements last year—and are awaiting significant reforms by Sudan before resuming full-scale assistance.

The IMF has recommended several reforms, including an almost 50-percent devaluation of the official exchange rate, a floating free market rate, substantial price increases in sugar, bread, and petroleum, and various tax increases and budget cuts. Khartoum had already announced in November the reintroduction of excise and income taxes and selected commodity price increases, but almost all financial observers considered these modest reforms insufficient. IMF analysts have admitted that, even if the Fund's recommendations were fully adopted, it would be impossible for Sudan to close its foreign payments gap during the 1984 fiscal year.[1] This would be true even if all official aid that has been committed were disbursed. The only ground for optimism is that movement by Sudan on the IMF reform package might persuade donors to provide the additional financing required.

We believe Khartoum will seek modifications to the IMF reform package and probably will delay any reforms until it is convinced that its major donor, the United States, will accept no further watering down of proposed policy adjustments. Khartoum probably will use Vice President Bush's expected visit to Sudan in mid-February and Nimeiri's visit to Washington (probably in March) to test the limits of the United States' role as Sudan's chief benefactor. Nimeiri is likely to argue that major

[1] Sudan's fiscal year beginning 1 July 1984.

Sudan: Current Account [a] *Million US $*

	1982	1983	1984 [b]	1985 [c]
Current account balance	**−769**	**−566**	**−647**	**−900**
Trade balance	−943	−656	−653	−650
Exports	573	732	675	650
Cotton	175	344	310	300
Imports	1,516	1,388	1,328	1,300
Net services	174	90	6	−250
Remittances	415	380	350	350
Other (including interest payments)	−241	−290	−344	−600

[a] Fiscal year data beginning 1 July of the stated year.
[b] Estimated.
[c] Projected.

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economic reforms would lead to growing political unrest at a time already made difficult by current austerity measures.

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Impact of Drought and Economic Stagnation

The Nimeiri regime's survival over the next six months may also depend on its ability to cope with drought-related shortages of food and energy and general economic stagnation. The regime has managed to minimize the public impact of drought- and refugee-related food shortages. The distribution of food grains has been fairly equitable, ensuring that no region has suffered disproportionately. Nor have the government's policies favored urban areas at the expense of the hinterland, thereby lessening the probability that drought-stricken migrants will descend on the Khartoum area.

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Food shortages are unlikely to disappear. The US Embassy estimates the Sudanese grain shortfall in the current harvest year to be 633,000 metric tons after all currently pledged food aid from abroad is

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deducted. Sudan's severe foreign exchange shortage largely precludes commercial imports of food by the government. The responsibility for making up the deficit probably will fall on already overburdened international relief agencies.

Economic activity remains severely depressed. Manufacturers have been badly squeezed by a combination of recession, new taxes, and price controls that have throttled production to less than one-third of capacity. Gasoline supplies are approaching critically low levels, with most vehicles restricted to a ration of two gallons per week. Private investment in the economy has also sunk to negligible levels as investors await the latest reform package and a clearer definition of the government's Islamization policies on business practices in Sudan.

Despite shortages and economic stagnation, there have been only a few signs of growing discontent including small disturbances in early February over shortages of bread and fuel. Many urban residents appear to believe that drought, the influx of Ethiopian refugees, and the intransigence of international donors share blame with the government for the current economic mess. Many other skilled and articulate—and thus potentially dissident—Sudanese are leaving the country to seek economic opportunities elsewhere.

Effects of the Insurgency

The insurgency in the south has stopped development of Sudan's oil resources, the exploitation of which would have greatly benefited its balance of payments over the next two to four years. The US company holding the principal oil concession in the south refuses to return to the area, despite veiled threats by the government to turn elsewhere to develop this resource. The recent establishment of the Sudan National Oil Company, a joint venture between the government and Saudi entrepreneur Adnan Khashoggi, may have been intended to make this threat appear more realistic. We believe the deteriorating security situation in the south, however, will deter anyone from operating in this region in the immediate future.

The upsurge of military activity in the south is also financially straining the government. 25X1
the Finance Ministry is having increasing difficulty meeting payroll expenses for the armed forces. Although hard currency shortages have been apparent for some time, this is the first instance in which Khartoum has found it difficult to raise local currency for recurring operating expenses. The growing cost of military operations could force the government to abandon monetary restraint and thereby worsen inflation. 25X1 25X1 25X1

Critical Period Ahead

We doubt the Nimeiri regime will be capable of making the structural changes to stimulate economic growth. As previous reform programs have shown, the Sudanese, for political and administrative reasons, usually are unable to maintain the continuity and momentum needed to see a program through to its completion. In addition, the government's propensity to misappropriate and squander resources will severely compromise any adjustment process. 25X1 25X1

The recent establishment of a Supreme Council for National Economy, chaired by the President, offers a faint ray of hope that a more integrated and coherent economic decision making process will develop. This body in theory could cut through the bureaucracy and provide the leadership to sustain difficult policy adjustments. Nimeiri's behavior, however, suggests that his interest and close personal attention will not last much beyond the immediate objective of securing renewed Western financing. We believe that without the President's active involvement, economic decision making will revert to its previous inconsistency and lack of focus. 25X1 25X1

Nimeiri is likely to resort to increasingly desperate measures to avert economic collapse if foreign donors continue to withhold their full financial support. The government reportedly has already

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committed a significant portion of the current cotton crop to a company owned by Khashoggi as collateral for badly needed crude oil. Similar deals with opportunistic middlemen could become more frequent if alternative financing for Sudan's critical import requirements is not found. [redacted] 25X1

Nimeiri may also attempt a temporary rapprochement with Libya, or even with the USSR, if political and economic conditions continue to deteriorate. He might expect that a curtailment of Libyan support for Sudanese insurgents would enable oil development to resume in the south. We believe, however, that full settlement of the insurgency would be needed. Moreover, we doubt that either the USSR or any other foreign power that is not currently an ally of Khartoum would provide the level of financing that Sudan would require to weather its current economic difficulties. [redacted] 25X1

[redacted] 25X1

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North Yemen: Meeting the Challenges of the Oil Discovery [redacted]

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The discovery of oil in July 1984 has brightened the long-term outlook for the North Yemeni economy but has heightened tensions along the disputed borders of North Yemen, South Yemen, and Saudi Arabia. To date, North Yemen's primitive economy has faced increasing financial problems as a result of import dependency, severe drought, a decline in foreign aid, and a corresponding sharp decline in foreign exchange reserves. The package of austerity measures imposed by the government in 1983 is easing the immediate balance-of-payments problem but has nearly halted development programs. To develop the economy and improve the living standards of most Yemenis, Sanaa needs to avoid the "boom" atmosphere and the grandiose projects that all too often accompany oil discoveries in the Third World. [redacted]

The Oil Find

The Yemeni Government's hopes for the economy's long-term vitality are pegged on the recent oil find. The Hunt Oil Company's first strike was in the Ma'rib Al Jawf Basin in July 1984. The original concession area—near the poorly defined borders with Saudi Arabia and South Yemen—was extended in November. Hunt has drilled two more successful wells and intends to drill six more to delineate the field. The drilling program is expected to be completed by this spring, and initial results will be analyzed before further development plans are made. On the basis of sparse preliminary evidence, North Yemen's Petroleum Minister estimates production potential from the first field at 200,000 barrels per day (b/d). [redacted]

Sanaa has commissioned the Hunt Oil Company to do feasibility studies on a domestic refinery, a crude oil pipeline, and an export terminal. [redacted] production of at least 100,000 b/d is needed to warrant an export pipeline to the Red Sea, a route approximately 240 kilometers long that crosses a 3,000-meter mountain range. Hunt has estimated that exportable oil production is at least four years away, but Yemeni officials are hoping to accelerate the timetable by transporting crude oil in trucks. In either case, this is a formidable undertaking because port facilities are underdeveloped, and constructing new roads and pipelines across the mountains would be arduous. [redacted]

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Disputed Borders Near Hunt Oil Concession

Tensions among North Yemen, South Yemen, and Saudi Arabia over disputed borders could complicate Hunt Oil Company efforts to develop its recent discovery and drill other exploratory wells. None of the borders in the area have been fully defined, and Saudi Arabian–North Yemeni territorial claims overlap by as much as 175 kilometers. [redacted]

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In mid-December, South Yemen deployed elements of three brigades in the border region east of Ma'rib. In response, North Yemeni troops occupied high ground near the border that Sanaa considers essential to the defense of the oil-drilling sites. Early last month, North and South Yemeni troops clashed briefly nearby. [redacted]

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North Yemen President Salih and South Yemen President Ali Nasir appear to have defused tensions in three days of shuttle talks that ended on 21 January. Salih reportedly agreed to extend a 1982 accord between the two countries that provides for joint exploitation of oilfields in the vicinity of the border. As a result, Salih may approve joint efforts,

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Problems in a Primitive Economy

North Yemen is the least developed country on the Arabian Peninsula:
- *Despite efforts at development during the 1970s, much of the population lives in areas without roads and electricity and where government authority is minimal.*
- *Subsistence agriculture is restricted by a domestic labor shortage and harsh and erratic climate.*
- *Until the recent oil discovery, few commercially exploitable minerals were found.* [redacted]

The economy is heavily import dependent, with one of the worst trade imbalances in the world—exports typically cover less than 1 percent of imports. Remittances from expatriates, largely workers in Saudi Arabia, provide the bulk of the foreign exchange to cover the trade deficit. Despite predictions [redacted] *that the recession in the Gulf would cause remittances to decline, data for the first half of 1984 indicate that remittance income has held up. Worker remittances have been a mixed blessing, however. The labor shortage caused by the departure of roughly 1 million Yemeni workers has inflated domestic wages, while remittance income has increased the demand for imports. Government attempts to benefit from this import boom by levying customs duties resulted in a burgeoning black market of smuggled goods, which the Embassy estimates is equivalent to one-third of officially recorded imports.* [redacted]

Foreign aid, primarily from Saudi Arabia and other Gulf oil producers, is the other important source of funds covering the trade gap. Recently, however, the Gulf-wide recession has caused government transfers to decline markedly, from $439 million in 1982 to $160 million in 1983. We estimate that 1984 aid remained at roughly the 1983 level. As a result, official foreign exchange reserves fell to a low of $135 million in August 1983, compared with almost $600 million a year earlier. Embassy reporting suggests that reserves recently have increased to $300 million, but this would provide only three months of import coverage. The persistent drought and the estimated $2 billion in damage from the December 1982 earthquake continue to aggravate the budget and current account deficits. [redacted] 25X1

Sanaa implemented a series of austerity measures in mid-1983 to deal with its deteriorating financial position. The government raised tariffs on consumer items, restricted import licenses, and stepped up antismuggling measures. Sanaa also cut government spending and increased taxes. The result was a rise in customs revenue and a $900 million improvement in the current account deficit. The estimated 1984 current account deficit was $155 million. [redacted] 25X1

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Faced with further depletion of hard currency reserves, the Central Bank stopped selling foreign exchange in June 1983. Although Sanaa resisted devaluation because of fears of rapid inflation and widespread public discontent, the divergence between the official rate and the moneychangers' "street rate" forced the Central Bank beginning last February to devalue the riyal several times. Moreover, to restore business confidence, Sanaa forced the closing of all moneychangers for two weeks in November 1984 and then issued stringent regulations requiring adherence to the official exchange rate. [redacted] 25X1

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Sanaa's success in temporarily stabilizing its foreign payments has come at the cost of scrapping most of its Second Five-Year Development Plan and has sharply reduced growth rates. Real GDP growth averaged only 2 percent in the last two years—slightly less than population growth—compared with a 6-percent average annual rate between 1978 and 1982. Inflationary pressures have increased, spurred by the recent devaluations, import restrictions, and the continued—albeit reduced—deficit spending; consumer prices rose an estimated 16 percent in 1984. Because many families hold "mattress money" as a buffer against hard times, there has been no observed increase in public dissatisfaction with government handling of the economy. [redacted] 25X1

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North Yemen: Balance of Payments *Million US $*

	1980	1981	1982	1983	1984 [a]	1985 [b]
Trade balance	−1,855	−1,714	−1,921	−1,761	−1,295	1,395
Exports (f.o.b.)	13	11	5	10	5	5
Imports (c.i.f.)	1,868	1,725	1,926	1,771	1,300	1,400
Services balance	1,022	742	875	1,038	1,110	1,200
Of which:						
Remittance exports (gross)	1,254	943	1,175	1,228	1,300	1,350
Private transfers	2	15	23	26	30	25
Current account	**−831**	**−957**	**−1,023**	**−697**	**−155**	**−170**
Government grants	146	332	439	160	150	150
Government loans (net)	NA	NA	185	197	200	225
Direct investment	34	40	27	8	10	15
Other	416	166	−104	−24	−355	−370
Errors and Omissions	90	98	69	168	100	100
Change in reserves	−145	−321	−407	−188	−50	−50

[a] Estimated.
[b] Projected.

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but only if promising geological structures are found that straddle the border zone. 25X1

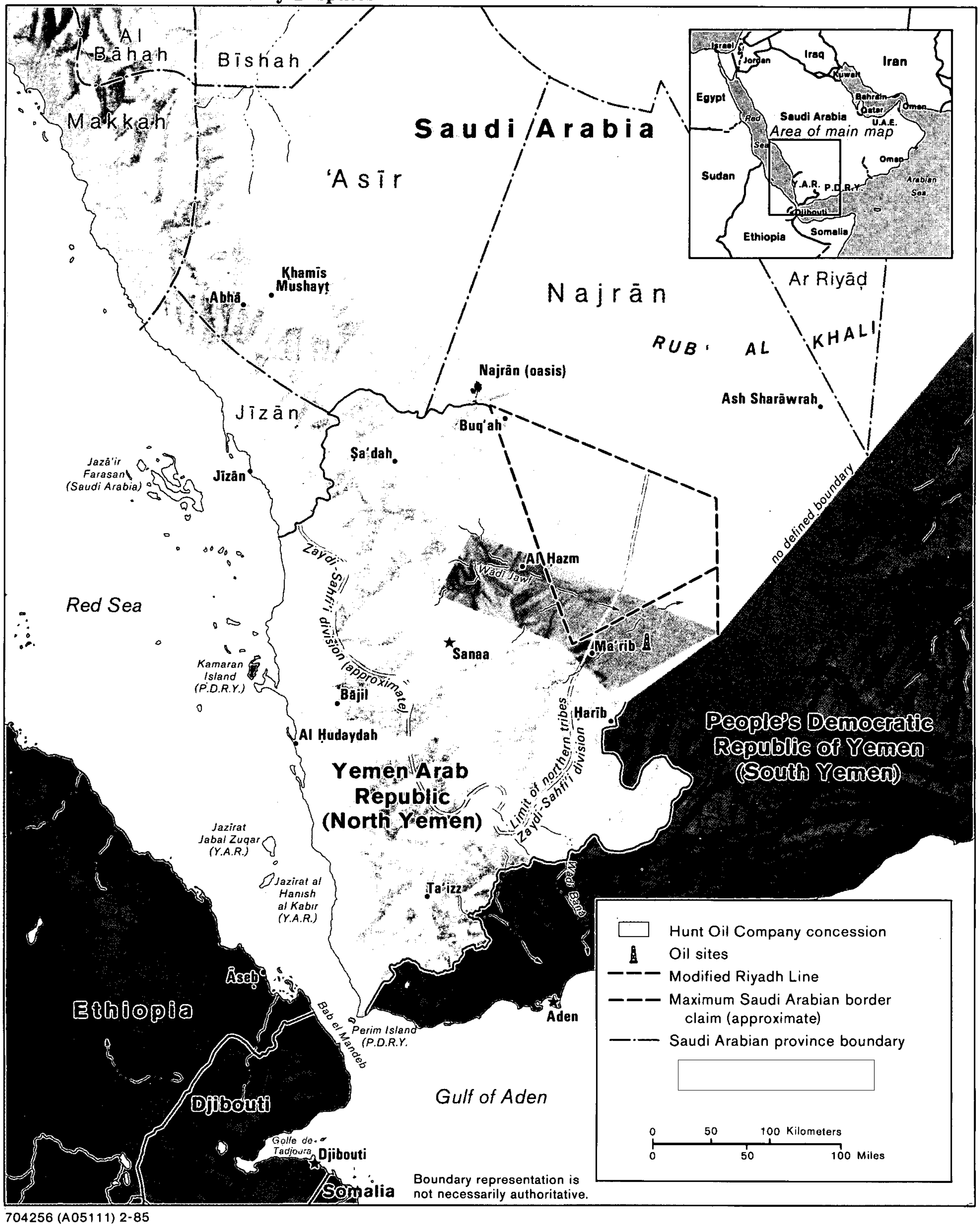
Riyadh is following developments in the border area closely, and we doubt that the Saudis will abandon claims to territory near the drilling sites. Saudi Arabia has never officially accepted North Yemen's version of its eastern border, which is based on the so-called Modified Riyadh Line declared unilaterally by the British in 1955. The Saudis, however, are unlikely to interfere directly with operations at the present drilling sites. They know that the stakes for Sanaa are high and that the Yemenis can be expected to fight to protect the concession area.

Outlook

We do not believe that North Yemen's economy will show any improvement in 1985 over its performance in 1984. Sanaa will probably try to continue to limit imports and rebuild its foreign exchange reserves. The estimated increase of $8.2 million for investment and development spending in the 1985 budget, however, would make it difficult to decrease or maintain low import levels. It is likely that remittances and foreign aid—despite Saudi threats to cut contributions—will remain at their 1984 levels. 25X1

Although any benefits are still several years away, the discovery of "promising amounts" of oil has presented Yemeni officials with the challenge of preventing a "boom" atmosphere. The discovery has changed North Yemen's status in the eyes of foreign investors. It also has led the Yemeni business community to start making grandiose plans despite recent government efforts to avoid excessive expectations. The news came at a propitious time 25X1

Oil Concession and Boundary Disputes



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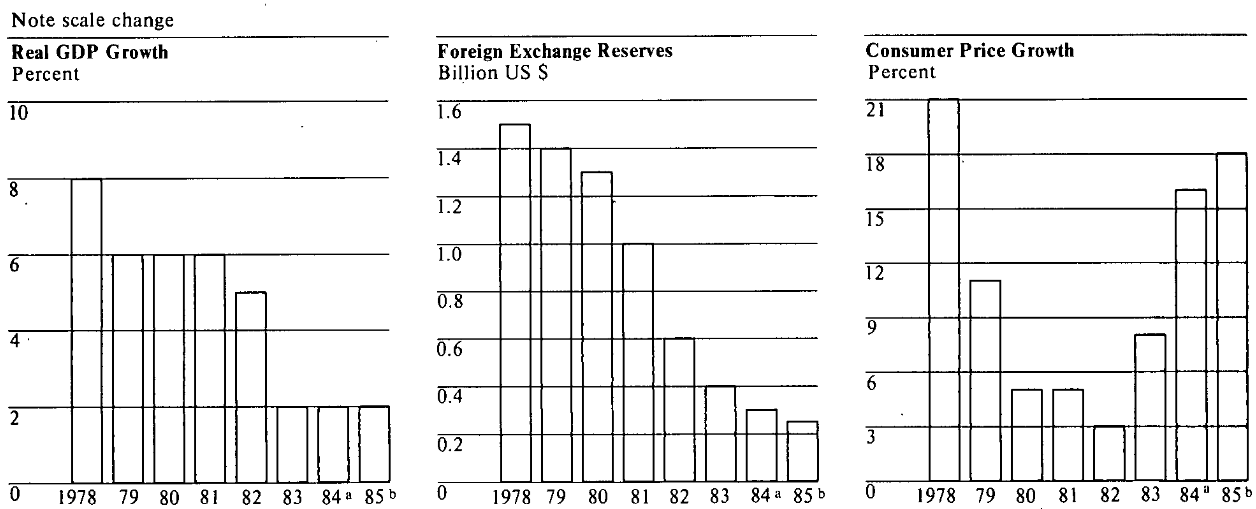
North Yemen: Economic Indicators, 1978-85



[a] Estimated.
[b] Projected.

[redacted] 25X1

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for Sanaa because businessmen have been increasingly critical of government policies that have curtailed growth. As expectations rise, Sanaa will probably attempt to secure its power base by distributing the benefits of economic growth to a broad spectrum of the population. The government is likely to concentrate on building infrastructure and increasing health and education levels. Because of the competing business, tribal, and religious interests, it is likely that the government will attempt to balance development throughout the country. Most of the initial returns from oil production will be used to make payments on debts incurred on oil development projects, but Sanaa may not be able to put off for long expectations of higher living standards based on oil revenues. [redacted] 25X1

The Hunt Oil discovery has led to a slight upturn in US–North Yemeni relations. The discovery is the one bright spot in the economy, and the fact that a US firm made the find is a major plus for Washington. President Salih probably will press for expanded relations with the United States as a useful check on the Saudis and a counter to the Soviet-backed regime in South Yemen. The Yemenis believe that Saudi Arabia has a major influence on US policies toward North Yemen and Salih will remain sensitive to signs of Saudi influence on US actions. [redacted] 25X1

[redacted] 25X1

Jordan: Weathering the Arab Recession

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The Jordanian economy has weathered the sharp cutbacks in trade with Iraq and in Arab aid and is showing signs of recovery. The inflation rate is low, industrial production has picked up, and exports to Iraq—one of Jordan's major markets—have started to recover. Faced with bleak prospects for oil earnings, Saudi Arabia and Kuwait—Jordan's largest donors—are unlikely to increase aid levels to permit the high growth rates of the early 1980s. Moreover, foreign exchange reserves have fallen to their lowest level in eight years keeping Jordan dependent on even the reduced level of Arab aid. Amman may have to turn to greater foreign borrowing from non-Arab sources to finance its expenditures for 1985.

Production, Prices, and Employment

Jordan's real GNP grew at an impressive average of almost 14 percent per year between 1974 and 1981. The rapid decline in trade with Iraq in 1982-83 and cutbacks in Arab aid caused real growth in those years to drop to about 5.5 percent. Last year growth slowed further to an estimated 4 percent.

Price increases have been restrained with the falloff in economic activity. Inflation slowed to an estimated 4 percent last year, as compared with 5 percent in 1983. Unemployment, estimated at 2 percent, is not a problem. In fact, Jordan has a labor shortage and employs about 35,000 skilled expatriates—primarily from the Far East and Indian subcontinent—and about 120,000 unskilled workers—mostly Egyptians. Moreover, about 300,000 skilled Jordanians work abroad, predominantly in neighboring oil-producing countries. When the oil-glut recession hit these countries, it was feared that many of these Jordanians would have to return home and that an unemployment problem would emerge. This did not occur, however, and worker remittances, an important component in Jordan's balance of payments, have remained strong.

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Foreign Aid and Payments

After receiving $1.2 billion in 1980, Arab aid dropped to around $800 million in 1983. Last year, Saudi Arabia was the only country to fulfill its commitment to Jordan and total Arab aid fell to about $500 million. Kuwait has resumed its aid at a lower level, but Arab aid in 1985 will probably only match last year's total.

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Estimates for 1984 suggest that Jordan was able to increase its exports, decrease imports, and maintain its very positive net services balance. Despite the falloff in overall grant aid, Jordan's current account deficit of $380 million for 1984 remained at roughly the 1983 level.

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Jordan's civilian foreign debt totals about $2 billion and is largely owed to multilateral lenders. Debt service is manageable, and there is no capital flight. Short-term capital inflows, however, might have tapered off last year.

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Foreign Exchange Reserves Fall

Jordan's officially reported foreign exchange reserves fell to $490 million at the end of November 1984, the lowest level in eight years. Reserves reportedly fell over $100 million in September despite a $40 million aid payment from Kuwait that month, and fell another $53 million in October despite a $120 million aid payment from Saudi

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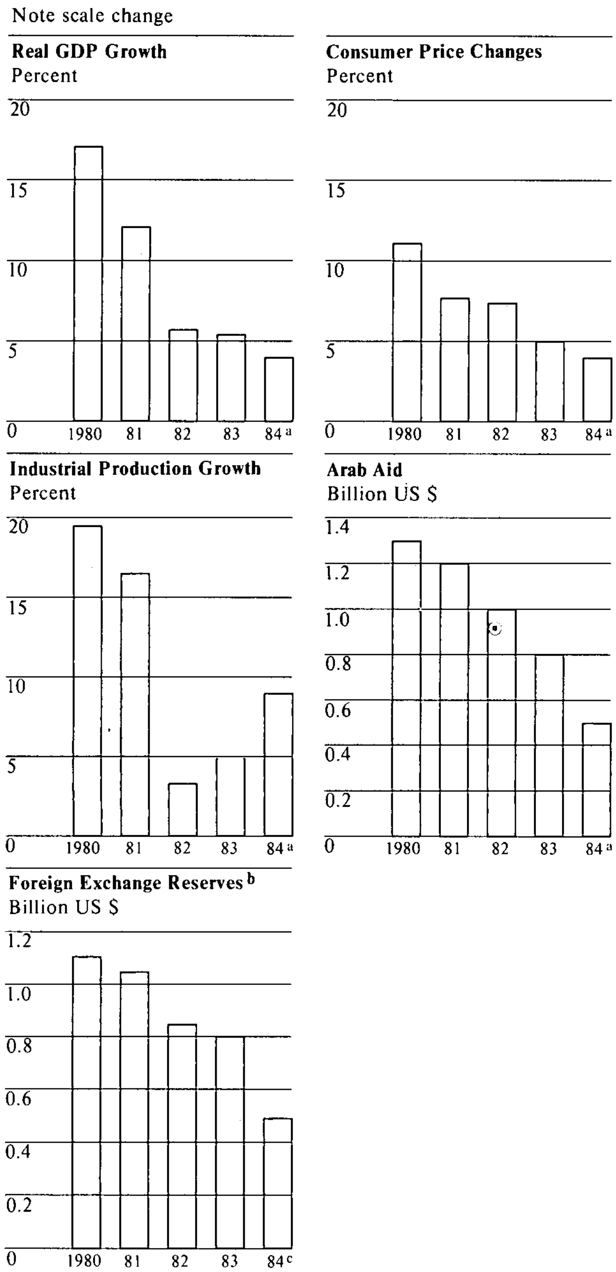
Jordan: Economic Indicators, 1980-84



a Estimated.
b Yearend.
c November 1984.

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Jordanian Government Budget [a] *Million US $*

	1983	1984 [b]	1985 [c]
Revenues	1,701	1,638	1,949
Arab budget support	511	322	476
Development aid	141	178	225
Domestic revenue	1,049	1,138	1,248
Expenditures	1,845	1,941	2,109
Current	1,165	1,266	1,267
Capital	680	675	842
Deficit	144	303	160

a Data based on 1 dinar = US $2.60.
b Estimated.
c Budgeted.

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Arabia. Overall, official reserve outflows—including some gold sales—appear to have totaled about $325 million from January through November 1984. This large outflow—which may only show up as 1984 errors and omissions in the balance of payments—may reflect large unrecorded government payments for arms transactions. The Jordanians signed an arms deal totaling about $300 million with the Soviets last December, but it seems unlikely that more than 10 to 20 percent would be used as a downpayment. Amman also may be deliberately underrepresenting its reserves in order to gain additional aid or concessionary terms for future arms deals. Jordan is considering arms purchases from the French and the British, if concessionary terms can be worked out. 25X1

High Hopes for Energy

Jordan is undertaking a two-pronged plan to reduce its hefty bill for imported oil. Oil imports from Saudi Arabia and Iraq cost almost $600 million last year, about 20 percent of all imports and

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Jordan: Balance of Payments *Million US $*

	1980	1981	1982	1983	1984 [a]
Trade balance	−1,823	−2,435	−2,488	−2,456	−2,185
Exports (f.o.b)	575	735	751	580	675
Phosphate	158	166	162	142	186
Imports (c.i.f)	2,398	3,170	3,239	3,036	2,860
Net services	859	1,088	1,092	1,254	1,270
Worker remittances (net)	640	875	907	909	925
Unrequited transfers	1,338	1,305	1,060	813	535
Current account balance	374	−42	−336	−389	−380
Capital account balance	−91	216	325	425	350
Errors and omissions	−119	−122	−151	−30	NA
Overall balance [b]	**164**	**52**	**−162**	**6**	**NA**

[a] Estimated.
[b] Does not equate with changes in official reserves because of transactions involving official gold, SDR allocations, and official foreign exchange valuation changes.

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[redacted]

almost equal to total merchandise exports. Subsidized energy prices kept overall energy demand last year at an annual rate of about 14 percent. Under the plan, Amman will double expenditures on oil exploration and development to about $36 million a year. [redacted]

Two successful wells have been drilled, and the Jordanians hope the field—as yet undelineated—may produce 20,000 b/d, about one-third of Jordan's needs. [redacted] a third completed well has also produced oil at a flow rate substantially higher than the first two wells. The plan also involves measures to lower consumption. Subsidies have been reduced on petroleum products, and electricity rates, above a base amount, have been raised. Import tariffs on energy-consuming luxury items, such as large cars, are also being increased. [redacted]

Prospects Good for 1985

Despite the cash shortage, economic prospects for 1985 are relatively good. The current account is likely to improve considerably. Tariffs have been increased on imports of certain finished goods and lowered on some raw materials. To reduce consumption of imported oil and decrease government subsidies, fuel prices have been increased. Worker remittances remain strong. The government hopes to increase exports by $300 million this year and may come close to this figure. A number of industrial projects involving fertilizers, phosphates, and cement are coming on line, and the government has arranged some countertrade deals, such as Iraqi oil for cement, agricultural products, and other goods, in order to stimulate sales. [redacted]

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Although the low level of foreign exchange reserves is worrisome, the situation is still manageable. Jordan is unlikely to experience a further dropoff in Arab aid. The government has proposed an overly ambitious budget. With large arms purchases in mind, however, King Hussein may well seek further monetary help from his customary Arab donors. If donors balk—as expected—Jordan's credit rating with world bankers is still good and, if necessary, the country can turn to this source to fill its financial gaps. [redacted] 25X1

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