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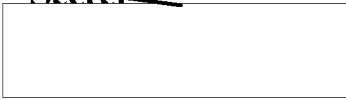

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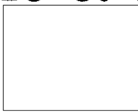

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25 March 1983

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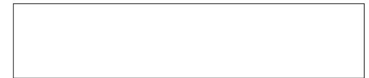

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Synopsis

Perspective—*Implications of Lower Oil Prices for Soviet Policy (U)*

Lower world oil prices threaten to disrupt the USSR's efforts to shore up its hard currency payments position, with potentially wide-ranging implications for Soviet policy. The prospect of falling revenues is probably forcing Moscow to consider adjustments that could hurt domestic economic performance and complicate its realtions with East European allies and Third World clients.

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Communist Countries: Impact of Lower Oil Prices

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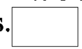
At the current OPEC price of $29 per barrel, the net impact on Soviet earnings could be minimized if, as we believe likely, Moscow increases hard currency oil exports above last years's level. Eastern Europe probably would benefit marginally from lower oil prices, unless its oil supplies are cut by Moscow. The Chinese hard currency position would probably change little at current prices and suffer only moderately from further price declines.



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French Protectionism: Old Wine in New Bottlenecks

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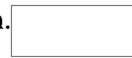
French protectionist and mercantilist inclinations have taken on new vigor under the Socialists. In part, this is attributable to the persistence of economic hard times. The Socialists' predilection for planning and their support for an active role for the state reinforce such an inclination.



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Italy: Protectionist Trends

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Italy, which is highly dependent on foreign trade, has contributed relatively little to rising EC protectionist pressures. Although there is some increase in domestic protectionist pressures, Rome is unlikely to change its policies significantly.

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South Asia: Impact From Falling Oil Prices

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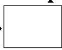
The largest and most immediate impact of lower oil prices on India, Pakistan, Bangladesh, and Sri Lanka will be savings on their import bills. India stands to be the largest gainer on this account; with imports of 350,000 b/d it was hit with about two-thirds of the region's $7 billion oil bill. We believe that the diminished prospects for jobs as a result of the slowdown in economic development in the oil-producing countries pose the greatest potential danger for South Asia.



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Perspective

Implications of Lower Oil Prices for Soviet Policy

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Lower world oil prices threaten to disrupt the USSR's efforts to shore up its hard currency payments position, with potentially wide-ranging implications for Soviet policy. Since mid-December the price for Soviet crude oil on the spot market has dropped by approximately $5 to roughly $27 per barrel. Each $1 decline in price is costing the USSR $400 million in oil revenues and could lead to a serious drop in overall hard currency earnings. If the USSR holds the volume of hard currency oil exports at 1982 levels, oil revenues at current prices could fall by roughly $1.5 billion. Should prices decline by another $5-10 per barrel, Moscow's hard currency losses could quickly double or triple. Nonoil earnings, meanwhile, will probably not cover serious shortfalls in oil revenues and could themselves decline. Because gas prices are tied to heavy fuel oil prices, gas earnings will slump substantially this year. Moscow may also consider itself lucky if combined revenues from gold and arms sales—the other leading sources of foreign exchange—fall only slightly.

The prospect of falling revenues is probably forcing Moscow to consider adjustments that could hurt domestic economic performance and complicate its relations with East European allies and some Third World clients. The most likely options include:

- **Increasing oil exports to the West.** The USSR raised hard currency deliveries by an estimated 200,000 b/d last year, and another increment of similar size could prevent any significant erosion of hard currency earnings at current oil prices. This would require reducing subsidized oil shipments to Eastern Europe and possibly to LDC clients and diverting some oil from domestic supplies. Moscow did this last year and probably believes that further marginal reductions are feasible.

- **Further curtailing imports from the West.** Machinery and industrial materials would be prime targets, as they were last year.

Such moves, however, could entail considerable political and economic costs. Further cutbacks in oil deliveries to Eastern Europe, for example, would undercut the region's benefits from declining prices for the oil it imports. If deep enough, the cutbacks could aggravate economic troubles with potential danger for Moscow's political relationship with the area and for its efforts to push Warsaw Pact modernization.

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In the Third World, reductions in soft currency oil shipments to Cuba or other clients could prompt economic disruptions in those LDCs. Soviet ties with some countries in the Middle East could become more complicated. Moscow almost certainly will continues pushing weapon sales because other hard currency earnings are threatened. Yet key oil-exporting customers may be less able or willing to pay in cash. Several countries probably will petition for easier payment terms, and the Soviets will have to decide whether to maintain a tough stance, as they often have done in the past, or to ease up to preserve customers and political relationships. Syria, Moscow's main foothold in the region, is likely to receive preferential treatment, but some countries may encounter less sympathy. On the other hand, lower oil prices could benefit hard-pressed Soviet clients that buy oil on the world market. Moreover, Moscow may believe that key oil-producing contries will suffer economic problems that could present the USSR with new political opportunties.

Near-term prospects for Soviet trade with the West could suffer somewhat from the weakened oil market. West European demand for Siberian gas—Moscow's main hope for expanded trade in coming years—could diminish in view of cheaper oil. Moreover, West European interest in additional gas export projects would be discouraged.

At home, diversion of more than 100,000 b/d of oil from domestic users to Western exports could compound substantially the problem of spot shortages of oil products. If the Soviets were forced to reduce imports of machinery and industrial materials, modernization plans would be delayed, further complicating efforts to improve productivity. Moscow, as a result, may count more heavily on new compensation deals—which minimize Soviet hard currency outlays for Western goods—when it determines trade's role in the 1986-90 economic plan.

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Briefs

Energy

Spot Oil Market Trends

Following OPEC's announcement of a $5 per barrel reduction in the price of the benchmark crude, spot crude oil prices remain weak. Arab Light is quoted at $28.25 per barrel, and Bonny Light is selling at $28.45 per barrel, up only slightly over early March levels. Spot product prices have exhibited similar trends—after bottoming out in late February, product prices rose slightly in early March but have now flattened out. The apparent continued decline in consumption, destocking, and expectations of another reduction in the price of North Sea crudes have contributed to the weakness in prices. Buyers will probably continue to defer purchases as they await a pricing decision by the United Kingdom and OPEC's reaction to it. 25X1

Nigerian Oil Price Concerns

25X1 Nigerian oil officials claim that OPEC will retaliate with further price cuts if the United Kingdom lowers its North Sea oil prices by more than $0.50 a barrel and that some OPEC members have threatened to withdraw funds from British banks if a price war ensues. At least one major operator in Nigeria has suspended its liftings of Nigerian crude until it sees whether the British National Oil Company responds to the recent OPEC price cut. Nigeria's price currently is $0.50 per barrel below that of comparable North Sea crude. Other OPEC states are more concerned with keeping prices uniform within the cartel than in responding to cuts by the United Kingdom or other non-OPEC producers. Lagos has been firm, however, in insisting on keeping prices competitive with the North Sea. A 25X1 move by London to substantially undercut the new OPEC pricing structure probably would force OPEC into another difficult negotiating session, with Nigeria pushing hardest for retaliation. 25X1

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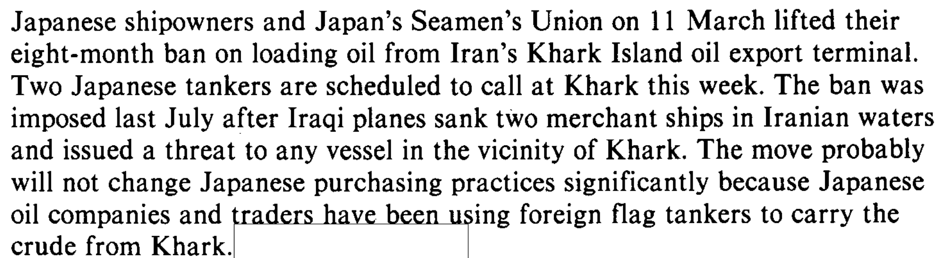
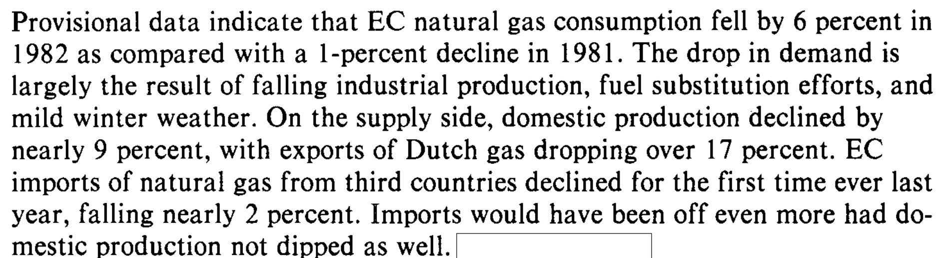
Japanese Ban on Khark Rescinded

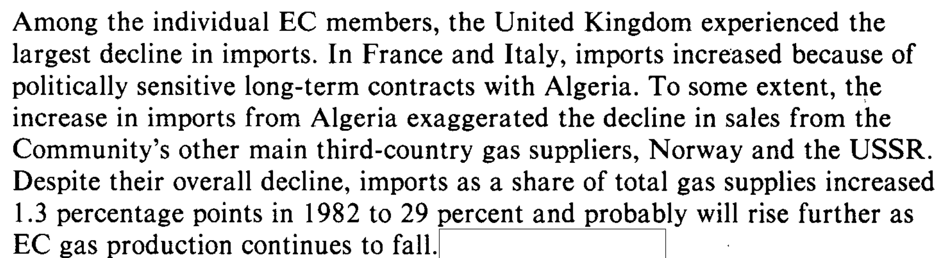


Japanese shipowners and Japan's Seamen's Union on 11 March lifted their eight-month ban on loading oil from Iran's Khark Island oil export terminal. Two Japanese tankers are scheduled to call at Khark this week. The ban was imposed last July after Iraqi planes sank two merchant ships in Iranian waters and issued a threat to any vessel in the vicinity of Khark. The move probably will not change Japanese purchasing practices significantly because Japanese oil companies and traders have been using foreign flag tankers to carry the crude from Khark. 25X1

EC Gas Situation

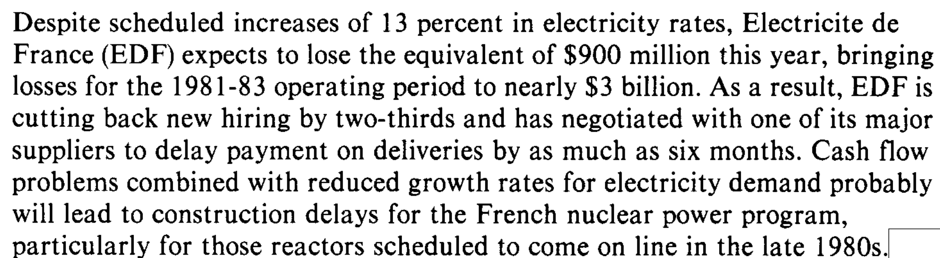


Provisional data indicate that EC natural gas consumption fell by 6 percent in 1982 as compared with a 1-percent decline in 1981. The drop in demand is largely the result of falling industrial production, fuel substitution efforts, and mild winter weather. On the supply side, domestic production declined by nearly 9 percent, with exports of Dutch gas dropping over 17 percent. EC imports of natural gas from third countries declined for the first time ever last year, falling nearly 2 percent. Imports would have been off even more had domestic production not dipped as well. 25X1



Among the individual EC members, the United Kingdom experienced the largest decline in imports. In France and Italy, imports increased because of politically sensitive long-term contracts with Algeria. To some extent, the increase in imports from Algeria exaggerated the decline in sales from the Community's other main third-country gas suppliers, Norway and the USSR. Despite their overall decline, imports as a share of total gas supplies increased 1.3 percentage points in 1982 to 29 percent and probably will rise further as EC gas production continues to fall. 25X1

Possible Delays for French Nuclear Power Program



Despite scheduled increases of 13 percent in electricity rates, Electricite de France (EDF) expects to lose the equivalent of $900 million this year, bringing losses for the 1981-83 operating period to nearly $3 billion. As a result, EDF is cutting back new hiring by two-thirds and has negotiated with one of its major suppliers to delay payment on deliveries by as much as six months. Cash flow problems combined with reduced growth rates for electricity demand probably will lead to construction delays for the French nuclear power program, particularly for those reactors scheduled to come on line in the late 1980s. 25X1

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International Trade, Technology, and Finance

Political Compromise on EC Exchange Rates

The ability of EC countries to forge a political compromise over the hotly contested issue of how to realign their currencies bodes well for the long-term viability of the European Monetary System (EMS). The compromise worked out required West Germany to revalue its currency in the system; in return France agreed to a small devaluation of the franc and will soon implement an austerity program. West German Finance Minister Stoltenberg apparently received President Mitterrand's assurances that the economic measures would be speedily implemented and that French Government ministers would consult with their West German counterparts on economic policy coordination. 25X1

EMS: Currency Realignment *Percent*

Revalued Currencies		Devalued Currencies	
West German mark	5.5	French franc	2.5
Dutch guilder	3.5	Italian lira	2.5
Danish krona	2.5	Irish punt	3.5
Belgian/Luxembourg francs	1.5		

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Negotiations on the realignment were the most divisive since the inception of the EMS four years ago. Despite revaluation of the West German mark, Bonn probably is pleased with the outcome because France, the weaker currency country, will make the domestic economic adjustments necessary to strengthen the currency system. For the second time in less than a year, France has moderated its economic policy rather than float the franc and adopt more protectionist measures. French Finance Minister Delors, who during the negotiations threatened to withdraw France from the EMS, must welcome the results, which spared France the political embarrassment of a large devaluation. He has advocated new measures to reduce inflation and cut the budget and trade deficits, and he has argued effectively against those in the government who urged Mitterrand to ignore external constraints such as the EMS. 25X1

If West German and French contacts are successful and promote further consultations, this will be a step forward in the evolution of the EMS. Although the system was primarily designed to promote the coordination of economic policies among EC members, little progress has been achieved. Even if France's program and consultations with West Germany prove effective, however, the inflation differential between the two countries probably will not be narrowed sufficiently to prevent another realignment later. 25X1

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EC Fails To Eliminate French Protectionist Measures

Despite continued efforts, the EC Commission has been unable to persuade Paris to abolish completely trade measures requiring customs documentation to be in French and imported VTRs to clear customs at Poitiers. As part of a compromise worked out last week, the EC Commission has dropped legal proceedings aimed at barring France's use of the language requirement. In return, Paris has agreed to accept import documents on goods from other EC countries if written in an "understandable language" such as English, German, and Italian. Paris will continue to require instruction manuals and related material to be in French, but control will be at the point of retail sales, not the border. France, however, has suggested that the amended language regulation will not necessarily apply to goods from non-EC countries.

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The Commission also has been pressuring Paris to discontinue its practice of channeling all VTR imports through the single customs clearing point of Poitiers, but so far to no avail. As part of the recent EC-Japan trade accord, the Commission agreed to prevail on France to remove the VTR restriction. Paris apparently will not terminate the measure until the Commission provides more specific guidelines on how imported VTRs will be monitored under the accord and determines if the 200,000 VTRs currently held at Poitiers will count against the Japanese quota for this year.

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Spain Lowers Tariffs on EC Automobiles

Spain has agreed to lower import duties on automobiles produced in the EC from 36.7 percent to a range of 19 to 25 percent in an effort to prevent conflict in the negotiations over its accession to the Community. EC negotiators expect the reduction in Spanish tariffs to raise EC automobile exports to Spain from 40,000 to 55,000 units annually. British business and labor leaders, as well as members of Parliament, had urged the Thatcher government to try to eliminate the unfair competitive advantage of Spanish automobile exporters. Spanish officials feared that if they did not act, London might take retaliatory steps, preventing Spanish manufacturers from making inroads into the British market. Madrid's action does not affect the basic 1970 trade agreement that permits a wide discrepancy—in Spain's favor—between Spanish and EC import duties. The reduction of the automobile tariffs, however, is only the first of many modifications Madrid will ultimately be forced to make in the context of EC accession.

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Asian Drought No Boon to US Rice Exporters

A widespread drought will curtail Asian rice production this year by about 10 million tons from a record 361 million tons in 1982. Indonesia and India have been hardest hit. Dwindling rice stocks have forced Indonesia to purchase more than 600,000 tons of rice in the last two months, almost twice the amount imported all of last year. The USDA now estimates 1983 Indonesian imports, almost all from Asian neighbors, will total 1.75 million tons. India, with rice production down about 15 percent from last year, is cutting by nearly two-thirds its rice exports to the USSR. High-priced rice from the United States, the world's second-largest exporter after Thailand, will find few takers among financially strapped buyers, and US stocks probably will total a record 2 million tons.

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National Developments

Developed Countries

French Cabinet Changes

The cabinet shakeup on Tuesday reflected President Mitterrand's desire to streamline his government before implementing a new round of politically sensitive austerity measures. The changes will strengthen the hand of Socialist moderates who are trying to reduce the hostility of business toward the government and who oppose a sharp turn toward increased protectionism. Mitterrand's closest associates, including Prime Minister Mauroy, Foreign Minister Cheysson, and Defense Minister Hernu, kept their posts. The already strong position of Jacques Delors has been enhanced; he will take on responsibility for the budget in addition to his duties as Economy and Finance Minister. Jean-Pierre Chevenement has been replaced as Industry and Research Minister by a moderate, Mitterrand loyalist Laurent Fabius. Chevenement had drawn Mitterrand's ire by his excessive interference in the management of nationalized firms, and his departure appears to confirm Mitterrand's determination to preserve their market orientation. Michel Jobert, who resigned last week as Foreign Trade Minister, has been replaced by Edith Cresson. Cresson was a vocal and aggressive defender of the EC's Common Agricultural Policy in her previous post as Agriculture Minister. The new Agriculture Minister will be Michel Rocard, who has been an advocate of economic realism within the government.

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Israeli Government Under Pressure To Assist Exporters

With export receipts continuing to decline after a fall of 7 percent last year, Israeli exporters are demanding help from the government. Although the worldwide recession has contributed to the decline, the government's policy of slowing the depreciation rate of the shekel has made Israeli products less competitive abroad. The Manufacturers' Association has recommended that, in addition to changing the depreciation policy, the government subsidize exports. The government is unlikely to change its depreciation policy any time soon because inflation remains at near record levels, but it is moving to help exporters. Earlier this month, Finance Ministry Director General Sadan announced a program to pay exporters to Europe 5 percent of the value added on their industrial goods, and Industry Ministry Director General Asheri has called for a $100 million fund for export promotion. US Embassy reporting indicates, however, that there is a considerable amount of indecision within the government over how to help the hardest hit exporters without violating international trade commitments.

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Japan Moving To Protect Industrial Laser Industry

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Although Japan lags the United States in the

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development of industrial lasers, Japanese firms have developed commercial models of low-power industrial lasers (up to 5 kw), based in part on technology acquired from the United States and Western Europe. Japanese users of industrial lasers are beginning to look to domestic rather than foreign suppliers to meet their needs. For example, firms manufacturing laser-assisted machine tools, which formerly used US-made lasers, are switching to Japanese products.

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Less Developed Countries

Mexico Again Requests Delay on Payment of Principal

Mexico City last week asked its international creditors to extend the moratorium on principal payments from 23 March to 15 August. To gain banker support for the anticipated extension, it agreed to pay a higher rate on interest due during the period. The new postponement became necessary when Mexico's immediate financial problems took longer to resolve than either government officials or bankers anticipated and delayed discussion on a debt rescheduling timetable. The recent agreement for a $5 billion loan from commercial bankers calls for a 15 August deadline for completion of discussions on rescheduling $20 billion of Mexico's public-sector debt.

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We believe bankers will agree to extend the moratorium, in the realization that Mexico's available foreign exchange has barely covered public-sector interest payments and essential imports because of lower-than-expected oil revenues and delays in obtaining the $5 billion loan. The extension request is not likely to hold up the initial $1.7 billion disbursement from the loan scheduled for this week.

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Brazilian Foreign Exchange Losses

Contraband exports and capital flight are aggravating Brazil's persistent cash-flow difficulties.

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Growing doubt about Brazil's economic prospects reportedly is causing investors to channel funds into overseas money market accounts. Despite the faster pace of devaluations, the illegal trade diversions probably were a major cause of the 6-percent decline in exports through February. Failure to stop the contraband trade will undermine Brazil's ability to meet IMF targets and could force another major devaluation. Unless the government stems these losses, it also will continue to encounter increasing difficulty in meeting its daily foreign exchange obligations even if bankers resume short-term lending.

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Beirut's Financial Picture Improves

Government customs revenues are rising sharply now that the central government has closed down two lucrative "illegal ports" operated by the Christian Lebanese Forces militia. Press reports indicate that receipts in the first half of March jumped 93 percent over the same period last year. Beirut's recently

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approved 1983 budget projects that customs revenues in 1983 will reach about $470 million—four times the 1982 total and enough to cover about 20 percent of total expenditures. Despite this improvement, however, Beirut projects that the budget deficit this year will amount to over one-third of total spending; the actual deficit probably will be even higher. The rise in tax collections should hearten Lebanese bankers, who are expected to finance most of the deficit. 25X1

Ecuadorean Devaluation

Despite Quito's 27-percent devaluation of the sucre last week and promises of additional adjustments, we expect Ecuador will post a $1-2 billion current account deficit this year. The devaluation probably will lead to reduced imports but will not halt capital flight because it has failed to close the gap between the free market value and the official exchange rate. Export gains will be constrained by the decline in the price of crude oil, agricultural export shortfalls caused by recent floods, and depressed world market prices for bananas, cocoa, and coffee. 25X1

The devaluation will, however, add to President Hurtado's immediate political problems by intensifying inflationary pressures—despite efforts to enforce a tight monetary policy—and will make debt servicing more onerous. The move has also sparked labor discontent. This week the Workers Unity Front, the country's largest union, scheduled a two-day general strike with other labor unions expected to participate. 25X1

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Philippine Private-Sector Debt Problem

Earlier this month Manila acquired 90-percent ownership of the financially troubled Construction and Development Corporation of the Philippines, the country's largest private foreign debtor. Some $400 million of CDCP's debt to various government institutions will be converted to equity, and Manila will assume responsibility for the firm's foreign debt service obligations—currently about $90 million annually. CDCP has been flirting with default on its foreign loans for over a year and is in arrears on payments to several large US banks. On the heels of the announcement last month that the Philippines' 1982 current account deficit reached $3.3 billion, the move may further damage the government's international credit rating, especially if private foreign bankers perceive it as a new direction in public debt management policy. Nearly a dozen other large firms, several heavily indebted to US banks, are in financial positions similar to CDCP's. 25X1

India's 1983/84 Budget

The central government budget proposed for the year beginning 1 April provides for tax concessions to stimulate exports and the production of basic goods, but a new provision for a minimum tax on corporate profits may blunt investment incentives. Total expenditures will rise only moderately, partly

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because higher government-administered prices for petroleum products will permit most of next year's $2.8 billion spending on exploration and refining to be financed outside the budget. Current budget plans probably will enable New Delhi to stay within ceilings that the International Monetary Fund is likely to impose on government borrowing later this year. In his budget speech last month, the Finance Minister hinted that India may selectively increase import duties to protect domestic industries.

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Water Shortages In India

More than 4.5 million residents of Madras, the largest city in southern India, are experiencing unprecedented shortages of water for drinking and sewage disposal. Reservoirs are nearly depleted following inadequate rainfall, and no relief is expected before June, at best. Although last summer's drought depressed agricultural and industrial production throughout much of India, rainfall, except in the southern states, has been adequate in recent months. National foodgrain production for the year ending in June probably will only be 6 percent below last year's level. Government stocks have been augmented by 4 million tons of wheat imports and are sufficient to maintain traditional per capita grain consumption.

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Moroccan Protectionist Moves

Morocco is moving to limit imports in light of a mounting current account deficit and uncertainty over IMF and Saudi financial assistance for 1983. Prior authorization is now required for all Moroccan imports. It was previously needed only for luxury goods and controlled items. The government is ill prepared to process the expected volume of import requests under the new rules. Businessmen and bankers have already voiced concern that essential imports will be severely hindered and that economic growth will suffer.

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Communist

Hungarian Economic Reform

Budapest, in an attempt to improve labor efficiency, is encouraging enterprises to be more profitable, is allowing greater wage differentiation, and is calling for the elimination of excess labor. Under the new program begun in January, wages and bonuses will depend on the profitability of an enterprise—wages can be raised 0.12 percent for each 1-percent increase in profits, and there will be no ceiling on bonuses paid to managers. Earlier regulations tended to equalize wage rates and bonuses among enterprises regardless of their profitability by progressively taxing annual wage increases and capping bonuses. Another new measure will permit enterprises to use 30 to 60 percent of the savings from labor reductions to boost wages. To help counter the labor dislocations that may result, reformers have set up computer-linked labor exchange offices in every county to relocate displaced workers.

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The new program represents a victory for reform advocates, and those opposed to rapid reform will be watching the results closely. Attempts in the early 1970s to promote efficiency through wage differentiation and larger bonuses for successful managers were virtually abandoned because of worker complaints. The Hungarian National Trade Union Council has agreed to accept the new reforms only if furloughed workers can be relocated quickly. [ ] 25X1

Increase in Chinese Alloy Steel Production

A recent metallurgical conference in China called for an increase in domestic production of alloy steel from the current level of 5 million tons to 7 million tons in 1985. The state has appropriated $100 million to accelerate production by upgrading special steel plants rather than building new facilities. Most of the required alloying materials will come from the growing nonferrous industry, but China may seek more advanced alloying technology abroad. Increased domestic production of alloy steel will allow China to reduce imports of the high-priced steels required by the shipbuilding, chemical, hydropower, oil-drilling, and military industries and may enable it to increase exports of high-speed tool steel. [ ] 25X1

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Communist Countries: Impact of Lower Oil Prices

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Lower world oil prices will have varying effects on the hard currency positions of major Communist countries. At the current OPEC price of $29 per barrel, the net impact on Soviet earnings could be minimized if, as we believe likely, Moscow increases hard currency oil exports above last year's level. Soviet willingness to expand oil shipments to the West is limited, however, and a further drop in OPEC prices could reduce hard currency earnings by several billion dollars. Eastern Europe probably would benefit marginally from lower oil prices, unless its oil supplies are cut by Moscow. The Chinese hard currency position probably would change little at current prices and suffer only moderately from further price declines.

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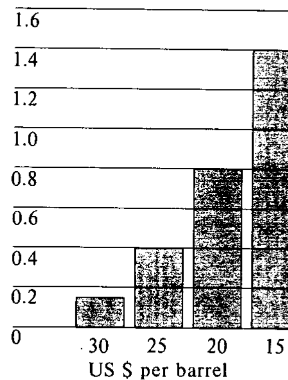
Implications for the USSR

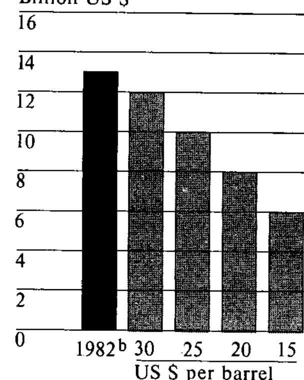
Substantially lower oil prices could undo the Soviets' recently improved hard currency position, a consideration that almost certainly has prompted Moscow's call on OPEC not to break ranks. The current Soviet average crude and product price of roughly $30 per barrel would create a manageable burden, but a drop to $25 or below would threaten a serious decline in revenue:

- At $30, Moscow could export at the 1982 level of 1.1 million b/d and still approximate 1981 oil earnings of $12.2 billion. Alternatively, it could raise exports by less than 200,000 b/d to sustain 1982 oil revenues of $13.6 billion.

- At $25 or below, the Soviets would have to raise exports by at least 400,000 b/d—an unlikely prospect—to completely offset the oil price drop. Without such an increase, total hard currency revenues could fall by at least $3 billion.

USSR: Hard Currency Oil Exports





[a] At an estimated 1982 level of 1.1 million b/d.
[b] Estimated.

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We believe that Moscow probably will raise hard currency oil exports this year to 1.2-1.3 million b/d. It has already shown a willingness to avoid revenue losses in a weakened oil market by increasing deliveries 200,000 b/d last year over 1981. Although stagnating Soviet oil production is forcing Moscow to achieve such increases primarily by cutting oil deliveries to Eastern Europe and by diverting some oil from domestic consumption, the Soviets probably believe that another cut in those supplies of up to 200,000 b/d, while painful, will be manageable in the short run. Lower oil prices

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Communist Countries: Impact of Lower Oil Prices on Selected Hard Currency Accounts, 1983

Billion US $

1982		1983						
Net Oil Earnings	Total Hard Currency Earnings	Oil Price (*US $ per barrel*)	Net Oil Exports [a] (*Million b/d*)	Net Oil Earnings	Change in Oil Earnings From 1982	Change in Nonoil Earnings From 1982	Savings in Interest Costs [b]	Total Change in Hard Currency Earnings From 1982
USSR								
13.6 [c]	26.7	30	1.1	12.1	−1.5	0.7 [d]	0.1	−0.7
		25	1.1	10.0	−3.6	0.5	0.2	−2.9
		20	1.1	8.0	−5.6	0.2	0.3	−5.1
		15	1.1	6.0	−7.6	0.0	0.5	−7.1
Eastern Europe								
−1.3	47.3	30		−1.4	−0.1	3.2 [e]	0.3	3.4
		25		−1.2	0.1	3.2	0.9	4.2
		20		−0.9	0.4	3.2	1.4	5.0
		15		−0.7	0.6	3.2	2.0	5.8
China								
4.8	21.8	30	0.36	3.9	−0.9	1.1	NEGL	0.2
		25	0.34	3.1	−1.7	1.5	NEGL	−0.2
		20	0.30	2.2	−2.6	1.9	NEGL	−0.7
		15	0.20	1.1	−3.7	2.4	NEGL	−1.3

[a] Not available for Eastern Europe.
[b] Savings on debt servicing. Assumes nominal interest rates decline from 1982 base in proportion to projected drop in rate of inflation under various oil price levels.
[c] Estimated.
[d] Earnings from gold and arms sales held constant.
[e] Unadjusted for increased Western demand for East European exports.

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might facilitate slightly increased East European purchases on the world market, and a warmer Soviet winter may have freed up domestic oil for export.

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Nonetheless, the USSR is unlikely to push hard currency oil exports beyond an average 1.3 million b/d for the entire year. Moscow has shown no specific signs of planning to undercut world market prices to gain a larger market share. Moreover, Moscow is almost certainly unwilling to make substantially larger cutbacks in supplies to domestic consumers and allies:

- The East European economies are already hard pressed, and the soft currency oil deliveries to Cuba and other Third World clients could not be cut substantially without serious economic and possibly political repercussions.

- Soviet users would face an absolute decline in oil availability if more than 100,000 b/d were additionally diverted to Western sales. Utilization of industrial capacity probably would be reduced, even at the projected slow rate of growth of GNP.

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Impact on Other Exports

Lower oil prices should have a generally negative effect on nonoil hard currency earnings. Although sales of minerals and metals may increase, revenues from gas, gold, and weapons—the major hard currency earners—will probably stagnate or decline.

Natural Gas. Earnings will fall because gas prices under existing contracts with Western Europe are tied to heavy fuel oil prices. The Soviets have already cut 1983 prices to Italy to $3.35 per million BTUs; Moscow had hoped to be receiving about $4.50 per million BTUs for its gas this year, about a 10-percent increase over the average price they obtained last year.[1] With oil at roughly $30, gas prices could decline by almost another $1 per million BTUs, a revenue loss of up to $1.5 billion. In the longer run, cheaper oil could weaken West European demand for gas from the Siberian export pipeline—currently expected to earn $4 billion or more annually by the latter half of the decade. Alternative West European gas projects also would be discouraged, however, leaving Moscow in a better position to increase exports if gas demand picks up later in the decade.

Gold. Increased gold sales almost certainly will not shore up a weak Soviet balance-of-payments position. Although the USSR has ample stockpiles and production capacity to expand exports, falling oil prices have weakened the gold market, and large Soviet sales would further depress prices. A drop of $100 per ounce in gold prices reduces Soviet revenues by nearly $1 billion when sales volume is in the 300-ton range.

Arms. Lower oil prices will probably constrain the ability of some major Soviet weapons customers to pay in cash for their purchases. Algeria, Libya, and Iraq account for 40 percent of the estimated value of recent Soviet arms sales, and OPEC states also finance Syria's purchases. Because the USSR is still delivering sizable amounts of weapons under existing agreements, substantial immediate reductions in earnings are unlikely.

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Impact on Eastern Europe

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A decline in oil prices probably will have a limited direct effect on Eastern Europe's hard currency balance of payments. All of the countries have already cut their hard currency imports, particularly oil, because of the decline in Western lending to the region. Yugoslavia alone stands to gain significantly from a softening oil market because it buys about 80,000 b/d on the world market. We project that the cost of its 1983 imports would decline by about $150 million for every $5 drop in oil prices. We expect that Romania and East Germany will continue to import feedstocks for their extensive refining industries and therefore could benefit from appreciable declines in their hard currency import bills. To the extent that product prices follow crude price declines, however, import savings will be offset by diminished product earnings. In 1981 East Germany earned over $1 billion from sales of petroleum products (18 percent of hard currency export earnings), and Romania earned nearly $2 billion (28 percent of hard currency earnings).

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Eastern Europe could be seriously affected if the Soviets reduce subsidized oil deliveries in order to expand oil sales to the West. Excluding Romania and Yugoslavia, the region depends on Soviet deliveries at below-market prices for 90 percent of its crude oil imports. Cutbacks in deliveries on top of those made last year to Czechoslovakia, East Germany, and Hungary would deny the East Europeans any growth stimulus or cost savings from lower oil prices. If the level of Soviet oil deliveries in 1982 is maintained, we project that the 1983 growth rate of East European GNP would average about 1 percent. A further cutback of 100,000 b/d would lead to stagnation, and a cut of 200,000 b/d would cause regional GNP to fall by 1 percent.

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[1] The $3.35 price includes transport fees. It is 15 percent below the energy equivalent price for residual fuel oil on the Rotterdam market.

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Economic recovery in the West, sparked by falling oil prices, might enable the East Europeans to increase export earnings. A fall in interest rates induced by lower inflation would reduce debt servicing costs. Although the coal market is only loosely tied to the oil market, the Poles already have expressed concern that declining oil prices might depress the price of coal, which accounts for 20 percent of their hard currency earnings.

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Implications for China

Lower oil prices will reduce China's hard currency earnings, but Beijing's strong balance-of-payments position should enable it to avoid major difficulties. Regardless of developments in world prices, Beijing will probably reduce oil exports somewhat—perhaps 10 percent per year—because oil output is stagnating while domestic demand for oil is expected to increase. Beijing may well decide to cut volume more rapidly than planned should prices decline well below $25 and keep the oil either in reserve or for more important domestic uses.

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Aside from prompting Beijing to scale back its ambitious import program, lower oil prices could affect China's economic development program by complicating its search for offshore oil. Declining oil prices are causing the Western oil firms to drive a harder bargain. Beijing is currently evaluating bids from 32 firms and is reportedly displeased with the profit share that the companies have requested and the heavy concentration of bids in the most promising blocks. Although reports from a number of the firms indicate that the companies are still interested in the project, the threat of a major price decline has reduced their willingness to compromise on both issues and is forcing Beijing to reconsider its bargaining position.

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French Protectionism: Old Wine in New Bottlenecks

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The Mitterrand government's current aggressiveness on trade issues—which is unlikely to change significantly following the cabinet shuffle on Tuesday—and the apparent ease with which Paris opts for protectionist solutions offer additional evidence, if such were needed, that the French are not committed free traders. The protectionist flurry demonstrates that they are still trying to reconcile an old hankering for autarky and controlled markets with new obligations they accepted with something less than full conviction. Their protectionist bent is strengthened by a feeling that the odds are stacked against them in international competition.

Mercantilist and Protectionist Tradition

The French are inclined by tradition and experience to view trade through mercantilist and protectionist lenses. Until the postwar era, the national economy was substantially closed. Imports of manufactures, discouraged by quotas and high customs duties, were relatively insignificant. Exports were directed as much toward captive markets in the colonies and other less developed areas as toward the industrialized countries. Within the country and in the colonial trade, French business enjoyed comfortable arrangements whereby markets were shared and competitive risks minimized.

The mercantilist tradition continues to influence the formation of trade policy. In addition to the "normal" tendency of a French government to want to direct events, several other factors are at work:

- **National pride**—a French presence on the industrial heights is seen as essential to French political stature. This has been one of the impulses behind state support for highly visible projects such as the Concorde, the Airbus, the nuclear industry, and various attempts to promote a fully competitive electronics industry. The state has assisted both development and external marketing efforts, providing capital, procurement preferences, operating grants, the underwriting of research and development costs, subsidized export credits, and Treasury loans at concessional rates to accompany commercial financing arrangements.

- **Uncertainty**—the French remain unsure about their ability to compete in international markets. French leaders believe that French exporters are handicapped by being relative latecomers to international trade. They are concerned, for example, by their exporters' lack of adequate distribution networks and service followthrough in industrialized markets. Thus, policymakers involved in these projects justify the government's role by contrasting its ability to take a longer view and greater risks with a private sector they still find shy of venture capital and an entrepreneurial spirit.

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Government officials on both left and right see other dangers in open competition. For them, complete acceptance of an "international division of labor" could leave France caught in a vise, with more powerful competitors—such as the United States, Japan, and West Germany—in command of high-technology markets and the newly industrializing countries, with lower labor costs and newer facilities, in control of basic industries such as steel and textiles. The French fear that the result could be to relegate France to the position of a "subcontractor" unable to control its trading destiny. Growing inroads in the domestic market by a broad spectrum of foreign goods have served to reinforce this concern.

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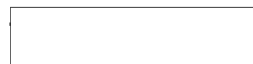
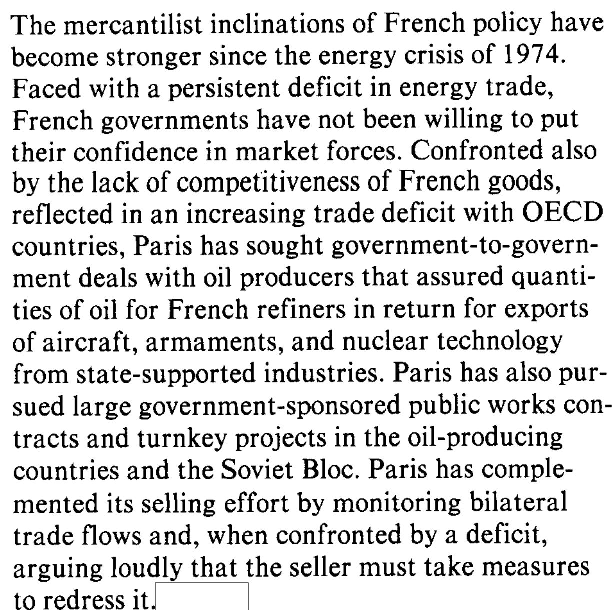
France: Selected Trade Deficits *(Billion US $, customs basis)*

	1979	1980	1981	1982
European Community	2.0	5.3	5.8	9.6
Of which:				
West Germany	2.6	4.0	4.2	5.8
Netherlands	1.2	1.9	2.5	2.1
Other OECD	3.2	4.6	5.3	6.6
Of which:				
Japan	1.1	1.7	1.7	2.1 [a]
United States	3.3	5.8	4.2	3.9
USSR	−0.8	1.1	1.5	1.4 [a]

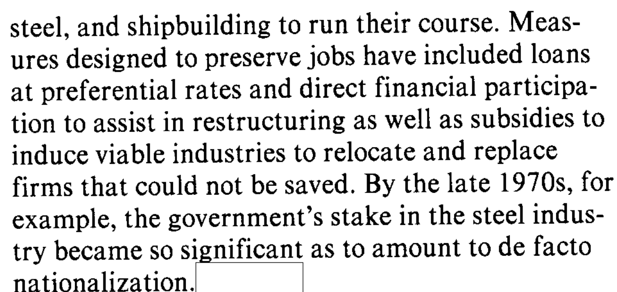
[a] Annualized from 10 months of data.





The mercantilist inclinations of French policy have become stronger since the energy crisis of 1974. Faced with a persistent deficit in energy trade, French governments have not been willing to put their confidence in market forces. Confronted also by the lack of competitiveness of French goods, reflected in an increasing trade deficit with OECD countries, Paris has sought government-to-government deals with oil producers that assured quantities of oil for French refiners in return for exports of aircraft, armaments, and nuclear technology from state-supported industries. Paris has also pursued large government-sponsored public works contracts and turnkey projects in the oil-producing countries and the Soviet Bloc. Paris has complemented its selling effort by monitoring bilateral trade flows and, when confronted by a deficit, arguing loudly that the seller must take measures to redress it.

For political and economic reasons, French governments have become increasingly reluctant to permit mounting job losses in industries such as textiles,



steel, and shipbuilding to run their course. Measures designed to preserve jobs have included loans at preferential rates and direct financial participation to assist in restructuring as well as subsidies to induce viable industries to relocate and replace firms that could not be saved. By the late 1970s, for example, the government's stake in the steel industry became so significant as to amount to de facto nationalization.

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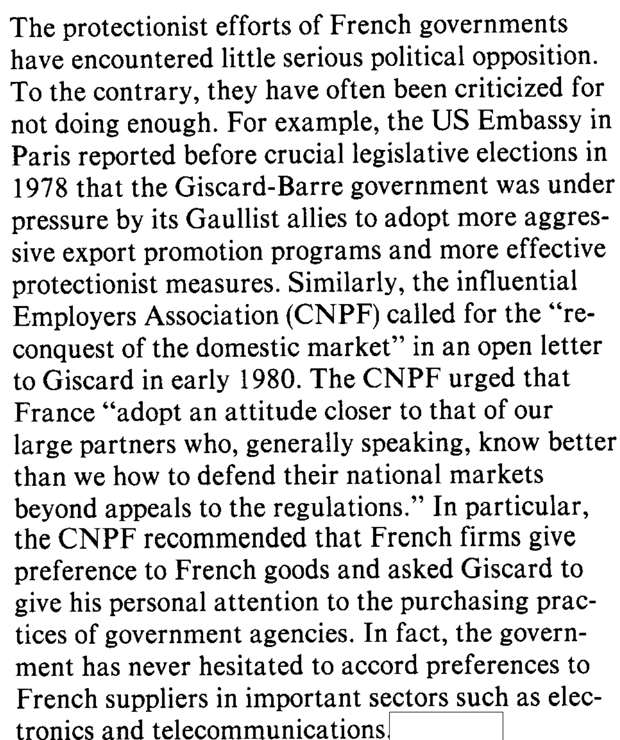

The protectionist efforts of French governments have encountered little serious political opposition. To the contrary, they have often been criticized for not doing enough. For example, the US Embassy in Paris reported before crucial legislative elections in 1978 that the Giscard-Barre government was under pressure by its Gaullist allies to adopt more aggressive export promotion programs and more effective protectionist measures. Similarly, the influential Employers Association (CNPF) called for the "reconquest of the domestic market" in an open letter to Giscard in early 1980. The CNPF urged that France "adopt an attitude closer to that of our large partners who, generally speaking, know better than we how to defend their national markets beyond appeals to the regulations." In particular, the CNPF recommended that French firms give preference to French goods and asked Giscard to give his personal attention to the purchasing practices of government agencies. In fact, the government has never hesitated to accord preferences to French suppliers in important sectors such as electronics and telecommunications.

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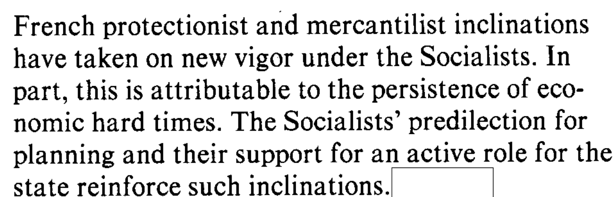
The Socialists Take Up the Cudgel



French protectionist and mercantilist inclinations have taken on new vigor under the Socialists. In part, this is attributable to the persistence of economic hard times. The Socialists' predilection for planning and their support for an active role for the state reinforce such inclinations.

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Speaking of Protectionism . . .

"France cannot allow international competition to develop under conditions that would throw its economic structure into confusion, bring about the sudden collapse of whole sections of its industry or agriculture, put thousands of workers out of work, and jeopardize its independence by eliminating essential activities."

Raymond Barre
Prime Minister under Giscard

"I cannot accept that France should suffer from insidious protectionism practiced throughout the world, especially in the EC. Protectionism will be met with protectionism and a half."

Francois Mitterrand

"There are no outmoded industries, only outmoded technologies."

Jean-Pierre Chevenement
Mitterrand's former Industry Minister

"We have to create a generation of exporters in France. That's why I propose the creation of a 'Superior School of Exportation.' That's the way we do things in France. When we needed engineers, we created the Polytechnic. Later on, to modernize and strengthen public administration, we created the Superior School for Administration. If the conquest of foreign markets becomes—as I believe it must—an absolute priority, then we must give ourselves the tools."

Laurent Fabius
Mitterrand's new Industry Minister

"Beware of those who set up or consolidate commercial fiefdoms in the name of free trade. Does the massive subsidization of agricultural exports, such as practiced by the United States, really come from free trade convictions? It's easy to be an evangelist when one has a position of strength."

Michel Jobert
Mitterrand's former Foreign Trade Minister

On the export side, the Mitterrand government is continuing to try to identify markets, especially in high-technology areas, in which an effective French presence may be secured. Going beyond their predecessors, the Socialists are using the expanded nationalized industrial and banking sectors and substantially increased levels of government funding to achieve success. Government funding of R&D, a preferential procurement policy, subsidized credits, and the use of the state's good offices are all seen as essential tools in the struggle for export markets. 25X1

On the protectionist side, the Socialists have embraced the earlier proposals to "reconquer" the domestic market. For the Socialists, previous governments erred in being too halfhearted. They reason that French basic industries—vital for national security and jobs—can be saved if the task of reorganizing and modernizing is carried out systematically and thoroughly. Plans have already been developed to rescue a number of sectors—among them machine tools, shoes, textiles, and toys—and others are on the drawing board. These feature, in varying combinations, government assistance for investment through grants and loans at preferred rates, partial assumption of labor costs by the government, agreements to favor domestic suppliers, and preferential marketing arrangements. 25X1

The Socialists, no less than their predecessors, are mindful that the French market is too small to permit the development of a fully efficient and competitive manufacturing sector, and they emphasize that their plans for the "reconquest" must necessarily be taken within the context of the European Community. They have attempted to carry out this strategy both by encouraging major French firms to make offers for cooperation with, or the purchase of, competitors in other countries and by taking a more aggressive line in Community councils on trade policy vis-a-vis outsiders. Paris has complained for years about the reluctance of the EC Commission, backed by Bonn, to retaliate

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against those who take advantage of the Community's "openness." Whatever the rhetoric, however, French prospects for implementing French plans at the Community level are uncertain. Other EC governments may be skeptical about takeovers by French nationalized firms and do not fully support French views on dealing with third countries.

A Question of Timing

Socialist plans for strengthening French export capabilities and for reducing import penetration depend on investment, retooling, and the development of new top-of-the-line products through increased R&D spending and, if required, purchasing foreign technology. This will take time, and more than one official has concluded that the gap between the anticipated result and France's current weak trading position will have to be bridged by greater recourse to protectionist tactics. The worsening trade deficit, brought about by an ill-advised stimulus package in 1981 and by the burden of mounting wage and social insurance costs on business, probably only had the effect of accelerating the implementation of protectionist measures.

In line with this approach and in keeping with their insistence on looking at bilateral balances, the French have recently made highly visible gestures against Japan and the USSR. Japanese products were the target of a ruling that video tape recorders would have to clear customs at Poitiers, a city in west-central France with only a small customs post. Last fall, French imports of Soviet petroleum products were temporarily halted in advance of a major bilateral meeting between trade officials of the two countries. These gestures were intended to serve, as the irascible former Foreign Trade Minister, Michel Jobert, put it, as "shots across the bow." Somewhat more ominously, the French recently circulated a memorandum detailing the protectionist devices used by other EC members.

Outlook

The French will continue to prod the Community to take steps to limit outside access to the Common Market. For industrial products, the targets are principally Japan, the newly industrializing countries, and the East Europeans. For agricultural products, it is primarily the United States. If necessary, Paris will simply block Commission measures aimed at liberalization, but France's political weight and the threat that Paris might resort to unilateral measures, will put pressure on the Commission. It is probable also that other EC members, beset with economic problems of their own, will find it convenient to let the French take the lead in advocating more restrictive trade measures, as they sometimes have in the past.

The French are most unlikely to abandon either their penchant for viewing trade in mercantilist terms or their willingness to resort to protectionism if circumstances dictate. The French course toward making good on their commitment to more open trade is likely to be erratic, with periods of heightened protectionism—as now—alternating with periods when relative success in international markets—as before 1974—makes a more liberal approach possible.

A reversion to the autarkic patterns of the past, however, is out of the question. Very few, other than the Communists, any longer seriously argue that France should try to go it alone. This is attributable in part to the country's inescapable dependence on energy and raw materials imports and in part to awareness of the limitations of relying solely on the national market. The possibility of retaliation against French exports thus acts as a brake on excesses of protectionist zeal.

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Italy: Protectionist Trends

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Italy, which is highly dependent on foreign trade, has contributed relatively little to rising EC protectionist pressures. Rome does, however, make use of nontariff barriers, including quotas and import surveillance schemes, directed—in large part—against Japan. Industrial support policies also tend to inhibit imports, although claims of anticompetitive effects are probably exaggerated. Although there is some increase in domestic protectionist pressures, Rome is unlikely to change its policies significantly. US exports are likely to remain little affected by Italian trade policy.

Free Trade Advocacy

Both industry and government generally consider relatively free world trade essential to the development of the Italian economy. The General Confederation of Italian Industries—the organization that represents most private industrial concerns—is a strong supporter of free trade. All the major political parties—the Christian Democrats, the Socialists, and the Communists—maintain an antiprotectionist posture. In the preparatory documents for this month's Communist Party Congress, for example, the Communists called for "surmounting protectionist temptations and national egoism." Only an insignificant segment of the Socialist left looks favorably on protectionism.

Import Barriers

Under the umbrella of EC restrictions, Italy has developed a moderate number of import restraints directed, in large part, at complementing Community protection. Italy's own contribution to rising protectionist sentiments within the EC has been modest. Aside from initiatives on chemical fibers, Rome has not actively sponsored protective EC policies. Indeed, more often than not it has sided with West Germany in resisting stronger protectionist proposals. At last year's GATT Ministerial, Rome took an antiprotectionist stance.

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As a member of the EC, Italy subscribes to the Common Customs Tariff and the Common Agricultural Policy (CAP). As a result of the last MTN tariff-cutting exercise, Italy's average tariff will drop from about 18 percent in the early 1960s to about 5 percent at the end of 1987.

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With declines in tariffs, nontariff barriers—including quotas, import surveillance schemes, voluntary export restraints, import deposit programs, and border tax adjustments—have become more important. Quotas on products such as chemicals, textiles, clothing, machinery, and transportation equipment are aimed mostly at Japan and the Communist Bloc countries. Japan alone has 38 products subject to quotas, including passenger cars, motorcycles, and mopeds.

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Rome has frequently resorted to slowing import entry as a means of protectionism. National surveillance programs, in addition to EC-wide schemes, are one such tool. Products subject to import surveillance tend to be the same as those under quota, and Japan is once again most affected. The primary purpose of monitoring schemes is to send a warning to exporting countries. In addition, products under surveillance can be delayed by the graduated application of time-consuming administrative requirements for documentation. In the sensitive textile sector, for example, required documentation has ranged from a simple import declaration to a license application accompanied by technical information and product samples.

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Rome has also made use of import deposit schemes to correct trade and balance-of-payments deficits. The most recent program was introduced in May 1981 and phased out in February 1982. It required a mandatory 90-day, noninterest-bearing deposit or bank guarantee equal to 30 percent of the value of the import order. Future trade and balance-of-payments problems could result in a new program despite EC opposition.

In addition, Italy sometimes has tried to slow imports by limiting ports of entry. This has been the case for steel and textiles. In 1978, for example, steel entry points were cut from 29 to four while those for textiles were cut from 12 to six. Contrived disagreements over local content ratios and country of origin, as in the case of passenger cars and color televisions, also have been used to delay entry of EC products.

Italy has recently come under attack for its government procurement practices. Some exporters, including US firms, have charged Rome with favoring local suppliers over foreign competitors. Foreign complaints about this type of discrimination, however, are probably exaggerated. "Domestic suppliers" are defined by Rome to include foreign subsidiaries and foreign merchandise distributed by domestic firms.

Industrial Support

Italy's relative moderation in resorting to trade barriers has been offset by a strong bent toward industrial support policies. The aid, which consists mainly of interest subsidies and direct financial support, rose sharply in the mid-1970s, from an estimated $1.5 billion in 1974 to $5.7 billion in 1978. As a percentage of GNP, funding increased from 0.9 percent to 2.2 percent. The programs have been directed largely at the industrialization of Italy's underdeveloped southern regions, in support of failing firms, or at state-owned or -controlled enterprises.

A major share of government transfers to industry has gone to finance the three main state industrial holding companies—IRI (heavy industry), ENI (energy), and EFIM (light industry). Rome has provided billions of dollars to operate the firms, which are a maze of about 1,000 companies employing over 700,000 people. Last year IRI, whose profit position has deteriorated since 1974, received about $3 billion from Rome.

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Rome also provides aid to revitalize firms through the Industrial Participations and Management Company (GEPI), an autonomous state agency created in 1971. GEPI was established to take over ailing but basically sound private companies, turn them into profit makers, and resell them to private owners. Through the end of 1981 GEPI had cost the Italian taxpayer nearly $1.6 billion. The agency has reorganized and disposed of about 80 firms and now has nearly 80 operating firms completely under its control. Another 100 are being operated as joint ventures with private sector firms.

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In addition to direct capital infusion, Rome also provides interest subsidies, amounting to about $1 billion in 1980. Other investment incentives include tax exemptions and deductions, local infrastructure cost exemptions, and temporary suspensions of mandatory pension contributions. Most of the investment incentives are designed to stimulate economic growth in the Mezzogiorno, Italy's poor southern region.

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The impact on trade of Italian industrial aid is difficult to measure. Complaints that government funding provides Italian firms with an unfair competitive edge are, however, probably exaggerated because Rome's policies are generally not very effective:

- State firms frequently retain redundant labor for political reasons, and management is riddled with patronage and featherbedding.
- Bailouts are frequently economically irrational and are based on political considerations.

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- Budgeted funds are frequently not disbursed. For example, a much publicized industrial reconstruction and reconversion plan was budgeted at about $2 billion for 1980-82, but no funds were ever distributed.

In short, Italian Government policies contribute little to rationalization and focus more on managing crises rather than solving them. At the same time, however, Rome has been fairly successful in avoiding alliances between labor and management in support of increased protection against imports. (C NF)

Moreover, Rome's present intent is to reduce the dimensions of industrial aid programs, partly in response to concern over an expanding budget deficit:

- GEPI has come under increased parliamentary pressure to divest itself more rapidly of financially sound firms.

- Some government funds, such as a fund for promoting investment and employment, have been given tougher disbursement guidelines. Rome is also considering slashing the funds' resources by about $1.4 billion during the latest round of budget cutting.

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Outlook

No substantial changes in Italian trade policy are likely in the near future, even though some domestic pressures for protectionism are increasing. Industries such as textiles, autos, footwear, and major household appliances have begun to clamor for more protection as competition from East European and Third World countries has increased. Rome has thus far dealt with the complaints without expanding protectionist policies. Complaints from the automobile industry, for example, have been handled by maintaining, rather than tightening, existing quotas on Japanese automobiles.

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US exports to Italy, about 2 percent of total US exports, have thus far been little affected by Italian policies. Any further government concessions to domestic pressure groups are likely to have little impact on US exports. Italy may, however, support measures within the EC that could have a more important impact, but we do not expect Rome to take the lead in sponsoring more protectionist moves within the EC.

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South Asia: Impact From Falling Oil Prices

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The largest and most immediate impact of lower oil prices on India, Pakistan, Bangladesh, and Sri Lanka will be savings on their import bills. The net oil imports of these four countries were just under 600,000 b/d in 1982. India stands to be the largest gainer on this account; with net imports of 350,000 b/d, it was hit with about two-thirds of the region's $7 billion oil bill. Bangladesh will also see its current account pressures sharply reduced—net oil import costs take more than 60 percent of its total merchandise export earnings.

Exports Only Slightly Affected

We believe that South Asia will be little affected by cutbacks in imports by oil producers. Merchandise exports to the oil producers amount to only $1.8 billion or 14 percent of total South Asian exports:

- India, whose exports of construction materials and equipment for development projects make up about 30 percent of its exports to the Middle East, is likely to suffer the greatest loss.

- Pakistan, with 25 percent of its total exports going to the oil producers, has the largest stake in the Middle East–South Asian trade relationship, but, because its exports comprise mostly foodstuffs and textiles, they are less likely to be reduced.

- Exports of foodstuffs, tea, and textiles by Sri Lanka and Bangladesh to the oil producers also are not likely to face sharp cuts.

Demand for Military Personnel Could Grow

We believe that falling oil prices and reduced oil production might increase Middle Eastern demand for military personnel from Pakistan and Bangladesh. The potential for greater political instability could prompt the Gulf states to bolster their security with apolitical military forces from outside the region. There already are [redacted] military assistance personnel from Pakistan in the Middle East and North Africa, including [redacted] combat troops in Saudi Arabia. These countries could well seek additional South Asian troops.

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Job Prospects in the Middle East Threatened

We believe the diminished prospect for jobs as a result of the slowdown in economic development in the oil-producing countries poses the greatest potential danger for South Asia. The presence of South Asian workers in the Middle East has grown dramatically since 1975. Using official South Asian government data, we calculate that some 2.1 million Pakistanis, Indians, Bangladeshis, and Sri Lankans work in the nine major labor-importing countries in the Middle East, five times the number estimated to be in these countries in 1975 by researchers at the International Labor Organization and the World Bank.[1]

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The rapid growth in numbers of South Asian workers has been paralleled by the dramatic

[1] The nine labor-importing countries are Kuwait, Bahrain, the UAE, Qatar, Oman, Saudi Arabia, Iraq, Libya, and Iran.

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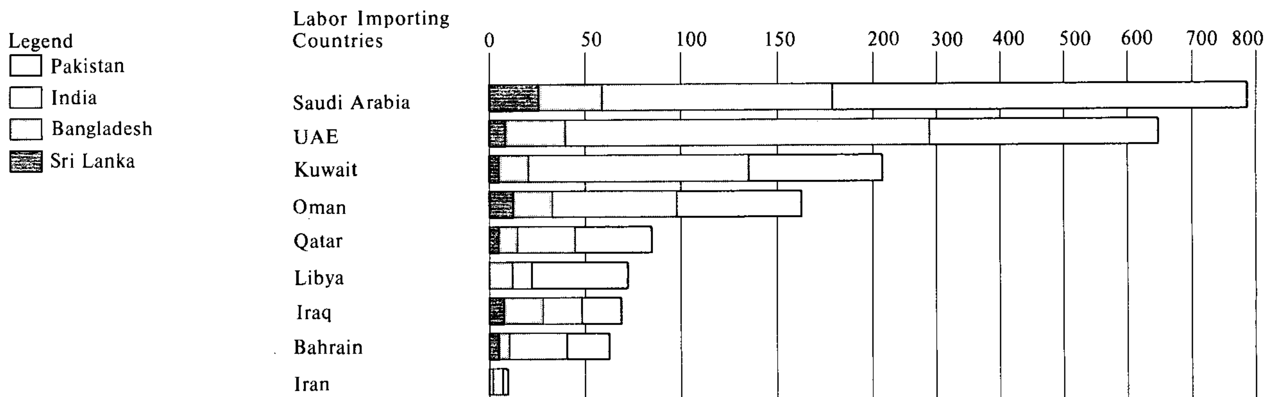
South Asian Labor in the Middle East, 1982[a]



[a] Estimated.

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growth in their remittances. A cutback in economic growth in the oil-producing states would affect remittances in at least two ways:

- Fewer new job opportunities would open up.
- Greater competition in the job market would dampen wage hikes for existing workers.

Although oil prices started falling over a year ago, government data show an increase in remittances since then. We believe that this increase will not continue:

- There generally is a long leadtime before development projects can be scaled back to the extent that there is a major impact on employment.
- The lag from when a worker receives his wages and the arrival of his savings at home can be several months.
- The current surge in remittances and savings might be prompted by workers who anticipate losing their jobs or impending instability in their place of employment.

A leveling or decline in remittances has important implications for hard currency earnings in South Asia. On the basis of official government statistics, we estimate that remittances from the Middle East to South Asia totaled $3-3.5 billion last year and constituted 60 to 70 percent of the total earnings from remittances. Remittances equaled 85 percent of Pakistan's export earnings in FY 1982. In Sri Lanka, remittances rival tea exports as the largest source of foreign exchange.

Remittances for New Delhi peaked at about $2.7 billion in FY 1981 and have since shown a sharp decline to about $1.6 billion. India was hit particularly hard by the loss of jobs and remittances caused by the Islamic revolution in Iran and by the war between Iran and Iraq.

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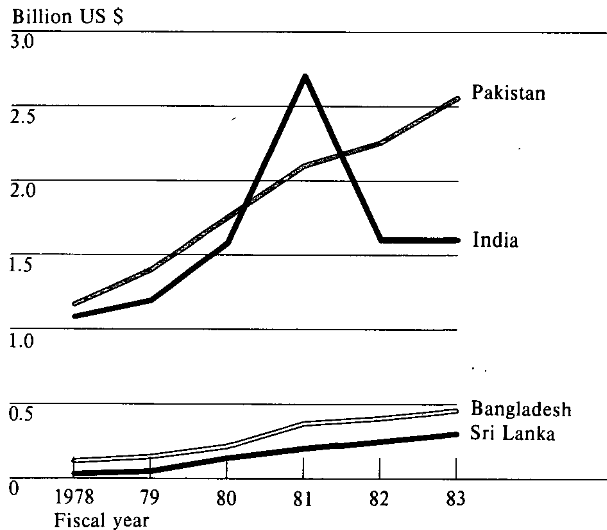
South Asia: Foreign Exchange Earnings From Worker Remittances[a]



[a] Based on Central Bank Reporting, and World Bank/IMF staff estimates.

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A Cutback in Aid?

South Asia, primarily Pakistan and Bangladesh, has been a key non-Arab recipient of aid from Middle Eastern oil producers. The region received about $600 million from the oil producers in 1981:

- Pakistan has received more financial aid than any non-Arab state. During 1974-80 Middle Eastern oil producers provided about $1.6 billion in bilateral economic assistance and nearly $1.3 billion in financing for military needs. Pakistan has been trying to line up an additional $0.8 million to $1.5 billion from the Gulf states for military purchases. Thus far, we are aware of a current military commitment of only $550-600 million from Saudi Arabia. Most of it is being used to pay the 1982 and 1983 cash installments for F-16 fighters and other US military equipment purchased in 1981.

- Foreign assistance, essential to the economy of Bangladesh, is nearly equal in value to total exports. In FY 1981 OPEC, Islamic institutions, and individual oil-producing countries provided about $180 million in project assistance. The Middle East provides about 10 percent of total aid.

- Sri Lanka has been less dependent on Middle Eastern aid. In FY 1981 it received about $15 million from the oil-producing states, only 4 percent of total aid.

- For India, aid from the oil producers, averaging about $70 million annually, has accounted for less than 5 percent of total aid.

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Short-Term Outlook

On balance we expect the South Asia region will benefit from the soft oil market for the next two years or so. On a strictly financial basis, we estimate that the net benefits for the region for this period will average about $1 billion annually. Lower oil prices will provide immediate relief on import bills. The need for South Asian workers is not likely to decline in the short run, and aid donations are likely to be maintained near current levels in the near term.

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South Asia: Current Account Balances [a] *Million US $*

	1979	1980	1981	1982 [b]	1983 [b]
India	375	−431	−3,073	−3,500	−3,400
Pakistan	−1,126	−1,145	−991	−1,424	−1,345
Bangladesh	−806	−1,472	−1,397	−1,440	−1,755
Sri Lanka	−413	−805	−654	−868	−890

[a] Fiscal year ending 31 March in India; 30 June in Pakistan and Bangladesh, and 31 December in Sri Lanka.
[b] Estimated.

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We expect India to be the big winner. Lower oil prices will have an immediate positive effect on the current account deficit, and New Delhi is probably better equipped than other South Asian states to withstand a potential slowdown in development in the Middle East.

We believe Pakistan faces the largest problems because it has tied its political, economic, and military development to the Islamic countries in the Middle East. A loss of willingness or ability in these countries to provide Pakistan with job opportunities and financial assistance could seriously hinder its economic development and military modernization.

Long-Term Outlook

If the soft oil market persists beyond the middle of the decade, diminished opportunities for working abroad will mean that emigration will serve less effectively as a safety valve for the continuing rapid growth of the South Asian labor force. We expect the leveling off in remittances and aid will have an adverse impact on economic growth, especially for Pakistan, and, to a lesser extent, for Bangladesh. Borrowing to compensate for lost remittances and aid would force these countries to contend with guidelines set by commercial banks or international financial institutions.

In the unlikely event of a sudden expulsion of several hundred thousand South Asian workers from the Middle East, their home countries, with the possible exception of India, would be hard pressed, we believe, to absorb their return. A sharp decline in hard currency from remittances and a complete cutoff in aid would force at least the three smaller countries to adopt austerity measures and press the IMF, Western donors, or Arab sources for additional financial support. If the governments fail to meet the economic and social expectations of returning workers, a likely event under such a scenario, we expect that forces in opposition to the government would pick up additional political support.

Implications for the United States

Short of a complete collapse of the market for foreign labor and consequent political unrest by the returning workers, we believe the major concern facing the United States will be coping with greater demands for financial assistance. With reduced prospects for increased aid from the oil-exporting states and worker remittances, the South Asian nations will look increasingly to the United States and Western financial institutions for support to cover the projected growth in foreign exchange deficits.

The United States faces a related financial and political problem with Pakistan on financing future military purchases. If Islamabad fails to secure additional funding for its military modernization program from the Islamic oil producers, Saudi Arabia in particular, we expect it will look to the United States for support as a test of our commitment to the region. If the United States makes large sums of military financing available to Pakistan, it could jeopardize the recent thaw in US-Indian relations.

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