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Debt Issues in the Middle East and South Asia: Trends and Prospects

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An Intelligence Assessment

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Debt Issues in the Middle East and South Asia: Trends and Prospects [redacted] 25X1

An Intelligence Assessment

This paper was prepared by [redacted] Office of Near Eastern and South Asian Analysis. Comments and queries are welcome and may be directed to the Chief, Issues and Applications Division, NESA [redacted] 25X1 25X1

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Debt Issues in the Middle East and South Asia: Trends and Prospects

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Key Judgments

Information available as of 1 June 1988 was used in this report.

The major countries of the Middle East and South Asia display broad differences both in the magnitude of their external debt problems and their responses to servicing this debt. Barring a precipitous decline in oil prices, the debt issue in these regions is unlikely to attain the significance that the much higher Latin American debt represents to US policy interests. Nevertheless, debt-related difficulties will still present many governments in the Middle East and South Asia with hard political and economic choices as they attempt to cope with the effects of adjustment measures and the need for new sources of external financing. 25X1

Some countries—Egypt, Algeria, Iraq, and especially Sudan—will remain troublesome debtors over the next several years. Their financing requirements are likely to require constant attention and, occasionally, special consideration from Western creditors. The United States and other Western governments are likely to be caught in the recurring dilemma of either insisting upon more rapid implementation of economic reform—to gain International Monetary Fund (IMF) and World Bank support and funding for the debtor country—or agreeing to slower reforms to avoid political unrest. 25X1

Other countries within the region, notably Morocco and Tunisia, probably will continue to make significant strides in coming to grips with their debt problems. In both cases, adherence to IMF-supported economic reform programs is paying dividends in the form of increased multilateral financial assistance and significant improvement in external payments balances. 25X1

Regionwide, the tendency to press Western creditors—both official and commercial—for more generous debt rescheduling is likely to produce strains in important bilateral and multilateral relationships in the years ahead. There are likely to be more attempts by countries such as Algeria and Iraq to circumvent traditonal IMF-supported adjustment programs or debt rescheduling under the auspices of the Paris and London Clubs, the official and commercial creditors, respectively. For the United States, the debt issue in the Middle East and South Asia is likely to spill over into disputes with key clients—especially Egypt, and possibly Morocco or Pakistan—over new aid commitments, the composition of programmed economic assistance, and the rescheduling terms for military and civilian debts. More generous aid and debt relief from other Western and Gulf Arab states could serve to undermine US leverage with such clients and lead to some diminution of US influence regionwide 25X1

Contents

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Scope Note

This study examines the economic problems of significant debtor countries in the Middle East and South Asia, ranging from countries where the debt issue clearly impacts on current political and economic affairs to others that have managed to bring their debt problems under control or are teetering on the brink of major credit problems. Saudi Arabia does not fit any of the debtor categories. Its large external debt is mainly in the form of short-term trade credits that—far from representing an inability to pay—merely reflect the kingdom's large merchandise import bill and its heavy use of credit lines [redacted] 25X1

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Debt Issues in the Middle East and South Asia: Trends and Prospects

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Regional Overview

External debt-related economic problems in the countries of the Middle East and South Asia, as elsewhere in the developing world, stem in large part from the inability of many of these countries to reduce chronic foreign payments deficits. A combination of soft world oil prices, poor macroeconomic management, and soaring population growth with its resulting demand for food imports appear to be the main contributors to persistent payments disequilibrium. The US dollar's relative decline against other major world currencies over the past three years has also, in some cases, added to debt burdens by appreciating the nondollar-denominated portion of external debt.

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What distinguishes the debt picture to some degree in the Middle East and South Asia from other Third World regions has been the relatively small proportion of borrowing from commercial banks. According to 1986 yearend data, private lending in the Middle East and South Asia accounted for only 39 percent of total medium- and long-term borrowing. By contrast, commercial lending in Latin America comprises 80 percent of borrowing in the same category and is a far larger figure in absolute terms as well: $274 billion in Latin America versus only $64 billion in the Middle East and South Asia.

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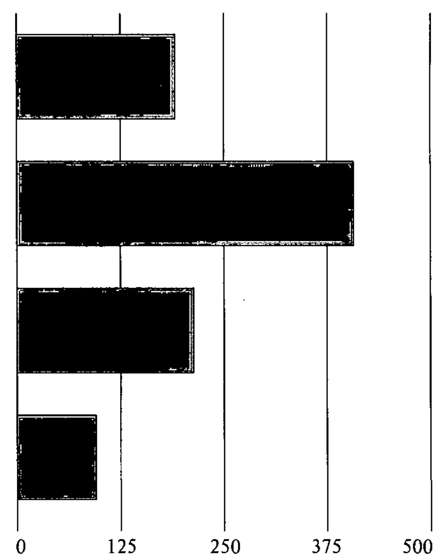
Figure 1
LDCs: Total Debt, 1986[a]

Billion US $



[a] Yearend data
[b] Data include North Africa.

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The correspondingly larger role official lending plays in the Middle East and South Asia has been a source of both strength and weakness for many regional borrowers. Their ability to gain access to official funds from the wealthier oil-rich states or from Western nations with strategic and economic interests in the region has eased financing problems. The relative accessibility of official grants, low-cost loans, officially backed trade credits, and generous reschedulings of official debt has also made it easier for some countries to ignore the need to adopt reforms and implement austerity programs. As official assistance continues to level off in the wake of tightening purse strings in the Gulf and among certain Western creditor governments, these debtors are coming under increasing pressure to accelerate politically sensitive reform measures. Such measures include energy price increases and reductions in consumer subsidies.

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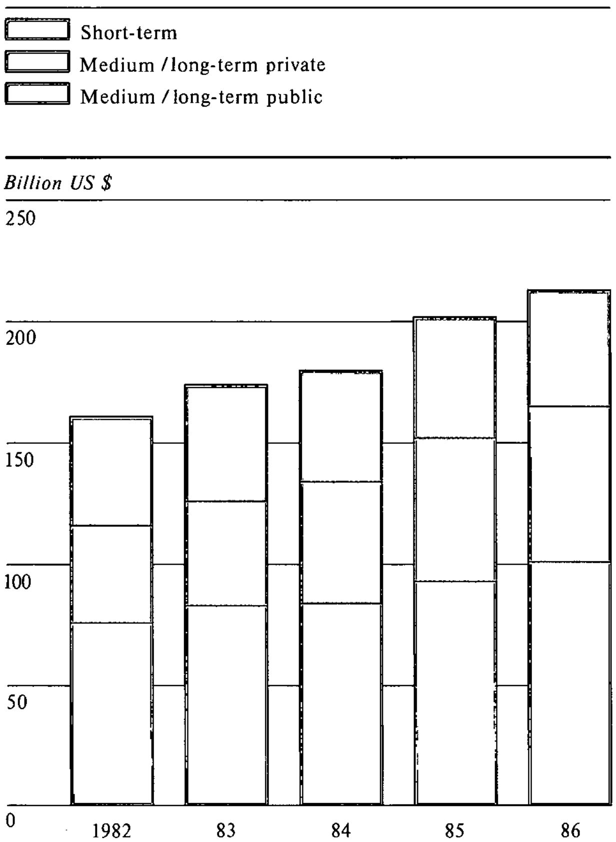
Figure 2
Middle East and South Asia: Aggregated External Debt, 1982-86[a]



[a] Yearend data include North Africa

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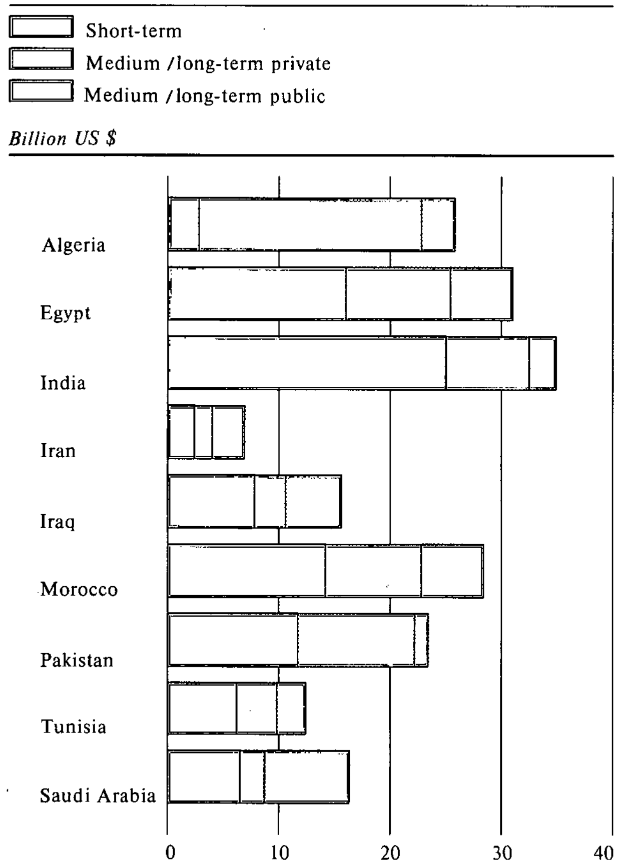
Figure 3
Selected Middle Eastern and South Asian Countries: External Debt, 1986[a]



[a] Yearend data.

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The Problem Debtors

Egypt

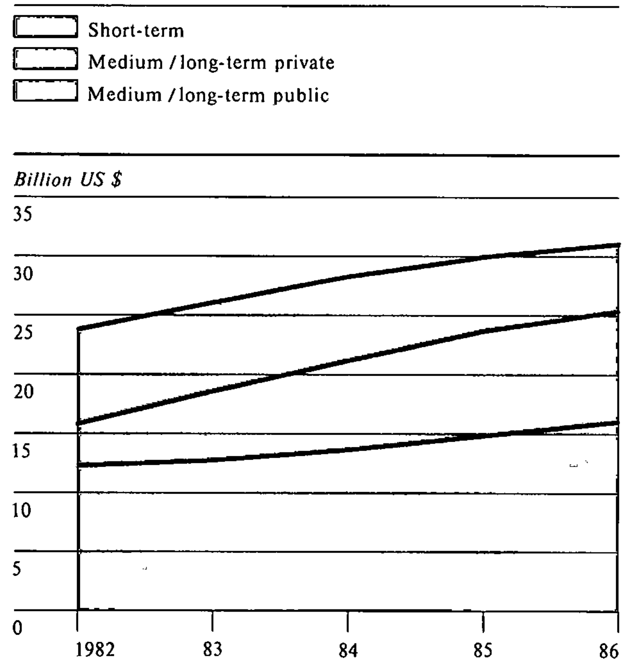
Among major Middle Eastern countries, Egypt's debt problems appear the most intractable and its structural adjustment prospects the most clouded by political considerations. Even moderately optimistic economic forecasts point toward the continuation of large current account deficits in the years ahead. With Western commercial lenders largely shunning Egypt, except for short-term trade financing, Cairo's deficits will continue to require constant injections of bilateral and multilateral assistance from both Western and Gulf creditors.

Cairo's May 1987 standby agreement with the International Monetary Fund (IMF), along with favorable trends in oil and tourist earnings, helped to temporarily stabilize Egypt's foreign payments position. In addition, with nearly 90 percent of its more than $30 billion in debt in the form of repayment obligations to Western countries and multilateral institutions, Egypt was favorably placed to take advantage of official reschedulings. Import growth was checked by a partial exchange rate devaluation of 63 percent, and service payments declined as a result of continuing, but slow, progress in rescheduling debt owed to 16 foreign governments.

Aside from the partial exchange rate devaluation and limited price increases, most of the conditions of the IMF agreement have not been met. Cairo has neither followed through on its pledge to raise interest rates, increase energy prices substantially, or unify the commercial and official exchange rates, nor has it made the cuts in budgetary growth that the IMF has requested. Partially as a result of its noncompliance with the terms of the standby agreement, Egypt has not received the large increase in new financing from Western countries that it had anticipated.

Significant improvement in Egypt's payments disequilibrium is, in our view, unlikely, given Cairo's extreme reluctance to engage more rapidly or more systematically in structural reform of the economy. The IMF, deeply dissatisfied with Egypt's performance under the standby, is calling for a more accelerated and

Figure 4
Egypt: Total Debt[a]
1982-86



[a] Excludes military debt.

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comprehensive reform effort. Exchange rate unification and budgetary cuts would help reduce demand on scarce foreign exchange reserves, while interest rate reforms would serve to attract private capital into the domestic banking system. 25X1

President Mubarak's regime is convinced that introduction of such measures would be an invitation for 25X1 widespread political unrest. With inflation averaging 25 percent coupled with sporadic, severe shortages of subsidized goods, public opinion in the country is decidedly antireform, according to US Embassy sources—strengthening the government's position that it cannot afford politically to go ahead with additional reforms. Egyptian leaders cite the riots that followed bread price increases in 1977 as an example of what might happen if reform is pushed too rapidly. [redacted]

Additional multilateral assistance in the form of further IMF standby loans and World Bank grants will probably remain contingent upon Cairo's willingness to acclerate its reform efforts. But Egypt, in our opinion, will continue to resist the type of comprehensive reform these institutions advocate. Instead, Cairo probably will continue to use whatever political leverage it possesses to exert pressure—via the United States and other friendly governments—on the IMF and World Bank to obtain financing on less stringent terms. [redacted]

If Egypt does exert such pressure, the United States and other friendly Western governments will find themselves in an uncomfortable position—either they can press the IMF and World Bank to push ahead with financing for Egypt regardless of Cairo's limited reform efforts or they can suggest to the IMF that it withhold funds until Cairo strengthens its compliance with the standby arrangement. In the first case Western countries risk establishing questionable precedents in dealing with Third World debtors. In the second case they would confront Egypt with potentially serious domestic unrest. [redacted]

With Egypt's gradual reintegration into the Arab world, expanded assistance from the Gulf Arab countries is another important potential source of external financing. Direct Arab assistance appears to have been sporadic over the past year [redacted] Egypt is also trying to attract more direct investment from the Gulf as an alternative to debt financing. This effort, if it is to be successful, will require streamlining the country's cumbersome bureaucracy—an excruciatingly difficult task—in order to create a more attractive investment environment. [redacted]

Algeria

Algeria's foreign debt position is precarious and will depend heavily on hydrocarbon prices. A downward movement in oil and natural gas prices could quickly push the country's debt service ratio above an already staggering 85 percent in 1987 and threaten rescheduling and further austerity. The government is committed to handling its debt problem without a formal Paris or London Club rescheduling and will probably take whatever import contraction measures are needed to reduce debt service requirements to more sustainable levels.[1] [redacted]

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The government has responded to mounting financial problems by cutting imports while opposing an IMF structural adjustment program. The deterioration in Algeria's foreign payments position in recent years stems largely from the decline in oil and natural gas prices since the early 1980s. Algerian efforts to control its trade deficit resulted in a 10.6-percent drop in imports in 1986 and an additional 14-percent cut in 1987. These actions were an important factor leading to the continuing flow of funds from Algeria's major official creditors:

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- In April 1987 France extended a three-year line of credit for about $500 million to finance imports.
- The United States recently increased credit guarantees to Algeria for the purchase of agricultural commodities from $301 million in FY 1987 to $596 million in FY 1988. [redacted]

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Algeria's commercial debt situation will continue to be watched closely, particularly by private bankers. About 75 percent of Algeria's external debt of $25 billion at yearend 1986 consisted of commercial obligations, primarily to Western banks. [redacted]

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[1] The Paris Club is the committee of creditors responsible for negotiating the rescheduling terms for official debt and usually consists of delegates from France, the United States, the United Kingdom, West Germany, and Japan. The London Club negotiates the rescheduling terms for commercial debt. Its membership varies but usually consists of representatives from major international banks with large loan exposure in the particular country undergoing rescheduling. [redacted]

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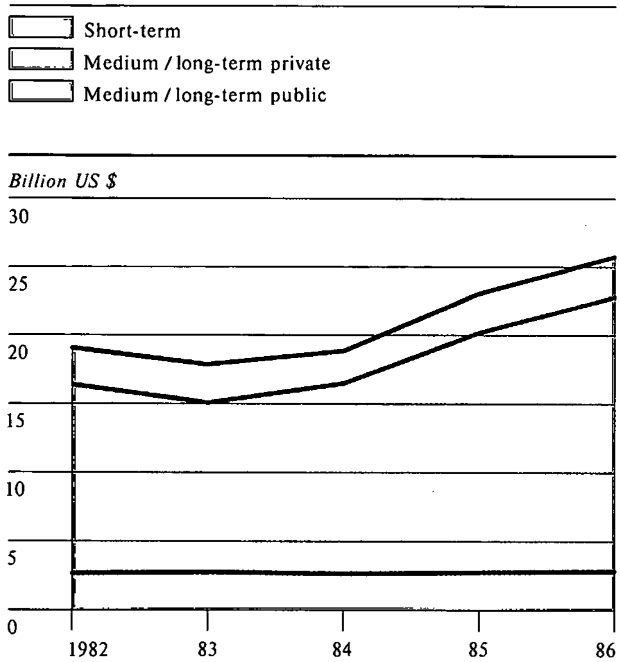
Figure 5
Algeria: Total Debt[a]
1982-86



[a] Excludes military debt.

[redacted] 317904 7-88

[redacted] banks have become increasingly cautious about medium-term lending because Algiers' heavy short-term borrowing appears excessive and could jeopardize servicing of medium- and long-term debt. [redacted]

President Bendjedid confirmed his government's commitment to economic reform and liberalization as recently as December 1987—a move that could spur further growth and boost lender confidence—but he will still face strong opposition from old line radicals in the ruling party and an entrenched bureaucracy opposed to liberalization. Lender confidence could also be shaken by further crop failures, which could result in large food import bills—pushing financing requirements even higher. The government has been fairly successful in restraining import growth, but continued crop failures resulting from adverse weather and locust infestation could strain import policies and erode lender confidence in the regime's ability to service debt. [redacted] 25X1

In our view, the regime is strong enough politically to cope with its debt problems. Although popular resentment against further austerity measures will probably fuel more discontent, with or without a formal rescheduling, we detect no effective political opposition that could deter the government over the next several years from its hardline approach to reducing expenditures by cutting imports. Moreover, the security forces appear capable of suppressing any outbreak of civil unrest. [redacted] 25X1

Iraq

Iraq's intensive use of foreign loans since the beginning of the war with Iran in 1980 has transformed Baghdad into a major debtor. Approximately 50 percent of its commercial and military debt of $30 billion is owed to Western countries, another 20 percent to the Soviet bloc, and the remainder to Third World countries. Higher oil revenues since 1987 and improved financial management are providing some relief, but debt servicing will remain onerous for several years.[2] *Serious arrearage problems will probably persist but are unlikely to result, in our opinion, in a further contraction of international credit lines.* [redacted] 25X1 25X1

Iraqi debt repayment problems have persisted. As of the first quarter of 1988, several countries had outstanding claims that remain unsettled. Italy, West Germany, Yugoslavia, and South Korea are among the countries that have curtailed credit to Iraq because of payment arrearages. [redacted] 25X1 25X1 25X1

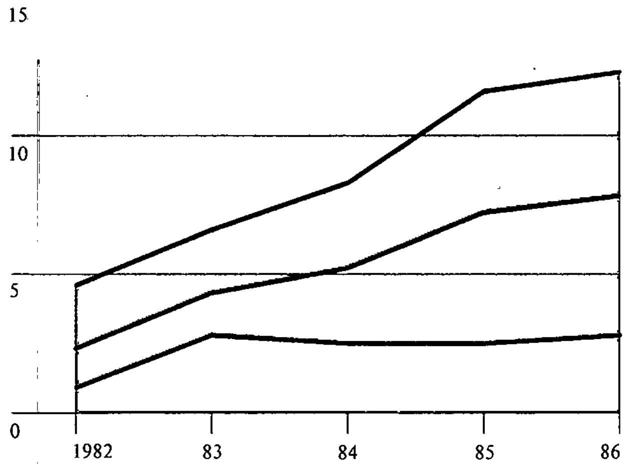
A rebound in oil prices in 1987, increased oil exports, and a hardline debt negotiating strategy have enabled

[2] This debt estimate excludes at least $35 billion in "soft" loans principally from Saudi Arabia and Kuwait, which are unlikely to be repaid [redacted] 25X1

Figure 6
Iraq: Total Debt[a]
1982-86

Short-term
Medium / long-term private
Medium / long-term public

Billion US $



[a] Excludes military debt

[redacted] 317905 7-88

Iraq to avoid more serious credit contraction. Baghdad has proved particularly adept at avoiding a general rescheduling—the Iraqis are shrewd and persistent negotiators. For example, in some deals Baghdad has obtained favorable repayment terms from one creditor by telling it that another creditor agreed to the same terms. [redacted]

Many lenders also are willing to grant generous rescheduling of Iraqi debt because they fear exclusion from Iraq's potentially lucrative postwar market. Baghdad repeatedly reminds creditors that it will remember who was accommodating and who was not. [redacted]

Western countries determined to support Iraq for political as well as economic reasons have also helped to stem credit problems. According to press reporting, debts to official British lenders have been deferred with minimum fuss, and officially backed credit facilities from the United Kingdom continue to be made available. The continued extension of official credit lines by the United States will probably allow the Iraqis to purchase at least $1 billion worth of US agricultural commodities during 1988. France is also providing a trade credit mechanism whereby each Iraqi repayment is matched by the provision of French credit worth twice the repayment. [redacted] 25X1

We expect Iraq's debt burden to continue to grow during the next several years despite projected higher oil revenues. Given recent reschedulings with lenders, we estimate that at least $5-6 billion in principal and interest payments will still be due each year during the period 1988-92. This amount is about 40 percent of the $14 billion in annual oil revenues that we project Iraq will earn during each of the next three years, based on current oil prices. In addition, financing new projects—the oil export pipeline across Saudi Arabia alone will cost upward of $1.5 billion over the next three years—will intensify borrowing requirements. [redacted] 25X1

Baghdad probably cannot start paring down its foreign debt until the early 1990s. Iraq's pipeline expansion across Saudi Arabia probably will be fully operational in 1990. Iraqi oil exports thereafter could, according to oil industry estimates, reach 3 million barrels per day, generating roughly $20 billion in revenues annually at current oil prices—as compared to about $11 billion in 1987. By the early 1990s, however, creditor claims for Iraqi revenues must compete with pent-up domestic demands for accelerated economic development and increased consumption—assuming the Iran-Iraq war has ended by then. [redacted]

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Sudan

With $11 billion in external debt and arrears and almost negligible repayment prospects, Sudan belongs in a special class of problem debtors. The usual adjustment mechanisms—debt rescheduling and IMF standby programs—have proved ineffective in dealing with its problem. Extraordinary measures—including some form of significant debt forgiveness and major coordinated assistance from donors—would probably be necessary to restore financial order. Even then, with a government in Khartoum incapable of managing the economy, such measures might bring only limited but very costly relief.

The prospects for multilateral aid are complicated by Sudan's arrearage problem with the IMF. Arrears of over $700 million owed to the Fund have resulted in Khartoum's disqualification, since 1985, from IMF financial assistance. Unless the arrearages issue is resolved—currently a dim prospect given Sudan's limited ability to attract donor support—Khartoum is unlikely to qualify for assistance under the new Enhanced Structural Adjustment Facility (ESAF). The ESAF, created by the IMF in 1987, establishes a special mechanism for dealing with low-income developing countries like Sudan. Even if the Sudanese Government qualified for ESAF funding, US Embassy sources calculate that Sudan would still remain $200 million in arrears on IMF payments—underscoring the need for additional bilateral assistance.

Khartoum's abysmal economic management clouds prospects for new bilateral aid. Donors are waiting for indicators that Sudan intends to put its economic house in order. With imports running two-and-a-half times exports, an overvalued exchange rate, and inadequate fiscal controls, evidence of serious intent is absent. Complicating US efforts to provide assistance are Brooke Amendment sanctions that bar the dispersal of funds to any government that falls more than one year behind in debt repayment. Chronic arrearages on the US debt threaten to place the Sudanese Government in recurring noncompliance with the Brooke Amendment, thereby jeopardizing US economic as well as military assistance programs.

We rate the prospects for a significant turnaround in Sudan's economic outlook as very poor. The government of Prime Minister Sadiq al-Mahdi demonstrates little willingness or capability to grapple with its economic problems. Its failure to build a workable coalition within the Constituent Assembly, its distraction by the country's worsening civil war, and its fear of provoking urban unrest effectively paralyze its economic decision making capabilities. 25X1

Successful Adjusters

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Morocco

Although Morocco has sizable repayment obligations on over $15 billion in external debt, significant improvements in economic performance and the government's continued adherence to economic liberalization should enable it to maintain the support of the IMF and World Bank, its major sources of international credit. Nevertheless, we believe that payments will remain a serious burden on the economy for years to come—absorbing an estimated 50 percent of export earnings through the early 1990s. 25X1

Sharp devaluations in 1984 and 1985 helped lift exports and restrain imports—by 1986 the Moroccan trade deficit had declined to about $1 billion, its lowest level in 10 years. For 1987, official figures showed a 5.2-percent increase in exports through the first 10 months, while imports were held to only a 0.2-percent growth rate. Moreover, exports grew despite steadily declining revenues from phosphates, the country's most important merchandise export. 25X1 25X1

The improvement in its foreign trade and payments balance over the past several years has made Rabat's creditors more flexible in negotiations to reschedule and restructure the country's debt burden. Late last year an agreement was signed that provided for the rescheduling of about $1.8 billion owed to over 200 international banks. Despite its improved standing with commercial banks, Morocco has not regained access to private lines of credit and is heavily dependent on official lending sources. 25X1 25X1

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Figure 7
Seriousness of Debt Servicing Requirements[a]

Very serious (40% or higher) Moderate to serious (15-39%) None to moderate (0-14%)

[a] Categories measured by the debt service ratio, the most commonly used indicator of a country's ability to repay debt. It measures principal plus interest payments as a share of exports of goods and services.

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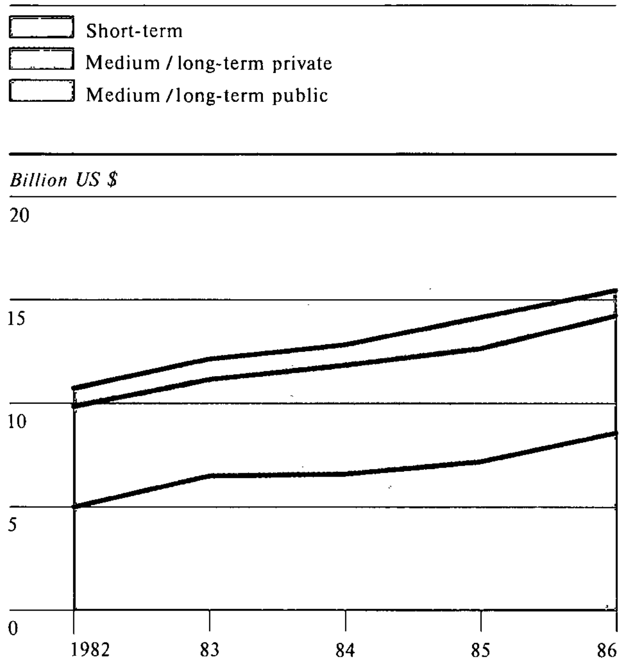
Figure 8
Morocco: Total Debt[a]
1982-86



[a] Excludes military debt

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Over the medium term, Morocco's ability to maintain the momentum of economic reform is crucial for economic performance and financing prospects. The government appears, in our view, to have realized sufficient benefits from reform to continue economic liberalization. Backed by a $240 million World Bank adjustment loan, Rabat is proceeding, according to US Embassy reporting, with plans for privatization of as many as 600 state-owned companies. The goal is to increase private savings—investors will, hopefully, be more inclined to participate in private ventures—and reduce the size of the budget deficit as well as broaden the economic role of the private sector.

Diversification of Morocco's sources of foreign exchange is also proceeding steadily. Tourism replaced phosphates as the largest source of hard currency earnings during 1987, and merchandise exports are growing as well. 25X1

We believe Morocco's political system does not present significant problems to maintaining economic momentum. King Hassan faces no major challenge to his power, and we believe his personal commitment to the reform program will help liberalization proceed. Rapid population growth—nearly 3 percent per year—and the heavy concentration of youth in the population—56 percent is under 20—will make job creation an increasingly vital national goal, however, if discontent is to be controlled over the longer term. 25X1

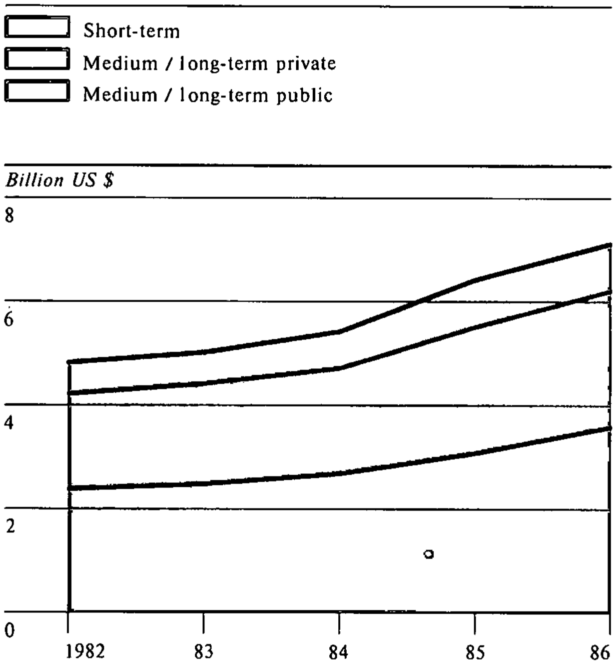
Tunisia

Tunisia, even more than Morocco, has made impressive strides in improving its foreign payments position over the past year. The painless transition to the government of President Ben Ali and the regime's evident commitment to economic reform have also served to bolster investor and lender confidence in the economy. The country still faces the difficult task of reducing many politically sensitive consumer subsidies. 25X1

Tunisia's faithful adherence to an IMF structural adjustment program negotiated late in 1986 has brought about an impressive economic turnaround. Devaluation of the dinar stimulated merchandise exports, tourist earnings, and remittances from Tunisians working abroad. The current account deficit dropped to only about $375 million in 1987 or about half the 1986 figure. 25X1 25X1

Refinancing short-term obligations dominates the government's debt strategy. About 40 percent of its total debt of $7.1 billion is short term. According to Tunisian economic officials, they hope to reduce this share to 25 percent by 1991. 25X1

Figure 9
Tunisia: Total Debt[a]
1982-86



[a] Excludes military debt

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Tunisia's excellent relations with the IMF and World Bank provide it with ready access to multilateral, concessionary loans. According to the World Bank, its lending to Tunis is the highest in the Middle East on a per capita basis, and the regime will be permitted to borrow an additional $1.5 billion over the next four years.

The government very prudently prepared the country for austerity with forthright explanations of its actions, but discontent may yet boil over—as in the riots of 1984—if tangible social benefits do not soon begin to accrue. Growing expectations among the urban middle class for political liberalization measures that would contest the ruling party's stranglehold on the political system are also likely to lead to further dissent and criticism, according to the US Embassy in Tunis

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Libya and Iran

Libya and Iran represent another breed of adjuster, whose response to payments disequilibrium entails an almost exclusive resort to domestic austerity and lower consumption to avoid debt. Both governments, largely for political reasons, have deliberately decided to refrain from utilizing Western credits, aside from short-term trade financing. In both cases the decision, in our view, stems from a desire to insulate themselves from the coercive use of financial power from the West. 25X1

We believe that both governments, given their harshly repressive nature, can hold down consumer imports to near current levels without generating adverse public reaction. Given the current limited potential for appreciably expanding oil revenues in either country, however, autarkic policies may require substantial revision if either chooses to reverse economic policy and pursue growth strategies dependent on large new doses of capital spending. In Iran's case, several strategic oil pipeline projects—which would lead to a substantial increase in export capacity even if the war with Iraq continues—probably face significant delays without greater recourse to foreign borrowing. 25X1

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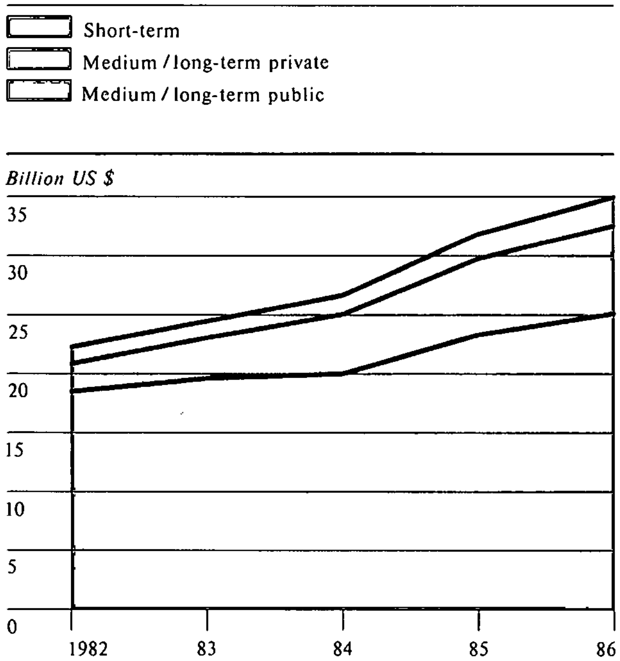
Potential Problem Countries

India

India's large foreign debt of $45 billion in 1988 and its debt service ratio of 30 percent remain manageable, according to international bankers. The fact that over 70 percent of foreign debt is in the form of official obligations to Western countries and multilateral institutions helps ease the impact of debt servicing—official debt is frequently offered at more attractive terms to borrowers. Indian officials also appear willing to sacrifice economic growth to maintain debt servicing well within acceptable limits. International bankers are concerned, however, that such conservatism may throttle future export growth and, ironically, lead to debt servicing problems within the next several years. 25X1

Figure 10
India: Total Debt[a]
1982-86



[a] Excludes military debt

[redacted] 317908 7-88

New Delhi emerged from the disastrous drought of 1987 in far better shape than most observers predicted. The current account deficit increased slightly, mainly because exports rose 20 percent to $12 billion. World Bank officials assessing the Indian economy note that, with its $6 billion in foreign reserves and $5 billion in official gold, New Delhi maintains a comfortable cushion against external financing requirements estimated at $4.8 billion in fiscal year 1988-89, which began 1 April. [redacted]

Beyond the current fiscal year, optimism is clouded by doubts among financial observers over India's export outlook. The government's capability to finance the current five-year development plan is suffering from a major shortfall in domestic savings. This, together with the costs of subsidies and interest payments, is constraining the capital investment India must generate if it is to remain competitive in world export markets [redacted] 25X1

Western financial observers are also concerned that New Delhi will not pursue economic liberalization aggressively enough—to the detriment of future export capabilities. According to them, the economy urgently needs to maintain the momentum of private-sector industrial change and competition. But Prime Minister Gandhi may not, according to knowledgeable observers, have the political strength to give industry what it needs the most—the freedom to shut down unprofitable enterprises and lay off workers. [redacted] 25X1

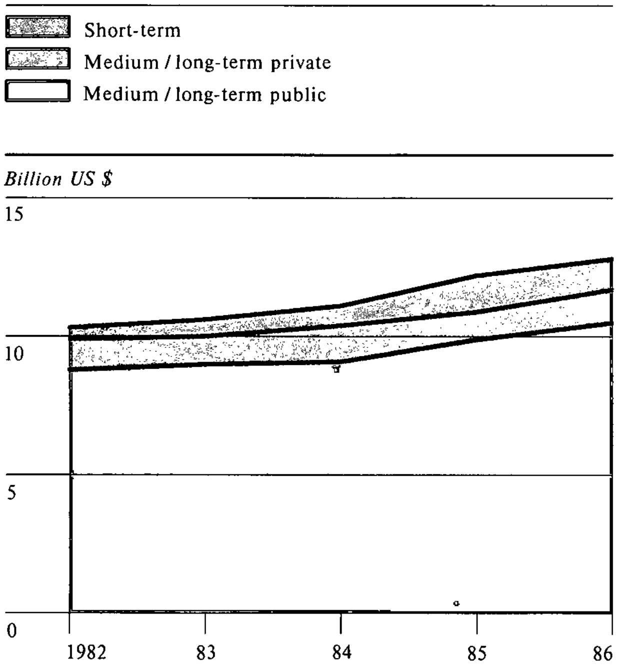
Pakistan

IMF officials are concerned that Pakistan will have debt management and foreign payments problems soon unless strong fiscal measures are taken to reduce large budgetary deficits, according to the US Embassy in Islamabad. Larger deficit spending could accelerate domestic inflation and erode the competitiveness of Pakistani exports. [redacted] 25X1

As of June 1988, the IMF and Pakistan were continuing intermittent discussions on the terms of a $900 million structural adjustment program. Islamabad's willingness to consider seriously the conditions of the 25X1
program—including tax reforms, trade liberalization, and deregulation of prices and markets—indicates the government's growing awareness of its financial problems. [redacted] 25X1

Pakistan's access to short-term commercial credit facilities is adequate for the time being [redacted] 25X1
[redacted] Lending is profitable 25X1
for banks because the Pakistanis are willing to accept interest rates two or three percentage points higher than the banks' cost of deposit. But political tensions in the region and uncertainty over ramifications of the 25X1
Geneva Accord on Afghanistan may adversely affect the country's future borrowing prospects. [redacted] 25X1

Figure 11
Pakistan: Total Debt[a]
1982-86



[a] Excludes military debt

[redacted] 317909 7-88

Despite the benefits of new oil production, Syria's foreign payments situation will probably remain weak. Additional oil revenues—perhaps as much as $600 million more annually by 1990—may be negated by the loss of much of Syria's traditional cash assistance from Arab donors. Such aid may increasingly depend on how well Damascus mends its relations with Iraq and other moderate Arab states. The prospects for such reconciliation are clouded by mutual enmity and mistrust between Syria and Iraq. Soviet aid has also been curtailed, and Soviet demands for repayment of debt have become more strident [redacted] 25X1

Attempts to introduce reforms to the economy are stymied by the opposition of powerful elements within the government, including the military and security services. Their control over large-scale smuggling operations would be jeopardized by economic and administrative restructuring. For example, rigorous enforcement of customs and import regulations at the Lebanese-Syrian border would deprive high-level officers of lucrative black-marketeering profits. [redacted] 25X1

Syria's poor creditworthiness and economic performance under the Assad regime makes increased access to commercial lending sources extremely difficult. Only a very few Western banks are presently providing credit [redacted] 25X1
[redacted] These credits are almost exclusively short term and in the form of highly secure, fully collateralized letters of credit. [redacted] [redacted] Damascus would like to increase trade credits from Western banks, but the response so far has been tepid. [redacted] 25X1 25X1 25X1 25X1 25X1 25X1

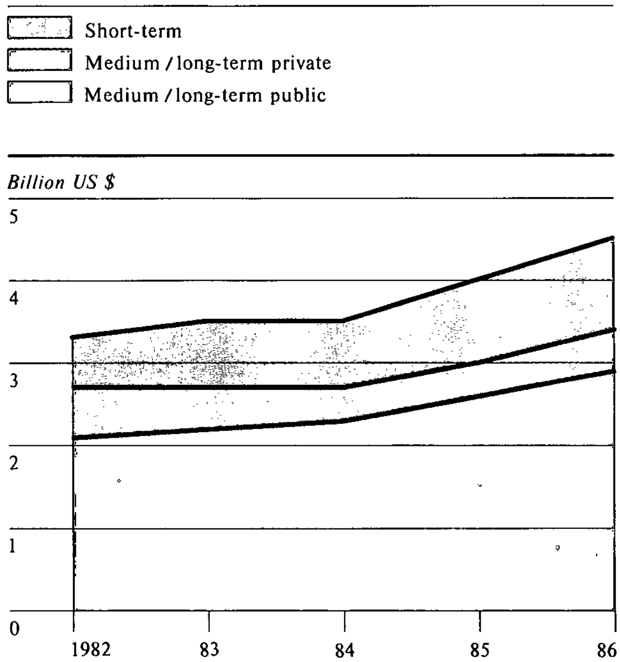
[redacted]

Syria has only limited access to multilateral funds, and its shaky international financial standing could deteriorate even further if it defaults on over $100

Syria

With its economy in disarray and traditional sources of aid becoming more problematic, Syria appears headed for serious financing difficulties. Lenders have noted the economic mismanagement that has left the economy in poor shape, with the value of real gross domestic product in 1987 below that of 1981. Basic weaknesses—a heavy military burden, a narrow export base, overvalued exchange rates, human and capital flight, and poor fiscal performance—persist and have forestalled recovery. [redacted] 25X1

Figure 12
Syria: Total Debt[a]
1982-86



[a] Excludes military debt

[redacted] 317910 7-88

million in arrearages to the World Bank. Under an agreement concluded in March, Syria has pledged to make a phased series of payments on these obligations beginning in August, according to US Embassy reporting. The Embassy, however, is skeptical—noting that the Syrians have not even made a token payment in the last 18 months. If the August deadline passes without action by the Syrians, it will jeopardize the chances for other financing from Western multilateral sources. [redacted]

Marketing Middle Eastern Debt

Despite the trading of about $250 million in Middle Eastern debt obligations during 1987—mostly in the form of debt swaps between banks in world secondary debt markets—recourse to debt-equity conversions remains a limited option for regional debtors. Asset traders in the world secondary debt market maintain that Middle Eastern debt represents too small a portion of total world debt to be affected by the debt-equity instruments being devised for countries such as Brazil and Chile. Moreover, most Middle Eastern debt is official, bilateral debt that is not tradable. A further problem is the lack of viable investment options in the region. [redacted] 25X1
[redacted] *most Arab states have not reached* 25X1 *the stage of devising debt for equity programs. Morocco appears closest to formulating such a program, but Rabat is unwilling to offer much in the way of discounts to provide incentives for investors to buy debt. Moreover, the lack of investment prospects in Morocco will limit the scope of debt-equity swaps.*
[redacted] 25X1

Outlook

For many of the oil-exporting problem countries debt servicing will probably remain a constraint over the 25X1 next several years. World oil market trends indicate continued weakness with little chance for much of an increase in prices, in our analysis:

- Iraq, with large export capacity growth projected over the next several years, probably is in the best position to manage debt servicing among the problem debtors.
- Algeria, with little or no projected increase in capacity, will be much more vulnerable to oil and gas price fluctuations and a more likely candidate for rescheduling.
- Egypt and Syria, more modest oil exporters, will 25X1 also feel financial pressure if oil prices decline.

[redacted] 25X1

Some Middle Eastern and South Asian countries stand to gain from weakened oil prices. Pakistan, India, Morocco, and Sudan, all oil importers, fit into this category.[3] [redacted]

For borrowers with the economic clout that results from large oil and gas reserves, such as Iraq and Algeria, the tendency to pursue more independent debt negotiating strategies probably will persist. Iraq's ability to abstain from dealing through the Paris Club or the IMF and its success in playing one lender against another will be strengthened by its strong oil export outlook. Algeria will also probably continue to resist a structural adjustment program and Paris Club rescheduling. With austerity straining the political system as well as a limited capacity to expand hydrocarbon earnings, however, Algiers may be forced to accept some form of debt rescheduling in cooperation with its international creditors. [redacted]

Egypt's strategic importance to Western allies, particularly the United States, should help ensure financial support, despite continuing large foreign payments deficits. President Mubarak almost certainly will take advantage of Western interest in maintaining a moderate and stable pro-Western government in Cairo. Nevertheless, most Western creditors are likely to push for compliance with IMF-supported structural adjustment measures. Such pressure, in our opinion, will strain relations between Cairo and its creditors. [redacted]

[3] Not all the consequences of a weakening oil market are positive for oil importers. Many countries—including Pakistan, Jordan, and Sudan as well as Egypt among oil exporters—are heavily dependent on remittance earnings from Arab Gulf countries. Further contraction in the expatriate worker forces in the Gulf that resulted from lower oil prices would erode, to some degree, the positive impact of lower import bills. [redacted]

The United States could find itself in the awkward position of arguing for less rigorous criteria for disbursing multilateral aid to Egypt—a move likely to be resisted by both the IMF and World Bank, concerned as ever about establishing precedents for other debtor countries. The generous terms of the 1987 Egyptian standby arrangement and Egypt's subsequent lax compliance with even these measures may have encouraged the belief, at least in Cairo, that when push comes to shove, Western creditors will offer softer terms. [redacted]

Regionwide, the tendency to challenge current assumptions about debt management and to press Western creditors—both official and commercial—for more generous debt rescheduling is likely to dominate financial relations in the years ahead and produce further strains in important strategic political relationships. For the United States, this will probably result in disputes over new aid commitments, the composition of current economic assistance, and the rescheduling of military and civilian debts with important client states such as Morocco, Egypt, and possibly Pakistan. Military debt, however, is likely to become a less contentious issue following recent Congressional approval of refinancing of Foreign Military Sales debt at more favorable interest rates. More generous aid and debt rescheduling from other Western and Gulf Arab states could still lead to some undermining of US influence, particularly within the Middle Eastern region. [redacted]

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