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International Economic & Energy Weekly

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26 October 1984

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26 October 1984

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26 October 1984

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International Economic & Energy Weekly

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Synopsis

1 **Perspective—*OPEC's Dilemma: Face Price Cuts Now or Later***

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OPEC will hold an emergency session on Monday to attempt to avert another general price decline. If OPEC does not reduce prices in the next week or so, it probably will face another price crisis during the next year or two in the absence of a significant supply disruption.

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11 **OPEC: Price Cuts Trigger Another Crisis**

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The latest series of oil price cuts by Norway, the United Kingdom, and Nigeria threatens to set off a chain reaction that could cause the current oil price structure to unravel. Even if OPEC is successful in its attempt to support oil prices, we believe downward price pressure is likely to reappear early next year in the absence of a significant oil supply disruption.

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17 **International Financial Situation: Political Update**

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During the past month, financially troubled LDCs have had to deal with continued civilian opposition to austerity programs and military unrest.

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19 **International Financial Situation: South American Financial Update**

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Despite progress with the IMF and commercial banks, South American debtors face continued problems in meeting repayments, complying with IMF agreements, and securing debt rescheduling and new loans. Many of these countries have reacted skeptically to last month's call by the United States for a conference of LDC debtors and industrialized countries under the auspices of the IMF and IBRD.

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23 **International Financial Situation: Latin American Capital Flight**

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We estimate more than $100 billion capital flowed out of 10 Latin American countries during 1979-83—roughly half the total capital inflows during the same five-year period. As a result, debtor nations are borrowing more just to balance their international accounts.

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25 **Lebanon: Worse Off Than Ever**

The Lebanese economy continues to deteriorate under the weight of the political and security situation. Until the political situation begins to stabilize and an extensive security plan is in place, the economy will remain depressed.

31 **Pakistan: Moves Toward Islamic Banking**

The Islamization of Pakistani society received new impetus recently with the announcement that the banking system, including foreign banks, will be run on a completely noninterest basis starting on 1 July 1985. In our view, the proposed change will at least temporarily slow the investment and savings rate and retard economic growth.

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Perspective

OPEC's Dilemma: Face Price Cuts Now or Later

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OPEC will hold an emergency session on Monday to attempt to avert another general price decline. Persistent weak demand and sagging spot oil prices forced three major oil producers, including OPEC member Nigeria, to slash prices by up to $2 per barrel last week. While short-term oil market conditions are far less ominous from OPEC's perspective than before the March 1983 price cut, recent events threaten a free-fall in oil prices. OPEC has promised to defend its current $29 per barrel benchmark price by cutting production, but has not developed a concrete plan to do so. Disagreement on the details of an approach to prop up prices could cause Monday's meeting to be highly contentious. In particular, OPEC will have to deal with Nigeria, whose intransigence could threaten any agreement.

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OPEC has incentives to cooperate and hold the line on official prices despite developments to date. Members certainly recognize that an official price break could trigger a downward price spiral. They also realize that major oil companies can ill afford to risk substantial further reductions in inventory levels because most industry analysts, including OPEC's Secretariat, predict a seasonal rebound in oil demand. The demand increase would not only help OPEC's price defense, but also provide the members additional revenue from higher winter sales. Still, OPEC's price defense will be difficult.

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Even if OPEC is successful in avoiding a price drop this time, the organization is far from being out of the woods. Price runups in the 1970s have resulted in substantial investment in energy conservation. As a result, demand for oil is likely to show only modest growth at best over the next few years. Indeed, the strong economic recovery in the United States and Japan over the past year has failed to boost oil demand at the same rate as economic growth. Moreover, non-OPEC producers will most likely capture most incremental demand, leaving OPEC with the prospect of only a marginal increase in demand for its oil at best.

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Rising non-OPEC oil supplies have forced the organization to confront the need to more effectively coordinate pricing and production strategy with non-OPEC oil producers. Recent OPEC success along these lines has been mixed. OPEC apparently has gained support from less developed countries such as Mexico and Egypt. There is little hope, however, of cooperation on production restraint with OECD producers—where a large part of the future non-OPEC production increase will be concentrated—or with the USSR. Without

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production cutbacks elsewhere, or an unexpected rebound in oil demand, increasing non-OPEC output will put additional downward pressure on prices.

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OPEC also will have to deal with rising output from its own members over the next few years. Projects now under way will increase Iraq's export capability by at least 500,000 b/d. The startup of additional Saudi export refinery capacity by 1986 could also compound OPEC's problems if Riyadh decides to sell its products at competitive market prices. Iran is also likely to ignore OPEC production quotas when it needs foreign exchange to support its declining economy. OPEC must also contend with a growing volume of natural gas liquids (NGL). Sales of products and NGL are not subject to OPEC pricing guidelines and provide a ready means for members to offer discounts.

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Until OPEC can effectively resolve internal problems of competing self-interests, the organization will remain under siege. We believe some type of price reduction is almost inevitable. If OPEC does not reduce prices in the next week or so, it probably will face another price crisis during the next year or two in the absence of a significant supply disruption.

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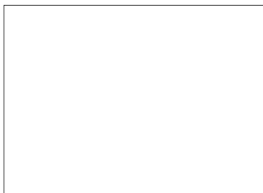
Briefs

Energy

Suspension of Mexican Gas Exports to United States



Mexico and its US customers announced this week that natural gas sales would be suspended on 1 November. The Mexicans are now unwilling to match lower Canadian prices, but they hope to reach a compromise in coming discussions with US buyers to salvage this vital source of foreign exchange. Last year, natural gas sales to the United States brought in $350 million. Although current sales of 180 million cubic feet per day are less than 1 percent of US demand, Mexico supplies a significant share of gas consumption in US border states. Settlement of this issue would influence a wide range of bilateral concerns, including long-term US access to important Mexican gas reserves.

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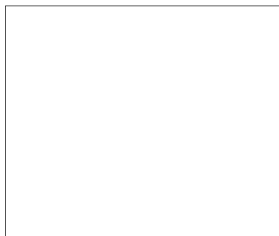
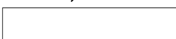
EC Energy Import Trends



EC imports of natural gas and crude petroleum grew significantly in the first half of 1984 in response to the pickup in economic activity. Real GDP for the Community was 2 percent higher in the first half of this year compared with a year earlier, and preliminary data indicate EC natural gas consumption in the January to June period was nearly 9 percent above year-earlier levels, while oil consumption increased 3.5 percent. Expanding imports largely covered the growth in gas and oil consumption—gas imports jumped more than 23 percent, and crude oil imports advanced almost 8 percent. Algeria was the chief beneficiary in the EC gas market, boosting its sales 29 percent. Highlighting the increase in oil imports was the nearly 6-percent hike in EC purchases from OPEC, the first such rise since 1979, when the EC countries began to diversify sources of supply. With the EC economic recovery forecast to continue into 1985, EC energy demand, and, hence, imports are likely to expand further.



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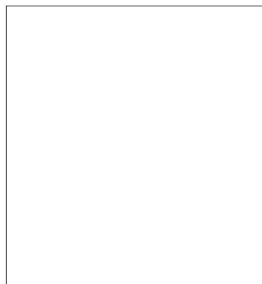
Optimism in Colombian Oil Sector



According to Embassy reporting, a US oil company has made a significant discovery in northeast Colombia. Preliminary estimates indicate proved reserves of at least 400 million barrels and production could reach about 100,000 barrels per day (b/d). Although the US oil company estimates the field could ultimately produce as much as 220,000 to 250,000 b/d, other industry personnel in Colombia believe these higher estimates are overly optimistic. Bogota has awarded a $177 million contract to a Western firm for construction of a 300-km pipeline to link the new oilfield with the existing Trans Andean Pipeline. The pipeline, however, will not be completed until at least early 1986. Current total Colombian oil output is averaging 170,000 b/d, and Bogota is likely to be a net exporter for 1984—the first time in eight years. According to estimates by the state oil company, Colombia, which has a $12.5 billion foreign debt, could increase net oil export earnings as a result of the new discovery by between US $200-300 million by 1990.

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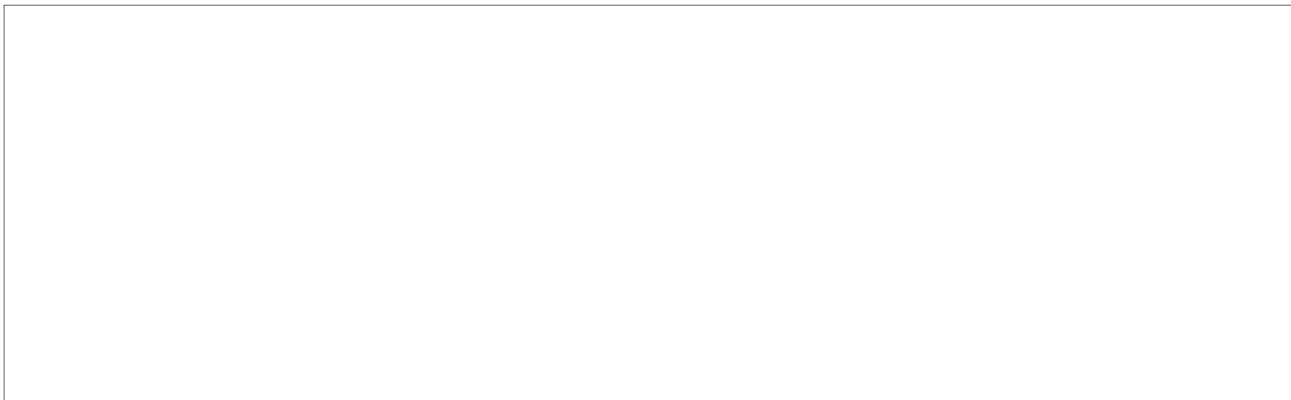

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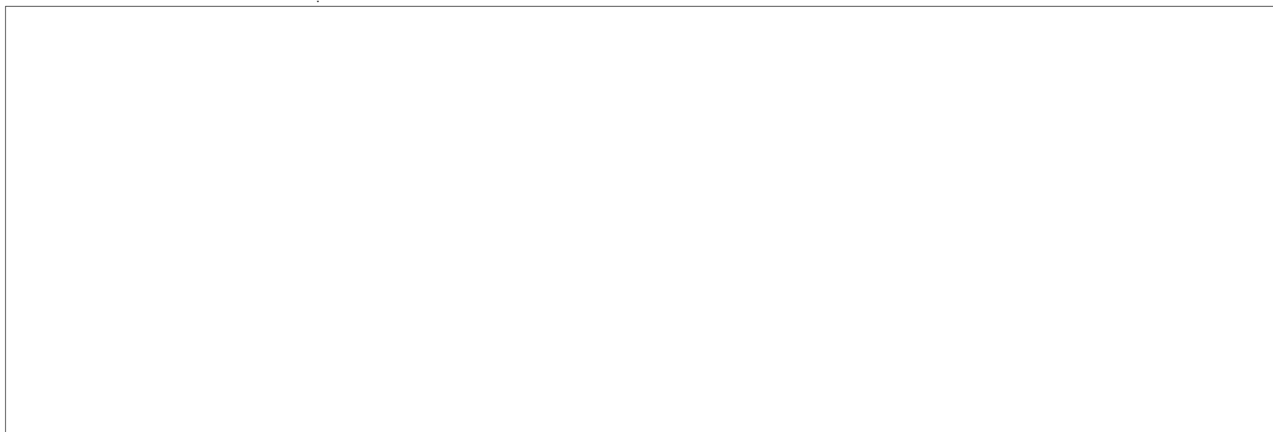
Global and Regional Developments



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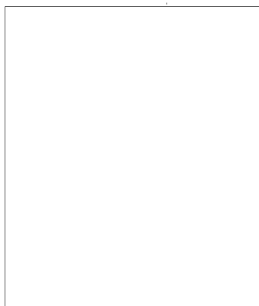
Aluminum Price Slide May Be Ending



The dramatic fall in aluminum prices may be bottoming out in response to production cutbacks, particularly in the United States, and growing demand. Since the first of the year, aluminum prices have fallen by more than a third to about 45 cents a pound—a level roughly 25 percent below average costs for US producers. We believe, however, that the price rise will be neither strong nor rapid, since there are substantial commercial stocks on the market at present. The modest turnaround in aluminum prices will not provide much relief for LDC bauxite producers. For Jamaica, which depends on the aluminum industry for more than 60 percent of its export earnings, probable price gains would be too small to offset revenue losses from the closures of US gulf coast aluminum plants—the major market for its bauxite.

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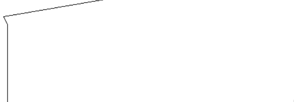
National Developments

Developed Countries

Portuguese Difficulties With the IMF



According to the US Embassy, the IMF refused to allow Portugal to resume drawings under its standby agreement in September because short-term debt at the end of July was $40 million above the Fund's 31 July ceiling of $200

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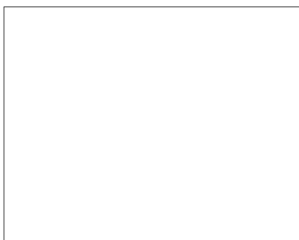
million for the first seven months this year. Portuguese officials also admit that they have exceeded the July ceiling on public-sector domestic credit as well and expect to surpass the 31 December limit. Nevertheless, Lisbon hopes to obtain IMF waivers to resume drawings in November. We expect that these waivers would be contingent on other austerity goals that the Soares government has not met. Additional cuts in government price subsidies promised this fall have been put off until next year out of fear of spurring inflation and prompting large pay demands. In addition, Lisbon has not cut public-sector enterprises' investment programs and is not effectively supervising their borrowing. Backsliding in these areas threatens to swell the budget deficit, hinder the repayment of arrears owed by state firms to the private sector, and crowd out private investment. 25X1

Philips-Siemens Joint Microchip Project



Western Europe's two largest electronics firms, Philips of the Netherlands and Siemens of West Germany, have announced a joint plan to develop advanced integrated circuits with considerable backing from their governments. The two companies have agreed on a $300 million research project to develop and produce one- and four-megabit random-access memory chips by 1989. Half the financing for the research project will come from the Dutch and West German Governments. This ambitious effort to close the gap in West European semiconductors, however, is not likely to decrease Japanese and US dominance in the West European microchip market. 25X1

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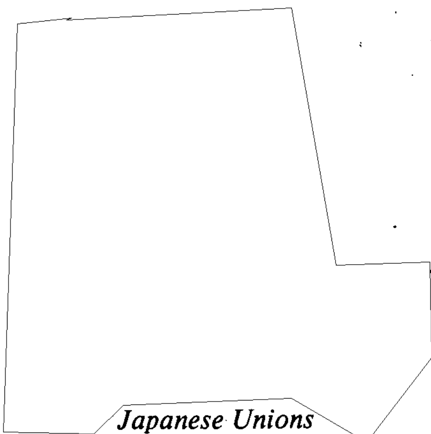
Irish Economic Plan Unveiled



On 2 October, Prime Minister FitzGerald unveiled his 1984-87 economic plan representing the second installment of the Fine Gael–Labor coalition's austerity program. The so-called "National Plan" is designed to maintain the Irish standard of living, reduce the growing foreign debt burden, keep the 16.6-percent unemployment rate from rising, and reduce the chronic budget deficit. Tax incentives for business are aimed at creating 25,000 new jobs in the private sector. Tax increases, a 20-percent cut in government capital spending, a proposed salary freeze for public employees, and a reduction of 5,000 civil service jobs will be used to reduce the budget deficit. The program probably will be passed by Parliament but will face a major test next spring when public employees bargain for a new contract. The plan's targets probably will not be met, in which case the burgeoning foreign debt burden could force Dublin to seek an agreement with the IMF in the near future. 25X1

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Japanese Unions Push for Shorter Hours

Demands that Japan bring its workweek into line with other advanced nations were a highlight of every labor convention this fall. 25X1 recommended that the 48-hour week be cut to a nine-hour, five-day workweek. Arguing that this does not go far enough, Sohyo and Domei—Japan's major labor confederations—have asked their opposition party allies to introduce a bill in the next Diet session calling for a 40-hour 25X1

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week. Reduced working hours appeal to the rank and file and could also help to cope with employment problems caused by slower growth. Labor leaders are probably also concerned about foreign criticism that the longer workweek gives Japan an unfair trade advantage.

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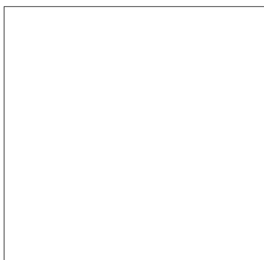
Australian Investment in US Resource Sector



Comalco of Australia is currently negotiating with a US firm to purchase aluminum-processing facilities and accompanying metal inventories in the United States for an estimated US $400 million. The move would guarantee an American market for alumina and aluminum exports from Comalco's Queensland operations. Comalco's action closely follows the US $2.5 billion purchase by Broken Hill Proprietary, Australia, of an American coal operation, indicating a focus of Australian investment in US mineral resources. This is likely to be viewed by Australian observers as an offset to the large role of US investment in the Australian mineral-resources sector.

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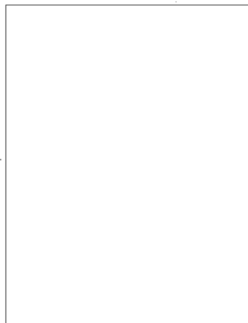
Less Developed Countries

Mexican Balance of Payments Underscores Flat Economy



Recent data from the Bank of Mexico show that continued depressed imports kept the current account in surplus during the first half of this year. While imports increased nearly $1 billion from the same 1983 period, they are still at $4.5 billion, less than half the comparable 1982 level. Exports during the same period rose by nearly $1.5 billion to $11.8 billion, led by higher sales of petroleum products, manufactures, farm products, and minerals. The deficit on services improved by about $0.5 billion to $4 billion as payments on foreign debt interest held steady and income from tourism and cross-border assembly industries substantially increased. Despite the unprecedented $3.3 billion six-month surplus on the current account, foreign exchange reserves only increased $2.2 billion because of capital outflows. Capital flight remained high—an estimated $1 billion. New bank loans largely offset rescheduled debt-principal payments. Meanwhile, the stalled economy and fear of growing state control are depressing foreign investment, which virtually dried up in the first half of this year.

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Mexican Pharmaceutical Decree

The tough regulations for Mexico's pharmaceutical industry published last week indicate the de la Madrid administration is still unwilling to accommodate foreign investors' concerns. Negotiations with industry representatives in the nine months since the regulations were first proposed failed to eliminate those provisions most opposed by the foreign firms. US-owned pharmaceutical firms are especially irked that the final decree requires generic names on many products, which will cause manufacturers to forfeit some patent protection and will tend to reduce profits. The government will also set retail prices, determine which drugs may be sold domestically, and directly participate in new drug manufacturing ventures. Moreover, to protect and foster a domestic drug industry, foreign-owned companies will be required to purchase a portion of their raw materials from local firms and invest in domestic research and development.

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Oil Price Cuts Pressure Nigerian Economy

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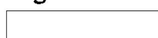
Nigeria's oil price cut will intensify the economic crisis facing General Buhari's 10-month-old military regime and further constrict its room to maneuver. The US Embassy in Lagos estimates Nigeria's oil revenues could drop by as much as $250 million for the last quarter of this year. Although declining oil revenues will intensify pressure on Nigeria to reach agreement with the IMF for a major standby loan, an impasse is likely to continue at least until the regime can complete its first year in power on 31 December. Devaluation remains the principal stumblingblock to an IMF agreement, and Buhari hopes to postpone this politically risky step as long as possible. As economic conditions worsen and grumbling continues in the officer corps, the regime is likely to become even more authoritarian to try to maintain control.



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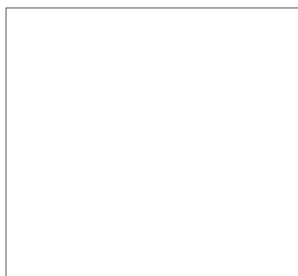
Tunisian Strike Activity



The US Embassy reports Tunisia's national labor union is planning a series of strikes between now and mid-November to protest the government's failure to implement wage hikes negotiated last spring. Strikes by automobile, steel, and transportation workers will hurt the economy. Initial protests probably will be peaceful, as were agricultural demonstrations last month, but a government crackdown on union activities would greatly increase the chances for violence. Government efforts to cope with the worsening economy, including gradual reduction of subsidies on consumer staples, have intensified popular concerns over wages. Unless a compromise is reached soon, wider unrest over the next several months will intensify the confrontation between labor and government.

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Indian Foodgrain Prospects Near Record Again

We expect Indian foodgrain production for the 1984/85 (July-June) crop year to approach the 1983/84 record of 150 million metric tons. Ample rains have brightened the prospects for a record spring wheat crop. Rice production, however, should be slightly lower than last year's record 59 million metric tons because of flooding in eastern India, drought in the south, and civil unrest in Punjab. Although rice imports are likely, New Delhi is negotiating wheat exports to the Soviet Union because another good harvest would add to already overflowing domestic stocks. We believe a favorable crop, by keeping food prices stable, will aid Gandhi's upcoming election prospects.

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Malawi's Crops Threatened by Transport Difficulties

Diesel fuel shortages in Malawi have disrupted the transport of fertilizer to outlying regions, while gasoline shortages may soon halt farm operations. Malawi—landlocked and largely dependent on Mozambican rail lines for transportation of vital fuel imports—has been cut off from Mozambican ports by insurgent attacks on the rail lines. Zimbabwe has agreed to lend over 20,000 barrels of fuel, but trucking difficulties may hamper shipments. A South African trucking firm has donated rubberized bags that will allow ordinary trucks to be used for importing South African oil but probably not in

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time for the October-November planting season. The completion of a 50-kilometer road next year from northern Malawi to southwestern Tanzania will partially offset the trade disruptions by connecting Malawi to the port of Dar es Salaam.

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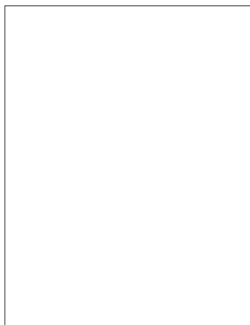
Zambian Economic Problems Persist



Despite a new IMF agreement last July, Zambia's economic crisis continues. Low world prices for copper—which accounts for about 90 percent of exports—have hurt foreign exchange earnings. Three years of drought have frustrated recent efforts to encourage food production and diverted scarce hard currency to food imports. As a result, Zambian industry has been deprived of critical imports and is operating at about 40 percent of capacity. Higher food prices have fueled demands for wage increases and have heightened tensions between the government and the labor unions

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Although an easing of the drought would help, the country's long-term prospects are dismal. Nearly half of the rapidly growing population lives in urban areas, plagued by high unemployment. A rebound in copper prices offers only limited benefit because copper reserves are expected to last less than 20 years. Moreover, Lusaka's efforts to diversify exports by promoting agriculture over mining and industry probably will continue to raise conflicts between the unions and the government.

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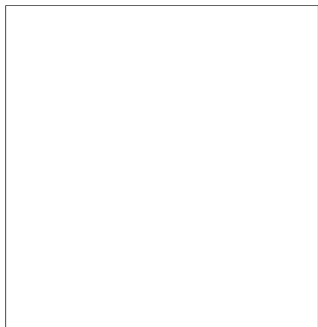
Philippine Labor Unrest Rising



The austerity program being implemented as part of the economic recovery package recently negotiated with the IMF is contributing to labor tensions in Manila. Organized labor is pressing for a wage increase to compensate for inflation caused by the weakened peso. Labor leaders last week participated in a demonstration of 5,000 people in front of the US Embassy to protest the IMF agreement. This week taxi drivers staged a two-day strike protesting petroleum price hikes, resulting in two deaths and over 300 arrests. Meanwhile, according to the US Embassy, a protracted strike by militant workers at an American-owned company is testing the government's willingness to enforce its labor laws. The strikers so far have resisted a back-to-work order by the Minister of Labor. Large protests will strengthen the left wing of the labor movement and increase the prospect of violence. Even conservative labor leaders, however, argue that the government could point to union pressures to persuade the IMF to back down on its demand for wage restraint. Backsliding on the austerity program at this critical point—before IMF Executive Board approval of the standby loan—would risk delaying the IMF agreement and leave the economy languishing through 1985.

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Communist

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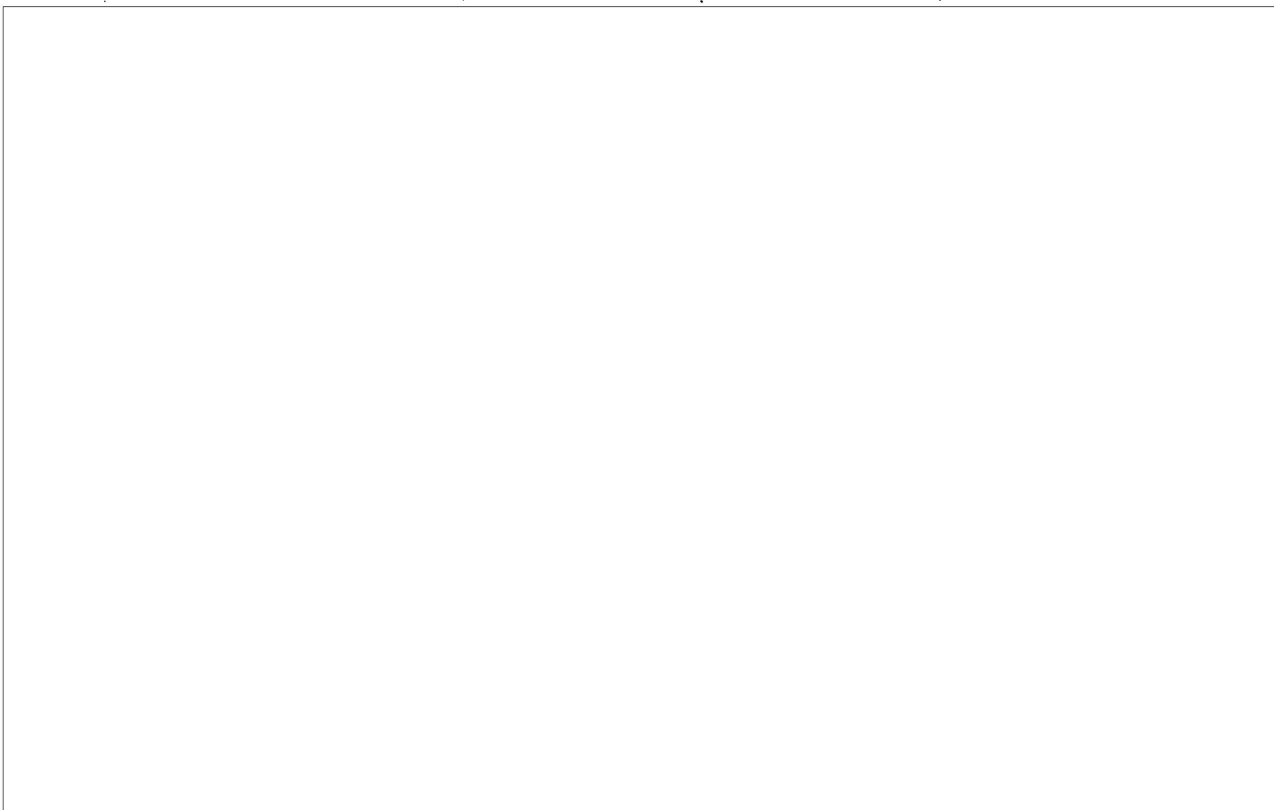
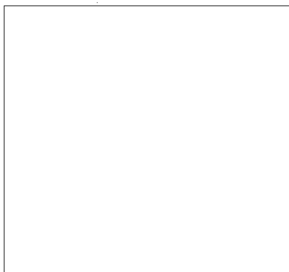


Soviet Railcar Shortages Affecting Grain Purchases



blamed railcar shortages at Soviet ports for the recent slowdown in grain purchases. incoming grain ships are spending an excessive three to four weeks in port. suggests that the shortages may be an excuse to delay additional purchases from the United States until after the November election.

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Record amounts of grain—roughly 15 million tons—have been lined up for delivery to the USSR during October-December 1984. The port congestion, if true, implies that Soviet measures to reduce the bottlenecks, such as the introduction of high-capacity grain cars, have not been sufficient, and that congestion problems could mount as the high volume of imports already under contract continues through December. In addition, the recent upturn in Soviet industrial activity may have resulted in competition for boxcars.

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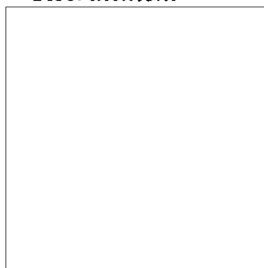
Politburo Calls for Increasing Use of Organized Labor Recruitment



The 28 September meeting of the Soviet Politburo called for stepped-up use of organized recruitment (*Orgnabor*) and voluntary mass mobilization of young people (through the Komsomol) to supply urban manpower to staff major construction projects in remote areas and to provide new plants with skilled workers. Those recruited through *Orgnabor* and the Komsomol sign fixed-term contracts, usually for two to three years, and receive substantial incentives, such as higher wage rates, home construction loans, and training to learn allied trades. The role of these programs has diminished steadily since World War II, however. In 1950, for example, *Orgnabor* accounted for 13 percent of all those hired by industrial enterprises, while currently the share is only about 3 percent

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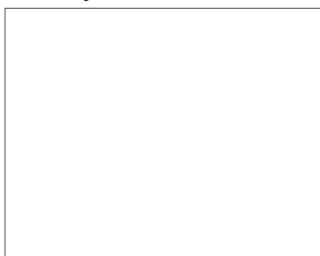
Hungarian Economic Objectives



A senior Hungarian banker has told the US Embassy that Budapest wants approval of its request for further IMF and World Bank funding before the Party Congress meets next spring to consider major new economic reforms. The National Bank contends that the size of new IMF standby credits is less important than evidence of continued support from international financial institutions. Quick conclusion of a new standby arrangement may prove difficult. The IMF apparently is urging more fundamental reforms than Budapest seems prepared to carry out because of concern over rising social tensions. The bank's stress on obtaining new support from the IMF and World Bank may be intended to deflect domestic criticism that Hungary is no longer obtaining benefits from international financial institutions and should favor closer integration of CEMA.

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OPEC: Price Cuts Trigger Another Crisis

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The latest series of oil price cuts by Norway, the United Kingdom, and Nigeria threaten to set off a chain reaction that could cause the current oil price structure to unravel. Even if OPEC is successful in its attempt to support oil prices, we believe downward price pressure is likely to reappear early next year in the absence of significant oil supply disruption. Sluggish growth in consumption, increasing output from non-OPEC suppliers, and attempts by some producers to maintain market share by price discounts and barter deals will cause continued pressure on oil prices for at least the next two years.

The Market Setting

Following a decline of 7.5 million barrels per day (b/d) in non-Communist oil consumption from 1979 to 1983, non-Communist oil use has increased about 3 percent so far this year—or more than 1 million b/d—over year-earlier levels. as much as half of this year's consumption increase to special factors, however, such as the coal strike in the United Kingdom and the colder-than-normal winter of 1983/1984, particularly in North America. At the same time, non-OPEC oil supplies have risen roughly 1 million b/d annually for the last several years. As a result of these factors, OPEC oil output fell from 32 million b/d in 1979 to 18.8 million b/d so far this year—including about 1 million b/d of natural gas liquids.

Against this background of lackluster demand growth and rising non-OPEC output, OPEC members have tried to increase their individual production levels through a variety of price-discounting measures that have undermined official prices. The rising number of spot sales and barter deals have caused buyers to shift purchases away from term deals at official prices.

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- Among major barter arrangements, Saudi Arabia will provide about 50 million barrels of crude in payment for 10 Boeing 747 jumbo jets, according to the US Embassy. Press reports indicate that the UAE will exchange oil for 18 Mirage 2000 fighters from France and that Qatar is trading oil to Japan, France, and South Korea for equipment and construction work. Libya barters much of its crude, including a reported 100,000 b/d to the USSR for military goods.

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- Iran and Iraq offer price discounts to maintain commercial ties with customers. Iran pays for war-risk insurance, and Iraq has been forced to offer spot market sales at prices about 50 cents per barrel below official levels to dispose of its crude.

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- Indonesia and the UAE also offer various concessional terms and hidden discounts. Jakarta has offered one customer crude at nearly $3 per barrel below its official price if payment is made in advance and Abu Dhabi extended payment terms from 30 to 60 days, a move that effectively discounts its oil by about 25 cents per barrel.

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The rising supply of, and slipping demand for, light crudes in recent years and their ready availability

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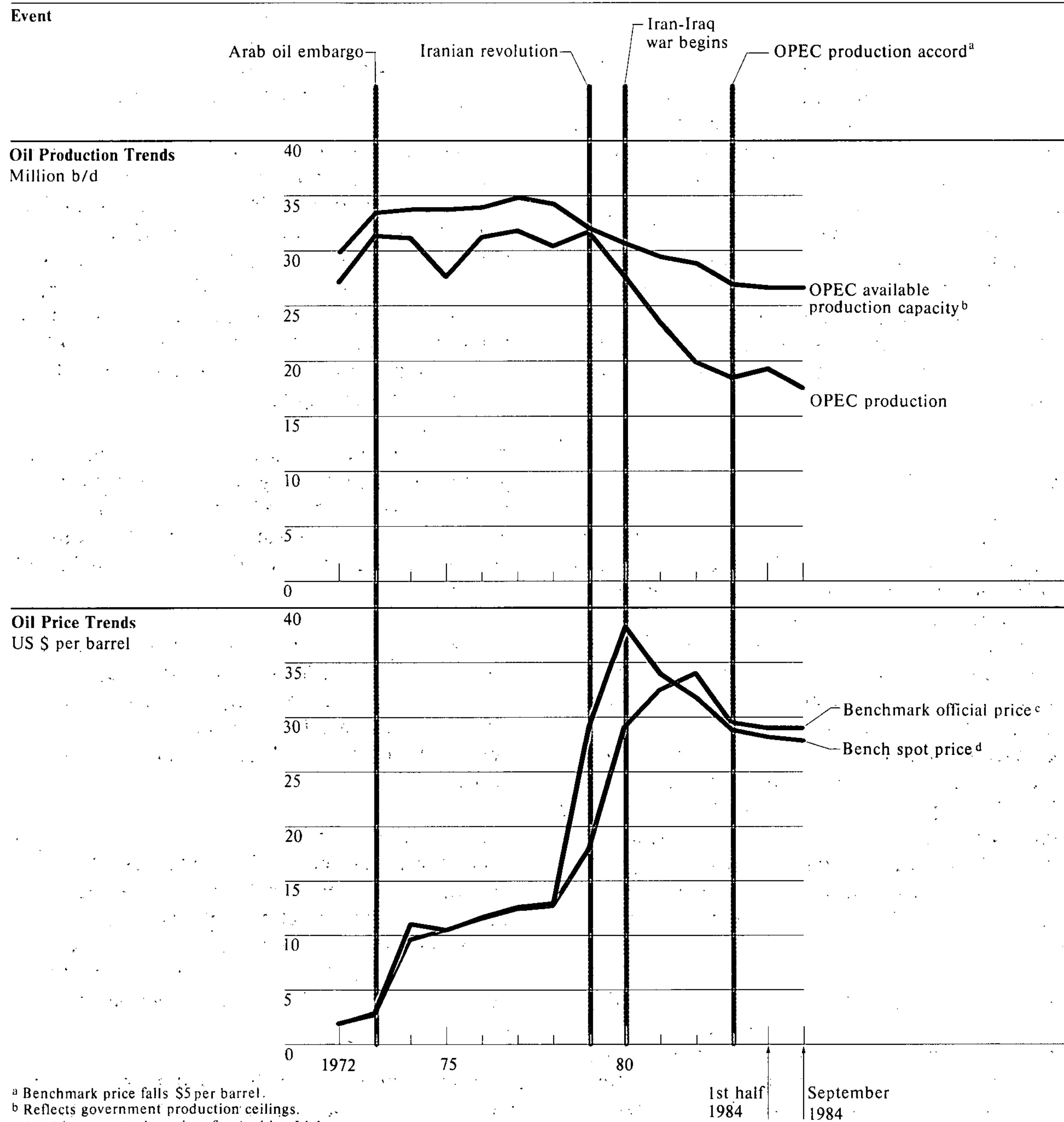
OPEC Oil Production Trends, 1972-84



[a] Benchmark price falls $5 per barrel.
[b] Reflects government production ceilings.
[c] Actual contract sales prices for Arabian Light.
[d] Actual annual average.

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on a spot basis—particularly from the North Sea—have especially weakened prices of these premium crudes. Light crudes yield greater proportions of light petroleum products such as gasoline. Investments to upgrade refineries, however, now allow processing of less expensive heavy crudes and the use of heavy refined product as feedstock. Currently, the official price differential between Arab Light—the OPEC benchmark—and Arab Heavy crude is $3 per barrel.[1] The relative value of these crudes to refiners in recent weeks, however, indicates that the market differential approximates only $1 per barrel.

Recent Price Developments

Norway's decision to reduce its oil prices—made public on 16 October—came as a shock to the British. London followed the Norwegian cut with a $1.35 per barrel price reduction on 17 October. Before the North Sea price cuts, the pressure on light oil prices was apparent when the UAE Oil Minister threatened to unilaterally reduce official prices by about 50 cents per barrel. Recent public statements by the Minister now indicate official prices will not change—at least until after OPEC meets.

The Nigerian price drop of $2 per barrel undercuts UK and Norwegian prices by 65 cents, and, in our judgment, reflects an attempt by Lagos to gain a competitive advantage over North Sea crudes. The move also puts severe pressure on other exporters of light crude. The British National Oil Company responded by advising buyers that a further price adjustment may be forthcoming, increasing the risk that current prices could unravel. In the wake of all these developments, spot oil prices declined an additional 30 cents to $2 per barrel over the past week.

[1] Differentials are the margins by which prices of various crudes differ from the price of the OPEC benchmark crude—Saudi Arab Light 34° API. These differences reflect variations in crude quality and proximity to major markets.

OPEC's Options

OPEC's ability to forestall a price break is in serious jeopardy. Saudi Oil Minister Yamani convened a "crisis" strategy meeting in Geneva on 22 October with the oil ministers of at least five other OPEC members and—in an unprecedented move—with representatives from two non-OPEC oil-exporting nations, Mexico and Egypt. The strategy meeting precedes a full ministerial emergency meeting slated for 29 October. We believe OPEC has several options as the organization confronts the difficult issues of price and production:

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- OPEC could attempt to buoy the market by lowering its current 17.5-million-b/d production ceiling or simply cut production below existing levels. The Libyan oil representative announced after the strategy session that OPEC is leaning toward a reduction in production quotas. The US Embassy reports that Venezuela probably is able to restrict output by 75,000 b/d. Press reports indicate that Libya also may be willing to reduce output to defend prices.

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- OPEC could try to obtain an agreement from members to limit light oil production. This approach would at least temporarily address the problem of excess availability of light crude oil.
- OPEC could opt to realign differentials by raising the price of the more attractive, heavier crudes. The differential issue is a thorny one to resolve, but an increase in the price of heavy crudes could help avert an official price break. Over the long term, the relative prices of light and heavy crudes will have to be realigned to reflect market realities.

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- OPEC could again agree to reduce official prices. Members certainly realize, however, the danger of a price cut to their economies and the risk of touching off further price cuts.

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OPEC—Non-OPEC Cooperation

Some OPEC members openly are critical of the recent surge in North Sea production, and the members could place a special tariff on manufactured goods from non-OPEC countries that refuse to cooperate with OPEC.

Less developed oil exporters have, for the most part, accommodated OPEC's wishes. Mexico has implemented a self-imposed export limit Egypt's Oil Minister claims that Cairo will support OPEC's efforts to uphold prices.

While non-OPEC less developed countries appear to be more willing to follow OPEC's lead, the organization has had minimal success in getting the United Kingdom, Norway, and the Soviet Union to cooperate. Yamani visited London in August, and industry speculation that the meeting resulted in a letter urging producers to maintain price stability brought a public outcry in Britain. In our judgment, Yamani's visit may have been to provide London with an accurate estimate of Saudi output. Britain has repeatedly vowed that it will not reduce production to help OPEC maintain prices. Norway's price cut—on the heels of an invitation to attend an OPEC Monitoring Committee meeting—raised questions about the success of Yamani's mission. OPEC's president recently stated that the Soviets are "in solidarity with OPEC." The USSR, however, has traditionally adjusted prices to reflect market conditions rather than reduce production or exports.

- The organization could appeal to Nigeria to raise its price and abide by OPEC guidelines. Although Nigeria might agree, a hefty financial incentive or a substantial increase in its production quota probably would be necessary to encourage Lagos to rescind its price cut. Press reports indicate that Saudi Oil Minister Yamani visited Nigeria, which failed to attend the strategy meeting.

  Although there may be some sentiment in Nigeria against remaining in OPEC, on balance we believe Lagos would prefer to retain the prestige afforded by OPEC membership.

- OPEC may be forced to give up hope of Nigerian cooperation and close ranks to avoid a general price decline by accepting even deeper production cuts.

Whatever option it chooses, OPEC will need to show strong and uncharacteristic cohesion. Because competing interests have divided OPEC in the past, any short-term solution could raise major problems as members jockey to maintain market share.

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The Outlook

OPEC's success in maintaining the benchmark in the immediate period depends on members' ability to lower output in line with market requirements. The expected seasonal increase in oil demand could temporarily ease the need for the organization to substantially reduce output. The OPEC Secretariat's estimate of demand for OPEC oil in the fourth quarter of this year is 18.3-18.5 million b/d, 500,000 to 1 million b/d below industry estimates. At the same time, however, oil inventories are unusually low for this time of year,

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according to our analysis. Preliminary data suggest oil stocks may have declined as much as 500,000 b/d in the third quarter compared to a normal seasonal buildup. As a result, we doubt companies are in a position to stretch inventories much further to meet seasonal needs.

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Even if OPEC manages to hold the price structure together now, we believe price pressures are likely to recur over the near-to-medium term. Most industry analysts project the underlying growth rate in non-Communist oil consumption at only about 1 percent per annum. As a result, if non-OPEC oil production continues to climb in the next few years—as we expect—demand for OPEC oil could continue to stagnate. Those members of OPEC who are financially strapped—especially Nigeria, Venezuela, and Indonesia—will find it increasingly difficult to justify austerity measures to their populations in the hope of an ever distant rise in oil revenues. In addition, opportunities for circumventing official prices—such as the sale of refined oil products at prices tied to the spot market—will increase. Saudi Arabia alone is expected to be marketing as much as 500,000 b/d of refined products by 1986. Plans to increase Iraqi oil-export capacity also suggest that means to accommodate at least 500,000 b/d of additional output from Iraq must be found. We believe OPEC again will be confronted with the need to defend oil prices, possibly in early 1985, and the organization's ability to carry out such action probably will be lessened.

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International Financial Situation: Political Update

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During the past month, financially troubled LDCs have had to deal with continued civilian opposition to austerity programs and military unrest. Some of these countries also have shown increased willingness to turn to the Soviet Union for economic support; Morocco has entered a union with Libya in the hope of more aid. At the same time, some countries have asked the United States for economic support or intervention on their behalf with the IMF and other official and commercial creditors.

The **Argentine** Government announced minimum-wage hikes that labor unions denounce as insufficient but that the IMF feels are inconsistent with the Argentine-IMF economic agreement. According to the press, Peronist labor leaders are urging unions to demand steep pay hikes. Economy Minister Greenspun, however, has already rejected similar demands by a large labor confederation. President Alfonsin also must deal with military criticism of deteriorating economic conditions, labor unrest, and military budget cutbacks. While Alfonsin has mollified the military on human rights, labor unrest over the economy could aggravate military concerns over political stability. Alfonsin, therefore, has reiterated to US Embassy officials his hopes for US assistance in facilitating debt rescheduling, encouraging foreign investments, and expanding access to US markets.

In **Bolivia,** labor protests against possible austerity measures are growing more violent, and the private sector is increasing its criticism of President Siles. In addition, Siles faces growing pressure from the military, and the US Embassy predicts that he could be ousted if he does not stem the economy's decline. Although Siles averted one problem by removing the unpopular Army commander, coup plotting probably will continue as the economy deteriorates. The US defense attache reports that the Soviet Union's taking advantage of Bolivia's economic crisis has offered free training for Bolivian Air Force pilots, but La Paz probably will not accept the offer.

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In **Peru,** the probability of a coup before national elections next April has diminished because of recent actions by President Belaunde. His naming of an Army general experienced in counterinsurgency to head the Interior Ministry should ease military demands for more government support for the antiguerrilla campaign. In another development, the USSR signed agreements with Peru to provide spare parts and replacement aircraft to the Peruvian Air Force, but Peru's ability to finance the deal is uncertain.

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Egypt's increase in bread prices and social security contributions led to a demonstration by textile workers near Alexandria in which three people were killed and 26 were wounded. The government raised prices on basic food items to reduce the $3 billion subsidy bill. The US Embassy reports that the plan was to introduce price increases for bread in the wealthier sections of Cairo and Alexandria and then gradually raise prices in other districts. But, according to the Embassy, bread price increases are more extensive than previously indicated, and flour prices are being doubled. The Embassy reports widespread disgruntlement with the price increases. It also reports that President Mubarak does not plan to rescind the price increases, but has directed that enough cheaper loaves be produced to supply low-income areas. He also will convene a conference of government ministers, academics, and opposition leaders to try to gain consensus on further price increases and has ordered monitoring of the availability of basic food items. He wants to ensure that other price increases have high-level approvals and that profiteering is prevented.

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In **Morocco,** rising prices, increasing unemployment, and reduced educational opportunities have spawned resentment that may erupt in violence. [redacted] the public mood in Casablanca is turning ugly. Rabat's decision to sign a treaty of union with Libya was motivated in part by the need for financial assistance and to find jobs for the unemployed. Since the treaty, Morocco and Libya have signed an agreement on movement across their borders, and Morocco has received $50 million. [redacted] Morocco also wants to expand economic ties with the Soviet Union. Rabat received a Soviet trade delegation, which gained unusually prominent press coverage and attention from high-level Moroccan officials. Agreements on a trade pact and a joint venture to develop Moroccan phosphate were signed, and talks to increase oil supplies and trade continue. [redacted]

The **Philippines** has had to cope with sometimes violent demonstrations related to the anniversary of martial law, the impending Agrava Board report on the Aquino assassination, and austerity measures recommended by the IMF. In response to the government's use of force, Cardinal Sin urged the middle class to demonstrate along with student protesters. According to the press, tax increases on vehicles and tourism brought criticism from the Labor Minister and strikes by bus and taxi drivers. Marcos has repealed both increases but replaced them with other levies. Authorities have lifted price controls on basic foods—including rice—and raised petroleum prices. These and other austerity measures prompted critics of the government to denounce the IMF accord as a "sellout." Trade union leaders have argued that wages should be raised to counter real-income erosion by inflation—now about 60 percent and expected to rise further—and that labor should resist the government's pledge to the IMF of wage restraint. If the wage-restraint policy is enforced, it is likely that more workers will join street demonstrations. [redacted]

In other developments, press reports say that antigovernment rioting in **Indonesia** manifests not only a reemergence of Islamic fundamentalism, but also the grim life of the urban poor in Jakarta. In **Nigeria,** reports of growing public restlessness and the government's inability to face economic problems have caused the Buhari government to order tighter security. According to the US Embassy, **Zaire's** President Mobutu fears that a third year of austerity will stir social unrest and expects the United States to take the lead with international creditors and donors to provide the resources necessary for some economic growth in 1985. [redacted]

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International Financial Situation: South American Financial Update

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Despite progress with the IMF and commercial banks, South American debtors face continued problems in meeting repayments, complying with IMF agreements, and securing debt rescheduling and new loans. Colombia, Peru, Chile, and Ecuador face immediate financing difficulties in part because of banker reluctance to provide credit. Despite temporary relief extended by creditors, Bolivia remains strapped for cash. Argentina already has been taken to task by the IMF for wage hikes that contradict the recent agreement, but talks are proceeding with the banks to gain access to new credits. Bankers have agreed in principal to restructure Venezuela's debt, but they are dragging their feet with Brazil until after the early-1985 presidential elections.

Debt Progress

South American debtors have reaffirmed their commitment to the collective political approach adopted in Cartagena last June, but creditors are undercutting this strategy. These debtors probably doubt that they can extract adequate debt concessions at the IMF/IBRD debt conference proposed by the United States for next year. Instead, we believe they may pursue joint political discussions to deflect attention from the technical IMF/IBRD debt talks. We judge, nevertheless, that the proposed debt talks—together with the Mexican and Venezuelan debt-rescheduling agreements and the Argentine-IMF agreement—have helped ease debtor-creditor tensions. Moreover, recent cuts in the US prime interest rate are blunting debtor complaints over high interest rates.

Liquidity Problems Persist

Lenders remain reluctant to provide credit in South America, leaving many debtors with immediate financial difficulties. In particular:

- Peru's interest arrears will grow rapidly unless bankers extend debt relief.
- Bolivia will encounter difficulties meeting its new payment deadline of 7 November.
- Chile could begin falling behind debt payments soon if an unfavorable IMF performance review leads to the withholding of committed and new bank financing.
- US bank regulators may classify overdue Argentine loans as substandard by the end of this month, thereby derailing negotiations with banks.
- Colombia soon may miss debt payments unless creditors extend new loans.

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Country Developments

Peru's failure to make interest payments and to comply with its IMF targets is jeopardizing committed loans and delaying debt-restructuring talks. Some US banks already have placed Peruvian loans on a nonaccrual status. Bankers want Peru to clear debt service arrearages by drawing down reserves and committing $100 million of a promised, but frozen, loan.

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Financial difficulties may intensify, possibly leading President Belaunde to suspend talks with bankers in the hope of rallying political support before next year's presidential election.

Banks have granted **Bolivia** temporary financial relief, but internal political pressures portend worsening relations with creditors. Debt-rescheduling negotiations with bankers have stalled with the resignation of Finance Minister Bonifaz and President Siles's refusal to oust Communists from his Cabinet. Banker good will eroded further when the government failed to suspend a new bank regulation increasing capital requirements for foreign branches operating in Bolivia.

Chile's bank advisory committee appears to be awaiting an IMF economic performance review due in early November before disbursing $195 million in committed loans and proposing new lending and debt-rescheduling terms. If Chile is declared out of compliance with its IMF program, bridge financing will be needed to cover a possible $800 million payments deficit and to avoid a suspension of debt payments. Regardless of the results of the IMF review, creditors are resisting new long-term lending to Chile in 1985 because they feel Santiago is near default on its present loans. Unless Chile scales back its loan request for 1985, Santiago may lose bank support and face critically low foreign exchange reserves by early next year.

Argentina reached agreement with the IMF on 26 September, but Buenos Aires announced wage increases on 1 October that could violate the agreement. Unless the government adjusts the budget to compensate for excessive wage increases, formal IMF approval of the accord, which is scheduled for December, could be jeopardized. President Alfonsin is under heavy political pressure to grant large wage hikes. Without formal IMF approval, Argentina will not receive a $1.4 billion IMF standby loan or attract significant bank lending. Relations already are strained with US bankers, who may be forced by bank regulators to classify Argentine loans as substandard in coming weeks because interest arrears on private debt exceed 180 days.

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Colombia probably will not receive new loans from banks or the IMF to ease its growing debt burden until Bogota implements fiscal reform and clears impediments to rescheduling private-sector debt. The opposition Liberals, who hold a majority in congress, also are plaguing the Betancur administration's efforts to cut public deficits. Moreover, Bogota's efforts to save the country's largest private bank and to assume responsibility for insider loans made by the bank fell short of convincing foreign lenders to agree to a rescheduling program or to grant a $200 million loan. Foreign exchange reserves stand at $600 million, according to the US Embassy, and Bogota continues regularly to draw down gold holdings.

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Ecuador's cash position continues to deteriorate, while international creditors await a new IMF standby agreement and the payment of overdue debt. estimated trade debt arrearages have doubled since April and now stand at $400 million. We believe that Quito probably will negotiate an agreement by yearend, opening the door to $350 million in commercial bank loans.

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Brazil may not be able to reschedule its debt with international banks until after the presidential election in January. Brasilia wants to launch negotiations soon to take advantage of the favorable negotiating climate resulting from the recent Mexican and Venezuelan debt agreements. Brasilia probably will seek to win banker approval for a multiyear rescheduling of debt by not seeking new loans and by encouraging banker coordination with both presidential candidates.

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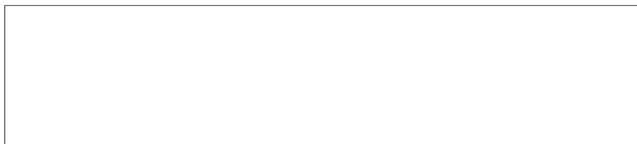

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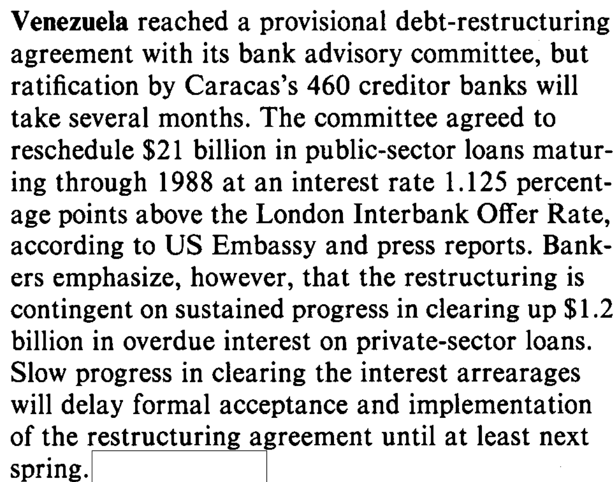

Venezuela reached a provisional debt-restructuring agreement with its bank advisory committee, but ratification by Caracas's 460 creditor banks will take several months. The committee agreed to reschedule $21 billion in public-sector loans maturing through 1988 at an interest rate 1.125 percentage points above the London Interbank Offer Rate, according to US Embassy and press reports. Bankers emphasize, however, that the restructuring is contingent on sustained progress in clearing up $1.2 billion in overdue interest on private-sector loans. Slow progress in clearing the interest arrearages will delay formal acceptance and implementation of the restructuring agreement until at least next spring.

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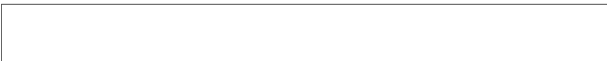

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International Financial Situation: Latin American Capital Flight

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The transfer of capital from Latin American countries is an important contributor to the region's fragile debt situation. We estimate more than $100 billion of capital flowed out of 10 Latin American countries during 1979-83 — roughly half the total capital inflows during the same five-year period. Losses actually exceed the initial amount of capital outflow because income on these assets is not repatriated. As a result, debtor nations are borrowing more just to balance their international accounts.

Directions and Causes

Press reports indicate the principal safehavens for the funds have been the United States and Western Europe, particularly Switzerland. Individuals, domestic companies, and multinational corporations have moved money out of Latin America into bank accounts, real estate, Eurobonds, and other investments. The United States is particularly attractive because of high interest rates.

Much of the drain of Latin American capital has been caused by the political and economic turmoil and uncertainty in debtor countries. Government economic policy decisions also have invited capital flight. Artificially low domestic interest rates, often below the rate of inflation, discourage saving at home. Overvalued exchange rates make dollars and other hard currencies a bargain. Fear that the peso is becoming overvalued is encouraging further capital flight from Mexico this year, according to press reporting.

Estimating Capital Flight

To calculate capital flight, we estimate the increase in a country's external debt and foreign direct investment and then add its current account balance and subtract the change in foreign reserve holdings. The result is our estimate of capital flight. We believe this methodology provides a better estimate than the traditional indicator of capital flight—the errors and omissions balancing item. Nonetheless, our estimates probably are low. We believe that other forms of capital flight not picked up by economic data are significant. For example, a company can underinvoice its exports and deposit the balance in a foreign bank account. In addition, some Latin American exports are never recorded at all—notably drugs—and the proceeds are not repatriated.

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The Long Road Back

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The IMF has recommended economic reforms that could help to stem further capital outflows and possibly encourage some repatriation of the flight money. Under IMF-supported adjustment programs, Latin American countries have sharply

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Latin American Capital Flight Estimates: 1979-83

Billion US $

	Increase in External Debt and Direct Investment	Current Account Balance	Change in Official Reserves	Capital Flight
Total	**208.9**	**−124.3**	**−22.4**	**107.0**
Argentina	35.9	−14.8	−11.2	32.3
Bolivia	1.5	−1.1	−0.1	0.5
Brazil	56.9	−58.4	−15.1	13.6
Chile	12.6	−11.3	0.3	1.0
Colombia	7.4	−6.2	0.6	0.6
Ecuador	5.1	−3.6	−0.5	2.0
Mexico	65.6	−27.3	1.6	36.7
Peru	4.2	−3.4	1.2	−0.4
Uruguay	3.2	−2.1	−0.4	1.5
Venezuela	16.5	3.9	1.2	19.2

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devalued their currencies and raised domestic interest rates. Countries also have imposed exchange controls to stop the cash outflow. Our data show that capital flight from Latin America has fallen from its highest yearly level of about $31 billion in 1981 to an estimated $25 billion last year. If IMF-supported programs fail or if economic adjustments trigger social unrest, however, we believe another surge of capital from these troubled countries will result.

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Experts are divided over whether or not Latin American countries will be able to lure flight capital back home. Some believe that with the correct economic policy mix and several years of political stability flight capital could be a potential source of funds. Considering the vast amounts of Latin American assets abroad, even a modest return of capital would ease the debt servicing burdens of financially troubled countries and permit the use of domestic savings as a base for domestic development.

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Lebanon: Worse Off Than Ever

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The Lebanese economy continues to deteriorate under the weight of the unstable political and security situation. Loss of government revenues because of militia control over numerous ports, inability to collect direct taxes, and Israeli control of the south has led to runaway deficit spending increasingly financed by borrowing from the central bank and commercial banks. Industry is operating at a fraction of preinvasion levels, and agricultural production has been hurt. Unemployment is a serious problem for the first time. Falling exports and the drop in overseas remittances have led to large current account deficits. International reserves have fallen and the Lebanese pound has tumbled to record lows, thereby fueling inflation

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The previously strong optimism of the Lebanese business community has been undermined by the internecine fighting over the past year. Until the political situation begins to stabilize and an extensive security plan is in place, the economy will remain depressed. In the meantime, government and foreign payments deficits will worsen, inflation will increase, and capital will continue to flee the country.

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Government Borrowing Soars

The security situation in Lebanon is forcing the government to resort to increased borrowing to finance its operations. Customs duties, the largest source of government revenue, totaled $38.5 million [1] for the first eight months of this year, down 78 percent from the same period last year. Illegal ports are flourishing, depriving the government of import duties. In addition, only limited revenues are accruing to the Lebanese Government from trade in Israeli-controlled south Lebanon. The government also lacks the means to collect direct taxes that use to make up its other large source of funds.

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According to Embassy and press reporting, various militias operate at least eight illegal ports, including one in Beirut. These ports reportedly charge a flat fee of $860 per shipping container, compared with legal port charges of up to $1,720 per container. Even with higher shippers' insurance premiums and longer waiting times, the illegal ports offer substantial savings to local importers.

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The government budget, approved last June, calls for 1984 expenditures to rise by 23 percent to nearly $2.1 billion. Actual spending will probably total around $1.5 billion. Even so, the 1984 deficit will exceed the government's projection of $655 million. The Bank of Lebanon (Lebanon's central bank) estimates that the government deficit was $480 million in the first quarter of 1984 alone.

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The combination of reduced revenue and unchecked spending has forced the government to rely on borrowing from Lebanon's commercial banks and from the Bank of Lebanon. Total government domestic debt hit $4.7 billion at the end of July, up over 27 percent from the end of last year, and probably will grow to at least $5.3 billion by yearend. With the treasury currently paying 13.5 to 14.5 percent on recently issued debt, debt servicing alone is estimated to be double current government revenue. The Bank of Lebanon has had to finance about one-fourth of this year's government borrowing because commercial banks are increasingly reluctant to absorb more of the debt.

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[1] Average exchange rates for the Lebanese pound used here are: 1984—5.8 pounds per US $; 1983—4.53/$; 1982—4.74/$.

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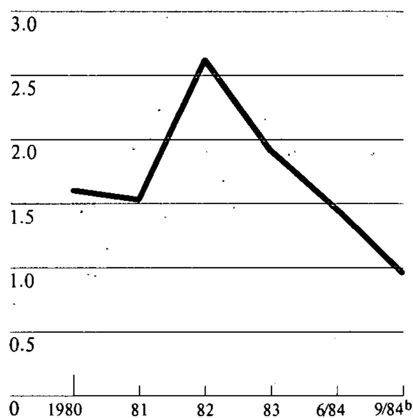
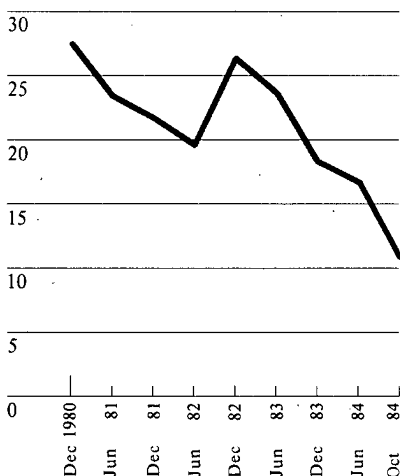
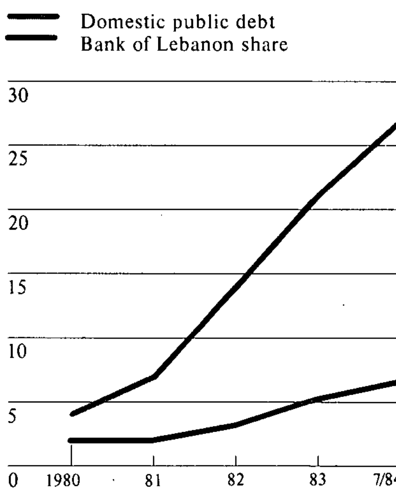
Lebanon: Selected Financial Data







[a] End of year, unless otherwise stated.
[b] Estimated.

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Foreign Payments Worsen Further

Although no accurate statistics on Lebanon's balance of payments are available, the country's international accounts are clearly deteriorating. Lebanon customarily runs a trade deficit offset by overseas remittances and by healthy surpluses in the services sector. Now, however, imports continue basically unabated, exports and remittances continue to fall, and Lebanon has lost its place as a banking, trade, and tourist center for the Middle East.

Lebanese exports have suffered not only from the destruction of part of its manufacturing facilities, but also from the loss of some important traditional markets. Saudi Arabia banned all imports from Lebanon following the Israeli invasion, but later started accepting goods that had been certified as to their Lebanese origin. Iraq, another formerly large buyer of Lebanese goods, has also cut back purchases due to war-related foreign exchange shortages. The disruption of traditional trade routes to the east through Syria has also hampered exports. In addition, agricultural exports have fallen not only from the loss of markets, but also due to the destruction of productive plots and the isolation of the agriculturally important Bekaa Valley and the south.

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According to Lebanese statistics, industrial exports for the first half of 1984 totaled $68 million

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compared with $172 million and $264 million for like periods in 1983 and 1982, respectively. Agricultural exports reportedly totaled $34 million in the first six months of 1984, down 30 percent from last year's depressed first-half figure. Total exports this year probably will be less than $400 million. Imports, although affected by this year's fighting, will still total $2.2-2.6 billion.

The major change in the Lebanese balance-of-payments picture is the drop in remittances from Lebanese abroad. Lebanese workers, who found employment in North America, Europe, and the Middle East, and overseas Lebanese businessmen who remitted at least a portion of their profits back home used to account for a large inflow of funds into Lebanon. Before the oil glut of recent years, it was estimated that 200,000 to 250,000 Lebanese, one-third of the country's work force, were employed in the Gulf states. Worker remittances, business profits, and other unrequited transfers provided an estimated inflow of $2.2-2.6 billion a year before 1983. With the current poor security and economic situation, these inflows probably have fallen by more than 50 percent. As a result, Lebanon probably will have a record current account deficit of $1.0-1.2 billion this year.

Industry Down, Unemployment Up

Industrial production, according to the Embassy, has dropped 70 percent since the start of 1983. Five months of sporadic fighting this year, a lack of raw materials, power interruptions, the emigration of skilled workers, and the loss of part of the domestic sales to illegal imports are contributing to this decline. Although there is no way to verify current production, one indicator, industrial exports, has shown a similar decline.

Even with all the turmoil that Lebanon has suffered since the mid-1970s, the country had relatively low unemployment until two years ago. Foreign workers, who used to make up a large part of the pool of unskilled construction laborers, left the country and have not returned. In addition, possibly as many as one-third of Lebanon's indigenous labor force has emigrated to the Persian Gulf and elsewhere. Last, a large number of the unskilled youth population are employed by the various militias.

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Unemployment and underemployment of workers are for the first time emerging as major problems for the Lebanese Government. Following this year's fighting in Beirut and the destruction of nearby facilities, the Lebanese Industrial Association estimated that 80 percent of the factories and workshops still operating had dismissed more than half their employees. The Embassy estimates that about 60 percent of the work force in the private sector has either been laid off or is working for a fraction of normal salary.

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The Isolated South

Israeli control of southern Lebanon has effectively isolated that area economically from the rest of the country. The south has traditionally relied on agriculture and small-scale industry. Goods were shipped north to Beirut and east to Syria, Iraq, and Saudi Arabia. Now the main coastal road north has been closed, the Batir-Jazzin crossing in the mountains is only intermittently open, and the port of Sidon has been recently shut down. The trade routes to the east have been cut since mid-1982. Some commerce by Christian businesses apparently is still allowed between the port of Jiyah and Beirut.

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Press reporting states that industrial activity in the south has fallen by as much as 80 percent because of raw-material shortages and a loss of markets. Agriculture has reportedly suffered a one-third cut in employment due to the loss of markets, the destruction of orchards, and the displacement of local produce with Israeli goods. Transportation costs have reportedly risen to three to six times their preinvasion level, and exporters claim that the long delays in shipping often cause the loss of perishable items.

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Israeli control of South Lebanon has worked to the economic disadvantage of the Lebanese, but it has adversely affected the Muslim population more than the Christians. Although the Israeli Government has forbidden the movement of Lebanese goods into Israel, average monthly imports from Israel reportedly total $4 million or more. Free market imports into South Lebanon through the Israeli ports of Haifa and Ashdod are said to amount to another $12 million per month.

The Decline of the Pound and International Reserves

The fall of the Lebanese pound over the last year and a half has paralleled the deterioration of the security and economic situation. Starting at 4.24 pounds to the US dollar at the end of June 1983, the pound fell 30 percent to 6.02 to the dollar in June of this year. Since then it has depreciated an additional 35 percent to close at 9.25 to the dollar on 20 October. This overall fall of 54 percent in the last 16 months reflects the changed perception of Lebanon's future on the part of its citizens and is an indication of the capital flight that is now occurring. This depreciation of the pound will result in increased inflation due to the higher cost of imports, with no possibility for greater exports existing because of a lack of salable goods.

The Bank of Lebanon has been intervening in the exchange market since the beginning of June and is estimated to have spent $700-800 million to support the pound. Foreign exchange reserves have declined 50 percent since late last year, from $1.9 billion to an estimated $900 million to $1 billion today. Official reserves now equal four to five months' imports, but substantial sums of foreign exchange are being held by the private sector.

Lebanon's commercial banks, as of the end of 1983, had net foreign assets of about $1.3 billion, and this figure is probably greater today. In addition, individual foreign exchange holdings outside the Lebanese banking system are substantial. Current Bank for International Settlements data indicate that Lebanon, as a whole, owes reporting banks around $1.8 billion, with nearly $1.6 billion of this due within one year. On the other hand, Lebanese deposits with these banks total $7.2 billion, a substantial surplus position. The Bank of Lebanon also possesses 9.2 million ounces of gold worth around $3.2 billion. This gold could be used, at least in part, as security for foreign loans to finance a part of Lebanon's massive reconstruction needs if and when the security situation improves.

The central bank's intervention in the foreign exchange market has had the beneficial effect of reabsorbing more funds than its lending to the government put into circulation. The money supply, therefore, has not been increased by this portion of the government's runaway deficit spending. The point is rapidly being reached, however, where the central bank will no longer be willing to draw down its foreign reserves further and will be under increasing pressure to fund more of the government's deficit.

Prospects

Lebanon's economic picture will remain bleak as long as political and security conditions discourage private investment. Following previous periods of hostility, the Lebanese business community was very optimistic about the future and willing to reinvest the time, effort, and money necessary to get the economy going again. This does not seem to be true today. Now, a substantial degree of security and stability will have to exist before confidence is restored, business is rejuvenated, and before Lebanon starts to receive the outside aid necessary for its reconstruction. To date, very little outside aid has been forthcoming and large-scale foreign financial assistance is unlikely even if the political situation improves.

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In the meantime, the government will face a fiscal crisis that can only add to the country's problems. The central bank cannot continue to support the pound for long and will probably be called upon to finance an increasing share of the government's deficit. This situation can only place additional burdens on an economy already in poor shape. As it now stands, industry and agriculture will remain depressed and contribute to a growing unemployment problem; the foreign payments situation will continue to worsen; and the inflation rate will increase.

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Pakistan: Moves Toward Islamic Banking

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The Islamization of Pakistani society received new impetus recently with the announcement that the banking system, including foreign banks, will be run on a completely noninterest basis starting on 1 July 1985. The Zia government views the move to Islamic banking as a means to strengthen its conservative credentials, domestically and internationally, and to boost its popularity in the upcoming elections. In our view, the proposed change will at least temporarily slow the investment and savings rate and retard economic growth, even though Islamabad is likely to allow practices that substitute for interest and meet the needs of bank customers. Many other Muslim states will be watching how Pakistan adapts to noninterest banking. Sudan is the only other Muslim state to adopt mandatory, noninterest banking to date. A widespread Islamic banking system would complicate the operations of international financial institutions and customers.

Principles of Islamic Banking

Islamic banking originates from the Sharia *(Islamic law), which forbids the use of* riba *(interest). The main principle underlying Islamic banking is the* muduraba, *a limited business partnership between one party who contributes capital and another who contributes managerial talent and labor. The net income is divided according to an agreed ratio.*

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When a bank extends a loan, its muduraba *with the customer guarantees the bank a certain percentage of the profit. Similarly, losses would also be proportionately shared. The* muduraba, *or profit-and-loss-sharing concept, also applies to savings and time deposit accounts. The bank uses such deposits to lend money and to invest in various enterprises. Depositors, in turn, receive a percentage of the profits generated by the use of their accounts. Depositors are also liable to bear losses in the same proportion as they share profits. Under the* muduraba *system, the bank becomes a type of investment bank; it is a partner of both its depositors and its borrowers.*

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Mixing Religion and Banking

The driving forces behind Islamic banking in Pakistan appear to be President Zia, Finance Minister Ghulam Ishaq, the state Bank of Pakistan, and the religious parties, including the Jama'at-i-Islami. The US Embassy reports, for example, that Ghulam Ishaq has forcefully defended interest-free banking in talks with World Bank and IMF authorities. Zia probably views Islamic banking as a means of placating the Jama'at and other fundamentalist forces, as well as enhancing his ideological credentials with other Muslim states.

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The proposed shift to mandatory interest-free banking is one of a series of moves to fulfill Zia's promises to adapt the economy to Islamic law. In 1980 the government revived the *zakat* (a tax on savings accounts and other assets) and *ushr* (a levy on agricultural produce), moves that were supported by the major religious parties. In 1981, Pakistani banks began to offer interest-free accounts and loans on an optional profit-and-loss-sharing (PLS) basis. The rates of return for PLS accounts have been higher than rates on interest-bearing deposits, but, according to government figures, the differential has been narrowing. According to US Embassy reports, PLS accounts represent about 13 percent of Pakistan's money supply.

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Pakistani Deposit Rates *Percent*

	Profit-and-Loss-Sharing Account						Comparable Interest-Bearing Account
	Jul-Dec 1981	Jan-Jun 1982	Jul-Dec 1982	Jan-Jun 1983	Jul-Dec 1983	Jan-Jun 1984	
Savings	8.70	8.60	8.20	8.25	7.70	7.50	8.50
Six months	11.15	10.75	10.50	10.50	9.90	9.50	9.50
Five years	14.90	14.60	14.25	14.10	13.25	13.50	12.75

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Bankers' Concerns

According to press and US Embassy reports, the reaction in the banking community, domestic and foreign, to the proposed banking measures has been generally negative. Although some Pakistani bankers have endorsed replacing interest with profit, others have expressed fears that Islamization will lead to a reduction in demand for credit and declining bank profitability. World Bank officials are concerned that the new measures could lead to increasing state interference in the banking system. The US Embassy reports that some Pakistani bankers have been urging the government to delay converting to Islamic banking, arguing that a longer transition period is needed. The Governor of the State Bank, according to Embassy sources, has also urged the regime to "go slow" on Islamic banking.

According to the US Embassy, US bank officials fear that participation in PLS accounts would leave US branches in Pakistan open to charges that they are violating the Glass-Steagall Act of 1933, which prohibits US banks from taking equity positions in clients' firms. If the projected banking laws force banks to become full partners with their customers, US banks might cease or sharply curtail operations in Pakistan.

US Embassy and banking officials speculate, however, that Islamic banking does not necessarily seriously threaten US banking interests in Pakistan. Various substitutes for interest could be used by US banks in meeting the letter, if not the spirit, of the new banking proposals:

- *Finance leasing.* The bank leases equipment to the customer at a markup. The difference between what the bank paid for the equipment and what it receives in rent would be the bank's profit.
- *Hire purchase.* The bank buys a productive asset and then sells it for the purchase price plus a percentage of the profit generated from its use.
- *Service charges.* Fees assessed when the customer takes out a loan might also be allowed.

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Banking and Embassy officials believe that because the state Bank of Pakistan will have the authority to set minimum and maximum rates of "profit," it probably will assure a positive rate of return on savings and investments. Administrative and accounting costs for banks probably would be increased, but, as long as acceptable substitutes for interest are available, operations of US banks in Pakistan could remain profitable.

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Problems of Implementation

Several operational issues remain unresolved. One major problem is the protection of an Islamic

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banking system from fraud and collusion. Without effective enforcement, underreporting of profits or overreporting of losses would be common. Lack of confidence in Islamic banking could lead to a black market in lending money. Another potential problem is the mechanism for dealing with unprofitable or delinquent loans. According to the US Embassy, Islamabad has proposed "collection courts" that would hear disputes. The penalties on borrowers who do not repay remain undefined, however.

The threat of interference by Pakistani religious authorities greatly concerns bankers. Thus far, the Islamic Ideological Council (IIC) and Pakistani banking officials have together made proposals for the Ministry of Finance. The fundamentalist clergy, however, want to abolish all forms of interest immediately while some bankers agree in principle with Islamic banking but want to adopt it gradually. The IIC already has recommended 39 lashes for those paying or receiving interest. US Embassy contacts are also apprehensive that the council might issue decrees against such measures as márk-ups, leasing, and service charges. The IIC, however, is only an advisory body and President Zia can ignore its opinions.

Finance Minister Ghulam Ishaq said that the proposed banking laws would not be extended to international institutions such as the World Bank and the IMF. Nonetheless, in one case the World Bank is rewriting a loan with Pakistan to conform with Islamic law. Further instances could endanger Pakistan's relationship with international lending institutions.

Outlook

Uncertainties generated by Islamic banking probably will hurt Pakistan's economic growth and foreign payments position, at least in the short run:

- A dropoff in savings and investments would result in a slowdown in business activity and crimp Pakistan's development program for 1983-88, which relies heavily on private investment.
- A slowdown in private investment would force Islamabad to seek increased official assistance.
- A shrinking of savings would cut a source of funds to finance budget deficits.
- Instead of investing in domestic ventures, businessmen might invest overseas.

The moves toward an Islamic economy come when Pakistan is trying to recover from the lowest rate of economic growth since Zia came to power and is experiencing a decline in remittances from overseas workers.

If political and religious authorities allow interest substitutes, and if they lengthen the transition, then the public might eventually develop more confidence in the system. The government can also be expected to take measures—such as a contingency fund—to assure some rate of return for savings.

The Zia regime appears committed to still more Islamization, despite the complications to an already inefficient economy. One such project, re-

Proposed Timetable for Islamic Banking

1 July 1984
No loans on an interest basis can be renewed for more than six months.

1 January 1985
All financing by banks to the government, public-sector corporations, and joint-stock companies must be based entirely on Islamic (noninterest) financing.

1 April 1985
All loans to individuals and firms will also have to be on an Islamic basis.

1 July 1985
Banks will not accept interest-bearing deposits.

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cently announced by Ghulam Ishaq, is a "Workers' Voluntary Welfare Program," which would provide funds for workers not covered by any existing scheme. Although some adjustments may be needed, we believe that the government will find it politically difficult to back away from an Islamic economy.

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Pakistan's success with an Islamic economy is likely to set an example for other Muslim nations. Foreign bankers are anticipating the adoption of Islamic banking elsewhere. Widespread acceptance of Islamic banking measures, particularly among oil-rich Arab states, would complicate international financial transactions.

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