PM/90/084

PRIME MINISTER

Prime Minister
CDP
9/11

Economic effects of the Gulf crisis on our main Aid recipients

1. I thought you might wish to see a paper which Lynda Chalker did for me on the economic impact of the Gulf crisis on our main aid recipients. The conclusions are pretty bleak for a number of economies.

2. We are not in the business of compensating for higher oil prices. We are urging these countries to make further domestic adjustments, including tight fiscal and monetary policies, and ensuring that the higher price of oil is passed on to the consumer.

3. It has been one of our key policies to support economic reform. It would be a severe setback if the progress made in recent years in a number of countries was to be jeopardised by the higher cost of oil imports. But the truth is that many of these countries have little further scope to absorb external shocks such as this. If adjustment is to be sustained, they will need some further help.

4. We are encouraging them to look to the international financial institutions, but once they have done this they in turn will look to us, not just for further bilateral assistance but for substantial multilateral aid spending which will result in an earlier drawdown of our own multilateral aid contribution to which we are already

committed. As I said again in Cabinet yesterday, we now have reduced capacity to respond.

5. I am copying this minute and its enclosure to the Chancellor of the Exchequer and the Cabinet Secretary.

DH

(DOUGLAS HURD)

Foreign and Commonwealth Office
9 November 1990

ECONOMIC EFFECTS OF THE GULF CRISIS ON OUR MAIN AID RECIPIENTS

Effects on Aid Recipients

1. The attached tables and country notes are based on an assumption of an average oil price of $28.70 in 1991, up from $16.30 pre-crisis (ie. the World Bank's assumptions). The tables also include estimates of other direct effects where relevant:- loss of remittances, cost of resettling refugees, lost exports. We have not included more speculative second round efforts, such as the impact of higher oil prices on interest rates or on global economic growth and hence the demand for their exports. The figures show effects in a full year (1991) compared with 1989; effects in 1990 are therefore no more than half the full-year effect.

2. The analysis is limited to main UK aid recipients. The front-line states (Egypt, Jordan, Turkey) are therefore omitted, as are some other countries likely to be severely affected (Sudan, Somalia) which are not main aid recipients. Most of our main recipients are unlikely to suffer damage comparable to that experienced by the front-line states, apart from Guyana.

3. Summarising the effects on those aid recipients who lose, the damage in 1991 is estimated to be equivalent to 1.4% of GDP, 10% of imports, and 13.7% of exports. All countries face significant costs (apart from the net oil exporters Nigeria and Indonesia), but countries likely to suffer most damage, taking account of their current situation, are, in Africa, Tanzania, Sierra Leone and Mozambique; in Asia, Bangladesh, Sri Lanka and Pakistan; and most of the open and oil import-dependent Caribbean economies, particularly Jamaica and Guyana. In absolute terms, the $700m costs to African economies are dwarfed by the $5b losses incurred by Asian and Oceans recipients, though the relative effects are at least as serious as those incurred by the large, populous South Asian economies.

4. For African and Caribbean recipients, effects are largely confined to the oil price increase. Some Asian countries are also significantly hit by loss of remittances and lost export markets.

5. The effects of losses on this scale will depend upon the reserves available to absorb the foreign exchange loss. Unemployment will result from returning workers and import compression; in some cases structural adjustment programmes will be affected and debt arrears will accumulate; income growth will be depressed almost everywhere and inflationary pressures increased.

Aid and Other Financial Flows

6. Other than the front-line states, we are aware of no significant aid offers to individual countries other than unconfirmed reports of a Japanese offer of $500m for Pakistan, and US assistance of $8m for Uganda. Several donors, including ODA in the case of Uganda, have offered to switch existing balance of payments support to provision of petroleum imports, but this does not represent additional money.

7. The lesson of previous oil shocks is that countries should take early measures to adjust their economies to higher oil prices. Aid therefore needs to be attached to sound structural adjustment programmes approved by the World Bank/International Monetary Fund. The oil shock will increase financing requirements for structural adjustment, but any additional aid must satisfy normal conditionality if it is not to be wasted.

8. The EC are considering ECU150mn (£105m) for badly affected countries other than the front-line states, but this is not yet agreed. The World Bank will try to assist by accelerating disbursements and expanding lending, within the constraints of credit worthiness. They have also indicated a desire to explore the possibility of additional contributions to the IDA: ODA would be unable to contribute, but this may be a good way to mobilise

contributions from countries unable to offer significant military support. The IMF are also looking at ways to increase access to their Compensatory and Contingency Financing Facility, though they too will be constrained by creditworthiness problems.

9. The World Bank is exercising a lead role in co-ordinating support for adjustment packages. The Special Programme of Assistance for low-income debt distressed African Countries (SPA) provides an existing and well-functioning mechanism for mobilising quick-disbursing assistance and for considering absolute and relative needs within low income African countries. The Bank envisage suggesting reallocation of aid within Africa to countries seriously affected, and see particular scope for such reallocation by the EC and the African Development Fund. They acknowledge that early international agreement to rescheduling under the more concessional Trinidad terms proposed by the Chancellor would be especially helpful to the low-income debt distressed countries. However, for the 21 active SPA countries the Bank are experiencing difficulty in obtaining pledges sufficient to fill a financing gap calculated on the basis of an oil price of $21. The more pessimistic assumptions reflected in the attached table would add $600m to the gap in 1991 alone.

Oil Stocks and Supplies

10. Physical supply problems are not a general problem for our recipients, other than those for whom the ability to contract for oil imports is constrained by foreign exchange shortages. Oil stocks are dangerously low in some countries (e.g. Sierra Leone 6 days) and others may elect to cut back on use (e.g. Ugandan electricity generation), but these generally reflect balance of payments difficulties as much as supply disruption resulting from the crisis.

11. Available data on oil stocks and supply sources are given in the attached country notes, but they are not comprehensive.

Differences with August assessment

12. The main difference with our August assessment is that the scenario now used most often by the World Bank ("short-term uncertainty") assumes an average oil price in 1991 which is higher than that we assumed in August ($28.7 per barrel compared with $25). All such assumptions are subject to considerable uncertainty, however, and the worst Bank scenario (ie. oil prices increasing beyond present prices) would result in much greater damage to the world economy and developing countries. Even the most likely scenario, combined with more comprehensive data on lost remittances and exports, yields a more gloomy forecast for main aid recipients than in August, however.

Economic and Social Division
16 October 1990

EFFECTS OF THE GULF CRISIS: 1991 (16/10/90)

	1	2	3	4	5	6	7
COUNTRY	OIL PRICE EFFECT Price $28.70 bbl	LOST REMITTANCES	OTHER EFFECTS	TOTAL EFFECTS			
	$mn	$mn	$mn	$mn	% GDP	% IMPS	% EXPS
AFRICA AND MIDDLE EAST							
Gambia	6	0	0	6	2.6%	6.8%	3.8%
Ghana	100	0	0	100	2.0%	7.2%	11.2%
Kenya	195	0	0	195	2.4%	7.8%	21.2%
Malawi	34	0	0	34	2.1%	6.3%	10.9%
Mozambique	36	0	0	36	2.8%	4.2%	19.1%
Sierra Leone	19	0	0	19	1.8%	11.2%	14.3%
Tanzania	99	0	0	99	3.5%	7.2%	19.0%
Uganda	41	0	0	41	0.9%	5.4%	18.4%
Zambia	58	0	0	58	1.2%	5.7%	3.9%
Zimbabwe	114	0	0	114	1.9%	8.4%	6.3%
TOTAL AFRICA ABOVE	701	0	0	701	2.0%	7.0%	10.5%
ASIA AND OCEANS							
Bangladesh	280	100	18	398	2.0%	10.8%	25.5%
India	2160	389	295	2844	1.0%	9.8%	13.4%
Nepal	44	0	0	44	1.4%	6.9%	22.0%
Pakistan	900	170	50	1120	2.8%	12.9%	14.4%
Sri Lanka	220	35	65	320	4.6%	12.4%	16.9%
Guyana	60	0	0	60	20.9%	21.6%	25.5%
Jamaica	210	0	0	210	5.4%	11.0%	10.7%
TOTAL A&O ABOVE	3874	694	428	4996	1.4%	10.7%	14.3%
GRAND TOTAL ABOVE	4575	694	428	5697	1.4%	10.0%	13.7%
Nigeria	-6749	0	0	-6749	-22.8%	-101.6%	-66.7%
Indonesia	-1693	0	0	-1693	-1.9%	-9.0%	-7.7%

SOURCES: IBRD: Briefing Note on Potential World Bank Assistance to Countries Affected by the Gulf Crisis (13/9/90), Scenario II

IBRD: The impact of the Gulf Crisis on sub-Saharan Africa (9/10/90)

IBRD: Tables supplied by Economic Advisory Staff, 15/10/90

ODA and IMF sources used where IBRD figures unavailable

NOTE: Imports figures for Gambia, Zambia, Zimbabwe and Nepal are derived from IMF sources and may be incompatible with IBRD exports statistics.

COUNTRY NOTES

AFRICA

GAMBIA

1. The Gambian economy has grown at 4-5% a year, following the adoption of a structural adjustment programme in 1985.

2. The incremental costs in 1991 of an oil price rise to $28.70 are estimated at 2.6% of GDP and 6.8% of imports. These might be met from a reduction in planned reserve accumulation if compensatory finance was not forthcoming - though this would mean reserves would remain at undesirably low levels. The impact on economic recovery is not expected to be substantial unless higher air fares lead to a marked decline in tourism.

GHANA

1. The Ghanaian economy has been recently growing at 5 to 6% a year, as a result of undertaking structural and financial reforms supported by substantial external assistance.

2. The incremental costs of the oil price rise are estimated at 2% of GDP and 7.2% of imports in 1991. These are likely to be met by rephasing a planned build-up in foreign exchange reserves, by an increase in borrowing, and by some import reduction. The latter is not expected to undermine the reform programme and continued economic recovery, though this could occur if second round effects led to a sharp drop in cocoa prices.

KENYA

Kenya is currently expected to achieve a 5-5.5% annual GDP growth, assuming real import growth of 2.4% a year. Gross official reserves were projected to rise from 2.6 to 3.0 months cover. The oil price

rise, which would represent 2.4% of GDP and 7.8% of imports in 1991, is likely to postpone the reserves build up and cut import growth by over half. GDP growth may fall below 5% but should remain in excess of population growth unless second round effects reduce demand for Kenyan exports.

MALAWI

Malawi was projected to have a relatively strong macro economic position for the early 1990's with GDP growth rising to 4.5% a year, falling debt service, further strengthening of external reserves and a reduction in adjustment financing needs. An increase in price to $29 a barrel in 1991 is estimated to cost 6.3% of imports and 2.1% of GDP. Malawi may be able to maintain its growth targets by modifying the objectives for reserves build-up and seeking a maintenance of donor flows rather than a contraction. The good tobacco harvest expected in 1990 may provide a temporary cushion.

MOZAMBIQUE

Mozambique's import needs are almost wholly met by concessional flows. The current programme envisages continued modest recovery with GDP growing 5% a year on the basis of further increases in assistance. Oil expenditure accounts for 25% of foreign exchange earnings and a rise in price to $29 per barrel in 1991 would increase this to 44%, at a cost of 2.8% of GDP and 4.2% of imports. Without compensating increases in aid, this is likely to lead to a fall in non-oil imports which could constrain recovery in those parts of the country accessible to Government. It may also delay introduction of the next stages of foreign exchange liberalisation. The USSR has traditionally provided oil imports largely on a barter basis but this will cease at the end of this year.

NIGERIA

Nigeria probably exceeds its OPEC oil quota and may be producing to capacity (1.7 million barrels a day). An average price of $29 per barrel in 1991 will close next year's external financing gap and increase export earnings on a full-year's basis by over $6.7 billion above the 1989 level. This represents a potential increase in GDP of 22.8% and in import capacity by over 100%. The Government is likely to use any windfall gain to add to reserves, loosen constraints on public expenditure a little, and perhaps to discreetly buy back some international debt. In the longer term, the rise in the price of oil could make it easier for the Nigerians to undertake structural change by easing the hardship of those affected.

SIERRA LEONE

Sierre Leone recently agreed to a policy reform package aimed at settling debt arrears and merging its parallel economies. An oil price rise representing 1.8% of GDP and 11.2% of imports in 1991 will test the political commitment to carry through reforms and place considerable pressure upon the limited foreign exchange reserves (0.7 months of imports). Any relaxation of reforms or suspension of payment of arrears will jeopardise any future agreement on IMF funded support. In early October less than a week of oil stocks remained, though a shipment was expected soon, financed by mortgaging future mineral exports. Iran is considering provision of compensatory finance.

TANZANIA

GDP growth of 4.5% a year is envisaged in the current Economic Structural Adjustment Programme, assuming 2.3% real annual import growth. Oil imports represent a significant proportion of GDP (6%). As foreign exchange reserves are already very low (less than 1 month

cover), the burden of the higher oil price, which would represent 3.5% of GDP and 7.2% of imports in 1991, will have to be borne by a reduction in imports and a deferrment in repayments of external arrears ($43 million outstanding at end 1989). If absorbed solely by the former, GDP growth could fall to the lowest levels since the mid-1980's (i.e. below population growth).

UGANDA

Uganda's oil needs are modest for a country of its size yet high in proportion to its external trade. Its foreign exchange reserves are negligible. The increase in the oil price is likely to represent 0.9% of GDP and 5.4% of imports in 1991. In the absence of increased donor financing, arrears repayment could be postponed further or even reversed and/or import volume frozen at current levels to compensate. The latter is likely to bring GDP growth down from the 5% target to below a level needed to maintain per capita incomes. However, USAID is reported to have offered $8 million of compensatory assistance. There are reports of short-term physical supply problems, with import volumes cut to 60% of previous levels and restricted operating hours of power stations, though this represents lack of foreign exchange to meet higher prices rather than supply disruption caused by the Gulf crisis. The Government have moved fast to adjust domestic energy prices, passing through the full effects to consumers and eliminating previous fuel price subsidies.

ZAMBIA

1. Net oil imports accounted for 7% of exports and 2% of GDP in 1989. An increase in the average price of oil to $29 per barrel in 1991 would add $58 million to the oil import bill, accounting for an extra 5.7 of imports and 1.2% of GDP. Although the main source of Zambia's non-household energy supply is hydro-electricity (70%), the situation is exacerbated by heavy dependence on oil by the country's major foreign exchange earner, the copper industry.

2. The economic reform programme is being reasonably well adhered to, but programmed growth is low (0.9%) and it is doubtful whether further belt-tightening is politically feasible. (The oil price increases have been passed through thus far.) The probable response would be further request for debt rescheduling and some slippage in achieving programme benchmarks.

3. Zambia had been obtaining its oil supplies from Kuwait, but has been able to find alternative supplies and has now concluded a long-term deal with Iran.

ZIMBABWE

A sustained increase in the oil price to $29 per barrel in 1991 would add $114 million to the import bill (amounting to 8.4% of imports and 1.9% of GDP). Zimbabwe has a relatively strong external position, resulting from cautious debt management. The debt service ratio has been falling and the current account deficit is not much above 1% of GDP. Reform policy is proceeding laconically but it is doubtful if GOZ will seek to economize much on oil. The likely response is to accommodate the oil price rise by increased borrowing.

ASIA

BANGLADESH

1. Oil products in 1989/90 account for 8% of total imports and 1.2% of GDP. An increase to $28.7 per barrel would add an estimated $280 million to imports or cost 1.4% of GDP. Including remittances and other direct costs raises this to 2% of GDP or 10.8% of imports.

2. Bangladesh is a producer of natural gas, which provides around 80% of the electricity generating energy. This explains the reduced dependency of Bangladesh on imported oil as compared to most other countries in the region.

3. There were an estimated 70,000 Bangladeshi's working in Iraq and Kuwait and loss of remittances could total $100 million. Most of the cost of repatriation itself is likely to be met by the international community, however, and the World Bank estimates that these costs may be as little as $5 million to Bangladesh.

4. Recent performance on economic management has been poor, so donors may not be sympathetic to pleas for additional resources for Bangladesh unless it makes strenuous efforts to adjust to this new problem.

5. Bangladesh oil imports were not sourced in Iraq or Kuwait (in 1988) and Kuwait and Iraq are only minor export markets (about $13 million of goods per annum)

INDIA

1. India has a relatively closed economy so oil imports account for only 1.5% of GDP; but at 16.1% they form a very significant proportion of imports. At 28.7 dollars a barrel the economy will incur losses equivalent to 1% of GDP or 9.8% of imports.

2. India produces domestically around two-thirds of its crude petroleum consumption. India is also a major coal producer which provides most energy for power generation. This explains the low dependency on imported oil compared to GDP.

3. India aims to maintain stocks of about 5 weeks consumption. Prior to the crisis India obtained about 45% of its oil from Kuwait and Iraq including that supplied by the USSR under trade agreements with India.

4. There are about 200,000 Indian nationals working in Kuwait and Iraq and gross remittances from them total $389 million in a full year. The full effect of the loss of these remittances may not be felt immediately since there is some evidence that migrants in other countries are reacting to the crisis by increasing their remittances.

5. The Indian Government expects to spend about $30 million in repatriating its nationals.

6. India exports about $180 million of goods to Iraq and Kuwait per year and was this year expecting a payment from Iraq as part of a deferred payment agreement.

7. No compensatory aid packages have been announced so far.

8. The increased deficit is likely to discourage the politically insecure government from its tentative programme of economic liberalisation. With a fairly high debt service ratio (29.9%) and limited international reserves (2.2 months of total imports) the government has limited room for manoeuvre.

NEPAL

1. Oil imports accounted in 1988/89 for 8.5% of total imports and 1.8% of GDP. An increase in the oil price to $28.7 would add $44 million to imports, costing 1.4% of GDPor 6.9% of imports.

2. Petroleum accounts for around two-thirds of commercial energy and there is no domestic petroleum production at present. However, the vast majority of Nepal's energy supply is traditional (mainly fuel wood). This probably explains the relatively small dependence on imported oil.

3. Nepal orders the petroleum through Singapore for delivery via India and aims to hold 3 months consumption in stock.

4. There are only thought to be 1,000 or so Nepalese working in the Gulf and so the impact of the crisis on either remittances or exports is likely to be negligible

5. Nepal has made 2 mercy flights carrying 200 passengers from the Gulf and is hoping that the International Red Cross will bear the cost.

6. With Nepal's access to concessional finance, low utilisation of oil products and healthy international reserves, she is relatively well placed to cope with the current price increases.

PAKISTAN

1. Oil accounts for 41% of Pakistan's energy (1988/89) and a further 35% is supplied by gas. In 1988/89 domestic oil accounted for only 18.2% of consumption, making the country heavily dependent on imports. Oil imports accounted for 12.3% of total imports and 2.2% of GDP in 1988/89.

2. At $28.7 a barrel Pakistan will face an additional oil import bill of $900 million, equivalent to 2.8% of GDP or 12.9% of imports. The size of oil stocks are not known. Before the crisis Pakistan imported most of its oil from Kuwait, but we understand that this has now been replaced by Saudi Arabian supply.

3. There were about 100,000 Pakistanis working in Kuwait and Iraq, remitting $170 million per year which will now be lost. In addition the Pakistan Government has estimated that it will cost them $70 million to repatriate their nationals, although their assumptions seem excessive and $20 million is likely to be nearer the true cost.

4. Pakistan will lose exports valued at about $30 million a year to Kuwait and Iraq.

5. There is an unconfirmed report that the Japanese Government is considering offering Pakistan $500 million of emergency assistance.

6. Pakistan has already failed to meet the performance targets on the structural adjustment programme before the Gulf crisis broke. With foreign exchange reserves equivalent to only 2 weeks of imports, the additional burden imposed by the crisis has markedly weakened the country's economic position.

SRI LANKA

1. All oil is imported, but oil imports accounted in 1988 for 6.5% of total imports. An increase in oil prices to $28.7 would add a further 3% of GDP to the oil import bill, increasing total imports by $220 million. Including lost remittances and exports, total losses equal 4.6% of GDP or 12.4% of imports.

2. Sri Lanka is well endowed with hydro electric energy which provides 92.8% of electricity generating energy (in 1988). Without this the level of dependency on oil imports would be much higher. They normally store 2 months of consumption and have in the past procured very little from Iraq or Kuwait.

3. There are estimated to be 100,000 Sri Lankans working in Iraq and Kuwait but the Government puts remittance value at only $35 million, which seems surprisingly low but may reflect effects of internal disorder in Sri Lanka leading workers to hold savings offshore. It is unclear what proportion of the costs of repatriation will have to be borne by Sri Lanka but it could be in the region of $20 million.

4. Exports to Iraq and Kuwait are about $45 million per year, mostly tea. So far the non-availability of these markets does not seem to have affected sales or prices.

5. No compensatory aid packages have been offered for assistance with the costs of repatriation.

6. Sri Lanka has made surprisingly good progress in meeting the second year performance targets under its IMF adjustment programme, but there is still much to be achieved particularly in bringing inflation under control. Higher oil prices will make the paths of continued adjustment more onerous.

INDONESIA

1. Indonesia stands to gain revenue equal to 9% of 1989 imports, equivalent to 1.9% of GDP, as a result of an increase in oil prices to $28.70 per barrel. This is due to gains on the oil current account surplus of $1.7 billion in 1991 alone. In addition there will be further gains from liquid Natural Gas exports.

2. The overall gain to the economy is limited by the fact that net oil exports are equivalent in 1989/90 to only 10% of total exports. This low dependency on oil exports results from a successful diversification of exports into non-oil products. Nevertheless the gain from increased oil revenues are significant, and will further boost an already healthy economy.

CARIBBEAN

GUYANA

1. Guyana is extraordinarily dependent on oil imports, these accounting for a third of total imports in 1989 and nearly a quarter of official GDP. An increase in oil prices to $28.7 per barrel would cost Guyana an additional $60 million a year, 21.6% of total imports or 20.9% of GDP. These figures may overstate the position because GDP and imports may be under-valued.

2. Guyana has only 2 weeks supply of oil. Venezuela is the normal supplier of oil products, although in recent years aid donors (including the ODA), have been providing aid in the form of oil as support to the adjustment programme. The President of Venezuela is reported to have offered longer credit terms in response to the crisis, but details are not yet available.

3. Guyana is not expected to face any other additional costs as a result of the crisis.

4. The financial situation is desperate, with a projected 1989 debt service ratio of 77.5% of exports (World Bank PFP) and minimal international reserves. Bridging finance has recently been put in place by donors in order to underwrite a new IMF programme. The viability of this programme was already highly questionable and it is now extremely likely to run into difficulties requiring extensive additional resources from donors.

JAMAICA

1. Jamaica is highly dependent on imported oil which accounts for around 90% of energy use. Fuel imports accounted for 15.1% of total imports and 7.3% of GDP in 1989/90. An increase to $28.7 per barrel for oil would add $210 million to the import bill and cost 5.4% of GDP or 11% of imports.

2. There are expected to be no other adverse effects of the Gulf crisis on the Jamaican economy.

3. Jamaica has about 3 weeks of stocks and normally procures from Venezuela and Mexico.

4. The weak balance of payments position has made Jamaica vulnerable to the previous oil shocks. The IMF programme was recently suspended because Jamaica failed to meet external balance

targets. This increase in oil prices will make renegotiation of the programme considerably more difficult.

5. The only new aid package agreed so far is a relaxation of the San Jose accord to provide a slightly greater deferred payment facility on oil import payments which should save £20 million in 1991.