

Rundt's World Business Intelligence

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TRENDS TO KEEP AN EYE ON Page 2

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The security forces have succeeded in foiling plans for al-Qaeda attacks on an oil refinery and a US base, but the risks persist. The economic outlook on the other hand, is not as bad as one might suspect. Last May’s elections have, predictably, not done much to smooth relations between parliament and the government.

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The economy should show some improvement in the third and fourth quarters of this year, following a dismal April-June result. The government is having to tighten the fiscal belt, however, as oil production and revenue are slumping. Hefty windfall profits from oil hedging will help.

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The economy has turned down more sharply than officials had anticipated, and this makes it impossible to meet the fiscal goals set by the IMF. Fortunately, the Fund is proving to be flexible in this matter, but the government is left without elbowroom for stimulating activity.

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While the external accounts are improving fast, the IMF is evidently prepared to release the second installment from its stand-by loan. It wants the authorities to do more to narrow the budget deficit and this could be a problem as the weakness of the economy is proving to be greater than anticipated.

VENEZUELA Page 11

Speculation is rife that the regime is about to alter FX rules to address a now unsustainably wide gap between the official and parallel rates. Various proposals are being discussed, however, and until more specific information is available parallel quotations will remain erratic.

YEMEN Page 14

The country is now under threat from four sources that could turn it into a failed state. For now this is only a risk, but to add to the problems, recent economic performance in Yemen has been mixed and water as well as oil resources are running out.

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International interest rates, spot and forward exchange rates, Euro, SDR, gold.

Trends You Should Know About

BRAZIL

The WTO has given Brazil the go-ahead to impose USD 294.7-million worth of sanctions against US goods to compensate for subsidies paid to American farmers. The figure is only a fraction of the USD 2.68 billion Brazil had sought. Moreover, while Brasilia had threatened to retaliate against the US by suspending market access concessions for American providers of services in the business, financial, construction, tourism, transportation, communications, and distribution services, the WTO judgment allows retaliation only against US goods unless payments to cotton farmers exceed a specified cap. In that case, Brazil would be allowed to strike back against US services or intellectual-property rights. Inter alia, Brazil would like to break patents on US pharmaceutical products. Brasilia's Ambassador to the WTO says that – while the ruling was based on 2006 figures – the US exceeded the cap by about USD 340 million in 2009. This has not yet been independently confirmed, however.

CZECH REPUBLIC

The country's constitutional court, accepting the argument in a complaint from an independent lawmaker saying that early elections violated his right to remain in office for a full four-year term, has invalidated President Vaclav Klaus' call for a parliamentary ballot on October 9-10. The result of this decision will be a continuation of a political crisis that is now likely to leave the country with only a provisional budget for 2010 at the end of this year – and one that will lack the spending cuts necessary to tackle the ballooning fiscal deficit

GUATEMALA

Inadequate rainfall and the slumping economy have joined forces to create a food shortage so dire that President Alvaro Colom felt compelled to declare a “state of calamity,” issuing what he says is “a fervent call to all of the country's sectors to contribute to confront this grave problem.” The plea was made in a televised address this week. It is now yet known exactly what Mr. Colom expects to result from it and how much money the government will allocate under emergency powers that allow him to redirect spending.

LEBANON

The country still has no new government, three months after the parliamentary elections of June 7. In fact, this week Prime-Minister-Designate Saad Hariri stepped down after the opposition rejected the list of Ministers he had presented to President Michel Suleiman. Under the power-sharing accord that the leading politicians had accepted in July, which neither gave the ruling pro-Western coalition a decisive majority, nor provided the Shi'ite Muslim Hezbollah and its Christian allies with the veto powers they had before, Hariri's coalition was to name 15 Ministers for the Cabinet, while 10 were to be loyal to Hezbollah and its allies. The President was to choose the remaining five. But, according to Hariri, the opposition had set “impossible conditions” for the Cabinet lineup. Suleiman is now likely to ask Hariri to take another stab at forming a government since, unless the Prime-Minister-Designate says he is not interested and supports someone else, it is not feasible, politically, for the President to go over his head. Under the covenant that in Lebanon takes the place of a constitution, the President is always a Maronite Christian, the Premier a Sunni Moslem, and the Speaker of Parliament a Shi'ite.

SPAIN

Although many private economists remain convinced that the fiscal deficit this year will blow out to nearly 10% of GDP, up from 3.8% in 2008, Prime Minister Jose Luis Rodriguez Zapatero continues to insist that the red-ink spill by 2012 will be brought back down to the 3.0% limit set for Eurozone members by the Maastricht criteria. In pursuit of this goal he has now, for the first time in public, dropped his usually optimistic demeanor and acknowledged that Spain will face a lengthy period of high unemployment (reported at 18.5% of the labor force) and economic difficulties even after it pulls out of recession. He announced that in next year's budget the tax burden will rise by 1.5% of GDP or the equivalent of USD 21.75 billion, without unveiling any details (except that he said income tax will not be raised). He also vowed an “exhaustive purge” of all non-essential spending.

Bosnia & Herzegovina

Economic growth has slowed drastically, but the existing currency board arrangement for the convertible marka is probably safe. The current-account

BoP deficit has been narrowing. An IMF aid package helps. But in the political arena centrifugal forces keep clawing at the fabric of national unity, and there appears to be a persistent risk of renewed hostilities between the principal religious and ethnic groups.

The economy's expansion has slackened sharply in recent quarters. While up-to-date statistics are not available (they are routinely published with great delay in Bosnia & Herzegovina, in part because national numbers are hard to compile), it is clear from inflation data that activity has been seriously undermined. Price trends have been negative since last November, and this attests to how weak the economy has become. While there could be a brief uptick in the CPI because of the impact of a hike in tobacco, alcohol, fuel, and coffee excise taxes, this will be temporary and inflation for all of 2009 should not surpass 1% by much.

Trouble With Loan Guarantees

Besides the absence of inflation, another sign of how troubling the softness of the economy has become is that private loan guarantors, increasingly, are forced to make good on their commitment. Before the collapse of Yugoslavia, jobs, for the most part, were secure until retirement and the dinar, which at that time was legal tender, was subject to frequent devaluations, which made servicing debt easier. On the other hand, borrowers had little or no private property to offer as collateral, so guarantors were the main backing mechanism for loans.

An Essential Feature of Micro-Credits

Even after the collapse of Yugoslavia in the 1990s, people in the new states still readily guaranteed loans for friends and relatives, unaware that their backing was no longer the mere formality it used to be in Socialist times. Now, their generosity, which in many respects was instrumental in reviving the economy after Europe's worst fighting since WWII, is coming to haunt them as people lose jobs and are no longer able to service their obligations.

The overall indebtedness in Bosnia is relatively low, compared to other Balkan countries. But the micro-credit sector, which was set up by the World Bank and other international aid donors, has enabled many to open businesses such as restaurants, food production facilities, farms, and wood-processing workshops, in the process creating more than 100,000 jobs.

The economic downturn has taken a harsh toll on such businesses, raising the default rate on such loans to 8%-9% since the start of this year. Many borrowers accumulated several loans, as micro-creditors until recently were not obliged to report on their clients to the central credit registry. In addition to their own borrowing, many micro-credit clients also acted as guarantors for others, and now many find themselves caught in a vicious circle of indebtedness.

IMF Help For the External Accounts

Bosnia's current-account BoP deficit narrowed by some 60% in the first quarter of this year, as imports of goods & services fell by 23% (reflecting the weakness of domestic demand), and indications are that the trend has persisted since then. Official international monetary reserves are not overly ample, reported most recently by the IMF at USD 3,420 million as of end-May, but this was slightly up from USD 3,300 million at the start of the year and should be sufficient in the near term.

The International Monetary Fund approved in July a 36-month, USD 1.57-billion stand-by loan intended to help ensure that the country has sufficient external finance and bank liquidity, that the currency-board system anchoring the exchange rate is not threatened, and that public finances remain manageable. The Central Government had approached the Fund for the bailout and has apparently agreed to a number of structural fiscal reforms aimed at changing the system of transfers and improving public finance management. Inter alia, Bosnia & Herzegovina's various levels of government have agreed to find BAM 580 million in combined spending cuts and tax adjustments, reflecting the impact the recession is having on the country's fiscal accounts.

Harsh Austerity Keeps Currency Board Safe

On the Central Government level, public-sector salaries and most social welfare programs have been reduced by 10% below 2008 levels. Similar cuts have been announced by the Republica Srpska. In May, the Federation Government announced it had finally clinched a loan deal with local banks to clear arrears of BAM 250 million arising from obligations in the 2008 budget. Since May 1, the mandatory reserve requirement on term deposits longer than one year has been lowered to 7% from 10%, freeing up BAM 262 million in additional liquidity.

None of this, obviously, proved to be very popular, but – although there has been much talk about a possible devaluation of the convertible marka (Bosnia &

Herzegovina's legal tender) – the existing currency-board arrangement is now probably safe for the foreseeable future, (a) because fiscal policy has come to look sustainable as presently formulated, and (b) the arrangement has strong international support from both the IMF and the European Union.

Given the deep-seated and frequently surfacing political difficulties of the country, putting at risk the currency board, the one genuine source of certainty in the area of economic policy, would have disastrous consequences.

Centrifugal Forces

As it is, the centrifugal forces that are constantly trying to tear this artificial construct of a country apart are as strong as ever. It was clear from the outset that this creation of the Dayton accords of 1995 would prove difficult to hold together.

In the latest show of ill will toward the Federation, Bosnian Serb leaders recently passed legislation and published in the official gazette 68 powers that they say the Bosnian state had “stolen” from the Republika Srpska. These include control of the judiciary, powers to collect Customs duties, authority to manage foreign trade, and the authority to deploy the police. Publication in the official gazette effectively made the list and its implied demands law.

In response, though, the international community's envoy in Bosnia, the so-called High Representative, currently the Austrian career diplomat Valentin Inzco, who was appointed to his post as recently as last March, decided that it was necessary to assert his special legal authority and rescinded the legislation. He argued that the Serbian Republic “is trying to renegotiate Dayton through political means” in a way that is “extremely dangerous for the country.” Clearly, the European Union and the US are determined to maintain the Dayton agreement.

The so-called Bonn powers give the High Representative authority to issue decrees, impose laws, and remove elected as well as appointed officials who, he thinks, are obstructing the Dayton accords. These powers have been invoked more than 800 times in the past 13 years to remove officials and to annul laws. They are hated by local officials who, rightly, regard them as undemocratic. But they have been instrumental in holding the country together so far, and in preventing the eruption of new armed hostilities where the wounds of war are still far from having healed. (9/10/09)

Brazil

The CB appears to be at the end of its easing cycle, but we tend to disbelieve predictions of an early return to rising interest rates. The government's latest plans to play a much bigger role in exploiting newly discovered oil reserves will not sit well with some of the potential investors, but Petrobras CEO Gabrielli is embarking on a week of meetings designed to persuade executives at major oil companies that Brasilia has no intention of stiffing those who decide to remain in the game. At least to some extent, the new approach is being taken for strictly political reasons, to improve the electoral chances of Pres. Lula's chosen successor.

Banco Central, after five cuts in its benchmark Selic rate in 2009, decided this week to leave the bellwether unchanged at 8.75%, as its Board tries to determine how effective the monetary easing to date has been in stimulating economic activity. There is a good chance that further rate cuts will prove unnecessary. As it is, total outstanding loans rose by 2.6% to a record 1.31 trillion reais (USD 688.2 billion) in July. Industrial production has been expanding for the past seven months and rose 2.2% in July from June. Companies have resumed hiring and retail sales have returned to pre-crisis levels.

Brightened Outlook

The brightened picture owes much to the fact that the CB has slashed the key interest rate from a two-year high of 13.75% in January and has injected the equivalent of about USD 100 billion into money and currency markets to boost loans to companies and consumers in the midst of the global credit crunch. The government has also lowered taxes on cars and electronics to perk up retail sales. As things look now, real GDP is expected to show positive numbers for the second quarter, following contractions in January-March and October-December, and while the economy may be down marginally for 2009 as a whole, a strong gain of around 4% is anticipated for 2010.

Under these circumstances, it would not make much sense for the Central Bank to keep its foot on the accelerator. So, the cyclical easing of monetary policy may well be near its end. But, whereas estimates based on overnight interest rate futures contracts would seem to

suggest that Brazilian interest rates will rise fairly strongly from here on, reaching 9.4% by next April, we tend to disbelieve such signals. The economic recovery, once it begins in earnest, will be at least initially fragile and in need of some continued support. As for inflation, as measured by the IPCA index it slowed to 4.5% in July, the lowest rate since December 2007 and compared with 5.8% in January. The IGP-M, a gauge of wholesale prices by which costs for home rentals and utility rates are adjusted, turned negative in July for the first time since 2006.

No Reason For Reversing Course

Since inflation peaked at 17.24% in 2003, the government has met its inflation target every year. This makes it rather unlikely that pressures for a reversal of policy will become too strong for the CB to resist in the near term. More of a consideration in the markets could be that Banco Central President Henrique Meirelles has political ambitions (he is widely expected to run for the governorship in his home state of Goiás in October next year) and has an October 3 deadline for joining a political party. He has been an exemplary steward of the Central Bank and there is some concern that a run for office may put an end to this record. We are fairly convinced, though, that whoever may be picked by the President to replace him will strive for policy continuity.

Tricky PR Job

On a different front: The CEO of the state-run Petroleo Brasileiro SA, Sergio Gabrielli, will begin a week of meetings in New York next Monday with the top priority being to convince the executives at major oil companies that they can and will have an important role in developing the potentially huge petroleum deposits discovered two years ago off Brazil's coast in the so-called pre-salt area. This area runs roughly 500 miles offshore from the Espirito Santo to Santa Caterina states and has deposits beneath a layer of salt resting as deep as 3,000 meters below the ocean surface and another 5,000 meters beneath the seabed.

Doubts have arisen in the minds of the oil majors asked to participate in developing these fields because of a package of rather vague laws the government has asked Congress to pass under an emergency procedure, of which one would create a social fund with revenue from the oil exploration to finance social programs and investments in science and technology, another would create a special state company (Petrosal) to govern all oil & gas exploration and manage the resources, and a third would establish

that rights over fields in the pre-salt and other strategic areas be shared between the government and companies that win the licenses.

Resource Nationalism Brazil-Style

While saying that already existing contracts will not be affected, the government wants to change the present concession regime with production-sharing agreements (PSAs) where it retains legal title to the oil and the companies get a share of the petroleum as payment for their services. Petrosal is to have half the votes on each consortium's operational committee and a veto over any decisions, including the rate of oil production and the acquisition of goods & services. Petrobras is to take at least 30% of any consortium, will be the lead operator in all of them, and may be granted licenses on its own, for any field, at the government's discretion.

Mr. Gabrielli's job is to convince international oil companies that, despite the appearance of these rules as "resource nationalism," Petrobras will retain its free-market ethos and their role in helping to develop the deposits will be material. Brazil needs not only technical assistance, but also money, considering the enormous cost of bringing the oil reserves on stream. On the other hand, the oil companies have a keen interest in resources estimated at between 50 billion and 100 billion barrels. The main reason why the government is pushing the change in rules now – it expects Congress to pass it within seven months – is that it wants to show its determination to retain control of what is likely to turn out to be Brazil's greatest material asset and to use the proceeds for funding an ambitious social agenda.

Political Background

Presidential elections are due in October next year and President Lula is working hard to put his hand-picked successor, Chief Minister Dilma Rousseff, into a favored position. His quest is being complicated by the fact that his Brazilian Workers' Party (PT) is under growing strain. Last month, two of its 12 Senators walked out. One, Marina Silva, a PT stalwart since the 1980s, left to join the Green Party.

A few months ago, we said that the presidential contest will likely be fought between only two contestants, namely Ms. Rousseff and Jose Serra, the governor of Sao Paulo and the banner bearer for the opposition PMDB. Since then, though, other candidates have thrown their hats into the ring or shown an inclination to do so, including Heloisa Helena (who leads a party that splin-

tered away from the PT), Ciro Gomes (a populist former Minister in Lula's government), and Marina Silva. None of them has much of a chance of being elected. But Ms. Silva, for instance, if she ran for the Green Party, could take votes away from Ms. Rousseff. This could spell trouble for the PT, the more so as Mr. Serra has been commanding a consistent 40% or so in the public opinion polls, 20 points ahead of Ms. Rousseff... (9/10/09)

Kuwait

The security forces have succeeded in foiling plans for al-Qaeda attacks on an oil refinery and a US base, but the risks persist. The economic outlook on the other hand, is not as bad as one might suspect in light of the international crisis. The country has no problems with its external accounts. While it is running a budget deficit in the current fiscal year, the red-ink spill is less serious than it might seem at first blush. In the political arena, last May's elections were highly significant, but they have, predictably, not done much to smooth relations between parliament and the government.

Kuwaiti security forces succeeded last month in foiling a plan by an al-Qaeda-linked group to attack the country's Shuaiba oil refinery during the holy month of Ramadan and to bomb the US army camp of Arifjan as well as other "important facilities." The incident served as a vivid reminder that al-Qaeda, having suffered setbacks in Iraq and Pakistan and having been hit hard by government forces in Saudi Arabia, remains as determined as ever to sabotage oil facilities and Western interests in the Gulf, to destabilize US-allied rulers in the region, and to harm the economies of Western countries by disrupting the flow of oil and petroleum-products to industrial economies.

Al-Qaeda Regrouping

Al-Qaeda is now trying to regroup around its Yemeni wing, which announced plans earlier this year to widen the scope of its operations to include all of the Arab peninsula and the rest of the oil-exporting region. The Shuaiba oil refinery is an aging installation and, with a throughput of 200,000 barrels a day, the smallest of Kuwait's three refineries with a combined capacity of

around 930,000 bpd, but a successful attack on it would, nonetheless, have produced a serious disruption, not to mention the psychological effect it would have had. Camp Arifjan, a sprawling American logistics and supply base in the desert South of Kuwait City, is the main US military base in the country and is critical for the support of US troops in Iraq.

The Shuaiba refinery is well protected and it is by no means certain that the six men who were arrested in conjunction with this plot would actually have been able to reach it. They are said to have confessed buying a truck and filling it with chemicals and gas cylinders with the intention of ramming it into Camp Arifjan, and this terrorist attempt may also have been doomed to failure from the outset. But the fact remains that al-Qaeda and linked groups, which have carried out a number of attacks in Kuwait in recent years, remain active in the region and certainly a threat to be reckoned with.

Economic Outlook Better Than Advertised

The outlook for the economy, on the other hand, is not as dire as one might suspect at first blush. It is dominated by the fallout from the global credit crisis, to be sure, and real gross domestic product in Kuwait is projected to be near stagnation for 2009 as a whole due to lower oil production and a decline in non-oil growth. But, reduced import prices and weakened domestic demand have also been instrumental in bringing inflation down, which should average less than 6% this year versus 10.5% in 2008, and the government's fiscal affairs remain in good shape.

True, parliament in July approved a budget for the year through next March that – even though it cuts spending – has a projected deficit of 4.8 billion dinars or about USD 16.7 billion. Spending is forecast at KWD 21.1 billion. For one thing, though, the shortfall follows a string of annual surpluses of which the one for the fiscal year ended last March 31 came to KWD 2.74 billion, or USD 9.5 billion. And for another, actual oil revenue in those 12 months was 69.2% higher than budgeted because the government had estimated it with an assumed price of only USD 50 a barrel.

The target price for fiscal 2009/10 has been set at a very low USD 35 a barrel, whereas Kuwaiti crude traded at USD 70.93 at the end of June. Revenues, in other words, will again surpass projections substantially, and this includes that by law 10% must be set aside in the Reserve Fund for Future Generations (a fact that is accounted for in the deficit calculation).

The Issue of Iraqi Reparations

In this context: Kuwait is being urged not only by Iraq's Prime Minister Nouri al-Maliki but also by Ban Ki-moon, the Secretary-General of the United Nations, to convert USD 25.2 billion in reparations still owed from the time when it was invaded into investment projects that can benefit both countries. Iraq originally owed USD 52 billion. Of this, USD 26.8 billion has been paid to Kuwait as well as to individuals, companies, other governments, and international organizations. Mr. Maliki has been arguing that the debt should be canceled, since Iraq is no longer a threat to security and peace. This is not likely to happen, however. Iraq currently pays 5% of its quarterly earnings from oil, gas, and petroleum products to a reparations fund. This is down from 30% in the immediate aftermath of the war. US President Barack Obama has pledged support for lifting the remaining UN sanctions on Iraq.

No Problems With the External Accounts

As for Kuwait, even at present, relatively low world market prices for oil it has no difficulty keeping the external accounts in the black. In 2008, the estimated current-account BoP surplus was on the order of nearly 45% of gross domestic product. In the current year, the ratio will be considerably lower, projected at just under 20%, but it will still be very substantial. Kuwait's sovereign wealth fund, managed by the Kuwait Investment Authority (KIA), is one of the largest in the world, recent losses due to adverse global developments notwithstanding.

The apparent suicide in July of a Kuwaiti broker, however, sued for fraud by US regulators in a case linked to the Emirate's ruling family and its top investment firm, served as a reminder that Kuwait, home to the Arab world's second-largest bourse, needs a much better regulatory environment than it has. The Sheikhdome has no financial regulator and lax rules, by international standards, on what companies must tell the stock market. Only a minimum of corporate data has to be released and some companies leak market-moving news or even release their results first in the local press, late at night or over the weekend, to the detriment of investors. Newspapers are full of "unsourced" reports and officials rarely respond to requests for denials or confirmations.

Political Confrontations

In the political arena, last May's elections were highly significant in that they brought a major victory for secular reformers over Islamist hardliners by (a) getting

four women elected to the 50-seat parliament and (b) causing substantial losses for the Islamists themselves. Kuwait is the most democratic of all Arab countries. Its parliament has real power, its politicians are chosen in legitimate elections, and the press is relatively free. At that, Sheikh Sabah al-Ahmad, who became Emir in 2006, has repeatedly exercised his privilege of giving family members top Cabinet posts.

Disputes between parliament and the government have forced the Cabinet to resign and governments to fall five times in the last three years, and it appears that the revolving-door game is not over yet. The Emir has reappointed his nephew, Sheikh Nasser al-Mohammed al-Sabah, as PM for the sixth time since February 2006. In the new parliament's first session, almost a fifth of the members walked out to protest the new Cabinet. It is, in other words, doubtful that the political turmoil will now settle down. And continuing tensions could continue to block important legislation, including that of setting up a USD 5-billion stimulus package which had faced resistance in the old parliament and was approved by the government after that legislature had been dissolved. (9/10/09)

Mexico

The economy should show some improvement in the third and fourth quarters of this year, following a dismal April-June result. The government is having to tighten the fiscal belt, however, as oil production and revenue are slumping. A boost for the budget that was available for the current year in the form of hefty windfall profits from oil hedging is not likely to be repeated in 2010.

At first glance, the annual 10.3% by which gross domestic product slumped in the second quarter of this year looks like a painful deterioration in trend from the decline registered in the first quarter. It was the fastest contraction in more than 25 years. Manufacturing output was down 16.4% in April-June compared to the like year-earlier span, and the service sector was off by 10.4%. So, it may sound odd when Central Bank President Guillermo Ortiz said that "we'll have a better GDP in the third quarter compared with the second, and in the fourth quarter compared with the third."

Less Bad Than It Appears

When one looks at a quarter-to-quarter comparison, however, the change from January-March to April June was by minus 1.1%, while that from October-December to January-March had been 5.9%. In other words, there was a material improvement, and Mr. Ortiz' statement no longer sounds absurd. Granted, the official expectation for all of 2009 is still a GDP fall by at least 7%, which would be a result worse than that following the Tequila crisis in 1994-1995. But the main reason behind the cave-in has been the weakness of the US economy with its repercussions for Mexican exports, especially those of the maquiladoras, and business conditions in the US are bottoming out.

Cave-In of Oil Production

This is not to say, of course, that the coming months will be easy for Mexico. So far this year, the economy has lost more than half a million jobs and there is more of this to come. The homebound remittances from expatriates living and working in the US, which by 2007 had increased to more than USD 26 billion, are way down and many Mexican families, having come to rely on such money, are struggling to survive. Most importantly, Mexico's oil production has fallen in the past year due to a drastic decline in liftings at the largest and most important field, Cantarell, and Energy Minister Georgina Kessel now predicts that the country may pump no more than 2.6 million barrels per day this year, which is off from an earlier expectation of 2.8 million bpd.

Production at Cantarell has been receding at twice the rate forecast by the state oil company Pemex. To boot, prices are still down by more than 50% from their peak of USD 147.27 per barrel last year. The drop may cost the government, which last year depended on oil to fund 38% of the budget, as much as 300 billion pesos (USD 23.1 billion) in 2009, leading to serious fiscal problems. Mexico has said that it holds 30 billion barrels of oil-equivalent under the waters of the Gulf. BP has just announced the discovery of a giant field, called the Tiber well, about 250 miles Southeast of Houston at a depth of more than 35,000 feet, well below the seabed.

Reaching these deposits, however, requires drilling through miles of rock, salt, and packed sands, which is a capital- and technology-intensive job. It could take three or more years to begin extracting the oil, and production would be commercially viable only if world market prices are at least USD 70 a barrel. Pemex also wants to partner with companies such as Petrobras of Brazil,

ExxonMobil, and Chevron to develop its deep-water reserves. In the interim, though, the government has to find other ways of keeping its fiscal accounts manageable. In his annual state-of-the-union address earlier this month, President Felipe Calderon proposed a number of measures to shore up the budget accounts and promote growth and efficiency. He stressed that the country must expand tax collection from sources other than oil, end corruption at state energy companies, and extend access to healthcare to all citizens. Mexico still has a relatively very narrow tax base and total revenues for the federal and local governments taken together were just 19% of GDP in 2008.

Fiscal Austerity

Toward its goals, the government will fight hard for maintenance of the alternative minimum tax on businesses, which is currently "under review" by the PRI, the largest party in parliament. This impost, which companies must pay if it is higher than the ordinary tax on incomes, is to be levied at 17.5% next year, up from 17.0% now and from 16.5% when it began in 2008. In the budget for next year, the government proposes a new 2% sales tax, which is to be applied to items including food and medicine and of which it earmarks the revenues for social programs. Calderon's proposals also call for raising the tax rate for high-earning individuals and corporations to 30% through 2012 and for the imposition of a 4% excise levy on telecommunications services.

President Calderon also announced sweeping cuts in the public administration, including the axing of three Ministries, namely the Public Function Secretariat (in effect the Anti-Corruption Ministry, which will be replaced by a Comptroller General's office), the Agrarian Reform Ministry (whose activities will be divided up between the Ministries of Agriculture and Social Development), and the Tourism Ministry (which will be absorbed by the Economy Ministry). These and other changes are to save upwards of 180 billion pesos (USD 13.4 billion), which are to benefit the poor, especially through the so-called Oportunidades program, which, according to Mr. Calderon, will now benefit some 33 million Mexicans.

A One-Time Windfall

Earnings from tourism, which in 2008 came to USD 13.3 billion, will be sharply lower this year, in part because of the impact of an outbreak of swine flu. One of the unexpected windfall benefits the budget will receive this year is a record USD 8 billion Mexico stands to gain from oil price hedges in the form of put options that Finance Minister Augustin Carstens shrewdly took out on

the (correct) expectation that world market prices would stay down for a while. He did so at considerable risk – the premiums on these options cost a cool USD 1.5 billion – but this is not something he is likely to be able to repeat for 2010. (9/10/09)

Romania

The economy has turned down more sharply than officials had anticipated, and this makes it impossible for the authorities to meet the fiscal goals set by the IMF. Fortunately, the Fund is proving to be flexible in this matter, but the government is left without much elbowroom for stimulating activity. Against this backdrop, the big bailout package the country has received from the IMF, the EU, and the World Bank is a huge benefit. In the political arena, the battles marking the approaching presidential elections will not bring the government down, but they may rattle its stability.

Real gross domestic product contracted by an annual 8.8% in the second quarter of this year, following a decline by 6.2% in January-March. This was a worse-than-expected performance, especially after the 7.1% gain the economy had registered in 2008. In retrospect, though, business activity has been sliding for four quarters in a row and it is clear that Central Bank Governor Isarescu was gilding the lily when he suggested, not long ago, that with the help of the International Monetary Fund the country will probably be able to avoid a recession this year. In fact, on present trends the economy will contract by at least 5%, and it will most likely stagnate in 2010 before returning to (modest) growth in 2011.

Little Room For Stimulative Measures

An important reason for the expectation of a drawn-out slump is that the authorities have very little elbowroom for monetary stimulation and none for fiscal efforts to put more pep into the economy. The Central Bank did lower its main interest rate on August 4 to 8.5% from 9.5%, which put this rate at its lowest level in more than a year. But the niveau is still high by international standards and Banca Nationala a Romaniei at the same time also lowered the minimum reserve requirements on foreign currency commercial deposits to 30% from 35% with ef-

fect from August 24 (in June, the CB had cut the ratio from 40% and had lowered the rate on deposits in lei to 15% from 18%).

The cut in reserve requirements on FX deposits came as something of a surprise – and as a worry to some – since it stimulates foreign currency lending while the risk of a further weakening of the leu versus the euro remains. This type of lending has proven to be a problem throughout Central Europe because it puts companies and households at risk when the local currency's exchange rate drops and servicing what is owed becomes that much more difficult. Also important, the Central Bank was able to opt for the latest round of interest rate cuts mainly because government austerity measures linked to the country's international bailout had made room for a further easing of monetary policy.

Concession From the IMF

It will be recalled that the IMF approved in early May a USD 17.1-billion loan as part of a USD 26.4-billion international bailout package to which the European Union is contributing USD 6.6 billion, the World Bank USD 1.3 billion, and the European Bank for Reconstruction and Development and the International Finance Corp. the rest. Of the IMF part of the facility, USD 6.6 billion was available immediately to Bucharest, while the remainder is to be disbursed in installments following quarterly performance reviews. To comply with the requirements for the above-mentioned bailout loans, Bucharest has announced tax increases, has frozen state wages, and has cut other expenses to constrain the budget deficit.

Even so, Romania is likely to post a budget deficit considerably larger than originally agreed with the IMF. Fortunately, the Fund is reported to have agreed to an increase in the target for the shortfall to 7.3% of gross domestic product and for much of the funding it is providing (initially earmarked “to provide reassurance to the markets that Romania's external obligations will be met”) to be used to bridge the gap. The European Union, however, has given Bucharest only six months, starting in July, to outline and enact the measures it plans to take to narrow the shortfall, and until 2011 to get the red-ink spill back down to under 3% of GDP, as prescribed by the Maastricht criteria and required for adoption of the euro.

The European Union, which had allowed Romania to join back in 2007 only with warnings that it had to step up its fight against corruption (or else lose access to the EUR 32 billion in aid that Brussels is supposed to

provide through 2013), says in its latest report that – while there has been progress – it still needs to be reinforced. Whereas “the necessary structures are in place,” Romania “still has to work on the structural changes.” The report, issued on July 22, was published a year after the EU’s first annual report on Balkan nations’ fight against graft, and to date, the authorities have not managed to convict a single senior politician.

Presidential Elections Ahead

Prosecutors in Romania, which Transparency International lists as the EU’s most corrupt nation, have accused almost 20 Cabinet Ministers and former Ministers of graft since the country joined the EU. Says the report: “Romania is still struggling to overcome the fact that the criminal and civil codes were never fully revised.” The report recommends that Romania ensure prompt investigation of senior officials, promote measures to prevent corruption, and better monitor the efficiency of the justice system in connection with corruption trials. It is, however, positive overall, concluding that Bucharest is winning on the reform front.

Presidential elections are due to be held in November, with the main contenders being the incumbent Pres. Basescu, the head of the PSD Mircea Goana, and the leader of the opposition party PNL, Crin Antonescu. The electoral battle is not likely to bring the governing coalition down, but it could rattle its stability. After last November’s parliamentary elections the Liberal Democrats aligned themselves with the Social Democrats and formed a governing coalition with a two-thirds majority. This alliance is tricky, though, as ideological differences make it difficult for the two parties to work together. (9/10/09)

Serbia

While the external accounts are improving fast, the IMF is evidently prepared to release the second installment from its stand-by loan. It wants the authorities to do more to narrow the budget deficit and this could be a problem as the weakness of the economy is proving to be greater than anticipated. The government is determined to get the country into the European Union as quickly as possible, but there are still a number of important issues to be resolved, Serbia’s relations with Kosovo being one of them.

The current-account BoP deficit is narrowing more rapidly this year than most pundits had anticipated. It is currently projected at 9% of GDP. Foreign banks have largely rolled over their exposure with Serbia and the banking system seems to have weathered the repercussions from the global credit crisis. Households have begun to return FX deposits to banks and immediate financial tensions have eased. With the global economy in recession both exports and imports have plunged, and capital inflows while they have stayed low in recent months, have been stable. Hence, external financing pressures are abating.

Satisfied IMF

Indications are, moreover, that the IMF is prepared to go ahead and make the country eligible for receiving the next installment from its USD 4.3-billion loan. Serbia has already drawn 788 million euros or about USD 1.1 billion from this facility. The next installment is for EUR 800 million. The IMF delegation which made the recommendation had a few nice things to say in its report about Serbia’s situation. For one thing, it seems to have been impressed by the fact that the Central Bank has not intervened in the exchange market since the end of February.

The dinar is on a managed float and in one measure to support the exchange rate the authorities introduced currency swaps with effect from March 1 which allow investors to make bets on the exchange rate without having to buy the dinars up front. The CB also introduced lower obligatory reserves that commercial banks keep in euros if they lend to local companies. There is occasional talk that the country might benefit from replacing the RSD with the euro now, since this is “likely to happen in any event,” but such a currency change is no simple affair and Serbia will probably be an EU member for some time before it is attempted in earnest.

A Problem With the Fiscal Deficit

The IMF also noted that stress tests for the 12 largest banks indicate that the banking system is adequately capitalized and liquid. But the mission saw a need to address more seriously a fiscal deficit which in the current year is threatening to blow out to 5.5% of gross domestic product, a magnitude the people from the Fund think “could be inconsistent with sustainable public finances.” The shortfall reached 1.5% at the end of June, headed for a marked widening in the second half. It will

in any event substantially surpass the 3% of GDP originally agreed with the IMF.

The problem for the government is that the economy is considerably weaker – and, therefore, tax revenues are considerably lower – than initially anticipated. Real GDP fell by 3.5% in the first three months of this year, following a 5.8% expansion in the last quarter of 2008. The expectation for all of 2009 is now a contraction by at least 4%. The biggest disagreement between Belgrade and the IMF at this time is over how the resulting fiscal deficit is to be remedied.

The Fund Wants Higher Taxes

The IMF says that, while developments in the first half of the year have been “somewhat worse than previously anticipated,” output in Serbia is likely to stabilize in the second half of the year, “consistent with the output decline of 4% for 2009 as a whole.” For next year, a modest recovery by about 1.5% is projected, and the risks to the growth outlook are now deemed to be “more balanced.” Concerning the 2009 budget, the Fund says there has been agreement to raise the deficit target to 4.5%, “given the need to avoid excessive tightening in a period of output weakness.” The government has already agreed to a continuing freeze in public wages and pensions, as well as a public hiring freeze.

The IMF has been suggesting, however, that a VAT hike would be most effective for getting the fiscal gap narrowed to the targeted 4.5%, while the government wants to concentrate on spending cuts. The Fund people say that a VAT increase would be least distorting, as it would be broad-based and tax also the informal economy and would support the needed shift away from consumption to investment. The authorities are concerned that a VAT hike could have a strong adverse impact on economic confidence, just when the economy is bottoming out, and would also take away the political pressure to implement spending reforms. The most likely outcome of the face-off will be a compromise under which some currently lower-taxed items will be brought up to the standard VAT rate.

The government is determined to get the country into the European Union as quickly as possible, but there are still strong anti-Western sentiments in the populace in a country that earlier this year marked the 10th anniversary of the NATO bombing that ended Serbia’s control of Kosovo. Parliament approved last year a new government which is a coalition of the “For a European Serbia” (ZES) bloc, led by the Democratic Party, plus a coalition built

around the Socialists (including the Party of United Pensioners in Serbia or PUPS), plus ethnic minorities. The administration is quite large, its four Deputy Prime Ministers and 24 Cabinet Ministers reflecting the horse trading over posts that was needed to forge a consensus.

The governing coalition brings together no fewer than ten parties or alliances. But it has a majority of six in parliament and can, in the crucial reform initiatives aimed at bringing Serbia closer to the EU, also count on the support of Liberal Democrats (with 13 seats in the legislature). The biggest obstacle would seem to be even now the status of Kosovo, the embattled former Serbian province which declared its formal secession in February 2008 and which about 60 governments world-wide have now recognized as an independent country, while Serbian Foreign Minister Vuk Jeremic recently reiterated Belgrade’s unwavering opposition to this development.

Arguments Over Kosovo

The Cabinet Minister recently told the UN Security Council, citing numbers from the UN High Commissioner of Refugees, that tens of thousands of Serbs displaced by the war would like to return to Kosovo, but have been “stonewalled” in their attempts to recover illegally seized property. Jeremic insisted that, all told, close to 200,000 Kosovo Serbs have yet to return, and that a mere 500 went back in 2008 and just 30 during the three months from March to May of 2009. He said that more than 40,000 claims have been filed by Kosovo Serb IDPs (Internally Displaced Persons) for the return of illegally taken property, “and they have not heard back.”

Foreign Minister Skender Hyseni in Kosovo, which is 90% Albanian, disputes the estimates for displaced Serbs and calls the assertion of 40,000 property claims “science fiction.” He also accused Belgrade of encouraging Serbs not to return to Kosovo, but to remain in Serbia. To be kept in mind is that many of the Serbs who remained in Kosovo, and many among those who have returned, refuse to cooperate with Albanian-run institutions. (9/10/09)

Venezuela

Speculation is rife that the regime is about to alter foreign exchange rules in order to address a now

unsustainably wide gap between the official and parallel rates. Various proposals are being discussed, however, and until more specific information is available quotations on the parallel market will remain erratic and volatile. The future of one of the world's largest oil auctions, meanwhile, is in jeopardy because potential bidders don't trust Hugo Chavez. His relentless move toward ever more totalitarian rule underscores such concerns.

Even following a modest rise due to expectations of efforts to shore up the bolivar's exchange rate in the parallel market, this quotation was at end-August, at VEB 6.44 per USD 1.00, around 67% weaker than the official rate of 2.15:1.00 at which the foreign exchange agency Cadivi distributes greenbacks. This is a gap that is not only too wide for comfort, it is too big to be sustained. In mid-August, Finance Minister Ali Rodriguez let it be known that he "plans to close" the chasm and said that he had presented a plan to President Hugo Chavez that would reduce the "imbalance" in the parallel rate. Since then, speculation has been rife about how he expects to accomplish this, and in what way the foreign exchange system will be altered.

Venezuela controls the supply of dollars at the official exchange rate under restrictions the regime imposed in 2003. The authorities last devalued the official rate in 2005, when they pushed it down by roughly 11%. One option they have now is to devalue again. This would give the government more bolivars for every barrel of oil it exports – which is an important consideration since world market prices for Venezuelan petroleum are still 53% lower than they were at their peak last July. Oil accounts for more than 90% of Venezuelan exports and for more than half the government's revenues.

Four Different FX Rates?

The downside of such a move would be, aside from the psychological blow that would come from a step needing to be taken quite obviously because of macro-economic mismanagement, that it would heat up inflation – at a time when consumer prices in Caracas rose 28.3% in the 12 months through July. In the absence of a devaluation of the official rate, the regime could support the parallel rate, for instance by selling dollar-denominated debt to this bazaar, and formalize the current arrangement. It is questionable, though, whether this would offer more than a very short-term "solution" to the problem of widely divergent official and parallel rates.

Perhaps because of this, some pundits expect the government to wind up creating four different exchange rates, de facto if not de jure. One would arise from the maintenance of the current official rate at 2.15:1, which would, however, be limited in its applicability to essentials such as food and medicine. Another would be created with the imposition of a tax on all currency transactions that are done to import other, non-essential items. A third would come into being as a result of regular auctions of dollar-denominated securities on the Caracas stock exchange. And a fourth would result from the continued existence of the parallel market, dominated by swaps of dollar securities for local-currency assets.

At this point, no one really knows what the regime will decide to do. Indeed, it is doubtful that the authorities themselves have made a final decision. President Chavez is on a trip taking him to Libya, Algeria, Syria, Iran, Belarus, and Russia, where he hopes to strengthen oil and general economic ties. He is scheduled to return on September 11, and the exchange rate matter, according to him, will be resolved before the end of this month. It warrants pointing out, though, that – as international petroleum prices recovered a little in recent months – the government has increased its dollar sales at the official exchange rate and, reportedly, has brought itself up-to-date on 70% of back orders for dollars that had built up. The state oil company Petroleos de Venezuela SA, moreover, also started paying off USD 12 billion in debts that accumulated this year to its service providers.

Oil Auction In Jeopardy

The future of the world's largest oil auction, meanwhile, is in jeopardy because the companies that would be key bidders – from state entities such as those of China, Russia, and India to private enterprises including Shell, BP, Chevron, Total, ENI, and Statoil – find it difficult to swallow the terms the Venezuelan regime wants to impose on them. At stake is Orinoco's Carabobo block, which could require a collective investment of between USD 30 billion and USD 50 billion to develop. There are three projects that together could wind up producing 1.2 million barrels per day.

Companies are attracted by the sheer size of the Orinoco Belt, the fact that there is no exploration risk, and a lack of alternatives elsewhere in the world. But they worry about the unstable political climate in Venezuela and the unpredictability of Hugo Chavez. They are well aware that barely a month goes by without the government seizing another private company. It has just expropriated the assets of more than 70 oil service companies.

It has seized firms in the electricity, cement, telecommunications and food production industries and grabbed heavy crude oil joint ventures in 2007, forcing ExxonMobil and ConocoPhillips to pull out of the country and seek international arbitration.

A Climate of Uncertainty

In doing so, it has generated a climate of uncertainty in which no one believes in the sanctity of contracts and in which investment across the board has been severely dampened. Price controls have made matters worse and Venezuela, which – for instance – used to be one of the world’s top coffee exporters, recently for the first time was forced by looming shortages to import sizeable quantities from Brazil. The shortages, typically, prompted Chavez to nationalize the country’s two largest coffee roasters, accusing them of hoarding, speculation, and smuggling. But the problem extends across the whole food industry, where rising demand has been running into falling production.

Food imports have quadrupled in the past decade. Imports now cover about two-thirds of the nation’s entire food consumption, while huge tracts of fertile, arable land lie fallow. The oil companies know all this, of course, and they are also well aware that tax rates for petroleum firms in Venezuela have been increased four times since 2004, while PdVSA has been dragging its feet on paying dividends owed to partners in existing joint ventures. They are trying to insist that they have the right to settle contract disputes in international courts, but PdVSA is reported to be extremely reluctant to comply (although such clauses were included in contracts signed with Russian investors).

New Threats Against Financial Firms

Add to this 33% royalty rates, a newly introduced windfall tax, high startup costs, and the prospect that PdVSA will have operational control, and many companies will shy away from putting serious offers on the table. We do not believe that this will necessarily doom the auctions, since national oil groups such as those from China and Russia will remain interested. But they will have to keep an eye on the constantly changing regulatory environment, as will the financial companies, which have just been put on notice that the regime intends to introduce “reforms” to reduce speculation and encourage investment that will increase productivity. The government is worried because the economy contracted by 2.4% in the second quarter, its first such decline since 2003 (to be sure, the government insists that this was

wholly due to external factors, including the fall in the price of oil and the global financial crisis).

March Toward Ever More Authoritarianism

Investors’ concerns are being reinforced by Chavez’ relentless march toward an ever more totalitarian state. In July, Petroleum Minister Ramirez told oil workers that there must not be “a single counter-revolutionary” among them and that they will be suspected of conspiring against Pres. Chavez’ Socialist revolution if they do not join Socialist workplace groups. Last month, the regime closed 32 radio stations and two television broadcasters because it did not like the content of their programs. By the time Public Works Minister Diosdado Cabello, who also heads the nation’s telecommunications regulator, is through with his “cleansing” program, he may have taken back as many as 285 radio and television licenses, following up on Chavez’ insistence that he will not allow private networks to continue “poisoning” the public.

It may be recalled that when Chavez in 2007 refused to renew the broadcasting license of the most-watched television network, Radio Caracas Television or RCTV, that shut-down sparked nation-wide protests and was criticized by the European Parliament, the US Senate Foreign Relations Committee, and the Committee to Protect Journalists. Now, though, such a response is far less likely to happen. Chances are, there will be next to no reaction abroad and this may well help to bring about the demise of the last national television channel that is critical of the government – Globovision.

Harassment of Opposition Media

Globovision has been accused by the President of “media terrorism” and government agents have repeatedly raided the property of Guillerma Zuloaga, the president of the company, accusing him of “usury and environmental crimes” (apparently he has some African hunting trophies on his walls). Activists with the UPV, a radical Left-wing party that backs Chavez, at one point forced their way past security guards to enter Globovision headquarters and wave guns and fire teargas inside the compound. The authorities hit the company with USD 2.3 billion in back taxes, and when this money was raised via a public collection, the regime doubled the fine.

At the same time, the government has built a huge media empire for itself and now controls six of the dozen free-to-air national television channels as well as hundreds of radio stations and dozens of newspapers and magazines that spew propaganda for the President and

smear his opponents. Still, he claims that his popularity would be closer to 80% than 50%, were it not for the incessant “media lies,” and Globovision’s days of shackles-free broadcasting are probably numbered. (9/10/09)

Yemen

The country’s fragile stability is now under threat from four sources that could turn Yemen into a failed state. For now this is a risk, not a fait accompli, but if Yemen slid further into instability this would endanger its neighbors (especially Saudi Arabia), militate against efforts to fight al-Qaeda, and further complicate attempts to protect international shipping routes from piracy in the Gulf of Aden. To add to the problems, recent economic performance in Yemen has been mixed and water as well as oil resources are running out.

Yemen, which emerged in a form akin to its present one – after a long and checkered history that began with one of the earliest recorded pre-Islamic Arab civilizations – with the merger in 1972 of the Yemen Arab Republic (YAR, capital: Sana’a) and the People’s Democratic Republic of Yemen (PDRY, capital: Aden), was from the very outset fragile structure. The 1970s were a turbulent period marked by mistrust and frequent border clashes between the YAR and the PRDY. It was not until 1988 that the YAR and PDRY governments reached an agreement on renewing unification discussions and demilitarizing their borders, and the Republic of Yemen, under a unity constitution, was declared as recently as in May 1990.

At that time, a five-member presidential council assumed power and Lieut.-Col. Ali Abdullah Saleh, formerly the commander of the Ta’iz military area and the president of the Constitutional Assembly in the YAR, was appointed for a transitional period as President. By 1993, relations between the North and the South had again deteriorated, with Vice President Albidh having withdrawn to Aden to demand political reforms. Sporadic military clashes exploded into full-scale war in May of 1994 between disillusioned Southern elements and Yemen’s Northern-based government. The Southerners actually went so far as to announce their secession from Yemen,

but the Northern forces prevailed in the confrontation and Aden was captured in July of that year.

Centrifugal Forces

President Saleh was confirmed in office by parliament in October 1994 for a five-year term. He was re-elected by popular vote in 1999, although the turnout in that balloting was low (especially in the South). An extension of his term in office from five to seven years was approved in a referendum in February 2001, and in April 2003 his ruling General People’s Congress retained power in parliamentary elections with over two-thirds of the seats in the 301-member Assembly of Representatives. Not surprisingly, opposition parties charged at the time that the poll was badly marred by ballot rigging and intimidation.

We reiterate this recent history of Yemen mainly because it goes a long way in explaining why central power in this country was never fully consolidated and why centrifugal forces time and again prove too strong to be fully contained. Ali Abdullah Saleh, who is now 67 but was only 36 back in 1978, when he became President and Commander-in-Chief of the Armed Forces of the Yemen Arab Republic, has a remarkable knack for keeping friends and supporters close with an extensive and intensive patronage system and for divide, conquer, and accommodate strategies toward declared or potential enemies. These tactics have helped to keep him in power, but they have also kept the tumultuous land of feuding tribes and factions in a state of controlled chaos that is now, once again, under threat from several sources.

The Southern Insurgency

One is a renewed surge of violence in the formerly Communist South, which erupted this year after an April 28 opposition rally to mark the 1994 civil war. Armed rebels have been raising the flag of the once-independent South Yemen. A number of people were killed after demonstrators in the Abyan Province threatened to break open a local prison. Several ambushes by rebel forces left a number of police officers dead. Many Southerners, including former military officers, complain that they are being treated as second-class citizens. Sharply rising unemployment in the region has helped to fuel discontent. People in the South, where most of Yemen’s oil facilities are located, also resent what they regard as a “resource grab” by the Northerners. Some Southern leaders have been complaining bitterly about a “Northern occupation.”

Protests spearheaded by army officers (who, in turn, were upset about meager pensions after their retirement) had turned violent already in 2007. That the simmering protest movement in the South once again blew out into open rebellion is only part of the problem, as several leading political figures have recently defected from the central government. One was, last April, Tareq al Fadhli, a key ally of Pres. Saleh, who decided to join the Southern secessionist movement. Mr. Fadhli, an influential tribal leader, had fought with Osama bin Laden in Afghanistan and had helped, in 1994, to organize one-time jihadists to fight against the Southern secessionist movement.

Rebellion In the North

A second source of trouble is an insurgency in the North, where tribesmen led by the Houthi family began to stage an intermittent revolt against the government in the mountainous Zaidi Shia heartland around Sa'ada, near the Saudi border. The rebels belong to a banned organization called the Youthful Believers, driven by a complex mix of political and sectarian grievances. They are followers of a prominent Zaidi family once headed by the cleric Hussein al-Houthi. He was killed during the government's first sustained military campaign against the Zaidi fighters in 2004, and leadership of the organization then passed to his father, Badr al-Din, during a second round of fighting in 2005.

Hussein al-Houthi's brother, Abdul-Malik, now speaks for the group. The insurgents reportedly remain loyal to the memory of Hussein, but their political aims are not entirely clear. They deny that they want to overthrow the Yemeni government and reinstate the Shia Imamate that ruled Northern Yemen until the 1962 revolution. But they belong to the Zaydi branch of Shi'ite Islam (Sayyids claim descent from the Prophet Mohammed through his daughter Fatima and her husband Ali). They question the President's legitimacy, want their own schools, and insist they are defending their villages against government oppression.

They have economic as well as religious grievances, accusing Pres. Saleh (himself a Zaydi) of favoring Salafi Sunnis (who lean toward Saudi-style Wahhabi Islam). The central government has suggested that they are being morally, financially and materially supported by Iran, but the "proof" that has been published of this is rather flimsy, beyond the fact that Iran, of course, is predominantly Shi'ite Muslim. Yemeni forces have used tanks, airstrikes and heavy artillery in the latest offensive to crush the revolt. It is not clear, though, that they have the

ability to put an end to the uprising. Evident is only that in this area, as elsewhere, the policy of President Saleh to divide and rule has now run beyond his control.

Al-Qaeda Newly Resurgent

The third major problem he faces is al-Qaeda. Yemen, as has become widely known, is where Osama bin Laden's father was born. It was also the site of the bombing of the USS Cole in 2000, an al-Qaeda strike that preceded the September 11, 2001 attacks in New York and Washington. Yemen was one of the first fronts in the "Network's" battle with the United States. But after Pres. Saleh became an avowed supporter of Washington in the War on Terrorism, there was a time, a few years ago, when al-Qaeda was thought to have been defeated in Yemen and a program to de-radicalize jihadis and reinsert them into society was believed to have been so successful that European governments held it up as an example of how extremists could be turned away from violence.

Alas, the impression was deceiving. Over the past couple of years, al-Qaeda has made a strong comeback in Yemen. Recently, the country has seen a rash of terrorist acts perpetrated by the organization. Last February, Al-Qaeda's Yemen "wing" changed its name to Al-Qaeda in the Arabian Peninsula, suggesting ambitions that reach beyond Yemen's borders. The younger generation of Al-Qaeda jihadis, believed to be led by the 33-year-old Nasir al-Wahayshi (a former bin Laden secretary), seem less inclined than their predecessors to strike deals with the state and more determined to destabilize the weak Yemeni state.

Dangers For Saudi Arabia

Moreover, security officials in neighboring Saudi Arabia, which shares a 1,800-km border with Yemen, seem to think, rightly, we believe, that al-Qaeda-linked militants are training in Yemen with the goal of launching attacks in the Kingdom and toppling the Saudi royal family. A crack-down in Saudi Arabia has made it difficult, perhaps even impossible, for the jihadists to work and organize there, but there is little doubt that they are still targeting the Kingdom. Many trace al-Qaeda's regrouping in Yemen to a prison break in 2006, which left a number of senior operatives at large.

It merits pointing out that with regard to al-Qaeda, too, President Saleh played a tricky game. First, he welcomed back into the country tens of thousands of Arab fighters returning from the war against the Soviet Union in Afghanistan, many of whom had been barred

from returning to their own countries. Then, when a brief civil war broke out between North and South, he sent many of them to fight for his interests in the South. But after September 11, fearing that Yemen could become a target for an American invasion, he flew to Washington and promised Pres. Bush that he would cooperate in the War against Terrorism. He did round up thousands of jihadists, but then he let many of them go again and angered Washington by freeing key figures among them. He also maintained close ties with extremists such as Abdul Majid al-Zindani, labeled as a “specially designated terrorist” by both the US and the UN.

Refugees From Somalia

Aside from the three cited insurgencies, which he seems less and less capable of “managing,” Pres. Saleh also has to contend with a growing wave of refugees from troubled Somalia across the Gulf. Thousands of them risk their lives for the chance to be smuggled into Yemen, where they are recognized as refugees on a “prima facie basis,” meaning they are automatically granted the right to stay. A reported 12,000 are currently crammed into temporary shelters in Bossaso, from where they hope to be able to make the treacherous crossing when sea conditions get calmer in the weeks ahead. The “invasion” not only places a strain on Yemen’s limited resources, it also opens the possibility of bringing all kinds of unsavory elements to the country from Somalia, which is already a woefully failed state.

Oil Is Running Out

The convergence of all these problems, which are not actually linked, allows them to exacerbate one another in ways that are difficult to see on the surface, but worrisome in their effect. Combined with a deteriorating economy, they make for a troubling outlook. Oil exports account for about one-third of Yemen’s GDP, but production has been in decline since 2000 and in the absence of any major new discoveries reserves could be depleted in a decade. Petroleum is the source of 70%-75% of public revenues and or more than 90% of export earnings. Yet, liftings have lately averaged only 287,000 barrels a day, down from 300,000 bpd in 2008 and from a peak of 457,000 in 2002. Due to relatively low prices, oil revenues dropped 75% in the first half of this year compared with the like 2008 period.

Mixed Economic Performance

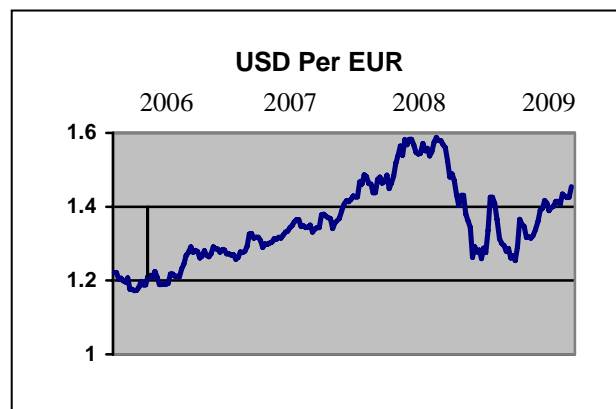
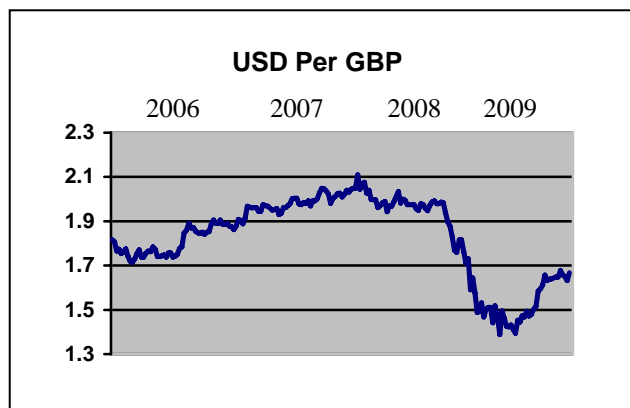
Not surprisingly, the country’s recent economic performance has been decidedly mixed. Real GDP

growth, which was 3.3% in 2007 and about 4.6% last year, even though oil prices were still high during the first nine months, should be near 5.0% in 2009 – below target because there have been delays in a USD 5-billion natural gas export project. The Central Bank predicts an expansion of 7%-8% for 2010 due to a jump in exports of liquefied gas and a variety of projects funded by foreign aid (the UK and Gulf countries have pledged nearly USD 5 billion over the coming years), but if the security forces cannot assure people that they can get the insurgencies and al-Qaeda under control, expatriates as well as foreign aid donors will get the jitters.

Water Is Drying Up, Too

Downside risks to macroeconomic stability and to the fiscal and external accounts have risen considerably in recent months and the authorities face an enormous challenge in diversifying the economy and the government’s revenue base in light of the expected exhaustion of oil reserves. The task is not being made any easier by rapid population growth, a seriously inadequate infrastructure, and weak governmental institutions. About 35% of the people are said to live in abject poverty. The global credit and economic crisis has sharply slowed the inflow of investment and remittances and, perhaps most problematic from a longer-term point of view, while Yemen was long ago dubbed Arabia Felix (Fortunate Arabia) because it was covered in fertile fields that – along with extensive trade in incense, coffee, and foodstuffs – helped make it one of the wealthiest places in the region, the aquifers that provide most of the water are now drying up. (9/10/09)

Exchange Market Trends



Short-Range Outlook

US DOLLAR, GENERAL: The greenback has now broken out of the range in which it had been trading against the euro for nearly a year and dropped this week not only against a big basket of currencies but also against gold and other commodities. The main reason: people who bought T-bills and Treasury notes when their risk aversion was high are slowly exiting these positions and shifting to higher-yielding assets elsewhere, on the assumption that the world will continue to be awash in dollars and the US Federal Reserve will be slower than other Central Banks in reversing its super-easy monetary policy. The outlook for the dollar is weak; the unit is now roughly where it was before the collapse of Lehman Brothers.

SWISS FRANC: The CHF has dropped from the strongest level versus the USD since July 2008 and against the euro, but only on speculation that Nationalbank will intervene to weaken it. Expect more backing and filling.

CANADIAN DOLLAR: As the Bank of Canada is worried that the loonie's persistent strength may threaten economic green shoots it will continue to keep Canadian interest rates as low as it can.

BRITISH POUND: Expect a stronger spell for the pound, as the notion is gaining ground that the UK economy has returned to growth in the third quarter.

Medium-Term FX Forecast – Miscellaneous

Currency	9/09/09	End-Dec 2009	End-Mar 2010	End-Jun 2010	End-Sep 2010	End-Dec 2010
Euro	1.4543	1.4700	1.5000	1.5000	1.5200	1.5500
British pound	1.6664	1.6700	1.6800	1.7000	1.7000	1.7000
Canadian dollar	0.9272	0.9300	0.9400	0.9500	0.9500	0.9700
Rand	7.5670	8.0500	8.0900	8.1000	8.3000	9.0000
Turkish lira	1.4978	1.5150	1.5200	1.5500	1.5700	1.5900

World Currency Tables

Foreign Units Per US\$

Country	Unit	9/11/09	12/31/08	%	Country	Unit	9/11/09	12/31/08	%
Algeria	DZD	72.6705	71.0299	-2.26	Kenya	KES	75.9555	77.6555	2.24
Angola	AOR	78.4560	75.2000	-4.15	S. Korea	KRW	1224.475	1339.505	9.39
Argentina	ARS	3.8469	3.4510	-10.29	Kuwait	KWD	0.2873	0.2761	-3.90
Australia	AUD	1.1578	1.4461	24.90	Lebanon	LBP	1502.50	1502.55	0.00
Bangladesh	BDT	68.8750	68.869	-0.01	Malaysia	MYR	3.4999	3.4785	-0.61
Bolivia	BOB	7.0200	7.0200	0.00	Mexico	MXN	13.3730	13.7610	2.90
Brazil	BRL	1.8124	2.3308	28.60	Morocco	MAD	7.9030	8.0199	1.48
Brunei	BND	1.4245	1.4369	0.87	N. Zealand	NZD	1.4559	1.7310	18.90
Bulgaria	BGL	1.3673	1.3959	2.09	Nicaragua	NIQ	19.9759	19.8350	-0.71
Burma	MMK	6.4350	6.4350	0.00	Nigeria	NGN	154.555	139.505	-9.74
Canada	CAD	1.0785	1.2160	12.75	Norway	NOK	5.9454	7.0114	17.93
CFA-Franc	CAF	458.505	466.989	1.85	Pakistan	PKR	82.8905	79.2050	-4.45
Chile	CLP	553.255	642.555	16.14	Paraguay	PYG	4965.05	4945.90	-0.39
China	CNY	6.8292	6.8303	0.02	Peru	PEN	2.9329	3.1470	7.30
Colombia	COP	1993.725	2248.585	12.78	Philippines	PHP	48.3650	47.5180	-1.75
Costa Rica	CRC	584.750	557.555	-4.65	Poland	PLN	2.8419	2.9605	4.17
Czech Rep.	CZK	17.4770	18.8650	7.94	Romania	ROL	2.9721	2.8513	-4.06
Denmark	DKK	5.1032	5.2897	3.65	Russia	RUR	30.8600	29.3755	-4.81
Dom. Repub.	DOP	36.0560	35.2770	-2.16	Saudi Arabia	SAR	3.7509	3.7528	0.05
Ecuador	ECS.	1.000	1.000	0.00	Singapore	SGD	1.4245	1.4369	0.87
Egypt	EGP	5.5319	5.5275	-0.08	Slovakia	SKK	20.6540	21.3950	3.59
El Salvador	SVC	8.7480	8.7520	0.05	South Africa	ZAR	7.5670	9.4600	25.02
Europ. Union	EUR	0.7013	0.7098	1.21	Sweden	SEK	6.9941	7.5729	8.28
Fiji	FJD	1.9959	1.7805	-10.79	Switzerland	CHF	1.0381	1.1555	11.31
Guatemala	GTQ	8.2545	7.7355	-6.29	Taiwan	TWD	32.638	32.527	-0.34
Honduras	HNL	18.8950	18.8950	0.00	Thailand	THB	34.055	34.585	1.56
Hong Kong	HKD	7.7506	7.7502	-0.01	Trin.Tobago	TTD	6.2905	6.3065	0.25
Hungary	HUF	185.8850	190.111	2.27	Tunisia	TND	1.3195	1.2326	-6.59
India	INR	48.634	48.465	-0.35	Turkey	TRL	1.4978	1.5360	2.55
Indonesia	IDR	9930.55	10960.00	10.37	U.A.E.	AED	3.6730	3.6725	-0.01
Iran	IRR	9950.05	9835.05	-1.16	Ukraine	UAH	8.9301	7.5625	-15.31
Israel	ILS	3.7855	3.7579	-0.73	Uruguay	UYU	22.3950	24.3990	8.95
Jamaica	JMD	88.575	79.855	-9.84	Venezuela	VEB	2.1473	2.1473	0.00
Japan	JAP	091.715	090.280	-1.56	Vietnam	VND	17822.5	17472.9	-1.96
Jordan	JOD	0.7078	0.7078	0.00	Zimbabwe	ZWD	N.A.	N.A.	N.A.

Selected International Interest Rates

As of 9/11/09

	USD	GBP	CAD	EUR	CHF	JPY
CB Rate	0.50		0.50			0.50
Prime Rate	3.25	0.50	2.25	1.00	0.52	1.48
Euro-Currency Deposit Offered Rates						
	USD	GBP	CAD	EUR	CHF	JPY
1 Month	0.70	0.66	0.45	0.41	0.24	0.22
3 Months	0.78	0.75	0.70	0.74	0.47	0.43
6 Months	1.05	1.02	1.20	1.04	0.71	0.43
1 Year	1.47	1.83	1.60	1.26	0.87	0.80

NEW YORK	LONDON	TORONTO
Federal Funds 0.15	Interbank/Sterling	Treasury Bills
Commercial Paper	1 Month 0.51	1 Month 0.11
30-59 Days 0.18	3 Months 0.67	3 Months 0.21
60-89 Days 0.22	6 Months 0.98	6 Months 0.30
90-179 Days 0.24	1 Year 1.34	1 Year 0.54
Bankers Accept.	Sterling CD's	Corporate Paper
60-89 Days 0.32		1 Month 0.38
150-179 Days 0.52	1 Month 0.52	2 Months 0.39
Certif. Of Deposit	3 Months 0.61	3 Months 0.40
30 Days 0.21	6 Months 0.86	Bankers Accept.
90 Days 0.25	1 Year 1.30	1 Month 0.29
180 Days 0.36		3 Months 0.30
Treasury Bills		FRANKFURT
1 Month 0.09		EURIBOR
3 Months 0.14		1 Month 0.48
6 Months 0.23		3 Months 0.78
1 Year 0.40		6 Months 1.06
5 Years 2.38		1 Year 1.35
10 Years 3.48		

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Exchange Cross Rates								
9/11/09	USD	CAD	JPY 100	GBP	SEK	CHF	AUD	EURO
USD		1.0785	0.9171	0.6001	6.9941	1.0381	1.1578	0.6876
CAD	0.9272		0.8503	0.5564	6.4849	1.0025	1.0735	0.6375
JPY 100	1.0904	1.176		0.6543	7.6264	1.1319	1.2625	0.7498
GBP	1.6664	1.7972	1.5283		11.655	1.7299	1.9294	1.1458
SEK	0.1431	0.1542	0.1311	0.0858		0.1484	0.1656	0.0983
CHF	0.9633	1.0389	0.8834	0.5781	6.7374		1.1153	0.6624
AUD	0.8637	0.9315	0.7921	0.5183	6.0408	0.8966		0.5939
EURO	1.4543	1.5685	1.3337	0.8727	10.175	1.5097	1.6838	
LdnGold		\$997.80	Silver		16.755	SDR	1.58228	

9/11/09	CAD	JPY	GBP	SEK	CHF	AUD	EUR
2009 Hi	1.0778	088.81	1.6776	6.9941	1.0381	1.1578	0.6876
2009 Lo	1.2907	100.42	1.4681	9.3143	1.1862	1.5851	0.7975