Stability remained largely steady across the LEGSI countries in January despite the growing threat of war in Iraq. Turkey was the exception, as the increasing likelihood of war continued to weigh on its domestic politics and security. The two other countries that suffered the largest declines in stability for the month—Hungary and Mexico—experienced domestic political troubles. Venezuela suffered only a marginal decline in stability as the opposition-led strike against President Hugo Chavez finally weakened, although this was offset by the serious damage done to the domestic economy.

After a month of sitting on the fence, Prime Minister Abdullah Gul finally announced in early February that Turkey would support US plans for a northern front against Iraq. A war, although possibly beneficial for Turkey in the medium term, is likely in the near term to hit its economy hard and stir up domestic Kurdish unrest. TV Azteca, Mexico’s second largest media conglomerate, fought a bitter and sometimes extralegal ownership dispute with Canal 40, a small television channel. Although the government intervened and the issue is back in the courts, it was accused of being negligent in preventing Azteca from taking over the Canal 40’s facility through the use of force. Tensions over free trade also took center stage in Mexico City, with farmers participating in massive anti-liberalization demonstrations. Conversely, industrial groups are demanding that Mexico stick to its NAFTA commitments. An earthquake in Colima and numerous deaths due to a fireworks accident in Veracruz also contributed to the decline in Mexico’s stability.

In Hungary, foreign traders purchased approximately 5bn euros worth of forints on the expectation that the Central Bank (NBH) would relax the currency’s fluctuation band, which in turn would lead to a further appreciation of the currency. The NBH had to cut interest rates to stop the speculative attack, but this substantially reduced the credibility of Hungary’s inflation-targeting regime and increased tensions between the central bank—specifically its governor, Zsигmond Jarai—and the government.

Venezuelan President Hugo Chavez continued to defy demands that he resign, now helped along by the opposition’s wavering over the huge economic and social costs of the two-month old strike. Chavez has begun to consolidate his position, although the social tensions are likely to remain high until both sides agree on how to end the political impasse.
**LEHMAN BROTHERS EURASIA GROUP**

**FEBRUARY 2003**

**HIGHLIGHTS**

- **Peronist primaries cancelled, for now:** President Eduardo Duhalde scored a significant political victory over his adversary, former President Carlos Menem, by convening the Peronist party's National Congress, which voted to cancel the primary elections scheduled for 23 February. Menem is not expected to retaliate by mounting legal challenges to the Congress's decision, as feared by the government.

- **IMF deal:** Argentina finally sealed an agreement with the IMF one year after negotiations began. The short-term deal was designed to permit Argentina to roll over $11bn debt payments due to international financial institutions through August 2003. In return, Argentina must maintain a primary fiscal surplus of 2.5% of GDP in 2003, increase the prices of state-regulated utilities, and keep inflation under 22%. The deal will be renegotiated if the Supreme Court rules to re-dollarize bank deposits previously converted into pesos.

**RISKS AND FORECAST**

- **The fight within the Peronist party:** Duhalde's and Menem's political ambitions continue to cloud Argentina's political outlook. If the conflict continues, it is likely to further discredit the Argentine political system and deepen the social crisis.

- **Executive-judicial conflict:** A federal electoral judge is expected to rule on whether or not the Peronist party must hold primary elections. The same judge has ruled in Menem's favor in the past. A ruling against Duhalde could set off a crisis between the executive and the judiciary, as Duhalde would be pressed to ignore the decision. The judiciary could then retaliate by ruling in favor of re-dollarizing bank deposits converted to pesos early in 2002, thus exacerbating the country's economic crisis.

- **The Peronist renovation:** Duhalde's political coalition with presidential candidate Governor Nestor Kirchner and Buenos Aires Governor Felipe Sola has the potential to become the most formidable political force in the country. If Duhalde is unable to acquire the necessary political support for Kirchner's candidacy from key governors, congressmen, and fellow party members, the coalition could falter and Duhalde may be forced to switch candidates in the last minute. The coalition may also suffer if Duhalde's wife refuses to run alongside Sola as vice governor in provincial elections.
The Argentine economy appears to be enjoying a much-needed respite after more than 12 tumultuous months of decline and high inflation. Foreign exchange volatility also appears to have subsided as the peso continues to trade at close to three to one US dollar—a level unseen since early May 2002. But the financial calm may be deceiving, as current economic conditions rest on largely unsustainable macroeconomic policies, continued capital controls, and a short-term agreement with the IMF designed to allow Argentina to fulfill its multilateral obligations in the short term. On the political front, the calm appears to be alleviating fears that President Eduardo Duhalde will again change the date for the general elections, thus unleashing a fresh wave of uncertainty. But a deeper look into the Argentine political system yields a very different view. Stability is illusory.

Even though there is a high likelihood that the general elections will in fact take place on 27 April, the current conflict between Duhalde and former President Carlos Menem does little to boost confidence in the political system and the electoral timeline. Duhalde has been frantically searching for ways to curb Menem’s presidential ambitions. Duhalde struck a significant political victory at Menem’s expense when he successfully convened the party’s National Congress and abolished the party primaries. Duhalde is betting that it will be much more difficult for Menem to win the presidency if he has to run against other Peronist candidates such as former President Adolfo Rodriguez Saá and Governor Nestor Kirchner. The hope is that the dispersal of Peronist votes, along with Menem’s high rejection levels in the population at large, will end his presidential bid.

Aware of its minority support in the Peronist Congress, Menem’s camp turned to the judiciary. It requested that electoral judge Maria Servini de Cubria force the party to hold primaries. On 22 January, one day before the Congress convened, Servini ruled against Duhalde’s proposal that more than one candidate from each party run in the general elections and that all parties be prohibited from selecting only one candidate. The ruling was controversial, and politically driven, as Servini ruled on something that Duhalde may have been planning, but had not yet occurred. Duhalde and the Congress decided to appeal the decision and went ahead with their plans, arguing that the appeal suspends the first instance ruling. The matter will have to be resolved by the Chamber of Appeals (which has a reputation for political independence) and, eventually, by the Supreme Court in coming weeks.

The fact that an appeal by Duhalde’s faction is still under consideration means that political or judicial developments could change the electoral framework, thereby continuing to foster uncertainty. If the most likely scenario takes place and a federal electoral judge rules in favor of Duhalde’s plan to discard the primaries, then the general elections should be held on 27 April. Naturally, Menem is unlikely to accept political defeat and will retaliate in some fashion. Splitting off the Menemist bloc is possible, though unlikely, as Menem has more to gain from maintaining close ties with the party than from breaking with it.

Were the judiciary to rule against Duhalde and primaries be imposed upon the Peronist party, one of two equally unsettling consequences could result. First, Duhalde could choose to disregard the ruling, setting off a constitutional crisis at a time when the judiciary still has to rule on the delicate question of re-dollarizing the deposits that had been converted into pesos early in 2002. Re-dollarization is one of the biggest threats to government stability at this time, and a conflict between two branches of government would further erode confidence in the Argentine political class, undermining the country’s institutions. Second, the general elections could be postponed because the Peronist party would not be able to organize the primaries in time—they would have to be held on 23 February. The party would be forced to reschedule the primaries and the government would be forced to reschedule the general elections. Again.
**DUHALDE FINDS A CANDIDATE**

After several unsuccessful attempts to find a candidate who could successfully challenge former President Carlos Menem for the Peronist party’s presidential bid, President Eduardo Duhalde finally settled on Governor Nestor Kirchner. According to their deal, the governor of Santa Cruz would become the official candidate, thus obtaining support from Duhalde and his allies within the party—such as Buenos Aires Governor Felipe Sola—while Duhalde would have a candidate both capable of defeating Menem and unwilling to trespass on Duhalde’s Buenos Aires stronghold (and, perhaps, even to refrain from standing for re-election in 2007, thereby allowing an eventual return by Duhalde). The agreement creates what is surely the most important political force in the country—the so-called Peronist Renovation coalition.

Although Kirchner is poised to become a significant political force with Duhalde’s support, some risks remain. The Duhalde-Kirchner-Sola axis does not rest on the support of Governors Carlos Reutemann and Jose Manuel de la Sota—both of whom play significant roles within the Peronist party. Reutemann and De la Sota have preferred to adopt a neutral stance with regard to the Duhalde-Menem conflict thus far. There are also some sectors close to Duhalde that have not accepted his support for Kirchner. Duhalde will have to quickly incorporate these dissidents in the Peronist Renovation if he wishes to see Kirchner win the presidency. Duhalde is likely to use the vice-presidential and vice-gubernatorial candidacies as a means of convincing dissidents to subscribe to the Renovation. Duhalde will undoubtedly have a key role in deciding Kirchner’s and Sola’s running mates. The former’s running mate is likely to be one of the Buenos Aires province party bosses such as Alberto Balestrini or Julio Alak—mayors of two of the most important counties, La Matanza and La Plata respectively. Another possibility would be a prominent member of the administration, such as Finance Minister Roberto Lavagna.

Further complicating Duhalde’s coalition is the fact that Felipe Sola’s re-election to the Buenos Aires governorship is not as certain as he would like. Duhalde’s wife, Hilda “Chiche” Duhalde, who was poised to become Sola’s running mate, surprisingly declined the offer, shaking the foundations of the Duhalde-Kirchner-Sola coalition, which was predicated on Duhalde’s full support for Sola’s candidacy in Buenos Aires. Chiche’s own aspirations—she had previously stated that she wanted to run for governor—could significantly undermine her husband’s efforts to build a successful political coalition. She would have ensured Duhalde’s presence in the Buenos Aires administration and signaled his support for Sola. Duhalde has a tough road ahead and little time to shape his political project if, in fact, general elections are to be held on 27 April.

Governor Nestor Kirchner of Santa Cruz has the potential to become the strongest political force in Argentina ahead of the elections on 27 April.

- Kirchner is a candidate with relatively good numbers in the polls (close to 17%)
- President Duhalde’s expressed support should improve Kirchner’s visibility
- Kirchner can count on valuable federal government resources
- He can count on the support of Governor Felipe Sola of the crucial Buenos Aires province and of five other Peronist governors close to Duhalde
Government
- President Eduardo Duhalde successfully convened the Peronist party's National Congress, which voted to annul the primary elections scheduled for 23 February. Duhalde continued to vow that the 27 April general elections would be held as planned.
- Duhalde launched the Peronist Renovation coalition along with his newfound presidential candidate Governor Nestor Kirchner.

Society
- The government decreed a Necessity and Urgency Law, which temporarily authorizes electricity and gas tariff hikes by 7%-20%.
- The World Bank authorized a $600mn loan to help the Argentine government carry out faltering social policies. These include a job creation plan in which the government is committed to find employment for at least two-thirds of eligible beneficiaries.

Security
- Brazilian President Luiz Inacio “Lula” da Silva’s efforts to reinvigorate the South American trade pact, Mercosur, were welcomed by the Argentine government. Duhalde and Lula discussed the creation of a common currency, the peso real, in addition to a popularly elected Mercosur parliament. They also agreed to increase security along the Triple Border (between Brazil, Argentina, and Paraguay), an area known to harbor terrorists.

Economy
- The IMF reached a short-term agreement with Argentina to postpone debt payments due to multilateral organizations by one to five years. The agreement, which will last until 31 August, refinances $11bn of payments due international financial institutions in 2003. Argentina committed itself to maintaining fiscal surpluses of 2.5% of GDP throughout the year and keeping inflation below 22%. The agreement will have to be renegotiated if the Supreme Court re-dollarizes deposits previously converted to pesos.
Section 907 suspended: President George W. Bush prolonged the terms of suspension of Section 907 of the Freedom Support Act banning US government assistance to Azerbaijan due to the Nagorno-Karabakh conflict with Armenia.

Controversy over Justice Ministry decision: Under pressure from opposition and international observers, President Heydar Aliyev overturned a Justice Ministry decision to withdraw the registration of the opposition People's Front of Azerbaijan.

Baku-Supsa incident causes concern: The BP-operated Baku-Supsa oil pipeline was ruptured on 18 January near the Georgian city of Gori, increasing concerns over pipeline security.

External financing might be delayed: External financing of $600mn in loans by multilateral organizations for the Baku-Tbilisi-Ceyhan (BTC) oil pipeline could be delayed until the second half of 2003 due to increasing pressure from environmental protestors.

Police raid in Nardaran: Seventeen people were injured after police raided the village of Nardaran near Baku. The incident brought immediate condemnation from local human rights activists and the Organization for Security and Cooperation in Europe.

Decree on BTC restructuring: On 24 January President Aliyev issued a decree on restructuring the State Oil Company of the Azerbaijani Republic (SOCAR), aimed at transforming the legal and managerial structure of SOCAR and its enterprises.

Post-Aliyev succession: It is unclear whether the government would remain cohesive if the ailing President Aliyev were suddenly to depart from office, thus forcing a choice of successor. Ilham Aliyev, the president’s son and first vice president of SOCAR, remains the most likely successor.

Nagorno-Karabakh: The unresolved conflict over the now predominantly ethnically Armenian region within Azerbaijan remains the most significant threat to stability. A military confrontation with Armenia would result in massive refugee inflows and capital flight, destabilizing the entire region.

Tensions over Caspian Sea: A multilateral agreement on borders between all five littoral states is proving elusive. Iran and Turkmenistan have pushed for dividing the sea into five equal sectors, while Azerbaijan, Kazakhstan, and Russia contend that the sea floor should be divided into national sectors.

Energy prices: Azerbaijan’s sensitivity to energy prices makes it extremely vulnerable to a decline in oil prices. Oil provides almost 30% of Azerbaijan’s budget receipts.
SECURITY CONCERNS AND PROTESTS THREATEN PIPELINE PROJECTS

External financing of $600mn in loans by the European Bank of Reconstruction and Development (EBRD) and the International Finance Corporation for the Baku-Tbilisi-Ceyhan (BTC) oil pipeline could be delayed until the second half of 2003 due to increasing pressure from environmental protestors. The protests have focused on the threat that the project could pose to Georgia’s ecologically sensitive Borjomi Valley, the source of highly prized mineral water.

The multilateral organizations’ nervousness is a further indication of the difficulties that the pipeline’s 11-member consortium, led by BP, faces in finalizing terms for external financing, which is supposed to cover three-quarters of the project’s cost. The consortium members originally hoped to have all external credits and loans in place by the first quarter of 2003, but international banks closely examined the project in light of its high cost, technical challenges, and environmental and security concerns. The equity financing that has already been secured could therefore run out in April or May. Since the first pipes have already been delivered to Baku and construction is due to begin on 1 April, the consortium members may have to finance the project themselves for an undetermined period. Although these difficulties do not threaten the project, equity financing could pose an added challenge to the consortium’s smaller members, especially the State Oil Company of the Azerbaijani Republic, (SOCAR) which has a 25% stake in the pipeline.

The New Azerbaijan Party administration has announced that it will allocate $3mn to ensure the safe operation of the BTC pipeline. According to the Azeri Finance Ministry, the State Commission on Security of Export Oil and Gas Pipelines, which was set up in April 2002 to address safety issues, will be in charge of the funds. Azerbaijan’s Ministry of Internal Affairs also announced the establishment of a special Department for Safety of Export Pipelines under its Chief Office of Public Security. In January, Georgia stepped up security along its section of the planned route by hiring a US security firm. Security remains a concern after the BP-operated Baku-Supsa oil pipeline was ruptured on 18 January near the Georgian city of Gori, increasing fears of possible terrorist attacks. The incident, according to green groups, lent weight to their contention, that despite assurances from the oil companies, the BTC pipeline could leak. The rupture underlined a major weakness of the BTC project—the security risk of building the pipeline through Georgia, where the rule of law is perilously weak. Groundbreaking for the long-delayed BTC pipeline was held in September 2002, but the first pipe is to be laid in April 2003.

DECREE ON SOCAR AND SOFAR RESTRUCTURING RELEASED

On 24 January President Heydar Aliyev issued a decree on restructuring the State Oil Company of the Azerbaijani Republic (SOCAR). The main parameters of the decree are aimed at transforming the legal and managerial structure of SOCAR and its enterprises. Under the decree, the onshore and offshore oil and gas production units of SOCAR will be combined into the Azneft production unit, while a marketing and economic operations department will be established on the basis of the merger of the foreign economic relations department and the technology unit. Three enterprises—the Offshore Drilling and Construction Unit, the Offshore Social Construction Unit, and the Auto-Transportation Unit of SOCAR—are to be privatized.

SOCAR President Natiq Aliyev assured employees that very few would be dismissed due to the restructuring, but some could be transferred to other jobs in the company.

Aliyev also signed on 7 February a decree to regulate the activities of the State Oil Fund, in line with IMF recommendations. The decree significantly expands the sources of the Oil Fund’s revenues. For instance, among the sources of the fund’s additional revenues, the decree mentions profits from the

Lehman Brothers Eurasia Group Stability Index (LEGSI) · February 2003
EBRD gives go-ahead on Shah Deniz project

In a related development, the European Bank of Reconstruction and Development (EBRD) has agreed to lend the SOCAR $250mn on 27 February toward its stake in the Shah Deniz Caspian natural gas project. SOCAR owns 10% of the $3.2bn Shah Deniz project and will invest the remaining $70mn from its own funds. Oil majors BP and Statoil jointly own 51% of the Shah Deniz project, which is expected to deliver up to 6.6bn cubic meters of gas to Turkey. Other shareholders in Shah Deniz include TotalFinaElf with 10% and the Turkish company TPAO with 9%.

US COLLABORATION INCREASES AS PROBLEMS OVER CASPIAN PERSIST

President George W. Bush prolonged the terms of suspension of Section 907 of the Freedom Support Act banning US government assistance to Azerbaijan due to the conflict over the status of the Nagorno-Karabakh enclave. In return Azerbaijan promised to cooperate with the US in its anti-terrorist campaign. In addition, an Azerbaijani-American agreement on drug control and assistance to Azerbaijan law-enforcement bodies was signed on 3 January. The Azerbaijan Foreign Ministry stated on 11 February that it backed US efforts to rid Iraq of weapons of mass destruction.

Foreign Minister Vilayet Guliyev met on 14 January with the Special Representative of Iranian President on the Caspian question Mehdi Safari to discuss differences regarding the division of the Caspian Sea’s natural resources. The planned signing of a framework convention on protection of the Caspian Sea environment, scheduled for Tehran on 25-26 January, was postponed indefinitely.

TALKS OVER ELECTORAL CODE CONTINUE

Organization for Security and Cooperation in Europe (OSCE) Baku Representative Peter Burkhard and opposition representatives met on 10 February to discuss the ongoing dialogue between the opposition and the authorities on the draft electoral code. The opposition accuses the OSCE of being weak and indecisive and the authorities of being unwilling to make concessions. The opposition has set four conditions for participating in Election Code roundtables: that the authorities and opposition be equally represented, that the opposition be represented on working groups tasked with amending the draft electoral code, that the roundtable be broadcast in full, and that a conciliation commission including the opposition be set up to seek a consensus with the Azerbaijani leadership on disputed articles of the Election Code. The government has agreed to the first three conditions but rejected the proposed conciliation commission.

NARDARAN RAID GENERATES CRITICISM

Azerbaijani security forces on 5 February raided Nardaran, a village that has become a flashpoint for anti-government rallies. Eight villagers were detained; the authorities reportedly used an unknown gas that resulted in injuries. The Interior Ministry refused to comment on the raid. Some 3,000 villagers gathered to protest, demanding that the Azerbaijani leadership resign for having responded with violence to their legitimate demands for solutions to socio-economic problems.

Nardaran has been a flashpoint since June when police opened fire on protesters demanding better services; particularly clean drinking water and heating gas. One villager was killed, 15 received gunshot wounds, and another 50 suffered injuries. Since then, the village has witnessed several protests, which the government blames on Islamic extremists. Hajiaga Nuriyev, a leader of the Islamic Party of Azerbaijan, and other protest organizers dismiss the allegation of extremism and insist they are only demanding better social services.
LEMSI SUMMARY · FEBRUARY 2003

Government
- Under pressure from opposition and international observers, President Heydar Aliyev overturned a Justice Ministry decision to withdraw the registration of the opposition People’s Front of Azerbaijan.
- Organization for Security and Cooperation in Europe (OSCE) Baku Representative Peter Burkhard and opposition representatives met on 10 February to discuss the ongoing dialogue between the opposition and the authorities on the draft electoral code.

Society
- Seventeen people were injured after police raided the village of Nardaran near Baku. The incident brought immediate condemnation from local human rights activists and the OSCE.
- On the occasion of the Eid el-Adha Muslim holidays, Aliyev pardoned 116 prisoners, the majority of whom had been detained due to political reasons.

Security
- President George W. Bush prolonged the terms of suspension of Section 907 of the Freedom Support Act, which banned US government assistance to Azerbaijan due to the Nagorno-Karabakh conflict with Armenia.
- The BP-operated Baku-Supsa oil pipeline was ruptured on 18 January near the Georgian city of Gori, increasing concerns over pipeline security. The government has announced that it will allocate $3mn to ensure the safe operation of the Baku-Tbilisi-Ceyhan (BTC) pipeline.
- The planned signing of a framework convention on protection of the Caspian Sea environment, scheduled for Tehran on 25-26 January, was postponed indefinitely.
- Russia’s Defense Minister Sergei Ivanov announced on 11 February that there were Chechen terrorists in Azerbaijan, including high-ranking individuals from the 1994-1996 wars in Chechnya.

Economy
- On 24 January President Aliyev issued a decree on restructuring the State Oil Company of the Azerbaijan Republic (SOCAR), aimed at transforming the legal and managerial structure of SOCAR and its enterprises.
HIGHLIGHTS

- **From Porto Alegre to Davos and back:** President Luiz Inacio Lula da Silva made his annual pilgrimage to the World Social Forum in Porto Alegre, a gathering of progressive organizations from around the world. Immediately afterwards he flew to Davos to attend the World Economic Forum, where he called for an international campaign against hunger. Lula was warmly welcomed at both gatherings, although radical-left sectors of his party criticized his attendance at Davos.

- **Lula falls just short of a legislative majority:** January was all about political maneuvering before the inauguration of Congressional sessions. Twenty-six deputies changed parties, abandoned the opposition, and joined Lula’s coalition. As a result, Lula’s legislative support now stands at 254 deputies and 31 senators, or 49.51% of the Lower House and 38.27% of the Senate. Lula also hammered together an informal, though unstable alliance with the Democratic Movement Party (PMDB). With it Lula has the two-thirds majority needed for constitutional change.

- **What friends are for:** Brazil’s attempt to address the crisis in Venezuela has been well received in the international community. The Friends of Venezuela include Canada, Chile, Mexico, Portugal, Spain, the US, and of course Brazil. Venezuelan President Hugo Chavez insisted on including Cuba, China, Russia, Trinidad, and Algeria, but to no avail. The initiative also caused a rift between the governing Workers’ Party (PT) and Itamaraty, the Brazilian Foreign Ministry, over who has control of foreign policy in Lula’s administration. It remains to be seen whether the Friends of Venezuela will actually make a difference.

RISKS AND FORECAST

- **Full stop ahead?** Economic activity in Brazil will continue to slow down. The government is implementing $4bn in budget cuts to reach a 4.25% GDP primary surplus, while the Central Bank has raised interest rates to 25.5%. The measures are creating a fissure within the Workers’ Party.

- **House divided:** The legendary unity and discipline of the Workers’ Party (PT) is faltering. As the Lula administration implements pragmatic measures to ensure governability and economic stability (including alliances with controversial politicians and orthodox fiscal and monetary measures), some members of the PT are rebelling. This group may have as many as 25 members in Congress, thus posing a threat to Lula’s fragile majority.
BRAZIL

**Political system comes to terms with new government**

“Long divided must unite, long united must divide” are the words with which The Romance of the Three Kingdoms, the greatest Chinese epic, starts in order to explain the organic nature of power. Today Brazil is in a similar process of political realignment. Since the election of Luiz Inacio Lula da Silva as president in late October, political affiliations have become fluid as parties and personalities pursue their principles and interests in changing political circumstances.

**Discussion centers on government coalition**

One of the greatest concerns during the presidential campaign was whether Lula and his Workers’ Party (PT) would be able to forge a working coalition capable of passing structural reforms in Congress. After all, President Fernando Henrique Cardoso nominally enjoyed the support of over 70% of the Lower House and over 80% of the Senate and yet he was always involved in horse-trading. Could Lula forge such a coalition? The answer turned out to be no. He did manage to assemble a coalition of 13 parties, mostly from Brazil’s fractious left. As a result, Lula’s coalition consisted of 228 deputies and 31 senators, that is, 44.44% and 38.27% of each house.

**Party discipline is low; politicians cross aisle frequently**

But Brazil’s party system is quite fluid, and it is not uncommon for politicians to change parties after being elected. But never before had Brazil seen a political migration like the one that happened after Lula’s landmark victory. A total of 26 deputies decided to avoid the rigors of opposition and joined the government coalition. As a result, Lula now has the support of 254 deputies, or 49.51% of the Lower House.

**Lula recruits PMDB, support is weak**

The PT and the Democratic Movement Party (PMDB) also came to a working agreement to elect the leaderships of both the Lower House and the Senate. The Lower House presidency went to Joao Cunha of the Sao Paulo PT. The Senate presidency went to former President Jose Sarney, a decision first rejected but after much work and many assurances, finally accepted by the PMDB leadership. The government now has a working relationship with the PMDB, one that could produce the two-thirds majority needed for constitutional reform. But relations with the PMDB remain fragile.

**Opposition supports government’s agenda**

The opposition consists of the Social Democratic (PSDB), Liberal Front (PFL), Democratic Movement (PSDB), and Brazilian Popular (PTB) parties, the core of which is the PSDB-PFL axis. This center-right coalition has advocated structural reforms for the past 17 years. But the PT and its center-left alliance are now promoting the PSDB-PFL’s main proposals for structural reform. It would therefore be difficult for the opposition to reject the very policies it promoted for so many years. The real opposition to Lula’s policies is thus unlikely to come from the official opposition.

**Real opposition is in president’s party**

Opposition to Lula comes from inside the PT. His own party is divided. The PT, famous for the discipline and unity forged by years in the opposition has become unruly in power. Ideological disagreements have come to the fore such as the budget cuts, primary surplus targets, interest rate hikes, and many other measures taken by Lula’s economic team appear to contradict some of the party’s traditional stances. Equally controversial are the concessions made to other parties, particularly the PMDB, in the name of legislative majorities and governability. Lula’s alliance with Sarney, Antonio Carlos Magalhaes, and Delfim Netto is also anathema to an important sector of the party.

**Inertia has government working as opposition and opposition as government**

Political inertia may be at work here. The PSDB, the PMDB, and the PFL only know how to be government parties and are unused to attacking the government at the expense of their own beliefs; the PT and some of its allies are too used to being in the opposition to throw their weight against their own beliefs. Both sides must learn to play different roles. But the real question is whether the PT can avoid transforming the current fissure into an ideological divide.
Of the 91 PT deputies in the Lower House as many as 25 belong to an emerging dissident wing. This group is hardly monolithic. There are, it seems, three subgroups: six ultra-left deputies, eight moderate legislators, and eleven non-confrontationists. More important, this is not a backbencher rebellion; there are several PT leaders in the dissident bloc. The most visible are Senator Heloisa Helena (PT-Alagoas), Deputy Luciana Genro (daughter of Lula’s Minister of Socioeconomic Affairs), and Jose Batista Araujo “Baba”. Lula and Jose Dirceu, his main political operator, want to quell this rebellion before it grows into an embarrassing divide similar to the one that plagues the PMDB, where a third of the party actively opposes the rest, yet sees no advantage in abandoning the party.

However confusing, such fluidity does not preclude bold initiatives in social security and fiscal reform. Quite the contrary, with adept maneuvering Lula could easily succeed in advancing his agenda. Even so, lax party discipline remains a problem for both the government and the opposition, and both might be tempted to pursue political reform before social and economic reform. Such a course of action would be risky.

Political reform is a charged and contentious issue. True, if political reform is highly successful, Brazil could attain greater governability and party consolidation. If, as is more likely, political reform proves half-hearted, the political system will further balkanize and economic reform might die. Lula should strive to promote party discipline with the tools at hand and proceed with social and economic reforms now. In the end, that was the people’s mandate.
Government

- President Luiz Inacio Lula da Silva made his annual pilgrimage to the World Social Forum in Porto Alegre, a gathering of progressive organizations from around the world, and from there he flew to Davos (despite some domestic criticism) to attend the World Economic Forum. He was warmly welcomed at both conferences. In Davos, he called for an international campaign against hunger.
- Twenty-six deputies abandoned the opposition, and joined Lula’s coalition. As a result, Lula’s legislative support now stands at 254 deputies and 31 senators, or 49.51% of the Lower House and 38.27% of the Senate. Lula also hammered together an informal though possibly unstable alliance with the Democratic Movement Party (PMDB). If he can count on its votes, Lula will be able to promote constitutional change.

Society

- After 30 years of fierce discussions in Congress, Brazil has a new Civil Code affecting commercial contracts, family issues, real estate, and bequests. The new code is far from perfect, as the requirements for establishing new businesses are considered highly restrictive.
- Popular participation remains at an all-time high in Brazil. Over 150,000 people attended Lula’s inauguration as president. A few days later, over 100,000 attended the World Social Forum in Porto Alegre even though most Brazilians were enjoying their summer holidays.

Security

- Brazil’s attempts to address the crisis in Venezuela has been well received. The Friends of Venezuela include Canada, Chile, Mexico, Portugal, Spain, the US, and of course Brazil. The formation of the group caused a rift between the Workers’ Party (PT) and Itamaraty, the Brazilian Foreign Ministry, over who has control of foreign policy in Lula’s administration. It remains to be seen whether the Friends of Venezuela will actually make a difference.

Economy

- Brazil increased its primary surplus targets for 2003. From the previous projection of 3.75% of GDP, Brazil will now aim at a 4.25% of GDP. To achieve such a Herculean task, the government has already announced budget cuts of $4bn. The decision is adding fuel to internal dissent within the Workers’ Party.
- The Monetary Policy Committee (COPOM) decided again to raise the interest rate (Over-Selic) from 25% to 25.5%. Since mid-October interest rates in Brazil have jumped from 18% to the current 25.5% in order to meet market fears and inflationary pressures.
Lehman Brothers Eurasia Group Stability Index (LEGSI):

**CHINA**

**HIGHLIGHTS**

- **Migrant workers get more protection:** The State Council issued on 5 January a new directive on reducing discrimination against rural migrants in urban areas. The directive recognizes their “legal right” to work in cities and have their children enter urban state schools. It also requires employers to sign contracts with migrants and, in case of bankruptcy, to pay migrant workers before paying other debts.

- **Hong Kong government tones down anti-subversion proposal:** Following a three-month consultation process, the Hong Kong government released its changes to a consultation paper on how to implement the anti-sedition provisions of Article 23 of Hong Kong’s Basic Law. The changes limit the government’s ability to interfere with basic freedoms in Hong Kong. The draft was published on 14 February and legislative deliberation is expected to begin 26 February.

- **Cisco files patent suit against Chinese firm:** Cisco Systems, one of the largest computer hardware firms in the US, filed on 23 January a lawsuit in Texas against Huawei Technologies Co. Ltd, China’s largest telecommunications equipment manufacturer, alleging patent and copyright infringement of software and printed manuals. Huawei withdrew its products from the US market after the lawsuit.

**RISKS AND FORECAST**

- **Jiang likely to stay at CMC:** President Jiang Zemin is likely to retain the chairmanship of the Central Military Commission (CMC) after the National People’s Congress in March. His staying on as CMC chair will probably result in a continuation of policies from the Jiang era. Zeng Qinghong, Jiang’s close political aide, is tipped to become vice-president. Both developments are expected to limit in the near term General Secretary Hu Jintao’s ability to consolidate his leadership position.

- **Administrative downsizing:** The National People’s Congress is expected to adopt a plan to reduce the number of government ministries by almost a fourth—from 29 to 22—at its annual meeting in March. The overall intent is to reduce the state’s control of the economy and improve the management of state assets. Two important ministries, agriculture and energy, may also be upgraded to underline the government’s commitment to addressing rural poverty and improving energy security. China will also need strong policy reforms in these areas to complement the administrative changes.
CHINA'S MIGRANT WORKERS GET A BREAK

Recognizing both the benefits of rural migration and the potential of migrants to be a source of unrest, the government has begun to take steps to alleviate their plight. A directive issued by the State Council on 5 January states that all urban trades and types of work should be open to migrants from rural areas. It also requires employers to sign contracts with rural migrants and, in case of bankruptcy, to pay them before settling other debts. Also, urban state schools now have to open their doors to the children of migrants.

So far, the demands of migrant workers have been limited to grievances about their pay and working conditions. In Beijing, several hundred workers barricaded a luxury villa in mid-January, demanding that they be paid their wages. Workers threatened to jump off a skyscraper in Shenzhen last month, again because of unpaid wages. The situation was compounded by the fact that many workers were traveling to their home provinces for the Lunar New Year at the start of February and needed the money for both their fares and gifts.

China officially counts 94 million migrant workers, most of them squeezing a living from menial jobs in the cities. Migration, which has become commonplace as a result of more than two decades of economic transformation, is likely to continue as China opens up its economy. The government sees migration as a means of improving rural incomes, defusing the employment problem in the countryside, and easing wage pressures in the more prosperous cities and provinces. The presence of rural migrants in the cities is becoming a source of tension, however, with some of them being blamed for such problems as petty crime.

Providing a reliable estimate of the total number of migrant workers in China has never been easy, as municipal governments only count documented migrants. Yet, there is general agreement that the number is down—by some estimates up to 50% lower from its peak in the mid-1990s, when migration surged during the construction and manufacturing boom following Deng Xiaoping’s call for radical economic reform. Agricultural reform and increased global integration as a result of WTO accession may provide the impetus for the next round of migration. There may already be as many as 150 million unemployed farmers.

Protests related to working conditions and wages are likely to become a regular fixture of migrant workers’ activities, but they are unlikely to affect China’s stability as long as the workers remain uncoordinated and unorganized. For its part, the government is likely to continue with incremental steps to improve the conditions of migrant workers and to allow small-scale protests, as long as workers’ demands are restricted to direct grievances against their employers. Beijing will not allow larger protests, which have the potential to metamorphose into political or social demonstrations. Hence, the government’s swift arrest of worker activists Yao Fuxing and Xiao Yunliang, who had led large protests in the northeastern rustbelt city of Liaoyang in March 2002.

GOVERNMENT CHANGES IN THE WORKS AT ANNUAL LEGISLATIVE CONGRESS

Two important political changes are likely to take place during the annual meeting of China’s legislature, the National People’s Congress (NPC), which begins 5 March in Beijing. First, China ends its formal leadership transition with the accession of Communist Party General Secretary Hu Jintao to the presidency and Vice-Premier Wen Jiabao to the premiership. Jiang Zemin is scheduled to step down as president, but he is expected to retain the chairmanship of the powerful Central Military Commission. Second, the NPC is expected to formally adopt a government reorganization plan that may cut the number of state ministries by up to a fourth, from 29 to 22, and reduce the state’s role in economic control and planning.
Jiang's hold on military commission seen to continue

Jiang Zemin's continued stay at the CMC has been taken for granted in the last few months, with the focus now being on how long he will hold on to the position. The CMC chairmanship, together with the fact that he has at least five allies in the Politburo Standing Committee, gives Jiang the ability to influence China's politics and government and may in the short run lead to policy continuity and stability. The big question is when and how General Secretary Hu will try to assert himself within the top leadership. Hu has already begun to indirectly challenge Jiang's power by emphasizing that no individual is above China's constitution and by trying to associate his thoughts with the aspirations of China's masses. Unless precipitated by a crisis, a serious consolidation or loss of power by Hu may still be years away.

Government wants bureaucracy to be in tune with needs of market economy

Administrative changes due at the Congress are the reduction in the number of government ministries by up to a fourth, from 29 to 22, and the reduction of the state's role in the planning and control of the economy. The State Development Planning Commission is expected to absorb the Reform of Economic Systems Office and become the State Development Commission (SDC). Its planning function, a relic of the centrally planned economy, would be dropped. A new Ministry of Commerce may be created out of the Ministry of Foreign Trade and Economic Cooperation and the State Economic and Trade Commission (SETC) to oversee both domestic and foreign trade to emphasize that the two are linked. The SETC's role in channeling investment funds to state enterprises may be turned over to the SDC. A new Commission for the Administration of State Assets will take over 11tn yuan ($1.2tn) of assets now inefficiently managed by nine different ministries.

Real reform will take time

It will take time for the reforms to work. Some initial confusion on the jurisdictions, powers, and operations of the new agencies are to be expected. China has not always had success with bureaucratic reform, the most notable recent example of which is the inefficient Ministry of Information Industry, created in 1998 by the merger of the Ministry of Post and Telecommunications and the Ministry of Electronics and Information. The new ministry failed to deliver increased efficiency and even stifled the reform-oriented Ministry of Electronics and Information. The bigger challenge, however, will be on how the new agencies will keep the government's regulatory and administrative mechanisms in step with the needs of the market, and to move away from the state-wide planning and control system that had been one of the pillars of the communist economic structure.

HONG KONG GOVERNMENT BENDS A BIT OVER ARTICLE 23 DISPUTE

The Hong Kong government amended its proposals on how to implement the anti-subversion provisions of Article 23 of Hong Kong's Basic Law. Pro-democracy and human rights groups continued to voice their concerns, although journalists and businessmen welcomed the changes. The amendments limit the kind of information the disclosure of which would be penalized and restrict the law's applicability to Chinese nationals and outlawed mainland groups.

Hong Kong government amends anti-subversion law proposal

Apparently confident that it had won over a substantial portion of dissenters with the changes, the Hong Kong government published the draft bill on 14 February, and announced that the legislature would begin deliberations on 26 February. With businessmen and journalists apparently more at ease with the draft law, it is likely that apprehension over the bill will subside.
Government
- The Hong Kong government released amendments to its consultation paper on how it plans to implement the anti-subversion provisions of Article 23 of the Basic Law. Journalists and business groups greeted the changes, while human rights groups and the political opposition remained cautious.
- The government issued a new directive requiring 30 million state employees to pass job skills tests within the next three years before they can sign employment contracts with the government. The radical measure has two objectives: to cut government costs and to ensure that government personnel have the right skills for their jobs.

Society
- The State Council issued new regulations on 5 January aimed at reducing discrimination against rural migrants working in cities. Migrants now have the right to work in all urban trades and types of work. Employers are required to sign contracts with the migrants and, in case of bankruptcy, to pay them before other debts are paid. Urban state schools also have to accept the children of migrant workers.
- The Supreme People’s Court issued a regulation allowing parties with civil disputes against state-owned enterprises, such as employees and creditors, to seek redress in court.

Security
- China continued to maintain a low-key stance on events in the Korean peninsula, advocating dialogue and refusing to push for North Korean disarmament.
- Taiwanese airlines flew to the mainland for the first time since the communist takeover in 1949. The flights were limited to the days surrounding the Lunar New Year Holidays and had to stop over in either Macau or Hong Kong.

Economy
- Cisco Systems sued Huawei Technologies, China’s largest telecommunications equipment manufacturer, in a US court for patent infringement.
- Chinese officials led by Vice-Premier Wen Jiabao continued to dismiss talk of a yuan revaluation despite allegations that China’s currency was undervalued and that it was exporting deflation.
Lehman Brothers Eurasia Group Stability Index (LEGSi):

COLOMBIA

HIGHLIGHTS

- **Massacre in Bogota:** On 7 February a car bomb exploded in the exclusive El Nogal club in Bogotá, killing 35 people and injuring dozens. The attack is the most brutal terrorist action in years. Although no group has claimed responsibility, the massacre has been attributed to the Revolutionary Armed Forces of Colombia (FARC), the main left-wing guerrilla group in the country. In recent years, the FARC has been displaying increasing operational capacity in urban warfare enabling it to strike affluent and well-guarded neighborhoods.

- **Bureaucratic overhaul:** President Alvaro Uribe dismissed 714 officials and reducing the number of ministries to 13. The overhaul is part of an ambitious plan to streamline Colombia’s bureaucracy and reduce costs. The government aims at $20bn pesos in savings every year starting in 2005.

RISKS AND FORECAST

- **Fasten your seatbelts:** The most optimistic scenarios for peace talks between the government and the country’s insurgent groups have been shattered by the kidnapping of two journalists, the news that some AUC paramilitaries pulled out from negotiations, and the brutal terrorist attack in Bogotá on 7 February.

- **Divided we stand:** The referendum on political reform, a cornerstone of Uribe’s reforms, has succeeded in dividing the political class into supporters and opponents of the measure. If the divisions widen and deepen, the referendum could quickly turn into a serious problem for the Colombian government.

- **Problems in the neighborhood:** The two-month national strike in Venezuela has begun to affect Colombia’s economy. Total exports account for 13% of GDP and Venezuela accounts for 10% of those exports. Colombia’s exports to Venezuela, which had already fallen by 33% in the 11 months before the strike, are likely to drop still further, with deleterious consequences for both countries.
COLOMBIA

MASSACRE IN BOGOTÁ: BACK TO SQUARE ONE?

“Colombia cries, but does not surrender,” claimed President Alvaro Uribe on 9 February in his address to the nation right just a car bomb exploded in the exclusive El Nogal club in Bogota leaving 35 dead and leaving scores injured. The most brutal terrorist action in years was a deadly reminder that the Revolutionary Armed Forces of Colombia (FARC) has honed its capacity to engage in urban terror.

Attack on El Nogal was not isolated incident

The FARC has not claimed responsibility for the bombing, but neither has it denied the charges levied against it by the government and public. One thing seems clear: the El Nogal bombing came after several months of attempted negotiations with the FARC and other guerrilla groups, the Uribe government now has free reign to resort to military response. Armed hostilities are almost certain to intensify.

Urban offensive grows in intensity and frequency and now targets well-off areas

The terrorist attack on El Nogal is not the only incident dashing hopes for peace. A splinter group of the Self-Defense Forces (AUC) paramilitaries killed four Kuna Indians on the Panamanian border; days later another AUC commando kidnapped three US Discovery Channel journalists in Choco and held them hostage on 18-23 January. The National Liberation Army (ELN) also kidnapped two reporters for the Los Angeles Times and held them in captivity until 1 February. The FARC also tried kidnapping a crew of journalists from Colombian RCN network, days before the attack on El Nogal hostilities escalated. Four car bombs were detonated by the FARC, leaving 17 dead. Finally, just hours before the attack, an Army helicopter was attacked by FARC guerrillas in the vicinity of Tolima.

AUC dissident commandos emerge

Two developments are particularly worrisome. First is the emergence of a dissident wing of the AUC; second, the FARC’s turn towards urban warfare. The AUC dissidents, who consist of some 1,500 guerrillas, are the Elmer Cárdenas bloc that withdrew from negotiations with the government. The reiterated US decision to maintain extradition charges on AUC leaders under drug trafficking charges might have influenced this decision. The AUC generally supports Uribe, and has been considering demobilization and reinsertion in society, but the prospect of legal prosecution in the US has many of its leaders advocating continued hostilities.

Insurgent Violence in Colombia

![Insurgent Violence in Colombia graph](image)

Source: Ministry of Defense

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accession urban warfare incidents have been steadily on the rise, having started during Uribe’s inauguration, when the FARC launched rockets at the official ceremony. Then came the carnage at commune 13, a populous neighborhood on the outskirts of Medellín, where the army and the FARC battled for several days. The El Nogal bombing was the latest major attack. Significantly, not only have the intensity and frequency of the attacks grown, but the FARC has also been increasingly able to launch attacks against affluent and well-guarded neighborhoods.

In this environment Uribe can be expected to escalate hostilities. An offensive is not only appropriate for reasons of security, is also politically advisable. After all, Uribe’s performance with respect to political reform, economic improvement, and security, is the touchstone of his administration. With political reform lagging and the economy hostage to the Venezuelan crisis, it is only with national security that Uribe can continue to make inroads. A successful counteroffensive would not only improve security but also distract attention from politics and the economy. An unsuccessful counteroffensive, on the other hand, could spell disaster for both Uribe and Colombia.
Government
- President Álvaro Uribe dismissed 714 officials and reduced the number of ministries to 13. The overhaul is part of an ambitious plan to streamline Colombia's bureaucracy and reduce costs. The government aims at $20bn Pesos in savings every year starting in 2005.
- The referendum on political reform appears to be polarizing the political system across party lines. Trade unions, the Democratic Pole (PD), and some leaders of the Liberal Party (PL) are leading the anti-referendum bloc by promoting abstention. The government is trying to secure support for the final draft before the Constitutional Court rules on its legality.
- Juan Luis Londoño, head of the newly created Social Protection Ministry and part of Uribe's team, died on a plane crash on 30 January. The crash appears to have been an accident, even though his plane fell in a guerrilla-controlled area. The insurgents attacked an Army helicopter involved in the rescue operations.

Society
- Five US journalists were kidnapped in Colombia. Three Discovery Channel journalists were held captive by AUC paramilitaries and then released after five days. Two Los Angeles Times journalists were also kidnapped by ELN guerrillas who kept them for 10 days.
- Hernando Hernández, former president of Ecopetrol's Union Sindical Obrera (USO), Colombia's most important trade union, was arrested on charges of rebellion and accused of having ties to the ELN guerrillas. In protest USO staged a 24-hour strike.

Security
- On 7 February a car bomb exploded in an exclusive club in Bogotá killing 35 people and injuring dozens. The attack was the most brutal terrorist attack in years. Although the FARC guerrillas did not claim responsibility, the bombing has been attributed to them. If the tie is proven, the bombing will be yet another indication of the FARC's increasing operational capacity in urban warfare.
- In an effort to create incentives for irregular combatants to drop their weapons, a decree was passed to support their reinsertion into society. Under the new provisions, a blanket amnesty for blood crimes committed by AUC paramilitaries will be enacted.

Economy
- The two-month national strike in Venezuela has begun to affect Colombia, whose total exports account for 13% of GDP. Venezuela accounts for 10% of those exports. Colombian exports to Venezuela had already contracted by 33% before the strike.
**HIGHLIGHTS**

- **Hotel chain sale nullified:** After the Croatian Peasant Party (HSS) blocked the sale of the Suncani Hvar hotel chain, an independent commission found irregularities in what was thought to have been a transparent process.

- **Croatia's EU push:** Croatian diplomats have been actively currying favor with EU officials in anticipation of Croatia's official application for membership on 21 February.

- **Physicians' strike continues:** Physicians are asking for a substantial wage increase as their strike entered its second month. While there is no wide public support for the strike, Health Minister Andro Vlahusic may need to take some blame for failing to resolve a long stalemate that has deprived citizens of all but emergency hospital services.

**RISKS AND FORECAST**

- **Continuing coalition rift:** The HSS and the Social Democratic Party (SDP), though the leading members of the ruling coalition, are likely to drift apart in 2003, an election year. Differences will grow as the parties start announcing their political platforms.

- **EU hopes:** Even though EU officials reacted warmly to Croatia's announcement that it would apply for membership in late February, Croatia's limited progress on key issues of minority return, its difficulties with the International Criminal Tribunal for the Former Yugoslavia, preoccupation with the recently admitted countries and impending war in Iraq may substantially delay the start of negotiations.

- **New labor law:** If the parliament adopts a new labor law without taking into account trade union demands, a general strike that would further alienate the government from its core constituency could ensue. The trade unions argue the new law gives employers too much flexibility at workers' expense.
CROATIA

HOPES RUN HIGH WITH EU APPLICATION

Diplomatic offensive for EU membership

Croatia launched an unprecedented diplomatic offensive before its official application for EU membership on 21 February. The coalition government expects that significant progress on EU accession will ensure its re-election. However, even though EU officials have encouraged Croatia to apply, they are unlikely to offer a concrete timeline. The best Croatia can hope for is a firm commitment from the EU that it will be considered independently, rather than as part of the former Yugoslav group of countries that lag behind.

International criticism of government waning

After condemning Croatia’s failure to arrest suspected war criminal General Janko Bobetko in late 2002, the EU changed its tune, signaling that Croatia’s application was more than welcome and that the country was ready to start negotiations.

Country seeking desperately to distinguish itself from others in former Yugoslav region

When Croatia applies for EU membership on 21 February, it will embark on a long and arduous journey. Croatia still needs to adopt many reforms, but the main impediment to accession is the international community’s perception that the country is still inextricably connected to the former Yugoslav region. If EU officials were genuinely convinced that Croatia, like Slovenia, could be treated in isolation from Serbia and Bosnia and Herzegovina, then Croatia could follow Bulgaria as the next beneficiary of EU expansion. But thousands of unresolved property-related issues and Zagreb’s protectionist approach toward ethnic Croats in Bosnia and Herzegovina make it hard for the current administration to argue that Croatia is the next Slovenia. As long as these conditions prevail, EU officials will be justified in adopting a go-slow approach toward Croatia.

Bulgaria’s lead is frustrating to Croats

Most Croats are furious that Bulgaria is far ahead of Croatia in the EU accession process. They claim that Croatia’s economy, macroeconomic stability, and financial markets are superior to Bulgaria’s and that Croatia should at least be considered an equally acceptable candidate. In the meantime, Bulgaria has closed 23 of 31 chapters necessary to harmonize its laws with those of the EU, while Croatia is only hoping to start negotiations sometime in 2004, at about the time Bulgaria is planning to complete its own. Croatian chances of catching up with Bulgaria are minimal until and unless it takes steps to extricate itself from the former Yugoslavia’s tangled affairs. The current government will be unable to do much in an election year. But, regardless of the composition of the next government, it will have to make a choice.

PRIVATIZATION TRAVAILS

Hotel chain dispute resolved

The Croatian Peasant Party (HSS) and the Social Democrats (SDP), the two main coalition partners, resolved their disagreement over the privatization of a hotel chain on the island of Hvar by nullifying the sale and dissolving the Croatian Privatization Fund’s (HFP) board. HSS President Zlatko Tomcic insisted that there were irregularities in the sale, something an independent government commission confirmed, thereby leading to the nullification.

While the HSS has emerged a winner from the dispute, the bitter nature of the SDP-HSS tussle highlights numerous differences that may grow more pronounced as the general elections draw near. Many Croats believe that the HSS not only tried to score political points by appearing as the savior of national property, but also wanted to gain advantage in the overall privatization process by placing its members in the HFP.
Growing differences between the HSS and the SDP may influence the parliamentary elections timeline. While the SDP would like to schedule them for spring 2004, toward the end of the legal deadline, the coalition rift may force the government to hold elections as soon as fall 2003.

**LABOR LAW TO CHANGE**

The government presented a new labor law to the parliament for adoption. The law is intended to make the labor market more flexible. However, Croatia’s largest trade unions refuse to endorse the law, claiming it leaves workers without protection. The debate among the government, parliamentary party clubs, and the employers’ union continues. But it is unlikely that the unions will be satisfied with the final draft due in late February or early March, raising the possibility of broad social unrest and perhaps a general strike.

Trade unions deem unacceptable the proposed reduction in length of lay-off notice employers must give, the increased use of temporary workers, the increase in lay-off quotas, and the elimination of support for laid-off workers. The government’s intention is to stimulate the economy by making it easier for employers to compete with other emerging market countries. While the unions claim the above changes are unacceptable, the Croatian Employers’ Union, a group representing private sector interests, says that this version of the law does not go far enough in making Croatia attractive for investors.

If the government has its way, unions may express their discontent through a general strike, something the center-left coalition government would very much like to avoid in an election year. The government may therefore give the unions a few concessions and dare them to stage a general strike, calculating that the unions are not strong enough to do so, especially in the private sector. Relative trade union weakness also means that opposition parties are unlikely to offer future concessions in exchange for union support in the pre-election period. The Croatian public and media have remained neutral in the debate even though there is consensus that the current law needs to be changed. But which changes should be implemented and how remains up for grabs.
Government

- The clash between the main coalition partners continues. The Croatian Peasant Party is trying to win more concessions from the Social Democrats in return for preserving the coalition and avoiding calling elections earlier than desired.

Society

- Physicians continued to strike as the public showed little support for the doctors demanding a wage increase, but the government, which has failed to solve the problem for over a month, may suffer another drop in popularity.
- The government presented parliament with a new labor law. The parliament will probably pass the cabinet's version, thereby upsetting the unions that think the law gives employers too much flexibility.
- A long-awaited law does little to improve the decision-making process at the National Radio and Television. The Board of Editors, Board of Directors, and Chief Executive Officer still lack clearly defined responsibilities, guaranteeing that the conflicts that have plagued the institution will continue.
- The Suncani Hvar hotel chain privatization was nullified and the Croatian Privatization Fund's board was dismantled as a consequence. The episode halted the whole privatization process; the government will have to fix the situation quickly.

Security

- International officials praised Croatia for its intention to submit an official application to join the EU on 21 February.
- The right-wing military establishment swallowed the early retirement of a number of military personnel at the end of 2002. Minister of Defense Zeljka Antunovic reiterated her firm commitment to military and defense reform that includes large personnel cuts.

Economy

- The IMF approved a 14-month $146mn stand-by loan as an endorsement of Croatia's macroeconomic policies. Croatia has no intention of using the loan. The IMF cited unexpectedly vibrant economic activity, macroeconomic stability, commitment to labor reform, further privatization, and strong financial markets as reasons for its approval.
HIGHLIGHTS

- **President presents regional peace plan**: President Hosni Mubarak invited re-elected Israeli prime Minister Ariel Sharon for talks in Cairo in January in an attempt to rejuvenate the moribund Israeli-Palestinian peace process. Mubarak also urged other Arab leaders to put pressure on Iraqi President Saddam Hussein to comply with UN Security Council resolutions.

- **Egyptian pound floated**: Prime Minister Atef Obeid announced on 28 February that the country's currency would be floated, with foreign exchange rates to be determined by the market.

- **Egypt's ruling party pursues reform**: The National Democratic Party is attempting to reform and accelerate drives to reform and democratise its party structure. More progressive elements appear to have growing influence in the party's apparatus.

- **Cairo suspicious of Sudanese peace talks**: The Egyptian government remains cautious over the extent of its role in facilitating peace between the warring factions in neighbouring Sudan. A reunited Sudan may force a re-allocation of water from the Nile detrimental to Egypt's needs and interests.

- **Anti-Gamal petition appears on-line**: On 18 January, a petition with over 1,000 signatures opposed to Gamal Mubarak's succeeding his father as president appeared on the Internet. While the Internet is not a reliable measure of public opinion (especially as fewer than 1 million of Egypt's 68 million people have access to it), the petition is significant, because government approval is needed to collect signatures in public.

RISKS AND FORECAST

- **Anti-US protests**: Arab governments, particularly in Egypt, Yemen, Bahrain, Morocco, and Syria, are likely to tolerate anti-US protests as long as protesters refrain from directly criticising them or clashing with security forces. Tolerance may wear thin in the event of an actual war against Iraq. The Egyptian government could ban public protests altogether.

- **Unemployment and youth disaffection on the rise**: The main risk to Egypt's stability stems from unemployment and rising youth disaffection. Egypt's inclusion in the US terror "watch list" and the accompanying application of stricter visa and registration rules to Egyptian men travelling to the US will only aggravate the problem.
President presents regional peace plan

President Hosni Mubarak and government officials intensified diplomatic efforts on 30 January to revive the Israel/Palestinian peace process and to prevent a US-led invasion of Iraq. The diplomatic initiatives, which followed Israeli Prime Minister Ariel Sharon’s election victory and the intensification of US war efforts, appeared to signal that the Egyptian government is changing its position on the Iraq crisis.

Mubarak surprised observers by inviting the newly elected Sharon to the South Sinai resort town of Sharm Al-Sheikh for talks on the Israeli/Palestinian peace process. Sharon’s agreement to meet Mubarak, although possibly motivated by a desire to improve his image, could also signal a warming of relations. Mubarak has been overtly critical of Sharon’s hard-line policy. Egyptian officials did meet in mid-January with Israeli opposition leader Yossi Sarid and former Justice Minister Yossi Beilin of the Labor Party, but the government has avoided meeting members of the Likud Party. Egyptian-Israeli relations have been strained since the start of the second Intifada in October 2002. Egypt withdrew its ambassador to Israel in November 2000 in response to what it described as the use of “excessive force” in the Palestinian territories by the Israeli army.

A meeting in Riyadh on 5 February between Mubarak and Saudi Arabia’s Crown Prince Abdullah Ibn Abd al-Aziz and other Gulf officials signalled an attempt to give diplomacy another chance. While both leaders warned of the negative impact on the region of an attack on Iraq, Mubarak hinted that more direct pressure on President Saddam Hussein could in fact help force him to adhere to UN Security Council resolution 1441, passed in November 2002. Mubarak had previously only supported bolstering UN efforts to disarm Iraq.

Prime minister announces flotation of Egyptian pound

In a radical departure from Egypt’s conservative monetary policy, Prime Minister Atef Obeid announced in Cairo on 30 January that the government would allow the Egyptian pound to float freely, abandoning the managed peg system for a free market regime. In principle, the 57 banks authorized to trade currency will be able to set exchange rates independently. The weighted average would then be calculated by a newly established Central Bank of Egypt (CBE) bureau that will then send it to customs for the calculation of duties at 4pm each day. The CBE has reserved the right to intervene in the foreign exchange market without prior notice, while adding that the devaluation was a much needed move that should guarantee the free flow of foreign currency to a country severely suffering from US dollar shortages.

There are a number of reasons for the sudden shift in monetary policy. First, the annual Hajj to Mecca in Saudi Arabia has increased demand for foreign exchange dramatically. Second, the flotation of the pound is likely to support the government’s export-led growth strategy by making foreign exchange more readily available and increasing competitiveness. Last, the currency devaluation will provide the Central Bank with greater flexibility in case it has to...
respond to an adverse impact on the economy of a US-led war against Iraq. In the past foreign donors and institutions have balked at providing financial assistance unless the Egyptian government moved on its currency regime.

Although some local economists claimed that devaluation would produce little benefit for the export sector, the IMF, the World Bank, local foreign currency traders, and economists generally welcomed the decision. In particular, Director of the IMF’s Middle Eastern Department George Abed stated that the move should “inspire confidence and pave the way for further economic reforms”. According to the international rating agency Standard & Poor’s, the Egyptian economy should benefit from a return of liquidity to the foreign exchange market, allowing the central bank to further lower interest rates.

Some local economists and international institutions also expressed concern that devaluation would have little direct influence on Egyptian exports before the industrial sector is fully modernized. The industrial modernization program has so far failed to tackle Egypt’s manufacturing inefficiencies. Furthermore, a depreciated exchange rate could lead to an increased fiscal burden associated with subsidies on imported commodities. Despite the flotation’s obvious benefits, lingering uncertainties about the corollary negative economic corollaries remain.

CAIRO SUSPICIOUS OF FALTERING SUDANESE PEACE TALKS

Cairo continues to view with suspicion the September 2002 US-brokered peace protocol to unite the north and south of Sudan. Typical are the views of Saad Fehkry Abdel Noor, General Secretary of the Egyptian Wafd Party, who called the Machakos peace process a “Zionist-American conspiracy.” He went on to describe the initiative as a “continuation of the chain of the devious policy of occupation first practiced by the English and French in Africa which led to the division of Sudan and Egypt.”

Much to Egypt’s relief the talks continue to be bogged down by regular breaches of the ceasefire by armed units loyal to Khartoum and the Sudan People’s Liberation Army. Egypt’s main concern stems from the fact that it needs vast quantities of water to increase agricultural production and cope with rocketing population levels. With a population of approximately 63 million (which is expected to rise to 115 million by 2050), Egypt has embarked on a development plan consisting of two mega projects.

The first called the Toshka project will divert Nile waters upstream into Egypt’s desert oases and increase the exploitation of groundwater sources. Toshka expects to irrigate 200,000 hectares (ha) of land at a cost of $88.5bn. The other scheme in the Sinai, the North Sinai Development project, plans to expand the area of irrigated land by 250,000ha by mixing water from the Nile with drainage water. Widespread economic development is expected to accompany this with roads, new houses, electricity transmission lines, water and sewerage networks all being built. All of these are expected to create opportunities for the private sector. With water tables declining globally and especially in the Middle East, Egypt remains opposed to the peace process, which would abrogate a 1959 water treaty with Sudan and potentially reduce its access to the Nile’s waters.

Clearly therefore, these ambitious plans are reliant on the availability of water. As Egypt is already using its full allocation of Nile water and groundwater sources are increasingly overexploited, the projects depend on the application of wastewater reclamation and strict management techniques to save water. Egypt may be seeking to foster regional co-operation but it will need to use all its powers of persuasion to maintain its water allocation from the Nile.
LEGSI SUMMARY · FEBRUARY 2003

**Government**
- Egyptian President Hosni Mubarak proposed a regional initiative to kick-start the Israeli-Palestinian peace process and to urge Iraqi President Saddam Hussein to comply with UN Security Council resolutions.
- The government has been showing signs of increasing tolerance of the Islamic Brotherhood: 42 members were released from prison in January, preceded by 66 in October.
- Twelve Palestinian factions meeting in Cairo on 26 January failed to agree on halting armed attacks against Israel. The factions were reluctant to make major policy changes at a time when a possible war against Iraq added unpredictable variables to the conflict.

**Society**
- Persecution of homosexuals continues, with several gay men arrested in police stings set up through gay Internet chat rooms.

**Security**
- Intelligence chief Omar Suleiman raised his profile by hosting an EU-backed summit of Palestinian factions in Cairo. Suleiman is the head of the Egyptian General Intelligence Service, the country’s overseas security agency. Some observers view him as a possible successor to President Hosni Mubarak.
- Attention continues to be focussed on Egypt’s borders with the occupied Gaza Strip and Israel where the last month has witnessed an increase in Palestinian and Egyptian militant activity against Israel.
- Egypt continues to keep a close eye on the Sudanese Machakos peace talks, which if successful, could harm Egypt’s water supplies from the Nile.

**Economy**
- Minister of Petroleum Sameh Fahmy called for $10bn in foreign investment to establish 14 new petrochemical complexes by 2020. The new plants would be situated near Alexandria, Port Said, and Suez, and have access to international waterways.
- The government announced a 25% increase in bread subsidies. With the cost of imported wheat rising amid dollar shortages, the government is committed to making staple foods available.

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**COMPONENT SCORES**

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**REGIONAL LEGSI SCORES**

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Lehman Brothers Eurasia Group Stability Index (LEGSI):

HUNGARY

HIGHLIGHTS

- Speculative run on forint: In mid-January, the Hungarian forint came under a speculative attack by investors who expected the currency to appreciate beyond the levels dictated by Central Bank (NBH) law. The exchange rate regime survived the attack, but the NBH had to give up its 2003 inflation targets, and the environment remains volatile. NBH governor Zsigmond Járai may resign in the coming months.

- FDI concerns: The government grew increasingly concerned about multinationals deciding to move major parts of their manufacturing operations out of Hungary. It blamed a strong currency, but other factors such as wage rates and global demand were more important in the decision of companies to reduce production in Hungary.

- Anti-EU rhetoric from opposition: Opposition parties criticized the government’s handling of negotiations with the EU, and public support for joining declined ahead of the 12 April national referendum.

RISKS AND FORECAST

- Bad news on several fronts: In spite of Hungary’s overall stability and recent success with the EU accession process a number of negative developments suggest that the positive sentiment toward Hungary among investors could erode. The bad news includes:
  
  - Deficits: A very high budget deficit (almost 10% in 2002), which the government may not be able to get under control in 2003.
  
  - Current account: The current account deficit remains large and may continue to grow.
  
  - Central Bank credibility: The current turmoil and volatility associated with the currency and Central Bank more generally, and the lack of credibility in the policy of “inflation targeting,” has led to growing concern among investors.
  
  - Decline in support for EU accession: Opposition leaders have continued to criticize the terms of the deal at Copenhagen, and the public finally appears to be taking notice. Some polls are now showing that support for the EU is declining, and by the 12 April referendum could even be below 50%. A “no” vote on the EU is unlikely at this point, but it is now a real risk (5-10%).
GOVERNMENT’S RELATIONS WITH CENTRAL BANK REMAIN PROBLEMATIC

Speculative attack on forint

In mid-January, the forint came under a speculative attack. Over two days outside investors purchased approximately 5bn euros worth of forints with the expectation that the Central Bank (NBH) would relax the currency’s fluctuation band, which in turn would lead to a further appreciation of the currency. As a result of speculative pressure, the NBH cut interest rates by 200 basis points; it then changed the conditions for taking repos, which in effect pushed down interest rates by another 300-400bps to 2.5%-3.5%. As a consequence of the Central Bank’s firm action, the inflow stopped and the forint depreciated by 5%.

Forint band and Jarai survive

The exchange rate regime survived the attack, but at a high cost. With very low interest rates and a more volatile and weaker currency, the NBH had to give up its 2003 inflation targets. NBH Governor Zsigmond Járai was attacked by senior members of the governing parties for mismanagement of monetary policy, but the government took no steps to force him out of office. Nevertheless, his position has been weakened, and he may well resign in the coming months.

No real inflation targets

In the aftermath of the speculative run Hungary’s policy of “inflation targeting” lacks credibility. Where targeting works (the UK and Sweden, for example) it is a more open, consensual, and predictable process. In Hungary this sort of coordination is lacking, as the government appears willing to tolerate higher inflation than the NBH. The 2003 targets have essentially been abandoned. The government also appears determined to defend the current currency band, at least for the next several months, amid fears that the “overvalued” forint has driven foreign investors away from Hungary and hurt a range of local exporters.

Political tensions remain

Relations between the government and the NBH are becoming increasingly politicized. Járai, an appointee of the former (Fidesz) government, was also finance minister for Fidesz. Now Fidesz has moved into the fray and has promoted newspaper ads saying things like “the NBH is the last bastion of democracy; and down with inflation.” Tensions are likely to remain in the coming months.

EU REFERENDUM RISK AN ISSUE FOR THE FIRST TIME

Declining support for EU

According to one of Hungary’s leading polling groups, Szonda Ipsos, support for the EU has declined dramatically in recent months. The poll, completed in mid-January, found that just 55% of the population now believe they will benefit from EU membership. Six months ago the figure was 62%. Concerns about the 12 April national referendum may now be justified.

Fidesz sends contradictory messages on EU

The ruling Socialist Party has blamed opposition political leaders such as Viktor Orban and Josef Szajer (both linked with the right-wing Fidesz) for causing the slide in public opinion. Although both opposition figures have indicated they are in favor of joining the EU, at the same time they have continued with a barrage of public criticism of the terms for integration. Szajer accused the government of being “terribly weak” in the negotiations completed last December in Copenhagen. Orban suggested repeatedly that a range of Hungarians, particularly farmers, could have gotten a much better deal from the EU. This somewhat cynical attack on the process that they had been promoting while in the previous government did help Fidesz remain in the political spotlight, but it clearly increased the risk of a failed referendum. The government is on the verge of launching a pro-EU public relations effort, and in the end a “yes” vote is still likely on 12 April.
FDI WORRIES MOUNT

Since 1989, Hungary has been extremely successful in attracting foreign direct investment (FDI). Recent bad news on the FDI front, however, has startled the government, which is now scrambling for a response. Notable multinationals such as IBM and Phillips have decided to move major parts of their manufacturing operations out of Hungary. Other potential investors that were considering Hungary, including Peugeot-Citroen, have chosen to set up new production facilities in other countries in the region. The government has repeatedly argued that the strength of the forint has been a critical part of these decisions. In fact, other considerations such as weak demand and wage levels were more important factors.
**LEGSI SUMMARY • FEBRUARY 2003**

**Government**
- After the Hungarian forint came under a speculative attack the environment remains volatile. Relations between the government and Central Bank remain tense, and confidence in the government's ability to manage the problem eroded. NBH governor Zsigmond Járai may resign in the coming months.
- Fidesz began the process of reorganizing itself as a so-called modern European people's party. The party hopes to integrate the so-called civic circles movement.

**Society**
- A scandal erupted in the Roma Electors Assembly after the rivalry between left-leaning and right-leaning factions resurfaced. The Supreme Court of Justice ordered new elections for the assembly.

**Security**
- Along with seven other European leaders, Prime Minister Peter Medgyessy signed a letter in support of the US approach to Iraq. He admitted to having not consulted fellow party members or the foreign office. Fidesz harshly criticized his "servile" behavior.
- The government decided to spend an additional 30bn forint to purchase, rather than merely lease, Gripen fighter planes from Saab-BAE.
- Fidesz continued to criticize the government's handling of the negotiations over EU membership. However, former Prime Minister Viktor Orban said that the advantages of membership narrowly outweighed the disadvantages and that he would therefore vote "yes" in the forthcoming referendum.
- In one poll popular support for EU membership dropped by 10% to 56%. Some analysts and the government blamed Fidesz for its lack of Euro-enthusiasm.

**Economy**
- A new IMF report on Hungary praised the country’s performance in terms of growth and disinflation in 2002, but offered a severe critique of the present macro-mix. Wage growth was criticized as the main factor leading to external and internal imbalances. A wage freeze in the public sector and additional budget cuts were suggested.
HIGHLIGHTS

- **Bali investigation**: Investigators of the 12 October Bali bombing continue to make progress, arresting key figures and uncovering details of the Jemaah Islamiyah network. Police Inspector-General I Made Mangku Pastika announced the terrorist group had moved its headquarters from Malaysia to Central Java in 1999.

- **Police HQ bombed**: On 3 February a bomb exploded inside the National Police headquarters compound in Jakarta, injuring one person. While the device was small and unsophisticated, the incident highlighted the limits of Indonesian law enforcement. The bomb was similar to devices used in a series of bombings in Jakarta in June 2002 and in Medan on Christmas Eve 2000.

- **Government retreats on price increases**: After weeks of street protests, the government of President Megawati Sukarnoputri backtracked on its January price increases, reducing the subsidy cuts and price increases for fuel and postponing fee increases on telephone services. Protests continue, but on a smaller scale.

- **Attorney general investigated**: Police initiated investigations of two allegations against Attorney General M.A. Rachman. Rachman is accused of concealing personal assets in a mandatory wealth declaration and of embezzling 150mn rupiah from a relief fund for Bornean refugees. President Megawati continues to support her attorney general, and the subordinate who first made the asset concealment allegations against Rachman remains in jail on corruption charges.

RISKS

- **Anti-Americanism in Indonesia**: Students rallied outside a McDonald’s restaurant in Riau province on 29 January to protest US policy toward Iraq and urge a boycott of American products. The United Muslims Association (Persis) has also urged Muslims to boycott American and Israeli products. The popular reaction to an American military campaign in Iraq is likely to be as intense as last year’s response to the Afghan campaign and may unsettle the political landscape.

- **Akbar verdict upheld**: On 17 January, the Jakarta High Court upheld the Central Jakarta District Court’s guilty verdict and three-year jail sentence for Golkar party leader and House (DPR) Speaker Akbar Tandjung. Akbar remains free pending a final appeal to the Supreme Court, but pressure to remove him as both party leader and DPR speaker is simmering. A DPR steering committee has agreed to consider Akbar’s fate at a plenary session on 27 February, and Golkar may consider the issue at its party conference in March. A rift in Golkar—the most important political ally of President Megawati’s Indonesian Democratic Party of Struggle (PDI-P)—is unlikely, but possible.
Demonstrators broaden protest message

Student and labor protests against the government’s subsidy policies continue. While President Megawati Sukarnoputri’s government has postponed telephone price hikes and rolled back fuel price increases, the protestors have broadened their message. The focus has increasingly been on the government’s failure to combat corruption, its foreign borrowing, and the sale of state-owned enterprises to foreigners (most recently, the mobile phone operator Indosat).

Megawati’s reputation at stake

The protests are not an immediate threat to President Megawati, but a political warning to the government as the 2004 election campaign begins. She is losing her widely held reputation as a reformer and a nationalist, and is seen as increasingly beholden to the corrupt interests that flourished for 32 years under President Suharto.

US war on Iraq will provoke more protests

The government will face more protests if the US initiates military operations in Iraq. Low-level anti-American protests have already occurred. Protests will likely equal in size and passion the demonstrations that took place regularly outside the US Embassy in Jakarta and around the country during the US campaign in Afghanistan in late 2001. Indonesia has already formed a task force to handle the impact of the Iraqi crisis on Indonesia’s political, security, social, and economic affairs.

Papuan problems come to fore

Developments in Papua over the past month highlight the continuing problems associated with keeping this poor, underdeveloped, and culturally distinct eastern province within the Republic of Indonesia. Papua is unlikely ever to achieve independence, but the challenges posed by Indonesian sovereignty over the province will not end soon, either.

Soldiers on trial for murder

Progress in two legal cases could shed light on Indonesian military (TNI) activities in Papua. The first case is the trial of seven soldiers accused of the November 2001 killing of Papuan independence figure Theys Hiyo Eluay. A senior TNI officer has testified that men from his unit killed Eluay. It is still unclear whether the killing was the result of an accident, insubordination, or orders from senior officers.

Military suspected in death of two Americans

In a second case, Indonesia granted US FBI agents access to the investigation of the 31 August 2002 roadside ambush outside PT Freeport Indonesia’s Grasberg mine compound in which two Americans and one Indonesian were killed. There is strong evidence that TNI soldiers were involved in this incident, despite the government’s initial claims that separatists of the Free Papua Movement (OPM) were responsible. If it becomes clear that the TNI was involved in killing Americans, there will be increasing resistance in Washington to the Bush administration’s goal of resuming military assistance programs suspended in the 1990s. It appears that the TNI and the national police are already at odds over the investigation. The police investigation was initially led by Inspector-General I Made Mangku Pastika (who left Papua in October 2002 to take over the Bali bomb investigation) and made good progress. But the TNI grew uncomfortable with the police role and began interfering in the case in recent months. Jakarta has transferred two senior police officials involved in the Papua investigation.

Separatists and military clash in tough terrain

The TNI has intensified its military operations against the OPM in recent weeks. There has been fighting along the Papua New Guinea border as thousands of TNI troops pursued OPM separatists through the dense and inhospitable Papuan terrain. The OPM does not have the capabilities of the Free Aceh Movement (GAM) in Aceh province, and the TNI appears committed to ensuring that the OPM is defeated before it can develop an equivalent capacity. Having lost East Timor in 1999 and having to negotiate with GAM in 2002, the Indonesian government is particularly sensitive to separatist threats.
In early February, President Megawati Sukarnoputri issued presidential instruction (inpres) 1/03 implementing law 45/99 on the division of Papua into three provinces (to be named West Irian Jaya, Central Irian Jaya, and Papua). Law 45/99, which was passed under the Habibie government in 1999, had not been put into effect and was widely considered to have been superseded by law 21/01 on special autonomy for Papua. Law 21/01 granted Papua political and economic rights not enjoyed by other provinces (but similar to terms granted to Aceh in similar special autonomy legislation) and specifically stated in Article 76 that “Expansion of the Papua Province into provinces shall be carried out with the approval of the MRP [Papuan Assembly] and the DPRP [Papuan House].” Despite these terms, inpres 1/03 was issued without consultation with Papuan political bodies (the MRP does not yet exist), and has been interpreted as a de facto rejection of Papua’s special autonomy.

President Megawati and her government are known to be concerned about the course of decentralization and regional autonomy in Indonesia—a tremendously difficult undertaking initiated in 2001 and rife with implementation problems. However, there has been no formal rejection of the principal terms of these policies. And Megawati has reiterated her support of special autonomy for Aceh and Papua, while adamantly refusing to consider independence for either province. In this context, revival of the plan to divide Papua was most likely motivated by the government’s interest in increasing its control over security and administrative affairs in Papua, without publicly backtracking on its autonomy commitments.

The plan has drawn sharp criticism from Papuan politicians, religious leaders, and NGOs. The much-respected Papuan Governor Jaap Salossa said that now was not the appropriate time to divide Papua into three provinces because there were insufficient human resources to support the additional administrative demands. Human capital deficiencies are already a large problem for Papua, and Governor Salossa’s criticisms are accurate. There is also truth in the Indonesian government’s argument that Papua is too large and contains too many regencies (sub-provincial districts, of which Papua has 28) to be organized as a single province.

Papua has always been an uneasy participant in Indonesia’s national project. While the OPM will never become a serious separatist threat, the security situation in Papua needs to stabilize if it is going to successfully implement the special autonomy program. As the two pending legal cases attest, the TNI is also an important source of instability in Papua and often uses the OPM as a pretext for its own illicit activities. Further complicating the situation, there have been reports in the last year that Islamic paramilitaries—including the disbanded Laskar Jihad—have entered the overwhelmingly Christian province to stir up sectarian conflict as in Sulawesi and Maluku.

The worst-case scenario is that violence will persist in Papua, tempting the TNI to engage in more ruthless security operations that undermine military reform efforts and alienate the international community. While this outcome would have serious consequences for the social and economic development of Indonesia and Papua, it would likely have only minimal impact on the heavily guarded and critically important gas and mining industries. Perhaps reflecting this reality, Freeport McMoran—which derives most of its revenue from its subsidiary’s operations at the Grasberg mine—successfully issued $1bn of debt in early February to pay off a previous credit facility and resume dividend payments to shareholders.
LEGSI SUMMARY • FEBRUARY 2003

Government
- After weeks of street protests, the government of President Megawati Sukarnoputri backtracked on some of its January price increases, reducing subsidy cuts and price increases for fuel and postponing fee increases on telephone services. Protests continue, but on a smaller scale.
- Police initiated investigations of two allegations against Attorney General M. A. Rachman. Rachman is accused of concealing personal assets in a mandatory wealth declaration and of embezzling 150mn rupiah from a relief fund for Bornean refugees.
- On 17 January, the Jakarta High Court upheld the Central Jakarta District Court’s guilty verdict and three-year jail sentence for Golkar party leader and House (DPR) Speaker Akbar Tandjung. Akbar remains free pending a final appeal to the Supreme Court, but pressure to remove him as both party leader and DPR speaker is simmering.

Society
- Students rallied outside a McDonald’s restaurant in Riau province on 29 January to protest US policy toward Iraq and urge a boycott of American products. The United Muslims Association (Persis) has also urged Muslims to boycott American and Israeli products, in anticipation of a US campaign against Iraq.

Security
- As the Bali bombing investigation continues, police announced that their investigation had determined that the terrorist group Jemaah Islamiyah moved its headquarters from Malaysia to Central Java in 1999.
- On 3 February, a bomb exploded inside the National Police headquarters compound in Jakarta, injuring one person. While the device was small and unsophisticated, the incident highlighted the limits of Indonesian law enforcement.

Economy
- Sjahril Sabirin, governor of Indonesia’s central bank, Bank Indonesia, has indicated his desire to serve another five-year term when his second term expires in May. The corruption case against Sjahril is still pending before the Supreme Court. Prominent alternative candidates from Megawati’s own party include Minister for State-Owned Enterprises Laksaman Sukardi and National Development Planning Minister Kwik Gian Gie.

COMPONENT SCORES

REGIONAL LEGSI SCORES
HIGHLIGHTS

• Conflict on the airwaves: TV Azteca took the law into its own hands by seizing control of Canal 40, the object of a legal controversy with the television company CNI. Although the government intervened and the issue is back in the courts, it was accused of doing too little, too late, thereby setting another precedent for the violation of the rule of law.

• Infant mortality: Mexican health authorities are conducting an official inquiry into a sudden rise in infant mortality in the state of Chiapas. In late December and early January 30 babies died inexplicably in the Comitan Regional Hospital. The medical emergency also affected the government, as Health Minister Julio Frenk failed to return from Geneva, where he was jockeying for appointment to the World Health Organization Secretariat.

• Betting on yield compression: Mexico continues to bet on yield compression in its quest to be the first country to pay off all its Brady debt. Taking advantage of improved investor sentiment, the Ministry of Finance doubled its planned bond sale to $2bn. The new bond issuance at record low yield spreads was helped by the success of Pemex’s first-ever sterling-denominated bond.

RISKS AND FORECAST

• US vs. Mexico: Mexico has asked the International Court of Justice (ICJ) to impose provisional measures on the US to prevent the execution of 54 Mexicans currently on death row. Mexico claims that the US violated the 1963 Vienna Convention on Consular Relations by not informing arrested individuals of their right to consular protection at the time of arrest.

• Peso at record lows: The peso fell to record lows, surpassing at times the 11 pesos per dollar rate. The peso’s weakness is related to fears of a possible war in Iraq and to the current weakness of the dollar vis-à-vis the euro. Pressure on the exchange rate is raising even more doubts about this year’s inflation targets.
AZTECS AT THE GATES

On 27 December, TV Azteca, Mexico’s second largest broadcasting consortium, took the law into its own hands by violently seizing a small TV channel, CNI Canal 40. Seven days before this violent incursion into CNI’s transmission facilities, the International Chamber of Commerce (ICC), the arbiter in the dispute between Azteca and CNI, issued an award that was supposed to end the two-year long disagreement. The problem started when CNI’s owner, Javier Moreno Valle, decided to pull out of an agreement according to which Ricardo Salinas Pliego, TV Azteca’s CEO, would lend him $35mn with the guarantee that, in case of failure of payment, 51% of CNI’s social capital would become a call option for Azteca. Having received an advance of $15mn, Moreno Valle annulled the business bond on the grounds that Salinas Pliego was unilaterally defining the terms of the agreement.

The ICC reaffirmed the validity of the pact between the two broadcasting companies and granted Azteca the right to exercise its option of purchase. But soon thereafter both Azteca and CNI used the airwaves to turn the ICC award into an object of controversy by declaring themselves winners in the arbitrage. While CNI refused to sell and could not pay back its debts, Azteca demanded nothing less than the complete restitution of its financial assets. Since the courts were on their winter break, Azteca took matters in its own hands and a group of armed people stormed CNI’s facilities and took control of its signal. CNI immediately appealed to the Attorney General and other legal authorities.

Despite public outrage, the government did not come out with an official statement on the matter. The federal authorities eventually realized that the situation required their intervention. Their first move was to threaten both sides with the possible requisition of CNI’s signal. This initiative led both sides to negotiate for over 72 hours under the auspices of the Minister of the Interior Santiago Creel. On 9 January, however, the breakdown of the talks led the federal government to take control of CNI’s facilities, thus effectively interrupting all broadcasts on this particular TV channel until the Ministry of Communications and Transportation (SCT) decided what to do. A little more than two weeks after the seizure, a federal judge ordered the channels the restitution to the rightful concessionary of the broadcasting signal.

In a bizarre twist, Judge Luz Maria Diaz refused to pronounce on the specific identity of the concessionary, with the result that both companies made competing claims. To make matters worse, the SCT also abstained from ruling on the identity of the lawful owner and handed the matter over to a federal judge. In his turn, Judge Reynaldo Reyes conceded that the broadcasting facilities belonged to CNI and that the SCT should immediately restore them to Moreno Valle. CNI finally resumed operations on 28 January. There are still several legal matters to be settled, including payment of $5mn bail on behalf of CNI, but they are now being handled in various tribunals.

Mexico now has to contend with the political fallout of this incident. All political parties and Congress have condemned Azteca’s open violation of the rule of law and have demanded that the company’s legal counsel and other top executives be arrested, although Salinas Pliego appears to be safe from prosecution. They have also accused the government of procrastination that legitimized Azteca’s unlawful behavior. Most importantly, President Vicente Fox has been accused of ignoring the rule of law and establishing another precedent for the use of violence in the promotion of political or economic ends.
The center-left Democratic Revolution Party (PRD), whose symbol is an Aztec sun, has begun 2003 with another internal quarrel that threatens to undermine its chances in the year ahead. But unlike many past quarrels that were caused by political failure, this one is the consequence of possible electoral success. With President Vicente Fox’s troubles growing, PRD candidates could mount a successful challenge were it not for the squabbling that threatens to tear the party apart.

The PRD is an extremely fragmented party, organized along warring factions that reflect its foundation in 1989 as an umbrella organization in which radical and moderate left-wingers allied with Institutional Revolutionary Party (PRI) dissidents. As it evolved, the PRD attracted even more PRI members as well as some conservatives from the National Action Party (PAN). In recent years, the PRD has also become a powerful magnet for disaffected PRI members. As a result, the PRD’s cohesiveness has never been solid. Like every other left-wing party in Latin America, the PRD is torn by nationalistic, revolutionary, anti-globalization, and pro-market third way ideologies.

This time around the rift does not reflect the divides of the past, which often pitted three-time presidential candidate Cuauhtemoc Cardenas and party president Rosario Robles against Mexico City Mayor Andres Manuel Lopez Obrador. The Cardenas-Robles alliance controls the party and its most loyal voters, but Lopez Obrador, with an approval rating of 77%, has presidential aspirations. But so does Cardenas, who has been re-energized by his friend Luiz Inacio “Lula” da Silva’s electoral victory in Brazil. The possibility of a fourth Cardenas’s attempt for the presidency has generated controversy inside the PRD, but most people expected his allies, including Robles, to back him against Lopez Obrador. Now Robles’s support no longer seems certain.

Worse, Robles has turned against one of Cardenas’s main allies, Salvador Nava Campillo, son of a famous pro-democracy activist, who had won the PRD’s nomination for governor of San Luis Potosi. The PRD national leadership headed by Robles has not recognized his candidacy. Instead, Robles is pushing the candidacy of Elias Dip, a well-financed PRI turncoat. Not surprisingly, those machinations have led to an open confrontation inside the PRD. Cardenas now refuses to run for Congress, thus unleashing a divisive struggle for the PRD legislative leadership. Infighting has also erupted in all 16 counties of Mexico City, between winners and losers of PRD candidacies for local office. In short, if the internal struggle continues to escalate, the PRD’s bright prospects in this year’s election can only suffer.
LEGSI SUMMARY • FEBRUARY 2003

Government
- TV Azteca took the law in its own hands by seizing control of Canal 40, the object of a controversy with the television company CNI. Although the government intervened and the issue is back in the courts, it was accused of doing too little, too late, thereby setting another precedent for the violation of the rule of law.
- Electoral campaigns have started. The Institutional Revolutionary Party (PRI) launched a series of ads that claim that life was better when it was in office. The government’s National Action Party (PAN) has showered the PRI’s most notorious presidents with words such as “devaluations,” “fraud,” and “corruption.” The Democratic Revolution Party (PRD) is running ads almost identical to those of President Luiz Inacio “Lula” da Silva in Brazil.

Society
- Peasant protests against NAFTA’s recent liberalization of agricultural products ended, as a massive demonstration took place in Mexico City and negotiations with the government began. Business groups are demanding that the government stick to its international commitments.
- Mexican health authorities are conducting an official inquiry into a sudden rise in infant mortality in the state of Chiapas. The medical emergency also affected the government, as Health Minister Julio Frenk failed to return from Geneva, where he was jockeying for appointment to the secretariat of the World Health Organization.

Security
- Mexico has asked the International Court of Justice (ICJ) to impose provisional measures on the US to prevent the execution of 54 Mexicans currently on death row. The ICJ has already approved a cautionary measure according to which the US must not execute Mexican nationals until a decision is reached. The case promises to be complicated and politically charged.

Economy
- Mexico continues to bet on yield compression in its quest to be the first country to pay off all its Brady debt. Taking advantage of improved investor sentiment, the Ministry of Finance doubled its planned bond sale to $2bn.
- The peso fell to record lows, surpassing at times the 11 pesos per dollar rate. The peso’s weakness is related to fears of a possible war in Iraq and the current weakness of the dollar vis-à-vis the euro.

COMPONENT SCORES

REGIONAL LEGSI SCORES

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Lehman Brothers Eurasia Group Stability Index (LEGSI):

NIGERIA

HIGHLIGHTS

- **Lagos explosions**: A bank and an apartment building in Lagos were destroyed by bomb blasts. Thirty-five people were killed and hundreds displaced. The blast occurred barely four days after the anniversary of the 27 January 2002 munitions explosion in which 1,000 were killed.

- **INEC holds new voter registration**: The Independent National Electoral Commission held a supplementary voter registration. Last September, an estimated 20mn voters were prevented from registering due to fraud and mismanagement.

- **Police halt fake voter card scheme**: Police seized more than 100,000 fake voter cards and uncovered a scheme to print nearly 5 million cards for the April national elections. Police arrested three persons and are still searching for the man believed to be the financier of the plot—a retired army colonel.

- **Ekwueme challenges Obasanjo’s nomination in court**: Alex Ekwueme, who recently lost to President Olusegun Obasanjo in the People’s Democratic Party (PDP) presidential primary, challenged the outcome in court. He argued that the primary violated party regulations and that ballot papers were numbered, thereby intimidating delegates into voting for Obasanjo.

- **Conflict in Warri**: The oil-rich city of Warri, in Delta state, exploded in violence that killed at least 20 persons. The clashes were sparked by a dispute between rival factions of the ruling PDP over the selection of candidates for elections to the state legislature.

RISKS AND FORECAST

- **Presidential nominations close**: The 30 parties contesting the April presidential elections are required to submit their nomination papers by mid-February. Thus far about 15 parties have nominated candidates.

- **Offshore oil dispute**: Southern governors will continue to pressure President Obasanjo to sign the bill recently passed by the legislature that would include offshore oil in the 13% derivation that goes to oil-producing states. Obasanjo has refused to sign the bill because it will extend the offshore oil boundary from 24 to 200 miles.
ELECTION WILL BE DOGFIGHT BETWEEN OBASANJO AND BUHARI

Although 30 parties will contest the April elections, the presidential race will be a dogfight between President Olusegun Obasanjo, from the ruling People’s Democratic Party (PDP) and the All Nigerian People’s Party (ANPP) candidate, Mohammadu Buhari. Both men are former military rulers of Nigeria, but this time they will have to win with ballots rather than bullets.

Both Obasanjo and Buhari share a military past

Obasanjo will sweep southwest

Buhari will win in north

Revenue allocation is main issue in south-south

Although Obasanjo has many advantages, such as the financial clout of running as an incumbent, the race will be extremely close. Even so, Nigeria’s stability hinges not on the outcome but on the process of the election.

Race will depend on seven zones

Buhari will probably win most of northern Nigeria, which is predominantly Muslim and Hausa speaking, primarily because he is a Muslim Hausa-Fulani from the north. He will certainly have the support of the Abacha clan—the group of business, political, and tribal leaders loyal to former military ruler Sani Abacha. The critical factor will be the support of former military leader and “kingmaker” General Ibrahim Babangida. Although he overthrew Buhari’s government in 1985, he is likely to throw his immense wealth and influence behind the northern candidate, namely Buhari.

Obasanjo will sweep the southwest, dominated by Christian Yorubas. The region will close ranks behind their kinsman. One early sign of this is that the Alliance for Democracy party, which has its stronghold in the southwest, has all but endorsed Obasanjo because of his tribal credentials. The southwest did not support Obasanjo in the 1999 elections, but only because his opponent was another Yoruba.

The southeast is mostly Christian and dominated by the Igbo tribe. The region has never controlled the government and perceptions of political marginalization fueled its attempt to secede from Nigeria during the bloody Biafran civil war in 1967-1970. Although some smaller parties have selected Igbo as presidential nominees, these parties are not strong enough nationally to pose a serious challenge to Obasanjo. As a result, the southeast might support Buhari since he selected an Igbo—Chuba Okadigbo—as his running mate.

The politics of the oil-producing south-south will be dominated by one issue—the percentage of national revenue that goes to the region. Since last April’s Supreme Court ruling that excluded offshore oil revenue from the 13% derivation, Obasanjo has been embroiled in a scuffle with southern governors over the issue. Although he drafted legislation to include offshore oil in the derivation, southern legislators altered the bill to extend the maritime boundary from 24 to 200 miles, thereby including both offshore and deep offshore oil. Obasanjo, under pressure from northern power brokers, has refused to sign the bill. At the PDP primary, southern governors reportedly agreed to support Obasanjo in exchange for his support of the bill, but he has yet to sign it.
There are two reasons why the middle belt states could support Buhari. First, although the region is predominantly Christian (yet Hausa speaking and Fulani), years ago it formed an alliance with the north. Second, last year Obasanjo's soldiers massacred dozens of civilians in Benue state, thus stirring hostility toward the incumbent president.

The outcome of the election could ultimately depend on whether Obasanjo chooses to make Sharia law an issue. Buhari has made some strong statements in the past about his support of Sharia, which already exists in the northern states. Obasanjo could use the issue to exacerbate fears in the Christian south. Although this might help Obasanjo consolidate support in the south, as well as in the middle belt (which is primarily Christian), it would exacerbate north/south divisions in the country.

If the election were held tomorrow, Obasanjo would probably win simply because of the power of incumbency. However, the campaign has barely begun and only when issues emerge will the outcome become more predictable. That being said, of greatest importance for Nigerian stability is the electoral process and not its specific outcome. If Obasanjo wins, but does it through dirty tricks and massive corruption, the north is unlikely to accept the result. This could spark ethnic riots and provoke the military to retake power, as happened the last two times civilian governments staged elections. Only by conducting an election that the public believes is relatively credible and legitimate can Nigeria avoid a reversal of its democratic transition.

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Government
- The Independent National Electoral Commission held a supplementary voter registration aimed at people unable to register during the main exercise in September last year.
- Police seized more than 100,000 fake voter cards and halted a scheme to print nearly 5 million cards for the April national elections. Police arrested three persons and are still searching for the man believed to be the financier of the plot—a retired army colonel.
- Alex Ekwueme, who recently lost to President Olusegun Obasanjo in the People’s Democratic Party (PDP) presidential primary, challenged the outcome in court. He argued that the primary violated party regulations and that ballot papers were numbered, thereby intimidating delegates into voting for Obasanjo.
- The main challenger in the April presidential elections—All Nigerian People’s Party (ANPP) candidate Muhammadu Buhari—met with “kingmaker” Ibrahim Babangida to attempt to resolve historic differences. Babangida’s influence and money is critical to the outcome of the elections, but whom he will support remains unclear.

Society
- The oil-rich city of Warri, in Delta state, exploded in violence that killed at least 20 persons. The clashes were sparked by a dispute between rival factions of the ruling PDP over the selection of candidates for elections to the state legislature.

Security
- A bank and an apartment building in Lagos were destroyed by bomb blasts. Thirty-five people were killed and hundreds displaced. The blast occurred four days after the anniversary of the 27 January 2002 munitions explosion in which 1,000 were killed.

Economy
- In response to the Venezuela oil workers’ strike, OPEC raised Nigeria’s production quota by another 124,000 bpd to 2.018mn bpd, giving a boost to the federal government’s finances for 2003.
- At the monthly meeting of the Federation Accounts Allocation Committee, state finance commissioners requested that funds be withheld from debt service payments in order to help finance state re-election campaigns. Officials from the federal Debt Management Office convinced them of the importance of meeting external debt obligations.
HIGHLIGHTS

- **Communist rebels kill former leader**: Romulo Kintanar, who once led the communist New People’s Army (NPA), was killed by two NPA gunmen on 23 January in Quezon City. Kintanar commanded the NPA in the 1980s when the rebel movement’s strength peaked at about 25,000 armed fighters. He left the guerrilla army in the 1990s after an ideological and personal split with the top leadership. He later became a government consultant in the peace process with the communist rebels.

- **Arroyo hints at next military chief**: President Gloria Macapagal-Arroyo has hinted that she may appoint General Narciso Abaya as the next chief of staff of the Armed Forces when the current chief retires on 8 April 2003. If appointed, Abaya will serve until October 2004. This would make him the longest-serving chief of staff appointed during President Arroyo’s term and mute criticism of a revolving-door policy at the top of the military leadership.

- **Economy grows**: Official figures released in January show that the economy grew by 4.6% in 2002, spurred by a 5.4% expansion in the services sector. Political and economic uncertainties tempered the public’s response to the news.

RISKS AND FORECAST

- **Arroyo faces mixed public support for war in Iraq**: President Macapagal-Arroyo’s strong support for the US in the Iraqi crisis has drawn some criticism, especially from the Roman Catholic Church and some of her political allies. Public support in Manila for a war against Iraq also remains limited. The political fallout for the government is likely to be negligible in the short term, unless there is widespread dislocation of the 1.5 million Filipino workers in the Middle East or there are terrorist attacks in the capital.

- **Peace talks headed for collapse?** Government negotiators plan in February to present communist leaders in the Netherlands with a draft peace agreement approved by the president. Rebel leaders have demanded many concessions from the government before agreeing to hold formal peace talks, including lifting their designation as a terrorist organization. The prospect of peace talks has also declined because of the recent assassination of Romulo Kintanar, the former NPA chief who was acting as a consultant in the peace process, and continued posturing by rebel leaders. Whatever happens, the rebels are too divided and too weak to pose a serious threat.
COMMUNIST REBELS ASSASSINATE FORMER COMMANDER

On 23 January, two NPA gunmen in Quezon City in metropolitan Manila killed Romulo Kintanar, who led the communist New People’s Army (NPA) in the 1980s. Kintanar’s death pointed to continuing divisions within the leadership of the communist movement. Meanwhile, government negotiators are set to present a draft peace agreement to the NPA and the Communist Party of the Philippines (CPP), but progress is unlikely as long as the CPP and NPA remain tagged as terrorist organizations.

Kintanar commanded the NPA in the second half of the 1980s when the rebel movement’s strength peaked at some 25,000 armed fighters. After being captured, Kintanar was released on bail in the early 1990s as part of President Fidel Ramos’s peace initiatives. During this time, the CPP leadership split between the “reaffirmist” faction, which continued to believe in Maoist encirclement of the capital from the countryside, and the “rejectionist” faction, which sought a re-evaluation of the organization’s ideologies, goals, and methods following the collapse of communist states in Europe. Kintanar was accused of being part of the “rejectionist” faction and expelled from the party in 1993. Kintanar later joined the government and eventually became a consultant in the peace process.

Kintanar’s assassination reflects deep divisions within the CPP and may signal an attempt at consolidation by the current CPP leadership. Nathan Quimpo, past member of the CPP’s Mindanao command and a former close associate of party chief Jose Sison, has claimed that Kintanar’s assassination may have been intended to settle old scores. Kintanar, according to Quimpo, simply knew too much about Sison and the NPA. After Kintanar’s death, the “rejectionist” anti-Sison faction vowed to dislodge the NPA from Mindanao island.

The government is facing an uphill battle in trying to restart talks with the NPA. President Gloria Macapagal-Arroyo approved the draft peace agreement, which government negotiators plan to present this February to their counterparts in the communist movement. Sison has rejected the agreement, although he does not have a formal role in the negotiations. However, Luis Jalandoni, who heads the CPP/NPA negotiating team, denied that the rebels had rejected the agreement outright. But he did reiterate their demand that the CPP/NPA be removed from the list of foreign terrorist organizations.

Sison’s options are limited by the fact that the NPA, despite having 10,000 fighters, no longer poses a substantial military threat. Its activities have been limited to ambushes of government troops, attacks on police and military outposts, and the burning of mobile telephone transmitters. In fact, the increase in the reported collection of “revolutionary taxes,” the growing number of NPA camps being captured by the military, and the attacks on mobile telephone sites are an indication that the NPA’s funds from abroad are drying up.

ELECTION TALK FADES INTO BACKGROUND

President Gloria Macapagal-Arroyo’s 30 December announcement that she would not be running in the 2004 presidential elections continues to favor former Senator Raul Roco, who is seen as the middle-class candidate. But Roco is unsure of bagging the nomination of the ruling Lakas coalition, to which his Akson Demokratiko party belongs. There are hints that a powerful clique within Lakas headed by former President Fidel Ramos does not want to endorse Roco. Instead, it has begun to float the name of Senator Juan Flavier. Flavier, who was Ramos’s health secretary, is one of the country’s most popular and cleanest politicians. A doctor who has worked in some of the country’s poorest areas, Flavier could effectively undercut Roco by attracting young people and the poor.
Sources in Manila indicate that the opposition is still having difficulty settling on a candidate, especially if popular actor Fernando Poe Jr. sticks to his decision not to run. Aside from Poe, opposition support may consolidate around Panfilo Lacson, Estrada’s former police chief. Lacson is not as popular as Poe, and the primary question centers on how much he will benefit from Estrada’s support.

The debate about possible combinations in the 2004 elections will continue over the next few months. It is likely that a clear picture will emerge only by the end of 2003. In the meantime, the public will focus on Arroyo’s ability to deliver good governance and reforms.

One possible distraction is the push for constitutional change by some members of Congress, including the Speaker of the House of Representatives, Congressman Jose de Venecia, and Senate opposition leader Edgardo Angara. The business community and the Catholic Church oppose changing the Constitution, and initiatives are unlikely to prosper without their support. Those backing constitutional change have only until the second quarter of this year to initiate their efforts. As the second half of the year approaches, the focus will increasingly turn to the 2004 general elections.

**ARROYO’S POLITICAL WILL TO BE TESTED BY DIFFICULT LEGISLATION**

President Gloria Macapagal-Arroyo identified 14 bills that she would like Congress to pass by the middle of 2003 as part of her government’s reform efforts. These include laws allowing farmland as loan collateral, providing the tax and regulatory framework for securitization, rationalizing document stamp taxes, improving the tax system, privatizing the national electricity transmission company, rationalizing pay levels in the judiciary, allowing absentee voting, and creating a department of housing.

Given the divisions within the Senate, it is likely that only a handful of these measures will pass. The legislation on improving the government’s revenues, privatizing the national electricity transmission company, and creating a new revenue service are especially controversial.

President Arroyo’s legislative program would benefit from Senator Franklin Drilon’s staying on as Senate president. In June 2001, senators belonging to the ruling coalition agreed that the 36-month term of the Senate president should be split between Drilon, who would sit for the first 18 months, and Senator Renato Cayetano, who would take the helm in the next 18 months, with the transition taking place at the start of 2003. This agreement was forged to prevent the ruling coalition in the Senate from fragmenting early in the president’s term. However, Cayetano has been in the US since October 2002, reportedly to seek a liver transplant. With Cayetano abroad, Drilon is unlikely to lose the Senate presidency. This works to the advantage of the administration. A change in the Senate leadership would lead to multiple realignments and undermine the government’s ability to advance its legislative program.
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Government

- President Gloria Macapagal-Arroyo hinted that she might appoint General Narciso Abaya as the next chief of staff of the Armed Forces. Abaya's term will run from April 2003 to October 2004, making him the longest-serving military chief to be appointed by Arroyo.
- The opposition linked to former President Joseph Estrada seemed to be consolidating around Senator Panfilo Lacson as its standard bearer in the 2004 presidential elections.
- President Arroyo signed into law a procurement bill that aims to lower corruption in government.

Society

- Public support for active Philippine support of a war against Iraq remained weak despite President Arroyo's strong backing of the U.S.

Security

- NPA hit men killed Romulo Kintanar, the former top commander of the New People's Army (NPA).
- President Arroyo approved a draft peace agreement, which government negotiators reportedly plan to present to communist rebels this February. Underlying tensions created by the designation of the NPA as a terrorist organization and the killing of Kintanar are likely to slow negotiations.

Economy

- The government refused to back down from the implementation of the 10% VAT on professionals in 2003, although it did give them a one-month reprieve.
- The government reported a 212bn peso ($4bn) budget deficit for 2002. Full-year economic growth for 2002 was pegged at 4.6%, surpassing many estimates.
HIGHLIGHTS

EU referendum vote: In a move to ensure a higher turnout, Parliament adopted legislation that could extend the voting period for the referendum to two days. If turnout is less than 50%, the referendum would be invalid and, according to pending legislation, two-thirds of the parliament would have to vote in favor of joining the EU in order to circumvent the failed referendum.

Agreement criticized: Opposition parties criticized the government for alleged misunderstandings between Polish and EU negotiators. The two sides apparently did not have the same understanding of the accession treaty language covering several important issues such as milk quotas and farm subsidy distribution.

NBP under fire again: In February, the government developed a new twist in its on-and-off game of blaming the Central Bank (NBP) for Poland’s economic troubles. Senior cabinet members claimed that high interest rates and a strong zloty were to blame for the lack of economic growth and high unemployment.

RISKS AND FORECAST

Bribery scandal: “Rywingate,” a scandal involving an attempted bribery of the Agora media group will continue to make news in the coming months. The parliamentary commission charged with investigating allegations that the Democratic Left Alliance attempted to extort money from Agora in exchange for favorable legislation will continue its work for at least several months. At this stage it appears unlikely that Prime Minister Leszek Miller will be seriously damaged by the scandal.

NATO vs. EU? Poland’s strong support for the US on security matters could lead to tensions with leading EU member states such as France and Germany, which are challenging the US approach to disarming Iraq.

Referendum turnout: Popular support for joining the EU is likely to remain stable and strong—in the 60% range. Turnout threshold worries should diminish following a government media campaign and the possible addition of a second day of voting. The referendum is now likely to be held 7-8 June.
EU REFERENDUM CONDITIONS AGENDA

Voter turnout a concern

Although the level of public support for joining the EU appears high and stable, senior government officials are worried about voter turnout for the 8 June referendum. If turnout is less than 50%, the referendum would be invalid and, according to pending legislation, two-thirds of the parliament would have to vote in favor of joining the EU in order to circumvent the failed referendum. More than two-thirds of senators and members of parliament are in favor of joining the EU, but the political bargaining that would be required to produce a positive outcome could be intense and disruptive.

Two days, more voters

In a move to ensure a higher turnout the parliament adopted legislation that could extend the voting period for the referendum to two days. Language allowing for the additional day of voting was inserted into the draft law on referenda, which was passed easily by the parliament. The current target date for the vote is Sunday, 8 June, but the vote may now take place on 7 June as well. The only rationale for this move is that it would increase the chances of meeting the 50% threshold, as the "rainy Sunday" risk would be diminished.

Treaty language will be criticized

Some political leaders are concerned that public opinion could shift ahead of the June referendum. They fear ongoing criticism from opposition parties of the final content of the accession treaty. There will be a parliamentary debate on the treaty in late March or early April, before it is formally adopted at the EU’s summit in Athens on 16 April. One particular concern is that the contents of the treaty are now "final" and cannot be renegotiated. Opposition parties continue to criticize the government for alleged misunderstandings between Polish and EU negotiators. For example, the two sides apparently did not have the same understanding of the treaty language covering several important issues such as the process for distributing agricultural subsidies, the timing for changes to "special economic zones," and the terms of milk quotas.

No controversy, please

With these concerns in mind the government is going out of its way to avoid controversy in the months before the referendum vote. Sensitive issues that the Democratic Left Alliance (SLD) will not address until after 8 June include mining sector reform, Finance Minister Grzegorz Kolodko’s fiscal reform program and 2004 budget proposals, and the reform of the farmers’ pension system. In order to ensure the support of the Catholic Church, the government has also shown a great deal of flexibility in pushing for a church-inspired "morality" clause to the accession treaty. The SLD’s agenda for reforming Poland’s relatively restrictive abortion law is also on hold.
GOVERNMENT AND CENTRAL BANK STILL AT ODDS

In February, the government developed a new twist in its on-and-off game of blaming the Central Bank (NBP) for Poland’s economic troubles. Senior cabinet members claimed that high interest rates and a strong zloty were to blame for the lack of economic growth and high unemployment. In this instance the independence of the NBP was not threatened directly, but the accusations did serve to highlight a sense of desperation among government officials unable to get the economy moving again.

The government’s latest criticism of the NBP did not constitute a direct threat to the Bank’s independence, but draft legislation making its way through parliament could. The Sejm’s public finance committee is in the process of considering amendments to regulations governing the NBP. Some of the proposals would have very damaging effects, while others would be merely problematic. For example, Samoobrona is suggesting that all members of the Bank’s Monetary Policy Council (RPP) be given a parliamentary “vote of approval” each year; if they were not approved, they would be dismissed. This sort of procedure almost surely violates EU law. Other less dramatic suggestions include the enlargement of the RPP. In the end it is unlikely that the most damaging suggestions will be adopted and become law.

IDLE THREATS FROM THE PSL

Once again this month the junior coalition partner, the Peasants Party (PSL), threatened to leave the government. The PSL criticized the SLD on a number of issues, including its handling of EU accession treaty negotiations, the bio-fuel bill that was vetoed by President Alexander Kwasniewski, and the terms of the draft act on the sale of land. These sorts of threats and attacks are familiar and at this stage do not portend a failed coalition. The PSL still has good reasons to remain in the government, as many of its leaders enjoy the perks of power, such as ministerial positions, and control of the distribution of certain agricultural funds and subsidies that they would lose if they left the ruling coalition.
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Government
- Fears persisted about the EU referendum turnout. The government planned a major public relations offensive and delayed a series of controversial measures until after the referendum in June.
- The prime minister remained above the fray regarding the “Rywingate” bribery scandal involving an attempted bribery of the Agora media group.

Society
- Last month’s cabinet reshuffle improved the environment for the private sector. Investors viewed the removal of Wieslaw Kaczmarek from his post as treasury minister as a positive development.

Security
- Poland joined a number of other European countries in supporting the US security agenda in the Middle East.
- Prime Minister Leszek Miller met with US officials in Washington to discuss a range of issues including ongoing security cooperation. American and Polish officials celebrated Poland’s recent decision to buy US-made fighter planes.

Economy
- The government released economic data regarding growth for 2002. The news was mildly encouraging because it suggested that the slow-growth period had “bottomed out.”
- Risks remain, however, as the investment climate in Poland has not improved. Public tax and finance reforms have not been finalized, and the external environment – high oil prices and weak demand in Europe – remains problematic.
HIGHLIGHTS

- **Power outages**: Massive power system failures across Russia left tens of thousands of people without heat during one of the coldest winters on record. The crisis provoked conflict between the Duma and the government and spurred the Communists to initiate a no-confidence vote in Prime Minister Mikhail Kasyanov’s cabinet. Intra-Duma disagreements also flared, with pro-Kremlin centrist parties blaming local authorities for the crisis and liberal parties blaming the central government for delaying structural reforms of the power sector.

- **Pipeline battles**: The government and the oil majors sparred over export infrastructure. Kasyanov endorsed the right of state-owned pipeline monopoly Transneft to retain control over all pipelines, while the oil majors protested inadequate export capacity and proposed their own privately funded export pipelines. With oil production reaching a 10-year high and world oil prices well above $30 per barrel (bbl), the government’s 30% cap on exports has produced a domestic oil glut and domestic prices of just $5/bbl.

- **NTV under fire again**: US citizen Boris Jordan was dismissed from his positions as head of Gazprom-Media and the NTV national television station. His dismissal may have been politically motivated. President Vladimir Putin had publicly criticized NTV’s unfavorable coverage of the government’s handling of the October 2002 hostage crisis in Moscow.

- **Waffling on Iraq?**: Putin suggested that Moscow could consider taking a tougher line on Iraq to enforce UN resolutions if Iraq obstructed weapons inspections, bringing him closer to the US position on Iraq. He subsequently endorsed the German and French view that the weapons inspections regime should be strengthened and a diplomatic solution found.

RISKS AND FORECAST

- **Internal dissent on Iraq**: Putin’s ambiguous position on Iraq may lead to squabbles with parliament, which opposes a US-led war in Iraq. If the UN Security Council considers a second resolution on Iraq, Russia is not expected to veto military intervention.

- **Cash for space program**: With NASA’s shuttle fleet temporarily grounded due to the Columbia disaster on 1 February, Russian space capabilities will become critical to keeping the International Space Station viable. The US will have to increase funding to the cash-strapped Russian space program.
**OIL EXPORT WARS**

Tensions between the government and the Russian oil majors increased as domestic oil prices slumped to $5 per barrel (bbl), while world oil prices remained above $30/bbl due to the possibility of war in the Middle East and the general strike in Venezuela. The government continues to limit oil exports to 30% of production—even as production in 2002 rose to its highest level in a decade—and state-owned Transneft retains its monopoly over the Russian pipeline system. But the oil majors are fighting back with plans for new export pipelines, full usage of all ports, and capacity improvements to existing infrastructure. So far, the government has rejected their suggestions. Big business seeks to maximize profit, gain greater independence, and reduce regulation, while the government seeks to retain control over and extract revenue from the lucrative energy sector. Energy accounts for 40% of Russia's total exports and 13% of GDP; a $1/bbl change in world oil prices translates into a $1bn difference in Russian federal budget revenues.

The vast majority of Russia's oil exports go to Europe, and Transneft's Druzhba pipeline handles the bulk of the flow. The oil majors, keen to tap into US and Asian markets, want to develop several new pipeline routes with or without Transneft's participation. LUKoil, Yukos, Tyumen Oil (TNK), Sibneft, and Surgutneftegaz (SNG) have jointly proposed building a pipeline to the ice-free, deep-water port of Murmansk to facilitate exports to the US. Yukos has proposed building a pipeline from Angarsk in Siberia to Daqing, China. Both proposals have uncertain futures.

The Murmansk project competes with Transneft's new Primorsk terminal outside St. Petersburg and the associated Baltic Pipeline System. Only two years old, the Primorsk terminal has helped increase exports to Russia's traditional target area of Europe, but cannot accommodate the very large crude carriers needed for transatlantic shipments. If the Murmansk pipeline moves forward, it will almost certainly be with the express participation of and possible ownership by Transneft, rather than as a private venture. Prime Minister Mikhail Kasyanov signaled this outcome in January when he said that all Russian pipelines were to remain state owned.

Yukos's proposed Angarsk-Daqing pipeline appears to be in jeopardy as Transneft is backing an alternative Eastern pipeline project that would run from Angarsk to the Pacific port of Nakhodka. The former is backed by China; the latter is backed by Japan. Japanese Prime Minister Junichiro Koizumi, visiting Russia in January, explicitly offered Japanese financial support for the Nakhodka pipeline, which would serve a range of Asian oil importers. The Daqing pipeline, although considerably shorter and less expensive than the Nakhodka pipeline, would appear to have an uncertain future due to Transneft's opposition.

The oil majors also object vehemently to the fact that Transneft's export plans do not include access to Latvia's Ventspils terminal for at least the first third of 2003. With Latvia looking to sell a 37% stake in the terminal, Transneft's boycott of Ventspils, which is standing idle with no other significant supplier of oil, may be intended to pressure Latvia to favor a Russian bidder. Transneft increasingly prefers to use terminals and ports on Russian territory, unless it can win ownership and control over neighboring countries' assets.

The government is continuing to work on an amendment to the law on subsoil resources that could significantly alter the current system of natural resource licenses. The amendment, originally suggested by the Kozak commission in the summer of 2002 (Dmitri Kozak, the president's deputy chief of staff, heads a commission reviewing federal relations), met with stiff opposition from the oil companies, after which it was quietly dropped from public debate. The proposed amendment would change the current licensing system, which gives private companies...
ownership of natural resources, to a concession system, in which the state would continue to own the natural resources even after extraction by a private company. The company would be compensated for its operational costs and provided with a profit. There are indications that the government intends to submit the amendment to the Duma in the near future. Although licenses held by the oil majors should not be affected, smaller producers could be the intended target. The concession system would significantly diminish the power of regional administrations, as only the federal government would have signatory power over concessions. Currently, both the federal government and regional administrations have joint signatory power.

There is reason to believe that Kasyanov’s stated support of Transneft and its head, Semyon Vainshtok, in the pipeline debate reflects the position of President Vladimir Putin. Given Kasyanov’s well-known ties to the so-called Yeltsin-era oligarchs, his statist position on the pipelines flies in the face of his close association with oil barons such as Sibneft’s Roman Abramovich and LUKoil’s Vagit Alekperov.

MORE US FUNDING FOR RUSSIAN SPACE TECHNOLOGY?

The loss of NASA’s Columbia space shuttle has made Russian space capabilities critical to keeping the International Space Station (ISS) aloft. Russian space officials, quick to make the link after the 1 February disaster, have vowed that the ISS, with a crew of three, would be fully serviced through at least the rest of 2003. Additional Progress cargo ships and Soyuz crew-transport vehicles, already an integral part of the ISS program, could go into production, according to the Russian Aviation and Space Agency, but only if additional funding is secured from ISS partners. Since financing is unlikely to come from the European, Canadian, or Japanese space agencies, the US is likely to have to find the funds. Doing so would further the long-standing US agenda of helping to finance Russia’s cash-strapped space program in a bid to keep Russian scientists and engineers at home—rather than seeking employment in states unfriendly to the US. The Russian space program has an annual budget of $265mn. By contrast, NASA’s total budget is $15bn, with the space shuttle program alone funded at $3bn.

NASA’s space shuttles play an invaluable role in the ISS program, as they can carry up to 100 tons of cargo to the station and are reusable. Russia’s unmanned Progress ships carry a maximum of 2.5 tons of cargo and are subsequently burned up in the earth’s atmosphere. Thus, relying solely on Progress ships for cargo deliveries means having to build more. If the shuttles remain grounded for a substantial period of time, additional Soyuz crew-transport capsules would need to be built.

NASA’s plans vis-à-vis the shuttle program remain unclear, with US and Russian space officials planning to meet later in February to discuss the situation. Because of laws barring US agencies from funding foreign government programs that supply nuclear or missile technology to Iran—the US alleges that Russia is aiding Iran in the development of its nuclear capabilities—NASA may be legally unable to finance directly the production of Progress or Soyuz vessels. Broader political and bilateral considerations are likely to come into play, however. Not only is the US unlikely to allow the $100bn ISS to close down, but also the opportunity to support Russia’s space program comes at a time when the US is wooing allies in the Iraq crisis. A deepening of financial and operational co-dependence could help move Russia toward the US position on Iraq.
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Government
- Massive power system failures across Russia left tens of thousands of people without heat during one of the coldest winters on record. The crisis provoked conflict between the Duma and the government and spurred the Communists to initiate a no-confidence vote in Prime Minister Mikhail Kasyanov's cabinet.
- President Vladimir Putin sent the Duma a draft bill defining the role of power-sharing agreements between the federal center and the regions. The bill marks the start of broad reform of the federal system and may encounter resistance from regional elites, as it establishes the basic principles for administration and distribution of state property in the regions.

Society
- Conflict between the government and oil majors over export infrastructure flared. Kasyanov endorsed the right of state-owned pipeline monopoly Transneft to retain control of all pipelines while the oil majors protested inadequate export capacity and proposed their own privately funded export pipelines.
- US citizen Boris Jordan was dismissed from his positions as head of Gazprom-Media and the NTV national television station. His dismissal may have been politically motivated given NTV's independent, and often critical, editorial line.

Security
- Putin suggested that Moscow could consider taking a tougher line on Iraq if Iraq obstructed weapons inspections, bringing him closer to the US position on Iraq. He subsequently endorsed the German and French view that the weapons inspections regime should be strengthened and a diplomatic solution found.
- The visit of Japanese Foreign Minister Junichiro Koizumi to Moscow significantly improved bilateral ties. Japan desires access to the Russian Far East's massive oil and gas resources.

Economy
- With oil production reaching a 10-year high and world oil prices well above $30 per barrel (bbl), the government's 30% cap on exports led to a domestic oil glut and domestic prices of just $5/bbl.
- Kasyanov ordered the Ministry of Finance to prepare proposals by the end of February on more radical tax cuts in order to stimulate economic growth. This could lead to a reduction in the unified social tax by 2004.
HIGHLIGHTS

- **US-Saudi relations fragile**: Prince Bandar Bin Sultan, Saudi Ambassador to the US, stressed that relations between the two countries had not been weakened since the terrorist attacks of 11 September emphasizing the fact that a variety of joint activities between the two had been undertaken behind the scenes over the past months.

- **Saudis attend Istanbul meeting on Iraq**: Foreign Minister Prince al-Faisal visited Istanbul in January. The purpose of the six member ministerial meeting consisting of Egypt, Turkey, Syria, Jordan and Iran was to form a common goal to prevent a US-led war on Iraq and enhance cooperation between the six Islamic states. The meeting also sought to convince Saddam Hussein to comply with all existing UN Security Council resolutions.

- **Riyadh denies US use of Saudi Air Base**: The Saudis continue to deny that the US has asked for access to the Prince Sultan Air Base. The Defense Department in Washington in private briefings has said that the Saudis will offer some support.

RISKS AND FORECAST

- **Anti-US feeling on the rise**: Anti-Western and especially anti-American feelings are growing as the Iraqi crisis intensifies. The US Embassy in Saudi Arabia has advised Americans to consider leaving the country. Anti-US sentiment is likely to be highest during the Hajj, when over 2 million Muslim pilgrims convene in Mecca as part of the annual religious celebrations. The Saudi government and security services are committed to protecting foreigners.

- **Saudi-Yemeni border stresses**: If the US invades Iraq, the Saudi border with Yemen could witness armed conflict and mass migration of Shia refugees. Saudi troops are reportedly stationed along the border to repel the possibility of large numbers of Shia seeking safe haven. The Kingdom’s Shia minority population is already a cause for concern for the Saudi authorities who continue to ignore their calls for increased rights. Aside from migrationary pressures, Saudis are also concerned that the porous border would enable members of Al Qaeda to seek refuge between Yemen and the Kingdom.

- **Saudis under pressure to prop up world oil supplies**: The Kingdom will be under intense political pressure to ensure the flow of oil supplies if Iraqi crude oil comes off the market. Because of the continued disruptions of oil flow from Venezuela, Saudi Arabia is already pumping between 0.5-1 million barrels per day more than its new 7.96 million barrels per day quota to make up for the shortfall.
CROWN PRINCE ABDULLAH’S SURPRISE CALL FOR REFORM

Crown Prince Abdullah’s calls for political and economic reform are not destined to fall on deaf ears. Abdullah’s announcement in January that he would present an Arab Covenant at the next Arab League summit meeting scheduled for March in Bahrain will cover a number of issues such as the Arab-Israeli dispute, external aggression against the Arabs and perhaps the most interesting aspect is a call for political and economic reform in the wider Arab world. Although the prince’s initiative is not new and is most likely to fail, the Saudi hope is that all Arab Heads of State will sign up to it.

Exact details of the covenant are still vague as it has not yet been released in its entirety, but a key quotation from a draft document illustrates the beginning of a bout of new renewed thinking and a potential shift in the Kingdom whereby:

The leaders decide that self-reform and the promotion of political participation in Arab countries represents two basic tools for building Arab capabilities. They provide the conditions needed to realize comprehensive and sustainable development, meet the requirements for positive engagement in international affairs, encourage creative thinking, and deal objectively with international changes, notably globalization and the rise of mega-economic blocks, as well as catch up with rapid developments in such areas as technology, communication, and information.

The most significant aspect of the draft is the reference to political participation as a precondition of sustainable development. The claim is an admission that democratic orientated change is imperative. Jamal Ahmad Khashoggi, a Saudi political analyst and the deputy editor-in-chief of Saudi Arabia’s English-language Arab News, claimed that Abdullah’s reformist vision meant a new Saudi state that initiates reform and seeks to widen and develop political participation. Khashoggi went on to claim that “It definitely would not be the same Saudi Arabia that fears change and modernity. It would be a new Saudi Arabia that strives for continuous and self-perpetuating development that does not rely on state aid or oil revenues.” In a related development, a group of Saudi intellectuals presented Abdullah with their own ideas for reform, which included holding elections to the Majlis al Shoura (Consultative Council).

Although reformers appear to have the upper hand at present, the Crown Prince must also have to listen to the conservative clergy, the Ulama who have as much influence on this thinking as do the liberals. Not surprisingly, the document could appeal to both constituencies. As such, it is likely to both raise and dash expectations.

Calls for reform are not new. Similar initiatives surfaced in 1992, but unsurprisingly failed to produce any tangible results. Abdullah’s initiative is probably cosmetic, geared toward improving the Kingdom’s image in the West. As the US is pursuing regime change in Iraq and calling for greater transparency in other Arab states, the crown prince’s talk of reform may temporarily distract critics and give the impression that something is being done to construct more transparent institutions outside of control of the House of Saud.
MOSQUES TO TOW THE GOVERNMENT’S LINE

The Ministry of Religious Affairs announced a series of measures that seek to impose greater control on the country’s thousands of mosques. There will be much closer supervision of Imams and other religious leaders. Model sermons will be issued to set guidelines. The ministry’s announcement is the latest in a string of measures designed to control the activities of extremist organize the country’s thousands of mosques in a more bureaucratic form. There will be much closer supervision of Imams and religious leaders on the content of their sermons. Model sermons are to be issued to help guide them in what the authorities want them to say. This is the latest in a string of measures designed to control the activities of extremist preachers and clerics. Crown Prince Abdullah and Prince Nayef (who has responsibility for keeping the mosques under control) have urged preachers to moderate their sermons and to stop extremists from using their pulpits.

Egypt tried a similar move in the early 1980s but it took about 15 years to implement. Reforming the mosques may also also may also take a long time in Saudi Arabia. The government has replaced several of the leading Ulama but some imams will continue to resist. The religious universities will continue to produce students with fundamentalist and extremist views. The extremists who operate through social groups sometimes linked to mosques, are attracted to Osama bin Laden and Al Qaeda but are deterred from organizing or taking action by the Saudi security services. The extremists are not a threat to the regime in the short or medium term and are unlikely to be able to coalesce into terrorist groups.

HUMAN RIGHTS WATCH VISIT TO THE KINGDOM

Saudi Arabia has signaled that it intends to implement tougher human rights standards. A senior official from Human Rights Watch (HRW) met in January with Ministers of interior, foreign affairs and justice. In addition, Foreign Minister Prince Saud al Faisal is to head a committee that will examine how human rights can be improved in the country.

Until the terrorist strikes of 11 September, the Saudis claimed that their own Islamic interpretation of human rights laid stress on the rights to housing and employment and was opposed to western interpretations. Although Saudi attitudes may be changing, Riyadh is probably more concerned with improving Saudi Arabia’s tarnished image in the West than with actually adopting tougher human rights standards. If so the Kingdom will continue to violate international human rights norms and conventions. Until the government adopts and adheres to more transparent procedures and norms, its human rights record will continue to be a bone of contention with the West and the subject of scrutiny by HRW and other similar organizations.
Government
- Crown Prince Abdullah announced in January his commitment to an Arab Covenant on political and economic reform the Arab world.
- The Kingdom is supporting the efforts of European and Arab leaders who want to give Chief UN Weapons Inspector Dr. Hans Blix, more time.

Security
- Saudi security patrols have begun patrolling the border with Yemen to repel potential Shia refugees from Iraq and members from Al Qaeda seeking refuge in the Kingdom.
- Saudi attempts to reorganize mosques and get Imams to tow the governments line may produce a backlash by devout students against such reforms.

Society
- The government has announced that it will improve the country's social security program in the field of training, professional health and international labor standards.

Economy
- The country's tightening fiscal position has forced the government to take drastic measures. The latest is a reduction in the number of foreign workers in the country. Saudi Arabia said it would reduce foreigners working in the kingdom to 20% of the total population by 2013.
- The Kingdom will be under intense political pressure to ensure the flow of oil supplies if Iraqi crude oil comes off the market.
HIGHLIGHTS

- **World Cup cricket**: The world’s eyes were on South Africa when it staged the opening ceremony for the 2003 cricket World Cup. The event was hailed as a success, thus increasing South Africa’s chances of winning bids to host future international sporting events.

- **Truth troubles**: The Truth and Reconciliation Commission (TRC) averted a court battle with the opposition Inkatha Freedom Party (IFP) over the final TRC report. The commission agreed to amend certain sections of the report that blamed the IFP for human rights abuses during the final years of apartheid. The final report will now be published in the first half of 2003, paving the way for victims to finally receive reparations.

- **AIDS activism**: The Treatment Action Campaign (TAC) threatened to inaugurate a national civil disobedience campaign if the government fails to sign and implement a national prevention and treatment program. Although government, the TAC, business, labor had agreed on a plan in late 2002, the government has yet to sign.

- **Corruption controversy**: Deputy Minister of Social Development David Malatsi resigned after allegations surfaced that he accepted money from the company that won a tender to develop a golf resort outside Cape Town.

- **Telkom IPO**: Citing higher than expected public demand, the government announced that the initial public offering of the state telecommunications company, Telkom, would be pushed back from 25 February to 4 March 2003. The sale is expected to raise 4.7 - 5.7bn rand, half of the government’s privatization budget.

RISKS AND FORECAST

- **Parliament reopens**: After President Thabo Mbeki’s speech on 14 February, parliament will re-convene for its first session of 2003. On the agenda will be black economic empowerment and anti-corruption legislation.

- **Budget speech**: Finance Minister Trevor Manuel will deliver his annual budget speech on 26 February. He will outline government priorities for the next three years.

- **Black economic empowerment**: The government intends to make black economic empowerment (BEE) a priority for 2003. BEE began with the mining charter, but other sectors—such as energy and banking—are likely to follow suit and adopt similar charters.
ALL SYSTEMS GO FOR TELKOM IPO

The government announced that the sale of the state telecommunications company, Telkom, was set for 4 March. It had previously been slated for 25 February but the government cited “unprecedented” public interest as the reason for the delay. Although trade unions continue to oppose the government’s privatization program, the Telkom listing reflects the government’s continued commitment to restructuring.

Sale expected to raise about 5bn rand

The government will offer 139.3mn shares, or 25% of Telkom, at between 33.50 and 40.90 rand each. The sale is expected to raise 4.7bn - 5.7bn rand, about half of the government’s privatization budget. However, because the government’s tax collection proceeds have far exceeded its target, this will not negatively impact South Africa’s fiscal profile. Other privatizations are expected later this year, including electricity distributors currently under Eskom.

Government believes offering will bolster investor confidence

Although global events, such as a US attack on Iraq, could negatively impact the listing, for now the government remains optimistic. Government officials believe that the offering will bolster investor confidence in South Africa. In addition, they believe that the offering will demonstrate the government’s confidence in black economic empowerment. One of the IPO’s unique features is that low-income earners can buy shares worth up to 5,000 rand at a 20% discount through the black empowerment company Khulisa.

Privatization’s impact on job creation is critical for stability

Although the IPO might increase state stability in the short term, the long-term impact will depend on how restructuring affects job creation. Although the philosophy behind privatization is that it shifts jobs to the most profitable sectors, this remains to be proven in South Africa. Leftist critics of government policy, such as the Anti-Privatization Forum, contend that privatization only exacerbates unemployment, which now stands at 30%. Unless the government devises concrete solutions to mass unemployment, political stability will eventually deteriorate.

TACKLING BLACK EMPOWERMENT IN POST-APARTHEID SOUTH AFRICA

One of the government’s priorities in 2003 will be the implementation of its black economic empowerment (BEE) agenda. Although aspects of the agenda may unsettle foreign investors, domestic investors support the broad contours of the strategy and view it as essential for South Africa’s long-term stability.

Mining charter was first stage of empowerment

The first stage of black economic empowerment was the drafting of the Minerals and Petroleum Resources Development Bill and the subsequent mining charter. This bill aimed to increase black empowerment in the mining industry. After lengthy negotiations between the government and mining industry representatives, the charter adopted a broad definition of empowerment. It reduced the target of black ownership from 51% to 29% to be reached in 10 years and mandated stakeholders to pursue other empowerment strategies, such as human resource development, employment equity, and community development projects.

Empowerment was big issue at ANC national conference

Empowerment and its definition were also major issues at the African National Congress (ANC) national conference in December. The ANC adopted a resolution that laid out five indicators of empowerment: (1) ownership; (2) operational participation and control within firms; (3) the transfer of skills to blacks; (4) the contribution of firms to employment creation; and (5) the degree to which schemes lead to an overall reduction in income inequality.

Government plans to introduce BEE charter

The government plans to introduce a national empowerment charter that will lay out general guidelines and clearly state the intentions of government, labor, and business to meet
empowerment objectives. Within this framework, each sector of the economy will be expected to draft a specific empowerment charter similar to the mining charter.

Banking sector will be focus of empowerment

The banking sector will be an important focus of empowerment efforts. The government has decided that access to credit is important to alleviating poverty and stimulating growth. One element of banking sector empowerment is the recently drafted Community Reinvestment Housing Bill.

Bill marks attempt to increase access of poor to housing finance

The bill marks an attempt to provide adequate housing for the 60% of South African households that earn less than 4000 rand per month. Its stated goal is to “meet the needs of low and medium income households in assessing home loan finance.” In order to meet this objective, the draft bill prohibits redlining—the practice of denying loans to people based on their neighborhood of residence. It also proposes that banks meet certain targets for lending to low-income households.

Banks on board with overall goal, but differ on best means to achieve it

The CEOs of the major banks have initiated weekly meetings to discuss empowerment in the banking sector. According to a source at the Banking Council of South Africa, an organization that represents the interests of banks, the banks believe that “empowerment is an economic, political, and moral imperative.” Although they agree with the overall goal of empowerment, they advocate a slightly different means of achieving it. They would like to see government and banks jointly share the risks that such lending would entail. For example, their solution to housing finance is to establish a national housing trust to which both government and banks would contribute and through which they would jointly make lending decisions.

Government and banks are negotiating

Government and banking representatives are currently negotiating an empowerment in the banking sector. According to representatives from the Banking Council, these discussions are progressing smoothly and the government is receptive to their ideas.

Empowerment important for long-term stability

Although foreign investors have reacted nervously to news of banking sector empowerment there are two reasons why these fears are unwarranted. First, the example of the mining charter negotiations suggests that the government is committed to working with the private sector, not against it. When mining companies disagreed with certain proposals, negotiations ensued and compromises were eventually reached. Second, empowerment—whether it is through direct ownership, job creation, or access to finance—is necessary to address the problem of poverty in South Africa—an issue increasingly important to the electorate. The ANC knows it must begin to alleviate poverty if South Africa is to remain stable and become economically prosperous.
LEGSI SUMMARY - FEBRUARY 2003

Government
- The Truth and Reconciliation Commission (TRC) averted a court battle with the opposition Inkatha Freedom Party (IFP) over the final TRC report. The commission agreed to amend certain sections of the report that blamed the IFP for human rights abuses during the final years of apartheid.
- The Treatment Action Campaign threatened to inaugurate a national civil disobedience campaign if the government fails to sign and implement a national prevention and treatment program.
- Deputy Minister of Social Development David Malatsi resigned after allegations surfaced that he accepted money from the company that won a tender to develop a golf resort outside Cape Town.

Society
- Citing higher than expected public demand, the government announced that the initial public offering of the state telecommunications company, Telkom, would be moved from 25 February to 4 March 2003.
- Government officials and representatives from the banking sector continued discussing plans for black economic empowerment in the banking sector. The government believes that access to credit remains a crucial impediment to both economic growth and the provision of basic services, such as housing.
- The presiding officers of parliament requested that the media vacate its offices in the main parliament building, although they contended the move is necessary to free up space for parliamentary staff, journalists argued that it will reduce their ability to cover legislative activities.

Security
- The world’s eyes were on South Africa when it staged the opening ceremony for the 2003 cricket World Cup. The event was hailed as a success, thus increasing South Africa’s chances of winning bids to host future international sporting events.

Economy
- Consumer inflation declined for the first time in 15 months, falling to 12.4% in December, from 12.7% in November.
- Producer inflation was 12.4% in December, down from 13.9% in November.
**HIGHLIGHTS**

- **Surprise cabinet reshuffle:** On 8 February, Prime Minister Thaksin Shinawatra initiated a surprise cabinet reshuffle. The changes moved the energy, justice and finance ministers, and a number of deputy prime ministers. No senior cabinet members were left without portfolios following the reshuffle, and no major policy changes are expected as a result.

- **Anti-drug campaign:** The government created a National Center to Defeat Narcotics and Prime Minister Thaksin vowed—quite unrealistically—to rid the country of drugs by 30 April. Recent public statements by politicians and the deaths of over 100 drug suspects since 1 February suggest the return of extra-judicial killings as a tool of law enforcement.

- **Burma and Cambodia:** Prime Minister Thaksin traveled to Rangoon, Burma in an effort to improve recently strained relations. But while Thai-Burmese relations have stabilized, Thai-Cambodian relations were put into crisis when a rumor sparked widespread anti-Thai rioting in Phnom Penh in late January.

- **Sukhumvit Square demolition:** In the early morning of 26 January, a wrecking crew entered the Sukhumvit Soi 10 entertainment area in Bangkok, evicted tenants and patrons, and leveled the shops and bars using heavy machinery and cranes. Certain parties to a land dispute may have decided to settle the issue by force. The startling lawlessness of the episode prompted Prime Minister Thaksin to announce that, “We will not tolerate mafia rule in Thailand.”

- **Several ministers cleared:** The National Counter Corruption Commission exonerated Deputy Prime Minister Somkid Jatusripitak, Natural Resources and Environment Minister Praphat Panychartraksa, and Deputy Finance Minister Suchart Jaovisit of impeachment allegations submitted by the opposition Democrats in May 2002.

**RISKS**

- **Campaign mode?** In recent weeks, Prime Minister Thaksin has increasingly been making grand, campaign-style pronouncements. He has stated that poverty will be eliminated in 6 years; that Thailand will have 6% growth in 2 years; that his government will invest 100bn baht more into the Village Fund and increase Peoples Bank microcredit facilities. The talk has prompted speculation that Thaksin is preparing to dissolve the House and call new elections. Such a move is possible, but unlikely.

- **Development controversies:** The government appears increasingly intolerant of public opposition to its development policies. Authorities dismantled the Pak Moon dam protest camp outside Government House in Bangkok in early February. The government continued to arrest participants in the 20 December protest in Hat Yai that was attacked by police. Despite these tactics, opposition groups continue their activities unabated.
CABINET RESHUFFLE

On Saturday, 8 February, Prime Minister Thaksin sprung a surprise cabinet reshuffle, moving the energy, justice, finance and deputy finance ministers, and creating another deputy prime minister portfolio [see graphic]. No senior cabinet members were left without portfolios following the reshuffle, and no major policy changes are expected as a result. Nevertheless, there are a number of interesting implications.

Prommin will tackle development controversies

A number of the changes impact economic portfolios. Prommin Lertsuridej’s transfer from deputy prime minister (economy) to energy minister was viewed by some as a demotion. However, he is a close confident of the prime minister, and Thaksin may have wanted Prommin at the energy ministry to deal with increasingly difficult development issues like the Trans Thai-Malaysian gas project and the Prachaup Khiri Khan coal plants. In addition, Thaksin is known to be personally involved in economic policymaking, so Prommin’s new portfolio may actually offer greater autonomy and power.

Somkid moving upstairs

Somkid Jatusripitak’s move from finance minister to deputy prime minister (economy) removes him from management of the financial bureaucracy and daily operations, and allows him to contribute to strategic economic planning in close cooperation with Thaksin. This is probably more in line with Somkid’s skills and interests. Increasingly, the larger decisions on investment and foreign economic policy are likely to be made by Somkid and Thaksin, outside the finance ministry.

New finance minister will focus on tax collection

Replacing Somkid as finance minister is his former deputy, Suchart Jaovisidh. Suchart has more experience in the bureaucracy than Somkid, and is particularly expert on tax collection issues. Suchart has already stated that he will pursue more stringent tax collection policies, and the government has promised a larger budget for that effort. This is an increasingly important issue for the government. Thaksin has promised increased social spending as well as a balanced budget by 2007, so improving tax collection is critical if he wants to avoid tax increases. The government has recently implemented an excise tax on a range of goods and services, and is even considering bringing parts of the informal economy into the tax base. The entire informal economy is estimated to total 30-40% of GDP. There are also indications that the government’s new anti-drug campaign has a revenue-generating aspect to it [see next item].

Personality conflict resolved at Justice

The cabinet reshuffle also alleviated a personality conflict that had been brewing since the last reshuffle in October 2002. As justice minister, Purachai Plumsombun had a poor working relationship with Justice Ministry Permanent Secretary Somchai Wongsawat—Thaksin’s brother-in-law. Purachai’s difficult work style was also unpopular at the ministry. But Thaksin did not want to get rid of him, as Purachai is close to Thaksin and a popular figure, largely due to the “social order” campaign against vice that he initiated when he was interior ministry in 2001. So Thaksin created a new deputy prime minister portfolio for Purachai.

Revised discretionary expenditure, increased consolidation

The government has promised increased social spending as well as a balanced budget by 2007. Thaksin has promised increased social spending as well as a balanced budget by 2007, so improving tax collection is critical if he wants to avoid tax increases. The government has recently implemented an excise tax on a range of goods and services, and is even considering bringing parts of the informal economy into the tax base. The entire informal economy is estimated to total 30-40% of GDP. There are also indications that the government’s new anti-drug campaign has a revenue-generating aspect to it [see next item].
Replacing Purachai at the justice ministry was Pongthep Thepkanchana. Pongthep is returning to the justice ministry, having had the portfolio in an earlier Thaksin cabinet. One hundred members of the ministry, including the permanent secretary, welcomed Purachai upon his arrival; Somchai presented him with a bouquet of flowers.

**A WAR ON DRUGS**

On 31 January, Prime Minister Thaksin launched a dramatic three-month anti-drug campaign. The effort has mobilized local and provincial governments, the police and military, and a range of ministries. The initiative is likely to have only modest impact on drug use. But it could be very important for its public relations, civil rights and public policy implications.

Thaksin is considering a series of incentives to encourage participation in the anti-drug campaign. First, he threatened to fire provincial governors and police chiefs who do not contribute effectively to the campaign. In mid-February, Thaksin cited 20 governors who are not performing adequately in the drug campaign, and gave them until the end of the month to improve or face transfer.

In addition, the government is considering extending to Burmese soldiers the rewards program that pays Thai security forces 3 baht ($0.07) for every methamphetamine tablet confiscated (up to 1mn baht). The anti-drug campaign was also the backdrop to Thaksin’s weekend trip to Rangoon on 10-11 February. In meetings with Burmese officials, Thaksin put forward an ambitious plan for negotiations to end the fighting between Burmese troops and ethnic rebel groups. That fighting has been a catalyst for a large surge in drug production inside Burma in recent years. Of course, circumstances along the border cannot possibly improve dramatically within three months, so this significant source of drug production and trafficking will not be significantly impacted by the current campaign.

Nevertheless, the government is pursuing a startling domestic policing effort. According to Thaksin, in the first five days of February, 5700 drug suspects were arrested, and 3.8 million methamphetamine tablets and 129mn baht worth of drug dealer’s assets were seized. This reflects a remarkable policing effort. However, over 100 drug suspects were killed in the first two weeks of the campaign, and the government’s contention that the deaths occurred as a result of drug gang fighting is not credible. The anti-drug campaign has initiated a dangerous level of extra-judicial killings by police.

This police behavior appears to be condoned by the government. To inspire the police for the campaign, Thaksin quoted a famous former police chief from the 1950s, Pao Sriyanond, saying, “there is nothing under the sun that the Thai police cannot do.” Pao was known for killing his opponents. And Interior Minister Wan Muhamad Nor Matha has told drug dealers to stop their activities or they will be arrested or “vanish without a trace.”

As the number of deaths have continued to rise, human rights groups have become increasingly critical of police tactics. In addition, the UN high commissioner on human rights has asked to send a special representative to Thailand to investigate the killings. Thaksin rejected any foreign review of Thai police practices, calling the idea “pretentious.”

Just as the “social order” campaign has been very popular, the anti-drug campaign may improve the image of the Thaksin government among a population that is increasingly concerned with the drug problem. But short of a comprehensive solution to the Burmese border problems and widespread corruption throughout government and the security agencies, the drug problem is likely to persist. Nevertheless, Thaksin may hope to claim victory based on the accumulation of high-profile arrests, confiscations—and killings. The anti-drug campaign represents both the best and worst of Thaksin: it demonstrates his bold and ambitious agenda, and his dangerous disregard for legal process.
LEGSI SUMMARY - FEBRUARY 2003  

Government

- On 8 February, Prime Minister Thaksin Shinawatra initiated a surprise cabinet reshuffle. The changes moved the energy, justice and finance ministers and a number of deputy prime ministers.
- The government created a National Center to Defeat Narcotics. Recent public statements by politicians and the deaths of over 100 drug suspects since 1 February suggest the return of extra-judicial killings as a tool of law enforcement.
- The National Counter Corruption Commission exonerated Deputy Prime Minister Somkid Jatusripitak, Natural Resources and Environment Minister Praphat Panychartraksa, and Deputy Finance Minister Suchart Jaovisit of impeachment allegations submitted by the opposition Democrats in May 2002.

Society

- Authorities dismantled the Pak Moon dam protest camp outside Government House in Bangkok in early February and continued to arrest participants in the 20 December protest in Hat Yai that was attacked by police.
- In the early morning of 26 January, an unauthorized wrecking crew entered the Sukhumvit Soi 10 entertainment area in Bangkok, evicted tenants and patrons, and leveled the shops and bars using heavy machinery and cranes.

Security

- Prime Minister Thaksin traveled to Rangoon, Burma in an effort to improve recently strained relations. But while Thai-Burmese relations have stabilized, Thai-Cambodian relations were put into crisis when a rumor sparked widespread anti-Thai rioting in Phnom Penh in late January.

Economy

- In early February, the central bank governor stated that external factors—including a protracted Iraq conflict or a weak recovery in Thailand's trading partners—represent the main risks to Thailand's ongoing economic progress. The National Economic and Social Development Board separately forecasted that a protracted Iraq conflict could take two percentage points off Thailand's growth rate in 2003.
HIGHLIGHTS

- **Government to support US on Iraq**: Prime Minister Abdullah Gul announced early February that Turkey would support US plans for a northern front against Iraq. The Parliament voted on 6 February to allow US personnel to begin work on upgrading Turkish bases for use in a potential US campaign against Iraq.

- **Bilateral economic assistance expected**: The government continued negotiations with US Treasury officials over a bilateral economic aid package in the range of $14-26bn in grants and loan guarantees.

- **Erdogan to run in Siirt**: Recep Tayyip Erdogan, the chairman of the ruling Justice and Development Party (AKP), was formally nominated to stand in the 9 March re-run of the general election in the southeastern province of Siirt.

- **Fourth review begins**: An IMF mission arrived in Ankara on 7 February to complete its fourth review of the $16bn standby arrangement. The talks focused on the 2003 budget and measures to achieve a public sector primary surplus target of 6.5% of GNP.

- **Military supports Denktas**: The military sided with Turkish Cypriot leader Rauf Denktas in his disagreement with Ankara on the Kofi Annan plan, decreasing chances of a swift resolution of the Cyprus question.

- **Pamukbank dispute resolved**: The Banking Regulation and Supervision Agency announced on 3 February that it finalized a deal with Cukurova Group over its debts with Yapi Kredi and Pamukbank.

- **Widespread anti-war demonstrations**: January witnessed widespread anti-war demonstrations. Activists accused the government of hypocrisy for pursuing regional peace initiatives while negotiating with the US about support for an invasion of Iraq.

RISKS AND FORECAST

- **Economic policy**: The government is expected to remain cohesive over its economic program and likely to complete the budgetary process and IMF fourth review by early March. The possibility of AKP leader Erdogan losing some fiscal discipline when he becomes prime minister remains a key concern, however.

- **Iraq**: The growing possibility of a US-led military campaign against Iraq continues to concern Turkish authorities. A war, although possibly beneficial for Turkey in the medium term, is likely to hit its economy hard and stir up domestic Kurdish problems.

- **Tensions over Cyprus**: A resolution of the conflict over the status of the island before the UN-imposed deadline of 28 February appears unlikely in the absence of clear short-term incentives for both sides to make politically costly concessions.
GOVERNMENT ON BOARD FOR IRAQ

AKP remains cohesive over Iraq

After sitting on the fence for a month, Prime Minister Abdullah Gul finally announced in early February that Turkey would support US plans for a northern front against Iraq. The Justice and Development Party (AKP) managed to keep the number of party rebels below 20 in the secret parliamentary vote on permitting the US to upgrade Turkish military bases for use in a potential campaign. Future parliamentary debates on allowing large numbers of US troops into Turkey will likely provoke larger rebellions against the party leadership. Nonetheless, Parliament is likely to vote in favor of US deployment of troops.

Economic package on way

Turkey is discussing US reparations for its war-related economic losses. Economy Minister Ali Babacan and Foreign Minister Yasar Yakis visited Washington on 12 February to negotiate an aid package, which is estimated to be in the range of $14-26bn, at least $6bn of which would be grants. The remaining money will be a contingent reserve facility up to $20bn that Turkey could use depending on the economic impact of the Iraq campaign. A quick operation lasting one to two months might benefit Turkey in the medium term, as it will ensure US assistance and increased trade with Iraq.

Military discussions continue

Turkish and US military officials are still working on a draft accord of military operation plans. It seems likely that at least 30,000 US troops will cross into northern Iraq through Turkish territory. The US will also maintain troops on Turkish soil to provide logistical support during war. US soldiers will be allowed to stay in Turkey for a limited, though renewable period. The US will probably use the air bases in Batman, Diyarbakir, and Incirlik as well as the southern ports of Antalya, Mersin, and Iskenderun. Negotiations are apparently continuing over how many Turkish troops will enter northern Iraq along with the Americans, how the two armies will be coordinated, and what the role of the Turkish troops will be. Turkey has already reinforced its deployments in northern Iraq.

Opposition against support for US

With opinion polls showing public rejection of war in Iraq, the Republican People's Party's (CHP) opposition to the government's decision to permit US troops to enter Turkey has the potential to garner popular support. Alternatively, many Turks are likely to conclude—probably rightly—that any Turkish government, including a CHP-led one, would have followed the military's lead and acted as the AKP did. Cem Uzan's Young Party (GP) has also sought to make political capital out of anti-war sentiment, taking out advertisements on television and in newspapers to denounce the government's stance.

ERDOGAN SET TO BECOME PRIME MINISTER

Justice and Development Party (AKP) Chairman Recep Tayyip Erdogan still appears on course for the premiership after the Siirt by-election in March, despite some legal hiccups in January. The Constitutional Court ruled that he was no longer the leader of the governing AKP because he had resigned his position as its founder in compliance with an earlier court ruling. The AKP promptly re-elected Erdogan as its chairman on 23 January, one day after the ruling. By early February Erdogan was officially installed as the AKP candidate for Siirt, where victory would make him eligible for the premiership. He is likely to win a seat in Siirt on 9 March, given his family connections in the province and the attraction for most Turkish voters of having the prime minister represent their own constituency—traditionally a guarantee of abundant construction projects.
NO OPTIMISM ON CYPRUS

After harsh discussions of the foundation plan submitted by UN Secretary General Kofi Annan for the reunification of Cyprus with Turkish Cypriot leader Rauf Denktas, the government suggested in late January that the UN revise the plan again. The UN is pressing for a reunification deal by 28 February, so that a united Cyprus can join the EU in April. The government’s shift followed open support from the military for Denktas.

General Aytac Yalman, the head of land forces, warned on 27 January that the UN plan could pose security risks for the island and region and underlined that the sovereignty of the unrecognized Turkish Republic of Northern Cyprus must be recognized. The army’s expression of support will enable Denktas to maintain his rejectionist stance even if his relations with the government continue to deteriorate. If the 28 February deadline passes and no Cyprus deal is yet in sight, the EU’s faith in the government’s ability to deliver on foreign policy will no doubt deteriorate.

FOURTH REVIEW SET TO FINISH BY EARLY MARCH

An IMF mission headed by Turkey desk chief Juha Kahkonen arrived in Ankara on 7 February to complete its fourth review of the $16bn standby arrangement. The officials will work throughout the nine-day religious holiday, Eid Al Adha, to finish their work ahead of a possible war in Iraq. To help complete the review, the government is in the process of implementing tax law reform, public sector staff reductions, and privatization plans for Tekel, the alcohol and tobacco monopoly, and Turk Telekom, the landline monopoly.

The talks between IMF and the government focused on the 2003 budget and spending measures in order to achieve a public sector primary surplus of 6.5% of GNP in the coming year. Turkey failed to meet the same target in 2002, with a surplus estimated at around 3.5% of GNP, and must seek a formal waiver from the IMF for the next $1.6bn tranche to be released by March. As the failure to meet the target has increased pressure on Turkey to submit a credible 2003 budget, with IMF budget experts working with the government last week in preparation for the arrival of the full mission. The government is likely to complete the budgetary process and IMF fourth review by early March.

The government announced its strategy of speeding up privatization, pledging that it would support the process politically. Deputy Prime Minister Abdullatif Sener said that the government’s 2003 privatization revenue target was $4bn, or half of the total value of privatized assets in the past 17 years. The Privatization Administration (OIB) announced the bidding procedures for the sale of at least 51% of Petkim, the petrochemical refinery—the first step in the privatization of its 89% stake. Petkim’s privatization may result in the sale of the government’s entire 96% stake in the company. The government also plans to commence the sale of nearly all the major companies in the OIB portfolio, including Tupras, the state oil refineries corporation, in 2003. The government will hold an auction for a portion of Tupras in May 2003.

On 24 January the Banking Regulatory and Supervisory Agency (BDDK) announced that all ownership and management rights of Pamukbank had been transferred back to its previous owners Cukurova Group. The BDDK finalized a deal with Cukurova on 3 February over its debts with Yapi Kredi and Pamukbank, a move that should smooth relations with the IMF ahead of the fourth review. Cukurova must sell its majority stake in Yapi Kredi within two years, having lost eligibility to hold a controlling share in a bank after the seizure of Pamukbank. Meanwhile the Savings Deposit Insurance Fund will retain shareholders’ rights in Yapi Kredi except for dividends.
LEGSI SUMMARY • FEBRUARY 2003

Government
- Prime Minister Abdullah Gul announced in early February that Turkey would support US plans for a northern front against Iraq.
- Recep Tayyip Erdogan, the chairman of the ruling Justice and Development Party (AKP), was formally nominated to stand in the 9 March re-run of the general election in the southeastern province of Siirt.

Society
- Parliament adopted a series of reforms designed to meet EU entry criteria, paving the way for a retrial of former legislators sentenced to 15 years imprisonment in 1994 for assisting the terrorist Kurdistan Workers Party.
- January witnessed widespread anti-war demonstrations. Activists accused the government of hypocrisy for pursuing a regional peace initiative with Iraq's neighbors while negotiating with the US about support for an invasion.

Security
- Parliament voted to allow US personnel to begin work on upgrading Turkish bases for possible use in a potential US campaign against Iraq.
- Prime Minister Gul hosted a 23 January summit of the foreign ministers of Egypt, Iran, Jordan, Saudi Arabia, Syria, and Turkey. The ministers urged the Iraqi administration to display more active cooperation with UN arms inspectors.
- The military sided with Turkish Cypriot leader Rauf Denktas in his disagreement with Ankara, decreasing chances of a swift resolution of the Cyprus question.

Economy
- An IMF mission arrived in Ankara on 7 February to complete its fourth review of the $16bn standby arrangement. The talks focused on the 2003 budget and measures to achieve the public sector primary surplus target of 6.5% of GNP.
- Deputy Prime Minister Abdullatif Sener announced the government's 2003 privatization revenue target of $4bn.
- The Banking Regulation and Supervision Agency announced on 3 February that it finalized a deal with Cukurova Group over its debts with Yapi Kredi and Pamukbank.
- January monthly inflation figures for consumer prices inflation and wholesale prices inflation came in at 2.6% and 5.6%, respectively. Annual figures correspond to 26.4% and 32.6%.
**HIGHLIGHTS**

- **Opposition gearing up again:** The Kyiv Court of Appeals reversed a district court decision banning mass, anti-presidential demonstrations in Kyiv. Opposition parties plan to sponsor actions in March under the “Arise, Ukraine!” banner. After some waffling, the most popular opposition faction, Our Ukraine, said it would participate in the actions.

- **Elections on horizon:** Our Ukraine leader Viktor Yushchenko announced his candidacy for president. Outspoken opposition leader Yulia Tymoshenko, who has called for a single “democratic” candidate for president, hailed his decision. The Communists, though also in opposition to President Leonid Kuchma, will not support Yushchenko’s candidacy.

- **Ex-Soviet club convenes:** The Commonwealth of Independent States (CIS) summit was moved to Kyiv from Ivano-Frankivsk due to fears that nationalist and anti-Russian protests in the western region would be difficult to contain. Kuchma was named head of the CIS, but only eight of the 12 heads of state attended the summit, indicating the declining importance of the organization for some member countries.

- **US still suspicious:** The US charged Ukraine with selling military pontoon bridges to Iraq, in violation of UN sanctions. Ukraine denied the transfer. Washington also announced plans to divert $34mn in aid originally earmarked for the Ukrainian government to Ukrainian pro-democracy groups. The US cited Ukraine’s failure to adequately account for all its Kolchuga radars, several of which were allegedly sold to Iraq.

- **International sanctions:** Several member countries of the Financial Action Task Force (FATF) on Money Laundering introduced sanctions against Ukraine in January. In response, the Ukrainian parliament changed the Criminal Code and stiffened measures to combat money laundering. The FATF lifted the sanctions on 13 February.

**RISKS AND FORECAST**

- **More protests planned:** Opposition groups—the Communists, the Socialists, the Yulia Tymoshenko bloc, and Our Ukraine—are planning an organizational congress on 1 March and mass, anti-presidential protests on 9 March. Neither development is expected to lead to Kuchma’s ouster.

- **Trilateral gas negotiations:** Ukraine, Russia, and Germany plan to meet in late March to discuss the proposed gas consortium for the development and management of Ukraine’s gas pipeline system. Germany’s Ruhrgas is expected to become a formal participant in the currently bilateral consortium spearheaded by Russia’s Gazprom and Ukraine’s Naftohaz Ukrainy.
UKRAINE UNDER FIRE. RUSSIA TO THE RESCUE?

Events in January demonstrated to what extent Ukraine’s relations with the US and the international community are as uncertain as its relationship with Russia remains pivotal. The international Financial Action Task Force (FATF) on Money Laundering imposed sanctions on Ukraine for failing to enact adequate legislation to counter money laundering, while the US accused Ukraine of additional military technology transfers to Iraq and announced two new reductions in financial aid. At the same time, Kyiv hosted the Commonwealth of Independent States (CIS) summit in January, and President Leonid Kuchma was named the group’s head—on the recommendation of Russian President Vladimir Putin.

The Paris-based FATF, which comprises 29 member states, put Ukraine on its so-called blacklist of non-cooperative countries in June 2001 and recommended to its members that their financial institutions pay special attention to transactions with Ukrainian individuals and companies. After repeatedly warning Ukraine that it must adopt legislation in line with international standards or face the consequences, the FATF imposed additional “countermeasures” against Ukraine in mid-December 2002. The Ukrainian parliament had passed an anti-money laundering law in early December, but the FATF deemed it insufficient. In January 2003, many of the FATF’s member countries applied the countermeasures. These entail the use of enhanced identification, reporting, and warning systems in financial transactions with Ukrainian entities. Faced with this reality, the Ukrainian parliament took swift action in January to upgrade its banking legislation and the Criminal Code. After reviewing Ukraine’s status at its 12-13 February plenary meeting, the FATF recommended that its members terminate the countermeasures against Ukraine.

Although the sanctions have impacted Ukraine’s external trade insignificantly, they further impair Ukraine’s already damaged reputation in international circles. President Leonid Kuchma’s second term, which began in 1999, has been marred by major problems, including the still-unresolved murder of journalist Georgy Gongadze, US allegations that Ukraine sold anti-stealth radars to Iraq in violation of UN sanctions, and a fractious and at times non-functional parliament that includes vocal opposition groups working toward Kuchma’s ouster. The FATF sanctions may slow down Ukraine’s joining the World Trade Organization—which now looks unrealistic before 2004 at the earliest.

Even countries supporting the cancellation of sanctions against Ukraine noted that the eleventh-hour measures taken by parliament are evidence of Ukraine’s general disregard for the international rule of law. The US in particular believes that Kuchma personally authorized Gongadze’s murder and the transfer of the Kolchuga radars to Iraq. In January, the US leveled new accusations against Ukraine, alleging that Ukraine also sold pontoon bridges and other military hardware to Iraq.

The US also announced plans to divert $34mn in aid originally earmarked for the Ukrainian government to Ukrainian pro-democracy groups just one day after a high-level Ukrainian government delegation met with US counterparts in Washington in January. The delegation, led by Economy Minister Valeriy Khoroshkovsky, had clearly failed to convince the US that Ukraine deserved the benefit of the doubt. The funding diversion came just four months after a US decision to reduce assistance to Ukraine by $55mn in fiscal year 2003 because of suspicions that Ukraine sold Iraq the radars. Then, in early February, the US government announced that overall aid to Ukraine would drop significantly in 2004 to just $94mn (down from $155mn in 2003). Although the 2004 reduction reflects a broader pattern of reduced funding for the former Soviet republics, Ukraine’s cut is among the steepest. Europe, too, recently downgraded its relationship with Ukraine. In late 2002 European Commission President Romano Prodi gave Ukraine the indeterminate status of “neighbor”—together with perennial outsiders Moldova and Belarus.
While Ukraine and Kuchma in particular are getting the cold shoulder from the West—NATO, too, considered Kuchma a persona non grata at its November 2002 summit—Russia is continuing to woo Kuchma and Ukrainian business. 2002 marked the “Year of Ukraine” in Russia, and Putin and Kuchma recently marked the opening ceremony of 2003 as the “Year of Russia” in Ukraine. Russia has been pressuring Ukraine—thus far unsuccessfully—to join its club, the Eurasian Economic Community (Eurasec), rather than to look toward the European Union. Putin’s handing of the CIS leadership torch to Kuchma in January was thus the latest in a series of moves designed to bolster Kuchma’s international reputation, at least in the East, and to remind Ukraine that Russia is and should remain Ukraine’s big brother and benefactor. Indeed, Russia is now poised to gain control over one of Ukraine’s most valuable assets—its natural gas pipeline system—through the establishment of a joint consortium in which Russian gas giant Gazprom will no doubt dominate its smaller Ukrainian counterpart Naftohaz Ukrainy despite the 50-50 ownership structure.

Russia courts Ukraine in bid to keep Ukraine in its sphere of influence

Ukraine remains split—politically, geographically, ideologically, and linguistically—between the dual lures of East and West. Ukrainian nationalists and pro-West liberals became outraged in December when Russian Ambassador to Ukraine Viktor Chernomyrdin advised Ukraine to integrate with Russia and Eurasec rather than with Europe. They sent a letter, signed by 107 MPs, to Prime Minister Viktor Yanukovych in early January, urging him to expel Chernomyrdin for what they perceived as his insulting remarks. Similarly, the CIS summit in January was moved to Kyiv from its original venue of Ivano-Frankivsk, in western Ukraine. The authorities feared that anti-Russian protests there would be too difficult to contain.

Western-oriented political forces oppose Ukraine’s tilt toward Russia

Kuchma himself appears to be at a loss as to how to repair relations with the West. For their part, Europe and the US seem to have written him off as a discredited and unreliable leader and are biding their time until he leaves office in November 2004. The US has repeatedly stressed that it holds no grudge against Ukraine itself, but only against Kuchma and his associates. Popular opposition leader Viktor Yushchenko, following high level talks in Washington in early February, urged the US to keep engaging Ukraine and to continue supporting Ukraine’s independent media and democratization projects. He warned that the presidential elections, scheduled for the fall of 2004, could be conducted fraudulently in the absence of such support, given the high degree of control currently exercised by authorities over the mass media.

West has written off Kuchma

Ukrainians’ Perception of their Leaders, NATO, and Eurasec*

- 78% of the population believe that either the overwhelming majority of or all Ukrainian officials are engaged in bribery and corruption.
- 41% of the population are against NATO membership, while 32% support NATO membership.
- Only 9.7% of the population support full Ukrainian membership in Eurasec.

* Polling data compiled by the Oleksandr Razumkov Center for Economic and Political Studies, Kyiv, February 2003
LEGSI SUMMARY - FEBRUARY 2003

Government
- The Kyiv Court of Appeals reversed a district court decision banning mass, anti-presidential demonstrations in Kyiv. Opposition parties plan to sponsor actions in March under the “Arise, Ukraine!” banner.
- Our Ukraine leader Viktor Yushchenko announced his candidacy for president. Outspoken opposition leader Yulia Tymoshenko, who has called for a single “democratic” candidate for president, hailed his decision. The Communists will not support Yushchenko's candidacy.

Society
- A parliamentary majority recommended a review of the presidential administration’s practice of exerting editorial influence over the mass media. It also recommended that the General Prosecutor’s Office take all necessary steps to resolve the murders of journalists Georgy Gongadze, Ihor Oleksandrov, and others.
- The Commonwealth of Independent States (CIS) summit was moved to Kyiv from Ivano-Frankivsk due to fears that nationalist and anti-Russian protests in the western region would be difficult to contain.

Security
- The US charged Ukraine with selling military pontoon bridges to Iraq, in violation of UN sanctions. Ukraine denied the transfer.

Economy
- Several member countries of the Financial Action Task Force on Money Laundering introduced sanctions against Ukraine in January. In response, the Ukrainian parliament stiffened measures to combat money laundering.
- President Leonid Kuchma signed into law a decrease in the profit tax from 30% to 25%. It will come into force on 1 January 2004.
- Washington announced plans to divert $34mn in aid originally earmarked for the Ukrainian government to Ukrainian pro-democracy groups. The US cited Ukraine’s failure to adequately account for all its Kolchuga radars, several of which were allegedly sold to Iraq. This followed an earlier US decision in the fall of 2002 to withhold $54mn in aid to Ukraine due to allegations that Ukraine violated UN sanctions by transferring the radars to Iraq.
HIGHLIGHTS

- Widespread rumors of corruption among the highest-ranking members of government flooded Uzbek web sites (including the opposition party Birlik’s) in early February. While allegations of corruption are not new, the level of official accused of illicit practices was unusually high. The government initially banned access to web sites carrying the stories and no evidence corroborating the charges emerged.

- The EU increased pressure on President Islam Karimov to speed up economic and political reforms. Particular stress was laid on the need to introduce currency convertibility and harsh anti-corruption measures. The country’s poor human rights record was commented on, as was the limited freedom enjoyed by the press. The second refusal of admission into Uzbekistan to a Russian human rights activist, in early February, brought the issues of freedom of expression and human rights to the forefront again.

RISKS AND FORECAST

- Relations with Kazakhstan, Kyrgyzstan and Tajikistan remain fair despite the sudden border closures initiated by the president in January. A series of bilateral meetings with leaders from all countries resulted in some progress on territorial issues. President Islam Karimov failed to make significant headway, however, on the issue of Uzbek traders flooding across the borders to avoid the new export tariff regime.

- The IMF mission that arrived in Uzbekistan on 12 February will review the country’s recent economic performance and discuss the key issue, which is the introduction of a unified exchange rate and real currency convertibility. Though the official and black market rates have converged to below the spread set by the IMF in August, it is far from clear that the government can maintain this.
CORRUPTION, ECONOMIC REFORM AND HUMAN RIGHTS UNDER THE MICROSCOPE

A combination of events in January and early February put Uzbekistan’s slow progress with economic, social and political reform in the spotlight. EU officials arrived on 27 January in Tashkent and issued several strongly worded statements calling for a faster rate of change and clearer signs of commitment from President Islam Karimov’s administration to fundamental and lasting reform.

A corruption scandal that erupted in February served as an excellent example of the type of problems EU officials were suggesting needed to be tackled urgently. Finally, the refusal of entry into the country, for the second time, of a Russian human rights activist had the international NGO community based in Tashkent up in arms at the Karimov administration’s failure to give more attention to the human rights situation in Uzbekistan.

EU officials arrived for talks under the auspices of the Cooperation council ahead of the European Bank for Reconstruction and Development (EBRD) annual meeting due to be held in Tashkent in May 2003. Their statement at the conclusion of the trip left no room for maneuver for Karimov. It called for an immediate and effective acceleration in the pace of reforms in all sectors and stated that an improvement in the country’s human rights record was fundamental to any future rapprochement.

Discussions also touched on the need for full currency convertibility, an issue that the EBRD will doubtless focus on in May, and the need for tougher anti-money laundering measures.

On 4 February a number of web sites, including the opposition group Birlik’s, carried stories that accused officials within the highest levels of President Islam Karimov’s administration of corruption. The anonymously posted stories, reportedly authored by an Uzbek journalist, also suggested that Karimov was very unwell and could be about to pass away. Allegations of corruption are not new in Uzbekistan but what caught people’s attention in these reports was the seniority of the figures accused.

The government responded very quickly by blocking access to all the sites reporting on the issue. No new material emerged substantiating the claims made though a spokesperson for Karimov did come out to reassure everyone that the president was in very good health and took all charges of corruption seriously so that matter would be investigated.

BORDER TENSIONS ON THE WANE

Despite closing its borders suddenly and without warning with Kazakhstan, Kyrgyzstan and Tajikistan in January relations between Uzbekistan and the neighboring countries remain fair. President Islam Karimov’s government entered into bilateral negotiations with all three government’s to try and address its concerns regarding illegal trading across the borders. Traders, in part to escape harsh new export tariffs, had begun flooding into the markets of neighboring states, causing significant damage to the local Uzbek economies. Karimov did not manage to persuade the governments from refusing to accept Uzbek currency in exchange for goods but he did extract promises of increased cooperation regarding the smuggling of goods.
IMF LOOKING FOR STRONGER GOVERNMENT COMMITMENT TO ECONOMIC REFORM

An IMF delegation arrived in Tashkent on 12 February to carry out an assessment of the country’s recent economic performance. Currency convertibility, which has been on the agenda since mid 2002, remains the main issue. A review carried out in September 2002 found that not enough progress had been made to warrant substantial IMF financial assistance. Due to poor performance by President Islam Karimov’s government, the IMF ceased lending activities in Uzbekistan in 1999. These reviews aim to judge the government’s commitment to reform in order to restore an IMF credit facility to the country.

There has been a marked convergence in the official bank and black market exchange rates especially over the last 30 days. However, even though the differential is now at 16% (well under the 20% required by the IMF) there is some skepticism on the part of IMF officials that the government can sustain this. Despite theoretical relaxation of the regulations governing currency exchange (citizens may now purchase up to $1500 in any three month period) in practice this proves nearly impossible for anyone to actually do. There are long lines at every bank both day and night prompting people to return to the black market.

![Official Uzbek Soum/Dollar Exchange Rate](image-url)
Government
- The EU put pressure on Uzbekistan to speed up economic and political reforms. Particular stress was laid on the need to introduce currency convertibility and harsh anti-corruption measures.
- A new website covering general governmental information will be launched next month. This is one of the first steps taken by the government to try and increase transparency and share information more widely with the general public. The website www.gov.uz is due to be online by mid-March.

Society
- Widespread rumors of corruption among the highest-ranking members of government flooded Uzbek web sites. While allegations of corruption are not new, the level of official accused of illicit practices was unusually high. The stories, reportedly authored by an Uzbek journalist, also suggested that President Islam Karimov was very unwell and that the country could be about to lose its leader. The government initially banned access to web sites carrying the stories and no evidence corroborating the charges emerged.
- A Russian human rights activist was turned away at Tashkent airport for the second time. NGO activists protested the government’s lack of commitment to addressing its appalling human rights record.

Security
- Relations with Kazakhstan, Kyrgyzstan and Tajikistan remain fair despite the sudden border closures in January. A series of bilateral meetings with leaders from all countries resulted in some progress on territorial issues.

Economy
- Russian oil major LUKoil opened an office in Tashkent in order to accelerate implementation of an investment project to develop the Kandim group of oil and gas fields jointly with Itera international gas company and other projects. However, a production-sharing agreement postponed from February 2002 still has no set date for signature.
- Foreign direct investments made up over 27% of the country’s GDP in 2002. Foreign Economic Relations Minister Elyor Ganiyev released the figures for 2002 at a forum on economic reform organized by the Tashkent-based Centre of Economic Research and supported by the UNDP.

Component Scores

Regional LEGSI Scores
Lehman Brothers Eurasia Group Stability Index (LEGSI):

VENEZUELA

HIGHLIGHTS

- **National strike ends**: The opposition called off a two-month national strike on 2 February, after the economic consequences became too much to bear. The strike began fraying by mid-January, at which point the government exploited differences within the opposition to weaken it.

- **Government shuts down all foreign exchange operations**: The government was forced to temporarily suspend all foreign exchange operations on 22 January as a result of a sharp depreciation of the bolivar vis-à-vis the US dollar.

- **Consultative referendum**: The Supreme Tribunal ruled against a 2 February consultative referendum on President Hugo Chavez’s mandate on the grounds that the National Electoral Council (CNE) could not organize electoral processes until it had a new board. The old board was declared null and void due to the irregular incorporation of one of its members.

RISKS AND FORECAST

- **National Electoral Council**: The government and the opposition are expected to announce a new CNE in the next four to six weeks. If no agreement is reached and a new CNE board is not announced, negotiations are likely to fall apart and prospects for a peaceful resolution of the political crisis could decrease significantly.

- **Capital controls**: After shutting down all foreign exchange operations for a brief period, the government announced capital controls to contain a run on the country’s currency. The discretionary nature of the capital control measures has raised alarms within the opposition, which believes that the controls will be used as a political tool to punish participants in the national strike.

- **Media Responsibility Law**: The government introduced a Media Responsibility Law, also known as the Content Law, into the National Assembly where it is under discussion. The opposition claims that the government’s law contravenes free speech and allows for wide ministerial discretion with regard to media content.

- **Administrative processes against media groups**: The government opened administrative procedures (legal actions) against the country’s major media groups. Shutting down television stations would re-ignite social tensions, adding to the animosity created by the Media Responsibility Law.
POST-STRIKE POLITICAL LANDSCAPE

The opposition to President Hugo Chavez called off a two-month national strike on 2 February, after the economic consequences became too much to bear. The opposition made a tactical error by linking the strike to Chavez’s removal. Their inability to force the president out of power generated discontent among opposition supporters, who believed that an indefinite strike would accomplish their objective. Instead, Chavez appears to have become politically stronger and the entire country is facing a catastrophic economy. Chavez now claims victory and is on the offensive. He has regained control of state oil company PDVSA, he now has control of the country’s international reserves, and he continues to enjoy the support of the military. Chavez is therefore expected to take a more aggressive stance in the coming months. This, in turn, is likely to cast serious doubts on the future of the negotiations spearheaded by the Organization of American States (OAS).

The opposition is banking on continued street protests and strikes as a means of pressuring Chavez to negotiate an end to the crisis. The Democratic Coordinator (CD) opposition umbrella group appears to be concentrating on a constitutional amendment to hold early elections. On 2 February, the opposition claimed to have collected over 4mn signatures in support of such constitutional exits, thereby demonstrating significant organizational capacity and civil support. The opposition is also expected to listen to its more moderate voices now that the radical ones have failed to produce results. Unfortunately, control of the government appears to be returning to the hardliners.

2003 SCENARIOS

Although the national strike is over, Venezuela’s political crisis continues. The range of scenarios in the year ahead is as follows:

Relatively benign scenarios:
- Legally binding referendum (by late 2003): 35% probability
- Negotiations leading to early elections/constitutional amendment (also by late 2003): 30%

Destructive scenarios:
- Constituent assembly (the opposition’s logic being to topple the government by recreating the state): 15% and growing
- Authoritarian Chavez: 10%
- Chaos/violence leading to Chavez’s deposition: 5%
- Widespread civil conflict: <5%

The precondition of any electoral scenario (referendum/elections) is the creation of a new National Electoral Council (CNE). Negotiations between President Hugo Chavez’s party (MVR) and opposition parties (excluding Primero Justicia) appear to be moving forward and there is a high probability that a new CNE comprising an equal number of government and opposition delegates will emerge in 30-40 days. If the CNE is not created in a reasonable timeframe, negotiations are likely to be called off, and more destructive scenarios will become more probable.

REGAINING CONTROL OF PDVSA

President Hugo Chavez has slowly regained control of state-owned oil giant PDVSA, after the company’s support of a two-month strike paralyzed a significant part of oil-sector related activities. After weeks of crude oil production hovering around 200,000bn barrels per day (bb/d)—down from 3.1mn bb/d prior to the strike—production is currently nearing 1.7mn bb/d and is expected to increase by 200-400,000 bb/d in two weeks’ time (which would mean close
to 2mn bb/d by the end of February). Full recovery of the wounded industry is expected to take at least 12-18 months and substantial amounts of investment.

PDVSA's restructuring is passing from mere rhetoric to reality, as the government appears determined to significantly reduce the size of the company's holding subsidiary in Caracas—where most of the managers who supported the strike are concentrated. The sale of non-strategic assets and subsidiaries could actually improve the government's critical fiscal situation, which financial analysts believe will represent a gap of 9-10% of GDP in 2003. PDVSA's reorganization into two separate subsidiaries (PDVSA East, PDVSA West) also raises the remote possibility of partly privatizing one subsidiary in the future, especially if Chavez feels that economic conditions will fail to improve and the government's financial health is seriously threatened.

**GAINING CONTROL OF THE COUNTRY'S RESERVES: CAPITAL CONTROLS**

President Hugo Chavez decreed the creation of a Foreign Exchange Commission (Cadivi) on 6 February to control all dollar transactions in the country in an effort to stop capital flight, which was threatening to deplete the country's international reserves. The type of capital control mechanism put in place by Chavez aims to eliminate private transactions in foreign currencies without expressed government supervision. A black market instantly arose since the official rate was set at 1,596 bolivars per dollar bid price and 1,600 bolivars per dollar ask price, while the dollar was actually selling for close to 2,100 bolivars. Capital controls are expected to prove ineffective in the medium term.

The creation of the Commission drew criticism from the opposition, which claims that Chavez is using capital controls as a political tool to punish those sectors that supported the two-month national strike. Chavez has repeatedly stated that the "coup-mongers" will never see another dollar as long as they are in Venezuela. The situation is worrisome, as it may lead to further deterioration of the economy.

The Cadivi may, paradoxically, lead to a weakening of the government in the next six to eight weeks, as its creation drew attention to significant divisions within the cabinet. On 22 January the government shut down all foreign exchange operations after the bolivar lost 20% of its value the week before. Finance Minister Tobias Nobrega declared the government's intention to implement exchange rate controls, the details of which were to be announced in a week. This did not happen, as the Central Bank of Venezuela, the Ministry of Finance, and other government agencies did not reach a timely agreement on the details. The announcement of the measures unleashed a dispute between moderate elements led by Nobrega and other, more radical elements including former Vice President Adina Bastidas. The dispute was won by the radicals, who then proceeded to enact a convoluted and discretionary system.

The discretionary nature of the capital controls and the creation of a parallel black market are also expected to exacerbate corruption on a large scale. If any major corruption scandal is exposed, Chavez could face a powerful legal challenge and the opposition will finally have a more tangible cause around which to rally its forces. Thus far, the opposition has been unsuccessfully trying to challenge Chavez on a more ideological basis.

Although the government is expected to become stronger in the short term, the situation could easily be reversed if it adopts the capital controls permanently as a result of corruption and/or intra-governmental disputes.
LEGSI SUMMARY · FEBRUARY 2003

Government
- The opposition was forced to end the two-month national strike on 2 February, as support declined to critically low levels. Opposition supporters became increasingly unable or unwilling to sustain the destructive economic consequences of the strike, as it became clear that President Hugo Chavez would not be forced out of power.
- The Supreme Tribunal invalidated the petition for a consultative referendum on Chavez’s mandate scheduled to take place on 2 February.
- Chavez continued questioning the legitimacy of the so-called Friends of Venezuela contact group comprising the US, Brazil, Mexico, Spain, Portugal, and Chile. The group was set up to bolster ongoing negotiations between the government and the opposition.

Society
- The government launched an offensive against the country’s major media groups, which it accused of knowingly diffusing false information in order to overthrow the current regime. Chavez threatened to take full legal action against the media groups. The government also introduced a Media Responsibility Law into the National Assembly. The law would give discretionary power to the government to control all transmitted media content.
- The opposition purportedly collected on 2 February an unconfirmed 4mn signatures to demonstrate its strength and commitment to a democratic solution.

Security
- Brazilian President Luiz Inacio “Lula” da Silva decided to work more closely with the US in the Friends of Venezuela Group, frustrating Chavez’s hopes of including controversial countries such as Cuba and Algeria in the contact group.

Economy
- The Ministry of Finance was forced to shut down all foreign exchange transactions on 22 January after the bolivar experienced a sharp depreciation vis-à-vis the US dollar, dangerously draining international reserves.
- The government implemented a strict capital control regime in order to halt the outflow of international reserves. The official rates were set at 1,596 bolivars per dollar bid price and 1,600 per dollar ask price.

COMPONENT SCORES

REGIONAL LEGSI SCORES

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Lehman Brothers Eurasia Group Stability Index (LEGSI)

Lehman Brothers Eurasia Group Mission Statement

Lehman Brothers Eurasia Group LLC is a joint venture between Lehman Brothers investment bank and Eurasia Group, a political consultancy. By leveraging the intellectual capital of economists and political analysts, the joint venture provides fixed-income traders, investors and policy analysts with forward-looking analysis on political risk in emerging market countries. The Lehman Brothers Eurasia Group Stability Index (LEGSI) marks the first effort to integrate political science theories with financial markets expertise in a robust comparative framework.

Description of Model and Methodological Approach

The LEGSI incorporates twenty composite indicators of emerging market country risk, considering both quantitative and qualitative criteria of stability—defined as the capacity of countries to withstand shocks and crises, and to avoid generating shocks and crises. Constructed on the basis of leading social science theories, LEGSI variables have structural (long-term) and temporal (short-term) components. Structural scores reflect long-term underlying conditions affecting stability, thereby providing a baseline for temporal scores, which reflect the impact of policies, events, and developments occurring within the monthly scoring interval.

The LEGSI ranks countries according to their capacity to withstand shocks and crises and to avoid generating crises. Ratings are expressed on a scale of 0-100, with higher numbers corresponding to higher country stability. The composite stability ratings are broken into categories: Maximum Stability (80-100), High Stability (60-80), Moderate Stability (40-60), Low Stability (20-40), and Failed State Stability (0-20).

Highly stable countries can be expected to possess all or most of the following characteristics: efficient state institutions; high degree of political institutionalization; high degree of political legitimacy among the population; sound economic performance and policies; absence of significant anti-state opposition; rare instances of political violence; low level of social, ethnic or religious tensions; infrequent occurrence of natural disasters or humanitarian emergencies.

Variables are scored by LEGSI analysts in consultation with our in-country teams, typically independent think tanks and social science research institutes. Scoring is subject to a rigorous monthly review process to ensure consistent implementation of the guidelines. In-country teams receive hands-on training in the LEGSI methodology and provide regular input into its development. LEGSI analysts employ hundreds of local language and open sources in developing their analyses.
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