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17 December 1987

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TOP SECRET UMBRA
NOFORN NOCONTRACT PROPIN ORCON

Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

International Financial Situation Report #71
17 December 1987

Summary

The joint communique issued by the presidents of eight Latin American countries following their summit meeting in Mexico on 27-28 November included a unified position on debt, but did not indicate any radical joint debt actions would be taken. More noteworthy, than the communique itself were the behind-the-scenes debates that led to the joint declaration. Peru, Brazil, and Argentina reportedly pushed for radical debt initiatives, including limitations on interest payments. In other developments:

- Many international banks are girding for a suspension of payments on Argentina's foreign debt, which they believe is inevitable and could occur as early as this month, [redacted] We believe a mid-December $500 million loan from international banks will bring Argentine reserves to about $1.1 billion and should forestall a moratorium this month. To avert radical debt action in 1988, however, Buenos Aires will require at least $1.6 billion in yet-to-be-negotiated new money coupled with quiescence from the IMF. Meanwhile, President Alfonsin's economic team appears to be losing control over the economy and has discussed resigning en masse in January or February.

- Brazil's $4.5 billion bridge loan to cover 1987 interest obligations was signed on 15 December and the initial $1.5 billion tranche will be made in three disbursements within the next month. Negotiations began on 1 December on the term sheet for a debt rescheduling and new money package but, so far, little progress has been made. The Brazilian delegation returned to the bargaining table with essentially the same proposals it brought when negotiations began on 25 September, which the banks rejected as unrealistic and vague. The negotiating atmosphere will likely become even more contentious in January if—as is likely—Brasilia does not resume scheduled interest payments.

- The Mexican Government announced on 15 December new economic measures designed to fight record inflation over the longer term and lower the bloated federal budget deficit, while increasing workers' wages to help counter rapidly rising consumer prices. The move apparently stops short of the strong medicine needed to significantly reduce inflation, but some slowing is likely. Nonetheless, the austere nature of many of the new measures may be a political liability for the government during the runup to next summer's presidential election. [redacted]

NOTE: REPORT #72 WILL BE PUBLISHED ON 14 JANUARY 1988

KEY ISSUE

The Latin American Summit Meeting

The joint communique issued by the presidents of eight Latin American countries following their summit meeting in Acapulco on 27-28 November included a unified position on debt, but did not suggest any radical joint debt actions. According to the press, the presidents essentially appealed for more creditor cooperation to find a just and permanent solution to the Latin American debt problem and proposed various mechanisms for achieving that objective. More noteworthy than the communique itself were the behind-the-scenes debates that led to the joint declaration. [redacted] the debt talks were difficult and contentious. Peru, Brazil, and Argentina reportedly pushed for radical debt initiatives, including limitations on interest payments. By contrast, Colombia and Uruguay apparently opposed a joint declaration that expressed a hardline debt position because of the potential damage it could inflict on their own relatively favorable negotiating positions with banks. [redacted] Mexico effectively played the role of moderator and influenced the phrasing of the final declaration, which confined the most radical measures—such as ceilings on interest rates, devaluation of debt through secondary market discounts, or linking debt servicing to export market access—to "proposals" and emphasized that all such steps were subject to negotiation with creditors. [redacted]

DEVELOPMENTS IN MAJOR COUNTRIES

Argentina

Many international banks are girding for a suspension of payments on Argentina's foreign debt, which they believe is inevitable and could occur as early as this month, [redacted] We believe a mid December $500 million loan from international banks will bring Argentine reserves to about $1.1 billion and should forestall a moratorium this month. To avert radical debt action in 1988, however, Buenos Aires will require at least $1.6 billion in yet-to-be-negotiated new money coupled with quiescence from the IMF. Both commercial banks and the Fund, however, are becoming increasingly disillusioned with the slow pace of economic reform and are ill-disposed to increase lending to Buenos Aires. [redacted]

President Alfonsin's economic team appears to be losing control over the economy. Its October reform measures—whose cornerstone, a tax package designed to halve the fiscal deficit, is languishing in Congress—have failed to regain the confidence of the Argentine public. Treasury Secretary Brodersohn admitted that the team has no short-term plans, and that its only long-term goals are those that the IMF has imposed, [redacted] Brodersohn added that he is unable to reduce government spending, and that the Central Bank's recent decision to print 900 million australes to fund unanticipated Treasury expenditures will merely accelerate inflation, which reached 180 percent during the first 11 months of 1987. [redacted]

Exasperated by their inability to stem Argentina's economic decline, the President's top economic advisors have discussed resigning en masse in January or February, [redacted] The press reports that Foreign Minister Caputo and former Interior Minister Troccoli are frontrunners to replace Economy Minister Sourrouille. As politicians rather than economists, we believe that both men would concentrate on selling Alfonsin's economic policies to the public. A Caputo- or Troccoli-led team might be tempted to announce radical debt action and a new economic plan simultaneously, in the hope that a moratorium would deflect domestic criticism from the austerity measures. [redacted]

Brazil

Brazil's $4.5 billion bridge loan to cover 1987 interest obligations was signed on 15 December and the initial $1.5 billion tranche will be made in three disbursements within the next month. The remaining $3 billion will be disbursed in June provided:

- A term sheet for a debt rescheduling and new money package is negotiated with the Bank Advisory Committee by 15 January 1988.
- A "critical mass" of banks—probably 90 percent of the more than 700 banks with loans to Brazil—sign onto the agreement by 15 March 1988.
- The agreement becomes effective by 16 June 1988. [redacted]

Negotiations began on 1 December for the term sheet but, so far, little progress has been made, [redacted] The Brazilian delegation returned to the bargaining table with essentially the same proposals it brought when negotiations began on 25 September, which the banks rejected as unrealistic and vague. Although Brasilia agreed to seek an IMF program, it is not expected to begin negotiations with the Fund before next year, and it refuses to link economic performance targets to commercial bank disbursements. Moreover, it insists on an interest capitalization scheme and new money equivalent to about half of its interest obligations in 1988-89. With less than one month before the 15 January deadline and the two sides far apart on the most basic issues, the deadline will likely be pushed back. The negotiating atmosphere will likely become even more contentious in January if—as is likely—Brasilia does not resume scheduled interest payments. Bankers contend that Brasilia promised during negotiations for the bridge loan to resume payments, but Finance Minister Bresser has said Brasilia will only do so when it is assured of receiving the concessions it is seeking from banks. We expect the moratorium to drag on well into 1988. [redacted]

Meanwhile, the economy continues its downward slide. Consumer demand remains weak despite recent large wage increases, and investment is expected to drop to only 16 percent of GDP this year. Economic growth will fall to 2 percent—down from over 8 percent per year in 1985-86 and well below the 6 percent needed annually to employ new entrants to the labor force. Inflation in November was nearly 13 percent and is expected to exceed 16 percent this month to finish 1987 with a record 360 percent. The Finance Ministry has recommended a fiscal package, but President Sarney already has overruled certain tax hikes and Congress is likely to oppose major tax increases. Moreover, Sarney has consistently failed to implement promised spending cuts, personally authorizing billions of dollars for pet projects. Although a fiscal program may be announced soon, with a presidential election almost certain next year, it is unlikely that Brasilia will follow through with any plan to reduce the public sector's borrowing requirements, which will exceed 35 percent of GDP in 1987. As inflation continues to spiral, Brasilia probably will resort to another price freeze early next year. [redacted]

Mexico

The Mexican Government announced on 15 December new economic measures designed to fight record inflation over the longer term and lower the bloated federal budget deficit, while increasing workers' wages to help counter rapidly rising consumer prices. The program includes cuts in government programmable expenditures, lower import tariffs to foster competition, and increased prices on government-supplied goods. The government also negotiated with the private sector to grant Labor an immediate 15 percent wage increase and another 20 percent increase on 1 January 1988. [redacted] Mexican officials suspect inflation to soar much higher this month and next but believe they can almost halve this year's expected annual rate of about 150 percent by December 1988. The Bank of Mexico devalued the controlled peso—which accounts for about two-thirds of all transactions—by 18 percent to bring it in line with the free market rate. [redacted]

The move by Mexico City apparently stops short of the strong medicine needed to significantly reduce inflation, but some slowing is likely. The provision increasing workers' wages was welcomed by organized labor and averted the general strike planned for 18 December. Nonetheless, the austere nature of many of the new measures may be a political liability for the government during the runup to next summer's presidential election. [redacted]

Other Latin American Countries

The Government of Peru devalued its currency on 14 December while Panamanian banks are again suffering serious liquidity problems. [redacted]

Peru

Peru devalued the official exchange rate 40 percent against the dollar Monday in an effort to stem foreign exchange losses, but rising inflation and a stagnant economy continue to undermine President Garcia's sagging popularity. Lima had devalued the official rate by 20 percent in late October but, [redacted] this failed to stem a $40 million-a-week reserve loss that continued into November. Only 38 percent of Lima's inhabitants approved of Garcia's overall performance in a poll conducted in November. [redacted]

The devaluation, which should boost exports and slow both imports and capital flight, will ease pressures on Peru's reserves. Higher import costs, however, will add to Peru's 110-percent inflation, fueling greater labor discontent. The stagnating economy, which is plagued by lagging private investment and rapidly growing government borrowing, is likely to remain a major problem for Garcia. [redacted]

Panama

A senior government banking official stated in early December that, following six weeks of slow improvement, Panamanian banks are again suffering serious liquidity problems caused by a heavy seasonal withdrawal of deposits. The official stated that all Panamanian-owned banks—including the National Bank of Panama—are in precarious financial positions and some fear that the failure of even one bank could trigger a panic large enough to topple the country's banking structure, [redacted]. Meanwhile, the government estimates that its budget deficit—which totaled $185 million from January to September—will approach $250 million for 1987 or 4.9 percent of GDP, [redacted]. The fiscal deficit is expected to worsen next year, with the National Bank of Panama estimating it could grow to $600 million if the government decides to resume debt payments. In an attempt to finance and reduce this deficit, Panama probably will ask its commercial creditors for $100 million in new money and is considering a 10 percent across-the-board spending reduction, including salary cuts and a hiring freeze. Because foreign banks are unlikely to grant new financing, Panama may be forced to enact politically unpopular spending cuts and continue to default on debt payments to governments and banks next year. [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Americas

Colombia's $1 billion loan has been fully subscribed ... expect loan will be signed by end December. [redacted]

Costa Rican Central Bank President Lizano stated that the foreign exchange target for its IMF arrangement will not be met because of a shortfall in capital inflows and increase in imports ... San Jose has yet to reach agreement with commercial banks but maintains a commitment to have accord in place by 30 June 1988. [redacted]

New legislation has been proposed for **Honduran** debt-equity program ... payment is to be made in long-term, non-guaranteed government bonds instead of local currency ... proposal unacceptable to foreign investors and banks ... Congress failed to vote on legislation before 4 December recess. [redacted]

Venezuela disappointed by slow investor response to its debt-equity swap program that was approved last April ... studying ways to ease foreign exchange controls and restrictions on profit repatriation. [redacted]

[redacted]

[redacted]

[redacted]