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Financially Troubled Borrowers: Prospects for Debt Rescheduling [redacted]

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An Intelligence Assessment

Secret

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October 1982

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An Intelligence Assessment

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Issues. It was coordinated with the National Intelligence Council. Comments and queries are welcome and may be directed to the Chief, Third World Issues Branch [redacted] 25X

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Key Judgments

Information available as of 4 October 1982 was used in this report.

The international financial system is under greater stress than at any time since World War II. Western banks face 18 separate debt reschedulings this year, led by Mexico, Argentina, Poland, and Romania. The near-term potential for rescheduling also exists for a number of other countries, including Chile, East Germany, Hungary, Peru, the Philippines, and Yugoslavia. Many international financial experts are concerned about Brazil's sudden difficulty in obtaining foreign loans. [redacted] 25X

Although we believe the international financial community can absorb an orderly sequence of reschedulings, the rise in reschedulings has important implications for lenders and borrowers:

- A growing share of bank loans to countries experiencing payments problems is being rescheduled and partially written off to the detriment of bank liquidity and profits. As a result, the credit ratings of several major banks have recently slipped and could further deteriorate, which could reduce the overall volume of lending to LDCs.

- The Mexican, Argentine, and Polish payments crises have increased bankers' perceptions of risk in international lending. Banks may sharply curtail lending to other countries—even to those with good credit ratings—which could precipitate additional financial crises and possible reschedulings. [redacted] 25X

The loss of banker confidence and risk of precipitous lending cutbacks are our most serious concerns. A cutback in the growth of Western bank lending would force debtor nations to undertake or strengthen austerity measures to compensate for the reduced availability of foreign exchange. Such moves would seriously impede economic growth and could cause political and social unrest in some countries. Another option is accelerated debt rescheduling; at the extreme, debtor countries could simply stop payment on their external debt. We are especially concerned about Brazil's sudden difficulty in obtaining foreign loans, which could spiral into an international financial crisis. [redacted] 25X

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Should one or more major countries repudiate their external debt or call for a sustained moratorium on debt servicing, the implications for the international system would be serious. The likelihood of debt repudiation is remote—among other things it would jeopardize a country's access to international credit. The decision to do so, however, would be made on political grounds. We currently have no indication that any major debtor country is willing to take such a drastic action. [redacted] 25X

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Financially Troubled Borrowers: Prospects for Debt Rescheduling 25

Seeds of the Current Problem

The combined external medium- and long-term debt of LDCs and Eastern Europe grew from $111 billion at yearend 1973 to $515 billion at yearend 1981. Nearly 85 percent of the debt is held by the LDCs. Most of this rise was funded by Western commercial banks. Before 1974 developing countries received over half of their financing from official sources, generally at below-market rates. By yearend 1981, Western bank loans to both LDCs and Eastern Europe stood at $375 billion and accounted for the bulk of their total external debt (see chart).

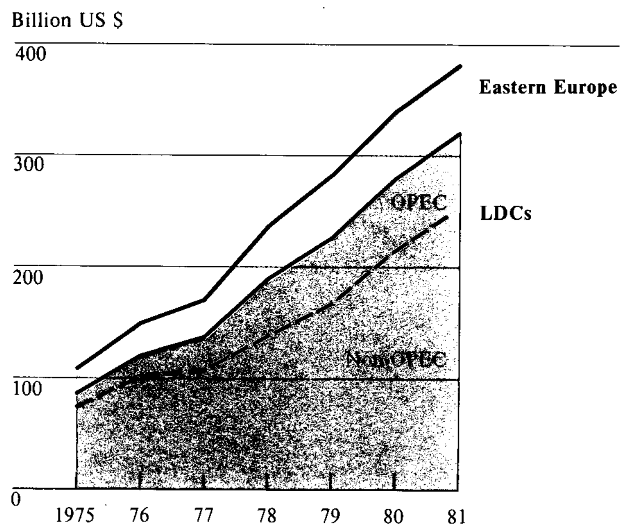
The enormous growth of external debt can be partially explained by the desire of several Third World countries—such as Brazil, Mexico, and South Korea—and East European nations to industrialize their economies rapidly. Specifically, they borrowed heavily to finance the development of export industries, with the belief that subsequent foreign exchange earnings would more than repay the loans. Market conditions during the past decade encouraged this approach:

- On the supply side, the recessions reduced industrial country loan demand, causing bankers to compete aggressively for East European and LDC business. Moreover, Western governments frequently encouraged greater bank lending to promote exports.

- Low real interest rates throughout most of the 1970s encouraged greater borrowing because debtors expected to service their loans with cheaper dollars.

In addition, many countries—such as Mexico and Chile—opted to borrow heavily to maintain domestic consumption levels rather than undergo the painful adjustments associated with higher world energy prices following the 1973 oil embargo. Furthermore, for most borrowers, the recession in the West that followed each of the oil price crises cut demand for LDC exports which, along with the rapid rise in LDC oil import bills, put more pressure on borrowing to cover trade deficits. 25

Western Bank Loans to LDCs and Eastern Europe



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The 1979-80 oil price crisis greatly altered borrowing conditions. It put borrowers in the position of having to take new loans both to meet the second round of high oil prices and to pay off loans coming due from the first round:

- As borrowers in general became riskier customers and loan terms deteriorated, several major LDCs drew down reserves and borrowed short term, actions that worsened their liquidity position and increased their susceptibility to foreign exchange shortages.

- The dramatic rise in interest rates in 1980—brought about by the restrictive monetary policies of the major OECD countries—compounded the debt

Short-Term Debt: A Growing Problem

In addition to the rise in external debt, creditors are very concerned about the short-term debt positions of LDCs and Eastern Europe. We estimate total short-term debt—defined as external liabilities of less than one year in original maturity—for these countries at $150-160 billion at yearend 1982; total medium- and long-term debt at yearend 1982 is estimated to be $625 billion.

For the most part, short-term debt consists of syndicated loans of short maturity, overdrafts or revolving lines of credit, bills of exchange, and letters of credit. In general, these are related to trade transactions and, in a sense, are self-liquidating; their absolute level tends to maintain a stable relation to the value of a country's trade, and the amounts involved are normally rolled over from year to year. However, at any given moment, the outstanding amount may place a net immediate claim on a country's foreign exchange reserves, thus affecting the overall payments position, including the country's debt servicing ability. As short-term credits are rolled over, they become the equivalent of a medium-term source of finance and may account for a substantial portion of a country's debt profile.

In spite of the importance of short-term debt, no comprehensive data have been compiled on a basis consistent with the medium- and long-term debt statistics produced by the World Bank and the OECD. Some estimates are available, but for most individual countries, a substantial part of their short-term financial transactions are often not properly recorded in the balance of payments but are lumped into the "errors and omissions" item.

In those countries for which we have made short-term debt estimates, the figures vary considerably:

Billion US $

Country	Total Debt [a]	Short-Term [a]
Brazil	71	9 [b]
Mexico	68	15
Argentina	34	11
South Korea	31	11
Venezuela	28	12
Poland	25	1
Philippines	16	5
Chile	14	3
Peru	11	2
Romania	11	2

[a] Yearend 1981.
[b] Some analysts believe Brazil's short-term debt may actually be closer to $18 billion.

At times, countries have resorted to sharp increases in short-term borrowing because of either a desire to avoid longer term borrowing at higher rates or an inability—because of declining credit standing—to obtain longer term credits. Greater short-term borrowing has caused serious problems for certain countries including Argentina, Mexico, and Venezuela. The constant need to roll over the short-term debt, combined with deteriorating lender risk perceptions, have added to these LDCs' already large debt burdens. Creditors are concerned that other debtors could fall into the same trap, with the end result being more debt restructuring and rescheduling.

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Table 1
Selected Countries: Debt Service Ratios [a]

Percent

	1973	1978	1981	1982 [b]
Argentina	32	45	70	80
Bolivia	23	55	56	60
Brazil	36	60	60	70
Central African Republic	6	4	15	18
Chile	22	50	60	62
Costa Rica	14	27	22	43
Dominican Republic	12	21	26	30
East Germany	18	38	58	64
Ecuador	9	25	48	45
Guyana	9	18	37	40
Honduras	7	15	20	25
Hungary	13	28	37	32
Liberia	6	6	14	18
Madagascar	6	6	45	55
Malawi	9	16	30	35
Mexico	40	74	59	75
Nicaragua	25	18	18	33
Pakistan	19	23	23	27
Peru	58	50	65	62
Philippines	20	23	28	29
Poland	15	67	80	80
Romania	22	20	27	32
Senegal	10	16	25	30
Sierra Leone	10	22	25	30
Sudan	18	19	58	60
Togo	8	15	47	50
Uganda	9	6	54	60
Venezuela	8	15	20	25
Vietnam	1	26	77	60
Yugoslavia	14	18	25	27
Zaire	11	11	42	50

[a] Ratio of medium- and long-term principal repayments and total interest payments to exports of goods and services.
[b] Estimated.

[redacted] 25

servicing problems of the LDCs and Eastern Europe (table 1). The London Inter-Bank Offered Rate (LIBOR) averaged nearly 17 percent in 1981, 5 percentage points above 1978 and the highest yearly average ever; each percentage point change in LIBOR translates into a change of about $2 billion in LDC interest payments. Moreover, borrowers have had to contend with the sharp increase in real interest rates that was largely brought on by the drop in US inflation. [redacted] 25

The East Europeans encountered similar problems meeting their debt obligations. The postcrises recessions in the West reduced demand for East European exports. Moreover, many of the investment projects undertaken in the 1970s to boost export earnings had either fallen behind schedule or never reached capacity because of shoddy construction and poor management. [redacted]

Poland and Mexico Shock the System

The financial problems of the LDCs and East European countries were not of great concern to lenders until Poland and then Mexico shocked the banking system. Until then, debt problems were increasingly prevalent but easily manageable. Before 1980 the most reschedulings in any one year were five in 1979 and four in 1974 (table 2). These totals were dwarfed in 1980 and 1981 with 13 and 14 reschedulings, respectively. Nonetheless, the total amount of debt rescheduled paled in comparison with total debt outstanding: the largest percentage share was only about 2 percent in 1981 (table 3). Even chronic reschedulers such as Sudan, Togo, and Zaire were more of a nuisance than a problem and Turkey's rescheduling—the largest before Poland's—was handled smoothly because of its strategic importance to Western governments. [redacted]

The debt problems of Poland and Mexico have shaken the international banking system. According to a European banker, before the financial difficulties of those two countries, bankers had a near-unanimous opinion that this was a safe world in which to expand international business. The few problems were among minor borrowers and easily managed by the banking system. Now, bankers face keeping a growing number of large debtors financially afloat with no assurance that these stopgap measures will improve the long-term likelihood of debt repayment. [redacted]

Poland. According to US financial experts, Poland's bankruptcy beginning last year shattered several assumptions that had boosted Western lending to Eastern Europe in the 1970s. The change in bankers' perceptions was reinforced when Romania joined Poland in the ranks of the reschedulers in mid-1981:

- Until recently, bankers regarded the dependence of these countries on the USSR as an advantage. The Soviet Union's refusal to bail out Poland disproves the so-called umbrella theory.

- The problems in Poland caused banks to reassess their lending policy to Eastern Europe as a whole. As a result, new credits to Eastern Europe nearly disappeared in 1981, and some banks have begun to write off portions of their Polish exposure. 25X

- Formation of Solidarity and its contest for political power with the Polish regime, along with the Soviet invasion of Afghanistan and the subsequent deterioration in East-West relations, forced bankers to give more weight to political risk factors in lending to Eastern Europe. [redacted] 25X

Mexico. In our judgment, Mexico's recent financial crisis called into question bankers' judgments in lending sizable amounts nearly unquestioned to large, resource-rich LDCs. In particular, bankers learned that they had to look beyond the performance of a key export such as oil or minerals and assess the overall strengths and weaknesses—including government economic policies—of LDC economies. The magnitude of Mexico's debt and the rapid deterioration in its financial position, coupled with the Argentine debt crisis, brought further changes in creditors' lending policies: 25X

- [redacted] 25X We also expect that syndicated loan terms to several key Latin American borrowers—such as Chile, Peru, and Venezuela, as well as Mexico—will stiffen during the next six months. 25X

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- The concurrent debt problems of Mexico and Argentina—two of the three largest LDC debtors—raised serious questions from financial analysts about the ability of banks to handle the financial needs of troubled debtors simultaneously. [redacted] 25X

Table 2
Debt Reschedulings (by Region), 1973-81 [a]

Million US $

Region	1973	1974	1975	1976	1977	1978	1979	1980	1981
Total	**447**	**1,494**	**478**	**480**	**382**	**2,312**	**5,250**	**5,281**	**10,786**
Asia and Middle East									
India	340	194	248	200	120				
Pakistan	107	650							250
Turkey						1,100	3,200	3,000	3,200
Latin America									
Bolivia								172	460
Chile		460	230						
Guyana								30	
Jamaica								110	103
Nicaragua								562	180
Peru						1,212			
Africa									
Central African Republic									72
Congo							330		
Gabon						NA			
Ghana		190							
Guinea								80	
Liberia								35	34
Madagascar									140
Mauritania								130	
Senegal								150	75
Sierra Leone					52			40	
Sudan							500		500
Togo							220	150	242
Uganda									730
Zaire				280	210		1,000	402	500
Eastern Europe									
Poland									4,300
Yugoslavia								420	

[a] Data include private and official credits.

Billion US $

Table 3
Selected Countries: External Debt [a]

Country	1973	1978	1981	1982 [b]
Argentina	4.3	11.6	23.5	25.0
Bolivia	0.7	1.7	2.6	3.0
Brazil	12.6	43.5	62.5	70.0
Central African Republic	0.1	0.1	0.2	0.3
Chile	4.0	6.9	11.0	12.0
Costa Rica	0.3	1.0	2.3	2.4
Cuba	0.5	2.0	3.0	3.5
Dominican Republic	0.4	1.0	1.6	1.8
East Germany	2.2	7.8	12.4	12.6
Ecuador	0.5	2.1	4.1	5.1
Guinea	0.6	1.0	1.2	1.3
Guyana	0.2	0.4	0.7	0.8
Honduras	0.2	0.8	1.2	1.4
Hungary	1.4	4.0	5.9	6.2
Indonesia	6.0	14.2	16.5	20.0
Jamaica	0.4	1.2	1.6	1.7
Liberia	0.2	0.3	0.6	0.7
Madagascar	0.1	0.3	1.4	1.6
Malawi	0.2	0.5	0.8	1.0
Mexico	8.5	33.6	52.5	55.0
Nicaragua	0.4	1.0	2.2	2.5
Nigeria	1.4	3.1	6.0	7.6
Pakistan	4.2	7.6	9.5	10.3
Peru	2.7	6.8	9.0	11.0
Philippines	2.0	6.8	11.3	13.0
Poland	2.6	15.6	24.3	23.7
Romania	1.3	3.8	7.7	9.0
Senegal	0.2	0.6	1.0	1.1
Sierra Leone	0.1	0.3	0.4	0.5
Sudan	0.5	2.2	5.2	7.2
Tanzania	0.5	1.2	1.5	1.6
Togo	0.1	0.6	1.0	1.1
Turkey	3.0	6.8	17.0	19.0
Uganda	0.2	0.4	0.6	0.7
Venezuela	1.8	8.9	16.0	19.0
Vietnam	0.4	1.8	3.5	3.6
Yugoslavia	4.1	9.8	15.6	15.6
Zaire	0.9	3.6	4.2	4.2
Zambia	0.7	1.5	2.0	2.2

[a] Data are for medium- and long-term disbursed debt at yearend.
[b] Estimated; does not include results of any rescheduling this year.

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Major Debtor Countries:
Status of Economic Policy Measures

Argentina
Taking steps to begin negotiations with IMF, but far from meeting IMF conditions. Unless willing to change policies, prospects are not good for an agreement.

Brazil
Self-imposed austerity measures have been successful but will need to be continued. Government is trying to lower public spending and further reduce imports.

East Germany
Regime is slashing imports and pressing harder for exports, but is unwilling to impose additional adjustment policies. Continued reluctance of Western bankers to roll over maturing credits could force formal rescheduling by next year.

Chile
Faced with political pressure, government has eased credit and spending limits in order to reduce unemployment and bolster domestic industries; could face problems if austerity policies continue to slacken.

Mexico
Has not seriously implemented austerity measures to comply with requirements of proposed IMF program; unlikely to do so before Lopez Portillo leaves office on 1 December.

Peru
Recent IMF agreement signed calling for ceiling on public-sector deficits and central bank purchases of government securities; over the next three years targets will probably not be met.

Philippines
Government has stayed within guidelines of prior IMF agreement, but problems have arisen from an overvalued exchange rate, high tariffs, and underdeveloped local financial markets.

Poland
Austerity measures have permitted a record trade surplus, but the regime faces rescheduling for at least several more years.

Romania
Sharp cuts in hard currency imports have reduced substantially the current account deficit; even so 1982 rescheduling talks with bankers have bogged down. Without an agreement, arrears will mount and Romania will need debt relief next year.

Venezuela
Central bank has recently injected additional liquidity into the financial system to stimulate a sluggish economy.

Yugoslavia
Stabilization program has cut growth and the balance-of-payments deficit, but inflation remains high. Persistent adjustment problems could precipitate a payments crisis soon.

2

Prospects for Rescheduling Through 1983

The economic situation faced by LDC borrowers, we believe, makes it almost certain that the number of reschedulings will continue to increase during the next 12 to 18 months. OECD growth in 1982-83 will probably be insufficient to substantially boost demand for LDC commodity exports. Just as important, most analysts believe real interest rates will remain high. The decision to reschedule, however, ultimately depends on such variables as the attitude of countries' economic managers toward rescheduling, availability of policy alternatives such as devaluation and other austerity measures—and the political will to use them—and financial support from other countries or international agencies. [redacted] 25X

Eighteen countries have already initiated rescheduling operations or have indicated to bankers that they will do so this year (table 4). These countries' combined medium- and long-term debt accounts for nearly 25 percent of total LDC and East European debt, or $146 billion. About four-fifths of this is accounted for by Mexico, Argentina, Poland, and Romania:

- *Mexico*, with a total debt of over $80 billion, has undergone a rapid deterioration in its financial position and faces certain rescheduling in the next few months. Western banks and the US Government agreed to provide emergency funds to Mexico in mid-August, a decision aided by Mexico's agreement to initiate talks with the IMF. Creditors are extremely concerned about Mexico, [redacted] However, banks did not refuse the recent Mexican request for a 90-day moratorium on principal repayments due in the next three months.

- *Argentina*, with a total debt of about $36 billion, has not yet recovered from the Falklands conflict, which was a drain on reserves and caused a dropoff in export revenues. [redacted] lenders have been rolling over short-term credits, but the large amounts due in the next several months indicate that a rescheduling is inevitable.

Table 4
1982 Debt Reschedulings

Definite or Probable Reschedulers Before Yearend	
Argentina	Nicaragua
Costa Rica	Poland
Cuba	Romania
Domincan Republic	Senegal
Guyana	Sudan
Honduras	Togo
Madagascar	Uganda
Malawi	Vietnam
Mexico	Zaire
Possible Reschedulers Before Yearend	
Bolivia	Peru
Central African Republic	Sierra Leone
Ecuador	Tanzania
Liberia	Yugoslavia
Pakistan	

[redacted] 25X

- *Poland*, with a $24 billion total debt, is renegotiating its 1982 commercial bank obligations. The guidelines are similar to those of 1981, but Western banks are to extend short-term trade credits amounting to 50 percent of 1982 interest. This would, in effect, capitalize interest payments, a condition that a number of banks had originally rejected. [redacted] 25X1 25X 25X 25X 25X

- *Romania* is in the process of rescheduling its 1982 debt, although it is still in arrears on a portion of its 1981 repayments. Its 1982 debt is estimated to reach nearly $11 billion at yearend. [redacted] 25X 25X 25X1

Table 5
Selected Countries: Prospects for Debt Rescheduling, 1982-83

Billion US $

Country	Last Rescheduling	Total Debt [a]	Total Bank Debt [b]	Bank Debt Due This Year [c]	Prospects for Rescheduling
Brazil	1964	71	53	18	Seriousness of debt problems emerging; possible in early 1983.
Mexico		68	57	28	Certain by yearend 1982.
Argentina	1965	34	25	12	Certain by yearend 1982.
South Korea		31	20	12	No major problems through 1983.
Venezuela		28	26	16	Some restructuring probable in 1982 or 1983.
Poland	1981	25	15	6	In the process of rescheduling 1982 bank debt payments.
Indonesia	1968	20	7	3	No major problems until possibly late 1983.
Yugoslavia	1980	19	11	3	Possible in 1982 or 1983.
Algeria		18	8	2	No major problems through 1983.
Turkey	1981	17	4	1	Still receiving benefits of prior reschedulings.
Philippines		16	10	6	Growing concern, but unlikely before late 1983.
East Germany		15	11	5	Possible in 1983.
Chile	1975	14	11	4	Unlikely before mid-1983.
Peru	1978	11	4	3	Possible in early 1983.
Romania		10	5	2	1982 rescheduling process under way; likely to recur in 1983.
Hungary		9	8	3	Some chance during 1983.
Nigeria		7	6	2	Growing concern, possible by late 1983.

[a] Debt of all maturities as of yearend 1981.
[b] Debt owed to Western banks as of yearend 1981.
[c] Debt owed to Western banks with maturity of one year or less.

[redacted] 25

Most of the other countries that will reschedule this year do not have large debts, and even together, their debts do not seriously trouble Western banks. Each of their medium- and long-term external debt is less than $6 billion; combined, they account for only about 5 percent of total debt, and only a small portion of that is owed to Western banks. Countries such as Togo, Uganda, and Zaire typically suffer from chronic economic mismanagement and slow growth, exacerbated by the global recession and high interest rates. Others, such as Costa Rica and the Dominican Republic have only recently gotten into financial troubles because of poor economic decisionmaking coinciding with depressed demand for their exports and high interest rates. [redacted]

[redacted] banks are also closely watching the financial conditions of other large borrowers whose financial situation could deteriorate to the point of needing debt relief (table 5): 25

- *Brazil*, with total debt of at least $80 billion, had until recently stabilized its debt position. Largely because of the spreading worry about the Mexican and Argentine situations, Brazil is now having difficulty obtaining new loans and its foreign exchange reserves are seriously low.

- *Chile* has attracted banker concern because of lower commodity prices (especially for copper) and a severe recession, and it may have to reschedule its 25 debt next year. Total debt currently stands at about $16 billion, and creditors have slowed new lending to Chile.

- *East Germany* is cutting imports in the face of continuing unwillingness by Western bankers to extend credits and difficulties in increasing its hard currency export earnings. Such actions may still be inadequate to prevent a rescheduling request by early next year, if banks continue to reduce their exposure. Total debt currently stands at $14 billion.

- *Peru's* financial situation has deteriorated during 1982, and total debt is about $12.5 billion. Despite a recent IMF agreement, bankers are wary of Peru largely because of depressed commodity export revenues. A rescheduling could take place in the first part of 1983.

- *The Philippines*, with a total debt of about $18 billion, is being watched closely by lenders. The main concerns are low commodity prices, rapidly growing short-term debt, and government economic policies that have discouraged industrial efficiency. Several private Philippine corporations are in deep financial trouble, but we believe a rescheduling is unlikely before late 1983.

- *Venezuela* has been attempting to restructure a portion of its $29 billion debt to a longer term maturity. The Falklands conflict made some creditors leery of Venezuela and was partially responsible for a recent $2.5 billion loan falling through. A continuation of the soft oil market could put added financial pressure on Venezuela, but a formal rescheduling seems unlikely during the next 12 months.

- *Yugoslavia*, with a total debt of $19 billion, faces possible rescheduling in 1983. The country has suffered from poor economic performance and has also been hurt by the credit squeeze in Eastern Europe. The leadership's inability to deal with economic problems, along with its refusal to consider rescheduling, has weakened its credibility among the Yugoslav people and has postponed key decisions until early 1983. [redacted]

Most of the bankers' concern is with the large size of the debts, especially those of Brazil and Venezuela. [redacted] 25X

Ac- 25X
cording to one authoritative financial journal, bankers worry that if global recovery does not take place, trade will continue to deteriorate and cause debt management problems for more countries. [redacted] 25X

Implications of Greater Rescheduling

The Bright Side. Recently, some financial publications have expressed concern that the international financial system will be unable to manage several simultaneous reschedulings by major debtors. [redacted] 25X1
we believe that multiple large reschedulings would not be insurmountable if agreements are implemented smoothly without substantial interruptions in interest payments. Many of the rescheduling countries are repeaters—such as Sudan, Togo, and Zaire—and have been in financial trouble for the better part of the past decade. Creditors have generally determined that these countries will be unable to service their debt for the next several years, and rescheduling is a means by which the banks can write off these loans over time. Because most of these countries have relatively small external debts, banks are able to do this without sharply cutting profits. [redacted] 25X

Most commercial bankers, according to a leading bank newsletter, view some reschedulings as beneficial when combined with properly implemented austerity measures because they allow a country to ease an immediate repayment problem without seriously damaging its longer term credit standing. For example, Chile (in 1974-75) and Peru (1978) underwent reschedulings that eased their financial burdens, and they were again borrowing heavily at favorable rates by 1980. [redacted] 25X

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Table 6
Estimated Share of Total Debt Held by US Banks

Percent

Argentina	25	Nicaragua	20
Bolivia	15	Pakistan	5
Brazil	25	Peru	15
Central African Republic	5	Philippines	30
Chile	35	Poland	10
Costa Rica	25	Romania	5
Dominican Republic	30	Senegal	10
East Germany	10	Sierra Leone	5
Ecuador	45	Sudan	5
Guyana	15	Togo	5
Honduras	25	Uganda	20
Hungary	10	Venezuela	30
Liberia	40	Vietnam	5
Madagascar	5	Yugoslavia	15
Malawi	20	Zaire	5
Mexico	25		

[redacted]

Reduced Bank Lending. The increasing number of countries unable to service their debt obligations reduces the quality of bank assets and hence the ability of banks to expand lending. A growing share of Western short-term bank loans that were scheduled to be repaid this year is having to be restructured into longer term assets, a move that decreases the banks' liquidity. [redacted]

Although we do not have any firm data on debt holdings of foreign banks, US banks are the major lenders to Latin America and Yugoslavia, and European banks hold most other East European debt (table 6). [redacted]

[redacted]

Besides decreasing banks' *ability* to lend to LDCs and East European countries, there is a danger that borrowers' financial problems could trigger a "herd" instinct on the part of bankers that would reduce their *willingness* to lend. Certainly, lenders as a group are looking much more critically at individual troublesome borrowers. Countries that were attractive to bankers several years ago now find lenders somewhat recalcitrant. [redacted] In the extreme, typically conservative bankers could decide that any new lending to LDCs and East European countries is not worth

Table 7
Potential Debt Problem Countries: Importance of Borrowing, 1982 [a]

Billion US $

Country	Trade and Services Balance Excluding Interest	Interest Payments [b]	Scheduled Principal Repayments [b]	Ex Ante Required Borrowing		Net Borrowing as Share of Imports (*percent*)
				Gross	Net	
Argentina	1.8	4.5	3.8	6.5	2.7	40
Bolivia	0.2	0.4	3.2	3.4	0.2	30
Brazil	−1.1	11.6	8.7	21.4	12.7	60
Central African Republic	Negl	0.1	0.1	0.2	0.1	50
Chile	−0.6	2.0	2.0	4.5	2.5	50
Costa Rica	0.2	0.3	2.6	2.7	0.1	10
Dominican Republic	1.2	1.7	2.2	2.7	0.5	40
East Germany	−0.2	1.3	3.2	4.7	1.5	20
Ecuador	−0.8	0.6	0.5	1.9	1.4	50
Guyana	−0.2	0.1	0.1	0.4	0.3	60
Honduras	−0.2	0.1	0.1	0.4	0.3	30
Liberia	Negl	0.1	0.1	0.2	0.1	20
Madagascar	−0.4	0.1	0.2	0.7	0.5	70
Malawi	−0.2	0.1	0.1	0.4	0.3	90
Mexico	2.5	10.0	7.0	14.5	7.5	40
Nicaragua	−0.5	0.2	0.2	0.9	0.7	80
Pakistan	−1.1	0.5	0.5	2.1	1.6	30
Peru	−0.6	1.1	1.5	3.2	1.7	40
Philippines	−1.5	1.5	1.2	4.2	3.0	30
Poland	1.3	3.3	6.8	8.8	2.0	40
Romania	1.2	1.0	1.9	1.7	−0.2	Negl
Senegal	−0.3	0.1	0.1	0.5	0.4	40
Sierra Leone	−0.1	0.1	0.1	0.3	0.2	60
Sudan	−0.8	0.4	0.4	1.6	1.2	60
Togo	−0.1	0.1	0.1	0.3	0.2	60
Uganda	−0.2	0.1	0.1	0.4	0.3	50
Venezuela	0.4	2.6	2.4	4.6	2.2	20
Yugoslavia	1.2	2.8	2.3	3.9	1.6	15
Zaire	0.3	0.4	0.4	0.5	0.1	10

[a] Unless otherwise noted, includes borrowing from all sources. Most, however, would come from Western banks.
[b] Medium- and long-term debt only.

Source: Prepared by CIA analysts on the basis of projections of trade and debt data for 1982.

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the risk. This reaction is likely to be strongest among the smaller banks, which watch very carefully for market signals from the major financial institutions. [redacted]

Lending Cutback Implications. A cutback in the growth of Western bank lending would have serious implications for a number of debtor countries and, in turn, for the international financial system. Specifically, these nations would be forced to undertake or strengthen austerity measures to compensate for the reduced availability of foreign exchange. Such moves would slow economic growth and could stimulate political and social unrest in some countries, including changes in governments. In the extreme, to avoid this outcome, countries could simply stop payment on their external debt. In our judgment, a general reduction in the growth of Western bank lending could force additional reschedulings and could push one or more of the large borrowers being closely watched by financial analysts beyond their debt management capability. [redacted]

Brazil's sudden difficulties in obtaining foreign loans particularly concerns bankers. [redacted] Some foreign banks are reducing the availability of short-term credits and demanding repayment of maturing loans rather than rolling them over. [redacted]

Table 7 illustrates the importance of commercial borrowing to countries that have serious financial problems. Brazil, for example, would have required net new borrowing on the order of $12.7 billion this year to cover its current account deficit. This amount is equivalent to over one-half Brazil's import bill. In the absence of new lending, Brazil would have to cut imports drastically to pay its debt service obligations or, alternatively, delay interest payments to maintain 25 the level of imports. Depending on how an import shortfall is allocated between capital and consumer goods, Brazil's economic growth would be reduced, perhaps sharply. The resulting austerity would raise the risk of serious political instability. [redacted] 25

Debt Repudiation Risk. Although the likelihood is small, we cannot discount totally the possibility that one or more LDC leaders may declare an extended debt moratorium or repudiate their external debt. From an economic standpoint, a debt repudiation or an extended moratorium on repayment does not correct a country's underlying economic management problems; it would, however, seriously disrupt that country's international trade, jeopardize access to credit, and run the risk of tying up whatever assets creditors could gain access to. Politically, however, an LDC leader may be tempted to refuse to honor debt 25 obligations by frustration over the inability to solve the country's economic problems under a large overhang of debt or by the need to salvage domestic support. If this were to occur, investors and depositors 25 could lose confidence in several major banks and 25 withdraw their funds; these funds would be reinvested in US Government securities and other instruments deemed safe. This could cause a liquidity crisis for 25 banks and, in turn, could trigger a rapid reduction in world credit as major banks cut back lending. Such a credit cutback would slow world trade and LDC 25X economic growth. While the seeds for such a collapse are present, we believe that appropriate and timely central bank intervention could check such a crisis without serious long-term damage to the Western 25 banking system. [redacted] 25

LDC Debt Relief: A Cabal Against Creditors?

The increasingly dire financial straits of several key LDC debtors combined with the generally dismal economic performance of most LDCs over the past several years raise the prospect that harassed LDC policymakers may try as a group to confront bankers for some form of universal debt relief. The idea is not new. Generalized debt relief was formally raised to the level of a Third World "demand" in the North-South dialogue in 1976. Particular emphasis was on then-dominant bilateral and multilateral debt, but a scheme to reschedule private bank debt and create a new international aid institution to compensate bankers was discussed. Proposals for generalized debt relief fell victim to sharply divergent economic situations and views of foreign debt among LDCs.

The magnitude and preponderance of private bank debt in LDC borrowing portfolios now puts a new perspective on LDC demands for debt relief because of the bargaining power inherent in a collective blackmail of creditors. Still, we do not yet see any valid evidence of moves in this direction, and the underlying arguments against it essentially pertain:

- *The largest LDC borrowers stand to make substantial economic progress over the longer term and have in the past evinced concern that radical proposals for debt relief could jeopardize access to needed credits.*

- *The most radical Third World leaders on debt relief as a North-South issue—such as Nicaragua and Tanzania—are not large debtors to private banks.*

- *The strongest early proponents of generalized debt relief that have relatively large debt burdens—such as Pakistan, Bangladesh, and Zaire—have viewed it simply as a resource transfer and would probably be just as pleased with increased aid.*

This argument is admittedly tempered somewhat, however, by the rapid rise of Venezuela and Nigeria into the ranks of problem debtors; both were strong proponents of generalized debt relief demands in the 1970s.

Although we are reasonably confident that no workable moves toward collective debtor action are imminent, we agree that it is an intelligence issue worth close watching. LDCs have in the past acted in ways we would have called contrary to their best interests. If external financial difficulties, domestic economic problems, and attendant political pressures reach some critical mass with no alternative relief in sight, the probability of a collective confrontation would increase.

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