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THE DIRECTOR OF CENTRAL INTELLIGENCE

WASHINGTON, D.C. 20505

DDI #7891-82
29 September 1982

National Intelligence Council

MEMORANDUM FOR: Acting Director of Central Intelligence

25X1

FROM: [redacted]
NIO for Economics

SUBJECT: Mexico, Brazil, Argentina--The International Financial Crisis

1. The financial crises in Mexico and Argentina have transformed the international debt problem from one which could be treated as reflecting deficiencies of policies and management in a few countries to one which involves the health of the entire international financial system and the performance of the world economy. Bankers are curtailing loans to Brazil not because their assessment of Brazil's economic policies and political stability have turned negative, but rather because they are extremely nervous about a high degree of exposure in the present international economic and political environment. This nervousness has reached the point of constituting a crisis of confidence in international lending, which is drastically curtailing the flow of capital to Less Developed Countries. At a minimum the LDCs will have to make strenuous economic adjustments. At worst these required adjustments may be so severe as to disrupt economic activity, spur a political backlash against Western governments and financial institutions, and, in a few countries, possibly bring about major changes in domestic and foreign policy orientation.

2. Mexico, Brazil and Argentina are the three largest LDC debtors, with over $110 billion of debt, mostly to banks. Argentina is seriously in arrears on its debt service payments. Its government is too weak to get the economy in shape and all political risks are in the down side from the point of view of international lenders. Argentina will probably have to reschedule its debt soon.

3. The critical question in Mexico is whether and how soon a political consensus can be developed in support of drastic, painful domestic economic adjustments. Far from facilitating this process, President Lopez Portillo so far has played political games that have further undermined the confidence of the financial community. Rumors abound that he will make some dramatic statements at the UN on Friday condemning the bankers, announcing default, and urging others to do likewise. Although some rhetoric can be expected, it would not make much sense for LP to do this at the same time that his central bank President is trying to negotiate with the IMF. Even so, the situation is fraught with risks, including the risk of serious popular reactions in Mexico, and some splits in the PRI.

Approved For Release 2006/02/06 : CIA-RDP84B00049R000300630006-9

Approved For Release 2006/02/06 : CIA-RDP84B00049R000300630006-9

4. Brazil is now feeling the impact of Mexico and Argentina, in spite of having followed very cautious economic policies. Brazil may have to go to the IMF, or further curtail imports, or reschedule its obligations.

5. The international financial problem could get a lot worse and there is some risk either that major countries will have to declare a debt moratorium, or that their economies will be severely disrupted by lack of imports. The problem involves the relationships between governments, central banks, commercial banks, and borrowing countries. It is unlikely that any single policy solution will work. Rather, a whole range of policies will have to be considered, including:

- domestic monetary policy and its international linkages;
- regulation and support of banks;
- assistance to the developing countries themselves.

6. The stakes are high. Although a banking collapse is highly unlikely because central banks would keep major commercial banks afloat, a contraction of world trade together with a lapse into bilateralism is a serious possibility.

7. Attached is a good review of the problem, hot-off-the-press, by the best financial analysis group in the country--the Morgan Guaranty.

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Attachment,
As stated

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1982

International lending: implications of a slowdown

After more than a decade of very rapid expansion, international lending, especially to developing countries, is slowing sharply. Comprehensive data covering all banks in the BIS-reporting area indicate virtually no increase in claims on developing countries in the first quarter of this year. Such claims by U.S. banks and their foreign branches actually declined by $1½ billion to $119 billion in the first quarter of 1982. Those of German banks and their foreign branches (but excluding their foreign subsidiaries) fell by more than $1 billion to $23 billion in the first quarter. Last year, by comparison, net new lending by the BIS-reporting banks to the non-OPEC LDCs increased by 20%, and that by U.S. banks increased by 24%. In previous years, expansion of bank lending to developing countries was even more rapid (see chart).

Data on the volume of *gross* new medium-term Eurocurrency bank credits publicized in the past few months point to a further scaling back of lending to the developing countries (see Table 1). Such gross new lending amounted to $32 billion at an annual rate in the third quarter and only a $15 billion rate in September alone, down from a $50 billion rate in the first half of this year. Provisional data for the past month indicate that there have been very few new syndicated Eurocurrency loans to developing countries, especially Latin American borrowers. With the exception of just a few credits for Yugoslavia, Hungary, and the Soviet Union, Eastern European borrowers have been shut out of Eurocurrency credit markets this year.

The immediate reason for the recent deceleration in bank lending to the developing countries is that two of the most prominent borrowers from commercial banks, Mexico and Argentina, have encountered difficulties in meeting their payments of principal and interest on part of their external debts. Together, the two countries account for almost one-fourth of bank claims on the developing countries. Table 2 shows that U.S. bank claims on Argentina and Mexico represent about 35% of total bank claims on these countries, or the same percentage as on all developing countries. Mexico, with new medium-term Eurocredits of over $7 billion in the first half of 1982, alone accounted for over a quarter of the

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Table 1

Gross new Eurocurrency credits

publicized medium-term bank credits
billions of dollars, at annual rates

	1981	1982 1st half	1982 3rd quarter
Developing countries	45.24	50.48	31.82
Non-OPEC LDCs	33.37	37.96	15.82
Brazil	5.75	5.91	4.51
Korea	2.82	1.58	3.00
Chile	2.20	.90	1.76
Taiwan	0.93	—	1.02
Peru	1.41	1.68	.76
Philippines	1.28	.68	.75
Mexico	7.53	14.59	.38
Colombia	1.01	.17	.30
Malaysia	1.73	3.59	.10
Thailand	0.69	.71	—
Argentina	2.53	.93	—
OPEC countries	11.87	12.53	15.97
Venezuela	7.56	7.89	7.56
Nigeria	1.80	.93	2.83
Ecuador	0.93	1.23	.80
Indonesia	0.73	.74	.24
Eastern Europe	1.36	.75	1.07
Hungary	.55	—	1.04
East Germany	.47	—	.03
Romania	.22	—	—
Soviet Union	.03	.75	—

developing-country total in the first half of this year, but only 1% of this total in the third quarter. In view of the importance of Mexico and Argentina to the entire banking community, their debt financing problems have had a major impact on lending to other countries in the region.

Even before the latest round of developing-country debt problems, it was widely recognized within the banking community that a slowdown in the pace of bank lending to these countries was inevitable. Bank lending to them accelerated sharply after the first oil shock, and it has continued to grow very rapidly in recent years. Over the past three years, for example, BIS-reporting banks' claims on the developing countries grew at a 21% average annual rate, and those of U.S. banks rose at a 17% rate. These rates of growth for loans far outstripped those of bank capital, which for the largest U.S. banks have been averaging close to 10% per annum since the mid-1970s (see chart). Moreover, the rates of increase in loans to several countries — particularly Mexico and Argentina — were considerably above the average pace of lending and, thereby, resulted in increasing concentrations of bank credit to certain countries (see Table 2).

Regulatory authorities in a number of countries also have taken or are planning steps that directly or indirectly could slow foreign lending. In addition to imposing capital-asset ratio requirements on a consolidated balance sheet basis, some countries have set formal or informal guidelines on foreign country lending in response to concerns about concentrations of country credit risk. Supervisory authorities in some European countries have contacted banks on an informal basis to limit lending to individual countries. The Japanese Ministry of Finance, which earlier set limits on Japanese banks' medium- and long-term loans to foreign countries in relation to capital, is reported to be considering an extension of the limits to cover short-term loans as well. This action could lead to a significant slowing of Japanese banks' international lending, which has been very rapid in the past few years, and in some instances to a contraction of loans outstanding to certain countries. Such a slowing could contribute to increases in lending spreads.

Another factor contributing to the slowdown in international lending is the negative impact of current international and domestic financial strains on the functioning of the Eurocurrency market. In particular, there are signs of a contraction of the interbank market. In a world environment of increased risks, the maintenance of adequate capital in relation to assets is especially important, and banks have been taking steps to moderate the growth of their total assets. One way is by limiting interbank lines. Interbank deposits, which account for more than half of gross Eurocurrency liabilities, are a major source of funding for many Eurobanks and an important component of their liquidity. With banks reviewing and, in some instances, reducing their internal guidance lines to certain other banks, the scope for interbank depositing is being narrowed. In addition, banks may shorten the maturity of their deposits with certain other banks, a move that could pose problems for attempts by the latter to match the interest rates on their liabilities to those on their assets. The resultant contraction of the interbank market is likely to cause difficulties for some banks in funding their Euroloans, and may lead some to withdraw from, or at least scale back their participation in, the syndicated Euroloan market.

Approved For Release 2006/02/06 : CIA-RDP84B00049R000300630006-9

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Table 2

BIS-reporting banks' claims on selected countries

	% change* 1979	1980	1981	Total end-1981 ($ billions)	U.S. banks' % share of end-1981 total: All	9 large
Developing countries**	25	20	17	331.3	35	23
Non-OPEC LDCs**	32	24	20	258.5	36	23
Mexico	33	38	34	56.9	38	20
Brazil	17	18	16	52.7	32	20
Argentina	91	49	25	24.8	34	21
Korea	59	39	19	19.9	45	28
Chile	67	51	43	10.5	55	31
Philippines	47	27	9	10.2	53	36
Taiwan	7	21	22	6.6	75	47
Colombia	62	30	17	5.4	51	36
Thailand	31	9	27	5.1	32	21
Malaysia	18	19	67	4.4	22	19
Egypt	22	49	35	4.4	27	20
Peru	5	8	9	4.4	45	24
Turkey	4	11	—3	4.2	34	21
OPEC countries	9	8	5	72.8	32	22
Venezuela	48	17	8	26.2	40	27
Algeria	18	—0	—8	8.4	16	11
Indonesia	—0	8	—16	7.2	33	27
Nigeria	52	30	34	6.0	19	15
Ecuador	19	24	16	4.5	47	27
Eastern Europe	20	9	2	71.5	11	7
Soviet Union	—0	3	21	16.3	3	2
Poland	27	2	—6	15.3	13	8
East Germany	26	16	8	10.7	9	6
Yugoslavia	34	28	3	10.7	25	15
Hungary	15	1	—4	7.7	15	9
Romania	52	31	—12	5.1	7	5

*Includes effects of exchange rate changes.
**Excludes countries that are offshore banking centers.
Source: Bank for International Settlements (BIS), *The Maturity Distribution of International Bank Lending;* and Federal Financial Institutions Examination Council, *Country Exposure Lending Survey.*

Table 3

Current account balance

% of exports of goods and services, annual averages

	1970-73	1974-75	1976-78	1979-80	1981-82
Latin America					
Argentina	—1	—14	+19	—25	—30
Brazil	—35	—75	—48	—57	—49
Chile	—21	—19	—19	—28	—63
Colombia	—21	—11	+9	—1	—46
Ecuador	—22	—7	—22	—23	—42
Mexico	—29	—54	—31	—28	—28
Peru	—3	—63	—37	—9	—33
Venezuela	+4	+36	—27	+13	+4
Asia					
Indonesia	—19	—4	—8	+10	—22
Korea	—23	—35	—4	—22	—12
Malaysia	—3	—11	+5	+2	—27
Philippines	+6	—17	—25	—25	—28
Taiwan	+10	—13	+8	—2	+5
Thailand	—9	—11	—21	—27	—19

With fewer banks able and willing to participate in new international loans, and with less bank capital to support such lending, international lending is bound to slow down further.

Impact of the global environment on the developing countries

The economic and financial problems confronting a number of developing countries today are, to an important extent, a result of an adverse global environment. Today's environment is far less conducive to developing-country economic growth and to maintenance of their debt servicing capacity than that which existed until a few years ago. In 1979-80, the non-OPEC LDCs were again confronted with large increases in their oil-import bills owing to a sharp rise in world oil prices. Balance-of-payments adjustment by the non-OPEC LDCs after the second oil shock, however, has turned out to be far more difficult than that after the first oil shock. This is best demonstrated by the fact that even though oil prices have weakened somewhat from their peak in early 1981 and the OPEC surplus has virtually disappeared (representing a swing of more than $100 billion in two years), the payments positions of the non-OPEC LDCs have benefited very little. Their aggregate current account deficit remains very large both in absolute terms and in relation to their exports of goods and services, and a number of countries now face larger deficits in relation to their exports of goods and services than they did after the first oil crisis (see Table 3). In addition, several oil-exporting countries such as Mexico, Indonesia, and Nigeria have very large current account deficits.

The large payments imbalances of the non-OPEC LDCs have per-

Approved For Release 2006/02/06 : CIA-RDP84B00049R000300630006-9

Approved For Release 2006/02/06 : CIA-RDP84B00049R000300630006-9

Table 4

Real GDP growth

annual averages, in percent

	1970-73	1974-75	1976-78	1979-80	1981-82
Latin America					
Argentina	2.8	2.8	0.5	4.3	—6.0
Brazil	11.7	7.6	6.6	7.3	—1.7
Chile	1.9	—2.5	7.2	7.9	—2.6
Colombia	6.8	4.9	6.1	4.5	3.0
Ecuador	12.9	6.0	7.4	4.9	2.9
Mexico	7.0	5.9	5.3	8.7	4.5
Peru	6.1	5.1	0.0	3.5	2.3
Venezuela	5.3	6.0	6.1	—0.2	0.0
Asia					
Indonesia	8.6	6.3	7.5	7.5	6.3
Korea	9.9	7.8	12.3	0.1	6.0
Malaysia	8.7	4.6	8.7	8.6	5.2
Philippines	6.2	6.1	6.4	5.9	3.2
Taiwan	11.6	3.8	12.4	7.3	4.7
Thailand	6.3	6.3	13.0	5.9	6.3

sisted despite a pronounced contraction of their economic growth, which is estimated to have slipped to about a 2% rate last year from a trend rate of close to 6%. There was little or no growth for Latin America as a whole last year, and there may be a decline this year (see Table 4). While the Asian developing countries have managed about a 5½% rate of growth in the last couple of years, this nonetheless represents a considerable slowdown for the region. By contrast, in 1974-75 the non-OPEC LDCs were able to maintain a rate of economic growth close to 5% per annum, or only slightly below the trend rate in the late 1960s and early 1970s.

LDC balance-of-payments adjustment efforts since the second oil shock have been thwarted to a considerable extent by the protracted weakness of economic activity in the industrial countries. After the first oil shock, the developing countries benefited from rapid economic recovery in the United States in the mid-1970s and from the expansionary policies adopted by Germany and Japan in 1978-79. By contrast, economic policies over the past three years have been far more restrictive. Economic growth in the industrial world averaged only about 1% in 1980-81 and will be close to zero this year. Moreover, prospects for a quick turnaround of economic conditions in the industrial countries are not good. Despite mounting unemployment and a disinflationary environment, governments have refrained from adopting stimulative economic policies implemented in the past. Rather, the broad thrust of economic policies — particularly monetary policies and more recently fiscal policies as well — continues to be directed at fighting inflation and curbing inflationary expectations to lay the groundwork for a sustained economic recovery. Even though hopes that disinflation could be achieved quickly and painlessly have faded away, the commitment to a new era of much lower inflation, if anything, has become more widespread. Thus, countries that pursued more expansionary policies — most notably France in 1981 and early 1982 — have by necessity begun to shift their policies in the direction of countries with relatively low rates of inflation and strong payments positions.

The disinflationary environment in the industrial countries, in turn, has affected the capacity of the developing countries to service external debt. The growth of non-OPEC LDCs' export earnings, for example, fell to less than a 5% rate in 1981 and is negligible this year, compared to about a 23% average annual rate during 1975-1980. This slowdown partly reflects a 35% drop since late 1980 in the dollar prices of internationally traded commodities (excluding oil), which are partly a consequence of very high interest rates in the industrial countries. In real terms, they are at their lowest level in the past three decades and about 20% below their level in the 1974-

Approved For Release 2006/02/06 : CIA-RDP84B00049R000300630006-9

Approved For Release 2006/02/06 : CIA-RDP84B00049R000300630006-9

Table 5

Estimated external debt service payments

% of exports of goods and services

	1978	1982		
	Total	*Total*	*Interest*	*Principal**
Argentina	70	179	44	135
Mexico	124	129	37	92
Ecuador	74	122	30	92
Brazil	84	122	45	77
Chile	74	116	40	76
Venezuela	62	95	14	81
Colombia	48	94	25	69
Philippines	53	91	18	74
Peru	142	90	21	69
Turkey	164	68	13	55
Korea	27	53	11	43
Thailand	38	48	10	38
Egypt	42	48	7	41
Yugoslavia	20	46	14	32
Algeria	42	39	12	27
Indonesia	38	27	8	19
Taiwan	16	21	5	16
Nigeria	7	20	7	13
Malaysia	18	17	5	12

*All debt due within the year, including amortization of medium- and long-term debt plus short-term debt outstanding at the beginning of the year.

75 recession. The export slowdown also reflects a more-than-halving of export *volume* growth of the developing countries from the 8% trend rate in the second half of the 1970s. Exports of many OPEC countries actually declined last year and will again this year as a result of reduced world oil demand and the softening in oil prices.

Beyond this, very high interest rates in the industrial countries have added considerably to the debt servicing costs of the developing countries. The impact has been especially great for such major borrowers as Argentina, Brazil, Chile, and Mexico, where interest payments on external debt now range between 35% and 45% of projected exports of goods and services (see Table 5).

In addition, many developing countries have faced a rapid increase in the amount of external debt maturing each year as a result of mounting amortization payments on medium- and long-term debt and large increases in their short-term debt. The rapid buildup of short-term debt was partly a consequence of borrowers seeking to avoid higher spreads on medium- and long-term loans — a tendency that Brazil by and large resisted — as well as an increasing reluctance by banks to extend term loans to some borrowers. A number of developing countries have reached the point at which they must refinance or roll over large portions of their existing external debt each year. In fact, estimated total 1982 debt service payments (interest payments plus *all* debt falling due this year) for a number of countries exceed their projected exports of goods and services (see Table 5).

Under normal circumstances, when credit markets are functioning smoothly and borrowers retain the confidence of lenders in their economic performance, prospects, and political stability, the rollover or refinancing process also proceeds smoothly. However, as recent events illustrate, when a situation occurs that causes lenders to question the ability of a country (or group of countries) to service its external debt, the rollover process becomes far from automatic. Banks become reluctant to extend any new loans to a country until steps have been taken to reduce uncertainties about its economic and political prospects.

Faced with global disinflation, countries that have lagged in reducing inflation and external payments deficits have little choice today but to speed up the process of balance-of-payments adjustment. As the managing director of the IMF has stressed, developing countries are no exception. For many of them, progress in reducing inflation over the past year or two has lagged far behind that of the industrial countries. This is especially true in Latin America, where, with the principal exceptions of Chile and Venezuela, inflation rates remain high *vis-à-vis* other countries and in relation to past trends (see Table 6). Some countries — Brazil is a notable example — have been able to maintain international price competitiveness despite very high inflation by allowing their exchange rates to depreciate more or less in line with inflation differentials. But a common practice for developing countries, especially in Latin America, has been to use the exchange rate as an instrument for combating inflation, rather than as a tool for balance-of-payments adjustment (see charts, and the February issue of this publication). This practice has led to a loss of price competitiveness for some developing countries — especially for those with high inflation that have pegged their currencies to the dollar. The maintenance of an overvalued exchange

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Approved For Release 2006/02/06 : CIA-RDP84B00049R000300630006-9

Table 6

Consumer price inflation

annual averages, in percent

	1970-73	1974-75	1976-78	1979-80	1981-82
Latin America	20.3	35.7	48.0	51.3	72.7
Argentina	42.2	102.9	265.0	130.1	145.6
Brazil	17.9	28.2	41.5	67.7	95.6
Chile	120.9	440.0	114.6	34.2	17.2
Colombia	12.3	23.6	23.7	25.6	26.5
Ecuador	8.6	19.3	11.8	11.7	16.4
Mexico	6.8	19.4	20.7	22.3	60.7
Peru	7.1	20.2	43.1	63.0	68.8
Venezuela	3.2	9.2	7.5	17.0	10.0
Asia	8.4	19.3	2.9	8.6	9.0
Indonesia	13.6	29.7	13.0	22.0	8.2
Korea	11.1	24.8	13.3	27.9	10.8
Malaysia	4.3	11.0	4.1	6.1	6.9
Philippines	13.3	20.8	7.2	19.3	11.4
Taiwan	4.4	26.3	-4.9	17.3	7.0
Thailand	5.2	14.8	6.6	15.6	8.7
Industrial countries	5.8	12.2	8.0	10.6	8.2

rate has meant that balance-of-payments adjustment must come about mainly through a slowing of import volume, rather than through an expansion of export volume. The effect of unrealistic exchange rate policies is to require much of the burden of adjustment to come from a slowing of domestic economic growth.

Impact of a lending slowdown

Besides the effects of recession in the industrial countries and high real interest rates, the developing countries now face the prospect of a marked deceleration in the growth of bank lending to them. After the first oil shock the impact of the severe 1974-75 recession in the industrial countries on the developing countries was cushioned by large-scale bank financing. Bank lending continued to play a significant role after the second oil shock, with new bank loans covering more than 25% of the imports of the major borrowing countries. Notwithstanding the continued sizable growth of bank lending, developing-country economic growth was reduced last year because of the worsening world economic conditions, and this could become even more pronounced now as a result of a deceleration of bank lending.

The potential effect that a slowdown of bank lending would have on the economic growth of the non-OPEC LDCs is examined under two different scenarios. Both are based on a world-trade framework that links industrial countries and developing countries. The first scenario assumes that net new bank lending, instead of increasing by 20% as in 1981, will drop to a 10% rate, or roughly in line with the growth of bank capital. Assuming that all other factors remain unchanged, this implies that net capital inflows would be about $25 billion less than if a 20% rate expansion were maintained. It is estimated that in the first year the growth rate of the non-OPEC LDCs would be about 1½ percentage points lower than if a 20% rate of bank lending were maintained. The impact would be especially great on developing countries in Latin America, where economic growth on average could be as much as 3% below that attainable if the faster pace of lending were continued. This reflects the very heavy dependence of many Latin countries on bank loans to finance their imports (see Table 7). Economic growth of developing countries in Asia, though, would be curtailed by only about half a percentage point, because they depend much less on bank credit.

The second scenario depicts a more extreme situation in which there is no net new bank lending to the non-OPEC LDCs. This could arise from cutbacks by some smaller banks with offsetting increases by other banks. In that case net capital inflows would be about $5

Approved For Release 2006/02/06 : CIA-RDP84B00049R000300630006-9

Approved For Release 2006/02/06 : CIA-RDP84B00049R000300630006-9

Table 7

Increase in debt owed to foreign banks

% of merchandise imports for selected developing countries

	Average 1979-81	1981
Latin America		
Argentina	75	60
Mexico	61	59
Chile	47	48
Brazil	31	32
Ecuador	28	27
Colombia	27	17
Venezuela	37	15
Peru	9	9
Average of above	44	40
Asia		
Malaysia	8	16
Korea	19	14
Thailand	10	12
Philippines	24	11
Indonesia	4	6
Taiwan	4	6
Average of above	11	10

billion less and growth of real output of the non-OPEC LDCs about 3% less than in the case of a 20% increase in net new bank lending. Real output growth in Latin America alone could be roughly 5½% less. It should be stressed that the above estimates assume constant marginal propensities to import by the developing countries. In practice, it may be possible for some countries to sustain a sharp slowing in bank financing with a smaller impact on economic growth than indicated by these estimates, especially if imports can be reduced selectively through controls and a more realistic exchange rate policy.

The effects of a slowdown in bank lending on the merchandise trade balance of the non-OPEC LDCs would be sizable. Because of the interdependence among countries, a reduction in developing-country imports slows industrial-country growth, which in turn leads to a subsequent slowing of the exports of developing countries. If bank lending slows to a 10% rate, it is estimated that the slower growth would improve the non-OPEC LDC trade balance by about $23 billion, including a $15 billion gain for Latin America. If net new bank lending is completely curtailed, the trade balance improvements are even larger — almost $45 billion for the non-OPEC LDCs as a whole and $30 billion for Latin America alone. It should also be mentioned that the reductions in the non-OPEC LDC current account deficit would be somewhat greater than the estimated trade balance effects, because imports of nonfactor services would also be affected by slower growth of output and trade. Slower accumulation of bank debt would also imply less rapid growth of interest payments.

Diminished growth in the developing countries resulting from a slowdown in bank lending would have important growth and balance-of-payments implications for the industrial countries. Developing countries account for roughly one quarter of the merchandise exports of the industrial countries as a group, and as much as 45% and 38% of the exports of Japan and the United States, respectively (see Table 8). Mexico — the United States' third largest export market, ranking just behind Japan — accounted for nearly 8% of U.S. merchandise exports last year.

Estimates indicate that depending on whether net new bank lending to the developing countries slows to a 10% rate or to zero, OECD growth would be at least ½% to 1% less than if growth of bank lending to the non-OPEC LDCs were maintained at a 20% rate. The effect on U.S. economic growth is likely to be somewhat below the OECD average, because the percentage of exports to the developing countries in relation to GNP for the United States (3.1%) is below the average for the industrial countries (4.2%). This would have a further deflationary impact on the other industrial countries and, amid growing indications of weaker-than-expected U.S. economic activity in the second half of this year, could further delay recovery.

It is estimated that over three-quarters of the reduction of the non-OPEC LDC current account deficit would find its counterpart in a reduction of the overall industrial-country surplus. The current account impact would be particularly great on the United States, which is estimated to account for roughly half of the reduction in the industrial-country surplus. This exemplifies the importance of the developing countries to the United States as a market for exports, as well as the trade interdependence between the United States and other industrial countries.

Approved For Release 2006/02/06 : CIA-RDP84B00049R000300630006-9

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Table 8

*Exports to selected groups of countries**

% of total exports and GNP of exporting countries

Exports from	Exports to: Eastern Europe	Developing countries: All	Developing countries: Latin America
OECD			
Exports	3.8	26.2	6.1
GNP	0.6	4.2	1.0
United States			
Exports	2.1	38.0	16.6
GNP	0.2	3.1	1.3
Japan			
Exports	2.7	45.0	6.4
GNP	0.4	6.0	0.9
France			
Exports	4.4	26.8	3.1
GNP	0.8	4.7	0.5
Germany			
Exports	5.6	17.8	3.4
GNP	1.4	4.5	0.9
Italy			
Exports	4.8	29.2	4.2
GNP	1.0	6.3	0.9
United Kingdom			
Exports	2.7	24.4	2.4
GNP	0.6	5.8	0.5

*1981 data except for U.K., which are 1980 data.

Table 9

*Real interest rates**

percent per annum

	Short-term rates** End-1981	Short-term rates** Latest	Long-term rates** End-1981	Long-term rates** Latest
United States	3 5	5.0	4.9	7.3
Canada	2.8	3.3	2.9	3.0
Japan	1.8	3.1	3.7	4.2
Germany	4.0	3.3	3.2	3.8
Franle	1.1	3.2	2.1	4.4
Italy	2.4	1.3	—3.3	—0.9
United Kingdom	3.2	2.5	2.6	4.0

*Interest rates deflated by consumer price inflation over previous twelve months.

**Representative money market rates(short-term) and domestic government bond yeilds (long-term) shown in appendix.

Need for a balanced approach

Several points stand out from the preceding analysis and observations. First, some slowing of commercial bank lending to developing countries from past trends is necessary to bring it more in line with growth of bank capital and to reduce country-risk concentrations. Second, in a world environment of disinflation, developing countries cannot avoid taking steps to reduce inflation and to promote more prompt balance-of-payments adjustment. This applies to oil-exporting and to oil-importing countries alike. To preserve the smooth functioning of the international trade and financial system, however, it is crucial that there be a proper balance between financing and adjustment. This will require close cooperation of all the principal parties — the banks, the developing countries, the IMF, and the industrial countries. Indeed, the quick and decisive action involving all of the above parties in Mexico's foreign exchange crisis has been constructive in maintaining confidence in the international monetary system.

As regards the banks, it is recognized that a cessation of new lending to the developing countries would be counterproductive. The cuts in economic growth and living standards would be so large as to have a "sledgehammer" effect on the major borrowing countries and could jeopardize the ability of these countries to pay the interest on existing loans. It is obviously in the banks' own interest to maintain an environment in which the process of rolling over or refinancing existing obligations proceeds smoothly. Clearly, a moderate overall expansion of say 5% to 10% in net new bank lending to the developing countries would be preferable to an abrupt cessation. Even this would imply $25-$35 billion less bank financing available to these countries than if recent trend rates were maintained.

From the developing countries' perspective, such a slowdown must entail quicker balance-of-payments adjustment and inevitably a temporary cutback of their economic growth. Experiences of a number of countries, nonetheless, have shown that in cases where comprehensive adjustment programs have been adopted, significant balance-of-payments progress can be achieved within one-and-a-half to two years, leading to renewed growth and to wider access to bank financing. A recent example is Turkey, where over the past couple of years there has been a very rapid improvement of the country's balance-of-payments situation and a restoration of moderate economic growth.

The IMF is playing a key role in providing policy advice and temporary financial assistance to countries with serious balance-of-payments difficulties. Implementation of policies meeting IMF requirements remains essential to restoration of confidence. In this respect, it is vital that the Fund has sufficient resources to meet the growing demands on it. Although the IMF is still fairly liquid, with available resources of $25-$30 billion, new loan commitments under standby and extended arrangements over the past couple of years have averaged close to $14 billion per year. At such a rate of new commitments, a sizable infusion of new money appears necessary. A quota increase, say of 50% would raise the Fund's holdings of *usable* currencies by, at most, $20 billion, which would not become available until the entire ratification process involving most Fund members was completed several years hence. This makes the establishment of a sizable new borrowing arrangement for special emergencies highly desirable. Even

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though such an arrangement would require congressional approval, it could become effective well before a quota increase were approved. Moreover, the IMF could obtain temporary "bridge" financing either from official institutions, such as that used for the supplementary financing facility, or from the private markets.

The main contribution that the governments of the industrial countries can make would be to assure that their present policies will lead to a significant reduction of interest rates and eventually to a sustainable economic recovery. The policies now in place already have brought about a softening of world oil prices and an appreciable reduction in inflation in most industrial countries, which has led to some drop in interest rates. Still, real interest rates remain very high, and have even risen at the long end of the market despite high unemployment and bleak prospects for an economic turnaround (see Table 9). Nevertheless, it would be a mistake to abandon the present course of policies, particularly the recent trend toward greater fiscal restraint to narrowing prospective budget deficits, and to replace it with policies that have failed in the past. However, unless the current mix of policies leads to a sizable reduction of nominal and real interest rates, a deeper and more prolonged economic slump, with adverse worldwide implications, could ensue. Now that the Federal Reserve has achieved considerable success in reducing inflation, and thereby in reestablishing its credibility, the flexibility that it has shown in tolerating temporary deviations of the money supply from its announced targets is a welcome development.

In sum, in the present difficult world environment confidence in the international financial system can best be assured if the burdens of adjustment and financing are distributed among the principal parties — the banks, the developing countries, the Fund, and the industrial countries.

Statistical appendix

for key to data in tables see pages 18 and 19.

Effective exchange rates, 10

Real effective exchange rates, 10

Eurocurrency market size, 11

Eurocurrency deposit rates, 11

Eurocurrency bank credits, 12

International bond yields, 12

New international bond issues, 13

Central bank discount rates, 14

Day-to-day money rates, 14

Treasury bill rates, 15

Representative money-market rates, 15

Commercial bank deposit rates, 16

Commercial bank lending rates to prime borrowers, 16

Domestic government bond yields, 17

Domestic corporate bond yields, 17

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Approved For Release 2006/02/06 : CIA-RDP84B00049R000300630006-9

Approved For Release 2006/02/06 : CIA-RDP84B00049R000300630006-9

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