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Risks to the International Financial System

1. Mexico's financial crisis creates major new risks for international financial stability.

- LDC long-term foreign debt increased about five-fold from 1973 to 1981, surpassing $500 billion. There has also been a massive growth of short-term debt, especially since 1971.
- The LDC debt service problem was manageable so long as exports were increasing rapidly and interest rates were low. But beginning last year LDC exports have fallen while interest costs have surged, reaching 50 percent of exports for some major countries.
- Until the Mexican crisis, LDCs encountering debt servicing problems (payments arrears or debt rescheduling) were all small, although the number had been increasing from year to year. In 1981 28 LDCs were in arrears, but their aggregate bank debt was less than 2 percent of the total.
- The Mexican crisis, together with the likely rescheduling of Argentine debt, increases the volume of debt subject to some form of relief to nearly a quarter of total LDC debt.
- Although no other major LDC seems on the verge of losing access to new credit, several of them, notably Brazil, Chile, Peru, Venezuela, and the Philippines, will have a difficult time balancing off external creditor pressures on the one hand with domestic political pressures for improved economic conditions on the other.

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2. Because of the LDC financial problems and increasing bankruptcies in the industrial world, the international financial system is now more prone to a major crisis than at any time in the past thirty years.

- Nervous bankers are apt to react quickly to disquieting political or economic shocks--shocks could come from anywhere, although they would probably have to be large to trigger a major crisis--for example, a total moratorium on debt servicing by Argentina or Mexico.
- The most directly affected banks could rapidly be pushed to the wall by withdrawal of other banks' deposits; one bank's failure or threatened failure would in turn affect other banks.
- There is little doubt that the central banks of at least the major countries would intervene to keep at least major commercial banks afloat.
- However, the international safety net does not cover all banks, and there may be enough legal and other complications to cause delays. In the meantime, damage could be done.

3. Although a banking crisis is unlikely to lead to a major financial crash, it could further undermine confidence in international lending.

- Many LDCs would then be unable to finance current account deficits, and might even have to run surpluses.
- This means they would have to curtail imports even more drastically than some have already.

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- In turn, lower LDC imports would slow economic recovery in the industrial countries and could lead to political trouble in some LDCs.

4. This pattern is already occuring in the Soviet bloc countries.

- These countries are cutting their hard currency imports, in some cases sharply.
- Some, like the USSR, are doing it voluntarily. Others, like Hungary, are forced to do it because of a withdrawal of Western funds.

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