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PRESIDENT'S ECONOMIC POLICY
ADVISORY BOARD MEETING

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President's Economic Policy Advisory Board

Personally share Walter's confidence in the resiliency of international financial system. But I will present somewhat less sanguine scenarios. That's what we're paid to consider. In the interest of being prepared and avoiding surprise, the intelligence community has been tasked to do an assessment of the international financial system in support of an interagency study led by Don Regan.

Last week we completed estimates on Poland's prospects for the next 12 to 18 months and on implications of Mexico's financial crisis. Suffice it to say that we project no progress either financially or politically in Poland--no payments, no new financing, continued stagnation from inability to get Western inputs.

In Mexico we did something interesting in projecting the most likely scenario for the next year as follows: (1) by the end of October Lopez Portillo will allow an austerity plan--perhaps to be implemented in phases--that meets the criteria of the IMF and the international banking community; (2) de la Madrid will give low-key support to the plan before taking office in December; (3) the leadership of organized labor will, after much groaning and some minor concessions, come around to supporting the plan by late this year; (4) some demonstrations by labor rank and file will take place, will be forcefully repressed, and will die out; (5) the opposition will gain little from the crisis; (6) foreign governments and the international banking community will, over time, give Mexico the minimum support that it needs; (7) economic growth will be negative and unemployment will skyrocket; (8) a substantial upsurge in illegal migration

will take place; (9) oil production and exports will rise somewhat; and (10) while the standard of living of the average Mexican will decline and his cynicism will increase, the Mexican political-economic system will remain intact.

A worst case scenario would have both Lopez Portillo and de la Madrid continue to shun responsibility for austerity measures, a spiral of negative developments continue as unpopular economic measures provoke domestic unrest leading to even more negative foreign reactions. Within Mexico, the leadership vacuum would soon be recognized and the authority of lesser leaders undermined. Vital imports would fall, businesses would go bankrupt, and unemployment would rise to unprecedented levels. These developments would upset the patron-client relationships that comprise the Mexican system, and class-oriented groups might coalesce. Strikes, riots, and crime in the cities would be matched by armed rebellion in the countryside. This could precipitate a revolt by the right or the left.

We then stuck our necks out further by laying out a set of some 30 possible future events and reactions as criteria which could indicate a worst case trend and a rising risk to economic recovery and political stability in Mexico. These criteria relate to six areas: (1) the prestige and leadership of the President; (2) the attitude of labor; (3) the behavior of the military; (4) the cohesion of the ruling party; (5) the militance of the opposition; (6) economic factors like the level of wage increases and inflation, a further weakening of the peso by more than 20%, trouble with IMF agreements, extensive defaults, mass reaction to food scarcities and unemployment. Significant action in two or three of these six general areas or in a few of the economic indicators could set alarm bells ringing about Mexican stability.

In much the same way, it would take combination developments in a few countries--Argentina, Peru, Eastern Europe, Brazil, Philippines, Chile, France--all carrying heavy external debt and experiencing some degree of falling internal confidence--to set bells ringing on the international financial system. We've looked at scenarios on the potential and nature of global financial panic. We view the prospects of panic as higher than usual but still low because of the system's flexibility and the growing common interest of both lenders and borrowers in a smooth functioning system and the track record of bankers and official financial leaders in working together effectively during emergencies.

Still, if you're looking for the signs of serious trouble you worry about some combination of three types of general development: (1) severe economic trouble resulting in severe capital outflows and foreign exchange restrictions with inability to repay debts to foreign banks (try this one on Mitterrand's France); (2) a breach in the prevailing code of financial conduct like a populist seizure of power and repudiation of foreign debt (read Argentina); or (3) the influence of the inability of a major debtor country to hold the confidence of banks which freeze payments and precipitate some major bankruptcies (read Mexico or Brazil). Some combination of shocks like these could trigger a mass flow of funds, probably to the US, old loans being called, new ones being denied and the interbank market shrinking drastically.

This is far out speculation. I don't believe we'll let it happen, but that's the kind of disaster we're paid to look out for on the basis that thinking about the unthinkable prepares us to avoid it.

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Risks to the International Financial System

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

- o 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.
- o 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.
- o There is little doubt that the central banks of at least the major countries would intervene to keep at least major commercial banks afloat.
- o 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.

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

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- o 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 occurring in the Soviet bloc countries.
 - o These countries are cutting their hard currency imports, in some cases sharply.
 - o 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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