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Directorate of
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Argentina: Economy in Trouble [redacted]

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An Intelligence Assessment

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ALA 82-10123
September 1982

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Directorate of Intelligence

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Argentina: Economy in Trouble [redacted]

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An Intelligence Assessment

This assessment was prepared by [redacted] 25X1
25X1 [redacted] Office of African and Latin American Analysis. Comments and queries are welcome and may be directed to the Chief, South America Division, ALA. [redacted] 25X1

This paper has been coordinated with the Directorate of Operations and the National Intelligence Council. [redacted] 25X1

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Argentina: Economy in Trouble

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Key Judgments

Information available as of 17 August 1982 was used in this report.

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The failure of successive military governments to implement consistent stabilization policies has weakened the Argentine economy, thereby heightening its vulnerability to unanticipated shocks. The reform program of former Economy Minister Alemann during the Galtieri regime proved too short lived to restore economic order.

War-induced disruptions, as evidenced by government statistics, have deepened Argentina's recession and pushed inflation higher, setting the stage for a variety of new problems. Economy Minister Dagnino's series of quick fixes in early July was aimed mainly at strengthening the government's domestic political position, but it has adverse implications for the economy. We project that:

- Any economic upturn resulting from the stimulative steps taken earlier this summer will probably prove short lived, and inflation will accelerate to the 200-percent level by the end of the year.
- Payments problems will persist, and some restructuring of Argentina's $35 billion debt will be needed soon to avoid a foreign exchange crisis.
- Increased state intervention will exacerbate Argentina's deepset economic problems and cause increased inefficiency in the longer run.

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We believe these economic pressures will make the planned transition to civilian rule increasingly difficult for President Bignone, who has lifted the ban on political activity and promised elections for 1984. In the current political climate, accumulating economic frictions will likely spark renewed political protests. The recently proposed wage increases, announced in late August, suggest that the Bignone regime will resort to more populist economic policies to assuage public discontent. Under these circumstances, abrupt policy shifts and cabinet changes are likely to occur. Moreover, military hardliners will exert growing pressure on Bignone to renege on initial political promises and adopt repressive measures to avoid widespread violence.

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Policy miscalculations—increasingly likely in this turbulent atmosphere—could cause Argentina's near-term economic performance to be worse than we anticipated in our baseline scenario. We believe disruptions of exports, a surge in imports, renewed capital flight, and a failure to restructure

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maturing debt would probably set the stage for a foreign exchange crisis late this year. A formal debt rescheduling would likely follow, possibly concurrent with a Mexican debt rescheduling. Moreover, failure to restore fiscal discipline and a heavy dose of populist policies would exacerbate inflationary trends.

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We believe Argentina's current difficulties contain the seeds of serious problems for its international economic relations. Argentine economic setbacks have already spilled over to affect its Latin neighbors. Bilateral trade and financial ties with Brazil, Bolivia, Paraguay, and Uruguay have been particularly disrupted in the wake of the Falklands crisis.

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Outside South America, the ramifications of Argentine chaos could also be serious. US commercial interests would be adversely affected by continued Argentine exchange restrictions, the resort to more nationalistic policies, or debt rescheduling. Major banks that have lent heavily to Argentina could suffer serious profit declines, but we believe the international banking system could manage with little damage if the problems of debt servicing are addressed promptly. Even so, Argentina's external financial difficulties could affect other LDCs borrowers' ability to arrange new credits. In turn, its ability to resolve its own financial difficulties may be more difficult because of the Mexican financial crisis.

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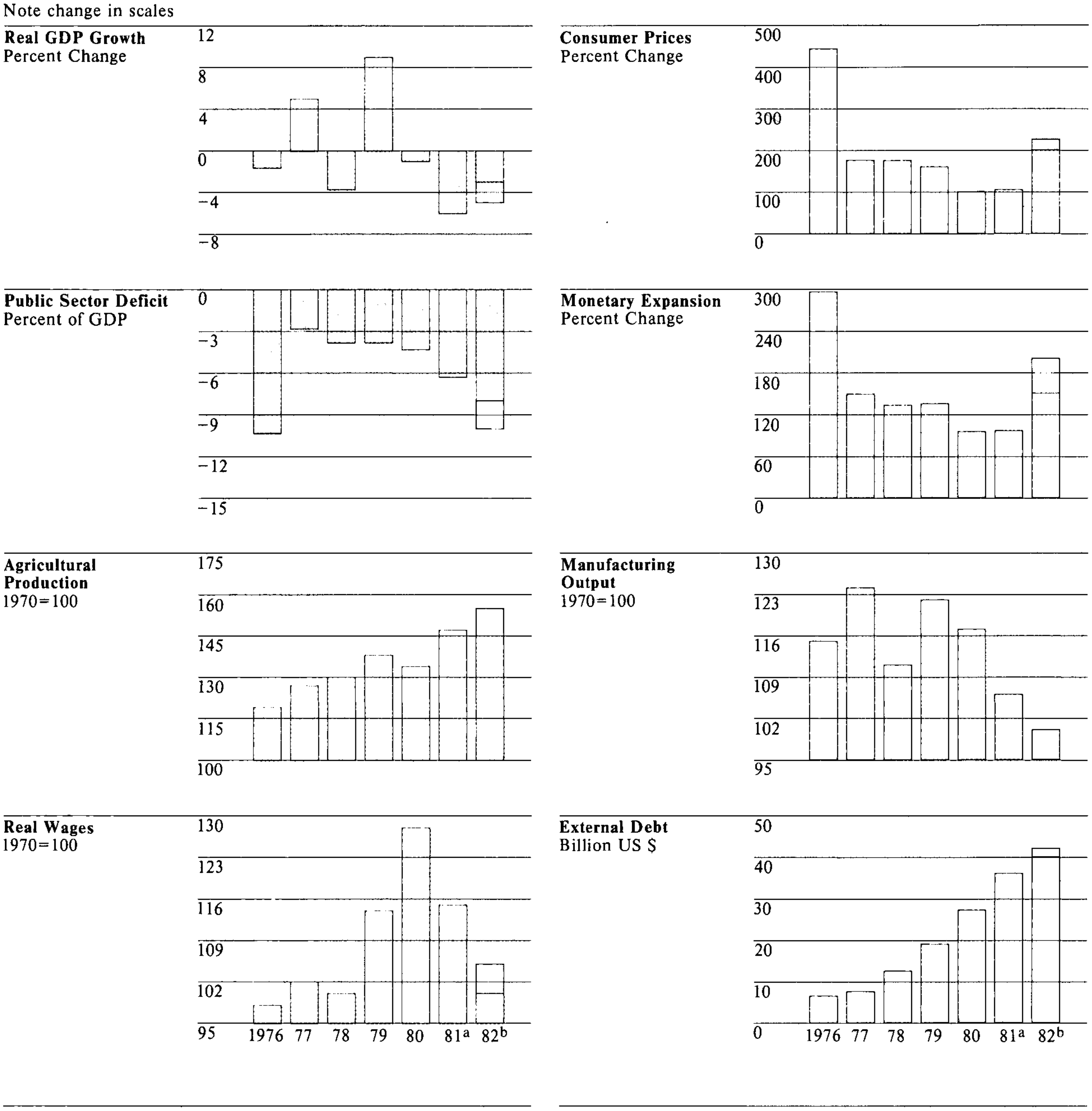
Figure 1
Argentina: Economic Indicators



[a] Estimated.
[b] Projected.

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Argentina: Economy in Trouble [redacted]

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A Legacy of Economic Chaos

After seizing power in 1976, the Argentine military moved to undo the economic chaos wrought by the Perons. Juan and Isabella Peron's populist policies in the early 1970s—large wage hikes, massive social spending—caused Argentina to face an economic crisis by mid-decade. By early 1976, economic activity was grinding to a halt, while inflation raged at an 800 percent annual rate during the first quarter. Payments problems intensified, foreign reserves were being rapidly depleted, and default on the foreign debt seemed imminent (figure 1). [redacted]

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The succession of military governments after 1976 pursued various reform programs to revitalize the economy. Between 1976 and 1982, three stabilization programs were enacted, each emphasizing different goals.

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- Economy Minister Martinez de Hoz, who served from 1976 through early 1981, implemented economic austerity and reforms during his first two years in office to wring out hyperinflation, restore external solvency, and lay the foundation for long-term growth.
- In 1979-80, de Hoz shifted priority to reducing inflation below the 100-percent mark, mainly by slowing the rate of devaluation and encouraging foreign competition.
- Treasury Minister Lorenzo Sigaut by mid-1981 returned to greater government intervention in the economy by resorting to government-financed bail-out programs and instituting multiple exchange rates and import controls. [redacted]

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Initially, Martinez de Hoz's thoroughgoing reforms proved successful in sparking economic recovery, controlling hyperinflation, and eliminating the enormous current account deficits of the mid-1970s. The abrupt shifts in policy since 1978, however, have proved counterproductive (table 1). [redacted]

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In the light of longer term trends, we believe that inconsistency in Argentine policies has weakened the economy and heightened its susceptibility to internal and external shocks. Production has characteristically been stop-and-go. Investment plans have been disrupted by the uncertainty resulting from frequent policy shifts. Erratic government efforts to soften the impact of ever-changing policies have boosted the money supply at inappropriate times, thereby leading to persistent triple-digit inflation. [redacted]

Although there have been some successes in boosting international earnings, tied largely to favorable crop conditions, the growing overvaluation of the Argentine peso has caused the current account to swing back into deficit. Moreover, the failure to maintain a realistic exchange rate has spurred heavy foreign borrowing and contributed to sharp declines in foreign exchange reserves because of sporadic speculation. [redacted]

Galtieri's Team Brings More Reforms

In late 1981, recurrent economic chaos and the lack of clearcut political and foreign policies convinced Chief of the Army General Galtieri that it was necessary to move against incumbent President Viola. After a few months of political maneuvering, the military junta installed Galtieri as President on 22 December. Lacking a well-defined economic philosophy, Galtieri quickly indicated that he would depend heavily on an economic team headed by Roberto Alemann, a proponent of the free market and advocate of the sale of unprofitable state-run enterprises. [redacted]

Alemann moved quickly to introduce a series of stringent austerity policies to bring order back to the economy:

- Exchange rate policies were revamped to include a free float for the Argentine peso and a unification of the financial and commercial exchange rates in order to eliminate peso overvaluation and avoid severe speculative outflows.

Table 1
Argentina: Changing Leadership 1976-1982

Date	President	Minister of Economy
Jan-Mar 1976	Maria Estela Martinez de Peron	Antonio Francisco Cafiero Emilio Mondelli
Apr 1976–Mar 1981	Lt. Gen. Jorge Rafael Videla	Jose Alfredo Martinez de Hoz
Apr 1981–Nov 1981	Lt. Gen. Roberto Eduardo Viola	Lorenzo Juan Sigaut [a]
21 Nov 1981–11 Dec 1981	General Tomas Liendo	
12 Dec 1981–22 Dec 1981	Vice Adm. Carlos Alberto Lacoste	
22 Dec 1981–17 Jun 1982	Lt. Gen. Leopoldo Fortunato Galtieri	Roberto Alemann
17 Jun 1982–30 Jun 1982	Alfredo Saint Jean	Roberto Alemann
1 Jul 1982	General Reynaldo Bignone	Jose Dagnino Pastore Jorge Wehbe

[a] Minister of Treasury and Finance.

[redacted] 25X1

- To lessen inflation, fiscal discipline was imposed by freezing public-sector salaries, increasing taxes, raising prices of public services, and reducing the government deficit.

- Interest rates were decontrolled to attract capital back into the country and further weed out inefficient operations. [redacted] 25X1

The tough austerity measures contributed to a 6-percent decline in real growth during the first quarter of 1982. The severe industrial recession resulted in increased unemployment and mounting bad debt. On the positive side, however, the economic contraction caused inflation to slow and resulted in balance-of-payments improvements. After jumping 14 percent in January, Argentine wholesale prices rose only 4.5 percent in March. Despite growing interest payments on the foreign debt, Buenos Aires nearly eliminated the current account deficit in the first quarter of 1982 because an export advance of nearly 10-percent and a 46-percent recession-induced plunge in imports. [redacted]

Prior to the Falklands invasion, the Alemann reforms had restored some stability to Argentine foreign exchange markets. The floating exchange rate helped to avert repetitions of 1981's monumental capital flights. Although foreign bankers remained cautious, Argentine borrowers were able to obtain foreign financing. Most bankers made routine disbursements on existing lines of credit, extended new short-term loans, and rolled over maturing debts. By early April, several new Argentine medium-term credits were in the process of being placed in the Euromarkets. [redacted] 25X1

Falkland Conflict Intensifies Economic Woes

War disruptions, commencing in April, triggered new difficulties on all fronts for the ailing economy. According to government statistics, real growth declined another 8 percent in the second quarter in the face of a battery of mounting problems:

- Consumer demand, already squeezed by real wage erosion, fell with the imposition of new taxes, sharp increases in the price of some staple products, and declining confidence.
- New investment fell in the wake of cutbacks in government-funded projects, the sharp rise in domestic interest rates, and business uncertainty.
- Industrial production slowed because of the imposition of import controls and the loss of loanable funds caused by withdrawals and capital flight.

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Argentina: Economic Ups and Downs in 1981

Abrupt shifts in policy undermined the government's efforts to stabilize the economy last year. Efforts to fight inflation by maintaining an overvalued exchange rate deepened the recession begun in 1980 and caused payments problems. The fall in exports, rising imports, and growing capital flight resulted in a $2.0 billion current account deficit in the first quarter of 1981 as well as a $3.0 billion loss of foreign exchange reserves.

In April, the Viola government shifted gears. It devalued the peso to encourage exports, restrain imports, and stem capital flight. The large devaluation and a large grain harvest resulted in a 65-percent reduction in the current account deficit in the second quarter and stemmed its loss of international reserves. Economic growth, however, responded sluggishly because increased inflation resulting from the devaluation contributed to a slide in real wages.

Internal disagreements over the steps necessary to revitalize the economy prevented the implementation of an effective stabilization program during the second half of 1981. Business confidence was undermined by public ministerial disagreements on the steps necessary to spur industrial recovery. In response to sporadic currency speculation, the government resorted to several uncoordinated devaluations and exchange controls. Multiple exchange rates were implemented last summer. Interim President Liendo imposed interest rate ceilings in December.

The consequences of these policy shifts were severe:
- *Real GDP contracted 6 percent compared with a drop of 1 percent in 1980.*
- *Inflation climbed to 120 percent from 88 percent in 1980, fueled by rising budget deficits and large devaluations.*
- *International reserves plummeted by $3.8 billion because of capital flight early in the year.*
- *Spreads on international loans to Argentina rose from 0.75 percentage points to 1.25 percentage points over the London Interbank Offered Rate (LIBOR) as foreign lenders became increasingly edgy.*

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[redacted]

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- Inflation began to accelerate by June because increased military payroll and supply spending undermined fiscal discipline, resulting in a rapid expansion of the money supply. [redacted]

Renewed payments pressures quickly materialized. In the early days of the conflict, importers rushed to build stockpiles, and capital flight became substantial. To contain the immediate disruptions, Buenos Aires implemented trade restrictions, thereby undermining earlier foreign exchange reforms. The prolongation of the conflict set back Argentine exports because of the temporary cessation of Soviet grain purchases and disruptions in normal export marketing patterns. Military purchases also increased. Taken together, these events caused a major loss in liquid foreign exchange reserves. [redacted]

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As a result, debt service became more difficult to manage. Buenos Aires' restrictions on debt repayments limited access to new loans and caused difficulty in arranging necessary rollovers. Argentina's external financial position came under growing strain:
- A reluctance by some banks to roll over maturing loans and the falloff in exports intensified immediate cash flow problems.
- A shorter term structure of the debt resulted because maturing longer term credits were replaced with short-term instruments.
- The costs of servicing the foreign debt escalated because of higher interest rate spreads and heavy use of expensive short-term credits.
- The country's international creditworthiness was seriously tarnished by delays in meeting interest and principal payments. [redacted]

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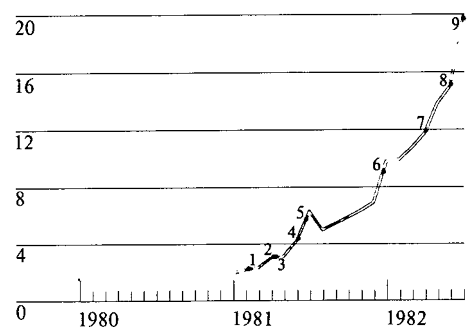
Figure 2
Argentina: Peso/Dollar Exchange Rates and Dollar Reserves

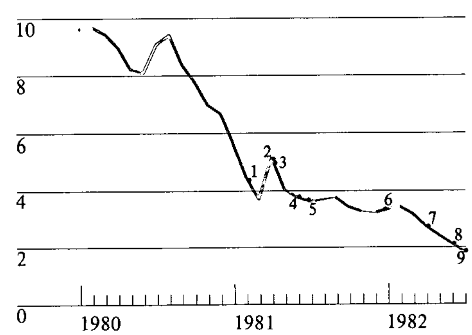
Key

1–10% devaluation, 3 February.
2–Viola assumes presidency, 30 March.
3–30% devaluation, 1 April.
4–30% devaluation, 1 June.
5–Peso set free to float–immediate 33% depreciation, 22 June.
6–Galtieri assumes presidency, 22 December.
7–Falklands invasion.
8–May devaluation.
9–Dagnino devalues commercial peso and implements multiple exchange rates.

Exchange Rate
Thousand Pesos per Dollar



Foreign Reserves, Excluding Gold[a]
Billion US $



[a] Data for May-Jul 1982 are estimated.
[b] Data for Jul 1982 includes $1.4 billion in reserves frozen in U.K.

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Policy Changes Now Under Way

Argentina's sinking economy made policy adjustments inevitable after the Falklands fiasco and the demise of the Galtieri regime at the end of June. New President Bignone and Economy Minister Dagnino found negligible political support for a return to the tough stabilization measures of the immediate prewar period. In fact, Dagnino radically reoriented Alemann's economic strategy, and greater state intervention will now replace the free-market policies. The export promotion policies and import controls of President Bignone's government also spell a shift toward mercantilism, a single-minded trade-surplus goal in international financial dealings. 25X1

On 5 July, Dagnino announced policies that aim at reactivating the economy. To spur growth, he devalued the commercial peso as a boost to exports, granted wage hikes to the public sector, and increased pensions. In the regulated credit markets, Dagnino announced lower interest rates. Savers will receive a maximum of 5 percent per month on deposits. At the same time, the government will also bail out Argentina's heavily indebted businesses. The central bank began offering eligible borrowers a fixed rate of 6 percent a month—well below prevailing inflation—on all new loans as well as to refinance existing peso debt. 25X1

Despite these stimulative policies, Buenos Aires still maintains that it will control inflation. At this juncture, the government is working to design agreements with the private sector to hold down price increases. Borrowers who agree to pass through only higher material and labor costs increases for the next four to six months will be treated to preferential credit on existing peso loans. Beyond this, President Bignone has ordered 10-percent cutbacks in the budget allocations for state corporations and has raised export taxes. Moreover, the government believes that the reduction in interest rates will reduce the need of state corporations for funds—contrary to normal economic laws— and the pressure to expand the money supply.

Major financial reforms have been initiated to insure more efficient banking. Dagnino has created a parallel credit market that he claims will supersede the

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regulated system by 1984. In this market, interest rates will be freely negotiated, and deposits will not be subject to reserve requirements. For the moment, state banks have been cautioned to limit their participation in this market to 3 percent of their portfolios.

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To improve the country's sagging payments position, the government will control foreign exchange transactions. Dagnino announced in early July that exchange controls will remain in place to curb foreign competition and stop capital flight. He also returned to a multiple exchange-rate system to promote exports, restrain imports of goods and services, and prevent renewed flight of capital. An initial 27-percent devaluation brought the commercial exchange rate to 20,000 pesos to the dollar. Henceforth, the commercial rate will be set daily by the Central Bank while changes in the financial rate will reflect a controlled float. Because of the large premium in favor of the financial rate, Argentine traders quickly became disenchanted with the two-tier system. To smooth these discontents, Dagnino has subsequently announced the creation of a series of preferential exchange rates mainly aimed at bolstering export incentives. Taken together, Buenos Aires must now administer some 15 different exchange rates for meeting international payments.

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Dagnino has reiterated Argentine intentions to meet external debt servicing obligations, but he failed to spell out specific policies. Argentina owes an estimated $15 billion in debt service in the second half of 1982. The government's initial moves—inviting a technical mission from the International Monetary Fund and ending prior approval requirements for private debt repayments—were apparently designed to cultivate the goodwill of foreign bankers. Buenos Aires has also initiated efforts at debt restructuring by offering Argentine borrowers exchange rate guarantees if they extend the terms of foreign currency loans. Argentina might seek to refinance maturing credits by arranging a series of medium-term jumbo loans.

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Additional policy changes are likely. In late August, Economy Minister Dagnino and Central Bank President Cavallo resigned to protest Bignone's proposed wage increases and the refusal of the country's three armed service commanders to lift financial sanctions against the United Kingdom. President Bignone named Jorge Wehbe, an attorney who lacks a well-defined economic philosophy, as Dagnino's replacement. At this juncture, we can only speculate that the resignations probably foreshadow a shift toward more populist and nationalistic economic policies.

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Near-Term Outlook

The recent ministerial shifts will have little immediate impact. Although Dagnino has lost power, he has set in motion the forces which will influence Argentina's economic performance over the near term. Any new moves by Wehbe will take time to formulate, implement, and take effect.

Domestic Economy. Because there is substantial idle capacity, we believe that Dagnino's new economic moves will spark a brief economic upturn. The recent wage hikes are stimulating consumer demand, while savings rates set below inflation are already encouraging speculative purchases. Argentine industrialists will also benefit from export promotion policies, lower interest rates on new loans, and curbs on foreign competition. Even with a strong rebound in the second half of the year, however, real growth is likely to show another contraction for the year as a whole.

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Past Argentine experience—as well as sound economics—indicates that the collapse of fiscal discipline will cause inflation to accelerate. According to the Argentine statistics, consumer prices jumped 16.3 percent in July, the largest monthly increase since early 1976. Compared with the year before, consumer prices were 137.2 percent higher. Even if Buenos Aires can successfully implement price controls, we believe that consumer price increases are likely to approach a 200 percent annual rate by the end of the year. In the worst case, however, the failure to implement effective pricing agreements and control the rapid expansion of the money supply could cause Argentina's price increases to head toward rates substantially higher than that.

Payments Accounts. Argentina's payments problems abated temporarily because of the cessation of the war. The large devaluation in early July and the

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Table 2
Argentina: Current Account Trends

Million US $

	1981	1982 [a]
Trade balance	−70	3,000
Exports	9,130	10,000
Imports	9,200	7,000
Net services and transfers	−3,835	−5,700
Net interest	−2,600	−4,500
Current account balance	−3,905	−2,700

[a] Estimated.

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resumption of Soviet grain purchases caused an immediate rebound in exports, while exchange restrictions tended to check import growth.

Despite these temporary improvements, payments strains will grow. According to press reports, Argentine farmers are now withholding grain for export because of their dissatisfaction over the commercial exchange rate and higher export taxes. As the recovery gathers momentum, imports will also increase because of the need to secure foreign producers' goods and raw materials. Lacking reliable inventory data, however, we cannot now anticipate the pace or strength of the rebound in imports.

We can stipulate that the usual seasonal decline in exports toward the end of the year, in combination with large debt repayments, will add to foreign exchange stringencies. Even with exchange controls in place, we believe the current account is now headed toward a $2.7 billion deficit in 1982, compared to the $1.0 billion earlier estimated. In addition, Buenos Aires must guard against any resurgence in capital flight which could quickly exhaust foreign exchange reserves.

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Debt Situation. The debt-servicing burden is becoming unmanageable. The Central Bank reports that Argentine borrowers must repay some $2.3 billion in debt-servicing arrears, roll over about $10 billion in maturing loans, and meet $2.5 billion in interest payments in the second half of 1982. Without new credits and rollovers, Argentina will be hard pressed to avoid a foreign financing crisis. Its available international reserves, the US Embassy believes, are now less than $500 million, while some $1.5 billion remain blocked in London by British sanctions. To supplement these funds, gold holdings in Switzerland could be sold for an estimated $1.6 billion. Argentina also has relatively free access to its International Monetary Fund quota, although the government has publicly stated that it will seek no assistance from the IMF (table 3). 25X1

We believe that Argentina still seeks to restructure its external debt during 1982. According to the Argentine financial press, Buenos Aires will try to enter the Euromarkets for three jumbo loans this year to refinance maturing obligations. Two officials of the Central Bank visited major world financial centers in early August to discuss the feasibility of such debt restructuring. 25X1 25X1 25X1

The US Embassy now fears that the resolution of the Argentine-UK sanctions dispute—key to any effort to begin debt restructuring—has been set back for months with the resignation of the financial team. 25X1 25X1

Unless Buenos Aires moves quickly to put its external finances in order by refinancing, we expect that Argentina will be forced formally to reschedule its external debt. The recent resignations, shifts in economic policy, large debt-servicing obligations, and dwindling reserves have caused creditor confidence to fall precipitously. Moreover, the IMF technical team that recently left Argentina added to banker nervousness by voicing public concern about the country's 25X1

Table 3
Argentina: External Debt and Servicing Burden, July–December 1982

Million US $

	Total	Public Sector	Private Borrowers
External debt [a]	36,579	21,297	15,282
Debt servicing [a]	15,070	8,932	6,138
Of which:			
Maturing loans	10,230	6,863	3,367
Interest payments	2,530	1,392	1,138
Commercial arrears	2,310	677	1,633
Debt servicing by month [b]	12,760	8,255	4,505
July	2,429	1,542	887
August	2,471	2,199	272
September	1,518	1,104	414
October	1,416	1,130	286
November	1,399	1,134	265
December	3,527	1,146	2,381

[a] As of June 1982.
[b] Excluding commercial arrears.

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[redacted]

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ability to repay its foreign debt. [redacted]

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A formal debt rescheduling would entail difficult policy concessions to lenders and heightened domestic, social, and political pressures. These negotiations will also be more difficult because of the spillover of Mexico's financial crisis. [redacted]

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The Risks

Dagnino's new economic moves were initially popular, but have laid the foundations for longer term problems. Any economic recovery probably will be, as we note, short lived. Accelerating inflation will quickly erode consumer purchasing power. Rationing of necessary imports will probably cause some spot shortages of raw materials and spare parts. The business uncertainty that has resulted from the incredibly complex series of new policies and the use of price controls will undermine private investment incentives. Moreover, credit availability will tighten in the face of a new loss in bank deposits triggered by the interest rate reductions. Failure to eliminate the large differential in favor of the financial peso will encourage exporters to continue to withhold corn and sorghum shipments. [redacted]

We believe that Argentina's deepset economic problems—domestic mismanagement, large public deficits, price distortions—will be exacerbated by the new policies. Financial bailouts, for example, will provide immediate relief to the business sector, but over the longer term will lock in industrial inefficiencies and prevent consolidation of the fragmented banking sector. Even if Buenos Aires restores fiscal discipline soon, government financial assistance to industry will

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enlarge the public deficit, thereby precluding a slowdown in the money supply necessary to prevent inflation from reaching the record levels of the mid-1970s. Negative real interest rates will lead to a loss of bank deposits and undermine future capital formation. [redacted]

Based on past experience, we believe that increased government intervention will trigger growing distortions and increased economic inefficiency. Heavy-handed use of price controls is likely to undermine the investment incentives necessary to develop Argentina's rich resource base. Government-mandated wage hikes in excess of productivity gains will increase unit costs for domestic manufactures and erode the competitiveness of Argentine exports. Financial bailouts will prevent the wringing out necessary to revitalize the industrial sector. [redacted] 25X1

By resorting to populist policies the Bignone government will also become vulnerable to demands for additional economic concessions. Erosion of real wages in the face of accelerating inflation has already generated labor demands for new wage hikes and sparked some strikes. Political parties are pressing for increased public assistance to blunt losses in income. The Radical Civic Union, for example, has publicly called for subsidies for the unemployed. Businessmen are lobbying for more state intervention and nationalistic economic policies. [redacted] 25X1

Economic pressures will make the transition to civilian rule increasingly difficult. Bignone, leading a nation disillusioned and divided over the loss of the Falklands, has promised to schedule elections for 1984 and has lifted the ban on political activity. In this liberalizing political climate, accumulating economic frictions—growing unemployment, strikes, and raging inflation—will spark renewed demonstrations. According to the Argentine press, a group of housewives recently demonstrated at the Presidential Palace to protest the high cost of living. To assuage discontent, the Bignone regime will probably resort to more populist economic policies, but any political gains are likely to be short lived. [redacted]

In this turbulent climate, we doubt the Bignone government will be able to formulate and to implement coherent economic policies. The lack of strong presidential leadership, strife within the military, and the clash of vested interests augur a period of weak government. Abrupt and frequent shifts in ministers and policies are likely. In the worst case, excessive policy zigzags could lay the foundation for economic crisis by paralyzing industrial activity, spurring inflation, and causing the collapse of foreign investor confidence. [redacted] 25X1

If the economy slips out of control, Argentines are likely to turn to large-scale political protests. Military hardliners, fearing widespread violence, will pressure Bignone to renege on initial promises and adopt repressive measures. [redacted] 25X1

Ramifications in Latin America

Argentina's economic difficulties are already causing problems for its neighbors; bilateral trade and financial ties have been particularly disrupted in the wake of the Falklands crisis.

- Brazilian Government statistics indicate that its exports to Argentina, its major Latin American market, had fallen by $120 million through May. 25X1 [redacted]
- The US Embassy in Montevideo reports that Uruguay's sagging economy has been buffeted by the loss of Argentine tourist revenues and the inflow of Argentine capital. [redacted] 25X1

Beyond this, Argentina's external financial difficulties are indirectly affecting other Latin borrowers. Even before the Falklands conflict, Western bankers were becoming increasingly wary of Latin American borrowers. The Bank for International Settlements reports that about half of new lending to Latin America in the second half of 1981 consisted of short-term credits. The war heightened bankers' anxieties and has led to a closer examination of each country's credit operations. Banks are continuing to curtail new longer term syndicated loans and demanding higher risk premiums for the region. Brazil, Mexico, Venezuela, and Chile are vulnerable to any tightening of Western credit. [redacted]

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Implications for the United States

The United States has a large commercial stake in the Argentine economy. We estimate that:

- US banks and corporations hold $13 billion of Argentina's external debt.
- US multinational corporations have $2 billion in direct investment in plant and equipment.
- US businesses exported $2.2 billion in 1981 against some $700 million in import purchases.

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Debt servicing will pose the major near-term risks. With limited reserves, Argentina remains vulnerable to serious payments difficulties because of export shortfalls, import surges, or renewed capital flight. The failure to implement necessary stabilization policies is increasing tension between Argentina and its external creditors, making debt relief more difficult to obtain. The ultimate resolution of these financial difficulties is now unclear, but several scenarios are possible:

- The US Embassy's preliminary assessment in early July indicated that Argentina would probably muddle through its financial difficulties, moving from minor crisis to minor crisis. In a recent update, however, the Embassy projected that Argentina would now do well just to meet interest payments.
- We believe that Buenos Aires will try to restructure its external debt, but the prospects for success are dim. If this effort fails, Argentina will attempt formally to reschedule its external obligations, probably by the end of the year. The primary risk in this scenario is that it would entail difficult policy concessions to lenders, thereby heightening social and political pressures.
- Under the worst scenario, Argentina would declare a debt moratorium for several months in order to work out a rescheduling or, failing that, be declared in default by its creditors.

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During the height of US support for the British Falklands policy, there was a serious risk of direct reprisals against US businesses. This remains a lingering threat, the Embassy believes, particularly if US banks force the country into default. Otherwise, the prospect that Buenos Aires will take reprisals is rapidly diminishing, because the government is interested in normalizing relations with the United States.

More worrisome now is the prospect of resort to nationalistic economic policies to prevent a severe deterioration in the country's balance of payments. Increased tariffs, import quotas, restrictions on dividend payments or capital repatriation, and deliberate slowdowns in interest and principal repayments would adversely affect US commercial interests. Moreover, the US Embassy reports that deep Argentine resentment could increasingly weigh against US companies in the award of major government contracts.

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