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The Deputy Director of Central Intelligence

Washington, D.C. 20505

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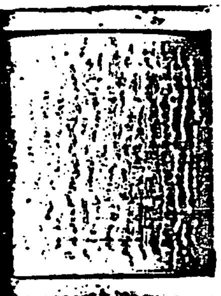
2 December 1982

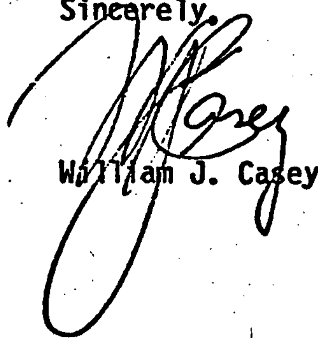


Mr. R. James Woolsey
Counsel, CSIS, and
Chairman, Contingencies Project
The Center for Strategic and International Studies
1800 K Street, Northwest
Washington, D.C. 20006

Dear Mr. Woolsey:

Thank you for sending me Dr. Thunberg's report on the "Vulnerabilities of the International Financial System." There is no doubt that the implications of LDC financial problems are far-reaching and closely interlinked. Dr. Thunberg presents an excellent review of these issues. Maurice Ernst, National Intelligence Officer for Economics, has been covering some of the same ground, and will be in touch with Dr. Thunberg in the near future so that they can exchange views.

Sincerely,



William J. Casey

PREPARED by NIO/ECON

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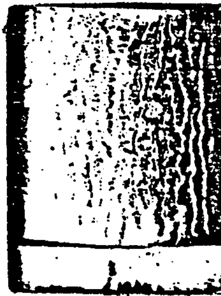

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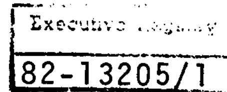

9588-82/1

30 November 1982

MEMORANDUM FOR: National Intelligence Officer for Economics

FROM: Director of Central Intelligence

SUBJECT: CSIS Contingency Report, "Vulnerabilities of the International Financial System"

Although this paper sort of falls off at the end it presents a very interesting picture in a way which I don't think I've seen before. I would like your evaluation of how it compares with our paper on the financial crisis and what additional insights this provides a reader.

William J. Casey

Attachment:
CSIS Contingency Report
and covering letter of 16 Nov 1982

25X1

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Remarks:

Please prepare acknowledgment for DCI's signature.

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Executive Secretary

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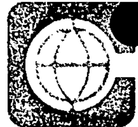

The Center for Strategic and International Studies
Georgetown University / 1800 K Street Northwest / Washington DC 20006 / Telephone 202 / 887-0200
Cable Address: CENSTRAT
TWX: 7108229583

November 16, 1982

The Honorable William J. Casey
Director of Central Intelligence
Central Intelligence Agency
Washington, D.C. 20505

Dear Mr. Casey:

I'd like to call your attention to the latest CSIS Contingency Report, "Vulnerabilities of the International Financial System," by Dr. Penelope Hartland-Thunberg, CSIS Senior Fellow in Economic Studies. A copy is enclosed.

Dr. Thunberg's report analyzes what might happen if a panic took hold in the international financial system and how this could lead to depression, or, conversely, hyperinflation. She calls for the convening of an international conference to avert these dangers by setting up a short-run safety net capable of supplying liquidity across borders and devising ways to refinance the huge amounts of long-term foreign debt.

As always, CSIS welcomes any comments or reactions you might have to our Contingency Reports. We look forward to hearing from you.

Sincerely yours,

R. James Woolsey
Counsel, CSIS, and
Chairman, Contingencies Project

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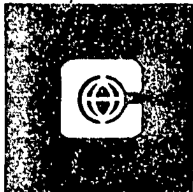

CSIS CONTINGENCY REPORT #8

November 15, 1982

Vulnerabilities of the International Financial System

This report reflects only the views of its author, Dr. Penelope Hartland-Thunberg, CSIS Senior Fellow in Economic Studies.

The international debt structure has been described as "the largest and most remarkable financial house of cards ever created." Many now believe it may collapse.

This appears unlikely. The costs would be too great. Instead, it seems more probable that rapid world inflation will be rekindled by frantic attempts to pump liquidity into the system.

To avert these dangers the United States should organize an international financial conference to provide: 1) a short-run safety net capable of supplying liquidity to the world in an emergency; and 2) the long-term refinancing of the existing foreign indebtedness of sovereign states.

CSIS Contingency Reports are for limited circulation only and cannot be quoted or reproduced without the permission of the author. For further information, contact: R. James Woolsey, Counsel, CSIS, and Chairman, Contingencies project; Center for Strategic and International Studies; 1800 K St., NW; Washington, DC 20006. Phone: (202) 887-0200.

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Approved For Release 2008/08/26 : CIA-RDP85-01156R000100040020-1

TABLE OF CONTENTS

BACKGROUND: CREATING A "FINANCIAL HOUSE OF CARDS"

Coping with the 1973-1974 Oil Price Shock.......... 1

Changed Circumstances of the 1980s................. 2

The Winding-down Process........................... 4

CONTINGENCIES

A Financial Panic.................................. 5

A Debtor's Cartel.................................. 6

Economic Recovery.................................. 6

U.S. INTERESTS AND POLICY OPTIONS.................. 7

The Inadequacy of Today's Financial Institutions... 8

ENDNOTES... 10

Approved For Release 2008/08/26 : CIA-RDP85-01156R000100040020-1

Approved For Release 2008/08/26 : CIA-RDP85-01156R000100040020-1

BACKGROUND: CREATING A "FINANCIAL HOUSE OF CARDS"

In 1974, after the first oil price shock, media commentators around the world viewed the ability of the international financial system to cope with imminent, massive financial flows across the foreign exchanges with varying degrees of concern, ranging from apprehension to alarm. At the time, bankers quietly pooh-poohed the concern, assuring everyone who would listen that the commercial banking system was quite capable of handling the petrodollars.

In 1980, after the second massive oil price shock, roles were reversed; the media essentially ignored the challenge (not to mention the hazards) of the newly generated wave of petrodollars, while the bankers in their own cloistered forums fretted over the gravity of the problem. David Rockefeller, then Chase chairman, warned of the "treacherous economic seas and gale-force financial winds strong enough to capsize" even the most prosperous of the LDCs.1/ At the time, the media viewed his language as merely colorful. The sharp difference between the two petrodollar innundations was clear even in 1980, however, although changes in the world environment after that were to make the difference even more acute.

Coping with the 1973-1974 Oil Price Shock

Within 12 months after the first price shock of 1973-1974 the share of fuels in the value of world trade rose from 12 to 20 percent, and the current account balance of the OPEC countries was multiplied by a factor of seven.2/ Unspent petrodollars were placed on deposit with the large international banks in Europe and the United States, and, despite warnings of financial chaos or collapse, the international financial system successfully recycled the funds, lending them to those countries that chose to maintain growth rates rather than to deflate in response to oil-induced balance-of-payments deficits. The rapidly growing countries, who were the large borrowers, were the non-OPEC LDCs, the smaller industrial countries (for example, Spain, Austria, and Sweden), and the countries of Eastern Europe including the USSR. At the same time, the United States, in choosing to fight unemployment rather than inflation, maintained an expanding market for LDC exports. So successfully did the international financial system cope with the flood of petrodollars that by 1979 the OPEC surplus had virtually disappeared. From more than $68 billion in 1974 the OPEC balance-of-payments surplus had been reduced to $3 billion by 1979.

Success in coping, of course, was not attributable solely to the international commercial banks. The OPEC countries themselves astonished all observers by their ability to absorb imports from the industrial countries and the rest of the world. Between 1973 and 1979 their spending on imports increased at an average annual rate of 15 percent.3/ The fact that the non-OPEC high borrowers were willing and able to go into debt at commer-

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cial rather than concessional rates of interest in order to maintain high growth was equally important. In addition, the borrowing was undertaken primarily to expand export capacity and thus provided the additional foreign exchange necessary for servicing the resulting external indebtedness. Finally, the successful adjustment of the world economy and the international financial system was accelerated by the post-1974 decline in the real price of oil. By 1978, inflation in the industrialized countries had caused the terms of trade of the oil-exporting countries with the industrial world to decline by nearly 20 percent below their 1974 level.4/ Also of great importance for the successful adjustment of the world economy was the fact that the real price of oil was not expected to change abruptly again.

Changed Circumstances of the 1980s

The outlook for successful adjustment to the 1979-1981 oil price escalation is not nearly so favorable. Although the increase was smaller in percentage terms than that of 1974 (200 vs. 400 percent), because it started at a much elevated level (roughly $13 a barrel as compared with $3 a barrel) the dollar effects were much greater. The very fact of a second oil price shock, moreover, severely jolted confidence in the stability of *relative* prices; that, by itself, helped to depress investment in the industrial countries.

The basic difference between the 1970s and the 1980s in the ability of the international financial system to cope with recycling problems lay in the decreased ability of the borrowers to borrow and of the international banks to lend. The success of the earlier recycling effort created serious difficulties for the later challenge.

Between 1973 and 1979 the LDCs were able to grow almost three times more rapidly than the large industrial countries largely by expanding their external indebtedness from less than $100 billion at the end of 1973 to nearly $400 billion in 1980. Nearly two-thirds of that was borrowed from commercial banks at market rates of interest. The non-OPEC LDCs accounted for nearly 60 percent of all new Eurocurrency credits in 1980, compared with 35 percent in 1974. Service charges on their external debt rose from 14 percent of exports of goods and services in 1973 to 18 percent in 1979.5/ More important, interest rates paid by these borrowers averaged 4 percent in 1973 but were approaching 20 percent by the end of 1980.

Borrowing, of course, was not spread evenly among all LDCs but was largely concentrated among a few. Twenty borrowing countries accounted for more than 80 percent of all Euromarket lending from 1974 to 1979 and just five (Brazil, Mexico, Argentina, South Korea, and the Philippines) accounted for more than 40 percent.6/

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During the 1970s, the net hard currency debt of Eastern Europe and the USSR (CMEA) rose from less than $6 billion in 1971 to more than $60 billion in 1979.7/ Nearly two-thirds of this total was accounted for by Poland, East Germany, and Hungary. As was the case with the LDCs, the burden of servicing this hard currency debt increased, although not to the same degree.

Even before the second oil price shock in 1979-1980, concern was spreading about the amount of exposure to "country risks" in the investment portfolios of the large international banks. Not for a century or more had private banks financed the external requirements of sovereign nations to such a degree. The accumulated debt of Brazil, the largest borrower, had reached $55 billion in 1980, including $37 billion owed to private banks. Oil imports and interest payments together absorbed about 80 percent of Brazil's foreign exchange receipts in that year. For the Philippines, the burden of this national overhead (oil imports plus interest charges) was 70 percent; for Thailand, 50 percent; for Turkey, 40 percent. Moreover, amortization charges (not included in these figures) were to become especially heavy in the early 1980s.

The combination of political and economic risks entailed in lending to sovereign nations makes the meaning of prudence in bank policies difficult to define. The borrowing governments in the 1970s were thought to be somewhat more politically insecure than the industrial democracies, but the larger LDC borrowers were on the whole viewed as politically stable: Taiwan, Korea, Mexico, Brazil, and those countries in Eastern Europe. In the early 1980s, however, political disturbances in Korea, Taiwan, Poland, and Iran brought into doubt assumptions about political stability in all LDCs.

In addition, high debt service ratios are properly viewed in the context of the rate of growth of the borrower's production and foreign exchange receipts. The main error of borrowers and lenders alike in 1979 and 1980 was their failure to foresee the deflationary impact of the second oil price rise on world trade and production and thus on the ability of the borrowers to earn the foreign exchange necessary to meet their rising debt service charges.

This failure was in fact largely a failure to forecast a different policy reaction in the United States to the second oil shock. In contrast to 1973-1974, when the United States chose to fight unemployment rather than inflation, the United States -- confronting inflation of 13 percent in 1979 (and nearly 20 percent in the first quarter of 1980) -- pursued an anti-inflationary policy that was accompanied by rising unemployment and declining income and production. The other industrial countries -- more or less willingly -- followed the same course. The result was world recession, contracting demand and world trade, and a collapse of raw material prices. (Commodity export prices are now -- in late 1982 -- one third lower than at the end of 1980.)8/ The foreign exchange receipts of the LDCs, further-

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more, dropped far more sharply than the costs of their imports.

The high pace of bank lending to the rapidly growing LDCs continued after 1979 until the third quarter of 1982, when it fell to less than half its previous levels. In the aggregate it now amounts to about half a trillion dollars.9/ Mexico surpassed Brazil in 1981 as the top borrower ($57 billion for Mexico vs. $53 billion for Brazil at the end of 1981) with Venezuela tied with Argentina for third place ($26 and $25 billion) and South Korea not far behind ($20 billion). The Soviet Union and Poland ranked next in line with indebtedness of $16 and $15 billion. (These data exclude short-term -- less than one year -- credits.)

The Polish de facto default in 1981 sobered the bankers who had not already become more cautious. Argentina's Falkland adventure added a further chastening effect, but still, for the most part, Mexico's financial embarrassment took them by surprise. The August 1982 issue of Euromoney, which appeared during the unfolding of the Mexican crisis and featured an article on debt rescheduling, did not even mention Mexico.

As the recession in the industrial world deepened during 1982, the persistence of an oil glut and weak oil prices diminished the flow of petrodollars to the international banks. In fact, OPEC as a whole shifted from a net lending position to that of a net borrower. The virtual disappearance of the OPEC surplus coupled with the continued scrambling for international credits even at astronomical interest rates provided clear evidence that the world was attempting to consume more than it was producing.

As of mid-1982 there were nine LDCs whose estimated interest and principal payments as a percentage of expected 1982 foreign exchange receipts amounted to 90 percent or more. For Argentina, Mexico, Ecuador, Brazil, and Chile, the ratios were all above 100 percent (with a horrendous 179 percent for Argentina).10/ There were, moreover, an additional five countries whose debt service ratios amounted to more than 45 percent. Because all of those countries were heavily dependent on imports of materials, supplies, and machinery, they were forced to borrow just to maintain production at existing levels. They were no longer using their loans in a way that would provide the means of repayment. Starting in 1981 their reduced import levels forced growth rates everywhere to fall; they actually became negative in Argentina, Brazil, and Chile.

The Winding-down Process

The lending banks' problems, of course, have been compounded by recession, high interest rates, and mounting business failures at home. With perceptions of heightened risks both at home and abroad mounting abruptly, banks have taken steps to protect the adequacy of their capital in relation to assets by curtailing the growth of the latter. In particular -- in a development potentially hazardous to the health of the world system -- not only

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credits but also interbank deposits are being curtailed domestically and internationally. The nervousness of the credit market is underlined by the fact that several of the largest U.S. banks have lost their triple-A credit rating, a development that Lord Lever, former financial advisor to Prime Ministers Harold Wilson and James Callaghan, termed "sensational."11/ A contraction of the interbank market will make it difficult for some banks to fund domestic as well as Euromarket loans, thus making a further slowdown in international lending likely. As a consequence, the list of countries being forced to renegotiate their debts is bound to lengthen, and "underborrowed" countries such as many in Africa are effectively being shut out of credit markets.

Sovereign debts rescheduled in 1979 amounted to $4.9 billion, in 1980 to $4.5 billion, in 1981 to $10.8 billion, and in the first half of 1982 to $27.9 billion.12/ How much more can the banking system take?

CONTINGENCIES

A Financial Panic

The worst-case possibility, which worries bankers and statesmen alike, centers around a collapse of one or two perhaps widely separated financial institutions that would trigger a chain reaction of failing banks. The interdependence of the world economy reaches its apogee in the interdependence of financial institutions. The interconnection of banks, brokerage and investment houses, and insurance companies around the world is intricate and vast; the specifics are unknown. In an environment of extreme nervousness about world financial stability, panic and consequent runs on banks could spread like wildfire. Even healthy banks could be forced to close their doors. Commodity, security, and foreign exchanges would be forced to shut down. Money and trade (domestic and foreign) march hand-in-hand; with money unavailable (that is, interest rates at infinity) trade and production would halt.

Such a collapse is unthinkable. Clearly governments would have to act individually or jointly. Within each country the central bank is the institution of last resort with the authority to provide liquidity to the domestic system, but there is no comparable institution to act on a world scale. The existing resources of the IMF are not nearly adequate to cope with world collapse. The recent failure of the Luxembourg subsidiary of an Italian bank (Banco Ambrosiano) demonstrated that holes exist in the effectiveness of the central banks' Basle agreement concerning responsibilities for external operations. Even with the best will in the world central bank cooperation in an atmosphere of panic and emergency is unlikely to be optimal.

In such circumstances the immediate pumping of liquidity into the system would get top priority, with worries over its

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inflationary impact postponed until later. The challenge facing central bankers would be the timing of efforts to mop up excess liquidity after panic has subsided and before the inflationary consequences have taken root. If the central banks initiate tighter credit conditions too soon, the pause in economic activity could be turned into a severe depression. If they wait too long, rising prices would be difficult to curtail. Many, if not most, developing countries, whose expertise in monetary policy is in most cases superficial, could be deluged by hyperinflation after not too many months. Governments are not likely to survive such chaos; political turmoil would be its handmaiden.

No one knows the probability of such an Armeggedon, a fact that accounts for much of the world's current nervousness. It may not have been happenstance that the abrupt recovery of the U.S. stock market after the second week of August, with volume at an all-time high, occurred at the height of the Mexican crisis. Volume probably was substantially buoyed by orders from abroad, the United States being viewed as the safest haven in a financial storm. Similarly, the sustained strength of the dollar in foreign exchange markets since then reflects widespread attempts to minimize perceived risks.

A Debtors' Cartel

Another danger is a debt renunciation announcement by one or several of the larger debtors. Collusive action by LDC debtors in renouncing their indebtedness is being urged by leftwing and nationalistic groups throughout much of Latin America. Belief in the efficacy of a "Debtors' OPEC" is founded in the conviction that LDCs will always be exploited by the imperialist North, that the North's prosperity depends on captive LDC markets, and that, consequently, the North will have to continue to provide the South with the means for buying its exports. The consequences of such a debt renunciation would also be worldwide panic and either acute and prolonged depression or high inflation through most of the world.

Economic Recovery

A third contingency, recovery of economic activity in the United States and other parts of the industrial West would be a mixed blessing for the LDC borrowers and the CMEA countries alike. Increased demand for their raw material and manufactured exports would mean rising foreign exchange incomes. The danger that rising business activity in the United States will be accompanied by rising interest rates is real, however. It has been estimated that every 1 percent increase in interest rates adds nearly $2 billion to the interest payments required of the LDC borrowers.13/ Recovery, moreover, also carries the risk of a tighter oil market and a rise in oil prices, which would add a further burden to the non-oil producing LDCs' balance of payments problems. For OPEC and the USSR a firmer oil market would, of course, be a plus.

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IV. U.S. INTERESTS AND POLICY OPTIONS

Even if the world survives 1982 with no major default or financial crisis, the danger will by no means have passed. The same worries and tension over world financial stability will continue in 1983 -- and beyond. The existence of this nervousness not only makes banks less willing to lend, it also makes borrowers in the industrial countries less willing to borrow. The low level of investment activity in the OECD countries is likely to be prolonged by the perceived risks of financial insecurity; the consequent continued recession in the industrial world will perpetuate the problems of both the LDCs and the banking community.

It is in the national self-interest of all countries of the trading world to remove this depressing overhang of risk and doubt. No one country, not even the United States, can do it alone. No single country is capable of insuring world financial stability unilaterally, because today no one economy is sufficiently large in relation to the world total to do more than influence the rate of change. No single economy can determine the rate or the absolute level of world economic activity. International cooperation among the major participants is therefore necessary.

The United States, however, should immediately initiate two international efforts aimed at removing first, the short-term threat to international stability and second, the underlying long-run threat. The forum is not too important -- it could be the Bank for International Settlements, the IMF, or some spot of scenic beauty like Bretton Woods. The essential part of the agenda for the first effort is to come to agreement on ensuring sufficient liquidity in the immediate, short-run future in order to prevent panic and collapse. If the major central banks of the financial world announced the existence of a multibillion dollar safety net capable of providing the international liquidity necessary in an international financial crisis, the likelihood of such a crisis would be greatly diminished.

At the same time, however, it is necessary to initiate an international effort aimed at solving the long-term, on-going problem -- how to manage the existing world structure of debt ("the largest and most remarkable financial house of cards ever created" -- again, Lord Lever) to ensure that sovereign debtors can continue to meet service charges without a sudden precipitous, politically explosive collapse of their economies. What is necessary is a massive renegotiation of outstanding indebtedness that spreads existing debt out farther into the future, reduces the annual debt service burden, and evens out the bunching of maturities so that borrowers can continue to meet interest payments. Lending banks require that their assets be "performing" -- that is, earn regular interest at commercial rates --not that they be repaid. Banks exist to earn money --

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that is, interest -- not to keep cash in their till.

Such a massive rescheduling of existing sovereign indebtedness should require a quid pro quo from the borrowers in the form of domestic economic policies to be pursued by them that will avoid the wasteful, noneconomic expenditures of the past and instead encourage an increase in their productive and export potential founded on increasing competitiveness in world markets -- without subsidies.

Clearly this is not an agenda for the weak-hearted. The problem is of worldscope, and all parts of the world would benefit from its resolution. Similarly, all parts must participate in bearing its costs. It would, however, not be a zero-sum solution -- the potential benefits to the world outweigh the costs.

An obvious part of such an international program would include a continued willingness of OECD countries to import from the LDCs. Borrowers cannot service their debts if lenders do not permit them to earn the export receipts necessary to do so. Another part of such an agenda would involve an attempt to improve the quality and quantity of available data on outstanding international loans. Our knowledge of the volume of international indebtedness of any one country is woefully incomplete and often of dubious reliability. A related problem is the adequacy of central banks' supervision of commercial banks' lending, especially through offshore subsidiaries.

Such a program is likely to require participation by the governments of the creditor banks, to ensure that these banks can continue domestic and foreign lending while rolling over interest and principal payments due from the sovereign borrowers. Such participation could take the form of a government guarantee of selected liabilities, or a special discount facility for the paper of sovereign states, or other instruments to support the liquidity of the commercial banks. This type of government support should bear a high price; it is not the function of the government to make good the past errors of bank managers.

On the other hand, some part of today's financial mess can be ascribed to the failure of governments to act. If in the 1970s, Europe, Japan, and the United States, the main oil importers, had been able to agree on collusive action to form a buyer's club (monopsony) to bargain with OPEC and to ration available energy effectively among themselves, they might well have forestalled the second oil price shock. They might even have succeeded in bargaining down the original price increase. In any event, it was the failure of governments to devise any concerted program that left to the private banks the full burden of financing the oil price rise.

The Inadequacy of Today's Financial Institutions

The private commercial banks of the world are not in a

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position to enforce those adjustments of internal economic policy in the borrowing LDCs that will increase the latter's ability to service their foreign debt -- nor should they be. The number of banks involved as creditors of a single country may be in the thousands; they are not organized except on an ad hoc basis in the Paris Club; most do not have the required expertise. Clearly the fashioning and enforcement of a feasible economic policy for each LDC debtor is the kind of task for which the IMF is well equipped.

The function of the IMF, however, has never been one of aiding in the solution of long-run developmental problems. The IMF was conceived and set up to ameliorate short-run cyclical problems -- to aid countries beset by short-run temporary balance of payments exigencies until the time when cyclical recovery would remove the cause of the payments deficit. The problems confronting today's world debtors are in many cases more than cyclical. They are, in addition, long-term problems involving the economic structure being set in place by the development process. These structural problems were created by or aggravated by the sharp 600 percent increase in real oil prices during the decade 1972-1982, which shifted certain industries in certain location from a profitable category to a marginal one or from a marginal to a noneconomic position. Such structural problems are not confined to the LDCs but affect all economies. They have been made more pressing in the LDCs by the huge overhang of debt service requirements.

The Bretton Woods agreement assigned to the World Bank (IBRD) responsibility for aiding in long-term development problems, while the IMF was to cope with short-term cyclical deficits created by the perceived necessity for supporting a fixed exchange rate. The Bretton Woods agreements never foresaw that the world's economic structure might be subjected to the kind of abrupt and severe wrenching as that caused by the gargantuan distortion of energy prices. Nor did the agreements foresee a necessity for abandoning a system of fixed exchange rates. The World Bank and the IMF served the requirements of the world reasonably well for the best part of a quarter-century. Today's requirements, however, are quite different. It is time for reconsideration.

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ENDNOTES

1. World Business Weekly, August 11, 1980.

2. IMF Survey, March 3, 1980. See also, CEA Annual Report, Jauary 1980.

3. Economist, March 8, 1980.

4. Amouzegar, J. "Petrodollars Again," Washington Quarterly, 4, no. 1, (Autumn 1982) : 132; George Eklund, World Oil, January 1980.

5. International Monetary Fund, World Economic Outlook, 1982.

6. Economist, November 3, 1979.

7. Department of Commerce, Statistical Abstract of East-West Trade Finance, August 1982.

8. Financial Times (London) October 18, 1982.

9. Morgan Guarantee Trust Company, World Financial Markets, October 1982.

10. Ibid.

11. New York Times, September 24, 1982.

12. Euromoney, August 1982.

13. Financial Times (London) October 15, 1982.

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