

The Director of Central Intelligence

Washington, D.C. 20505

NIC #4123/1  
8 June 1983

National Intelligence Council

NOTE FOR: Director of Central Intelligence  
FROM: Maurice C. Ernst, NIO/Economics  
SUBJECT: International Debt Issues

1. I understand you are planning to meet with Norm Bailey of the NSC Staff to discuss international debt issues. Norm is very concerned not only about the current liquidity problems, especially in Brazil, but also about what may happen to the international financial system when the next recession hits. As I am sure you know, he has developed and publicized a proposal to permit repayment of LDC bank debt by issuing shares tied to future export earnings. Although he does not consider his proposal, or any of the other more radical reform proposals, to be practical in dealing with the current crisis, he believes that the debt issue could develop into a solvency problem in the longer term, and that proposals such as his should be considered in that context.

2. Policy deliberations on the debt problem have led to a general strategy of dealing with liquidity crises on an ad hoc basis, pushing for Congressional approval of the expansion of IMF resources, and hoping that economic recovery will take care of the problem in the longer term. As I see it, there are three potential weak points in the strategy:

- o Ad hoc short-term solutions may require substantially more funding from the US Government, and it is not clear where the money will come from. The Brazilian crisis is once again coming to a head (I have just sent out an informal contingency memo on this issue, a copy of which is attached.) Even if the banks come up with new money and the IMF shows flexibility, the problem will recur later this year, when funding for 1984 is discussed. Other countries, especially including Nigeria and Venezuela, will need large new funds, and some of those already under IMF programs, including perhaps Mexico, will be coming back for more. Most of the new credits are coming from the large US banks and are essentially involuntary. The liquidity problem is greatly worsened by a general lack of market confidence, withdrawals of interbank deposits by smaller banks and many large foreign banks, a contraction of trade credit, and other forms of capital flight.

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The US Government is not even considering additional funding until the IMF bill gets through Congress.

- o A related problem for the current strategy is the inflexibility created by the many debt refinancing agreements involving the IMF, the banks, and the debtor countries. The IMF understandably is very concerned about its credibility. It does not want to establish bad precedents by bowing to borrowers' pressure, but this can lead to potentially dangerous confrontations.
- o The debt situation should improve in the next two or three years as world economic recovery proceeds. If recovery is not sustained, radical solutions will probably be needed. Even if it is sustained, however, several of the largest debtors, notably Brazil, Mexico, Argentina, and Venezuela, will face extremely difficult structural adjustments and depressed per capita incomes. There is a substantial risk that the political reaction to forced, prolonged austerity will become stronger and better organized even after the worst part of the economic crisis is over. We will be examining this medium-term problem in a National Intelligence Estimate tentatively scheduled for October.

  
Maurice C. Ernst

Attachment:  
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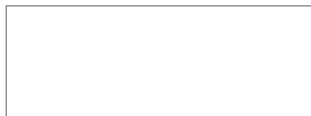
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NIC #4123-83  
8 June 1983

SUBJECT: The New Brazilian Financial Crisis

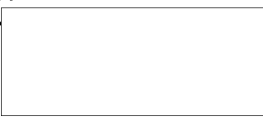
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SUBJECT: The New Brazilian Financial Crisis

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MEMORANDUM FOR: See Distribution

FROM: Maurice C. Ernst, NIO/Economics

This contingency memorandum The New Brazilian Financial Crisis is designed to examine possible scenarios which would lead to dangerous consequences. The chances are that Brazil and the IMF will negotiate a comprehensive agreement, and that the major international banks will provide new funding, so that Brazil's financial crisis will temporarily recede. But there is a substantial risk, especially if the IMF insists on large adjustments in domestic economic policies, that Brazil's relations with its major creditors will begin a downhill slide, possibly leading to default or to a debtors' revolt led by Brazil.



Maurice C. Ernst

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### The New Brazilian Financial Crisis

1. The continuing Brazilian financial crisis once again is coming to a head and poses a major threat to international financial stability. Both the external financing and the internal adjustment components of Brazil's IMF-sponsored stabilization program must be substantially revised. At the same time, the confidence of foreign creditors in the Brazilian government's ability to manage its financial problem has greatly declined. It is doubtful that Brazil can ride out the uncertainties accompanying new negotiations with the IMF and the banks for more than a few weeks without arrears reaching unacceptable proportions. Although all the major parties badly want agreement, there are substantial risks of mutual miscalculation because political pressures in Brazil and IMF concern for the credibility of its many debt refinancing programs will limit flexibility.

2. If a new agreement is not worked out, Brazil will have little choice but to declare a freeze on foreign exchange deposits and a moratorium on debt servicing, probably including interest. Such a step not only could be a major new shock to the confidence of creditors, but also might make the Brazilian advocates of cooperation with the IMF and the banks, who so far have determined Brazilian policy, politically vulnerable. With political resistance to economic austerity building, it is unlikely that any new economic team will be better able to deal effectively both with external creditors and with internal pressures. It is possible, moreover, that Brazil would adopt a more nationalistic approach, consciously using debtors leverage to drive a hard bargain with the banks and the IMF. There would then be high risks of a slide into mutual confrontation, possibly leading to default on Brazil's massive debt or to an organized effort by LDC debtors, following Brazil's lead, to obtain substantially better terms on their debt service obligations.

### The Financial Crisis Intensifies

3. The financial adjustment package that Brazil had worked out with the IMF and the major banks last February is in danger of coming apart. In addition to IMF credits of \$2.2 billion and additional medium-term bank credits of \$4.4 billion, banks were to replenish their deposits in Brazilian banks, which had been drawn down before the IMF agreement was signed. In spite of the strenuous efforts, Brazil is still falling some \$1.5 billion short of target on interbank deposits. In addition, capital flight has continued, although probably at a reduced rate. Consequently, Brazil probably will need at least \$2 billion and perhaps as much as \$4 billion in new funds beyond those already committed this year if the original target for total net foreign financing is to be met.

4. If substantial new funding is not available, Brazil will have to reduce the current account deficit even more than planned, mainly by

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cutting imports. Trade data through April suggest that Brazil can meet its original trade commitment. This will require a decline of about 25 percent in imports this year on top of declines of about 15 percent over the two previous years. Imports are probably already at the lowest level relative to production or consumption than at any time in the past 20 years. Further cuts will be very difficult indeed.

5. While so far meeting external IMF targets, Brazil is not coming close to meeting some of its internal targets. The IMF agreement mandated a reduction from 100 percent to 80 percent in the annual inflation rate and a halving of the share of the public sector deficit in GDP in nominal terms. These targets were clearly unrealistic. In Brazil's highly indexed economy, a massive reduction of about \$7 billion in the current account deficit was bound to accelerate inflation, at least temporarily. In turn, high inflation was bound to increase public sector borrowing needs, a substantial part of which reflect internal developments. To meet nominal borrowing targets in spite of accelerating inflation, Brazil would have to depress real economic activity far more than the 3 to 4 percent decline now anticipated. Inflation has indeed accelerated, to an annual rate of 160 percent, and the IMF has found Brazil to be out of compliance with the program. Consequently, disbursement of IMF and new bank credits has been withheld, pending a new agreement.

6. The IMF decision to withhold additional credit drawings is likely to exacerbate an already severe liquidity problem for Brazil. Brazil has accumulated close to \$1 billion in arrears on payments. A \$400 million loan payment to the BIS, due on an earlier \$1.5 billion credit, has been postponed for a month. Confidence of foreign creditors in Brazil's future financial stability is already low because of what is seen as the government's inability to get control of the situation. It is likely to weaken further, stimulating an accelerated outflow of short-term capital, until a new agreement with the IMF can be negotiated.

### Brazilian Options

7. So far, the Brazilian government is continuing the policy of cooperation with the IMF and the banks. The Brazilians appear willing to take additional domestic measures, such as reductions in agricultural subsidies, in order to demonstrate their good intentions and cooperative attitude. At the same time, by allowing large arrears on both interest and import payments to accumulate, the Brazilians are pressuring the creditors into making concessions. While negotiations with the IMF are underway, efforts to replenish interbank deposits are continuing. The current approach is unlikely to work for more than a few weeks, however, before arrears reach unacceptable proportions.

8. To complete a new agreement with the IMF and the banks within a month or so would be difficult, but by no means impossible. All the major actors badly want an agreement. An agreement with the large bank creditors

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for new credits to cover arrears and compensate for the loss of interbank deposits--perhaps totaling \$ 2 to \$3 billion--could probably be negotiated quickly, but disbursements on new credits also would have to wait for a green light from the IMF. An IMF delegation is about to leave for Brazil and the IMF is aware of the high stakes involved. The flexibility of the IMF, however, is limited by the intimate links between its own loans and those of the banks, and by the importance of maintaining credibility with the many other large debtors, with whom it also sponsors debt refinancing programs.

9. Brazil too has limited flexibility. There will be pressure on the Brazilians to substantially ease price indexing, as well as to cut government expenditures. With political resistance to IMF-induced austerity building, especially from the large business community oriented predominantly to the domestic market, it is unlikely that Brazil will be willing to make many concessions on internal policy. Substantial modification of price indexing is particularly unlikely.

10. With flexibility limited on both sides, there are serious risks of mutual miscalculation, resulting in protracted, perhaps acrimonious negotiations. Brazil would then have no choice but to freeze foreign exchange deposits to stem the capital outflow and possibly declare a temporary moratorium on debt servicing. Such a moratorium would probably include interest payments. Presumably the moratorium would be announced for a limited time (for example, a period of up to three months) and would be justified by the necessity to maintain financial stability while a new agreement is being negotiated with the IMF and the banks.

#### Possible Consequences of a Debt Moratorium

11. A deposit freeze and a temporary debt service moratorium would not necessarily be a bad thing. Some of the large creditor banks might welcome it as an effective means of stemming the loss of deposits from smaller banks and other short-term capital, thereby potentially reducing the volume of new credit the large banks may be forced to provide. Much would depend on how these measures were introduced--whether, for example, on the recommendation of a creditors' group, or alternatively as what would be seen as a unilateral action. Similar steps taken earlier by Mexico were effective and generally well received, in comparison with the alternatives. But there are important differences between the present Brazilian situation and that of Mexico last September. Mexico imposed its freeze and moratorium before initiating negotiations with the IMF and the banks, and has since been slowly reducing its controls. Brazil would take such a step after months of trying to avoid it and with a refinancing and adjustment program in effect. For Brazil the step would signal a major failure of policy. Moreover, a Brazilian moratorium, unlike the Mexican, probably would have to include interest payments, some of which are already in arrears and which otherwise could be met only by further reducing imports.

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12. It is possible only to speculate about how such a mark of policy failure might change the direction of Brazilian economic policy itself. There seems to be little chance at present of a drastic policy shift--for example, the adoption of narrowly nationalistic, populist policies a la Goulart. The present Brazilian military leadership appears far too conservative and internationalist minded to even consider such an option. It is also unlikely that this Brazilian leadership would jeopardize relations with the IMF and the banks, by renouncing debt obligations. The Brazilians believe that their long-term economic development prospects are good, and realize that they will need foreign funds and investment to aid in this development.

13. Although extreme policy shifts are highly unlikely, moderate policy shifts could well follow from a freeze and a moratorium. The present economic team is already being criticized for having made economic policy commitments to the IMF on which it could not deliver. It will probably be reshuffled or replaced in any event, and almost certainly would not survive a moratorium. We are unable to identify likely successors or to specify likely policy changes. Given political pressures in Brazil, however, and the apparent commitment of the Figueiredo leadership to a process of democratization, the chances are that economic policy would be no more accommodating, and possibly would become substantially less accommodating, to the creditors. Consequently, the risks of mutual miscalculation would grow.

14. In particular, there would be the increased possibility of a nationalistic backlash. Nationalistic, populist, inward looking tendencies have deep roots in Brazilian history. A prolonged, apparently externally induced, economic recession is difficult for most Brazilians to accept. The Brazilians might take a harder stance in negotiations with the IMF and the banks--in other words, would more consciously and systematically use Brazil's substantial leverage as the Third World's largest debtor. Brazil might, for example, ask for much larger new credits than are now envisaged and make few, if any, additional internal adjustments to meet the IMF part way, claiming that domestic political constraints preclude such adjustments, and that, so long as reasonable external targets are met, Brazil should manage its economic policies as it sees fit. In order to reconcile external financial limitations with internal economic expansion, use of export subsidies and direct import controls would have to increase, thereby creating added frictions with the IMF and the US Government.

15. A tougher Brazilian negotiating stance would be fraught with risks:

- o The IMF and major private creditors would be unlikely to make major concessions under pressure for fear of encouraging other debtors to imitate Brazil.
- o In Brazil what would seem an inflexible attitude by the creditors might trigger even stronger pressure, including threats to continue the moratorium.

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- o A debt service moratorium which continued for several months could trigger default actions, at least by some smaller foreign banks and would create major problems for the banks in dealings with regulatory authorities.
- o An extended, acrimonious negotiation, even if successfully concluded, would leave a residue of distrust in the financial community which would make it difficult for the new agreement to succeed.
- o Brazilian success, or prospective success, in obtaining major concessions from the IMF and the banks without giving much in return, would encourage other debtors to take similar actions, and possibly even to join with Brazil to press for substantially improved debt service terms.

15. Such events obviously would seriously endanger the entire complex of agreements involving debtor countries, creditor banks, and the IMF and would create major risks for the stability of the international financial system. The pessimistic scenario is not a highly likely one, but neither is it implausible. Among all of the LDC debtors, Brazil is the key, not only because it is the largest, but also because it has been one of the strongest proponents of cooperation with the banks and one of the most willing to make substantial internal adjustment. For these reasons, Brazil is the most natural leader of a "debtors' revolt" should its policy direction change. Although radical voices in Brazil are unlikely to be heeded by the leadership, it would not take a major shift in policy direction to begin a slide away from cooperation with creditors and toward confrontation, with unpredictable and possibly disastrous results.

16. Even if an agreement with the IMF and the banks is negotiated quickly, Brazil's financial crisis may recur within a few months. It is unlikely that a new credit package in the \$2 to \$4 billion range will suffice to bring a general return of creditors' confidence, and the loss of short-term capital may resume. Moreover, a new round of large-scale involuntary lending will have to be organized to cover projected Brazilian current account deficits in 1984.