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Outlook for the International Debt Strategy

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GI 84-10104
June 1984

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An Intelligence Assessment

This paper was prepared by [redacted] Office of Global Issues. Comments and queries are welcome and may be directed to the Chief, International Finance Branch, OGI, on [redacted] 25X1 25X1

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Outlook for the International Debt Strategy

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Key Judgments

Information available as of 11 June 1984 was used in this report.

Over the last two years, rescue packages coordinated by the IMF have forestalled default by debt-troubled less developed countries (LDCs) and East European countries and averted a major disruption in the international financial community. Debtors and creditors have negotiated these packages on a country-by-country basis. In return for complying with an IMF economic adjustment program, debtors have obtained debt restructurings, new commercial bank and IMF loans, and official emergency short-term loans and export credits. This strategy has assumed that as world economic recovery proceeds and LDC adjustments are undertaken, the financially troubled countries would regain normal market access to new loans and be able to service their debt on time. 25X1

Although Western economic recovery is under way and debtor country external accounts are steadily improving, we believe that serious problems still could arise under the present debt strategy:

- Some US regional and European banks are becoming increasingly reluctant to participate in new loan packages for these financially troubled countries. This implies an increased burden on the larger banks; the financial community is already concerned about high loan exposures to troubled debtors.

- Governments of many financially troubled countries face intense political and social pressure to abandon or weaken austerity measures. Reduced subsidies, wage restraints, and sharp import cuts are provoking widespread discontent and in some cases, such as the Dominican Republic and Bolivia, are directly responsible for recent political turmoil.

- Global economic conditions may not improve enough for these countries to attract sufficient capital to service their debt and to finance development needs. 25X1

Many observers are concerned that Western economic recovery may falter and interest rates rise further, and they believe new proposals should be considered for dealing with the international debt problem. Already a number of proposals have been put forward—including capitalization of interest, multiyear restructuring, and a new SDR allocation. While these

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proposals conceptually would make more foreign exchange available for imports and help spur economic growth in the LDCs, there are several disadvantages:

- Some would require legislation that would be time consuming and perhaps not feasible.
- Some would treat all debtors identically and fail to recognize the uniqueness of each debtor's situation.
- They may reduce the incentive of debtor countries to continue implementing austerity measures.
- They could reduce the willingness of commercial banks to extend new credits to the debtors in the future.

Debtor countries are also calling for new proposals that would share responsibility for solving the debt problem and assuming losses with creditors. As a result, we expect tougher stances in negotiating with creditors this year. Moreover, recent reaction to the rise in interest rates suggests closer coordination of debt policies by the debtors. 25X1

We believe demands for alternative solutions to the debt problem increasingly will be heard from LDC debtors, academics, and some Western allies. The political strains on the debtor governments are growing, and we cannot rule out more hardline demands or radical actions. While in some cases calls for action may simply be rhetoric, Washington, could be forced to find a way to respond to creditor and debtor concerns in the months ahead. Moreover, pressure could build rapidly if a major roadblock were hit in financial dealings with a major debtor. In this regard, the Argentine situation probably bears the closest watching; Argentine negotiations with the IMF and commercial banks could be difficult and prolonged. 25X1

Outlook for the International Debt Strategy

Prelude to the Current Problem

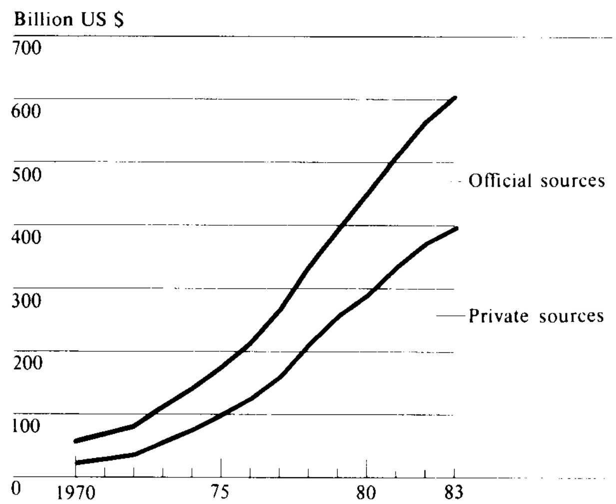
The debt burden of the less developed countries (LDCs) and the East European countries has become extremely large. Spurred by grand development plans and the easy availability of foreign bank credit, these countries boosted their combined medium- and long-term debt from only $55 billion in 1970 to over $600 billion at yearend 1983 (see figure 1). By the late 1970s, the LDCs and East European countries were adding nearly $50 billion a year to their medium- and long-term debt burden. In addition, they have at least $165 billion in short-term debt.

The structure of these countries' external debt shifted dramatically in the past decade. In the early 1970s, these countries borrowed mostly from multilateral institutions on concessionary terms; only 40 percent of their borrowing was from commercial banks. By the late 1970s, the ratio had reversed with private sources providing nearly two-thirds of these countries' external loans; the Latin American countries rely on private sources for almost all of their financing needs. This shift has made the cost of financing more onerous for the debtor countries, because the majority of commercial bank loans are tied to market interest rates, whereas official credits carry lower, fixed interest rates. In addition, bank loans have to be repaid more quickly than official credits.

While these trends set the stage for the debt problem, the crisis actually came when countries such as Poland, Mexico, and Brazil were no longer able to repay their debt as scheduled. We and other financial observers believe several factors were responsible:

- The size of the annual interest and principal payments owed by the LDCs and East European countries mushroomed, growing from only $9 billion in 1970 to $140 billion by late 1983 (see figure 2). Much of the increased burden resulted from a dramatic rise in interest rates as industrial countries fought inflation with tight monetary policies.

Figure 1
LDC and East European Medium- and Long-Term Debt, 1970-83



Source: CIA estimates based on IMF, World Bank, BIS, and OECD data.

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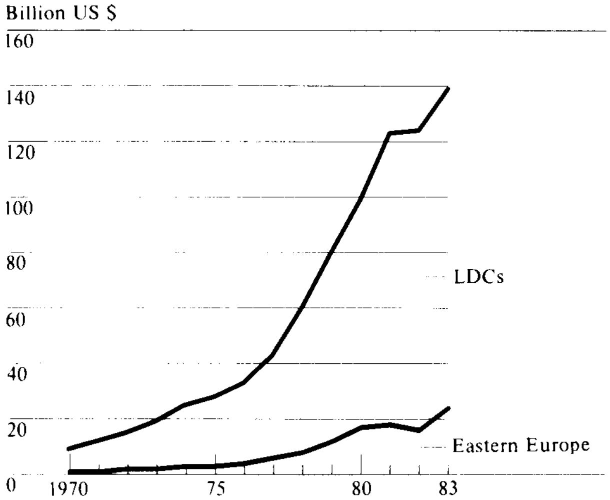
- Concurrently, recession in the industrial countries and low commodity prices weakened debtor countries' exports so that the LDCs had less income with which to service their debt. As a result, several key Latin American countries—Argentina, Brazil, and Chile—saw interest payments alone as a share of export earnings rise to more than 40 percent in 1982.

- Finally, given world economic conditions, international lenders perceived growing risks in the LDCs; as a result, they cut back new lending and refused to refinance maturing debts, especially short-term credits.

Figure 2
LDC and East European Debt Service, 1970-83[a]



[a] Medium- and long-term principal repayments and all interest payments.
Source: CIA estimate based on IMF, World Bank, BIS, and OECD data.

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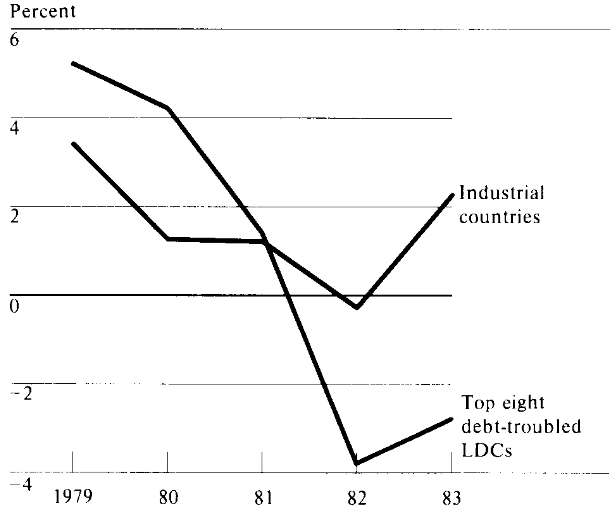
Figure 3
Real GDP Growth: Selected Debtor Countries, 1979-83



Source: IMF data.

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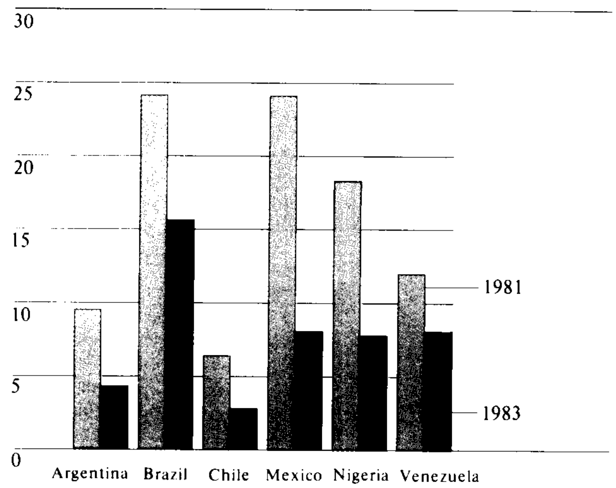
Current Strategy for Coping With the Debt Problem
A review of country rescue programs shows that over the last two years creditors have dealt with LDC debt servicing problems on a case-by-case basis. Generally, when a country has fallen behind in payments, creditors have agreed to temporary delays of payment while the debtor country began discussions with the IMF. Within a month or two, the debtor country has adopted an IMF-supported economic adjustment program that is monitored quarterly. In return, the debtor country has obtained new financial assistance from creditors and a restructuring of its debts. The strategy assumed that, as world economic recovery proceeds and LDC adjustments are undertaken, the financially troubled countries would regain normal market access to new loans and be able to return to servicing their debt on time. 25X1

This case-by-case approach has been publicly articulated by the United States and other industrialized countries as a five-point debt strategy, which includes:
- Encouragement of continued bank lending.
- Continued willingness of Western governments and institutions to provide bridge financing when necessary.
- Strengthening of international financial institutions such as the IMF.
- Adoption of policies by industrialized governments to promote sustained noninflationary growth.
- Encouragement of sound economic policies within LDCs. 25X1

So far under this strategy, no countries have repudiated their debt, and there has been no major international liquidity crisis. Most of the financially troubled countries have implemented IMF-supported austerity measures. In addition, the resources of the IMF have been increased. Finally, Western governments and commercial banks have restructured a large portion of maturing debt and have agreed to lend additional funds to several countries as part of their debt-relief packages. 25X1

Figure 4
Import Trends in Key Debt-Troubled Countries, 1981 and 1983



Source: IMF data.

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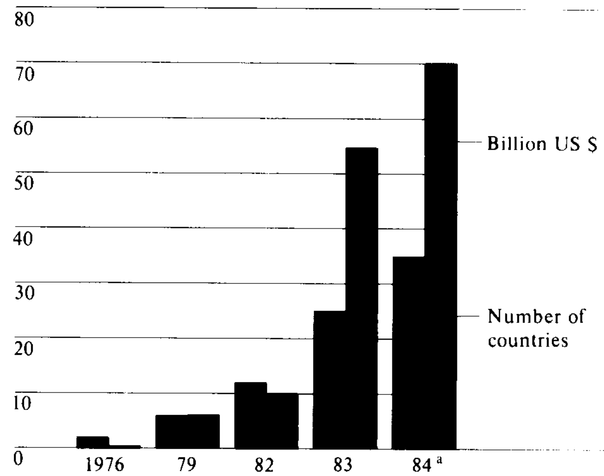
Figure 5
LDC and East European Debt Restructurings, Selected Years, 1976-84



Source: CIA estimates based on OECD and IMF data.
[a] Estimated.

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Economic Impact on the Debt-Troubled Countries and the United States

While cooperative efforts have prevented major disruptions to the international financial system, the impact of adjustment programs on the debt-troubled countries has been severe. Austerity measures, such as restraints on wages, government spending, and domestic credit, as well as foreign exchange constraints, have led to steady declines in the debtor economies. According to official government and IMF statistics and our estimates, the largest debt-troubled LDCs have seen their real GDP actually fall during the past two years, a sharp turnaround from the 4- to 5-percent growth of 1979-80 (see figure 3). Imports have even fallen below levels originally targeted in IMF-supported adjustment programs. The imports of Argentina, Chile, and Mexico have fallen by at least half in the last two years (see figure 4).

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Moreover, it is not only the major debtors who are having financial difficulties and undertaking economic austerity measures. Close to 40 countries currently have or are seeking IMF-supported programs. Last year 25 countries obtained debt relief totaling about $55 billion (see figure 5). We expect that 35 countries will ask for debt relief this year in the amount of $70 billion.

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The US economy has not been immune from the fallout of the LDC debt problem. The sharp drop in imports by the debtor LDCs has aggravated the US trade deficit. Trade statistics show, for example, that US exports to Latin America declined from roughly $42 billion in 1981 to $22 billion in 1983. In addition, US banks are highly exposed to debt-troubled countries. LDCs and East European countries owe US banks nearly $150 billion, with the nine largest US banks accounting for roughly $90 billion. Moreover, the exposure of large US banks is highly concentrated in a few large debt-troubled countries; Argentina, Brazil, Mexico, and Venezuela together owe the nine largest US banks over $40 billion, which substantially exceeds these banks' net worth. This vulnerability of the large US banks to the debt problem is reflected in the decline in their stock prices relative to the overall market. press reporting indicate that many investors fear that these banks may have to write off a large portion of their foreign loans, which would depress bank earnings and could raise depositors' concerns over the solvency of these institutions.

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Potential Problems Under the Current Debt Strategy
Although Western economic recovery is under way and LDC external accounts are steadily improving, we believe that serious problems still could arise. In the past six months, there have been signs that many commercial banks have become increasingly reluctant to lend new money to debt-troubled countries. For example, about 30 smaller US and foreign banks, according to press reporting, refused to participate in the recent $3.8 billion loan to Mexico. While most of the large, heavily exposed US banks are willing to make new loans to get back their interest payments on existing loans, a growing number of US regional and European banks are refusing to go along. Financial observers state that US regional bank reluctance is part of a strategy to limit exposure to troubled debtors. European banks operate under less stringent accounting rules and do not feel compelled to lend new money to keep interest payments current on existing debt. Under current US regulations, when interest payments are past due by more than 90 days, US banks—unlike their European counterparts—generally must place their loans in a nonperforming category and deduct interest not received from income.

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As the foreign and smaller US banks drop out, the large US banks are forced to take on even more of the burden of new lending. In the four big Latin American countries, the nine largest US banks already account for 60 percent of total loans made by US banks, according to Federal Reserve Board statistics (see figure 6). Concern about regulatory and stockholder reactions to increased LDC loan exposure hinders these banks' ability to assume this greater burden.

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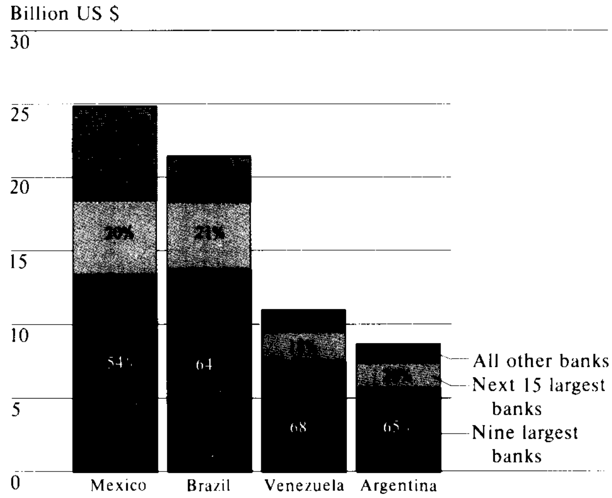
Figure 6
US Bank Exposure in Latin America, by Size of Bank, as of June 1983



Source: Federal Reserve Board data.

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For this reason, we believe there could be shortfalls in meeting new money requests later this year. According to press reporting, Argentina will need over $2 billion to keep interest payments current, and we believe raising that amount could be difficult. The Philippines is already seeking over $1.6 billion in new money from banks, and some banks are indicating reluctance to participate, according to press reporting. We believe Brazil could require more than $3 billion in new loans from banks to meet 1985 financing needs, but many European and smaller US banks have already said that they will not participate in a third package

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A second problem area under the five-point strategy is that the governments of many financially troubled countries are having an increasingly difficult time

maintaining austerity programs. As wages and subsidies have been cut in response to IMF conditionality requirements, political resistance to austerity programs has grown. Such resistance has caused several key debtors to fall out of compliance with their IMF-supported programs, leading to interruptions of new money disbursements and the buildup of arrearages. Once such a disruption occurs, renegotiation of new IMF terms becomes even more politically difficult for the incumbent governments. Argentina, the Philippines, and Bolivia have all been declared out of compliance with IMF agreements, and relations with creditors are fragile. Efforts to negotiate new agreements have dragged on for months largely because of political constraints these governments face in implementing measures to satisfy the IMF. The Bolivian Government's decision last month to devalue its currency and to increase food prices as preconditions for an IMF agreement spurred widespread labor strikes, including disruption of the banking system. In Argentina, continued sporadic strikes make it increasingly difficult for President Alfonsin to move forward on economic issues. In the Philippines, creditors are
25X1 concerned that new opposition strength in the Assembly will make it more difficult to implement austerity measures and conclude IMF negotiations.

Over the last year, favorable economic trends have helped improve debt-troubled countries' external financial positions; since mid-1983 OECD real GNP has risen 4.5 percent annually. In addition, oil prices and, until recently, interest rates have remained steady. It is not clear, however, that the coming months will be as favorable. According to a number of forecasters, economic growth is expected to slow—perhaps as soon as fourth quarter this year—and
25X1 interest rates could rise further. Moreover, if the situation in the Persian Gulf worsens, oil prices could rise.

These economic trends would have the following kinds of impacts:

- Each one-percentage-point drop in OECD real growth cuts more than $2 billion from non-OPEC LDC export earnings.
- Each one-percentage-point rise in US dollar interest rates boosts non-OPEC LDC's annual interest payments by about $2 billion; such a rise costs Brazil and Mexico over $500 million each.
- A $5 per barrel oil price increase raises import costs for an oil-importing debtor such as Brazil by at least $2 billion; while an increase would improve the financial situation of oil-exporting debtors such as Mexico, Egypt, and Peru, on balance we believe a runup in oil prices would be destabilizing for those banking centers and countries with high loan exposure to non-oil-exporting LDCs. 25X1

Smaller amounts of official assistance could also hamper the present debt strategy. The capability and willingness of Western nations to provide emergency bridge financing is uncertain. US Government resources are constrained; available Commodity Credits Corporation and Eximbank credits are relatively small. Western governments helped to bolster the IMF's pool of funds last year. The IMF, however, provides only temporary and generally limited balance-of-payments relief to financially troubled countries. Many of these debtors require longer-term-investment-related capital to spur economic activity. 25X1

New Proposals

Concerned that Western economic recovery may falter and interest rates remain high, many observers believe new proposals should be considered for dealing with the LDC debt problem. Even with a sustained recovery, debt restructuring and new bank credit are likely to continue to be necessary for many LDC debtors over the next two years. Moreover, consensus is growing among debtors and some Western governments that LDC economic adjustments have been rigorous and that new policies are needed to enable debtor countries to finance growth and investment. There is also the concern that, as IMF assistance nears the debtors' quota limits over the next 18 months, these debtors will not be sufficiently creditworthy to attract needed capital in the marketplace. 25X1

New proposals under discussion—including capitalization of interest, multiyear restructuring, and a new SDR allocation—vary widely in the amounts of debt relief they would provide and who would bear the

New Proposals for the Debt Problem

	Pros	Cons
Lower bank interest rates: banks reduce interest rates charged on loans to LDCs below their cost of funding	Reduces future borrowing requirements Frees up money for LDC imports to spur economic growth	Interest losses must be assumed by banks or Western governments Requires changes in banking regulations Could reduce banks' desire to lend new money
Capitalization of interest: banks add all or part of interest payments to the principal amounts owed by debtors	Burden is distributed more evenly among banks Frees up money for LDC imports to spur economic growth	Requires changes in banking regulations Effects willingness of banks to lend new money Increases overall level of debt
Multiyear restructuring: a debt-relief package that restructures principal for more than one year	Spreads bunching of maturities over many years Could improve the creditworthiness of debtors Reduces costs of restructuring	Reduces creditor influence over LDC economic policies Provides no relief from high interest charges
SDR allocation: the IMF creates new money to build up debtors' foreign exchange reserves	Helps to rebuild LDC creditworthiness New money for imports to spur economic growth	Could be inflationary Across-the-board relief to all IMF members; does not distinguish debtor economic performance and reduces debtor's incentive to adjust
One-year grace period: immediate hiatus of all debt payments for one year, with the amount being rescheduled	Frees money for imports to spur economic growth	Disincentive to take economic adjustments Requires changes in banking regulations Increases overall level of debt
Exchange participation notes: debtor governments service debt on the basis of a set share of export earnings	Debt repayment linked to ability to pay Encourages creditors to invest in export industries	Difficult accurately to measure export earnings in LDCs Hinders LDCs' ability to plan and adjust for future changes in economies and world markets
Debt discounting corporation: new institution issues bonds to banks in exchange for banks' loans, and the institution reschedules loans on softer terms	Reduces risk to the banking system	Requires funding from the United States and its allies Reduces bank responsibility to debt problem Does not provide substantial interest payment relief to debtors
Debt corporation: new institution purchases problem loans from banks, sells loans to private investors, and guarantee debt servicing	Reduces risk to the banking system	Requires funding from the United States and its allies Reduces bank responsibility to debt problem

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costs (see the table). Some would require banks to take larger losses, while others would require substantially more aid from Western governments. According to financial observers, these proposals present other difficulties:

- Some would require legislation that would be time consuming and perhaps not feasible given current Western political environments.
- By providing across-the-board relief, some would treat all debtors identically and fail to recognize the uniqueness of each debtor's situation and economic adjustment performance to date.
- A new initiative will require the approval and cooperation of commercial bank and official creditors, which have divergent views between and among themselves.
- They could reduce the willingness of commercial banks to extend new credits to the debtors in the future.
- By shifting the responsibility for the debt problem to commercial creditors and Western governments, debtor countries will have less incentive to undertake needed economic adjustment measures. 25X1

Major banks and official creditors have announced that they will consider a multiyear restructuring package with extended grace periods for those debtors who have adjusted their economies. This restructuring, however, does not address the problem of higher interest costs, and presumably would exclude debtors, such as Argentina and Bolivia, who have not taken sufficient adjustment measures. [redacted]

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The debtor countries are also calling for ways that would share responsibility for solving the debt problem and assuming losses. The Latin American debtors' conference on 21-22 June may provide a forum for debtors' views. [redacted] the major debtors are unlikely to establish a formal cartel or repudiate their debt, largely because of concern that they would jeopardize access to trade credits and world money markets. Nonetheless, collective action will press creditors for debt servicing concessions and the IMF for easing austerity measures. Even if specific proposals or more hardline positions do not surface from the debtors' conference in June, the sponsors—Argentina, Mexico, Brazil, and Colombia—will have generated political pressure for a stronger stand in bilateral negotiations with creditors. [redacted]

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Implications for the United States

We believe calls for new initiatives to the debt problem increasingly will be heard from LDC debtors, academics, and some Western allies. If not responsive, the United States could be criticized for being insensitive to longer term growth and development needs of LDCs. [redacted]

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Despite new creditor flexibility on multiyear restructurings, any further increase in US interest rates will probably continue to provoke LDC political opposition to US economic policies and strengthen collective calls for easier repayment terms or a new solution to the debt problem. [redacted]

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Moreover, the political strains on the debtor governments are growing, and there is much uncertainty over debtor-creditor positions in upcoming debt negotiations. In this environment, we cannot rule out more radical demands or actions by debtors. For example, a major debtor such as Argentina could refuse to cooperate with the IMF; Argentina or Mexico could call for a global debt conference; or a major debtor could insist on substantially easier terms from commercial banks, resulting in deadlocked negotiations. [redacted]

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While calls for action may simply be rhetoric, Washington could be forced to find a way to respond to creditor and debtor concerns. The Argentine situation bears close watching. US banks again may face another nonaccrual loan problem at the end of June. Bankers are insisting that a letter of intent be approved by the IMF before an agreement can be reached on interest arrearages. Meanwhile, negotiations between Argentina and the IMF are dragging. And even when an Argentine letter of intent is accepted by the IMF's managing director, we believe negotiations between Argentina and commercial banks for the restructuring of 1982-84 maturities and new money will be difficult and prolonged. [redacted]

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