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9 March 1987

PFIAB Meeting

Wednesday, 11 March 1987 - 1030-1200

TAB A Background on the Meeting

TAB B Iran-Contra Investigations

-- IG Analysis of the Tower Report

-- Chronology of your Involvement

-- Your Letter to Senator Boren

-- Response to Bradley

TAB C Gorbachev's Initiative

-- Talking Points

-- Blackwell's Paper "Why Now"

TAB D Brazil Debt Moratorium

-- Talking Points

-- DI Typescript - "Brazilian Debt Moratorium = Potential
International Financial Repercussions" - 26 February 1987

DCI/DDCI Executive Staff

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gm

4 March 1987

MEMORANDUM FOR: D/DCI Executive Staff

FROM:

EA/EXDIR

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SUBJECT: PFIAB Meeting, 11 March 1987

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1. At the Board meeting next Wednesday, Gary Schmitt indicates that the PFIAB would like to hear Bob's views on the Tower Commission and SSCI reports on Irangate and give him a chance to set the record straight with the Board on whatever points he thinks would be appropriate. Scowcroft will be meeting with the Board the following day. In addition, Gary suggests having Bob give a rundown on the Brazil debt moratorium and on Gorbachev's new INF initiative--especially, why now? (In this connection, ACIS, at Gary's request, will be sending something down for the PFIAB members to peruse ahead of time; I'll have ACIS send you a copy of whatever they send to PFIAB.) Bob will be on from 10:30 to 12:00 noon.

2. I understand that the reception for Bob planned for 5:00 o'clock Wednesday afternoon is still on.

3. I also understand (and I think Bob is aware) that PFIAB has decided not to brief NFIC on the results of its SDI study at the NFIC meeting on that subject next Thursday, March 12.

4. Attached is a summary of Agency support for the PFIAB since the last meeting.

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cc: SA/DCI
SA/DDCI

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CIA Support to PFIAB
15 January - 11 March 1987

D/NESA, NIO/NESA and a NESA branch chief met several times with Albert Wohlstetter on the Iran-Iraq war, the internal situation in both countries, and the major lines of analysis reflected in interagency and Agency publications since the Iranian revolution. Prof. Wohlstetter appeared more interested in the analysis concerning battlefield developments than the internal situation. He also focused on Soviet activities and the Soviet threat to Iran and seemed somewhat surprised that this subject had not received more treatment in the interagency arena. Prof. Wohlstetter was planning to use this background and historical information on intelligence analysis of Iran in connection with a speculative paper which he was doing for Carlucci on "whither Iran."

NIO/CT met with Richard Brody (of the PFIAB staff) on perspectives on Iranian support of terrorism.

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Documents Provided

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The Tower Commission and the CIA:
An Evaluation

We have read carefully the Tower Commission Report's discussion of CIA's role in the Iran-Contra affair, and conclude that the Commission's findings and conclusions about the Agency are generally well-founded. Some of the same shortcomings were cited in the initial IG Fact Finding Report; some were mentioned by the A/DCI in his address to employees in the Auditorium; and others were identified in the "Lessons Learned" outline the IG gave the A/DCI last month. We cannot argue with the Commission's principal conclusion: that this was an operation undertaken outside CIA's normal covert operation process and that Agency managers deferred to others--"amateurs"--who ran the show.

Essentially, the Commission found the Agency guilty of sins of omission rather than commission.

- o The operation was not vetted internally, including obtaining the views of the Directorate of Intelligence, as is usually the case with important covert actions.
- o Several tradecraft and command-and-control shortcomings were identified, including the question of why Gorbaniyar was permitted to play such a central role despite his unsavory reputation, the fact that the DDO did not monitor closely the extent of George Cave's work for LTC North, and the implicit criticism of senior officials who did not bring their own professionalism into play in questioning an operation about which they had major misgivings.

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- o DCI Casey is criticized for not pressing the President to have the CIA assume operational control of the Iran operation. Without endorsing the Commission's specific criticism (while still supporting the general thesis that the Agency, not the NSC, should run covert operations), we would argue that a more relevant criticism concerns the DCI's failure to have been more forceful from the beginning in pointing out the potential flaws in the ill-starred scheme.
- o The DCI apparently did not promptly inform the President directly when he was first alerted to the possibility that funds had been diverted to the Contras in early October 1986.
- o CIA officials shunned knowledge of the fact that the Contras were receiving out-of-channel funds, despite its being a legitimate foreign intelligence issue, because they did not want to know the source of such funds.

One possible sin of commission concerns the actions of the Agency at the time of the 20 May 1985 SNIE on Iran. The Commission report alleges that the NSC staff was "actively involved" in the preparation of that SNIE and goes on to note that "it is a matter of concern if this involvement and the strong views of NSC staff members were allowed to influence the intelligence judgments...." However the estimative process worked for that particular SNIE--and it is not an issue the IG addressed in its own report--it seems clear that Commission members perceived or feared that the integrity of the analytic process had come close to being threatened. As the Agency seeks to draw the appropriate lessons from the entire affair so that any mistakes will not be repeated in the future, we would be wise to keep in mind the endorsement for the integrity of the CIA's analytic process that is implicit in the Commission's statement.

It is difficult to compare the Inspector General's report on CIA involvement in the affair with information surfaced by

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the Commission for two primary reasons: (1) the IG was not able to question DCI Casey before his illness, and thus was unable to assess accurately either the extent of the DCI's own involvement or his knowledge in general of the NSC initiative; and (2) we have no way of knowing at this point how valid the many references to CIA are in LTC North's White House Computer messages, which are quoted extensively in the Tower report. With these caveats in mind, we note that it would appear that the roles of some Agency officers--Clarridge, Allen, George, Fiers--were larger than they indicated during the IG's interviews with them. They apparently were consulted more by Ltc North than they told us, even though it is clear that they were only bit players in a much larger drama.

Meanwhile, the IG is investigating further the roles of the above-mentioned officers in an effort to clarify their actual activity. The IG has already learned, for example, that Allen was not totally forthcoming about his role in the operation during our initial interviews with him, and that he failed to provide us with much of his documentary holdings until after the IG report was published. Moreover, the IG investigation into the diversion of funds to the Contras is ongoing and we are not yet in a position to comment on the extent of Agency knowledge or involvement.

We did find some minor factual inaccuracies in the Commission report. For example, on p. B-39, the Commission quotes former DDCI McMahon as saying that General Secord "visited the Agency" to try to obtain assistance in securing an airplane to aid in the November 1985 shipment of Hawk missiles to Iran. To our knowledge, it was LTC North, not Secord (who was in Lisbon) who made the request. Similarly, on p. III-9, the Commission asserts that Clarridge "put Secord in contact with a carrier that was a CIA proprietary." As we understand it, Clarridge dealt directly with North who, in turn, passed the information to Secord. But these are minor points of detail that do not detract from the Commission's main message.

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In one instance, the Commission report accurately ascribes to John McMahon the decision to have the initial Finding cover the use of the CIA's air proprietary retroactively. Then-General Counsel Sporkin had told the IG that the retroactive provision was his idea and we so noted in the report. However, we neglected to note that this conflicted with McMahon's statement, in an interview with the IG, that it was his idea.

In sum, we believe the Agency received fair treatment by the Tower Commission and that its criticisms of Agency officials at the time were largely justified. The Commission's principal overall conclusion, that the Iran-Contra affair "was a failure of people, not process" applies to CIA as well as to the NSC.

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My Involvement with the NSC Iran Initiative: A Chronology

17 May 1985 Receive copy of NIO paper recommending that the US consider allowing European arms sales to Tehran, simultaneously with others inside and outside CIA. Did not know of, review, or approve paper prior to distribution. Was not aware at this time of NSC staff discussions and operational planning that ultimately led to arms sales. Neither did NIO, who authored the paper.

5 December 1985 In capacity as DDI, attend meeting in DDCI's office involving other officers from Intelligence and Operations Directorates. McMahon mentions recent flight to Iran, plans for future flights and Presidential Finding. First awareness of some form of covert action related to Iran.

24 January 1986 Attend meeting in DDCI office involving McMahon, North, Charlie Allen and C/NE. [REDACTED]

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29 January 1986 Meet with Charlie Allen and receive an MFR from him regarding a 13 January meeting he had had with Ghorbanifar. That meeting covered the US hostages and some background on the November 1985 shipment of Israeli Hawk missiles.

Early February See scenario paper prepared by North laying out proposed schedule for exchange of arms and hostages leading to mission to Tehran and strategic dialogue.

18 February 1986 Briefed by Allen on another meeting with Ghorbanifar regarding international terrorism.

19 February 1986 [REDACTED]

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20 February 1986 Recall MFR from Allen related to other discussions with Ghorbanifar.

20 March 1986 [REDACTED]

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<u>16 April 1986</u>	Tower Commission Report refers to communication from North to Poindexter say "C/NE and Gates have urged" North meet with Iranians in Frankfurt. Still DDI, I would not have had such a role. Did receive phone call from C/NE on 16 April and may have been updated on negotiations status at the time.
<u>3 May 1986</u>	Receive a memorandum, also addressed to the DCI, in which Allen reports information concerning Ghorbanifar and release of the hostages.
<u>8 May 1986</u>	Meet with Allen and am briefed on the status of hostage negotiations as well as preparation for the McFarlane mission.
<u>3 July 1986</u>	Meet with Allen. Probably briefed on developments leading to release of
<u>1 October 1986</u>	Allen meets with me to express concern over operational security of NSC initiative and also offer speculation that some proceeds may have gone to support Contras. I tell him to brief DCI.
<u>2 October 1986</u>	DCI and I hold regular weekly meeting with Poindexter. Iran initiative discussed but I did not share Allen's concerns since DCI not yet briefed.
<u>7 October 1986</u>	NIO briefs DCI in my presence. DCI tells him to outline concerns in memorandum. DCI later receives call from Furmark, who provided specifics of unhappy investors. No mention of diversion.
<u>9 October 1986</u>	DCI and I met with North for update on new channel to Iranians -- DCI expressed concerns about operational security. I told DCI we should have copy of 17 January Finding and North agreed to provide. Conversation turned to capture of Hasenfus two days earlier and his public assertion that same day that he was involved with CIA officers. I asked North--as cross-check, if he was aware of any CIA involvement in private funding/support effort. He said no. I made record. During this half of discussion North made cryptic remark re Swiss accounts and Contras.
<u>14 October 1986</u>	NIO memorandum received. In 7 pages only one reference to possibility that unhappy intermediary might allege profits from arms by diverting to "other projects of US and Israel". Even more tenuous than NIO's earlier concern.

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15 October 1986

Call in General Counsel. Relate NIO concern including possible diversion. Asked him to look into CIA's involvement in NSC initiative. He later advised that he found no sign of impropriety. DCI and I meet with Poindexter and have him read NIO memorandum in our presence. We stress concern that project out of control and should be made public. DCI suggests he consult White House Counsel.

17-30 Oct 1986

Out of country. DCI receives additional information from Furmark on 17 and 22 October. On 22 October Furmark for first time mention Ghorbanifar's allegations of diversion to Contras.

6 November 1986

DCI and I meet with Poindexter. DCI again urges that White House Counsel review whole project, also urge that public accounting be made.

17 November 1986

1700 I call DCI overseas to urge him to cut short trip and return to give SSCI testimony on 21 November.

I hold meeting (George, Gries) to lay on draft Testimony providing factual accounting of CIA role.

1845 I call North--presumably to tell him that DCI returning for hearing.

19 November 1986

Serious dispute with North and CIA officer attempting to pull together facts of CIA involvement. North claims neither he or CIA involved in November 1985 flight. Other differences regarding dates.

1100-1300 I have three telephone conversations with North.

1415 meet with those involved in preparing testimony (Gries, George, Doherty, [redacted]) to get update on testimony preparation. Again urge that all facts regarding CIA role be laid out.

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1600 George, [redacted] Cave and I meet with Poindexter in his office to brief him on results of George's 18 November briefing of SSCI and HPSCI staffs.

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Doherty suggests that I seek postponement of hearing until all facts can be accumulated and discrepancies cleared up. I consider but conclude just not feasible. Insist that testimony make clear that not all facts yet in.

DCI returns late evening.

20 November 1986

DCI and I meet with Poindexter to deal with unresolved dispute re November 1985 flight. We join ongoing meeting with Attorney General. I tell North that three of our officers prepared to testify under oath to his involvement. Issue resolved on our terms. I pick up copy of North's chronology.

1645-1830 I attend meeting with DCI and about 12 others for final scrub of testimony. Considerable confusion since DCI was simultaneously editing and revising text and quizzing officers as to their recollection. Considerable discussion of events related to November 1985 flight.

1900 DCI and I depart for day. I have no further involvement in testimony preparation.

Central Intelligence Agency



Washington, D.C. 20505

2 March 1987

The Honorable David L. Boren
Chairman
Select Committee on Intelligence
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I want to set the record straight on several false allegations:

1. Allegation: That I encouraged, approved and disseminated a paper by the NIO for the Middle East in May 1985 recommending that the US consider allowing European arms sales to Iran.

Fact: The memorandum was prepared by the NIO at his own initiative. I did not know that the paper was being drafted, and I neither saw nor approved it prior to distribution. I received my copy simultaneously with others inside and outside CIA. The NIO's actions were consistent with my policy that intelligence analysts feel free to challenge conventional wisdom and provoke debate.

2. Allegation: That CIA colluded with NSC officials in preparation of the May 1985 Estimate on Iran to reach specific conclusions.

Fact: Officials at State, DoD and NSC often request preparation of estimates and list questions they would like to have addressed. In this case, as with other estimates, while the NSC requested the paper, it was not involved in drafting nor was it allowed to participate in the interagency intelligence coordination of the draft. There were no dissents to the Estimate from any agency. The independence and integrity of the intelligence process were preserved throughout. This can be independently corroborated, and has been in the NIO's memorandum to me of 27 February, which I am providing to the Committee. Finally, I might note that a 1986 SSCI report on intelligence estimates recommended that, "once the production of intelligence reporting has begun, the National Intelligence Officer or other appropriate official should consult regularly with the principal consumer to ensure that the concept paper, terms of reference, or other guidance address the appropriate question. This is particularly important with respect to unscheduled product." The report also stated that "the product should explore the effects of alternative policy options."

3. Allegation: That I encouraged an invasion of Libya in the summer of 1985.

Fact: CIA analysis prepared at my direction was the basis for rejection of this policy option. My memo to the Director, which the SSCI has, was downbeat on the chances of success and raised alternative policy options for examination. Officials in DoD and State can independently affirm CIA's role in this.

4. Allegation: That the Attorney General on 21 November launched an intensive investigation of the Iran affair, and especially the possibility of a diversion of funds, based on less information than CIA had.

Fact: The Attorney General has told me that when he observed at the White House on 20 November that there was disagreement between CIA and NSC on basic facts surrounding the November 1985 flight, he became concerned over the need for those who were to testify to have accurate information about the whole Iranian initiative. On the 21st, the Attorney General told the President it was important to get an accurate picture of what had happened and the President asked Mr. Meese to assemble such an accounting. There was no investigation and no indication of possible wrongdoing at that time. It was only in the process of assembling the accounting, including interviews with key players, that the Attorney General found on 22 November the North memorandum indicating a diversion of funds. It was that which changed the Attorney General's effort to assemble facts into an investigation. No evidence remotely resembling the North memo ever came to my attention or, to the best of my knowledge, to the attention of any other CIA officer.

5. Allegation: That CIA participated in a cover-up in preparing the DCI's 21 November testimony to the SSCI.

Fact: This is particularly outrageous. All available evidence substantiates my testimony that I urged getting all the facts before the Committee, and insisted on accuracy and advising the Committee that we did not yet have all the facts on 21 November and would provide them as they were assembled. A note I prepared for the DCI to send to Poindexter on 12 November (provided to the SSCI) in response to a request from HPSCI for a briefing, urged that CIA not appear unless we could brief on the finding and CIA's full operational role. I did not know during the period up to 21 November many of the facts of CIA's role and, while coordinating the effort, did not participate in drafting the testimony. The Director changed a good deal himself in the last 24 hours. The Committee can easily corroborate my effort to have the DCI present all the known facts by interviewing those who did draft the testimony.

6. Allegation: That I acquiesced in the Iran policy, including non-notification of Congress, and turned a blind eye to evidence of diversions of funds to the Contras.

Fact: As Deputy Director for Intelligence, I was not informed of the full scope of the Iran initiative until late January/early February 1986; I had no role in the November 1985 shipment of arms; I played no part in preparing any of the Findings; I had little knowledge of CIA's operational role. When I became DDCI, the policy initiative had been underway for many months and the Finding in place for three months. I received updates on the initiative every few weeks. During the summer, I expressed my concerns to the DCI about the effect of non-notification of Congress and about the policy. As deputy, I had no alternative to this other than resignation. I — along with others more senior in the Administration — did not believe the policy warranted resignation.

In October, I did not turn a blind eye to the speculation about possible diversion I received from our National Intelligence Officer. He acknowledges that I urged him to brief the Director as soon as possible and that he waited a week. I pressed North on whether CIA was involved in private support to the Contras and was assured we were clean. I told our General Counsel all I knew about the Iranian initiative, including the operations security concerns as well as the speculation regarding the funding. I asked him to ensure that CIA's activities were proper and sought his advice. And, I took his advice to get the information we had to Poindexter and recommend review by White House Counsel. Had he recommended we go to the Attorney General, I likely would have done so. In October/November, I was not given pertinent information by our own people and was misled by the NSC. In my role as deputy, and with little information, I acted to assure CIA's adherence to the law, followed the advice of our lawyers, and brought what little information I had to the attention of those who could properly evaluate it and act — our General Counsel, the DCI and Admiral Poindexter.

There is nothing in four independent investigations (the CIA Inspector General's report, the Senate and House Intelligence Committees' investigations and the Tower report) plus my 13 hours of testimony to the SSCI that is in substantial disagreement with this description of my role. I should have argued harder for notification and I should have been more aggressive in October, but I advised my boss of my concerns and took action to bring information to the attention of the highest ranking officials to whom I, as deputy, had access — the DCI and the National Security Advisor. I continue to believe that the steps I took were reasonable, that the advice I received was sound, and that CIA's actions were proper.

7. Allegation: That I lack independence.

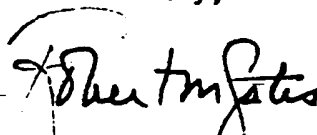
Fact: The far-reaching organizational, procedural and methodological changes I made in CIA's analytical directorate challenged long-established practice and attitudes. The results in terms of improved intelligence have been widely and publicly recognized. I am, and always have been, a challenger of the status quo. Moreover, the integrity and independence of intelligence assessments has been preserved and protected. It is not unusual for our assessments to challenge or be at odds with the positions of policy agencies, including The White House. A list of examples has been made available to the Committee; more

are available. We call them as we see them. And, in the last six years, the Senate Intelligence Committee has not brought to our attention a single instance of what they believed was slanted or politicized intelligence -- and they get it all. We are sometimes wrong, but we are proud of our independence.

I have worked with this Committee on a regular basis for more than five years. During that time I believe the Committee has found me forthright, candid and responsive. Similarly, it is my impression that my actions as Acting Director over more than three months, particularly with respect to trying to establish a new and more satisfactory relationship with the Committee, have met with approval.

I appreciate this opportunity to correct the most egregious allegations against me. I intend to make this letter available to the press to correct the public record.

Sincerely,



Robert M. Gates
Acting Director of Central Intelligence

cc: The Honorable William S. Cohen
Vice Chairman
Select Committee on Intelligence

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ANIO/USSR
2 March 1987INF: WHY NOW?

The timing of the Soviet decision to move away from its package approach to arms control comes as something of a surprise. While movement on INF has been one option for ending the Iceland stalemate from the beginning, the Soviets provided little advance warning that they intended to move in this direction (save for Vorontsov's briefing the proposal to Kampelman a few hours before the announcement). Why did Gorbachev decide to move now during the nadir of the administration? What are Soviet calculations?

Beyond a desire to preempt our scheduled tabling of a draft treaty on Tuesday, a number of considerations were likely involved. First, Gorbachev knows that his approach at Iceland has run its course. There is little or no prospect that any agreement on arms control can be reached if the USSR holds to its package concept. Continuing to hold to it makes it appear that the USSR is the primary obstacle to progress. Gorbachev's strategy up until now has reflected a desire to avoid giving any such impression. (1)

Second, Gorbachev is impatient. He has a bias for action and a distinct distaste for lack of progress on achieving his objectives. In this case he wants to keep the pressure on the US to deal on arms control. He probably thinks that reaching agreement on INF -- a peripheral issue -- will generate political pressure within the US to work the main issues (SDI and strategic arms). He does not want to wait another two years to get this going, especially given the uncertainties of what will follow and the inevitable need for a new administration to take some additional time to get its views set on this issue. (2)

Third, he wants to further isolate the US from its allies in Europe and indeed, build pressure on European governments from their own publics to pressure the US. To do this he has singled out the one issue where agreement in principle already exists and signaled that European concerns about Soviet short range systems will be addressed. This will make it very difficult for the basing countries to oppose an agreement although privately they are nervous about any hint that Europe is decoupled from the US nuclear umbrella. It is also apparent that Gorbachev thinks the Zero-Zero Option in Europe is a good deal on its own merits removing a US threat with little real degradation in Soviet capability, enhancing Soviet political influence in Europe, and at the same time encouraging anti-nuclear sentiment in Europe. (3)

Fourth, he knows the administration is politically vulnerable at home and badly in need of some victory to restore credibility to its management of foreign policy. The Soviets have publicly been divided on the implications of Iran/Contra for the President's ability to negotiate but on the whole it is highly likely that Gorbachev's advisers (Dobrynin and Yakovlev) see the President's predicament as a real opportunity for the Soviet Union to play its cards. The position on short range systems is designed to make it difficult (4)

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for the administration's arms control skeptics to use poison pills to knock it down. They may calculate that disagreements within the administration on verification and allied opposition to highly intrusive verification regimes will also make this issue less of a factor than it otherwise would be.

There may be some inclination in town to see this initiative as a reflection of Soviet internal politics. The political temperature in Moscow has heated up considerably and indications of resistance and even opposition to his agenda abound. But, if it is, it clearly suggests a Gorbachev that still has the bit between his teeth and room to run. The proposal if anything is more forthcoming than any the Soviets have put forward on this issue and contrary to the implications of the recent Rogov report almost certainly would have required Gorbachev's active support. As in Iceland, however, he reduced his political exposure by associating the Politburo with it; he even invoked the authority of the Defense Council which he heads by making the first public reference to his chairmanship of that body.

Finally, Gorbachev has made a tactical judgment that an INF agreement is all that he likely can get from this administration and decided that now is the time to make his final effort to cut a deal. He probably believes that there is already enough agreement on this to make it possible to finalize a treaty within the year and sign it at a summit in Washington. This would provide him a grand stage to promote his broader agenda on the eve of the 1988 Presidential primary season. (2)

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Central Intelligence Agency
Washington, D.C. 20505

DCI/DDCI Executive Staff

10 March 1987

NOTE TO ADCI

In addition to Bob Blackwell's paper on "Why Now", [] and Larry Gershwin have produced separate but coordinated papers on various aspects of INF. Attached is a memo from Larry on his concerns about the current momentum. Behind that are two papers from [] one on INF key issues and one on the verification package, and finally a paper from Larry on monitoring the draft INF treaty. You have so much material here that I have pulled out some of the other background Larry provided to which he refers in his "concerns" memo. I am holding it if you should need it.



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The Director of Central Intelligence
Washington, D.C. 20505

NIC-01054/87
10 March 1987

National Intelligence Council

MEMORANDUM FOR: Acting Director of Central Intelligence

FROM: Lawrence K. Gershwin
National Intelligence Officer for Strategic Programs

SUBJECT: Monitoring an INF Agreement

1. I am concerned that with the current momentum towards trying to conclude a separate INF agreement with the Soviets, monitoring issues will take a back seat, despite the Intelligence Community's longstanding and current emphasis on this issue. This may sound paradoxical, since several senior US officials have said publicly that breakthroughs have been made on verification, specifically with respect to on-site inspection. An impression is being created, at least with the public and possibly within the US Government, that on-site inspection is a panacea. As US intelligence has pointed out before, the monitoring situation is considerably more complex. [REDACTED]

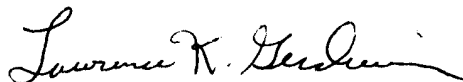
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3. If you'd like to discuss this further, please call. I have shown this package to [REDACTED] and we are in agreement on the potential for problems down the road and the need for continued efforts by all of us.

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Lawrence K. Gershwin

Attachments:
As Stated

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9 March 1987

TALKING POINTS FOR ADCI

Brazil's Debt Situation and Potential Repercussions

Backdrop. Brazil's current economic crisis is rooted in the growth-oriented economic policies Jose Sarney embarked on to bolster his popular and political standing after he unexpectedly ascended to the Brazilian presidency in April 1985.

- Freespending policies spurred 8 percent growth--fastest in the world in 1985--but drove up inflation to double-digit monthly rates which Sarney viewed as a threat to his democratic government.

To halt the inflationary spiral, he announced the Cruzado Plan in February 1986--sweeping price-wage controls, currency reform, and an end to the indexation system.

- Inflation was stopped in its tracks, the balance of payments remained strong, growth boomed, and Sarney's public approval rating soared to 90 percent overnight.
- The program's immense popularity caused Brasilia to hesitate from implementing necessary economic adjustments for fear of losing support in the November 1986 elections.
- Consequently, shortages surfaced, inflationary pressures resurged, and the strong trade surplus dwindled.

Sarney's coalition party campaigned on a pledge to preserve the Cruzado plan, but six days after scoring a resounding electoral victory Brasilia announced economic correctives.

- The abrupt announcement caused a firestorm of political protest and a sharp decline in Sarney's popularity.
- The loss of confidence in the government led to a rapid economic slide. Inflation skyrocketed from 2 percent in November to 20 percent in February. The trade surplus plunged from \$800 million in October to \$100 million since November, making debt repayment increasingly difficult.
- To regain political support and protect nearly depleted international reserves, Sarney announced an indefinite suspension of interest payments on longer-term foreign debt on 20 February.

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Current Situation. Sarney's unilateral debt action has scored political points at home and the government is now searching for options to resolve the country's economic difficulties.

- Sarney has recovered political ground temporarily; polls indicate the decision was supported by voters and endorsed by the coalition.
- Nevertheless, he is not capitalizing on his political rebound to implement needed economic adjustment policies.

At the government-to-government level, Brasilia is now pressing for a political solution to its debt problem.

- No negotiations have been set with commercial banks, probably because Brasilia has not developed an economic program or a consensus about what it will seek from creditors.

International Repercussions. Bankers report concern that other Third World debtors will follow Brazil, but a "bandwagon" effect is not developing.

- Initial reactions have been low key, especially as creditors have mobilized to settle outstanding issues with other debtors in an effort to isolate Brazil.

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Directorate of Intelligence Coverage. We continue to devote substantial analytical resources to monitoring the evolving Third World debt situation.

- For example, our Brazil branch alerted officials to problems with the Cruzado Plan in the International Economic and Energy Weekly last August and followed by publishing regularly on that country's economic and political difficulties for the National Intelligence Daily. In early February they issued an Intelligence Assessment entitled, "Brazil: The Demise of the Cruzado Plan."
- A Directorate task force was convened in advance of 20 February to analyze the potential repercussions of a Brazilian moratorium, and this study was issued as part of a special edition of the Financial Situation Report on 27 February.

- The Directorate is drafting a Special National Intelligence Estimate entitled, "Brazil: Outlook for Debt."
- We are bolstering our economic and financial coverage of the key Third World debtors in the International Economic and Energy Weekly and will convene our country analysts and international financial experts at least monthly to discuss evolving trends.

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Central Intelligence Agency

Washington D.C. 20505
DIRECTORATE OF INTELLIGENCE

26 February 1987

**Brazilian Debt Moratorium: Potential International Financial
Repercussions.** [REDACTED]

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Summary

Brazil's decision to suspend interest payments indefinitely on its medium and long-term debt is fraught with risks. Given its potential repercussions, we have analyzed the likely impact of this move on Brazil, on the other key debtors, and on their creditors. Our analysis has been developed by using the experience of our country analysts, international financial experts, and the Directorate's most-seasoned economists. We are projecting the consequences of the Brazilian move during a six month time horizon. We have also identified the key factors that could condition the outcome.

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This typescript was prepared by [REDACTED]

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[REDACTED] the Offices of African and Latin American Analysis, East Asian Analysis, Global Issues, and Near Eastern and South Asian Analysis. Comments and queries are welcome and may be directed to the Chief, South America Division, ALA, [REDACTED]

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Following Brazil's unilateral moratorium on interest payments, we believe:

- Brazil's economy will continue to grow for several months despite higher inflation and more difficulties in conducting trade;
- This action will shock financial markets--it immediately drove down bank stock prices--but probably not lead to destabilizing financial panic.
- Other key Third World debtors will not initially follow the Brazilian move, despite rhetoric to the contrary, nor band together to answer a call for multilateral debtor action.
- Rather, the debtors will carefully monitor creditor response--particularly ones showing retaliation against Brazil and willingness to negotiate--for signals that they should reevaluate their debt management strategies.
- International cooperation in resolving debt problems could be derailed by a series of swing factors--sudden shifts in economic teams, volatile domestic political events, imitative behavior, sudden economic deterioration, and a hostile creditor response.
- Successive debt payments suspensions by other key Third World debtors could occur if debt rescheduling and new money negotiations break down.

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The Motives

On 20 February, President Sarney announced that the country would suspend interest payments on Brazil's \$65 billion medium-and-long term debt to commercial bankers for an unspecified period. He indicated that the suspension was necessary to preserve Brazil's foreign exchange reserves, which have plunged since September and are currently reported to be from \$1.5 to \$3.9 billion, levels Brasilia reportedly considers to be an absolute floor. Moreover, assessment that an overvalued cruzado and shortages of key components for exports will mean the trade surplus will not likely recover from its recent monthly level of \$100 million before April. In addition, we know of no significant capital inflows programmed for Brazil through March. In addition, we believe Sarney was unable or unwilling to fend off intense

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inflows programmed for Brazil through March. In addition, we believe Sarney was unable or unwilling to fend off intense political pressure from several groups within Brazil--including the left, labor, and some influential members of the ruling coalition--to suspend payments. [REDACTED]

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Impact on Brazil

According to initial US Embassy reports, the unilateral action against creditors has met with general public approval, although it has drawn some critical response from the conservative press in Brazil. According to the Central Bank, interest payments will be held in a blocked account in Brazil while the suspension remains in effect. Initially, we believe, Brasilia will accumulate these payments as a war chest of additional reserves. Consequently, the suspension of payments would add some \$800 million per month to the Central Bank's coffers. [REDACTED]

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We also believe that Brasilia will soon be tempted to use this cash windfall to support growth-oriented policies--the major economic priority of the populist Sarney government. With the funds saved by suspending payments, Brasilia will probably seek to increase imports in an attempt to alleviate domestic shortages of key foreign intermediate and producer goods and sustain growth. Within a month or two, we anticipate Brazil will encounter increased difficulty in conducting trade, except on a cash-and-carry basis. Because trade will become more expensive, inflation will begin accelerating in the subsequent six-month period. [REDACTED]

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Immediate Financial Impacts-The System Holds

The unilateral Brazilian moratorium on interest payments hits world financial markets at a time when several other Latin American debtors are in the process of negotiating new financial packages. A review of all source intelligence indicates that:

- Mexico has yet to complete its \$7.7 billion new money package from commercial banks.
- Argentina has begun negotiations for \$2 billion in new bank loans.
- Venezuela is in the midst of negotiations for lower interest rate spreads, a reduction in scheduled principal payments and \$400-600 million in new financing.

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-- Ecuador is bargaining for an immediate loan to cover its cash-flow difficulties. [REDACTED]

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In cases where negotiations are nearing agreement on rescheduling and new money, we anticipate talks will proceed. For example, Chile agreed with bankers on 23 February to reschedule \$12 billion of extensive debt and retime its interest payments to save \$535 million. Given stronger institutional arrangements than were in place in 1982, creditors are unlikely to "cut-and-run" or retract short-term credit facilities. Nevertheless, with \$25 billion in US loans at risk, Wall Street was shaken by the Brazilian announcement, with bank stocks declining on 23 February. Prior to Sarney's announcement, press reports indicated that bank stocks dropped slightly in West Germany and Japan. [REDACTED]

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Banker Reaction

The scanty public reaction so far from international banks indicates they are hopeful that new negotiations can lead to an agreement to lift the moratorium on interest payments. According to a press report, Brazil's Bank Advisory Committee will request that Brasilia obtain an IMF program in return for financial assistance. Other press commentary indicates that Brasilia is preparing to table proposals for major financial concessions, but we cannot confirm or deny these reports. Brazil's bank advisory committee (BAC) has already set a date in early March for financial negotiations. Some banks, especially smaller US and foreign banks, are likely to try to cut trade and interbank lines, but Brasilia has contingency plans in place to freeze these facilities to prevent a major runoff. Full scale banker retaliation, however, would occur only if Brazil completely stops servicing its debt for an extended period. [REDACTED]

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Spillover Effects

Mexico stated it will continue to service its debt and not follow Brazil in declaring a debt moratorium. We believe President de la Madrid will continue to adhere to the rules of the game in order to get promised credits needed to expand the economy as the 1988 elections approach. [REDACTED]

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Argentina indicated it would suspend interest payments on its debt if western banks refuse to provide new loans, but we believe it will not initially follow suit. We judge that President Alfonsin would not jeopardize recent progress on inflation, structural reform and World Bank and IMF loans. Nevertheless, we interpret the Argentine statement as exerting maximum pressure on commercial banks for \$2 billion in new money,

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a risky gambit. We believe Alfonsin will continue to rhetorically support Brazil, but will stand firm in the face of political pressure for radical action on its debt for the immediate future. [REDACTED]

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Although Brasilia claims that Caracas has cabled its private support, Venezuela's President Lusinchi will be slow to react publicly, seeking consensus before making any moves and assessing creditor response to Brazil's action. [REDACTED]

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In the Philippines, Finance Minister Ongpin is likely to advocate continued negotiations with creditors to avoid jeopardizing financial packages now in place and nascent economic recovery. [REDACTED]

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Egypt is unlikely to experience any near term adverse impact. The Mubarak government recently moved closer to reaching an agreement with the IMF over the terms of a standby agreement. Moreover, with most of Egypt's external debt in the form of public and publicly guaranteed obligations, the major portion of the debt rescheduling exercise will take place within the relatively congenial confines of the Paris Club. [REDACTED]

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Creditors' Unfolding Response

Because Brazil's move is unlikely to create an immediate bandwagon effect with other debtors, creditors will most likely focus their energies on Brazil. Last year, for example, Mexico's financial predicament caused creditors to postpone other negotiations. If discussions became protracted, negotiations with other debtors could be pushed aside for many months. [REDACTED]

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Given generally reliable reports that bankers insist that Brasilia must tackle its basic economic problems before new funds will be forthcoming, we anticipate most major banks will initially take a hard line.

- The BAC will continue to demand an IMF-supported program to obtain new bank credits and a restructuring agreement even if Brasilia initially refuses to cooperate with the Fund.
- The BAC will closely scrutinize and contest Brazil's economic and financial data.
- The BAC will resist agreeing to concessions similar to those Mexico received.

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- The BAC will insist that raising new medium-term credit will be extremely difficult, in part because smaller banks will refuse to participate.
- European and Japanese creditors will be unwilling to put up substantial new funds for Brazil; they can resist Brazil's demands because of reserves against troubled loans.

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Swing Factors-The Signs to Watch

Events could unfold in a very different manner if the debtor governments' and private creditors' assumptions were different from those we postulated. In the event pivotal swing factors came into play, the world financial system could be rocked by successive debt payment suspensions.

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Shifts in Economic Teams. We have identified at least one instance where a ministerial shift could result in a policy change adverse to US interest. According to our Philippine analysts, if current negotiations with the banks break down and confidence in the economy falls, Ongpin may lose President Aquino's confidence and a harder line might prevail. In that event, Manila will be more likely to look to the other debtors for support in forging a new financial deal. If an agreement with the commercial banks does not appear likely and Brazil calls on debtors to join together and press the banks for a better deal as a group, then Manila might join.

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Internal Political Pressure. Several analysts spotlighted internal politics as a crucial and volatile swing factor. For example, our Ecuadorean analysts observe that Febres-Cordero has swung from one of the most financially responsible nations in South America in honoring its foreign debt obligations into technical default. He has been on the defensive since his temporary abduction by Air Force paratroopers last month and he does not want to be seen slashing reserves to satisfy foreign economic interests. he has been angered by bank demands for assurances that Ecuador will not seek recourse to new money to meet February debt service repayments. He feels Ecuador deserves special consideration, given his administration's responsible debt payment record.

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In another assessment, the analyst for Venezuela speculates that strong public opinion against debt repayment could cause Lusinchi to change Venezuela's course. Lusinchi's political opponents have already capitalized on the administration's relations with creditors, claiming the president is bowing to foreign interests in the current negotiations.

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Imitative Behavior. The situation could be made worse if other debtors imitated Brazil. According to our experts, elements within both the Egyptian government and the political opposition who are opposed to what they see as intervention by the IMF, may be emboldened by a Brazilian debt moratorium. They could attempt to block final approval of the standby program, which could force a de facto payments suspension. [REDACTED]

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Creditor Response. We judge this is potentially the most important factor. Bankers are growing weary over the many protracted negotiations and are divided over how to handle debtors. If bankers continue their hardline with Brazil and it spills over to other debtors, these factors could lead to long delays in reaching agreements for new money and rescheduling. If other key debtors then experienced financial crises, these governments would reconsider their strategies. For example, according to our country expert, Mexico's stance over the longer term likely would be affected by the way creditors responded to Brazil. The strategy of de la Madrid or his successor almost certainly would change if creditors failed to retaliate against a Brazilian moratorium or if Brasilia appeared to gain by its actions. [REDACTED]

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