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LDC External Debt: Significant Trends and Risks



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An Intelligence Assessment

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*GI 86-10063
September 1986*

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LDC External Debt: Significant Trends and Risks

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An Intelligence Assessment

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**LDC External Debt:
Significant Trends and Risks**

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Key Judgments

Information available
as of 15 August 1986
was used in this report.

Falling prices for oil and other commodities are causing a major resurgence in LDC economic strains and, in turn, LDC demands for external financing and debt relief:

- **Mexico**—facing dwindling reserves, negative growth, and rising inflation—may request that a \$12 billion international rescue package be assembled that includes \$6 billion in new commercial bank loans for 1986 and 1987 and a contingency fund to cover earnings losses from a further oil price decline.
- **Argentina's** economic program is faltering and Buenos Aires is likely to ask for as much as \$1.5 billion a year for 1986 and 1987—or it might seek interest rate concessions—coupled with a program to reschedule about \$14 billion of debt due during those years.
- According to Embassy reporting, **Venezuela** may request \$600 million in new money, ask for postponement of \$3.4 billion in principal repayments due during 1987-89, and seek further unspecified concessions on interest rates.
- **Peru** has serious problems with its relations with creditors, and there is a danger that it may be the first debtor in recent years to be formally declared in default. Already, the International Monetary Fund (IMF) has declared Peru ineligible to draw on Fund resources.

Although its trade prospects are improving, **Chile** continues to struggle with low copper prices and is now expected to seek at least \$450 million in new money for 1987 to 1988. Santiago also plans to ask for postponement of commercial bank principal repayments for 1988 to 1990, according to Embassy reporting.

Bank creditors expect **Egypt** will need a debt rescheduling soon—its first—to help offset sharply lower oil export revenues and worker remittances.

Nigeria will need as much as \$1 billion in new loans annually over the next few years, according to World Bank estimates, even with maximum debt rescheduling. Lagos still must request an IMF standby arrangement to obtain commercial bank new money and a Paris Club rescheduling.

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Raising new money or obtaining debt relief will be difficult for these heavily indebted countries, even with IMF-supported economic programs in place. Doing so will put the biggest US and foreign banks in riskier positions. These banks remain a diverse group whose interests, commitments, and financial strength vary between and within countries, making it difficult for them to organize and lead efforts to boost lending to LDCs. Commercial banks with small LDC exposure, for example, increasingly are opting to write off troubled LDC loans and take a loss rather than contribute to fresh loans they believe would not be repaid. As a result, forced bank lending over the next few years is likely to be concentrated even more among the world's largest banks—increasing both the burden and the risk of new LDC exposure for these banks.

In our view, debtor-commercial bank negotiations during the next 18 months probably will result in some middle ground between the extremes of large sums of forced new lending and partial debt forgiveness by commercial banks on one hand and unilateral debtor action on the other hand. The costs of a complete breakdown in relations—earnings losses for banks and curtailment of loans for debtors—are too high. Potential actions by debtors and creditors alike will produce many situations in which the US Government may be called upon to intercede:

- Washington will have to stay involved in the Mexican negotiations with commercial banks, where the short-term risks are that foreign creditors will be unwilling to supply new money in the amount requested because of disagreement over Mexican proposals, thereby dragging out financial negotiations.
- If a major debtor country chooses not to play by the current rules of the debt game, Washington will be called upon by international banks to use its leverage to bring the debtor around or to provide new regulatory changes to help cushion the resulting bank losses.
- If the United States were to go into a recession, if dollar interest rates were to rise, or if US trade protection were to grow, the LDC debt service problem would increase and debtors would demand countering actions from Washington.

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- As economic troubles continue in the major debt-troubled countries, further calls for Washington's leadership in providing an orderly way to write down LDC debt can be expected.

Finally, despite recent modest improvements in US banks' financial positions, debt repudiation or a long-term interest payment delay by a major debtor still would present a serious problem. The greatest danger to the solvency of the US banking system would be if other countries joined that debtor's action. Although the likelihood of an outright repudiation is small, there is substantial risk of a debt-troubled country acting unilaterally to curtail its debt payments if it cannot find further orderly ways to reduce them.



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LDC External Debt: Significant Trends and Risks

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The Debtor's Perspective: Increased Relief Needed

In an atmosphere of continued reduced bank lending and dubious prospects for other sources of financing—such as foreign aid or direct investment—the major debt-troubled countries continue to face an economic development crisis. The high rates of economic growth obtained during the 1970s and early 1980s with big government spending and massive external borrowings are no longer possible. Moreover, many LDC government officials believe that the classical approach to balance-of-payments adjustments taken by some since mid-1982—to improve export performance and cut imports with monetary and fiscal measures, including realistic interest and exchange rate policies—has not worked. Indeed, after four years, the debtor countries appear no closer to gaining access to voluntary, substantial medium-term loans from commercial banks. Also, living standards have fallen, unemployment has risen, inflation remains a worry, a rising share of domestic savings goes into interest payments, and domestic investment has slowed dramatically. In effect, economic development for many LDCs has been deferred to preserve limited creditworthiness in the international financial markets. The net outflow of resources from these countries to commercial banks and creditor countries totaled some \$22 billion in 1985 and is continuing to a similar extent in 1986. []

Debt service payments will remain onerous for the next several years. For some major debtors, past restructurings have created new repayment schedules that cause scheduled principal repayments to peak during the second half of the 1980s (table 1). Therefore, many LDCs will need to restructure their debt during the next several years to keep payments manageable if large sources of new financing are not available. []

LDC debt probably will reach about \$855 billion by yearend 1986—up some \$21 billion from yearend 1985. We project that LDC debt service payments will be about \$115-120 billion in 1986, about the

Table 1 *Billion US \$*
**The 10 Major Debtors:
Projected Future Principal Repayments, ^a
1986-91**

	1986	1987	1988	1989	1990	1991
Argentina	9.3	6.2	5.0	4.5	3.5	3.0
Brazil	13.5	13.9	13.2	13.9	12.0	7.6
Chile	0.5	0.4	3.1	2.7	2.2	1.6
Indonesia	2.6	2.9	3.4	3.6	3.4	2.9
Malaysia	0.9	1.0	1.5	1.6	1.6	1.5
Mexico	6.2	7.1	6.5	8.0	8.1	8.5
Nigeria	3.3	2.7	2.3	1.8	1.1	0.8
Philippines	0.8	2.1	2.7	2.1	2.7	2.6
South Korea	4.0	4.3	4.1	3.7	2.8	2.3
Venezuela	3.9	3.9	2.9	2.5	2.0	1.2

^a For medium- and long-term debt contracted as of December 1985. Includes 1985 reschedulings. Future prepayment, restructuring, or cancellation of principal would alter this schedule.

[] same as last year.¹ Continued debt reschedulings and lower interest payments would help offset the overall growth of the debt stock, keeping debt service payments from rising rapidly and providing some relief to the overall LDC payments position. Given the stagnation of LDC exports, however, the aggregate LDC debt service ratio will remain high and constrain improvements in their debt situations. In this environment, we expect a major resurgence in LDC demands for external financing and debt relief and increased deterioration in their economic performance. []

¹ For further information on quantitative debt trends, see appendix, "LDC Debt Analysis." []

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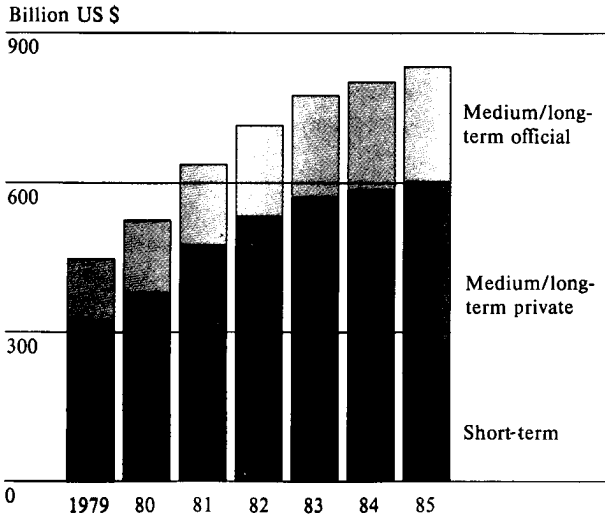
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Figure 1
Aggregate LDC External Debt,
1979-85



climate in Latin countries.

Mexico may request \$6 billion in new loans from banks as part of an overall \$12 billion, 18-month new money package. It also may ask for a contingency fund to cover earnings losses from a further oil price decline or to boost economic growth if current actions and lending are insufficient. These negotiations with banks are likely to be arduous, however, lasting at least two to as long as six months, and it is not certain that banks will be willing to provide all Mexico wants. Meanwhile, Mexico continues to face difficult problems, despite its recent signing of an International Monetary Fund (IMF) letter of intent. Gross domestic product (GDP) is projected to fall 4 to 5 percent this year and inflation may reach 100 percent; we expect the inflation level to reach as much as 120 percent by the end of next year. More important, many of the policies that are at the root of Mexico's economic problems have not been changed—for example, the lack of privatization and foreign investment—and President de la Madrid is likely to resist adopting difficult economic reforms.

Individual Country Situations. Despite the similar financial problems experienced by debt-troubled countries, we believe the debtor countries are beginning to diverge into two distinct groups. Favorable global economic conditions—such as falling oil prices—and the results of a greater commitment by some countries—Brazil and Colombia—to economic adjustment are primary factors leading toward an improving economic performance. On the other hand, in debtor countries such as Mexico, Venezuela, and Peru, the prospects are for unsteady economic growth and continuing financial problems because they are unwilling or unable to undertake the necessary economic reforms that will build confidence and attract foreign capital. In our judgment, the differences among debtor countries probably will become more distinct in the coming years.

Brazil and possibly Argentina are the only major debtors who can undertake substantial structural economic reforms at this time, given the political

Argentina is likely to begin negotiations with the IMF soon on a new standby agreement. Buenos Aires is likely to ask for \$1.5 billion a year for 1986 and 1987, but international banks would prefer to lend no more than \$1 billion. Alternatively, Buenos Aires might seek interest rate concessions. In addition, Argentina is expected to ask the banks to reschedule about \$14 billion of debt due during 1986 and 1987. On the economic front, the Austral Plan to lower inflation is faltering, despite its early success. GDP growth has been slow, inflation is on the upswing again, and this year's fiscal deficit is running above the targeted 3 percent of GDP. Investment continues to stagnate as a forced savings plan funnels capital to the government and discourages foreign investors from making new commitments. Over the longer term, major obstacles facing Argentina include a bloated public sector, an

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Table 2
The 15 Largest LDC Debtors,
Yearend 1985

Billion US \$

	End-1985 Debt
Total	578.7
Brazil	109.1
Mexico	103.7
Argentina	50.2
South Korea	50.2
Venezuela	35.7
Indonesia	34.1
Egypt	29.1
India	28.5
Philippines	26.3
Chile	21.0
Nigeria	20.5
Algeria	20.0
Malaysia	19.3
Thailand	16.6
Saudi Arabia	15.8

inefficient and protected industrial sector, and an overdependence on agricultural exports. Meanwhile, difficult external trading conditions—notably falling grain prices—are likely to prevent any improvement soon in the balance of payments. []

As a result of the lower oil prices, *Venezuela* has indicated it wants to revise its February debt rescheduling agreement. According to press reporting, Caracas is considering requesting \$600 million in new money from its 75 largest bank creditors, asking to postpone \$3.4 billion in principal repayments due during the period 1987-89, and seeking further unspecified concessions on interest rates. None of these actions deal directly with Venezuela's fundamental economic problems, including dependency on oil; a highly restricted, controlled economy; and a need to devalue its currency and unify its exchange rate to become more competitive. Moreover, Caracas's relatively strong position of 1985 has been dramatically worsened by the collapse in oil prices:

- Petroleum export revenue will drop by at least \$5 billion from last year.

- The oil collapse will cause the public-sector fiscal accounts to post huge deficits.
- A recently announced economic package is likely to have a depressing effect on the domestic economy.

Chile also remains in dire financial straits, suffering from a heavy dependence on depressed copper export receipts; a high external debt load—its debt-to-GDP ratio is 120 percent, among the highest in Latin America; high but declining unemployment; and large internal debts. Santiago is now expected to seek at least \$450 million in new money from international banks for 1987 to 1988 and to ask for postponement of commercial bank principal repayments for 1988 to 1990, according to Embassy reporting. []

Ecuador's prospects have been dampened by low export prices. Negative economic growth and a current account deficit of \$750 million is expected this year. Bankers apparently have been made nervous by the unexpected depth of the oil price plunge and initially were reluctant to commit to a \$200 million syndicated loan secured by oil receipts. The loan is a key component of efforts by Quito to cover its external financing gap. Meanwhile, the IMF postponed a decision for two weeks in early August to approve a new arrangement because Ecuador had not implemented economic adjustment measures, particularly devaluing the sucre. We believe a continuation of low oil prices will necessitate the implementation of severe—and highly unpopular—austerity measures and could force the government to request additional relief from debt payments to assure minimum import levels. []

Peru is heading toward a severe economic crisis, in our judgment. Large real wage increases and big tax cuts have temporarily spurred economic growth, but inflation—currently 70 percent—is running far above the government's annual target of 40 percent. Because the government's budget deficit is growing—it could exceed 10 percent of GDP this year—we expect Peru will have to print more money, and inflation could exceed 100 percent later this year. Export revenues are lower this year not only because of falling oil and

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mineral prices but also because of the overvalued exchange rate. In addition, Peru has serious problems with its relations with creditors, and there is a danger that it may be the first debtor in recent years to be formally declared in default. In mid-August, the IMF declared Peru ineligible to draw on Fund resources when Lima failed to clear its arrearages to the Fund.

In Central America, the Core Four countries—*Costa Rica, El Salvador, Guatemala, and Honduras*—may become increasingly restive concerning their financial squeeze. Their \$11 billion collective external debt is small compared with most other LDCs, but weighs heavily on their equally small, cash-starved economies. For each of the four countries, relations with creditors are strained, and the region's political leaders perceive their problems as receiving short shrift from an international financial community that pays greater attention to the largest debtors. US Embassy reports indicate Core Four leaders reason that creditor concessions are more important for their new democracies than for the rest of Latin America because the risk of political instability is greater. IMF and World Bank data indicate debt service for the Core Four will remain high at least through 1987, and the region's leaders can be expected to increase pressure for debt relief, possibly focusing on the US Government—creditor for about 14 percent of the four nations' debt.

Alone among the major Latin debtors, *Brazil* and *Colombia* have achieved some modest success in their external adjustment efforts. Brazil—resource rich and with strong export performance—is continuing its drive toward sustained growth despite its large debt load. In Colombia, a recent coffee bonanza and President Barco's Liberal Party's majority in Congress probably will enable it to sustain economic growth, reduce unemployment and inflation, and strengthen external accounts.

In Africa, foreign bank creditors expect *Egypt* will soon need its first debt rescheduling to help offset sharply lower oil export revenues and worker remittances. Recent statements by President Mubarak and other high-level Egyptian officials suggest Cairo has accepted the

inevitability of an IMF-supported adjustment program, but Egyptian attempts to extract a lenient economic adjustment program from the Fund might well complicate progress toward an agreement and subsequent debt rescheduling. Cairo's latest reform measures, proposed in July, still fall short of requirements for IMF and World Bank assistance, particularly concerning the budget deficit, domestic credit expansion, and exchange rate reform. The Fund reportedly does not expect an agreement with Cairo for at least several months.

Plunging oil export earnings—97 percent of total foreign exchange receipts—have created financial turmoil in *Nigeria*. Oil earnings were halved from \$24 billion in 1980 to almost \$12 billion in 1985, and probably will drop another 40 percent this year to less than \$7 billion. Against this, Nigeria's scheduled debt service obligations are about \$5 billion this year, on top of an import bill of at least \$6 billion. Even with the maximum possible debt rescheduling, Lagos would still need at least \$1 billion of fresh loans annually over the next few years to maintain essential imports, according to World Bank estimates. Lagos still must request an IMF standby arrangement—which it has avoided so far—to obtain commercial bank new money and a Paris Club rescheduling, and even then negotiations would be likely to drag on through the end of this year.

Morocco has asked banks for rescheduling and \$200 million in new loans to help cover an expected \$500 million financing gap this year. The country's IMF accord was scuttled in June because of failure to meet economic adjustment targets, however, and, while Rabat plans to negotiate a new standby, differences over such politically sensitive issues as price hikes probably will delay agreement for several months. In the meantime, the country's foreign exchange crunch—which already has resulted in at least \$500 million in trade credit arrearages, according to the IMF—will worsen, threatening creditors' willingness to offer future trade finance.

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In Asia, the greatest problem is the *Philippines* which, with a \$26 billion debt, remains mired in financial troubles. The most immediate challenge for President Aquino is to get foreign financial assistance flowing into the country again. Rampant spending by the Marcos administration prior to the February 1986 election put the Philippines out of compliance with its IMF standby program and made it ineligible to draw on commercial bank lines. Manila's commercial bank creditors have extended the drawdown deadline on the \$325 million in undisbursed funds remaining in the new money facility until December 1986. Hopes are that an IMF program will be in place soon in time for Manila to draw on these funds. Executing a new economic plan without considerable new external financing will be difficult because of the discordant voices of those President Aquino has appointed to her Cabinet. One particularly divisive factor will be the approach the government takes in maintaining control over an increasing militant labor force. []

Elsewhere in that region, oil and commodity exporters *Indonesia, Malaysia, and Thailand* have also seen a worsening of their financial position, although we would not yet categorize their position as serious as that of the other countries examined. The sharp decline in world oil prices is having a serious impact on Indonesia's ability to service its \$34 billion debt because petroleum products account for about 70 percent of its foreign exchange earnings. In addition, depressed prices for commodities have cut Malaysia's and Thailand's export earnings, and economic difficulties are mounting and debt relief could be necessary in the next 18 months. []

Calls for Alternative Approaches. Calls by LDC leaders for more funds and for reduced interest payments on the debt already incurred result from frustrations over their continuing economic difficulties and dim prospects for resolving their debt problems. The Cartagena Group and some debt-troubled country leaders state that debtor countries require greater new lending than the Baker initiative proposes. According to a report from the UN Committee for Development Planning, developing countries will need to double their rates of financial inflow—to at least \$80 billion annually by 1990—to achieve what LDC leaders deem as politically acceptable growth rates of about 5 percent a year. []

In contrast, other leaders and financial experts in debt-troubled countries believe that additional lending would only worsen these countries' financial positions in the long term and make the present debt more risky. In their view, the only way the debt problem will be defused is for banks and creditor countries to take on more of the burden of adjustment by providing interest relief or debt forgiveness or both. The amount of debt that proponents suggest should be written off ranges from 3 to 33 percent of the total stock of debt held by debt-troubled countries. These proponents also believe that debt forgiveness would help solve the LDC debt problem and, by knocking the debt level down, move the countries toward creditworthiness. []

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In the debtors' eyes, debt servicing remains particularly burdensome. As a result, the debtors are presenting new payment schemes to creditors in an attempt to reduce their debt servicing burden:

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- Mexico has proposed tying new loans to the price of oil—its chief export earner.
- Venezuela recently legislated a below-market-rate bond payments mechanism to service its private-sector debt.
- Some financial observers have suggested a zero-coupon bond issue to assist debtor countries.

The risk is that, if a debt-troubled country cannot find further orderly ways to reduce its debt payments, it might unilaterally act to curtail them. []

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The Creditors' Side: Financial Positions and Perspectives

While debtor positions are growing more strained, some international banks—especially smaller US regional and West European banks—are in a better position now to deal with LDC payment difficulties than they have been since the debt crisis began in mid-1982. Most of these banks have strengthened their financial situations by increasing their capital base while lending little additional money to debt-troubled LDCs, and thereby have built up reserves against some of their bad loans. As a result, some of these banks now feel they can refuse to participate in new lending if they find the lending arrangements unacceptable. []

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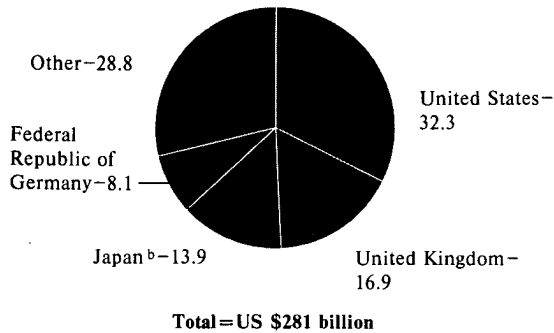
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Figure 2
Commercial Bank Exposure to 15 Troubled Debtors, 1985^a

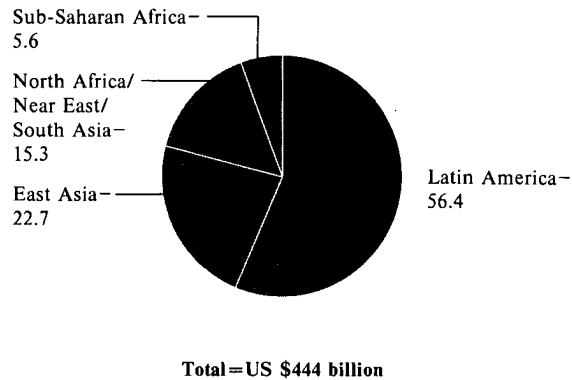
Percent



^a Data are for December 1985. The 15 countries are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.
^b Estimated.

Figure 3
Regional Distribution of Commercial Bank Loans, 1985^a

Percent



^a Data are for the Bank for International Settlements (BIS) reporting area, December 1985.

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The change in the situation of US banks is indicative. The exposure to debt-troubled LDCs of the top nine banks, which account for almost two-thirds of loans by US banks to Latin America, has fallen from nearly 180 percent of primary capital in 1982 to under 130 percent at present, according to financial reporting. With restrained lending to LDCs and a continued buildup in banks' capital bases expected over the next several years, we believe further improvement is likely in banks' ratios of LDC loans to capital—indicating a further easing of banks' vulnerability to LDC financial troubles. [redacted]

West European, Canadian, and Japanese banks have been even more aggressive in building loan-loss reserves than US banks, thereby strengthening their balance sheets. [redacted] the Swiss Federal Banking Commission has issued guidelines suggesting loan-loss reserves ranging from 10 to 50 percent for certain debtor countries. The Dutch banking supervisory authorities require specific loss

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provisions ranging from 5 to 100 percent against loans to more than 20 debtor countries. West German banks currently keep reserves ranging from 20 to 50 percent of the face value of Latin loans. [redacted] Moreover, the fall in the value of the dollar has boosted the value of their reserves, increasing their capital strength over the past year and a half. [redacted]

Commercial banks will remain unwilling to extend new medium-term loans to most LDCs unless pressured to do so in financial packages in conjunction with the IMF, [redacted]. Despite being more able to extend such loans, the banks prefer to reduce their exposure further and improve the integrity of their loan portfolios. Private creditors—primarily commercial banks—probably will boost their lending by only 3 to 5 percent during the

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next year. Moreover, most of the increase in bank lending will come in conjunction with debt restructuring packages for a handful of major debtor countries.

[redacted]

Raising new money for heavily indebted countries will be difficult even when the country has an IMF-supported program in place.

[redacted]

[redacted] during current negotiations Mexico will meet resistance from US regional banks and some smaller foreign banks, leaving about 150 to 200 international banks to supply the new loans, in contrast to the 530 banks that participated in Mexico's previous loan syndication in 1984. US regional banks and other foreign banks with small exposure would prefer to write off their Mexican debt and take a loss than to contribute to a loan they believe would not be repaid. To avoid the arduous effort needed to try to bring skittish smaller banks aboard a new money package, Venezuela may request a \$600 million loan from only its top 75 creditor banks. Thus, the forced bank lending to LDCs over the medium term is likely to be concentrated even more among the largest commercial banks in the world—increasing both the burden and the risk of new LDC exposure for these banks.

[redacted]

In our judgment, a resumption of banks' willingness to lend voluntarily substantial amounts of new money to the debt-troubled countries is unlikely this decade. The greatest hindrance to a revival of voluntary bank lending is the high-debt levels of many LDCs.

[redacted] a bankers' rule of thumb these days is that a financially sound country should have a GDP-debt ratio of no more than 20 to 25 percent. By comparison, Mexico's ratio is 80, Argentina's is 70, and Chile's is 120.

[redacted] even under the best of external circumstances—continued world growth, lower US interest rates, and rising commodity prices—debt as a percentage of export earnings in the major debtor countries will remain above desirable levels until after 1990.

New lending to LDCs is also discouraged by other factors, such as the existence of a secondary market that trades LDC debt at a deep discount and the rapid evolution of financial markets that is changing bank-lending strategies away from sovereign country lending. Moreover, [redacted] banks

complain about what they perceive as conflicting signals from regulators that penalize them for lending new money, even within the context of the Baker initiative. For example, in Japan and several European countries, supervisory authorities require sizable reserves, which apply to both old and new loans. As a result, these banks must take a charge against earnings when they make new loans, and this charge often is not tax deductible.

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Outlook: Compromise Likely but Risks Remain

In our view, debtor-commercial bank negotiations during the next 18 months probably will result in some compromise between the extremes of large sums of forced new lending or partial debt forgiveness by commercial banks on one hand and unilateral debtor action on the other hand, largely because the costs to both parties of a complete breakdown in debtor-creditor relations are extremely high. From the creditor point of view, the Baker initiative provides a broad framework within which bilateral negotiations will be carried out.

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[redacted] international bankers expect debtor countries to seek further reductions in spreads, a lengthening of repayment and grace periods, and a rescheduling of previously rescheduled debt. On the debtor side, while they will continue to press for concessions, they are also likely to accept compromise. Nevertheless, a break with the current debt strategy—by either a major debtor or creditor—cannot be ruled out.

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The prospects for collective action by debtor countries—such as the Cartagena Group of 11 Latin American debtors—appear diminished at this time. The diverse financial situations of the Cartagena Group members, their continuing disagreement over how to resolve their debt problems, and the fear of financial fallout have undercut a hardline approach by the group. The Cartagena Group has not met since February and has no meeting scheduled.

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However, we do expect debt-troubled countries to continue to see merit in meeting to discuss their debt troubles, whether as part of the Cartagena Group process or some other forum. Philippine officials, for example, visited Mexico and Peru to discuss debt problems with their counterparts, according to press reporting; and Argentine President Alfonsin visited Philippine President Aquino in July to compare notes

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LDC Debt: A Quietly Emerging Swap Market

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Creditors and debtors are increasingly active in a growing but often secretive swap market for LDC debt in which banks sell or swap troubled LDC loans at less than their face value. Some observers believe this could lighten the LDC debt burden but, in our view, both creditor and debtor reluctance to use these techniques will limit the overall impact. [redacted]

• Mexico has just developed a system to handle the swapping of public-sector debt for equity in private Mexican companies. For example, [redacted] arranged a debt-to-equity swap worth about \$40 million to finance expansion of Nissan's Mexican operations. [redacted]

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Bankers, frustrated by the current approach to debt problems, are expanding their use of swaps to limit risks, reduce exposure to a given country, and strengthen their balance sheets. For some smaller banks, swaps have provided an opportunity to eliminate LDC exposure completely. For others, it has offered a way to concentrate or consolidate loans within a preferred geographic region. West European banks and smaller US banks are particularly active in this market. Larger US banks, however, are constrained by accounting standards that require a bank that sells a portion of its debt at a discount to write down its remaining loans to that borrower. [redacted]

The swap market also is being stimulated by the increased use of a debt-for-exports scheme. Under such a plan, a company seeking to import goods from an LDC would purchase some of the LDC's debt at a discount and exchange it at the LDC's central bank in return for specified goods. [redacted]

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Approximately \$3 billion in international loans will be traded at a discount this year. [redacted] Purchase prices for debt range from about 10 cents on the dollar for Nicaraguan debt to 87 cents for Colombian exposure. Other price examples include 25 cents for Peruvian loans, 58 cents for Mexican loans, and 75 cents for Brazilian loans. [redacted]

Although offering relief to both sides, we believe swaps and conversions will provide only a marginal solution, given total LDC debt of roughly \$900 billion. Some observers doubt that there would be enough buyers for large-scale debt purchases unless the loans are substantially marked down, and they doubt commercial banks would be willing to take the resulting losses. Also, debtor countries will have to limit their use of debt-for-equity conversions because of their inflationary impact. If a debtor country were to allow many debt-for-equity conversions at the same time, too much of its currency would be put into circulation at once, causing inflation to rise rapidly. Moreover, if the market for discounted paper continued to grow, regulators could force the banks to value their entire loan portfolios at the lower market rate. [redacted]

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One of the most significant factors in the expansion of the swap market has been the debt-to-equity programs instituted by debtor countries including Brazil, Chile, and Mexico. In such schemes, a bank sells debt at a discount to a multinational corporation or private investor who transfers it to the debtor country for redemption at near or full face value in local business. These arrangements benefit the debtor country by reducing its external debt level and lowering the accompanying interest payments. They may also serve as a stimulus for additional foreign investment:

[redacted] a growing recognition that LDC debts are not worth par value could lead debtor countries to argue that their obligations to creditors should be adjusted correspondingly. For example, Mexico might argue that, with the market price of its debt only 58 cents on the dollar, its debt obligations should be only \$58 billion, rather than the \$100 billion it actually owes. Alternatively, debtor countries can buy back more of their own debt—through third parties—at deeply discounted rates. Thus, we believe bankers will continue to downplay their participation in this emerging hidden market. [redacted]

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- Chile's schemes for converting debt into equity will reduce its external debt by more than \$500 million by next year.

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***The Cartagena Group:
Politicizing the Latin Debt Problem***

The rising outspokenness of Latin debtors has become a key development in the Latin American debt situation over the past three years. The process of politicizing the debt issue began in February 1983, when the former President of Ecuador, Osvaldo Hurtado, sent a proposal to the Economic Commission for Latin America, the Latin American Economic Systems, and all Latin American nations seeking a common response to the region's economic crisis. His initiative led to formation of the Cartagena Group, which has held four ministerial-level meetings on the debt situation and issued several statements. The Cartagena Group consists of Argentina, Bolivia, Brazil, Chile, Colombia, Dominican Republic, Ecuador, Mexico, Peru, Uruguay, and Venezuela.

The Cartagena Group established a political forum to voice Latin concerns to industrial country governments through public declarations. The declarations are also part of the Latin debtor effort to gain concessions from their international creditors, an objective that heretofore has been accomplished through bilateral negotiations. In addition, the Group's pronouncements are intended to appease

growing domestic popular sentiment—in countries like Argentina, Mexico, and Venezuela—for a tougher stand with creditors. Moreover, Latin leaders want Washington to view their debt problem as at least as important as issues in Central America.

So far, no consensus has been reached on radical alternative proposals, such as a unilateral moratorium on interest payments. Indeed, by limiting itself to the lowest common denominator within the group, the Cartagena process has reinforced a moderate position. Most Latin leaders continue to take a two-track approach to resolving their financial burden: servicing their debt to the best of their ability, while concurrently seeking more concessions. Nonetheless, the Cartagena process has encouraged the Latin debtors to share information on debt negotiations and to use that information to seek better terms from creditors—the so-called spillover effect. The creation of the consultative system also has heightened the level of participation on the part of Latin political leaders to press for changes in the policies and operations of official and private international institutions.

on debt. In addition, we are watching to see if a Latin heads-of-state summit is organized later this year to discuss the debt problem.

we have no firm indication if such a meeting will take place. We also remain concerned that the currently dormant Cartagena Group—or some variation of it—could be revived by deterioration in external conditions that debtors perceive the United States as having some control over, such as sharply rising interest rates, spreading OECD protectionism, or slowing OECD economic growth.

Individual Country Risks. Although we believe the most likely outcome for debt negotiations in the near future is pressure from the debtors and initial stubbornness by the banks but with eventual compromise, some risks remain. In individual countries:

- ***Mexico*** has hinted at a possible suspension of interest payments in the past. If bankers refuse to renew substantial lending this fall, Mexico will reduce payments, possibly opening a special account in the central bank where interest owed to foreign banks would be deposited in pesos rather than in dollars.

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- **Argentina** could, on its own, take some action to cap interest payments if the labor situation grows worse and banks rebuff Buenos Aires' efforts to obtain \$3 billion in new money through next year. [redacted]

[redacted]

- **Peru** continues to limit debt payments to 10 percent of export earnings and would welcome similar action as support for its position.

[redacted]

- **Venezuela** had announced that under a new law the government will issue dollar-demonstrated bonds to be used to pay off private-sector debts totaling almost \$5 billion. The bonds, which do not mature for 15 years, carry an interest rate of 5 percent—below the commercial banks' cost of funds. Surprised by the intensity of bankers' reactions, Venezuela has scrapped the bond scheme.

- **Ecuador**, because of low oil prices, will need to implement severe austerity measures and could request additional relief from debt payments or unilaterally act to assure minimum import levels.

- Many smaller debtor countries—including **Bolivia**, **Costa Rica**, and **Nicaragua**—have either restricted their debt payments and allowed interest arrearages to build or have arranged with creditors for a rescheduling of some of their interest payments.

- **Philippines'** President Aquino plans to ask bankers for debt relief during her trip to the United States in September, according to press reports. In addition,

repayment of some loans arranged under the Marcos administration remains an issue within the Cabinet. [redacted]

Spillover Risks. We are also concerned that, with Mexico apparently obtaining significant concessions from creditors, other debtors may expect similar treatment, claiming that they too are constrained by external economic conditions, that they see no prospects for an improvement in export earnings, and that they cannot make further substantial spending cuts for domestic political reasons. Furthermore, if a major debtor is unable to come to terms with its creditors and takes action to limit its debt payments, other countries might reevaluate their positions in servicing their debt, particularly if they perceive that the debtor is not suffering serious consequences from its actions. At the very least, other debtors will use concessions granted to one as a benchmark for their own future negotiations with creditors. [redacted]

Several Latin American countries are positioning themselves to take advantage of the innovative financial package recently put together by the IMF for Mexico. Failure by these governments to obtain Mexican-like repayment terms tied to the prices of key export commodities or to economic growth could cause them to adopt confrontational tactics. For some, the large new money commitment to Mexico will raise expectations of substantial new credit infusions. [redacted]

These potential spillover effects pose the greatest danger for the US banking system. If only Mexico forces major concessions on interest or defaults, the magnitudes, while large, need not be catastrophic for the system. Mexico's interest due for 1986 to the nine largest US banks, which hold over half of the US portion of the Mexican debt, is equivalent to roughly 40 percent of their 1985 profits. If major concessions, such as forgiveness of one-half of interest due, are applied to other debtors, the consequences become much more serious. In the case of these nine large US banks, the lost interest from all LDC debtors would exceed the total profits for 1985. [redacted]

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Secret**Implications for the United States**

In this environment of increased debtor demands for relief and commercial bank reluctance to lend, we believe there may be a number of situations involving debt-troubled countries in which the US Government would be called upon to intercede:

- Washington will have to stay involved in the Mexican financial negotiations, where the short-term risks are that foreign creditors will be unwilling to supply new money in the amount requested because of disagreement over Mexican proposals. In this case, financial negotiations would drag out and Mexico almost certainly would have difficulty meeting interest payments on its external debt.
- If a major debtor country chooses to curtail interest payments unilaterally, the United States will be called on by international banks to use its leverage to bring the debtor around or to provide new regulatory changes to help cushion the resulting bank losses.
- Progress toward resolution of LDC debt difficulties also will be affected by global economic conditions. If the US economy were to go into a recession, or if dollar interest rates were to rise, or if US trade protection were to grow, the LDC debt service problem would increase and debtors would demand countering actions from Washington.
- As economic troubles in some major debt-troubled countries continue, further calls for Washington's leadership in providing an orderly way to write down LDC debt can be expected.

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Appendix

LDC Debt Analysis

Volume of Debt

The increase in the level of aggregate LDC external debt remained small in 1985. We estimate that total LDC debt—\$834 billion—grew by 3.9 percent last year, following a nearly identical 3.6-percent increase in 1984. These modest rises contrast with 8-percent LDC debt growth in 1983, 12 percent in 1982, and 21 percent in 1981. The rate of growth of the non-OPEC LDCs' debt has continued to taper off since 1981. Last year the non-OPEC LDC debt—\$662 billion at yearend 1985—rose 3.9 percent, compared with 4.3 percent in 1984 and 8.3 percent in 1983. The growth of the debt of the OPEC LDCs, however, reversed its three-year downward trend. OPEC LDC debt grew 4 percent in 1985, up from only 1-percent growth in 1984. []

The reluctance of creditors—primarily commercial banks—to increase their lending in view of continuing LDC economic and financial troubles remained the major reason behind the slow overall LDC debt growth, in our view. []

[] in most cases, new bank lending to financially troubled LDCs was done involuntarily in conjunction with IMF-supported economic adjustment programs. []

Debt Service Payments

Falling interest rates yielded a substantial dividend for LDC debtors last year; total debt service payments dropped 3 percent to \$115 billion. Even though principal repayments were up 7 percent last year to \$52 billion, a 10-percent drop in interest payments to \$62 billion resulted in the net drop in total debt service. We estimate that close to 60 percent of total LDC debt is at floating interest rates. []

The benefits of the drop in interest rates were offset by a decline in LDC exports of goods and services and higher principal repayments, keeping the average LDC debt service ratio at 21 percent last year—unchanged from 1984. Interest payments last year were equivalent to 12 percent of goods and services

exports, also unchanged from 1984. This ratio is important because interest payments are considered essential for LDCs to maintain minimum credit-worthiness with banks, whereas principal repayments can be rolled over or delayed. []

Major Creditors

Despite attempts to reduce their LDC exposure through swaps and some small-scale writeoffs, US banks continue to be major holders of LDC debt (table 3). According to US Federal Reserve data, US bank claims on LDCs totaled about \$117 billion at the end of 1985—down from about \$127 billion at the end of 1984—representing 26 percent of total bank claims on LDCs. Latin America accounted for about \$82 billion in US banks' claims, followed by East Asia with about \$27 billion. Mexico, Brazil, Venezuela, and South Korea remained the largest individual debtors to US banks at the end of 1985. []

UK bank claims on LDCs totaled about \$71 billion at the end of 1985, or about 16 percent of total Bank for International Settlements-reported bank claims on LDCs. Latin American countries owed nearly \$36 billion, with Brazil, Mexico, and Argentina the three largest debtors to UK banks. West German banks were owed about \$37 billion by LDCs at the end of last year—about 8 percent of total Western bank claims—with Brazil, Mexico, and Argentina also the largest individual debtors to FRG banks. Neither UK nor West German banks posted significant new exposure to LDCs in 1985. []

With the exception of British and West German banks, debt data for non-US bank creditors are largely unavailable. Japanese commercial banks are important LDC creditors, but Tokyo does not officially release bank exposure data. []

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Table 3
Selected LDCs: Debt Held by
US, UK, and West German Banks,
Yearend 1985

Million US \$

	US Banks	UK Banks	West German Banks	BIS Total
Algeria	829	1,481	829	9,621
Argentina	8,411	4,409	3,046	28,923
Bolivia	113	118	98	642
Brazil	22,796	13,926	6,097	77,329
Chile	6,569	2,511	1,003	14,272
Colombia	2,625	703	444	6,503
Ecuador	2,143	NA	327	5,167
Indonesia	2,748	1,463	2,192	15,085
Ivory Coast	358	512	498	2,901
Malaysia	1,087	1,529	557	10,507
Mexico	24,934	12,554	3,813	73,368
Morocco	905	NA	577	4,826
Nigeria	1,199	3,828	1,583	9,047
Peru	1,654	642	455	5,683
Philippines	5,418	1,457	552	13,333
South Korea	9,165	3,246	1,084	34,033
Thailand	1,877	617	524	7,527
Uruguay	913	341	84	2,150
Venezuela	10,091	3,454	2,104	26,024
Yugoslavia	2,398	2,981	1,954	10,508

Table 4
LDC Debt Reschedulings, 1982-85

	Official Creditors		Commercial Banks	
	Number of Countries	Value (Million US \$)	Number of Countries	Value (Million US \$)
1982	6	641	4	1,741
1983	17	10,559	14	41,091
1984	13	3,894	10	8,813
1985	19	5,916	12	86,877

Argentina, Chile, and Yugoslavia, rescheduled both official and commercial debt. Also, 11 additional commercial bank reschedulings—including a \$21 billion deal for Venezuela—were agreed to in principle in 1985 but not signed before the end of the year. Venezuela's rescheduling still has not been finalized.

Debt Reschedulings

Key rescheduling developments in 1985 included the first-ever Paris Club multiyear rescheduling agreement (MYRA), for Ecuador, and a commercial bank MYRA for Mexico covering nearly \$49 billion. There were a total of 31 LDC debt reschedulings in 1985—up from 23 in 1984—covering a record \$93 billion in debt obligations (table 4). Of these agreements, 19 involved debt owed to official creditors, and 12 covered commercial loans. Eight countries, including

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