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LDC Debt Problems: Outlook to 1990

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An Intelligence Assessment

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LDC Debt Problems: Outlook to 1990

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An Intelligence Assessment

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

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**LDC Debt Problems:
Outlook to 1990**

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Key Judgments*Information available
as of 6 March 1987
was used in this report.*

Brazil's unilateral suspension of interest payments has plunged the international financial system into a new, dangerous phase. Driven by a rapidly deteriorating economy, a plunging trade surplus, soaring inflation, and growing political pressures, Brasilia is confronting international bankers with demands for sharply lower interest payments, some \$2.5 billion in new money, and no IMF conditionality. This situation will not necessarily end in a dramatic outcome or a new approach to Third World debt problems, however. All parties have a great deal to lose from a complete breakdown of negotiations, and strong incentives exist to keep both sides at the table.

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Even resolution of the current Brazilian imbroglio, however, will not set Third World debt problems on a smooth path toward resolution. We believe the best outcome that can be expected over the next few years is lurching from crisis to crisis. While the odds are good that each time a solution will be reached, albeit in many cases after further rounds of brinksmanship by both debtors and creditors, there is a strong risk that other actors eventually will balk, threatening a collapse of the debt strategy and causing major financial problems for debtor countries and creditor banks and governments. In our view, the risks of this outcome will continue to rise, with banks becoming increasingly reluctant to provide new money or make concessions and debtors upping their demands for concessions.

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If the current strains between debtors and creditors were based on temporary economic conditions, we would be less concerned about the next few years; as economic conditions improved, so would the debt negotiation atmosphere. Our examination of the factors that will affect the LDC debt situation in this period, however, indicates the underlying trends will get no better:

- World trade will not grow rapidly enough to alleviate LDC debt service burdens. The IMF projects a 3.5-percent increase in world trade in 1987, roughly the same growth rate as that predicted for LDC debt and no more rapid than in 1985-86.
- Interest rates seem certain not to go much lower than current levels and more likely will increase over the rest of the decade. The consensus of major forecasting services is that interest rates will rise by 2 percentage points over the next three years, a reversal of the downward trend since mid-1984.

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- Commodity prices could recover slightly, but we believe they will remain far below levels necessary to bring a major improvement in LDC export earnings.
- Pressures for protectionism in industrial countries, particularly in Europe, seem likely to grow rather than abate, which will continue to restrict LDC export growth, in our judgment.

At the same time, we anticipate that political constraints will prevent the kind of reform needed to increase debtor country competitiveness. Moreover, without tangible moves toward improvements by debtor governments, commercial banks will continue to restrict the growth of new lending to LDCs.

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In addition to what we see as insufficiently favorable economic trends, our concern about the outlook for the debt situation is heightened by our belief that debtor attitudes and negotiation stances are hardening. In our view, Brazil's actions are symptomatic of a generally changing attitude in nearly all debtors. While debtor demands are not new, we detect a markedly increased toughness and arrogance in their present stances. In our judgment, these harder, more forcefully stated positions are not just negotiation ploys; rather, they represent a growing general perception among debtors that it is time for developed country governments and banks to bear more of the burden of the debt. Even if the current problems with Brazil are resolved, we do not see the debtors' negotiating toughness ebbing. Indeed, each additional bailout of a key debtor will harden these attitudes further, making it more difficult to reach agreements on debt.

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Preface

This paper is part of a continuing DI effort to monitor and assess the status and implications of the international debt situation. In this effort, the LDC debt situation is monitored both through crosscutting papers such as this one and through examinations of the debt situation in specific countries.

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LDC Debt Problems: Outlook to 1990

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The Current Setting

Third World debtors and creditors appear to be on another collision course. This time the crystallizing problem is Brazil, where rapid economic deterioration, underscored by a plunging trade surplus and soaring inflation, is accompanied by growing domestic political pressures.¹ As a result, Brasilia has taken a confrontational stance in negotiations with commercial creditors by declaring an interest moratorium and demanding from bankers a sharply lower interest spread, some \$2.5 billion in new money, and no IMF conditionality. Chile and Ecuador also have stridently demanded new concessions such as retiming of interest payments, and Chile has received much of what it asked for.

Argentina and the Dominican Republic are considering moratoriums. At the same time, completion of the Mexican package, which contains unique terms such as a linking of debt payments to oil prices and economic growth rates, continues to be held up by the reluctance of many regional US and foreign banks to sign on to the agreement.

The common thread in all the current negotiations—including those involving Brazil, Chile, the Philippines, Ecuador, and Venezuela—is that debtors are taking stronger stands while creditor banks and governments are increasingly divided. In our judgment, the debtors—best symbolized by Brazil—are being spurred by growing domestic protests over their deteriorating economies as well as a perception that their leverage over creditors is substantial. Threats of interest payment delays or reductions are becoming bolder. Debtors probably reason that the commercial banks are not in a strong enough position or united enough to deal with a major writeoff of loans, while official creditors are unwilling to step in and assume the burden from the banks. Moreover, recent publicity

Brazilian Debt Negotiations

On 20 February, President Jose Sarney announced an indefinite suspension of interest payments on Brazil's \$68 billion medium- and long-term debt to commercial banks. Since the announcement, Brasilia has sent conflicting signals to its creditors. In an official press statement on 23 February, a key presidential adviser said Brazil will not demand debt solutions that involve losses for creditors. At the same time, however, Finance Minister Funaro told reporters that Brazil will not negotiate away its growth targets or agree to an IMF program.

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Bankers, for their part, expressed uncertainty about what steps Brazil will propose in forthcoming negotiations. They are especially concerned about the lack of a credible domestic economic program. As a result, a few banks withdrew a portion of the \$15.5 billion short-term trade and interbank lines. To prevent a major loss of these credits, Brasilia sent instructions to Brazilian banks overseas directing them not to repay international banks that seek to withdraw such credits, but instead to deposit the money in an account in Brazil's Central Bank, according to Embassy reporting.

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Sarney's decision was prompted by a number of factors, in our judgment. These included a rapid drawdown of foreign exchange reserves since last September to a current level of less than \$2 billion, an escalation of inflation to an annualized rate of 800 percent, a sharp drop in the trade surplus to a point that will remain well below interest obligations for several months, Brazilian concerns that bankers were not aware of the seriousness of the problem, and rising domestic pressure for unilateral action to divert attention from domestic problems.

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about banks building reserves against future writeoffs probably is leading debtors to conclude that their leverage will wane over time. []

Even with these preconditions in place, an impasse or breakdown will not necessarily ensue. Both parties have a great deal to lose from a complete breakdown of negotiations, and strong incentives exist to keep both sides at the table. In these circumstances, the skill of the individual negotiators and the ability and willingness of the debtors and creditor banks and governments to make the hard choices and compromises will be pivotal. []

The Record Since 1982

The debt problem has changed in several aspects since it first emerged as an international issue in 1982. To sustain debt servicing, individual debtors have undertaken economic adjustment programs under the auspices of the IMF in exchange for debt restructuring and additional new funds from creditor governments and commercial banks. This strategy has avoided a default or repudiation involving a major debtor, as well as a collapse of major banks, while slowing the growth of LDC debt. The basic debt problem nonetheless remains. Almost every year, some major debtor has had to again restructure its debt, often in a strained, crisis atmosphere. Last year, creditors completed another arduous round of negotiations with Mexico; this year, they face rigorous talks with Brazil and probably Argentina. []

Despite the continuing financial problems and subsequent negotiations, aggregate LDC debt has continued to grow. At yearend 1986 the LDC debt total reached about \$860 billion, up from about \$637 billion at yearend 1981. Meanwhile, interest payments on the total debt still approximate \$65-70 billion per year despite the sharp decline in interest rates since the debt crisis began in 1982. []

The most important factor that has prevented a solution to the debt problems of the Third World, in our judgment, is that world trade has moved sharply against LDCs; indeed, except for 1984, LDC exports have increased below historical norms every year since 1980. As a result, instead of being able to resume some import growth while maintaining their trade

surpluses, LDCs have had to continue to restrict imports because of less-than-expected export earnings. Even where volume growth occurred, prices fell so sharply during the past few years that the increases in volume did not offset the decline. The oil exporters bore the brunt of the burden, with a 46-percent drop in export earnings in 1986, according to IMF estimates, but non-oil-exporting LDCs also suffered from a 12-percent fall in their export earnings because of weaker primary commodity prices and slower industrial country growth. Trade protectionism in industrial countries, particularly restrictions on imports from LDCs, also contributed to LDC trade problems. []

Although debtors have benefited substantially from declining interest rates, these gains have been offset somewhat by reduced amounts of new lending and restrictions on LDC access to international capital markets as banks' concern over LDC financial problems has grown. Voluntary lending now goes to a limited number of LDCs that are the least risky, primarily in East Asia. For countries with debt problems, new financing comes in the form of involuntary lending as part of restructuring packages. Bank portfolios are also being adjusted, with banks—mostly US regionals and foreign banks swapping, writing off, or converting to equity in debtor countries some or all of their loans; such activity serves to limit the banks' incentive for future lending. []

Meanwhile, debtor countries have borne almost all of the financial adjustment. For example, the \$37 billion improvement in the aggregate Latin American current account position in 1982-85 was due primarily to import declines totaling \$21 billion, in contrast to export increases of only \$5 billion. As a result of this pattern, the pace of aggregate LDC GNP growth has also fallen, from an average of 4 percent in 1977-81 to 2.5 percent in 1982-86. In addition, Latin America has experienced a net outflow of funds over the past several years and has seen per capita income levels fall to no better than levels of the late 1970s. In contrast, most of the major banks involved in Third World lending have continued to receive the interest

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Table 1
Improvements in Current Account
Balances, 1982-85

Billion US \$

	Total Improve- ment	Due to		
		Increased Exports	Import Cutbacks	Other Changes ^a
Argentina	1.4	0.8	1.4	-0.8
Brazil	16.0	5.3	6.3	4.4
Chile	1.0	0.0	0.6	0.4
Colombia	1.7	0.6	1.7	-0.6
Mexico	6.6	0.6	0.8	5.2
Nigeria	8.5	0.5	6.6	1.4
Peru	1.6	-0.3	1.8	0.1
Philippines	2.9	-0.4	2.6	0.7
Venezuela	7.1	-2.1	6.2	3.0

^a Includes changes in services and private transfers.

payments on these loans, albeit at occasionally reduced spreads above base interest rates such as the London interbank offer rate (LIBOR) or the US prime rate.

Key Elements in the Future

The variables that will most affect the LDC debt situation over the next five years include: external trade, commodity prices, interest rates, external financial flows, and industrial country and LDC economic policies.

we believe the combined impact of these variables will do little to improve the LDC debt situation over the next five years, and the LDCs will probably not be much better off in terms of debt service, capital account balances, and per capita incomes than they are today. Specifically, we expect slow growth of world trade, limited improvement in commodity prices, higher interest rates, continued slow growth of bank lending and foreign investment, and less-than-optimal changes in debtor and creditor country policies.

The Trade Problem. We and other observers expect world trade to grow no faster over the rest of the decade than it did over the last two years, an annual

Table 2
Key Economic Trends: Average
Annual Figures

	1979-82	1983-86	1987-91 ^a
Growth of world trade (percent)	5	3	4
OPEC oil price (\$/bbl) ^b	29	27	20
Real nonoil commodity prices (percent change)	-3	-5	3
Nominal interest rate—LIBOR (percentage points)	14	9	7
Real interest rate—LIBOR (percentage points)	6	5	4
LDC net external borrowing (billion US \$)	91	47	40
Foreign investment in LDCs (billion US \$)	11	10	12
LDC total debt/exports ratio (percent)	100	150	140
LDC total debt/GNP ratio (percent)	35	48	45
LDC debt service/exports ratio (percent)	18	21	20
LDC interest payments/exports ratio (percent)	10	12	11

^a Projected.

^b Market prices.

growth rate of barely 3 percent in volume terms. Several factors will contribute to this projected slow growth:

- The lack of a strong revival of trade in primary commodities, in turn due to slower than previous OECD economic growth and widespread structural changes.
- The threat of greater protectionist measures in industrial countries, particularly with regard to trade in manufactures, an important component of exports for many LDCs.
- An expectation of slow progress in LDC domestic adjustment, along with limited support for that process from foreign creditors, that will keep many LDC exports uncompetitive in world markets.

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In our judgment, the weak outlook for world trade will be the key external economic factor constraining resolution of the debt crisis. The need for a large number of debt-troubled countries to run large trade surpluses simultaneously will again put the onus on the developed countries to run trade deficits. For this to be successful, however, other OECD countries besides the United States will have to do more to absorb LDC exports. In the event US growth slows from its present 3-percent pace or the US trade deficit shrinks, possibilities that will become more likely over the next few years, the outlook for LDC exports will not be as promising. [redacted]

Weak Commodity Prices. Even with no increases in volume, the LDC trade picture could improve if there was a rebound in the prices of LDC exports. The aggregate nonoil commodity price index currently is almost 30 percent below its long-run average in real terms, with most commodities at their lowest levels in the past 40 years. Nonoil commodity prices fell by an estimated 18.5 percent in real terms during 1986, according to the IMF. The weakness in prices for agricultural commodities can be attributed largely to an oversupply of many goods brought on by favorable growing conditions, the adoption of more market-oriented pricing policies in many LDCs, agricultural subsidies in industrial countries, and increased productivity in certain LDCs.² Metals prices, on the other hand, have suffered from reduced demand as well as increased mining capacity and substantial cost reductions in metal production. [redacted]

Most observers do not expect a major recovery in commodity prices in the near term. Many of the factors that led to the current oversupply and weak demand will remain, including sluggish growth in industrial production in developed countries, government agricultural subsidies in producer nations, inventory reductions resulting from high real interest rates and low inflation expectations, and foreign exchange shortages in many LDCs. [redacted]

[redacted]

Table 3
Nonoil Commodity Prices

	1979-82	1983-86	Key LDC Exporters
Aluminum (cents/lb)	64	56	Brazil, Jamaica, Guinea
Cocoa (\$/lb)	1.10	1.01	Ivory Coast, Brazil, Ghana
Coffee (\$/lb)	1.41	1.44	Brazil, Colombia
Copper (cents/lb)	84	65	Chile, Zambia, Peru
Cotton (cents/lb)	82	68	Egypt, India
Hardwood (\$/cubic meter)	160	142	Malaysia, Indonesia
Iron ore (\$/ton)	25	23	Brazil, India
Maize (\$/ton)	120	117	Thailand, Argentina
Natural rubber (cents/lb)	53	40	Malaysia, Indonesia, Thailand
Palm oil (\$/ton)	563	494	Malaysia, Singapore, Indonesia
Rice (\$/ton)	386	240	Thailand, Burma, Pakistan
Soybeans (\$/ton)	280	249	Brazil, Argentina
Soybean meal (\$/ton)	243	194	Brazil, Argentina
Soybean oil (\$/ton)	554	542	Brazil, Argentina
Sugar (cents/lb)	16	6	Brazil, Philippines
Tea (\$/kg)	2.09	2.42	India, Kenya, Sri Lanka
Tin (cents/lb)	672	488	Malaysia, Indonesia
Wheat (\$/ton)	167	140	Argentina, India

Source: IMF.

[redacted]

The Impact of Exchange Rates. LDC exchange rates should continue to depreciate if the US dollar declines over the next few years, improving trade prospects for the LDCs and their ability to service debt; major econometric forecasting units foresee continued declines of the US dollar relative to other major currencies as Washington seeks to reduce its trade and

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budget deficits. According to a UN study, for example, a 20-percent fall in the nominal effective exchange rate of the dollar over three years—1986-88—will yield a positive growth effect on LDCs because of improvement in dollar-denominated commodity prices, an increase in LDC exports to the United States to replace exports from Japan and the EC, and a lowering of the burden of dollar-denominated debt. Depreciating LDC exchange rates, however, will not be enough by themselves to substantially ease the debt problem. []

Some improvement in this area already has occurred as LDC real exchange rates declined sharply during 1985-86, a result of many LDC currencies being tied to the dollar, or even depreciated against it. On a weighted-average basis LDC real exchange rates have fallen by an estimated 20 percent since early 1985. We expect these declines to help improve the external competitiveness of many of these countries. The gains will be limited, however, by the fact that most of the increased competitiveness has occurred vis-a-vis Western Europe and Japan, which are relatively less important markets for these countries' exports. Competitiveness gains in the far more important US market have been much less. Nonetheless, exchange rate changes should help LDCs recover some losses in export market shares that occurred when their currencies appreciated with the US dollar. []

Interest Rates. Changes in world interest rates will continue to have a direct and visible impact on LDCs; each 1-percentage-point shift in major interest rates—LIBOR and the US prime rate—equates to a \$4-5 billion movement in interest payments on debt. The largest debtors, Mexico and Brazil, are the most affected, with an \$800 million change for each percentage point. Changes in interest rates also affect deposits held by LDCs in foreign banks, although this impact is much smaller than that of interest payments because of the limited amount of deposits held by government entities. []

The forecasts vary as to the magnitude of future interest rates, but none call for major declines similar to those that benefited debtors over the past two

The Impact of Industrial Country Policies on LDCs

The policies undertaken by the industrial countries will continue to have a large influence on the outlook for developing countries, especially as these policies affect trade, exchange rates, and interest rates. In the short term, we believe industrial country governments will continue to emphasize controlling inflation and reducing budget deficits, while trying to maintain steady economic growth. The effect of these policies on debtor countries will depend on how these restrictive policies are implemented vis-a-vis maintaining growth and how stable exchange rates and sustainable current account balances are attained. According to one study, optimal industrial country policies—such as fiscal restraint, more flexible monetary policy, and reduced trade barriers—could add 1.75 percentage points annually to major debtors' growth rates, while inefficient policies could cut growth by 3 percentage points. Debtors that rely on official financing will benefit much less because economic developments in those countries generally reflect changes in domestic policies rather than those of industrial countries. []

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years. For the short term most of the econometric forecasting units show a slight decrease in interest rates in 1987, with rates beginning to climb again in 1988. For the longer term, interest rates generally are projected to rise until 1989 and then decline through the mid-1990s. []

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External Financing. LDCs will remain dependent on external sources of funds, both official and private. Despite the recent declines, foreign borrowing is second to export earnings as a source of funds for LDCs. We believe the prospects for major increases in lending to LDCs, however, are extremely poor, given the continuing financial problems of these countries and renewed emphasis by banks on voluntary lending to only the most creditworthy countries. More likely, debtor countries will receive at best a small increase in lending from banks. []

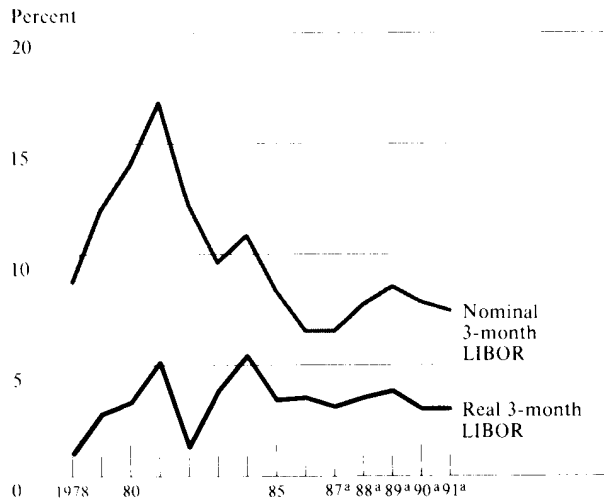
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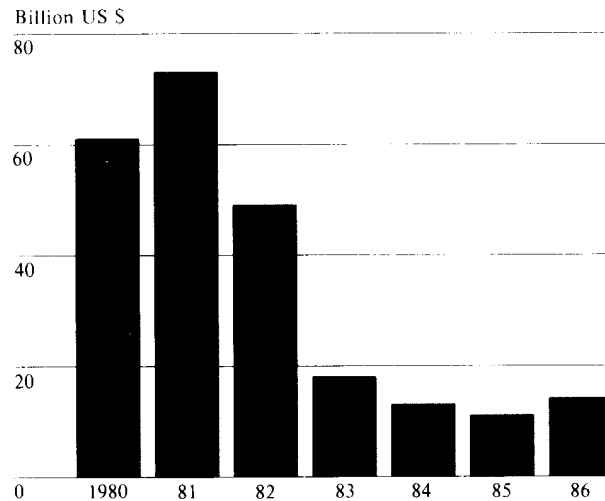
Figure 1
World Interest Rates, 1978-91



^a Wharton estimates.

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Figure 2
Private Sources: Net New Lending to LDCs, 1980-86



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The most consistent source of funds will remain official lenders—governments and multilateral institutions. The slow but steady growth of official loans has been the primary source of funds for most smaller debtors, many of which have chronic economic problems rather than strictly debt-related problems, and even for some of the medium-sized debtors such as Bolivia, Egypt, and Morocco. Bilateral lending from OECD countries is projected to increase at a rate of 2 to 3 percent over the next few years, or about \$1 billion annually; this rate is about the same as that of the period 1982-86. Additional increases beyond this projection, in our assessment, are unlikely because of developed country budget restrictions.

Multilateral lending can be expected to assume a greater role in LDC financing, both through increased loans and more cofinancing deals with private lenders, according to some observers. The World Bank—the largest multilateral lender—will be under pressure from debtors and some other creditors for not doing

enough to stimulate capital inflows to LDCs. Indeed, the results for the fiscal year that ended on 30 June 1986 show that total repayments from LDCs to the World Bank exceeded new disbursements. Among the primary goals of new IBRD President Conable is to strengthen the role of the World Bank and become more involved in ensuring continued lending to LDCs. We believe it will take several years to build up this capacity, however, and also will depend on a firm commitment from member countries to underwrite a general capital increase, a questionable proposition at best because of some budgetary constraints that will restrain growth in bilateral lending.

We see almost no chance that lending from private sources—primarily commercial banks and historically the largest source of funds for LDCs—will rebound in the next few years. Since the onset of the debt crisis in

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1982, the growth of bank lending has slowed sharply, in contrast to the LDC borrowing boom of 1978-81. Medium-term syndicated loans have become scarce, except in the case of IMF-led rescue packages, with only a limited number of countries like South Korea and Taiwan still considered favorable credit risks. Short-term credit lines also have been reined in as banks seek to limit their exposure to manageable levels. []

Bank lending probably will continue to increase at a pace of 3 to 5 percent each year, with as much as half of this amount made on an involuntary basis, in order to allow the debt-troubled countries to remain current on their interest payments. Trade-related financing will move in relation to the volume of trade activity, but medium-term credits will only be extended for specific projects. Even then, many lenders will insist on some form of government or multilateral institution guarantee. Any increase in the amount of loan writeoffs and loan loss reserves without regulatory adjustments also will prevent a quick resumption of large-scale bank lending to LDCs. []

The Role of Direct Investment. Foreign direct investment is viewed by some observers as a way to make up for reduced lending flows from commercial banks. Investment flows, however, usually follow those of bank lending, with investors tending to be more cautious than banks in investing capital in LDCs. Direct investment is more productive than bank lending from the LDCs' standpoint, but the problem of net outflows still exists, and investment flows will not be large enough to substitute for bank lending. Over the past 10 years, investment flows generally have been equivalent to only 10 to 15 percent of bank lending. []

Although many LDCs—particularly in Latin America—have embarked on foreign investment promotion drives, IMF forecasts project only slight growth in foreign investment over the next few years. Investment flows to LDCs are expected to be \$12-13 billion in 1987 and 1988, down from the high mark of \$14

billion in 1981. The reasons for the slow growth include:

- Limited economically viable investment opportunities. While good investment opportunities exist in most countries, they tend to be small-scale operations that are not well developed and consequently are hard to identify. Certain industries deemed to be in the national interest, such as energy-related industries, are usually the best known to investors but will remain untouchable for foreigners.
- Foreign ownership restrictions. Many countries have laws requiring majority local ownership. Mexican law, for example, requires that local owners hold at least a 51-percent stake in foreign investments in Mexico unless special exception is made by the government.³
- Exchange restrictions. The presence of restrictions on access to foreign exchange for domestic firms along with limits on repatriation of profits abroad also will hinder new foreign investment.
- Long-term security. Prior actions or threats of government interference such as nationalization or expropriation will turn away foreign investors. []

LDC Domestic Policy Changes. One positive outgrowth of the continuing debt problem is that LDC economic policy makers appear to be more aware of the importance of proper economic adjustment policies. Several trends indicate that steps are being taken in the right direction:

- LDC exchange rates are becoming more realistic, after being overvalued for a number of years.
- Domestic interest rates in LDCs are being adjusted to levels that encourage domestic savings ahead of foreign savings.

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- A growing number of countries are gradually loosening some of the barriers to new direct foreign investment. []

Although these steps are positive, in most cases we do not see them as nearly enough to placate creditors and stimulate a return to voluntary lending. Problems with inflation and controlling the public-sector budget deficit—partly because of a reluctance to cut subsidies—will continue to hinder adjustment efforts of many LDCs. Moreover, creditors remain concerned that debtor country governments will backtrack on implementation of these policies as soon as their current accounts turn around or if pressed politically for more populist economic policies. In addition, continued capital flight indicates that local populations are not yet confident of the ability of their governments to manage the economic situation. []

The privatization effort in LDCs, in our judgment, also is proceeding on an uneven course. Debtors have long been burdened with large, inefficient state-owned enterprises and, at the same time, have hindered the growth of the private sector by implementing excessive government controls and restrictions. However, the selling off or restructuring of public-sector firms has been a domestically unpopular move politically for most countries, and we expect that further changes will be slow in coming. []

In contrast to internal adjustments, debtors have been far more successful in making external adjustments since 1982, but we believe they will not be able, or willing, to do much more. The generation of large trade surpluses has reduced financing needs but has come at the expense of slower economic growth, higher inflation, and lower standards of living. Moreover, the trade surpluses were brought about by sharply restricting imports rather than boosting exports. These countries will be hard pressed to spur economic growth without increasing imports and thereby eroding the trade surpluses. []

[]

A Pessimistic But Manageable Scenario

Under the conditions outlined above, we believe the LDC debt situation over the next several years will be marked by a lurching from crisis to crisis. Although strong forces will encourage eventual agreement to end each crisis, in many cases, brinksmanship by both debtors and creditors will occur. In these circumstances, we expect both sides to do only the minimum necessary in order to avoid any serious disruption. Nonetheless, each individual country we have examined would continue to face debt servicing requirements that stretch its ability to meet them unless considerable new funds become available. []

Effects on Debtor Countries. If debtors and creditors are able to eventually work out each subsequent crisis, we see little incentive for debtors to significantly alter their slow movement toward economic adjustment over the next several years. The short-term benefits from implementing serious economic reforms still will not be great enough to offset the political risks for LDCs faced with substantial domestic dissatisfaction, net outflows of capital, and declining standards of living. LDC governments generally will concentrate on the short run in their views; they will talk about long-term solutions but will want immediate results. At the same time, most LDCs will realize that they need to play the negotiating game with creditors, although domestic pressure could force debtors to take more drastic actions—as Peru has done—such as debt payment limitations. []

Prospects for individual debtor countries vary considerably. Even LDCs with similar characteristics—such as oil exporters, middle-income countries, or large debtors—will have vastly different results. For example, the two largest debtors, Brazil and Mexico, have nearly opposite medium-range outlooks. Most financial observers believe that Mexico will continue to face problems over the next five years because it will still be far too dependent on oil earnings. Brazil, on the other hand, will have some short-term liquidity problems, but its diversified economy makes the long-term outlook much more encouraging. Debtors that

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Table 4
Key Debtors: Medium-Term Prospects

	Floating Rate Share of Debt (percent)	Manufactures Share of Exports (percent)	Oil Imports/ Exports (percent)	General Medium-Term Outlook	Major Problem Areas
Oil importers					
Argentina	82	18	6	Fair	Domestic spending; large foreign debt
Brazil	81	56	25	Fair	Overheated economy; short-term borrowing needs
Chile	85	25	15	Fair	Dependence on commodity prices; high debt level
Colombia	53	15	11	Fair	Diversification of exports
Philippines	66	36	16	Poor	Dependence on commodity prices; economic management
South Korea	63	95	18	Good	Large debt; susceptibility to world trade slowdown
Oil exporters					
Egypt	32	18	38	Poor	Drop in oil, remittance revenue; domestic spending
Indonesia	37	8	67	Fair	Adjustment of spending to lower oil revenues
Mexico	84	26	68	Poor	Diversification of exports; domestic spending
Nigeria	84	2	97	Poor	Diversification of exports; poor economic management
Peru	50	18	18	Poor	Relations with creditors and investors
Venezuela	91	7	91	Fair	Adjustment of spending to lower oil revenues

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are highly dependent on commodity exports—including Chile, Peru, and Ivory Coast—as well as oil exporters will have to seek to reduce that dependence by developing their industrial sectors. []

Countries that previously had avoided or had only occasional difficulties, in our judgment, may also face debt problems. For example, several East Asian debtors, including Indonesia and Malaysia, could require debt relief within the next two years, largely as a result of low oil and other commodity prices.⁵ Other countries such as Egypt face the prospect of repeated debt problems over the next five years. In addition, Sub-Saharan African LDCs appear to have little chance of improving their already poor economic outlook as debt restructurings become a regular event.



Meanwhile, we believe political pressures within debt-or countries also will continue to build. Most Third World political observers expect increased dissatisfaction with continuing debt problems as LDC living standards remain depressed; as perceptions build that the notion that these countries would require only a one-time dosage of adjustment measures has proved to be false, this dissatisfaction will be likely to intensify. As time goes on, making the necessary serious economic adjustments will be much tougher for LDC leaders than if they had made them when debt problems first broke out because of the built-up public resistance and the requirement that the adjustment be much greater to resolve the added problems built up during the interim period. []

The Impact on Commercial Banks. In this scenario, we believe the international financial system will remain vulnerable to LDC debt problems. Despite

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concerted efforts by commercial banks to strengthen their balance sheets through increases in capital and loan loss reserves, they remain heavily exposed to LDCs. A prolonged payment stoppage by Brazil or Mexico—or a combination of two or more other large debtors such as Argentina and Venezuela—would cause serious earnings losses for banks and could threaten the solvency of some major banks, particularly in the United States. [REDACTED]

Meanwhile, we believe further confrontation will stimulate the metamorphosis in the commercial banks' relationship with debtor countries, even those LDCs that have not previously experienced debt problems. The growing reluctance of commercial banks to provide any new medium-term, and in some cases short-term, credits to many LDCs will be particularly damaging to LDC growth efforts. Despite some cutbacks in short-term trade-related and inter-bank credits to LDCs, we expect banks to continue to extend such credits because they are less risky than medium-term credits and are very profitable. Any new medium-term loans, however, will be tied to specific projects or guaranteed by a third party. A greater number of cofinancing arrangements with multilateral institutions may help to resume medium-term loans to debtors, but it will still be on a small scale. In addition, many banks will seek to further reduce or even eliminate their international exposure and will engage in additional debt-for-equity swaps, sales of discounted debt, and debt writeoffs. [REDACTED]

There also will be a continuation of the shift under way regarding LDC financial rescue packages, in our judgment, resulting in an increased concentration of bank exposure to LDCs among a fewer number of banks. Many regional US banks, most of which have limited LDC exposure, will choose not to participate in involuntary loan packages such as the recent Mexican \$6 billion loan and upcoming packages to Brazil and Argentina. In past rescue packages, these banks were pressured by the larger US banks to participate; however, the experience of the Mexican deal will make it extremely difficult for larger banks to use the same tactics again. [REDACTED]

The split also will probably widen between US and non-US banks, in our assessment. The Swiss banks, and more quietly the German banks, will call for more

alternative measures to new money for LDCs, including interest capitalization, and could choose not to participate in new packages at all. The different set of banking and tax regulations governing non-US banks is the primary basis for their views; these banks have more aggressively set aside reserves for bad loans and are in a stronger balance sheet position than their US counterparts. European banks also will continue to view Latin America as a US banking problem in general and will remain less willing to become more involved in the region. We expect these attitudes to continue; therefore, there will be added pressure on the large US banks to modify their approach to LDC debt. [REDACTED]

Downside Risks

There are some downside risks that could lead to a serious deterioration of the LDC debt situation. Probably the most damaging event would be a recession in the OECD countries, which could emanate from a variety of sudden global economic changes such as a surge in interest rates or sharply higher oil prices; in our judgment, a downturn in OECD growth is probable during the next five years. A reduction of OECD growth would be devastating to developing countries largely because of the accompanying contractions of trade and financial flows. The situation could ultimately deteriorate to a point that threatens the stability of the international financial system, which then would require major creditor government intervention in the system. [REDACTED]

The impact of a recession, according to a CIA study,⁶ would be especially severe for Latin countries. Although all debtors would be hurt by reduced exports, the effects on individual debtors would hinge on oil price trends. Net oil exporters such as Mexico and Venezuela would be additionally hurt if oil prices fell further, while Brazil and other oil importers would receive benefits that would partially offset the damage done by a recession. Meanwhile, new money

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Table 5
Key LDCs: Vulnerability Ratios ^a

	1980-82	1985
Argentina	0.50	1.34
Brazil	0.95	6.40
Chile	0.65	5.77
Colombia	0.65	1.41
Ecuador	0.48	1.56
Egypt	0.69	1.88
India	0.32	0.86
Indonesia	0.60	1.76
Ivory Coast	0.65	3.18
Malaysia	0.37	1.24
Mexico	0.70	7.44
Morocco	0.66	1.35
Nigeria	0.35	3.02
Peru	1.01	1.37
Philippines	0.53	8.08
South Korea	0.67	0.84
Thailand	0.88	0.54
Venezuela	1.37	2.10

^a Ratio of interest payments to net new external borrowing.

requirements for LDCs would increase by at least \$19 billion in 1987-88 if a mild recession occurred, but the total would jump to \$30 billion in the event of a deep recession. []

The debt situation could also worsen if debtors became convinced that creditors were not doing enough to maintain the minimum flows of funds to keep the debtors financially solvent. The incentive for debtors to service their debts will diminish sharply if new money from creditors only covers interest payments. An examination of 18 key debtors reveals that all but three Asian countries paid more in interest than they received in new money in 1985, the most recent year of data available; this is in sharp contrast to the period 1980-82, when there were only two countries with so-called vulnerability ratios above 1.0. We expect that ratios will remain above 1.0 for most key debtors over

The LDC Debt Vulnerability Ratio

There are many indicators used in attempting to determine the relative debt burden of a country. The most common ones are the debt-service-to-exports ratio, total-debt-to-exports ratio, and total-debt-to-GNP ratio. A different and unique measure derived by financial analyst Anatole Kaletsky is the vulnerability ratio. The indicator is used to provide a quick reference point to a country's temptation to default on, or repudiate, its debts. []

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The vulnerability ratio is computed by dividing total interest payments by net new external borrowing. The key is whether the ratio exceeds 1.0:

- If the ratio is below 1.0, there is a positive or normal transfer of funds to the debtor country. This implies that the incentive is for the debtor to service its debt in order to keep the flow of funds coming.
- If the ratio exceeds 1.0, there is a negative transfer of funds out of the debtor country, meaning that the debtor will be forced to consider the option of not paying. At higher ratios, the incentive is greater to suspend or limit debt payments. []

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Using IMF data, the vulnerability ratio has been above 1.0 since 1983 for LDCs as a group, and this trend is projected to continue. The aggregate for Latin American countries has been the driving force behind the LDC average, with vulnerability ratios as high as 5.0 to 6.0 over the same period. It should be noted, however, that, despite the high ratios, only Peru has formally limited debt payments. Presumably, individual countries have different thresholds as to when to cease payments on their debts. []

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the next several years because of the probable increase in interest rates and the slow growth of new lending, which will make unilateral payment stoppages or limitations an increasingly attractive and viable option to the debtors. []

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We believe debtors will take such radical actions only as a last resort, but much depends on the perceived as well as the actual amount of flexibility demonstrated by the creditors. Domestic political pressure in debtor countries also will have a major influence on the governments' actions. If a major debtor decided to take unilateral action such as severely limiting debt payments, creditors almost certainly would have to accommodate it through additional debt concessions because they would have a hard time isolating the country's action. Most creditors probably would be able to deal with writeoffs of one major debtor, but a combination of several debtors would be too much to handle simultaneously. [redacted]

Should a debtor or debtors decide to take unilateral action, they generally are in a better position to deal with the expected credit reductions or cutoffs than they were a few years ago. LDCs have bolstered their foreign exchange reserves and accumulated greater stocks of imports. In addition, countertrade and other barter arrangements have become more common. Debtors also have made progress on import substitution as part of their need to maintain trade surpluses. Individual country situations vary widely, however, and most LDCs do not yet perceive themselves as being able to withstand a break with international creditors. [redacted]

A More Optimistic Scenario

A more optimistic scenario suggests that creditors and debtors will be able to build on a number of positive steps already undertaken. After a sobering couple of years, the players will seek to maintain overall progress, a key challenge given the severe liquidity problems that periodically plague key debtors like Mexico and Brazil. Debtors and creditors will continue to show flexibility in resolving these periodic crises, which have resulted in improved terms—such as lower interest rates and longer tenors—on existing debt. This flexibility, in conjunction with new initiatives by the private sectors and the debtor governments themselves, could lead to some, albeit slow, progress in resolving the issue. [redacted]

The debt situation also will improve if creditors and debtors will continue to seek ways of reducing the debt levels instead of merely adding to the already

Table 6
The Optimistic Scenario:
A "Solution Set" of Events

Necessary Trends	
World economic conditions	Stable interest rates at or below current levels
	Moderate and steady increases in nonoil commodity prices
	Stable oil prices
Industrial countries	Elimination of barriers and restrictions on imports
	Coordination of exchange rate and monetary policies
	Increased flow of funds to LDCs through either increased lending or greater guarantees of private lending
Developing countries	Serious and sustained commitment to adjustment policies
	Removal of barriers to foreign investment
	Maintenance of realistic exchange rates
	Strengthening of the private sectors by reduction of governments' role in the economy
Commercial banks	Greater export diversification
	Maintain or increase existing short-term trade credit lines
	Return to medium-term lending for specific projects
[redacted]	Reduce the volume of existing loans that have little or no chance of being repaid

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high total debt. Following Chile's example, other major debtors, such as Mexico, Brazil, and the Philippines, will take advantage of debt-for-equity swaps, although this will affect only a small portion of their total debt. Meanwhile, a growing number of banks will look more seriously at granting concessions on existing debt to LDCs instead of extending new money. The recent Mexican negotiations brought some of these ideas to the table, including interest capitalization, tying of repayments to commodity prices or economic growth, and interest forgiveness. [redacted]

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For the optimistic scenario to fully materialize, however, we believe world economic trends would have to improve. Above all, OECD growth would have to

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Table 7
Key Debtors: Foreign Exchange Reserves

Billion US \$, end of period

	1980	1981	1982	1983	1984	1985	1986
Argentina	6.1	2.6	2.4	1.2	1.2	3.1	2.3
Brazil	5.0	5.9	3.6	4.4	11.5	10.6	5.0
Chile	3.0	3.1	1.7	2.0	2.3	2.4	2.3
Egypt	1.0	0.7	0.7	0.7	0.7	0.8	0.9
Indonesia	5.0	4.5	2.6	3.6	4.7	4.8	3.9
Mexico	4.2	5.0	1.8	4.9	8.1	5.8	6.3
Nigeria	9.6	3.1	1.6	1.0	1.5	1.7	1.0
Peru	2.0	1.2	1.3	1.4	1.6	1.8	0.9
Philippines	2.8	2.1	0.9	0.7	0.6	0.6	1.7
Venezuela	5.6	7.1	5.4	6.4	7.7	8.9	5.0

accelerate above the pace we expect. Only in 1984 when OECD growth exceeded 4 percent did LDC debt problems actually recede. This scenario also would require continued low nominal and real interest rates and limited changes in oil prices. The latter seems possible but most observers expect interest rates to rise. []

There may be some future benefits to LDCs emanating from the current world economic situation. Low commodity prices, including oil, have forced many countries to more closely examine ways of diversifying their exports. Other debtors, however, will have to follow Brazil's example and diversify to a point where commodities and manufactured goods are in better balance. Debtors that have the longest way to go are oil exporters—such as Mexico, Venezuela, and Nigeria—and major commodity producers such as Ivory Coast, Peru, and Chile; progress on export diversification in these countries will have to improve dramatically in order to reduce their dependence on commodity prices. []

A New Risk

In addition to what we see as insufficiently favorable economic trends, our concern about the outlook for the debt situation is heightened by our belief that

debtor attitudes and negotiation stances are hardening. Aside from Brasilia's unilateral interest moratorium on its medium- and long-term commercial debt:

- Ecuador, previously a model debtor with a good payments record and good relationships with creditor banks and governments, suddenly has begun allowing interest arrearages to build.
- Chile has also taken an unusually tough negotiating stance, threatening a payments moratorium unless creditors accede to their demands for additional concessions. Chile, however, has reached tentative agreement with its bank creditors, obtaining favorable terms.
- Argentina and the Dominican Republic are considering suspension of interest payments identical to that put in place by Brazil if new money or concessions are not forthcoming from creditors. []

While debtor demands are not new—they always have asked for more than they have eventually been willing to settle for in negotiations with their creditors—we detect a markedly increased toughness and

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arrogance in their present stances. In our judgment, these harder, more forcefully stated positions are not just negotiation ploys; rather, they represent a growing general perception among debtors that it is time for developed country governments and banks to bear more of the burden of the debt. We believe debtors are becoming especially unwilling to let reserves be depleted again to the rockbottom levels of 1982-83—Brazil, in our view, is already at its minimum acceptable level of \$1.5 billion—or to place their people under a new round of further austerity.

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Even if the current problems with Brazil are resolved, we do not see debtors' negotiating toughness ebbing. Indeed, each additional bailout of a key debtor by creditor banks and governments will be viewed by debtors—not just the one affected but all others as well—as affirmation of their attitudes. In turn, we believe the debtors will perceive that they can continue to postpone their day of reckoning with the blessing of their creditors. In such a case, we see debtor attitudes hardening further in the future, making it more difficult to reach agreements on debt.

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