

TRANSMITTAL SLIP

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TO: Dave Cohen, DD/OGI

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REMARKS:

As promised

FROM: Harry Rowen, C/NIC

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FORM NO. 241
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(67)

U.S. DEPARTMENT OF COMMERCE



November 10, 1982

To :

25X1

From: Lionel Olmer *LO*

Attached are the papers I told you my staff was working on in an attempt to identify the trade effects of the LDC debt situation. These are working drafts but I hope you will find them useful. I welcome your comments or suggestions and hope to continue working with you on this.

Attachment

TRANSMITTAL FORM CD-82A (10-67)
PRESCRIBED BY GAO 314-3

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I. Issue: The severe economic difficulties of Mexico, Poland, and other major-developing country borrowers has raised questions about the security of the international financial system. Collapse of the international credit market caused by multiple developing country defaults or refusals to meet payments is held unlikely, but many bankers and analysts believe the situation is becoming untenable. While concern has focused primarily on the international banking system, little attention has been given to the effects of debt crises on U.S. commercial markets and the international trading system. However, steps taken to prevent a financial collapse may not prevent severe contractions in trade and economic activity with accompanying political impacts. These developments could also have severe consequences for U.S. interests and necessitate an integrated policy approach that addresses overall U.S. interests.

II. Background

Economic Conditions

The international economy is at a low ebb weakened by adjustment difficulties and faltering growth in major industrial countries. The consequences for developing countries have been harsh:

- Current-account deficits of developing countries totaled \$110 billion in 1981. The OPEC surplus has nearly disappeared, representing a more than \$100 billion swing in two years.
- Terms-of-trade deterioration has been particularly severe for countries relying on primary-commodity exports. Internationally traded commodities have dropped 35% to the lowest level in three decades and 20% below the 74-76 recession. Export commodities hardest hit in 1981 were sugar (-40.8%) logs (-25.1%), rubber (-22.9%), copper (-20.2%), and cocoa (-20.1%). Reduced prices for oil in Mexico, copper in Chile, tin in Bolivia, and sugar and coconuts in the Philippines have contributed heavily to the squeeze on foreign exchange earnings. Chile, for example, loses \$22 million annually for every one-cent decline in copper prices. (See Table 1 for percentage reliance on commodity exports and Appendix 1 for specific commodities.)
- Real GNP growth in 1981 dropped to 2.2. percent from 5 percent in 1980.
- Inflation rose 37 percent and 13 percent for nonoil and oil-exporting countries, respectively. (Inflation in Argentina, Brazil, and Mexico was 146 percent, 96 percent, and 61 percent, respectively, in 1981-1982.)

- Interest rates soared worldwide and, in particular, affected the cost of financial capital to developing countries from private sources. The London Interbank Offer Rate (LIBOR) averaged 17 percent in 1981, the highest yearly average ever. Each percentage point increase in LIBOR adds about \$2 billion to debt interest payments.
- Export growth declined (by volume) in 1981 to 3.9 percent and -16.2 percent for nonoil and oil-exporting countries, respectively. Export growth for non-OPEC countries in 1982 is expected to be negligible.

These combined factors of slowed economic growth, inflation, declining exports, deteriorating terms of trade and plunging commodity prices, in combination, have seriously crippled developing countries ability to manage external debt.

External Debt

Developing countries' external debt totalled \$659 billion in 1981.* The World Bank predicts that it will reach \$1 trillion by 1986. The volume alone is not the prime concern. Rather, the shift in debt structure from official to private financing (producing shorter maturities and higher interest rates); the squeeze on foreign exchange due to the convergence of adverse economic factors cited above and the increased reluctance of banks to continue lending, portend a rising incidence of debt crises and threats to the international trade and commercial system. Features of the current debt situation are:

- Debt-service climbed 18 percent in 1981 to \$112 billion. Increasingly, countries are borrowing to service debt rather than to invest in productive projects.
- Interest payments in 1981 jumped 25 percent to \$47 billion. This year Brazil and Argentina will pay 45 percent and 44 percent, respectively, of export earnings for interest payments. Mexico will need \$12 billion in 1983 to meet interest requirements.
- Debt service (principal and interests payments) as a percent of exports of goods and services has reached alarming heights. Examples of debt-service ratios in 1982 are: Argentina - 179%, Mexico - 129%, Brazil - 122%, Chile - 116%, Colombia - 94%, the Philippines - 91%, Korea - 53%. (See Table 1) Overall, nonoil countries' ratio of long-term external debt to exports will be 109 percent.

* World Bank, BIS, OECD data cited in Euromoney, August, 1982.

- Arrearages on debt service have risen to \$5.5 billion. The number of countries in arrears is about 26 compared to 4 in 1974.
- Short-term debt has escalated and contributed to the ballooning debt-service. This rapid buildup of short-term debt is a consequence of borrowers seeking to avoid high spreads on medium and long-term loans and of bank hesitancy to extend term loans to some borrowers.
- Debt reschedulings have increased dramatically in 1982. At least 18 countries will reschedule this year. This compares to five in 1979 and four in 1974.
- Of the total LDC debt outstanding in 1981 (\$629 billion) private banks are owed \$307 billion, \$140 billion of which is due this year.
- Banks no longer seem willing to bail LDC's out as was done after the 1973 oil shock. In the last 3 years U.S. bank claims on LDC's grew at a 21% pace while their capital was growing only 10% annually. However, U.S. bank claims on LDC's actually declined by \$1 billion in the first quarter of '82.

LDC Alternatives

Developing countries are reaching their borrowing limits and are stymied in efforts to finance further development and industrialization. Their alternatives include:

Adjustment -- Further belt tightening of their economies. Many countries already have adopted strict IMF-sanctioned programs and find little room to impose greater austerity without severe economic hardship and political disruption.

AID -- Increased assistance on concessional terms and adequate amounts; not a likely solution to immediate debt-servicing requirements.

IMF -- The lender-of-last-resort umbrella to the banking community is not the IMF's function, nor does it have resources for this role.

Barter trade -- An increasingly attractive alternative to many countries, such as recent swap proposals between Brazil, Mexico, and Venezuela.

Reschedule -- Dramatic increases in official and private reschedulings; commercial bank reschedulings may number 18 this year and more than double last year's volume.

Repudiate Debt -- Willfully repudiating debt obligations is an unlikely option due to future needs for capital.

Debt Cartels -- An OPEC-style organization of debtor countries to press for access to export markets and delayed debt-payment schedules, has been proposed and may be a last-ditch alternative for countries without other options.

Prospects in the 1980's

Economic conditions in the 1980's differ from those in the 1970's and will make economic choices more difficult. Debt and debt-service obligations have accumulated; banks have nearly reached lending limits; interest rates are higher and (although declining) add to debt burdens; world growth is slower and trade has declined. In addition to the consequences for developing-country economies and the banking system, the severity of the debt problem today means that it will be harder for the world economy to emerge from recession through a trade-led recovery.

III. U.S. Commerce and the International Trading System

Developing countries are the largest growth markets for U.S. exports at a time when the U.S. economy increasingly relies on trade. The share of trade in U.S. GNP has doubled in ten years, and over 20 percent of U.S. industrial output is exported.

- Developing countries now receive 38 percent (\$88.9 billion) of total U.S. exports. In 1981 the U.S. exported 19.5 percent more merchandise to developing countries than to the combined markets of Japan and the European Community.
- In 1981 when the volume of world trade dropped, U.S. exports to developing countries increased 9.6 percent. This compares to the 3.8 percent U.S. export increase to industrial countries.
- Latin America accounts for about half of U.S. exports to LDCs or nearly \$40 billion in U.S. sales in 1981.
- Mexico alone accounted for \$18 billion in U.S. exports in 1981, and was the third largest U.S. exports market in the world.
- Last year U.S. firms sold \$65 billion of manufactured products to LDC markets, over 40 percent of total U.S. manufactured exports, and more than was sold to Western Europe, Japan, and the communist countries combined.
- Over half of U.S. exports of general industrial machinery and electrical machinery went to LDCs last year.

- The developing countries also account for about one-fourth of all outstanding U.S. foreign direct investment, or about \$56 billion in 1981.
- U.S. firms have nearly \$40 billion invested in Latin America, including over \$8 billion in Brazil and almost \$7 billion in Mexico.

The increasing squeeze on developing-country foreign exchange exacerbated by rising debt-service obligations, will adversely affect their import capability.

- Already this process has begun. (See Table 1, for U.S. trade with major LDC debtors.) Comparing 1981 to 1980, U.S. exports dropped 12.5 percent in Mexico, 10 percent in the Philippines, 7 percent in Thailand, and 15 percent in Indonesia. Thus far in 1982 total U.S. exports to Latin America have dropped 20 percent, and the \$5.4 billion U.S. trade surplus with this region has already turned to a \$500 million deficit.
- Comparing January-August 1982 export data to the same period in 1981, U.S. exports to Mexico dropped 26 percent, to Argentina - 44 percent, Chile - 59 percent, Peru - 25 percent, and Thailand - 25 percent.
- If bank lending remains flat Morgan Gaurantee projects a \$30 billion trade reduction in Latin America alone. Mexico already plans cuts of \$8 billion in imports the U.S. share (70%) could be almost \$6 billion.
- In addition to causing a decline in U.S. exports, external debt problems may adversely affect U.S. foreign direct investors in these countries as well as the U.S. banks which have lent to these U.S. companies.
- Protectionist pressures are already growing but the combination of a strong dollar and LDC BOP adjustments could cause rapid deterioration in our trade balance. A more confrontational, protectionist Congress would be a likely result and bills that were narrowly defeated last year would reappear along with other more destructive legislation.
- The combination of a reduction in U.S. exports to LDC's and greater penetration of U.S. markets by LDC imports may hamper any attempt at U.S. recovery.

Developing countries have adopted a number of policy tools to deal with their troubled economies. These tools are damaging U.S. commercial interests and include:

- o Overvalued exchange rates used to combat inflation rather than to adjust balance-of-payments. The latter must then occur through slowing import volume, thus hurting U.S. export markets.

- o Barter and other related trade arrangements not requiring foreign exchange. The U.S. may face export competitors willing to provide discounts on surplus or depressed goods that we also produce. Poland, Indonesia, Mexico, Venezuela, and Brazil have already begun resorting to these techniques.
- o Investment requirements that are not beneficial to U.S. firms. For example, Mexico reportedly has offered international creditors of Mexican companies up to 15 percent in equity position in a Mexican company in lieu of an equivalent amount in debt repayments. Capital and import controls will further jeopardize business operations.
- o Trade protectionism imposed by developing countries to counter the outflow of foreign exchange needed for debt-servicing. These countries will make greater use of import controls, export incentives, exchange and capital controls, and currency devaluation. The open trade system which the U.S. and others have promoted through the GATT will be set back, and the new reforms we are seeking to liberalize trade further will not succeed. (i.e. GSP renewal, subsidy agreements)
- o Conversion of currency holdings to U.S. dollars for servicing external debt due to the slower expansion of dollar lending internationally. This demand contributes to the dollars unusual rise despite declining interest rates. Further, impairing U.S. export price competitiveness.

These factors affecting U.S. trade and other commercial relations will adversely impinge on U.S. economic recovery and particularly on employment.

- o The OECD Secretariat has now revised downward it's projection for 1982 & '83 OECD-real GNP growth by 1/2% due to the contraction in non-OECD countries. 1983 OECD growth is now expected to be 1 3/4%. Japanese and European 1983 growth projections have been reduced by 3/4%.
- o Current estimates show that 23,000 jobs are created for every \$1 billion in U.S. exports.
- o About one of every eight U.S workers in the manufacturing sector owes his job to exports.
- o Almost one-third of all U.S. corporate profits derive from the firms' international activities, including their foreign investments as well as trade.
- o The leading categories of U.S. exports to developing counties -- industrial and electrical machinery, chemicals, power generating equipment and aircraft -- likely are the imports that would be curtailed, thus injuring the stronger sectors of the U.S. economy.

The attached tables review the recent changes in trade flows between the U.S. and key LDC's. While these figures clearly show the magnitude of the import reductions thus far this year they need to be further refined to screen out aberrations (i.e. Mexican gold imports, exchange rate effects etc.) and identify the reductions caused by liquidity problems alone.

We are currently attempting to take this analysis one step further to determine the effect on U.S. trade and investments in the medium and short term. Initially this is complicated by the reliability of data on the financing needs of key LDC's. Estimates of future balance of payments, current and capital account changes vary and are further clouded by the changing conditions in IMF resources and in bank lending and reschedulings. Even if assumptions about these figures are accurate problems in trade finance and private sector LDC borrowing may intensify the impact on the trade account. Any assistance you can offer to improve our data in this area would be helpful. Our goal is to focus on a few key countries and using the available data and assumptions on their liquidity situation estimate likely effects on the trade account, how the trade adjustments will be implemented (i.e. type of import regime), likely U.S. export losses, sectors most likely to be effected, U.S. export losses vs. other OECD countries and the extent to which the dollars exchange rate affects any market share change. Related issues we are looking at which are harder to quantify but equally as important for trade policy are the effects on U.S. trade policy in general (GATT initiatives, export subsidy arrangements, GSP renewal etc.) The growing interest in barter trade among countries strapped for hard currency is particularly worrisome in this regard. Finally, we are reviewing recent attempts to quantify the effects on overall U.S./OECD economic activity. The models we've seen do not seem to take into account the effect on the U.S. of possible slower OECD growth due to the loss of export markets, reductions in South-South trade further slowing LDC growth, and the greater effects of Latin American imports reductions on the U.S. economy.

Attachment

TABLE 1
U.S. EXPORT MARKETS AND LDC DEBT

Major LDC Debtors	U.S. Exports ^{a/} U.S. \$ billion (1981)	U.S. Export Growth Percent Jan-Aug (1981)	U.S. Market Share (1979)	External Debt ^{d/} (\$ billion) 1982	Debt-Service Ratio e/ (percent 1982)	Energy Imports f/ (percent 1981)	Major Commodity Exports (percent 1981)
Total LDCs	\$88.9	9.6%	38% c/	659			
1. Mexico	17.7	17.4	63	81	129	-	24.8%
2. Saudi Arabia	7.32	27.0	21	0*		-	100
3. Venezuela	5.44	19.0	46	35.5	95	-	95
4. South Korea	5.11	9.1	23	35	53	30	N.A.
5. Taiwan	4.30	.73	24	7.0*	21	25	N.A.
6. Brazil	3.79	-12.5	18	87	122	48	34
7. Argentina	2.19	-16.5	21	36.6	179	2.5	48
8. Egypt	2.16	15.2	18	19	48		12.8
9. Philippines	1.78	-10.0	26	18	91	22.6	44
10. India	1.74	3.4	12	18.5*	8	-	95
11. Peru	1.48	26.8	34	9.9*	90	N.A.	54.7
12. Chile	1.46	8.2	23	18.2	116	12	51
13. Indonesia	1.30	-15.0	14	21.9	27	N.A.	75
14. Thailand	1.17	-7.0	16	10.2	48	20	56
15. Morocco	.43	24.7	6	8.5*	35	20	45

a/ Total U.S. exports in 1981 equalled \$233.7 billion.
 b/ Compared to Jan.-Aug. 1981.
 c/ Percent of total U.S. exports, 1981.
 d/ External debt and debt-service ratio estimates are from Morgan Guaranty Trust Co. and other private-bank sources. Total debt figure is compiled from World Bank, BIS, and OECD sources and includes short-term debt. Cited in EuroMoney, August, 1982. Asterisked figures are for 1980; Peru is 1981.
 e/ Debt-service ratio is the ratio of interest payments on total debt plus principal repayments on medium and long-term debt to exports of goods and services and (where positive) net private transfers. Figures for Morocco and Peru are for 1981.
 f/ Energy and commodity figures are from the IMF International Financial Statistics, August 1982.

	<u>1980</u>	<u>1981</u>	<u>JAN-AUG</u> <u>1981</u>	<u>JAN-AUG</u> <u>1982</u>	<u>% CHANGE</u>	<u>AUG</u> <u>1981</u>	<u>AUG</u> <u>1982</u>	<u>% CHANGE</u>	
<u>U.S. EXPORTS (FAS)</u>									
20 L.A. REPUBLICS	36.03	38.95	26.71	21.60	-18%	2.93	2.39	-18%	
981									
ANK									
1	LAFTA - 11	32.27	35.26	24.14	19.40	-20%	2.63	2.11	-20%
1	MEXICO	15.14	17.79	12.09	9.00	-26%	1.31	0.80	-40%
2	VENEZUELA	4.57	5.44	3.58	3.56	- 1%	0.40	0.46	+15%
3	BRAZIL	4.34	3.80	2.73	2.46	-10%	0.27	0.32	+19%
4	ARGENTINA	2.63	2.19	1.64	0.92	-44%	0.19	0.08	-58%
5	COLUMBIA	1.74	1.77	1.15	1.23	+ 6%	0.13	0.17	+30%
6	PERU	1.17	1.49	1.04	0.78	-25%	0.10	0.10	- 0%
7	CHILE	1.35	1.47	1.01	0.62	-39%	0.12	0.07	-41%
	OTHER								

	<u>1980</u>	<u>1981</u>	<u>JAN-AUG</u> <u>1981</u>	<u>JAN-AUG</u> <u>1982</u>	<u>% CHANGE</u>	<u>AUG</u> <u>1981</u>	<u>AUG</u> <u>1982</u>	<u>% CHANGE</u>	
<u>U.S. IMPORTS (CIF)</u>									
20 L.A. REPUBLICS	31.32	33.54	22.00	22.04	+0	2.74	3.00	+10%	
981									
ANK									
1	LAFTA - 11	27.86	30.22	19.78	20.05	+2%	2.51	2.73	+ 9%
1	MEXICO	12.84	14.01	8.99	10.30	+15%	1.14	1.45	+ 27%
2	VENEZUELA	5.57	5.80	3.98	3.10	-22%	0.54	0.29	- 46%
3	BRAZIL	4.00	4.85	3.12	2.96	- 5%	0.39	0.42	+ 8%
4	PERU	1.44	1.28	0.93	0.72	-23%	0.13	0.12	- 12%
5	ARGENTINA	0.79	1.21	0.76	0.82	+ 8%	0.09	0.09	0%
6	ECUADOR	0.95	1.10	0.60	0.85	+42%	0.07	0.16	+129%
7	COLUMBIA	1.33	0.90	0.62	0.57	- 8%	0.06	0.09	+ 50%
8	CHILE	0.59	0.66	0.45	0.53	+18%	0.06	0.07	+ 16%
	OTHER								

	<u>1980</u>	<u>1981</u>	<u>JAN-AUG</u> <u>1981</u>	<u>JAN-AUG</u> <u>1982</u>	<u>AUG</u> <u>1981</u>	<u>AUG</u> <u>1982</u>
TRADE BALANCE 20 L.A.	4.71	+5.41	+4.71	-0.44	+ 19	-0.61
BILLIONS						

NG#3268Q

U.S. Export Trends to Selected Financially-Troubled Nations, 1981-1982*

	Jan.-Sept. 1982		Jan.-Sept. 1981		Sept. 1982		Sept. 1981	
	U.S. Exports	% Change	U.S. Exports	% Change	U.S. Exports	% Change	U.S. Exports	% Change
Argentina	1,007.9	-42.9	1,765.0	-42.9	87.0	124.0	124.0	-29.8
Bolivia	83.4	-45.8	154.0	-45.8	9.6	10.6	10.6	-9.4
Brazil	2,770.0	-8.6	3,032.1	-8.6	306.0	302.3	302.3	+1.2
Chile	713.2	-36.6	1,124.4	-36.6	94.1	115.1	115.1	-18.2
Ecuador	646.0	+0.7	641.5	+0.7	87.8	68.9	68.9	+27.4
Mexico	10,038.9	-25.4	13,463.2	-25.4	1,042.6	1,375.4	1,375.4	-24.2
Peru	875.3	-23.1	1,138.8	-23.1	96.8	98.7	98.7	-1.9
Venezuela	3,961.7	-1.6	4,029.6	-1.6	402.5	453.1	453.1	-11.2
Sub Total-- Latin America	20,096.4	-20.7	25,348.6	-20.7	2,126.4	2,548.1	2,548.1	-16.5
E. Germany	181.7	-23.2	236.5	-23.2	1.9	9.0	9.0	-78.9
Poland	190.1	-67.7	588.7	-67.7	28.8	43.6	43.6	-33.9
Romania	193.6	-58.5	467.0	-58.5	3.7	24.9	24.9	-85.1
Yugoslavia	394.6	-15.9	469.3	-15.9	36.1	43.2	43.2	-16.4
Sub Total-- East Europe	960.0	-45.5	1,761.5	-45.5	70.5	120.7	120.7	-41.6
Nigeria	996.5	-13.1	1,147.2	-13.1	92.6	149.0	149.0	-37.9
Philippines	1,418.1	+5.4	1,344.9	+5.4	129.2	158.2	158.2	-18.3
Sub Total-- Other	2,414.6	-3.1	2,492.1	-3.1	221.8	307.2	307.2	-27.8
Total of Above	23,471.0	-20.7	29,602.2	-20.7	2,418.7	2,976.0	2,976.0	-18.7
Total U.S. Exports To Developing Nations**	63,509.1	-5.4	67,114.5	-5.4	6,574.7	6,951.8	6,951.8	-5.4
Total U.S. Exports To World	162,581.2	-7.4	175,654.6	-7.4	16,716.6	18,819.2	18,819.2	-11.2

* Merchandise exports, FAS. Countries selected are significant U.S. export markets where the ability to import is being (or may shortly be) curtailed substantially by reduced access to international capital markets and/or heavy external debt service payments.

** Excludes communist areas in Europe and Asia.

Source: U.S. Department of Commerce, Census Bureau, Highlights of U.S. Export and Import Trade, September 1982.

Prepared by: William F. Kolarik, IE/OTIA/x4691
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