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THE DIRECTOR OF CENTRAL INTELLIGENCE

WASHINGTON, D.C. 20505

National Intelligence Council

DDI #3744-82
5 May 1982

MEMORANDUM FOR: Director of Central Intelligence
Director, Office of African and Latin American Analysis
Director, Office of East Asian Analysis
Director, Office of European Analysis
Director, Office of Global Issues
Director, Office of Near Eastern and South Asian Analysis
Director, Office of Soviet Analysis
Director, Office of Current Production and Analytic Support
Chief, Product Evaluation Staff

VIA: Chairman, National Intelligence Council

FROM: Maurice C. Ernst
National Intelligence Officer for Economics

SUBJECT: The Implications of Severe LDC Financial Problems

Attached is a preliminary look at what I consider to be the growing difficulties LDCs will face in financing large current account deficits and the increased risks to the stability of the international monetary system. I believe these issues need to be carefully examined and that CIA needs to do more work on some important aspects.

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Maurice C. Ernst

Attachment,
As stated

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NIC/NIO/Econ [redacted] 25X1

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The Implications of Severe LDC Financial Problems

Argentina's conflict with the U.K. and Mexico's severe difficulties in making the necessary shift from expansionary to restrictive economic policies, in addition to broad negative world economic trends, could bring the financial problems of LDCs to a crisis phase during the next few months. There appears to be a substantial risk of a large contraction of bank lending to Latin American and African countries. There is also a much smaller, but still worrisome risk that LDC debt problems, on top of those already experienced in Eastern Europe, will trigger a banking crisis which could have adverse repercussions throughout the international economy. The next six months or so will be a period of exceptionally high risk of both kinds.

There is no question that the LDC's international financial position has been deteriorating. The debt service ratio rose sharply last year and will rise again this year as a result of rising interest rates and falling exports. The Western economic recession has caused prices of most LDC primary exports to fall sharply during the past year or so, with detrimental effects on both export earnings and domestic incomes. Many LDCs have had to curtail imports, which, for the Third World as a whole, have not grown for more than 12 months. In spite of these painful steps, current account deficits have not fallen because the impact of higher interest rates offset any reductions in trade deficits (see attached tables).

Unfavorable World Economic Trends

Most projections of LDC economic trends have assumed that current account deficits as large as or larger than last year could be financed. Although there have been signs of growing difficulties in meeting debt service obligations, until recently all of the LDCs who were in arrears on debt payments were small countries--mainly in Central America and Africa. The consensus view was that the big debtors--e.g., Brazil, Mexico and Argentina--would be able to finance large deficits. This assumption has become highly questionable because of both a worsening of some general economic and financial trends and some unexpected developments in key countries.

The international economy has been weaker than formerly expected. Recovery from the U.S. recession, once expected to begin early this year has been delayed for at least 6 months, and maybe longer. Western Europe's economic recovery also has been delayed. Consequently, demand for LDC exports is weaker than had been expected. This unfavorable trend more than compensates for the impact of declining world inflation on LDC import costs.

The dramatic turnaround in the oil market, from shortage to glut, and the resulting disappearance of the OPEC surplus, is having a mixed impact on the LDC economies, but many of the favorable effects will probably be delayed while the unfavorable effects are already being felt. Lower oil prices are beginning to reduce directly LDC import costs, are an indirect factor in lowering the prices of non-oil imports, and will eventually help to stimulate Western economic recovery. On the other hand, the disappearance of the overall OPEC surplus and the entrance of most OPEC countries into the financial markets as borrowers is increasing the competition for loanable funds while reducing their volume. This is clearly a factor in the tightening of the Eurodollar market, taking the form of both reduced lending and more stringent terms. Finally, a retrenchment is underway in official financing of LDC developmental and balance of payments needs, which places even greater pressure on private capital markets.

Besides these broad economic trends, events in Argentina, Brazil and Eastern Europe threaten to shake bankers' confidence in lending to LDCs.

The Argentine Crisis

The Falkland Islands conflict comes at a time when a recently installed Argentine military leadership was in the process of introducing a promising, but very painful economic stabilization program. Under the previous leadership, the economy had suffered at the same time rapidly declining production, accelerating inflation and a massive increase in foreign debt, the results of extraordinary mismanagement, even for Argentina. Even if the military conflict with Britain ends quickly, without major financial effects, any successor Argentine government will have great difficulty coping with debt service obligations, which exceed $6 billion this year. To meet these obligations would require both severe belt-tightening at home, which may not be politically possible, and enhanced lenders' confidence. Although formal default on Argentina's debt is unlikely, a great deal of rescheduling is a strong possibility. Argentina is the third largest LDC debtor, with over $20 billion in medium- and long-term debt and over $10 billion in short-term debt.

The Mexican Problem

Mexico is beginning to undergo a difficult economic transition during the interregnum between a lame duck Presidency and a new one. Soft oil markets are reducing both current and projected export earnings and the massive Mexican debt (over $70 billion), accumulated in a period of euphoria over surging oil earnings, no longer looks secure. The overdue, floating devaluation of the peso has been mismanaged. An attempt to insulate domestic real wages from the impact of the devaluation has kept the peso floating downward and has undermined confidence in the seriousness of government's intention to return to a stable situation. Although the government has announced a several-point stabilization program, there are questions both about its willingness to take unpopular measures and about the possible squeeze on private enterprises between overall credit ceilings and the continuing large demands of the public sector. At least one major private enterprise (Group Alpha) has fallen behind on its foreign obligations and is trying to negotiate a rescheduling. Bankers are extremely worried about Mexico and are reluctant to provide new money.

Eastern Europe

Far from Latin America, but with possible implications for LDC access to credit, are the severe debt service problems of Eastern Europe. The continued worsening of Poland's financial crisis; the growing crisis in Romania; and the spread of bankers' concerns to Hungary, East Germany, and the rest of the Soviet Bloc, are causing an overall contraction of private credit to that area. Apart from the fact that this credit contraction will force a reduction in imports, the experience in Eastern Europe may color bankers' attitudes about lending to LDCs.

A Possible Contraction of Credit to LDC's

These developing problems could give rise to either or both of two kinds of financial crises: a severe curtailment of lending to LDCs; and an international banking crisis. The first of these crises is far more likely than the second, but the possibility of both has increased greatly and will probably peak during the next few months. Beyond that period, economic recovery in the West should be underway, LDC export prices should be rising, and consequently the debt problems should begin to ease.

It would not be surprising if Argentina were unable to finance any balance of payments deficit for at least several months, although lenders will have little choice but to roll over existing credits. Mexico is not yet so badly off, but its creditworthiness has been severely eroded and strong stabilization measures are needed soon to reestablish bankers' confidence. It is highly unlikely that Mexico can finance a projected current account deficit of the order of $8 billion. Major difficulties in Argentina and Mexico, reinforced by the indirect effects of the problems in Eastern Europe, will almost certainly make funding of a large deficit more difficult for Brazil. Brazil has already substantially reduced its imports over the past three years. Further cuts are bound to adversely affect on economic activity. Most other Latin American countries are also in financial trouble, and not only those of Central America and the Caribbean. Venezuela faces a probably lengthy period of declining oil earnings, its dominant source of income. Negative bankers' attitudes may spread to the entire continent, as well as to Africa, where a substantial number of countries are already in arrears on their obligations. There are no signs, however, that the Far Eastern or South Asian countries are encountering any major difficulties in obtaining loans. So far, they may even be benefiting from the increased risk of bank lending to other parts of the world and from their comparatively strong economic position.

A substantial contraction of credit to LDCs would force severe additional economic adjustments in countries which are already depressed, and in some of them this could be highly destabilizing politically. Moreover, a sharp contraction of imports in both the LDCs and the Communist countries would act as a further drag on economic recovery in the West. In contrast, Western recovery from the 1975 recession was substantially aided by the continued growth of import demand in LDCs and the Soviet Bloc.

The Risks of A Systemic Crisis

The risk that a reduction in bankers' confidence in lending to LDCs will trigger a major banking crisis is difficult to assess. Concern about the vulnerability of the international financial system to events which could trigger major bank failures, and the spreading of the crisis throughout the international financial system has increased greatly. Although national and international financial authorities have addressed this issue and taken some steps to cope with crisis situations should they arise, substantial sources of concern remain. These are based on the following kinds of considerations:

- The enormous volume of interbank deposits in the Euro currency system (nearly a trillion dollars);

- The lack of transparency in the system and the speed at which money can move;

- Ambiguities concerning acceptance of responsibility for Lender of Last Resort functions by central banks--for example, who is responsible for the branches and subsidiaries of foreign banks in a particular country?

- Ambiguities concerning criteria for providing central bank support to private banks which are in trouble--which banks should be helped, why, and under what circumstances?

- Possible shortages of the particular foreign currencies in which intervention is necessary.

- Possible legal constraints on private or central bank support.

There is concern that a major bankruptcy among the LDCs or in Eastern Europe will trigger a liquidity crisis in banks which are particularly exposed, or in the extreme may wipe out some banks' capital. This process could begin with the direct effects of bad debts on a bank's balance sheet and quickly lead to cash flow problems when other banks withdraw their deposits from or at least refrain from making new deposits in the troubled banks. A chain reaction could then set in, involving an increasing number of banks in an increasing number of countries as confidence ebbs and bankers try to retrench to protect themselves. The retrenchment process could be stopped by central bank action but there is a question as to how prompt and effective this action would be. The problem is complicated by the great uncertainty as to what form initial stages of the crisis might take and by the concerns of financial authorities that too much prior discussion of this problem would become public knowledge and would itself undermine market confidence. The financial authorities also want to avoid promising so much support that private banks will feel free to take undue risks.

Even those who worry the most about the risks of an international banking crisis do not regard such a crisis as probable. The consensus view is that the chances of such a crisis are fairly small, but have been increasing and may be at a postwar peak during the next few months. A curtailment of credit to the LDCs seems far more likely than a banking crisis for several reasons:

- Where LDCs are unable to meet obligations, creditors rarely have an interest in a formal declaration of default--the growing arrears accumulated by Poland are a good example.

- Even if default is declared by some creditors, and forced on others through cross-default clauses, the debts are not necessarily wiped off the lending banks' balance sheets quickly--the impact is likely to be phased over a period of time so that the banks are more likely to suffer an erosion of their rating and liquidity position than a dramatic fall into insolvency.

- Central bank action is likely to contain the impact of an incipient banking crisis and prevent its spread.

Even so, the situation is worrisome. The aggregate debt of Mexico, Argentina, and Poland exceeds $120 billion, and U.S. exposure to these countries is about $30 billion, equal to nearly 80 percent of the equity capital of the 40 largest U.S. banks. If rescheduling of Poland's 1982 debt service obligations is long delayed, the risk of creditors declaring formal default will be high. If the war over the Falklands is not resolved quickly, the Argentine military regime could force formal default by declaring a moratorium on its debt service payments, even though Argentina would be hurt more than anyone else in the long run. Large scale defaults of Mexican debt are less likely but the stakes are enormous. The point is that any number of circumstances could trigger a major problem, the impact of which would probably be contained, but no one can be quite certain.

What Needs to Be Done

This worrisome situation will require close monitoring and analysis throughout the U.S. government and in CIA. While CIA has little unique expertise in evaluating risks to the international banking system, [redacted] 25X1
[redacted] and I have been familiarizing ourselves with the literature on 25X1
this subject and discussing it with officials at Treasury, the Federal

Reserve, the NSC and the State Department, as well as with private sector experts. Some steps are being taken to examine contingency plans and new forms of international cooperation through the Working Group on LDC Financial Problems of the Cabinet Council on Economic Affairs. I had considered sponsoring, although not managing, a kind of financial war game as an aid to learning more about the problem, but I suspect that this would take too long to be helpful during the high risk period of the next few months. In any event, the CIA role in this area has to be primarily to spur the financial authorities to look even harder at the problems they may face.

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SELECTED LDC DEBTORS: ECONOMIC PERFORMANCE

(billion US$ except where noted)

	1979	1980	1981e	1982e
ARGENTINA				
Imports	6.0	9.4	9.2	7.3
Exports	7.8	8.0	9.1	10.3
Trade Balance	1.8	-1.4	-.1	3.0
Debt	15.1	19.0	24.0	30.0
Debt Service	3.3	5.0	6.1	6.5
Current Account Balance	-.5	-4.7	-3.9	-1.0
Growth (percent)	12.0	1.0	-3.0	0.3
Inflation (percent)	160	100	105	120
BRAZIL				
Imports	17.9	23.0	22.1	24.8
Exports	15.2	20.1	23.3	26.8
Trade Balance	-2.7	-2.9	1.2	2.0
Debt	49.9	54.0	62.0	70.0
Debt Service	11.8	12.9	16.8	17.0
Current Account Balance	-10.5	-12.9	-10.6	-11.0
Growth (percent)	6.4	8.0	1.0	4.0
Inflation (percent)	50	80	95	80
CHILE				
Imports	4.2	5.3	7.1	8.5
Exports	3.8	4.7	4.4	5.0
Trade Balance	-.4	-.6	-2.7	-3.5
Debt	8.5	9.5	10.6	12.0
Debt Service	1.8	2.4	2.7	3.0
Current Account Balance	-1.2	-1.8	-4.1	-5.2
Growth (percent)	8.3	6.5	5.0	3.0
Inflation (percent)	35	35	20	NA
COSTA RICA				
Imports	1.4	1.4	1.2	1.2
Exports	.9	1.0	1.0	1.1
Trade Balance	-.5	-.4	-.2	-.1
Debt	1.4	1.9	2.5	2.7
Debt Service	.3	.3	.4	.6
Current Account Balance	-.6	-.6	-.4	-.5
Growth (percent)	4.9	1.2	-5.0	-3.0
Inflation (percent)	9	20	60	NA
EGYPT				
Imports	7.0	8.3	8.7	10.0
Exports	3.2	4.4	4.4	5.0
Trade Balance	-3.8	-3.9	-4.3	-5.0
Debt	11.4	13.5	15.2	17.6
Debt Service	1.0	1.7	2.1	2.5
Current Account Balance	-1.3	-.5	-1.5	-2.0
Growth (percent)	8.7	8.0	8.0	8.0
Inflation (percent)	10	20	10	10

SELECTED LDC DEBTORS: ECONOMIC PERFORMANCE (cont.)

(billion US$ except where noted)

	1979	1980	1981e	1982e
IVORY COAST				
Imports	2.2	2.5	2.7	2.8
Exports	2.7	3.0	3.2	3.2
Trade Balance	.5	.5	.5	.4
Debt	4.0	4.7	6.0	7.0
Debt Service	.7	1.1	1.3	1.5
Current Account Balance	-1.4	-1.5	-1.8	-2.0
Growth (percent)	5.2	6.9	1.5	4.7
Inflation (percent)	15	15	12	NA
MEXICO				
Imports	12.0	18.6	25.0	24.0
Exports	10.0	17.0	22.0	26.0
Trade Balance	-2.0	-1.6	-3.0	2.0
Debt	39.2	48.8	67.5	78.0
Debt Service	12.4	11.4	14.5	16.2
Current Account Balance	-4.9	-6.6	-11.7	-8.0
Growth (percent)	9.2	8.3	7.0	5.0
Inflation (percent)	20	25	30	45
MOROCCO				
Imports	3.3	3.8	4.4	4.5
Exports	2.0	2.4	2.5	2.8
Trade Balance	-1.3	-1.4	-1.9	-1.7
Debt	6.6	7.4	8.0	8.6
Debt Service	.9	1.3	1.3	1.4
Current Account Balance	-1.6	-1.5	-2.2	-2.0
Growth (percent)	4.5	4.0	1.5	3.5
Inflation (percent)	8	9	15	15
PAKISTAN				
Imports	4.2	4.8	5.5	6.7
Exports	1.9	2.6	3.3	3.4
Trade Balance	-2.3	-2.2	-2.2	-3.3
Debt	8.0	8.8	9.5	10.3
Debt Service	.5	.7	.8	1.0
Current Account Balance	-1.3	-1.0	-1.0	-1.3
Growth (percent)	3.5	7.5	5.5	7.0
Inflation (percent)	10	12	15	NA
PERU				
Imports	2.1	3.1	3.8	4.0
Exports	3.5	3.9	3.3	3.1
Trade Balance	1.4	.8	-.5	-.9
Debt	7.3	7.8	8.3	8.8
Debt Service	1.3	2.1	2.5	3.0
Current Account Balance	-.7	.01	-1.7	-2.2
Growth (percent)	3.8	3.1	4.0	5.5
Inflation (percent)	65	60	70	55

SELECTED LDC DEBTORS: ECONOMIC PERFORMANCE* (cont)

(billion US$ except where noted)

	1979	1980	1981[e]	1982[e]
PHILIPPINES				
Imports	6.1	7.7	8.5	8.8
Exports	4.6	5.8	5.9	6.0
Trade Balance	-1.5	-1.9	-2.6	-2.8
Debt	8.2	9.6	11.0	13.0
Debt Service	1.1	1.5	1.8	2.1
Current Account Balance	-1.7	-2.1	-2.5	-2.7
Growth (percent)	5.7	5.4	5.0	6.0
Inflation (percent)	20	20	12	NA
SOUTH KOREA				
Imports	19.4	21.6	24.4	27.5
Exports	14.7	17.2	20.9	24.5
Trade Balance	-4.7	-4.4	-3.5	-3.0
Debt	15.1	17.3	20.0	23.0
Debt Service	2.8	3.4	3.6	4.0
Current Account Balance	-4.2	-5.4	-5.1	-4.2
Growth (percent)	7.1	-3.5	7.1	6.0
Inflation (percent)	20	30	25	12
ZAIRE				
Imports	1.1	1.2	1.4	1.5
Exports	1.8	1.9	1.8	2.0
Trade Balance	.7	.7	.4	.5
Debt	4.3	4.2	4.3	4.4
Debt Service	.2	.4	.3	.9
Current Account Balance	-.03	.04	-.3	-.5
Growth (percent)	-3.3	2.5	1.0	1.5
Inflation (percent)	110	40	50	50

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* Source: Third World Branch, Economics Division, OGI.

Aggregate LDC Economic Data*

(percent)

	1979	1980	1981	1982
Change in GNP				
OPEC	2.9	-2.8	-4.5	negl
Non-OPEC	4.7	4.4	2.5	3.9
Net oil exporters	7.2	7.3	6.6	5.1
Net oil importers	4.2	3.9	1.7	3.7
Major Manufactures Exporters	6.3	4.4	-0.2	3.5
Africa	2.6	4.6	2.6	2.0
Asia	3.1	3.4	5.7	5.6
Middle East	5.0	6.1	4.7	6.8
Latin America	6.7	6.0	-0.1	3.5
Change in Export Volume				
OPEC	3.0	-12.8	-16.3	-7.0
Non-OPEC	9.4	5.6	3.1	7.0
Change in Import Volume				
OPEC	-12.3	14.9	19.8	7.0
Non-OPEC	11.2	3.5	2.5	3.0
Change in Terms of Trade				
Industrial Countries	-2.7	-7.6	-0.7	1.5
OPEC	28.7	41.7	12.2	-5.5
Non-OPEC	-0.2	-4.4	-1.7	-1.0

* Source: IMF preliminary figures, March 1982.