THE SECRETARY OF THE TREASURY
WASHINGTON 20220

June 25, 1984

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Executive Registry
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MEMORANDUM FOR THE VICE PRESIDENT
THE SECRETARY OF STATE
THE SECRETARY OF DEFENSE
THE SECRETARY OF AGRICULTURE
THE SECRETARY OF COMMERCE
DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET
DIRECTOR OF CENTRAL INTELLIGENCE
UNITED STATES TRADE REPRESENTATIVE
ASSISTANT TO THE PRESIDENT FOR NATIONAL SECURITY AFFAIRS
ASSISTANT TO THE PRESIDENT & DEPUTY TO THE CHIEF OF STAFF
ASSISTANT TO THE PRESIDENT FOR CABINET AFFAIRS
CHAIRMAN, COUNCIL OF ECONOMIC ADVISORS
ASSISTANT TO THE PRESIDENT FOR POLICY DEVELOPMENT
ADMINISTRATOR, AGENCY FOR INTERNATIONAL DEVELOPMENT

SUBJECT Senior Interdepartmental Group on International Economic Policy (SIG-IEP)

A meeting of the SIG-IEP is scheduled to be held on Wednesday, June 27, 4:00 p.m., in the Roosevelt Room.

The agenda is as follows:

1. Status on Argentina; and
2. Report on Cartagena.

Discussion papers on both agenda items are attached.

Attendance will be principal, plus one.

DTR
Donald T. Regan

Attachments

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

June 25, 1984

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MEMORANDUM FOR MEMBERS OF THE SIG-IEP

From: David C. Mulford

Secretary Regan notes that the attached Secret document entitled "Argentine Economic and Financial Outlook" contains extraordinarily sensitive material and requests that the document be closely held.

Attachment

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SIG-IEP

ARGENTINE ECONOMIC AND FINANCIAL OUTLOOK

This paper provides a brief overview of the current Argentine economic and financial situation and the outlook for the balance of 1984, in line with NSDD-8's call for regular monitoring by the SIG and IG. It outlines the implications of alternative scenarios that could develop in the course of the next several months and concludes that Argentina's ability to effectively defy the IMF and world banking system is strictly limited. Our conclusion is that if Argentina does not reach agreement with the IMF and cannot obtain significant concessions from commercial banks or the USG, it will be unable to bring interest on its external obligations current by September 30 and cannot expect to avoid a major political/economic crisis by late 1984 or early 1985. This raises certain important policy problems which are discussed in the conclusions section of this paper.

The Economic and Financial Outlook:

Argentina's moderate economic recovery, apparent since early 1983, has become mired in near-record inflation rates and accompanying further demonetization. While real GDP grew by 2.8% in 1983 (largely due to increased public sector expenditures and expanded manufacturing output) the GOA 1984 goal of an annual inflation rate of 285% will be far exceeded; the May CPI increase stood at 17.1%, or 568% on an annualized basis.

While the trade account has shown continued improvement it largely reflects a sharp contraction in imports and stagnant export revenues. The official exchange rate appears to be seriously overvalued with little prospect for improvement.

Continued delays in reaching agreement with the IMF and the banks is likely to increase diversion of export transactions through the parallel market and Argentina would face the prospect of a diminished trade surplus.

Argentina needs an estimated $4 billion in foreign exchange inflows in 1984 to meet its interest obligations and essential principal payments. This is substantially larger than the $2 billion commonly cited and reflects the need to repay $750 million of the bank bridge loan and $1750 million in arrears on public sector interest obligations and trade finance during the course of the year. The difference also reflects excessive GOA optimism on the anticipated size of official reschedulings and an overly optiistic view of trade prospects. If Argentina is unable to reach an agreement with the IMF this year, its financing requirements would grow by some $600 million (the equivalent of two drawings under the proposed standby arrangement) to $4.6 billion.

Our estimate of Argentina's financial outlook for the balance of 1984 presumes that Argentina has approximately $1.2 billion in cash reserves and would be willing to use all but some $300 million to meet its obligations, including payment of the remaining $350 million in accrued interest obligations on public sector debt due by June 30. It also presumes payment of an additional $900 million public sector interest obligations coming due in the second and third quarters of the year.

In addition to the immediate question of arrears on public sector obligations, there is a risk that U.S. banks may have to place a substantial portion of their exposure on some $2.2 billion in Argentine private sector debt with central bank exchange cover on a non-accrual basis on June 30. U.S. bank exposure to the private sector would become classified as "value-impaired" once interest arrears exceed 180 days past due. This could occur in a matter of weeks.

Argentina's financing needs cannot be met without substantial net new credits from private foreign banks. Such credit inflows are most unlikely in the absence of an agreement between the GOA and the IMF on a Letter of Intent. Even with an agreed Letter of Intent, the magnitude of financing required may exceed the market's potential for Argentina. Q.

- Relations with the IMF

Argentina and the IMF are still very far apart in negotiations and an agreed Letter of Intent is unlikely in the near term. The GOA's submission of its own draft Letter of Intent without approval of the IMF staff has also undermined confidence in the GOA's sincerity.

President Alfonsin has repeatedly stated his opposition to orthodox adjustment measures to deal with Argentina's economic difficulties. He still believes that Argentina can increase real wages and output while curtailing near-record inflation rates. As a consequence, large discrepancies exist between the IMF and the GOA over targets for the size of the fiscal deficit and rates of monetary expansion. In addition, substantial differences prevail over interest, exchange rate and pricing policies.

- Relations with Banks

Argentina's 11 major creditor banks (the advisory committee for the Argentine syndicate of some 300 banks) face a decision before end-June on a scheme to bring interest payments current through April 2. For now, the banks have opted for daily extensions on the repayment date for the $750 million due on the $1.1 billion commercial bridge facility. On June 20, the GOA applied the $100 million remaining in the New York Fed escrow account created on March 30 to bring interest payments current through January 24. This leaves a balance of $350 million needed to bring payments current through April 2.

If agreement can be reached on a Letter of Intent before June 28 the Advisory Group banks would provide Argentina with $125 million in new money and the GOA would put up $225 million; this would bring interest payments current through the first quarter. The $125 million in new bank money would be fully collateralized by GOA deposits with the NY Fed.

Without an IMF agreement by June 28, the banks have proposed that the GOA pay $350 million required to bring public sector interest payments current through the first quarter. It is our understanding that five members of Argentina's bank advisory committee oppose accepting GOA deposits as full security for a loan of the $350 million in the absence of an Argentine accord with the IMF. Those opposing are Chase, Lloyds Bank, Dressner Bank, Credit Suisse, and Royal Bank of Canada. The bank advisory group was to meet on June 25 to further discuss the problem.

Alternative Scenarios for the Balance of 1984:

Three recent developments will have a major impact on the course of events for Argentina during the second half of the year; (a) the regulatory decision (effective September 30) forcing loans with interest arrears of 90 days to a non-accrual basis, unless they are brought completely current, (b) Argentina's proposal of a unilateral Letter of Intent to the IMF, and (c) the U.S. decision to not renew the commitment for a $300 million Treasury swap beyond June 15.

The U.S. regulatory decision means that Argentina, to maintain its loans on an accrual basis with U.S. creditor banks, must not only pay the remaining $350 million by June 30 needed to bring interest arrears current through April 2, but must pay an additional $900 million by September 30 to bring payments current through that date. The GOA may not yet fully appreciate the significance of this decision.

The regulatory decision effectively defuses June 30 as a critical point for those banks that judge it unlikely that the GOA will bring payments current by the end of the third quarter. For this reason, several U.S. banks have decided to comply with the decision on June 30, although the decision is not binding until September 30. This requires that banks list their exposure on a non-accrual basis and deduct interest from earnings if interest is not current through the second quarter. Payment of the $350 million would not eliminate the need to report some adverse impact on earnings for the second quarter because interest would only be current through April 2. Nevertheless, payment of the $350 million is still important because it would permit banks the option of listing GOA loans on an accrual basis on June 30. It would also be seen as a demonstration of good faith by the GOA.

The GOA's unilateral "Letter of Intent" made it quite clear that the GOA finds itself unable to make the needed economic adjustments that would be consistent with economic stabilization with the support of the IMF. The non-renewal of the U.S. Treasury swap commitment beyond June 15 underscored the need for an agreed program with the IMF as a prior condition to additional financial support.

Scenario A: Cooperate/Play for Time

No Letter of Intent by June 30, but GOA pays bank interest and Latin Swaps. The Banks roll repayment of $750 million on bridge loan to September 15 while the GOA negotiates in earnest for the rescheduling of 1982-84 obligations and new finance despite the lack of an IMF Agreement.

- Immediate Cash. An immediate drain of $750 million, leaving gross liquid reserves of about $450 million; only $150 million more than a minimum acceptable level of about $300 million.

- Third Quarter. Payment of $900 million interest needed to bring Argentina current through September 30 is highly unlikely in the absence of significant net new finance (e.g. $1 billion or more).

- Fourth Quarter. Without substantial net new bank lending, the non-accrual of interest by the end of the third quarter leads to erosion of trade finance in the fourth quarter, possibly on the order of $0.5-1.0 billion. The negative impact on trade, however, is probably not felt until December.

Conclusion. In the absence of an IMF agreement, Argentina would begin feeling a financial crunch during the fourth quarter which could become severe by early 1985. When banks are forced to place Argentine loans to the public sector on a non-accrual basis, an immediate impact will be felt on the bank earnings of about 25% at the median for the laregest 23 institutions, with the reductions ranging up to 86% in one case.

Scenario B: Confrontation

No Letter of Intent and the GOA pays off the Latin loans but not the $350 million accrued bank interest.

- Immediate Cash. Improved by $350 million.

- Third Quarter. Banks are non-accrual on Argentine loans and GOA must pay a total of $1350 million on September 30 to be current. Prospect of net new finance -- either IMF or banks is almost nil, trade finance dries up in third quarter.

- Fourth Quarter. Loss of trade finance begins to disrupt trade by November.

Conclusion. An Argentine financial crunch emerges quickly in the third quarter. This could lead to increased GOA pressure for a rescheduling of interest payments. Demands by political opponents of Alfonsin could lead to an even more radical stance vis a vis debt. More conservative elements in Argentina would begin to think of the implications of the pending finance/trade collapse.

Scenario C: Extreme Confrontation

No Letter of Intent. No payments to banks or Latin creditors. The GOA declares a unilateral rescheduling of interest payments.

- Cash. Cash reserves are maximized in the short-run at around \$1.2 billion range, growing to as much as \$2.5 billion in the third quarter before quickly eroding following a collapse of trade finance.

- Third Quarter. Banks react very negatively and suspend trade finance as they are forced to list loans as "value-impaired." In some cases, creditors seek to attach assets, disrupting Argentine trade.

- Fourth Quarter. Major economic, financial and political unrest develops as the full impact of confrontation begins to be felt. Transitory political gains accrue to Alfonsin as xenophobic nationalism is focused against bank creditors, bolstering support from extremist elements. A substantial negative impact on the economy becomes increasingly clear by year-end and more conservative elements begin to think of alternative governments by the first quarter of 1985.

Conclusion. A major deterioration in the political situation follows close on the heals of economic crisis. Instability and a possible change of government could follow, with some successor regime ultimately renewing negotiations with creditors.

Overall Conclusions and U.S. Policy Implications

Even if Argentina agrees to a Letter of Intent and pays the \$350 million by June 30, there will still be a major payments crunch by September 30 as the GOA must bring all interest payments current to avoid classification. If Argentina does not agree to a Letter of Intent and the \$350 million payment to the creditor banks is not made by June 30, trade finance is expected to erode quickly with a visible impact on trade by the end of the third quarter or early in the fourth.

Argentina places a high priority on economic growth and would go to great lengths to avoid a recession precipitated by a reduced flow of imports. The GOA is quite sensitive to the need to supply domestic markets, even if this meant a shortfall in exports. Thus, any reduction in trade finance is likely to trigger a major effort to maintain imports through increased cash from export proceeds. However, Argentina's potential for adjusting through expanded trade -- including with Soviet block nations -- is extremely limited. The USSR is already quite unhappy with the large chronic negative bilateral balance of trade with Argentina and is not likely to purchase additional volumes to assist Argentina in its hard currency payments to Western industrialized countries.

There are essentially five courses of action open to the United States in the face of Argentine intransigence or confrontation on the debt issue over the next six months. These options are not mutually exclusive but are set out to assist definition and discussion of the issue.

(1) The United States could encourage banks and the IMF to "bend the rules" and be supportive of Argentina with substantial net new financing, despite its continuing failure to adjust. This option should be rejected out of hand. It would deal a mortal blow to the present international debt strategy and might quickly lead to reduced commercial lending to LDCs and would increase the risk of a major financial crisis. ?

(2) The U.S. Government could take actions to punish Argentina for its failure to pay interest to the banks and to reach agreement with the Fund. This would include encouraging banks to take legal action, encouraging U.S. bank regulators to classify Argentine loans as substandard, and cutting off finance from U.S. agencies such as short-term Eximbank trade lines. This option is not attractive since it entails a number of negative side effects including interjection into the regulatory process. But, it would make clear to the world that Argentina cannot successfully pursue a course of confrontation.

(3) As opposed to taking the aggressive actions listed in (2)above, the United States could consult with the G-5 Debt Deputies to determine the feasibility of a joint action plan to increase moderately the pressure on Argentina by curtailing financial flows from the MDBs and G-5 governments. This would be largely symbolic in the first instance, until it led to a cutoff of currently programmed disbursements.

(4) The United States could maintain its present stance of helpful but detached concern for Argentina. However, in order to avoid the possibility that other countries conclude that Argentina is "getting away" with no adjustment program while defying the banks, the United States would issue -- after appropriate consultations with other countries -- a detailed public statement expressing concern and summarizing the financial implications for Argentina of persistence in a course of instransigence or confrontation. The object would be to make it clear that the GOA could not proceed on its present course for more than another six months without serious deterioration. The utility of this option would depend on how it was implemented i.e., private consultations with the Argentines and others followed by a major public statement if the GOA was unresponsive.

(5) The United States could maintain its present stance of helpful concern for Argentina. The hope would be that in the next two months Argentina reaches agreement with the Fund and begins to put together the required critical mass of bank financing. Meanwhile, the United State would begin to assess (on a highly restricted basis) precisely how far it is willing to go to rescue Argentina when the inevitable crisis comes. This option presupposes that the Unites States would not, in the final analysis, be willing to see Argentina economically devastated and fall to a militant rightist or leftist dictatorship. The ultimate conclusion on which this option rests is that the United States should not commence aggresive actions which, in the final analysis, it would not be willing to see carried to a logical conclusion.

Treasury
June 25, 1984

Argentina
Uses and Sources
1984
(millions of dollars)

	First Half	Second Half	Year
A. Uses, total	7489	7121	14610
1. Arrears	1750	-	1750
i. Public sector interest	450	-	450
ii. Trade finance (private & public)	1300	-	1300
2. Interest payments, total	2839	3048	5887
A. on public sector debt	900	900 1/	1800
B. which must be made	939	948	1887
i. International organizations (incl. IBRD, IDB)	(100)	(102)	(202)
ii. BONEX	(185)	(197)	(382)
iii. BONOD (on A-251 private sector debt)	(283)	(326)	(609)
iv. Bonos	(47)	(47)	(94)
v. Swaps and assured interest	(224)	(176)	(400)
vi. Bridge and medium-term commercial credits	(100)	(100)	(200)
C. other interest payments	1000	1200	2200
3. Bank bridge loan repayment	-	750	750
4. Advisory group 3/30 loan repaid	-	100	100
5. Merchandise imports (FOB)	1926	2640	4566
6. Freight and insurance	120	160	280
7. Unpostponeable principal payments	554	423	977
i. International organizations	68	69	137
ii. BONEX	110	60	170
iii. BONOD (capitalized interest)	180	-	180
iv. Swaps	196	294	490
8. Repayment of 4 Latin countries	300	-	300
B. Sources, total	5187	5420	10607
1. Direct investment	120	80	200
2. Merchandise exports (FOB)	4779	3900	8679
3. Drawings on:			
i. IMF	-	600 2/	600 2/
ii. International organizations	56	-	56
iii. 3/30/84 package	400	-	400
4. Trade financing (suppliers credits)	-168	-60	-228
4. Reserves (- = increase)	-	900	900
i. GOA deposits with NY FED (as of 6/14/84 at $900 mn)	-	-	-
C. Gap B-A	2302	1701	4003

1/ Assumes no interest arrears on 9/30/84
2/ Assumes IMF Executive Board approval in 1984, and disbursement of first 2 conditional tranches
3/ Assumes reserves of no less than $300 mn. by yr.end 84

OASIA/IDN
6.20.84

OUTCOME AND IMPLICATIONS OF LATIN DEBTORS' CONFERENCE IN CARTAGENA ON JUNE 21-22

Overview

The Cartagena meeting of eleven Latin countries did not result in formation of a debtors' cartel, but moved Latin debtors further in the direction of presenting a common front to their creditors. The political content of the event was high. Specific proposals for solutions are greatly at odds with long-standing U.S. policy. Banks are likely to be concerned about the communique's suggestion that creditor governments pressure them for further concessions and by the support expressed for Argentina and Bolivia. The United States and other industrialized countries face increasingly contentious and frequent negotiations within the IMF, World Bank, and possibly other fora as the major Latin debtors press for greater debt relief and expanded trade and private and official capital flows.

Background

After three days of lower-level preparatory meetings, the Foreign and Finance Ministers of Argentina, Bolivia, Brazil, Chile, Colombia, the Dominican Republic, Ecuador, Mexico, Peru, Uruguay, and Venezuela met in Cartagena, Colombia, on June 21 and 22 to consider problems of their external debt. Colombian President Betancur gave the opening address, in which he mentioned the United States repeatedly in an exposition of the "largely external" causes of Latin America's crisis.

The Communique

The communique, the "Consensus of Cartagena," issued on Friday, June 22, was generally moderate in tone, did not create a "debtors' cartel," and did not mention the United States by name. However, the overlay of political rhetoric was heavy. The communique reiterated the signatories' intent to honor their external commitments, but not to the extent that this might interfere with their obligations to their people to assure economic development and social peace. While the 17 specific appeals for solutions were familiar, they went further than previous Latin declarations and were at odds with long-standing U.S. policy. The communique implicitly expressed support for both Argentina and Bolivia and effectively rejected President Betancur's strong call for substantial improvement in the climate for direct foreign investment. * It also established a mechanism for continued intraregional consultation, expressed willingness to meet with creditor governments and institutions, and proposed creation of a "Working Group" within the World Bank Development Committee. The first follow-up meeting of interested Latin countries will be held in Buenos Aires before the World Bank/IMF late September annual meeting.

Implications

Press reports over the weekend indicate that banks' public reactions to the conference have been low key and restrained. Nonetheless, the conference and its communique are likely to cause concern among money center banks and possibly alarm among the smaller banks that were already nervous about their Latin American exposure. The communique seeks to enlist creditor government support to pressure banks for additional concessions. The expressions of support for Argentina and Bolivia and the fact that Argentina is to host the first follow-up meeting later this summer could also unsettle the banks.

The proceedings and communique escalated the level of political rhetoric and appear to presage growing influence of Foreign Ministers. The meeting highlighted the Latins' view that their debt has ceased to be purely a financial matter and now requires top level international political attention if world peace is to be maintained. In his opening address, President Betancur noted that the Marshall plan to rescue Europe had been agreed upon in three weeks, implying that the industrial countries should now be equally expeditious in their response to Latin America's ills. The United States and other industrialized countries probably face frequent and increasingly contentious negotiations in the World Bank, IMF, and other international fora as the major Latin debtors pursue this theme.

While the participants stopped short of forming a "debtors' cartel," the establishment of the regional consultative mechanism and the renewed call for agreement on common criteria to guide individual countries' debt negotiations appear to move Latin America further in the direction of presenting a unified front to their creditors.

Information is not yet available to determine the individual countries' degree of commitment to the rhetoric of the communique. Additional analysis will required to determine the signatories' response to possible future developments such as another increase in the U.S. prime rate.

Attachment: Summary of 17 Proposals

Treasury/IDN
June 24, 1984

CONFIDENTIAL

CONSENSUS OF CARTAGENA

SUMMARY OF PROPOSALS

1. Immediate and drastic reduction in nominal and real interest rates (the fundamental objective to which the creditor governments should give their best efforts)

2. Shift in the reference interest rate to one which does not exceed banks' cost of funds and which is not based on an "administered" rate (e.g., the U.S. prime rate)

3. Minimal spreads and elimination of commissions and late payment fees while negotiations are underway

4. Temporary mechanisms to attenuate the impact of high interest rates, including:

   - a compensatory fund in the IMF
   - concessional official credits
   - extension of repayment periods

5. Improvement in repayment and grace periods based on:

   - the debtor's capacity for repayment and need for economic recovery
   - multi-year reschedulings and capitalization of interest where convenient to the debtor

6. Partial deferral of interest payments in the case of countries with extreme balance of payments problems (e.g., Bolivia)

7. Limitation of total debt service payments to a "reasonable" percentage of export earnings compatible with maintenance of domestic productive activity

8. Elimination of the requirement for the public sector to assume private sector commercial risk

9. Elimination of regulatory rigidities which impede new commercial bank loans, recognizing the creditworthiness of sovereign debtors

10. Reactivation of capital flows, including renewal of short-term trade finance

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11. Increase in the financial resources of the IMF, World Bank, and IDB

12. A new distribution of SDRs compatible with the liquidity needs of developing countries, longer terms for IMF adjustment programs, and increased access to IMF resources

13. Revision of IMF conditionality to:

    •• give priority to growth and employment creation

    •• shield the borrower from increases in interest rates

14. Accelerated use of World Bank and IDB resources through:

    •• an increase in program loans and in the maximum allowable percentage of financing of total project costs

    •• accelerated disbursements of credits already contracted

    •• a temporary but substantial reduction in local currency counterpart requirements

    •• elimination of graduation

15. Longer terms and lower interest rates for Paris Club reschedulings, accompanied by new lines of concessional credit sufficient to prevent the interruption of imports

16. Immediate attention to the developing countries' appeals for the stabilization of commodity prices at remunerative levels

17. Rapid elimination of industrial countries' tariff and non-tariff barriers for traditional and industrial products, including high technology goods

Drafted: T.Crawford, IDN
June 24, 1984

TWC:OAS

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