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Major LDC Debtors: Financial Impact of an Oil Price Decline

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An Intelligence Assessment

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An Intelligence Assessment

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

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Key Judgments

Information available as of 25 October 1984 was used in this report.

Assuming that a small decline in world oil prices—say $2/bbl—emerges from the 29 October OPEC emergency meeting, we believe the financial impact on most key LDC debtors will be moderate. Certainly a number of LDC debtors—notably Brazil, the Philippines, and South Korea—would obtain significant savings on their oil import bills. In addition, we believe most oil-exporting debtors would be able to manage the drop in foreign exchange earnings they would incur because they have adequate financial resources. Even with a small price drop, however, Egypt and Nigeria would be confronted with serious new financial strains because of their high dependence on oil export earnings coupled with currently tenuous financial positions. Finally, over the medium term all of the debtors would benefit from somewhat faster OECD growth and easing of interest rates, which probably would be prompted by a lower oil price.

If a major oil price drop were to occur, the implications for some other oil exporters also would become serious. With a drop in oil prices to approximately $20 a barrel, for example:

- Mexico would lose $5 billion in foreign exchange earnings. Such a drop would result in a substantial increase in banker resistance to signing on to the new multiyear rescheduling package and lead to a renewal of credit difficulties for Mexico.
- Venezuela would see its exports drop by $4 billion. Even with its ample reserves of $12 billion, we would expect Caracas to experience even greater difficulty than currently in obtaining new money.
- Indonesia would lose $3 billion in export earnings. Although quick implementation of austerity measures in the past has kept up Jakarta's credit standing, this position could quickly erode following such a sharp oil price decline.

Disruptions to the international financial system from sharply lower oil prices also could come from other countries less dependent on oil earnings. For example, Peru and Argentina already are in desperate financial straits. A reduction in their export earnings, which would follow an oil price decline, could push them closer to the brink of declaring a moratorium on debt payments.

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With respect to the oil-importing LDCs, a decline in oil prices would not be enough by itself to substantially ease their debt problems. Most of the larger debtors—particularly in Latin America—are unable to attract any new lending from foreign creditors outside of their debt restructuring packages. Moreover, capital flight remains a problem as does a lack of foreign direct investment. Still, to the extent that faster OECD growth and an easing of interest rates result from a lower oil price, the combination could lead to some easing of financial pressure.

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Introduction

OPEC's benchmark oil price is again in jeopardy. In early 1983, a British price cut, coupled with a precipitous drop in Nigerian production, triggered a $5.50/bbl reduction in Nigeria's official price. OPEC responded by dropping its benchmark price from $34 to $29/bbl. In mid-October, first Norway and then the United Kingdom reduced their official prices in reaction to weak spot prices. To avert a buyer exodus, Nigeria followed with a price drop of $2/bbl, undercutting Norwegian and British prices by 65 cents. OPEC has called a meeting for 29 October to determine its response.

A decline in oil prices of $2/bbl would have moderate repercussions on most LDC debtors. If a major oil drop were to occur, oil-exporting debtors would face substantial reductions in their export earnings and hence their ability to meet debt obligations. In any case, oil-importing countries would realize savings on their oil bill. Whatever the outcome, world oil price shifts will introduce greater uncertainty into the unfolding financial outlook for LDC debtors.

Table 1
Key Debtors:
Debt Service Ratios, 1983

Percent

	Debt Service/ Exports [a]	Interest/ Exports [b]
Argentina	70	40
Brazil	75	43
Chile	61	34
Ecuador	48	26
Egypt	33	15
Indonesia	19	11
Mexico	65	31
Nigeria	21	10
Peru	65	30
Philippines	41	28
South Korea	20	12
Venezuela	31	18

[a] Ratio of total debt service (medium- and long-term principal repayments plus interest payments of all maturities) to exports of goods and services.
[b] Ratio of total interest payments to exports of goods and services.

Source: CIA estimates.

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LDCs: Current Financial Situation

Even though some progress is being made, the LDCs continue to be affected by severe debt problems. Total LDC external debt continues to grow; we estimate it will hit about $750 billion by yearend 1984. Growth has slowed from previous years—both because of lower LDC external financing requirements and the reluctance of commercial banks to lend to financially troubled countries—but debt service ratios remain very high for some of the key debtors (table 1). Moreover, the need for economic adjustment in debt-troubled countries has pushed a record number of LDCs to implement austerity programs under the guidance of the IMF.

Overall capital flows continue to be a problem for LDCs, particularly Latin America. Extensive capital flight over the past several years—we estimate it may have reached $100 billion during 1979-83—has slowed but is still occurring. In addition, foreign direct investment remains stagnant, and prospects for future growth are not good. These factors, combined with the dropoff in bank lending, are raising serious doubts among financial analysts about the ability of Latin American countries to resume economic growth and development any time soon. 25X1

Several positive actions, however, recently have emerged. Creditor banks have granted multiyear debt restructurings to Mexico and Venezuela, an indication that creditors are moving toward a longer term approach to debt problems as opposed to annual restructurings. According to many forecasters, the 25X1

Western economic recovery, led by the United States, should continue through 1985 and should boost LDC exports as well. Moreover, interest rates have declined slightly in the last month. Softer oil prices are also aiding the oil-importing LDCs.

Oil Price Outlook

OPEC will try to support the current $29 benchmark price. OPEC's success in maintaining the benchmark in the immediate period will depend on whether Nigeria can be persuaded to rescind its price reduction and whether OPEC members can agree to and implement production cuts in line with market requirements.

We believe OPEC will have a difficult time maintaining the current benchmark price. First, there has been a steep decline in non-Communist oil demand since 1979, spurred by price-induced conservation and substitution. Second, oil inventory reductions and increased production from non-OPEC producers have added to supply. Despite OPEC's attempt to reassert control over prices through production ceilings, most members have been unwilling to adhere strictly to production and pricing guidelines. As a result of these factors, spot oil prices have been soft and have undermined official prices. OPEC's current enormous production overhang of some 9 million b/d of surplus available capacity will continue to encourage cheating among members, maintaining downward pressure on oil prices. Consequently, we view a drop in OPEC prices of $2/bbl or so as quite possible.

We believe there is a smaller chance that oil prices over the next year could plummet, perhaps to about $20/bbl. This could occur in at least a couple of ways:

- OPEC collectively could reach the conclusion that current oil prices are much too high from the view of their best long-term interests. At current prices, continued conservation and substitution adjustments, as well as production increases in non-OPEC countries, are keeping the market for OPEC oil flat. A substantial price reduction would alter these trends.[1]

[1] According to US Embassy reporting, a Nigerian official has suggested that OPEC should "fight back" against the Norwegian, British, and other high-cost producers by taking advantage of OPEC's low production costs through allowing the current artificially high price to fall.

- The conflict of interests among OPEC members could increase dramatically, resulting in a further loss of production discipline. For example, the major debtors in OPEC—Nigeria, Venezuela, and Indonesia—have a great incentive to overproduce. Collectively they now have about 0.7 million b/d in surplus capacity. Additional supplies on the market would place more downward pressure on prices and threaten OPEC's already tenuous March 1983 accord.

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Foreign Trade Impact

The impact of any oil price decline on the major LDC debtors will depend chiefly on their foreign trade position in oil. In the short run, any oil price decline will reduce the foreign exchange earnings of the oil-exporting countries, while resulting in savings on the oil bill of importing countries. LDC debtors, such as Indonesia, Mexico, Nigeria, and Venezuela, would find themselves with less foreign exchange to meet their import spending and debt service obligations. South Korea, the Philippines, and other debtors highly dependent on oil imports would be able to increase imports of nonoil goods and perhaps improve their debt service record. The foreign trade impact would not end here, however, as any oil price decline would start up a global adjustment process that would involve further trade shifts and require probably two or more years to work out.

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To quantify the impact of oil price declines on key debtors, we have made the simplifying assumption that export and import volumes stay constant at 1984 levels. We then calculated the dollar impact of two scenarios, which should bound any price decline: a price reduction of $2/bbl and a reduction of $9/bbl (table 2).[2]

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The Losers. If prices decline only $2/bbl, we anticipate that of the major debtors only Egypt and Nigeria would experience increased financial problems. With this price fall, Egypt's oil earnings would fall by $160 million, representing almost 5 percent of total exports.

[2] We are assuming across-the-board cuts in oil prices even though prices for different types of oil may not change uniformly. Thus, for some countries such as Mexico, the revenue loss may be less because of their export product mix

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Table 2
Major LDC Debtors:
Impact of Alternative Oil Price Declines

Percent

	Net Oil Exports [a] 1984 (*thousand b/d*)	Net Oil Trade Balance [a] 1984 (*million US $*)	Estimated Impact of Oil Price Declines on Trade Balance (*million US $*)	
			Of $2/bbl	Of $9/bbl
Argentina	5	52	−5	−15
Brazil	−456	−4,790	330	1,500
Chile	−67	−700	50	220
Ecuador	145	1,300	−110	−480
Egypt	218	2,200	−160	−720
Indonesia	934	10,000	−680	−3,070
Mexico	1,550	15,275	−1,130	−5,090
Nigeria	1,120	12,800	−820	−3,680
Peru	50	525	−40	−160
Philippines	−200	−2,100	150	660
South Korea	−550	−5,720	400	1,810
Venezuela	1,298	13,300	−950	−4,260

[a] CIA estimates.

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Nigeria's losses would be roughly $800 million, also 5 percent of total export earnings. Given a price fall of $9/bbl, almost all of the oil-exporting debtors would face serious problems. The revenue losses of Mexico would be $5 billion, 20 percent of total exports, while losses in Nigeria and Venezuela would amount to about $4 billion each, representing 25 percent of their total exports.

These countries and other oil-exporting countries would have essentially four options for adjusting to these revenue losses:

- Cut imports.
- Draw down foreign exchange reserves (including foreign assets).
- Increase foreign borrowing.
- Delay foreign debt service payments (run arrearages).

In most cases, countries would choose some combination of these policies depending on their credit standing, foreign exchange reserve level, and ability to manage import cuts. Thus, such troubled debtors as Mexico and Nigeria probably would have little success in borrowing additional new funds unless special help was provided. At the same time, according to press reports, Mexico has foreign exchange reserves of about $7 billion and Venezuela of $12.5 billion, which could provide a cushion if desired. Alternatively, a decision to maintain reserves would, as in the case of simply low foreign exchange holdings, imply some combination of import cutbacks and arrearages on debt payments. Delaying debt payments could be the preferred option, especially for countries like Nigeria that already have made substantial reductions in imports. 25X1

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Debtors with excess oil-productive capacity would have the additional option of increasing their oil exports, although such a move would almost certainly risk an unraveling of prices. Of the major LDC debtors, Nigeria currently has about 500,000 b/d of surplus productive capacity, and Venezuela and Indonesia each have about 100,000 b/d. 25X1

The Winners. Some of the major LDC debtors are heavily dependent on oil imports and would realize substantial savings if oil prices decline. Brazil and South Korea would save $0.3-0.4 billion each under a $2/bbl price decline, and about $1.5 billion each under a $9/bbl price decline.

These countries and others that are net oil importers would also face some policy decisions:

- In particular, there would be an excellent opportunity to raise government revenues relatively painlessly by imposing a tax on each barrel of oil that matched any price decline. Domestic oil prices would be maintained, thus not disturbing investment projects and energy consumption patterns that depend on a roughly $30/bbl oil price. Governments especially in need of funds, such as Brazil and the Philippines, could find this tax policy attractive.

- Alternatively, some countries could choose simply to pass on the full oil price reduction to their domestic economies. The oil bill savings would allow greater imports of other goods. At the same time, the oil price decline would also encourage a greater volume of oil imports, especially after an adjustment period of several years.

Second-Order Effects. LDC debtors that sell substantial amounts of goods to oil-exporting countries could find markets in these countries diminishing following an oil price decline. At the same time, however, markets in the oil-importing countries, including most of the OECD, would be expanding with the increased purchasing power of consumers in those countries. Thus, although initially exports to the oil producers might drop faster than new exports to oil-importing countries would increase, after a year or two these effects would tend to cancel each other out.

Because most of the OECD imports oil, any price decline will tend to stimulate the OECD economies: consumers' purchasing power would increase, producers' energy production costs would fall, and hence demand for and production of nonenergy goods would grow. Greater OECD growth would lead to greater demand for imports, including from LDCs. Although the diverse composition of LDC exports makes it difficult to assess which countries would benefit most from OECD growth, export-oriented countries, such as South Korea and Brazil, would be in the best position to gear up for increased export demand.

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Interest Rate Impact

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An oil price decline could have an effect on interest rates. Over the longer term, interest rates reflect both real supply and demand conditions for credit as well as the anticipated rate of inflation. A falling oil price would reduce the component of interest rates that reflects future inflation. While increased real incomes in the OECD could lead to greater savings and hence a tendency for lower interest rates, such income growth also would result in greater credit demand so that these effects would tend to wash out. Furthermore, credit demand could grow faster than savings if some of the oil-exporting countries were able to continue to increase their borrowing as they adjusted to lower earnings.[3]

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Overall, however, it seems likely that, if anything, interest rates would tend to fall with an oil price decline. Some analysts have predicted that a $2/bbl oil price cut would lead to a 1-percentage-point drop in interest rates. In this case, all of the major LDC debtors would gain, particularly those with proportionately large debts at floating interest rates, such as Argentina, Brazil, Mexico, and Nigeria (table 3).

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A Closer Look at the Oil-Exporting Debtors

The impact of lower oil prices would vary among key oil-exporting debtors. *Mexico* would be hard hit by lower oil revenues, largely because the country still has little room to maneuver. Imports have been cut to the bare minimum over the past three years, and nonoil exports—although growing—would not be able to pick up the slack generated by large oil revenue losses. Mexico recently reached preliminary agreement with its bank advisory committee on a debt

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[3] We estimate that OPEC states together will borrow $8 billion from banks and official creditors this year. Indonesia, Algeria, and Saudi Arabia will account for most of the borrowing.

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Table 3
Major Debtors:
Impact of an Interest Rate Decline

	Net Savings From a 1-Percentage-Point Drop in Interest Rates (*million US $*)[a]
Argentina	310
Brazil	780
Chile	130
Ecuador	50
Egypt	30
Indonesia	50
Mexico	710
Nigeria	120
Peru	50
Philippines	130
South Korea	220
Venezuela	210

[a] These data are derived from the change in net debt (gross debt less deposits) that is on floating interest rates.

restructuring, but the package must still be signed by all creditor banks. A small drop in oil prices could be absorbed by Mexico because some cushion has been built into the restructuring package, but a large price decline would pose serious problems. Many banks—some of which are already reluctant to participate in the restructuring—could find it even harder to justify their participation. In the worst case, Mexico would be unable to meet its interest payments, which would put a large burden on major creditor banks.

Venezuela probably would be able to absorb a small drop in oil prices because of its relatively better financial position. Foreign exchange reserves remain high, and the recent restructuring package with commercial banks will reduce debt service requirements over the next several years. The package probably will be signed by the individual banks because of its overall benefits for both creditors and debtor. Banks, however, could be reluctant to participate in new loans over the medium term should Venezuela not take actions such as drawing down reserves to make up for the loss in revenues from oil exports.

Indonesia also would be able to adjust to a small price decline, although at some cost to its economic growth prospects. Although Jakarta could not expect much help from nonoil exports, the government could reduce spending on development projects as it did in 1983. This in turn would bring about a reduction in imports of capital and intermediate goods, which would offset the loss in oil revenue. Foreign exchange reserves also would provide a cushion in the near term. Even with a sharp drop in oil prices, Indonesia would not have immediate debt repayment problems because of the favorable structure of its repayment schedule. Moreover, creditors probably would respond favorably to an Indonesian cutback in spending so that the country's credit rating would not be severely altered. 25X1

Egypt could be hard hit by falling oil prices because of its precarious financial situation. Banks currently view Egypt as a below-average credit risk, and a loss of oil income—which accounts for more than 60 percent of exports and more than 20 percent of exports of goods and services—could lead to debt repayment difficulties. Cairo would press the United States even harder for debt relief on Foreign Military Sales credits and might have to seek rescheduling from other private and official creditors. A significant reduction in prices could also interrupt Egyptian oil exploration efforts, hindering the future growth of oil production. Moreover, deepening financial problems in Persian Gulf countries could reduce the need for Egyptian migrant labor. 25X1

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Nigeria currently is under serious financial strain. Lagos has major debt servicing problems, with a large buildup of arrearages on short-term debt and dwindling foreign exchange reserves. If its recent oil price cut is maintained, the annual loss in export earnings would be some $800 million, according to our estimate. Reduced oil revenues would put increased pressure on Lagos to cut spending and reduce imports and to reach agreement with the IMF on a standby arrangement. The impasse with the Fund probably will continue through yearend, however, because of the government's unwillingness to implement a devaluation. 25X1

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Ecuador probably would be able to absorb a small drop in oil prices. Quito is close to reaching a new standby arrangement with the IMF that will be followed by bank negotiations on a debt restructuring and new money. Ecuador's economic team has been cooperative with the IMF and probably will take the steps necessary to adjust to lower oil export revenues. A large fall in oil prices, however, could make creditors reluctant to provide new money; some banks already are balking at increasing their exposure. [redacted]

Implications

We believe lower oil prices would, on balance, contribute appreciably to a more robust world economy, especially after an adjustment period of several years. OECD growth would be promoted and interest rates probably would ease. However, some LDC debtors that depend heavily on oil exports would be in a much more precarious financial situation, particularly if an oil price decline were substantial. Egypt and Nigeria are especially vulnerable because of their lack of maneuvering room; Egypt has few alternative exports, and Nigeria has large arrearages and dwindling foreign exchange holdings. [redacted]

The risks of a moratorium on debt service payments by one of these countries thus would increase if oil prices were to plummet. Initially these countries probably would start to run more arrearages in their debt payments and also attempt to negotiate much-improved debt terms and new credit. However, private creditors would be very reluctant to extend new loans after a fall in oil prices. Only relatively small amounts of new lending would be forthcoming as creditors attempted to protect outstanding loans. [redacted]

Disruptions to the international financial system from lower oil prices also could stem from some other countries that are less dependent on oil earnings. For example, Peru and Argentina already are in desperate financial straits. Even a small reduction in their export earnings, which would follow an oil price decline, could push them closer to a moratorium on all debt payments. [redacted]

With respect to the oil-importing LDCs, a decline in oil prices would not be enough by itself to substantially ease their debt problems. Most of the larger debtors—particularly in Latin America—are unable to attract any new lending from foreign creditors outside of their debt restructuring packages. Moreover, capital flight remains a problem as does a lack of foreign direct investment. Still, to the extent that faster OECD growth and a decline in interest rates result from a lower oil price, the combination could lead to some easing of financial pressure. [redacted]

We expect creditors to look at the oil-importing LDCs more favorably in the event of lower oil prices, but this could be overshadowed by lender concern for the financial situation of the major oil-exporting debtors. Mexico, in particular, would attract lender attention because of the size of the country's debt and the implications for the international financial system as a whole. Thus, the overall positive impact on oil-importing LDCs probably would be realized more over the medium term than in the short term.

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