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Western Europe:
Foreign Debt Problems

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An Intelligence Assessment

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EUR 84-10145
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Western Europe: Foreign Debt Problems [redacted] 25X1

An Intelligence Assessment

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Western Europe: Foreign Debt Problems

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Key Judgments

Information available as of 29 June 1984 was used in this report.

Twelve West European countries (WE-12)[1] currently face foreign debt problems of varying degrees of severity. Collectively they impose an additional burden on an international financial system already severely strained by troubled LDC and East European debtors, and several of them will need official assistance during the next two to three years. Total foreign debt for the WE-12 increased approximately $14 billion during 1983, to an estimated $383 billion—more than half the total debt for 100 LDCs and almost five times the level for Eastern Europe. Since the end of 1978, WE-12 debt has increased by 88 percent, about the same as the increase in LDC debt and more than twice the rate for the East European countries. Today, not a single country among the WE-12 has a prime credit rating for both short-term and long-term borrowing. 25X1

The debt problems facing most of the Twelve will limit their ability to respond to their number-one domestic economic problem—unemployment—without creating a balance-of-payments crisis. As governments attempt to reduce their debt burden, the effects on unemployment could contribute to:
- A greater turnover in West European governments as austerity programs in many of the WE-12 continue to worsen unemployment and weaken the political base of incumbent governments.
- An increase in protectionist measures as West European governments seek to limit imports in order to ease foreign borrowing requirements.
- A greater willingness on the part of these countries to expand trade with the Soviet Union and Eastern Europe.
- An increase in demands on the financially beleaguered EC to raise funds on the Euromarket for relending to member countries—demands that will only highlight the limits on the EC's ability to respond to member countries' problems. 25X1

These tendencies will affect the United States and its relations with West European governments. Specifically, trade disputes—symptoms of the debt and unemployment problems—will continue to plague relations. Recent problems with steel and agricultural trade may intensify. Because about 80 percent of the WE-12 debt is denominated in dollars and carries variable rates of interest, West European leaders will continue to pressure US officials to reduce the budget deficit, the major factor they believe is behind high US interest rates. In addition, the debt problems within the WE-12 are likely to result in greater support by these countries for additional resource allocations for the IMF and other multilateral groups.

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[1] The 12 countries are Belgium, Denmark, Finland, France, Greece, Iceland, Ireland, Norway, Portugal, Spain, Sweden, and Turkey. 25X1

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We believe the debt situation in six of the 12 countries constitutes a serious problem and will worsen at least through 1985:

- *Portugal* and *Turkey* currently have IMF programs but will need additional financial help this year and next.
- *Greece* and *Ireland* will soon need IMF programs.
- *Denmark* and *Sweden* will likely face debt service problems in the future if current policies persist; no IMF programs are on the horizon. 25X1

In four countries—*Belgium*, *Finland*, *Iceland*, and *Spain*—we believe the debt situation is troublesome but improving. These countries generally are following restrictive policies that will tend to curb their debt problems. There is still a possibility, however, that high levels of unemployment in Belgium and Spain may force a shift in government policies for political reasons that would quickly worsen the debt outlook. 25X1

France's austerity program has forestalled a serious debt problem. President Mitterrand is not likely to make any major changes to the economic program prior to the National Assembly elections in 1986. Nevertheless, public dissatisfaction with the austerity program is likely to force some moderation of economic policies. Under such a circumstance France would remain a net borrower, though the increase in debt would not pose serious problems. *Norway* is using oil earnings to reduce its large foreign debt and is not likely to run into difficulties unless there is a substantial drop in oil prices. 25X1

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The Debt Problem in Perspective

The foreign debt position of many West European countries has deteriorated markedly since 1978. Altogether we have identified 12 countries (WE-12) that show one or more indications of debt problems (see tables 1 through 7). While not all of these countries face a major payments crisis, we believe that collectively their increased credit risk creates additional strains on an international financial system that is still reeling from the LDC debt problem. During the last few years, the ability to repay foreign debts has diminished in most of the 12 countries, and two—Portugal and Turkey—have needed major debt reschedulings backed by IMF assistance and have implemented IMF austerity programs. Most of the others have independently instituted government-sponsored austerity measures. [redacted]

The rapid growth of debt in the WE-12 was faster than the growth in both LDC and East European debt. From 1978 to the end of 1982, the WE-12 saw their combined foreign debt jump 81 percent to $370 billion; during the same period, debt for 100 LDCs advanced 80 percent to $596 billion, and debt for the seven East European countries rose by 38 percent to $81 billion. By the end of 1983, we calculate the WE-12 countries owed $383 billion, assuming they borrowed just enough money to cover their current account deficits. The actual figure may be even higher, however, because countries such as Belgium, Denmark, France, and Sweden sought to rebuild their foreign exchange holdings in addition to covering their current account deficits. [redacted]

The debt profile of some in the WE-12 rivals that of the most-debt-troubled LDCs and in many cases exceeds the ratios for the East European countries. For example, the debt-to-export ratio for Portugal and Turkey in 1982 exceeded Mexico's 252 percent and the East European average of 221 percent; Portugal's 314 percent approached Brazil's 356 percent.[2] Interest and all amortization payments as a share of Portuguese exports in 1982 were 129 percent, equal to Mexico's 1981 debt service ratio. Most of the WE-12 countries had debt service ratios exceeding those of the East European countries, except Poland. Ratios for the other East European countries ranged between 37 and 73 percent while the WE-12 ranged between 29 and 129 percent. [redacted] 25X1

Sporadic debt problems existed in Western Europe during the early and mid-1970s, but it was not until late in the decade that widespread debt difficulties began to develop. As late as 1978, external debt as a share of GNP was only about 20 percent for the WE-12—reasonable by international standards and not much higher than the share for the other West European countries. The ratio of debt to GNP grew steadily from 1978 onward, however, and by 1983 reached 34 percent for the WE-12. While only five countries in 1978 had debt-to-GNP ratios of 40 percent or more, by 1983 the number had jumped to eight. [redacted] 25X1

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Reflecting rising debt problems in the region, bankers' confidence in a number of West European countries has slipped. Influenced by lessons learned from LDC problems, many banks are encouraging France, Greece, and Ireland to restructure their debt now before repayments become a serious problem. In the meantime they are lowering credit ratings on some countries, pricing credits with bigger spreads or shorter terms to reflect increased risks, and limiting exposures. Standard and Poor's has reduced Denmark's credit rating, and several banks have internally listed the other 11 countries on our list below the prime credit risk category for medium-term borrowings as well as for short-term loans (except in the case of Norway). A number of large banks have reduced their exposure to high-risk West European countries by selling off their share of syndicated loans to

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[2] If worker remittances are included with exports, Portugal's 1982 debt-to-export ratio drops from 314 to 216 and Turkey's falls from 286 to 224. [redacted]

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Table 1 *Billion US $*
Western Europe: Total External Debt

	1978	1979	1980	1981	1982 [a]
Total Western Europe	**410.9**	**506.9**	**594.7**	**626.8**	**681.9**
WE-12	204.1	254.3	302.3	334.7	369.5
Belgium	8.0	14.1	19.2	26.0	31.0
Denmark	25.8	30.4	30.4	31.8	33.4
Finland	13.0	14.2	17.1	17.6	19.1
France	50.3	65.8	81.1	91.1	106.1
Greece	5.8	6.5	8.6	10.0	11.2
Iceland	0.9	1.0	1.1	1.2	1.4
Ireland	8.1	12.0	15.0	16.5	18.9
Norway	28.3	32.6	33.9	32.1	31.0
Portugal	7.8	9.9	12.3	15.6	18.5
Spain	19.7	24.1	29.9	34.4	37.4
Sweden	20.9	26.9	34.3	36.8	38.9
Turkey	15.5	16.8	19.4	21.6	22.6
Other WE	206.8	252.6	292.4	292.1	312.4
Austria	9.7	11.7	14.3	14.7	13.3
Italy	36.3	39.5	52.8	61.3	66.0
Netherlands	12.2	16.2	20.0	15.9	16.8
Switzerland	15.8	21.6	26.0	25.3	28.6
United Kingdom	53.6	66.0	71.8	61.8	68.3
West Germany	79.2	97.6	107.5	113.1	119.4

[a] Preliminary.

Table 3 *Percent*
Western Europe:
External Debt as a Share of GDP

	1978	1979	1980	1981	1982 [a]
Total Western Europe	**16**	**16**	**17**	**20**	**23**
WE-12	19	20	21	26	31
Belgium	8	13	16	27	37
Denmark	46	46	46	55	59
Finland	38	34	34	36	39
France	11	11	12	16	20
Greece	18	17	21	27	30
Iceland	41	40	38	40	54
Ireland	66	69	84	99	111
Norway	70	69	59	56	55
Portugal	44	49	50	66	79
Spain	13	12	14	18	21
Sweden	23	25	28	33	40
Turkey	30	24	34	37	43
Other WE	14	14	14	16	18
Austria	17	17	19	22	20
Italy	14	12	13	18	19
Netherlands	9	10	12	11	12
Switzerland	19	22	26	27	30
United Kingdom	17	16	14	12	15
West Germany	12	13	13	17	18

[a] Based on preliminary debt data.

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Table 2 *Percent change*
Western Europe:
Change in Total External Debt

	1979	1980	1981	1982 [a]	1978-82
Total Western Europe	**23.4**	**17.3**	**5.4**	**8.8**	**66.0**
WE-12	24.7	18.9	10.7	10.4	81.0
Belgium	76.3	36.2	35.4	19.2	287.5
Denmark	17.8	0	4.6	5.0	29.5
Finland	9.2	20.4	2.8	8.5	46.9
France	30.8	23.3	12.3	16.5	110.9
Greece	12.1	32.3	16.3	12.0	93.1
Iceland	11.1	10.0	9.6	16.7	55.6
Ireland	48.1	25.0	10.0	14.5	133.3
Norway	15.3	3.9	−5.3	−3.3	9.5
Portugal	27.1	24.2	26.8	18.6	137.2
Spain	22.2	24.1	15.1	8.7	89.9
Sweden	28.6	27.4	7.3	5.7	86.1
Turkey	8.4	15.5	11.4	4.5	45.8
Other WE	22.2	15.8	−0.1	7.0	51.1
Austria	20.5	22.1	2.8	−9.4	37.1
Italy	8.8	33.7	16.1	7.7	81.8
Netherlands	32.8	23.5	−20.5	5.7	37.7
Switzerland	36.8	20.3	−2.7	13.0	81.0
United Kingdom	23.1	8.8	−13.9	10.5	27.4
West Germany	23.3	10.1	5.2	5.6	50.8

[a] Based on preliminary debt data.

Table 4
Western Europe:
External Debt Service Ratio [a]

	1978	1979	1980	1981	1982 [b]
Total Western Europe	**26**	**26**	**29**	**35**	**38**
WE-12	26	30	32	40	43
Belgium	6	9	12	17	29
Denmark	51	49	59	60	66
Finland	35	30	44	61	67
France	23	24	30	41	44
Greece	34	29	23	33	41
Iceland	28	25	29	36	43
Ireland	30	37	67	86	84
Norway	46	45	32	38	39
Portugal	46	43	62	93	129
Spain	31	29	32	40	43
Sweden	29	29	30	42	49
Turkey	155	163	106	73	77
Other WE	25	23	26	32	35
Austria	36	34	31	39	42
Italy	31	26	27	40	42
Netherlands	7	7	8	9	9
Switzerland	15	18	22	27	28
United Kingdom	18	17	23	28	26
West Germany	35	35	36	42	44

[a] Interest plus payments on long- and short-term debt, as a percent of exports of goods and services.
[b] Based on preliminary debt data.

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Table 5
Western Europe: Total Debt as a Percent of Exports of Goods and Services

	1978	1979	1980	1981	1982 [a]
Total Western Europe	**55**	**53**	**54**	**59**	**66**
WE-12	72	70	70	78	85
Belgium	14	19	22	30	37
Denmark	151	143	126	138	150
Finland	123	104	98	100	117
France	44	45	47	54	67
Greece	98	84	102	109	142
Iceland	100	91	92	100	128
Ireland	117	141	146	172	208
Norway	166	152	120	112	113
Portugal	200	187	178	248	314
Spain	88	80	88	102	108
Sweden	77	77	87	99	111
Turkey	535	560	524	365	286
Other WE	44	43	43	46	53
Austria	47	45	46	52	48
Italy	50	42	50	61	67
Netherlands	19	20	21	17	19
Switzerland	46	56	60	61	71
United Kingdom	53	49	43	39	47
West Germany	45	47	46	51	54

[a] Based on preliminary data.

[redacted]

Table 6
WE-12: Months of Imports Covered by Foreign Exchange Holdings

	1978	1979	1980	1981	1982
Total Western Europe	**2.1**	**2.1**	**2.2**	**1.7**	**1.5**
WE-12	1.2	1.6	2.5	1.4	1.1
Belgium	0.6	0.7	0.9	0.5	0.4
Denmark	1.8	1.5	1.4	1.1	1.0
Finland	1.3	1.2	1.1	0.9	0.9
France	1.0	1.4	1.8	1.4	1.1
Greece	1.9	1.5	1.3	0.9	0.9
Iceland	1.8	1.7	1.5	1.9	1.3
Ireland	3.7	2.2	2.5	2.4	2.3
Norway	1.6	2.1	2.5	2.7	2.9
Portugal	1.8	1.5	0.8	0.5	0.4
Spain	5.4	5.0	3.2	3.0	2.2
Sweden	1.7	1.0	0.8	1.0	1.0
Turkey	2.0	1.5	1.7	1.5	1.1
Other WE	2.6	2.5	2.0	1.9	1.8
Austria	3.0	1.6	1.7	1.9	2.1
Italy	1.9	2.3	2.2	2.0	1.4
Netherlands	0.7	1.0	1.3	1.1	1.3
Switzerland	7.2	5.5	4.4	4.3	5.0
United Kingdom	1.9	1.7	1.5	1.1	0.9
West Germany	3.3	3.7	2.2	2.2	2.3

[redacted]

Table 7 *Billion US $*
Western Europe: Current Account Balances

	1974-83	1974-78	1979-83	1982	1983
Total Western Europe	**−139.7**	**−28.7**	**−111.0**	**−21.5**	**2.3**
WE-12	−176.2	−62.1	−114.1	−33.4	−14.3
Belgium	−16.1	0.0	−16.1	−2.7	−0.5
Denmark	−17.7	−6.9	−10.8	−2.2	−1.2
Finland	−8.0	−4.1	−3.9	−1.0	−1.0
France	−19.0	2.0	−21.0	−12.1	−4.0
Greece	−15.6	−5.2	−10.4	−1.9	−1.9
Iceland	−0.8	−0.4	−0.4	−0.3	−0.1
Ireland	−9.5	−2.0	−7.5	−1.3	−1.1
Norway	−9.4	−14.3	4.9	0.5	2.5
Portugal	−14.6	−5.2	−9.4	−3.2	−1.5
Spain	−27.6	−11.3	−16.3	−4.2	−2.4
Sweden	−19.1	−5.0	−14.1	−3.5	−1.1
Turkey	−19.0	−9.8	−9.2	−1.2	−2.0
Other WE	36.5	33.4	3.1	11.9	16.6
Austria	−7.7	−4.5	−3.2	0.7	−0.1
Italy	−19.0	−2.7	−16.3	−5.5	0.1
Netherlands	11.8	6.0	5.8	3.2	4.5
Switzerland	25.3	14.1	11.2	3.6	3.0
United Kingdom	14.6	−10.8	25.4	9.4	3.1
West Germany	11.6	31.3	−19.7	3.6	3.9

[redacted] 25X1

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smaller banks; this happened to Greece in 1983, [redacted] 25X1 25X1 banks seeking to limit their exposure in a country have also resorted to withdrawing interbank deposits. [redacted] 25X1

Portugal and Turkey now have the most serious debt problems in Western Europe, and both are in the midst of IMF programs. These countries are the poorest in Western Europe, and their economies exhibit many LDC characteristics: low GNP per capita, basic infrastructure inadequacies, structural bias toward balance-of-payments deficits, a relatively small or narrowly based export sector, high propensity to import, a large percentage of the population in the rural sector producing a relatively small share of GNP, government protection of and involvement in a large share of the business sector, and inadequate capital markets. [redacted] 25X1

The debt problems of Greece and Ireland are also serious and getting worse, although borrowing in international capital markets has been somewhat easier for them than for Turkey or Portugal. The growth in debt for both countries has been exceptional: 141 percent for Ireland and 124 percent for Greece over

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External Debt: What Is It?

Following the definition used by the International Monetary Fund (IMF), external debt is the total stock of obligations residents of one country owe to the rest of the world. It comprises all short-, medium-, and long-term liabilities of the private and public sectors, including bonds, bank loans, bank deposits, trade credits, letters of credit, and bankers' acceptances. Liabilities to a country's own citizens living abroad and liabilities to nonresidents that are denominated in the country's own currency are part of foreign debt under this geographic approach, although these two categories are a very small part of the total. [redacted]

Because of data and reporting problems, country debt compilations cannot be completely accurate. Ironically, West European debt data are generally more difficult to compile than data on LDCs, which are published by the World Bank. Although the IMF, the Bank for International Settlements (BIS), and the Organization for Economic Cooperation and Development (OECD) are improving their collection systems, comprehensive disaggregated data are not available on a timely basis. Moreover, countries experiencing debt problems often hide or delay publication of data so that creditor confidence is not jeopardized. This is done by including borrowing activity in vague categories such as "other capital flow" or by increasing the relative amount of short-term debt—liabilities with a maturity of one year or less. Accurate figures for short-term debt do not usually exist until well after the end of a calendar year. As a result, short-term debt can swing greatly during the course of a year and may or may not surface as a problem depending on other financial flows. Portugal and France, for example, have used short-term debt extensively without the market's becoming fully aware of the extent of the borrowing activity. [redacted] 25X1

Conceptual and reporting problems also require making judgmental adjustments to the data. In countries where the banks are significant international financial intermediaries—Austria, Belgium, France, Italy, the Netherlands, Spain, Switzerland, the United Kingdom, and West Germany—short-term foreign currency liabilities are included only to the extent they exceed short-term foreign currency assets. We have made this adjustment because the amounts owed by banks in these countries are to a large extent deposit liabilities—a good portion of which are interbank deposits—used to finance lending as well as redeposit activity. Intercompany indebtedness between the nonresident parent and local subsidiary is technically a part of total debt but often not reported as such. Instead, in most countries this credit is reported, if at all, as a component of direct investment and is generally not separately identified. Finally, it is also common practice among countries not to report nonbank trade credits. These intercompany obligations skirt the normal letter-of-credit paper trail through banks and simply do not make it into the reporting system; these figures are relatively small. [redacted] 25X1

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the last five years. Ireland is the only West European country whose foreign debt exceeded its GNP in 1982. Like Portugal and Turkey, these countries cannot readily cope with a large debt burden when export revenues and capital inflows are weak, as was the case during the recent economic recession. In our view, neither Greece nor Ireland has an effective economic program to deal with its growing foreign debt problems and neither has an immediate financing alternative to borrowing. [redacted]

Belgium, Denmark, Finland, France, Iceland, Spain, and Sweden have also experienced rapid debt growth over the last five years. Belgium's debt has increased nearly fourfold, and the debt for the seven countries as a whole has doubled. Except for Belgium and France, in 1982 debt as a share of exports for these countries exceeded 100 percent and ranged between 108 percent (Spain) and 150 percent (Denmark). Moreover, all except Iceland tend to have large international capital flows that can exacerbate borrowing requirements during an economic or political crisis when capital flight creates a drain on central bank resources. Such a confidence problem occurred in France during 1981-83 following the election of Socialist leader Francois Mitterrand. [redacted] 25X1 25X1 25X1

Norway is the only country among the WE-12 whose debt position stabilized during 1978-82. Following a period of heavy investment in the oil sector during the 1970s, oil revenues are now sufficient to reduce the still relatively large amount of debt. [redacted] 25X1

Determining a Country's Credit Risk

No set formula exists for assessing a country's credit risk. As a result, we initially used a set of five indicators to help identify potential problem debtors in Western Europe. Though somewhat arbitrary, these indicators are frequently used by international banks to assess credit risk.

Risk Indicators

(1) External debt grew by at least 100 percent during 1978-82.
(2) External debt was equal to or greater than 40 percent of 1982 GNP.
(3) The debt service/exports ratio in 1982 (interest plus amortization on long-term debt plus short-term debt as share of exports of goods and services) is equal to or exceeds 50 percent.
(4) Total debt as a share of 1982 exports of goods and services equals or exceeds 100 percent.
(5) Foreign exchange holdings at the end of 1982 were equivalent to less than one month's imports.

The indicators are not weighted equally and vary in importance from country to country. Nevertheless, we believe any country facing a serious debt problem is likely to trip at least one indicator. In general, the greater the number of indicators tripped, the more likely the country will experience difficulty in servicing its foreign debt. 25X1

Other less easily quantified factors are also extremely important in assessing debt problems. These include particularly the government's policies to deal with the debt and the uses to which the borrowed funds are put. Norway, for example, had a rapid buildup in debt in the 1970s but used the funds to develop its oil and gas resources—which led to increased export earnings that are now being used to pay off the foreign debt. For the most part, determining the risk status of a country thus comes down to a subjective judgment about how well the country is utilizing the funds it has borrowed. 25X1

A total of 12 countries tripped at least one of the indicators, making their debt situation worthy of further study (see table 8). Portugal led the list, tripping all five indicators, while Ireland was in second place with four. France and Spain, on the other hand, tripped only one. 25X1

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Table 8
Debt Profile Indicators

	Debt Up 100 Percent (1978-82)	Debt/GNP Over 40 Percent (1982)	Debt Service Over 50 Percent (1982)	Debt/Exports Over 100 Percent (1982)	Foreign Exchange Less Than One Month's Imports (1982)
Belgium	X				X
Denmark		X	X	X	
Finland			X	X	X
France	X				
Greece				X	X
Iceland		X		X	
Ireland	X	X	X	X	
Norway		X		X	
Portugal	X	X	X	X	X
Spain				X	
Sweden		X		X	
Turkey		X	X	X	

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Causes of the Problem

The large increases in oil prices in the 1970s were the driving force behind the rapid runup in foreign debt for the WE-12, but domestic economic policies have been the decisive factor in determining the seriousness of their problems. Expansionary fiscal and accommodating monetary policies aimed at offsetting the depressive effects of higher oil prices on economic growth and employment pushed current accounts further in the red than otherwise would have occurred. Moreover, heavy government regulation and involvement in the economies, often combined with policies that kept exchange rates overvalued, impeded adjustment to the changing economic environment. Compared with the WE-12, the six West European countries (WE-6) that did not trip any debt problem indicators all followed more moderate monetary and fiscal policies, relied more extensively on market forces to adjust to higher oil prices, and exported more to OPEC countries because of their closer trade ties with the oil producers. [redacted]

During the 1979-83 period, we calculate that higher oil prices added $153 billion to the import bill of the WE-12—86 percent of the increase in foreign debt. Over these five years the cumulative current account deficit for the WE-12 totaled about $114 billion, roughly double the amount piled up during the preceding five-year period. [redacted]

Stimulative demand management policies—particularly in Denmark, Greece, Ireland, Portugal, Sweden, and Turkey—tended to make the external deficit situation worse by keeping the demand for imports relatively high while choking off export potential. Fiscal policy in the WE-12 after the first oil shock moved from a slightly restrictive stance to a strongly expansionary mode. Government spending for the WE-12 mushroomed from 35 percent of GDP in 1973 to 50 percent by 1982, and the governments' budget balances as a share of GDP moved from a 1.4-percent surplus in 1973 to an estimated 5.0-percent deficit in 1983. Most of the expenditure increase occurred in government transfer payments:

- The sharp rise in unemployment and the expansion of benefits since 1973 boosted unemployment benefit payments.
- Health care, pension, and social security benefits rose considerably.
- The growth of inefficient nationalized enterprises added to government spending. [redacted]

The WE-6 also increased government spending but did so at a slower pace and were able to keep the deficit relative to GNP at slightly lower levels. During 1973-82 government spending for this group rose from 40 percent of GNP to 50 percent, and their budget deficit as a share of GNP rose from 2.2 percent to 4.4 percent. [redacted] 25X1

Monetary policy was also highly stimulative in the WE-12 as government deficits tended to be financed by money creation. The WE-6, on the other hand, financed a greater part of their deficits by borrowing in domestic financial markets. Changes in the money supply reflect these differences in approach. In the 1973-82 period, the average annual growth in the money supply reached 13.3 percent in the WE-12 compared with 10.2 percent in the WE-6. [redacted] 25X1

Foreign borrowing requirements for the WE-12 also grew when governments failed to let their exchange rates adjust in response to widening inflation differentials. During the 1973-82 period, inflation in the WE-12 group averaged 13.7 percent in contrast to 9.9 percent in the WE-6. Authorities in several countries—Belgium, Denmark, France, Greece, Portugal, Spain, and Turkey—acted at different times to maintain overvalued exchange rates primarily in an attempt to hold down domestic price increases. As a result, current account balances deteriorated as import demand surged while export competitiveness declined. Artificially high exchange rates also adversely affected capital flows in several countries. [redacted]

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The international competitiveness of the WE-12—and hence their current accounts—also has been detrimentally affected by the high degree of government involvement in these economies. Although difficult to quantify, we believe the governments of most of the WE-12 have interfered with the operation of their economies to a greater extent than the other West European countries. Many of the Twelve have adopted measures that have inhibited adjustment to the changing world trade environment, including:

- Controls on prices.
- Direct subsidization of industry.
- Regulations on interest rates and credit allocation.
- Nationalization of industry.

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Price controls implemented at various times in Belgium, France, Iceland, Finland, Greece, Norway, Portugal, Spain, and Turkey have interfered with resource allocation; controls on energy prices in many countries, for example, kept the demand for imported oil high. Subsidies to industry in France, Greece, Portugal, Spain, and Turkey have kept alive many uncompetitive firms. Regulated interest rates in France, Greece, Ireland, Portugal, Spain, and Turkey have had similar effects by artificially providing credit. Nationalization of industries in several countries also has made economies less flexible and efficient. Greece, Portugal, Spain, and Turkey have for many years relied heavily on foreign debt to finance government-owned industries. While Portugal, Spain, and Turkey are attempting to reduce the role of government in the economy, Greece and France have expanded the number of nationalized sectors in recent years.

Composition of the Debt

The composition of medium- and long-term WE-12 debt is fairly well balanced between bank credits and international bonds. Bank loans now account for about an estimated 60 percent of the WE-12 debt and bonds, an estimated 40 percent. The trend over the past several years, however, has been toward increased use of bonds. New bond issues fulfilled 46 percent of WE-12 international financing needs in 1982, 53 percent in 1983, and 58 percent during the first quarter of 1984. The rise in the share of bonds is primarily the result of increased use of floating rate notes (FRNs), a debt instrument with a variable interest rate; regular bonds carry a fixed rate of interest over the life of issue. Investors have found FRNs attractive to hold because the variable rate protects them against inflation. In 1983 FRNs accounted for 26 percent of all new bond issues, compared with only 10 percent in 1978.

The interest rate charged on roughly 75 percent of the WE-12's foreign debt fluctuates with current market rates. We estimate that for every 1-percentage-point increase in rates, the cost of servicing the WE-12 debt goes up by about $2.5 billion. The variation in cost is particularly sensitive to rates in the United States and the Eurodollar market because about 80 percent of WE-12 obligations are denominated in dollars. The interest rate on syndicated credits is tied to the London interbank offer rate (LIBOR)—usually by a spread over LIBOR—or the US prime rate. Short-term debt, which accounts for about 35 percent of the $370 billion in outstanding WE-12 debt at the end of 1982, usually has a fixed rate of interest, but, because the maturities are very short—30 to 120 days usually—the cost of the credits can vary quickly.

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Six Will Worsen

We believe the foreign debt situation will be a serious problem for half of the WE-12 over the next few years (see table 9). Specifically:

- Portugal and Turkey almost certainly will need additional assistance in 1984. Turkey in particular faces a hump in its debt service obligations beginning later this year.
- Greece and Ireland are likely candidates for an IMF bailout in the next year or two.
- Denmark and Sweden, while not likely to require IMF assistance, probably will continue to see their debt expand and their credit ratings remain below prime.

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Despite Portugal's IMF program aimed at improving the economy and debt situation, Lisbon probably will need additional IMF and other official assistance in the near future. Lisbon should meet the $1.25 billion 1984 current account target set in the June agreement with the IMF, but Portuguese officials are worried that financing the deficit by borrowing from commercial banks could be difficult. To help matters, they have opened loan sources in Japan and plan to make new overtures in West European capitals. Portuguese officials have also asked the United States for help in meeting any external financing shortfall. Portugal has sold about $1 billion worth of gold through the Bank for International Settlements (BIS) and still holds nearly $8 billion worth at current prices. Finance Minister Lopes has indicated, however, that for now further gold sales are politically unacceptable; the new government believes that additional sales would be viewed by the public as sacrificing Portugal's national heritage.

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Table 9
WE-12: Foreign Debt and Current Account Estimates

Billion US$

	Foreign Debt						Current Account Balances [b]		
	Total [a]			Percent of GDP					
	1983	1984	1985	1983	1984	1985	1983	1984	1985
Total WE-12	**383.0**	**390.5**	**390.5**	**34**	**33**	**33**	**−14.3**	**−7.9**	**−0.9**
Belgium	31.5	32.0	30.5	39	37	34	−0.5	−0.3	1.5
Denmark	34.5	36.0	37.0	61	61	60	−1.2	−1.5	−1.0
Finland	20.0	21.0	22.0	42	41	40	−1.0	−1.0	−0.8
France	110.0	112.0	111.5	21	21	20	−4.0	−2.0	0.5
Greece	13.0	15.0	17.5	38	44	48	−1.9	−2.0	−2.3
Iceland	1.5	1.5	1.5	61	61	61	−0.1	0	0
Ireland [c]	19.5	20.0	20.5	107	108	108	−1.1	−1.1	−0.5
Norway	28.5	26.0	24.0	53	50	47	2.5	2.3	2.0
Portugal	20.0	21.0	21.5	101	110	116	−1.5	−0.8	−0.8
Spain	40.0	40.5	40.5	26	26	24	−2.4	−0.5	0
Sweden [d]	40.0	39.5	38.0	44	111	38	−1.1	0.5	1.5
Turkey	24.5	26.0	26.0	51	48	48	−2.0	−1.5	−1.0

[a] Projected. Based on current account balances and rounded to the nearest one-half billion dollars.
[b] OECD data for 1983 and estimates for 1984 and 1985; assumes no major shifts in government policies.
[c] Ireland's current account figures for 1983 and 1984 are official Irish numbers reported by the US Embassy in Dublin and were not available to the OECD for publication in the July Outlook.
[d] The OECD 1985 current account forecast for Sweden, we believe, is overly optimistic and should be closer to $0.5 billion.

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Although Turkey is generally meeting the economic targets set by the IMF, it probably will need additional official assistance to get over a hump in debt service that begins later this year. Turkey must begin repaying debts that were rescheduled earlier as well as money borrowed from OECD governments as part of the 1980 relief package. These principal repayments plus those to commercial banks will amount to $1.3 billion in 1984 and jump to $1.9 billion in 1985. In addition, Turkey must begin repaying its $1.6 billion IMF loan; $366 million is due this year and $385 million in 1985. At the same time, Turkey will have to finance a current account deficit of about $1.5 billion in 1984. The recent liberalization of foreign exchange regulations could also strain the central bank's resources in the short term if businessmen take advantage of the opportunity to divert funds to foreign bank accounts.

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Greece's debt problem is accelerating the most rapidly within the WE-12, and we believe the country soon will be forced to seek IMF assistance. Current trends clearly indicate a deteriorating situation:

- Negative real interest rates are discouraging savings and encouraging consumption and imports.
- The $1.9 billion current account deficit in 1983 will edge even higher in 1984 and in 1985 we expect the deficit to approach the record level of $2.4 billion recorded in 1981.
- Repayments on previous loans will accelerate in 1984 as a result of the large amount of borrowing during 1980 and early 1981.
- Foreign exchange reserves have already dwindled to less than one month's worth of imports.

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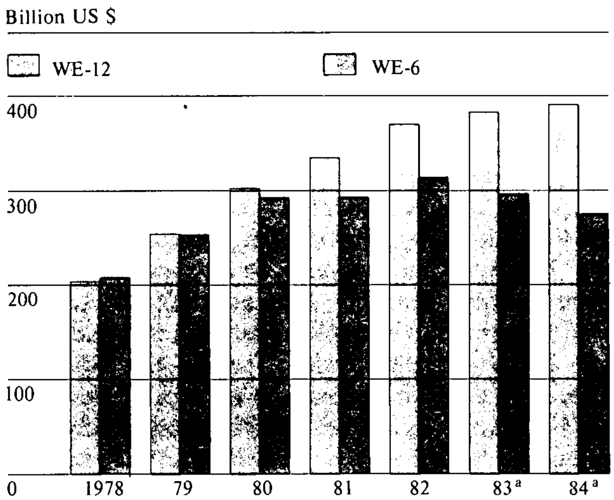
Figure 1
Western Europe: Total Foreign Debt



[a] Estimated.

[redacted]

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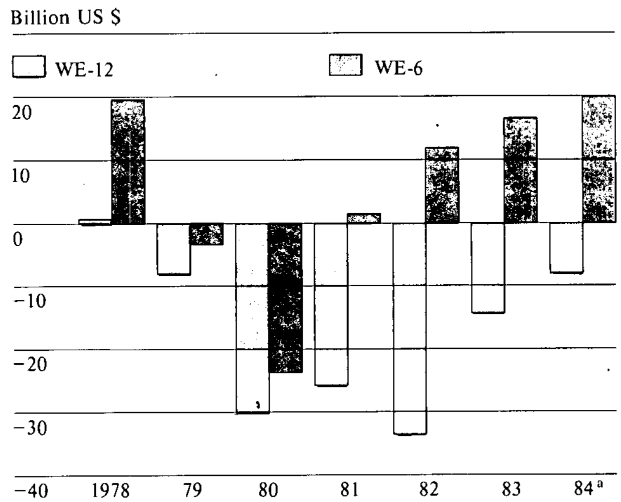
Figure 2
Western Europe: Current Account Balances



[a] Estimated.

[redacted]

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Although the pickup already under way in world trade will give a boost to Greek exports, we believe the increase will be moderate because of poor price competitiveness and a decline in import demand in the Middle East, an important market for Greece. On the import side, Greece will have to spend to rebuild oil inventories because of destocking last year, and payments on debt service will also rise as a result of the increased debt. Beyond 1984 only a significant increase in investment to improve international competitiveness can help Greece expand its export sector. But private direct investment inflows—particularly purchases of Greek real estate, a traditional source of capital inflows—have dropped from $1.5 billion annually during 1980-81 to $850 million annually during 1982-83. Bankers' attitudes toward Greece are also souring, [redacted] many banks have sold out their shares on recent loan syndications to Greece because they believed the terms were too generous for the risk involved. [redacted]

In our view, the Papandreou government's interventionist economic policies are primarily responsible for the continuing deterioration. Papandreou has relaxed the moderately restrictive income policy for 1984. Moreover, make-work unemployment programs are being discussed within the government as restive labor unions challenge the Socialist government's lack of attention to its prolabor platform. Political pressure from Papandreou's leftist supporters make it unlikely, therefore, that he will adopt the austerity measures needed to reduce the external deficit. [redacted] 25X1

Ireland almost certainly will not be able to improve its foreign debt position this year; there is a good chance it will deteriorate further. Any major increase in borrowing requirements would quickly trigger the need for an IMF-type debt restructuring program. Although Irish exports are doing better as a result of the upturn in world trade, we believe the Irish current account deficit of $1.1 billion in 1983 will be repeated this year. We also believe there is a strong possibility

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that the government will soon reverse its restrictive economic policies, thus leading to an even greater deterioration in the current account than currently forecast by the OECD. [redacted]

Pressures to relax economic policy are building because the unemployment rate has soared 5 percentage points since 1982 to almost 16 percent. Although the current coalition government—made up of the Labor Party and the United Ireland Party (Fine Gael)—continues to emphasize the need for restrictive policies, a split is beginning to develop. While the Labor Party is having second thoughts about austerity, Fine Gael is advocating new tax increases and spending cuts as part of its five-year plan to balance the budget by 1986. We believe the mounting unemployment problem could drive a wedge between the coalition partners, causing the government to fall. Under such circumstances, the opposition Republican Party (Fianna Fail) probably would win a national election and adopt more stimulative economic policies. [redacted]

International bankers are anticipating that Ireland will need an IMF restructuring program. As a result, some of them have suggested that Ireland should seek an IMF program now while foreign reserves are relatively strong and before a crisis atmosphere develops. [redacted] the structural changes in the economy necessary to reduce unemployment will take time to implement and to become effective. [redacted]

Denmark and Sweden will continue to experience increasing debt difficulties, but neither is likely to need IMF assistance during the next year or so. Both countries' capacity to export has been hurt in recent years by the small amount of productive investment in the economies; disinvestment has actually occurred in the Danish manufacturing sector. Until bankers are convinced that their investments will go toward productive ends instead of funding welfare policies, credit ratings will remain unchanged or drop further. [redacted]

The Danish economy will have to continue to borrow abroad in order to finance its external deficit, as it has for the past 20 years. The OECD forecasts a slight deterioration in the deficit this year to $1.5 billion. The figure is likely to be higher if the government retreats from its effort to cut the public deficit to 8 to 9 percent of GNP—down from 9.6 percent in 1983.

Pressures on the Schluter government to provide some stimulation will probably intensify, however, because we believe its program to reduce public-sector jobs will lead to an increase in the country's unemployment rate. External performance will also be weak in 1984 as Danish goods have suffered a loss of price competitiveness during the last year. [redacted]

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Sweden's debt situation continues to benefit temporarily from a competitive devaluation in 1982. We believe the current account deficit will fall again in 1984 and new foreign borrowings, therefore, will be less than in the last two years. In our view, however, current policies cannot be sustained; thus the outlook for 1985, or until there is a policy shift, is for an increase in foreign borrowing. The OECD's recent forecast of a $1.5 billion current account surplus for 1985 appears to us as unsubstantiated and overly optimistic. We believe the price effects of the devaluation will have played themselves out by then and further export capacity utilization will not be possible without substantial investment; a surplus of only $0.5 billion is more likely. Also, Prime Minister Palme's commitment to the welfare system will keep budget financing requirements and demand high, both of which will work to keep the current account in the red. [redacted]

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Six Will Improve

The remaining six countries in the WE-12—Belgium, Finland, France, Iceland, Norway, and Spain—probably will see an improvement in their debt profile over the next few years. The governments of these countries have already taken economic measures to reduce the debt burden, and we believe these programs will be successful. Nonetheless, potential problems remain, and in the cases of Belgium, France, Iceland, and Spain any relaxation of current restrictive policies would quickly create renewed debt problems. [redacted]

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Four countries—Belgium, Finland, Iceland, and Spain—are all implementing generally tight economic policies in conjunction with some structural changes that will help improve their current account outlooks:

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- Belgium implemented an economic reform program in 1982 that tightened fiscal and monetary policies, adjusted the exchange rate, and suspended wage indexation for two years.

- Finland tightened monetary policy beginning in late 1982, devalued the markka, and is planning to tighten fiscal policy during 1984.

- Iceland has strongly tightened monetary and fiscal policies, devalued the kronur, and suspended wage-price indexation until mid-1985.

- Spain has tightened monetary and fiscal policies, devalued its currency, and reduced norms for wage increases; it also is attempting to restructure the economy primarily by opening up previously protected sectors to domestic and external competition.

All these countries will improve their current account positions during 1984, a trend which began after 1980 for Belgium and Spain. Belgium, we believe, will be only $0.3 billion in deficit this year, and Spain's deficit will be reduced further to about $0.5 billion. Improved price competitiveness and the expected pickup in world trade should boost export volume this year by 4 to 4.5 percent for Belgium and 7.5 percent for Spain

A number of potential problems remain, however, which could slow further progress in containing the increase in foreign debt:

- Continuing high unemployment in Belgium (14.5 percent) and Spain (19.5 percent) could lead both governments to ease up on fiscal and monetary policy restraints, which in turn could boost imports.

- Belgium has restored wage indexation for 1984, which could affect international competitiveness later this year and beyond.

- Major wage negotiations in Finland this year could lead to wage and price increases that would hurt Finnish sales to Western markets—a development Helsinki particularly wants to avoid given an expected decline in exports to the Soviet Union.

France's foreign debt outlook is improving as well:
- Austerity measures introduced in 1982 and 1983 have slowed domestic economic growth, which has reduced the growth of imports.
- Recovery in the other major countries is promoting French exports.
- Exchange rate changes in the past have more than compensated for still relatively high inflation in France, thereby improving international competitiveness.

As a result of these factors, we expect France's current account to be in small surplus this year, reducing the need to borrow foreign funds. 25X1

The outlook for trends in French foreign debt during 1985 and 1986 is clouded by the possibility that President Mitterrand will ease up on austerity before the 1986 National Assembly elections. We do not 25X1 expect Mitterrand to make any major shift in policy given the economic problems his 1981 reflation policy created. Still, a strict adherence to the austerity program would probably add to the Socialist Party's problems as the election drew close, and we thus believe that a moderate relaxation of policies is likely. We estimate that such a moderate relaxation of policies would push the current account balance into a small deficit, as opposed to the small surplus that the OECD is now predicting for 1985. 25X1

Oil and gas revenues have helped reduce Norway's debt since 1980. The 1984 current account surplus 25X1 will be only slightly smaller than last year's $2.5 billion figure and will permit another reduction in foreign debt. Barring a sharp drop in world oil prices, Oslo should be able to continue trimming the debt over the next few years. Oslo has also taken steps to improve its foreign credit rating as well as the terms on loans taken out to finance new oil and gas development. Previously, major borrowings were done in the name of the Kingdom so that the debt was heavily concentrated in the public sector. A change in the law now permits Norwegian banks to invest in the oil sector. As a result, the public sector is reducing its share of the foreign debt as the banks raise funds on the Euromarket in their own names instead of the Kingdom's name. The strategy has helped to spread the risk on Norwegian borrowings and at the same 25X1 time has incorporated a higher degree of commercial decision making for investment in the oil sector. 25X1

Implications

Growing foreign debt service requirements in Western Europe, in conjunction with slow economic growth and continuing high unemployment, are likely to add to pressures for protectionist measures to aid domestic markets and improve current account earnings. Defensive West European policies—particularly with respect to agriculture, steel, textiles, and consumer electronics and watches—have already hurt the export earnings of some LDCs and newly industrializing countries. The combination of debt and unemployment problems will also tend to increase West European interest in trade with the Soviet Union and Eastern Europe, possibly leading to further differences with the United States over trade restrictions.

We also believe West European countries are likely to maintain pressure on the United States to further lower interest rates and the budget deficit, which is viewed as the cause of high US rates. Concern is particularly acute in the WE-12 because their debt servicing obligations will remain high and so much of their debt fluctuates with current market rates. There is a widespread perception in Western Europe that high US rates are forcing up interest rates around the world, thus increasing the burden of servicing foreign debt. The West Europeans also claim that high US rates of interest are affecting business investment in Western Europe because firms there traditionally have relied heavily on debt instead of equity to finance growth.

The likelihood that a number of West European countries could require some form of official external financial assistance will tend to boost West European support for increasing the resources of the IMF and other multilateral facilities. The special IMF quota increase in 1982, though it came three years earlier than specified in IMF rules, was felt by many LDCs and West Europeans to be too little, and the issue will be raised again at this year's IMF/World Bank meetings in September. We also believe West European countries in financial difficulty will find common ground with the LDCs in the idea of a new SDR allocation; French Finance Minister Jacques Delors has already said publicly he is supporting a proposal for a new issue of the special drawing rights. If a major increase in IMF quotas or SDRs is not approved, we believe that France and many of the other WE-12 countries would support a new IMF borrowing facility—like the 1974 oil facility—that would raise a country's IMF borrowing limitation above the current maximum of 600 percent of quota. 25X1

Debt problems among current and prospective members will present the EC with problems that it will be able to deal with in only a limited way. This is probably just as well as far as the more financially sound EC countries are concerned. West Germany and the United Kingdom, for example, would probably feel more comfortable if IMF programs are adopted by Greece and Ireland. Recently, in fact, Greece approached the EC for a loan and apparently was turned down because it did not have a comprehensive economic program. The Community has its own financial problems, and EC syndications on the Euromarket to be used to relend to member countries—such as the $3.7 billion 1983 EC loan to France—will probably be used only on a very selective basis. Any new loans for member countries, in fact, would require the express consent of West Germany, the ultimate financial guarantor for EC borrowings.

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Appendix

WE-12: Debt Situation in Individual Countries

Belgium

Causes

Belgium's fiscal, exchange rate, and wage policies encouraged heavy foreign borrowing during 1979-82. As as result, foreign debt increased by 288 percent—the largest increase of any West European country—and rose from 8 percent of GDP to 37 percent. Government spending as a share of GNP rose to 58 percent by 1982—up from 39 percent 10 years earlier—primarily because of increases in transfer payments that in turn impacted heavily on consumption and imports. Export competitiveness declined during the 1970s as real wage increases outstripped increases in Belgium's trading partners by 16 percent while the value of the Belgian franc was kept artificially high at different times in order to maintain parity in the European Monetary System (EMS) and hold down inflation. [redacted] 25X1

Responses

The government launched an economic reform plan in 1982 aimed at restraining demand by cutting the public-sector deficit and restoring the profitability and foreign competitiveness of firms. Some progress has been made in reducing real government expenditures, and in 1984 the government is projecting a decline of 0.2 percent; the deficit, however, will still equal 11.5 percent of GNP. Depreciation of the franc by 8.5 percent and real wage declines of 2.5 percent in 1982 and 3.5 percent in 1983 have helped firms boost exports. Wage indexation, however, was restored in 1984 and may again threaten foreign competitiveness. [redacted] 25X1

Outlook

Net foreign borrowing requirements will continue to diminish in 1984 paralleling the projected improvement in the current account. The OECD estimates that the deficit this year will be about $0.3 billion, down from $4.9 billion in 1980. Brussels faces a strong challenge in the next two years, however, as it attempts to further reduce the public-sector deficit and contain wage increases while at the same time the unemployment rate continues to inch upward. A sustained recovery in trade with West Germany, its main trading partner, will help most to reduce debt levels and improve employment. [redacted] 25X1

Denmark

Causes

Increases in government spending, wage indexation, and foreign exchange regulations drove Denmark's current account heavily into the red during 1979-83 and increased Danish reliance on foreign debt. Government spending now accounts for about 60 percent of GNP and the tax burden is 45 percent; there is currently a large structural component to the budget deficit that has contributed to foreign borrowing requirements. The growth of the public sector has contributed to a downward trend in private domestic investment since 1974, a cut in savings, a smaller manufacturing sector, and a shift in the work force out of the private sector—all factors that reduce Denmark's export potential. Automatic wage indexation and high minimum wages also hurt Denmark's price competitiveness in foreign markets, while restrictions on capital inflows limited foreign direct investment. [redacted] 25X1

Responses
The Danish Government is implementing a budget that is aimed at reducing the huge public-sector deficit and holding down demand. Some cuts in transfer payments were accomplished in 1983. Wage restraint and a national incomes policy are being used instead of devaluations to improve and maintain the competitiveness of Danish firms; wage indexation has been suspended until 1985. 25X1

Outlook
Denmark will continue to run current account deficits that will have to be financed with more borrowing in the years to come. This year's deficit will be slightly higher than last year's $1.2 billion if the government can effectively implement its new tightened budget, a prospect we consider likely at this time. Several factors, however, point toward a worsening in the foreign accounts over the medium term: the Danish export sector is in a depressed state and requires net new investment; the public sector is releasing workers faster than the private sector can absorb them; and wage indexation will be restored next year, threatening Danish competitiveness. Copenhagen will continue to rely on an incomes policy instead of devaluations to maintain foreign competitiveness, a more difficult policy option. 25X1

Finland

Causes
International competitiveness deteriorated during most of the 1970s and through 1982 as wage costs per unit of output increased at a greater rate than in partner countries. These increases were not completely offset by exchange rate changes, and, as a result, export performance—Finnish export growth relative to market growth—has lagged behind partner countries since 1979. Because of the lack of a broad domestic capital market, government deficits have been financed largely by foreign borrowing. 25X1

Responses
The Finnish Government tightened monetary policy during 1982-83 and is planning to tighten fiscal policy in 1984 in order to mildly restrict demand and prevent any worsening of the current account deficit. A 1982 devaluation helped improve foreign competitiveness despite continued and relatively rapid wage increases. Helsinki plans to maintain its share in foreign markets by selectively devaluing the markka when necessary. The government also hopes to contain any potential setback for the foreign sector by limiting increases in wages at this year's labor negotiations. 25X1

Outlook
The current account deficit this year will improve because Finnish policies are sound and the outlook for exports is good. The tighter monetary and fiscal policies should slow the rate of inflation. Unemployment will decline in 1984 to about 5.7 percent, helped primarily by a strong pickup in exports to industrial countries. Helsinki's policy of selective devaluation should help to maintain international competitiveness because there is still sufficient industrial capacity to take advantage of the pickup in world trade. 25X1

France

Causes

The highly expansionary Socialist economic plan implemented in 1981 increased foreign borrowing requirements significantly. Even before that, however, unbalanced economic policies were forcing Paris to rely heavily on foreign funds to finance large current account deficits. Government spending rose to over 50 percent of GNP in 1982 from 39 percent 10 years earlier, while export competitiveness declined during the 1970s as wage costs rose sharply. France's foreign market share declined by 1.2 percentage points during 1975-80, while the share of imports in the domestic market increased from 22 percent to 28 percent in the same period. The Socialist government's expansionary economic stance in 1981-82 strongly stimulated demand and put France out of phase with the other major countries, worsening the current account deficit. The Socialist victory also resulted in a decline in net new foreign investment in France, increasing the economy's dependence on borrowing as the source of foreign exchange to cover deficits. [redacted] 25X1

Responses

President Mitterrand, reacting to his failed attempt to spend France's way out of the recession and finding the Socialist platform expensive to implement, tightened the 1982 austerity program with broader and harsher measures in 1983. The focus of the new package was to reduce inflation and improve the balance of payments. Higher taxes, forced savings, and slower wage growth—designed to reduce consumption and imports—were coupled with foreign exchange controls to reduce the foreign borrowing requirement. Money supply growth was also reduced somewhat to slow inflation and ease pressure on the franc within the EMS. These measures were implemented following the March 1983 devaluation of the franc within the EMS and in part at least came about as a result of the realignment negotiations. [redacted] 25X1

Outlook

We expect the debt situation to improve in the short term, but there is some possibility that it will deteriorate in the medium term. For 1984 the OECD expects the current account to drop from a $4 billion deficit in 1983 to $2.0 billion. The improvement is due to the fact that the French austerity program is having its intended impact and depressing demand and imports, while at the same time recovery elsewhere is strongly boosting French exports. For the longer term, however, it is possible that Mitterrand will alter the course of economic policy to maintain the Socialist majority in the 1986 elections for the National Assembly. Some changes in the current program can be expected as unemployment and wage restraint stir the ire of the French labor force; the new budget, scheduled to be voted on in Parliament this fall, may give an indication as to how far the government is willing to go. A major shift in economic policy would quickly drive the current account deep into the red and significantly increase French foreign borrowing requirements. International bankers are concerned about a shift by Mitterrand, but a continuation of current policies could restore their confidence. Under the current economic regimen, France is still a relatively good credit risk. [redacted]

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Greece

Causes
Greek governments since the mid-1970s have relied on expansionary economic policies in an attempt to gain short-term political advantage but at the cost of thwarting economic adjustment. This overspending was financed by a fully accommodating monetary policy and foreign borrowing. Real wage increases were not matched by gains in productivity, and foreign competitiveness was made worse by maintaining the value of the drachma when inflation in Greece was higher than elsewhere. Domestic investment has slumped badly since 1980, impeding Greece's ability to expand production and exports. Foreign investment in Greece, which has helped to offset current account deficits in the past, has been concentrated in real estate rather than productive investments in the domestic and export sectors. [redacted] 25X1

Responses
Athens has avoided implementing an economic program to deal with its serious debt problem. The 1983 decision to devaluate the drachma and break its link to the dollar was a good move, but the government followed this up by deciding to maintain the value of the drachma. The government also tightened fiscal and credit policies somewhat in 1983 to restrict demand but at the same time kept alive plans for an employment program. In addition, Papandreou relaxed his moderately restrictive incomes policy for 1984 and tightened price, profit, and import controls, further alienating the business community. [redacted] 25X1

Outlook
The foreign debt situation is deteriorating rapidly. The current account deficit will not improve this year, according to the OECD, and could get worse at a time when foreign private capital inflows have been declining. Net new borrowings as a result will have to increase by 15 to 20 percent in 1984, and banker confidence is low as Papandreou fails to take effective action to deal with the debt problem. The US Embassy in Athens has said that IMF help probably will be needed in the next two years. If corrective economic measures are not implemented, we believe such a program will be needed sooner rather than later. [redacted] 25X1

Iceland

Causes
Foreign borrowing was necessary to cover chronic current account deficits during the last decade. These deficits resulted from a sharp deterioration in the terms of trade because of increased oil prices and a drop in the price of fish—Iceland's main export. Iceland's export earnings have also been strongly affected by fluctuations in the volume of fish catches, while a highly expansionary monetary policy during the 1970s kept demand for foreign goods high. [redacted] 25X1

Responses
Reykjavik has taken a number of steps to cut foreign borrowing and slow inflation—which last year dropped from 130 percent to 30 percent. In particular, it has reduced real government consumption, cut monetary growth, suspended wage-price indexation, and devalued the kronur. [redacted] 25X1

Outlook
Tightened fiscal and monetary policies are continuing to depress demand and improve the current account outlook. The current account will be in rough balance in 1984 as imports will actually decline again and exports will be the only sector providing positive growth to the economy. Iceland's borrowing requirements in part remain hostage to the fluctuations in fish catches and world fish prices, factors which are out of Reykjavik's control. 25X1

Ireland

Causes
Large increases in government spending unmatched by tax increases and an industrial policy that has made unemployment worse have forced the government to borrow large sums from abroad to finance its huge budget imbalance and cover current account deficits. Total government spending as a share of GNP soared from 39 percent in 1973 to 57 percent in 1982, pushing the Exchequer's borrowing requirement to over an average of 15 percent of GNP in 1981 and 1982. This stimulus to demand boosted imports while foreign sales were hurt because large wage increases were often not fully offset by exchange rate adjustments. Also, productivity gains have come mainly in the capital-intensive export industries. This has helped reduce the current account deficit but has had little impact on halting the rise in unemployment and the additional cost to government in unemployment benefits. Unexplained capital outflows rose to nearly $1 billion in 1982—about a tenfold increase over 1981—because of exchange rate uncertainties. 25X1

Responses
The government is currently relying heavily on fiscal and monetary restraints to hold down demand—despite a serious and growing unemployment problem—and is hoping for a boost to exports as recovery picks up in the United Kingdom and Western Europe. Interest rates and taxes were raised to stimulate savings and cut the government deficit—which fell to 13 percent of GNP in 1983. Exchange rate adjustments have not figured strongly in Dublin's policies since Ireland joined the EMS. 25X1

Outlook
Ireland's debt profile is dangerously high and the government's economic strategy needs better balance if a debt crisis is ultimately to be avoided. Even under the present austere economic program, the $1.1 billion current account deficit in 1983 will be repeated again this year. The near-16-percent jobless rate reflects the lopsided industrial policy that has strongly favored capital-intensive investment. We believe this to be an unhealthy situation and one that is likely to trigger a political crisis. The current coalition government—made up of the Labor Party and the more conservative United Ireland Party (Fine Gael)—would verly likely fall if a new economic program stressing economic stimulus and employment were popularly demanded. The current opposition Republican Party (Fianna Fail) probably would win a national election but would not be able to loosen the fiscal reins for very long before an IMF- type program would be necessary. Bankers are anticipating that Ireland will need a debt restructuring program at some point in the next couple of years and are encouraging Dublin to seek one now while foreign reserves are still adequate. 25X1

Norway

Causes

Large capital equipment imports to develop oil and gas reserves, along with a 30-percent reduction in market share of traditional exports, kept Norway's external balance in deficit throughout the 1970s. Traditional exports were hurt by a combination of poor commodity mix (largely intermediate goods that did not fare well after the first oil crisis), a poor country mix (buyers of Norwegian goods tended to be hard hit by the two recessions of the last decade), and poor price competitiveness. 25X1

Responses

Norway's oil revenues pushed the current account balance into the black during the 1980s, precluding the need for a policy shift to deal with the foreign debt. Fiscal policy in fact is relatively expansionary, emphasizing labor market support measures, and tax cuts have been announced. Traditional exports have also fared better in recent years. 25X1

Outlook

Oil revenues are now making it possible for Norway to reduce its foreign debt. The short-term outlook is favorable, and bankers have raised their internal rating for short-term lending to Norway back up to the prime category. The current account will still be in surplus this year, though down somewhat from 1983 because of rising imports. Wage negotiations this spring will play an important part in determining the future price competitiveness of traditional exports. 25X1

Portugal

Causes

Foreign borrowing requirements have been kept high by economic policies that have stimulated demand and imports and distorted the value of the currency. Lisbon followed a strong expansionary fiscal policy during most of the 1970s backed by a generally accommodating monetary policy. These policies, coupled with generous wage settlements, stimulated demand and pushed inflation up beyond most of its major trading partners, yet the government refused to let the exchange rate adjust to the changing price level. As a result, trade competitiveness was hurt, and since 1980 the trade deficit was made worse by the second oil shock and a drought that hurt agricultural production. Moreover, the overvalued escudo also adversely affected capital flows at various times, increasing the borrowing requirement. An IMF program was in effect during 1977-79 and relied on temporary demand restraint measures to reduce inflation and improve the foreign account. Moderate policies fell by the wayside during the second oil crisis as the government reflated again, precipitating another IMF program in 1983. 25X1

Responses

The 1983 austerity measures associated with the IMF program targeted a moderate reduction in money growth, raised interest rates, projected a reduction in the deficit from 12.5 percent of GNP in 1982 to 6 percent this year, incorporated a 12-percent devaluation, reduced subsidies, and outlined structural adjustments—primarily in the public enterprises. The government was able to meet all the 1983 targets in the program. The recession has kept credit limits well within IMF ceilings and has dampened import demand, helping Lisbon to reduce the current account deficit. The Soares government, however, is apprehensive about the political repercussions of the recession and has sought easier targets from the Fund. 25X1

Outlook

Portugal may have to seek increased financial assistance to finance its 1984 current account deficit and has already informally approached the United States for financial help. Portugal's long-term debt outlook depends upon structural reform of the economy: reducing government's role in the public enterprises, utilizing more of the work force with less emphasis on capital-intensive projects, and increasing reliance on market forces to determine resource allocation. The IMF is stressing these objectives for the new program. 25X1

Spain

Causes

The increase in foreign debt has been the result of the increase in oil prices and the inward orientation of the Spanish economy. Franco's policies produced an industrial sector that was accustomed to subsidies and protection from foreign competition and thus was not well positioned to compete effectively in world markets. Also, both increases in labor costs and an overvalued peseta have adversely affected trade at different times and increased foreign borrowing. 25X1

Responses

Spain has taken a medium-term approach in dealing with its foreign debt and other economic problems. Madrid has effectively implemented a tight monetary and fiscal stance to curb demand, while a devaluation in late 1982 and a reduction in wage norms have also helped to reduce the current account deficit. At the same time the government is pressing ahead on structural reforms to improve market forces and make Spanish firms more efficient and competitive. Structural reforms in the financial and manufacturing sectors, however, are taking their toll in the form of higher unemployment. 25X1

Outlook

Foreign debt will continue to grow this year but by a reduced amount as the current account deficit continues to decrease for the fourth straight year; we concur with the OECD estimate that the deficit will be $0.5 billion. Spanish exports continue to benefit strongly from the recovery abroad and the devaluation of the peseta while tight monetary and fiscal policy hold down the growth in imports. Shedding Franco's protectionist legacy has been costly and the unemployment rate has soared to 18.4 percent, second only to Turkey among OECD countries. While this is a serious problem that could eventually cause an unraveling of the economic program and a ballooning in the current account and foreign debt, we also believe that the unemployment problem is somewhat less than the statistics currently indicate because of the large underground economy. 25X1

25X1

Sweden

Causes

Government policies oriented toward improving employment and raising workers' incomes—policies such as public jobs programs, subsidies, and minimum wage rate increases—reduced foreign competitiveness. The increase in government spending to 69 percent of GNP in 1982 has resulted in one of the heaviest tax burdens in Western Europe and a government borrowing requirement equivalent to 12 percent of GNP. Although subsidies to industries increased from 3.4 percent of GNP in 1970 to almost 10 percent in 1980, industrial output did not increase during 1970-82. The heavy emphasis on demand stimulation and transfers to industries impacted heavily on the current account through increased imports. Devaluations offset the increases in wage costs, but the decline in productivity still caused foreign competitiveness to wither, hurting exports. 25X1

Responses

Stockholm has relied on a 16-percent devaluation in late 1982 to expand exports and improve its foreign accounts. Plans to tighten fiscal policy to reduce demand have not materialized, although monetary policy was tightened—which helped to slow inflation somewhat in 1983. Plans to hold real wage increases to zero this year will be difficult for the government to sell, given record profits in the export sector since the devaluation. 25X1

Outlook

The current account improvement this year is estimated by the OECD to continue in 1985, resulting in a $1.5 billion surplus. We believe this is overly optimistic for several reasons. Future devaluations to improve competitiveness will not stimulate exports to the extent the last one did because the Swedish export sector is approaching full capacity and will need more productive investment to take advantage of any price change. Prime Minister Palme's commitment to the welfare system will keep the budget deficit and financing requirement high, which along with the cyclical pickup in demand will help to keep the current account in the red. 25X1

Turkey

Causes

Turkish foreign debt soared during the 1970s, mainly as a result of the government's inappropriate response to the 1973 oil price hikes. Always jockeying to stay in power, a succession of weak coalition governments found it impossible to take the needed steps. By holding down the domestic price of oil and other goods, maintaining an overvalued exchange rate, and pursuing sharply expansionary policies, Ankara pushed the current account—which had recorded a $0.5 billion surplus in 1973—deep into deficit. In addition, a long history of direct government involvement in the economy through State Economic Enterprises created inefficiencies and a protected domestic sector that has increasingly discouraged both domestic and foreign private investment in Turkey. Worker remittances, a major source of foreign exchange, were also reduced because of the overvalued lira.

25X1

Responses

The 1980 stabilization plan along with direct economic assistance from OECD countries and the IMF has helped to slow the growth in debt. Inflation and the government deficit have been reduced, relative prices have been made more flexible, and the exchange rate consistently has been maintained at a realistic level. Recently elected Prime Minister Turgut Ozal has forged ahead in the same market-oriented direction and has removed more restrictions on foreign exchange transactions. 25X1

Outlook

Turkey faces a hump in its debt service obligations beginning later this year when principal repayments on rescheduled debt begin falling due. Meanwhile, exports are being hurt by the financial problems of OPEC—which now accounts for two-fifths of foreign sales. In this situation we believe Turkey will not be able to cover all of its financing needs in 1984 and 1985 without additional official assistance from the IMF or other OECD governments. We estimate total financing needs for these two years at about $6.5 billion. Current account deficits for both years will total about $2.5 billion in addition to which principal repayments on previous loans and reschedulings worth $3.9 billion will fall due, including a $0.7 billion repayment to the IMF. 25X1