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Argentina's Debt: Financial Imperatives in a Struggling Democracy



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An Intelligence Assessment

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July 1984

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Argentina's Debt: Financial Imperatives in a Struggling Democracy



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An Intelligence Assessment

This paper was prepared by [redacted]
[redacted] with a contribution from [redacted]
[redacted] Office of African and Latin American
Analysis. It was coordinated with the Directorate of
Operations. [redacted]

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**Argentina's Debt:
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Key Judgments

*Information available
as of 10 July 1984
was used in this report.*

President Raul Alfonsin took office in December with an electoral mandate that would have permitted him, in our view, to fulfill his pledge to reconcile differences with foreign bankers and the International Monetary Fund over Argentina's debt. He has failed to show much progress on this front largely because his administration's principal political goals have conflicted with foreign creditors' insistence on austere economic adjustment policies.

The first elected civilian president after eight years of military government, Alfonsin is primarily concerned with reestablishing democratic rule, which in his view necessitates maintaining strong popular support for his administration. Thus, he has pressed reform of the military, pledged to improve living standards for workers, and sought to avoid giving his political opponents—principally the Peronists—opportunities to attack him. He believes foreign creditors and the IMF should be sensitive to the fragility of Argentine democracy and ease the debt repayment burden.

Despite the difficulties to date, we believe there is a strong chance that Argentina will conclude an economic stabilization accord with the IMF this year. Even with an IMF accord, however, we believe Buenos Aires will make only partial progress in arranging with foreign banks the debt rescheduling and new loans necessary to resolve financial difficulties. This would leave Argentina with an overhang of past-due debt, while the delay in obtaining new loans would probably prevent the normalization of debt payments. These circumstances would hinder the chances for Argentina's economic recovery and cause political troubles for Alfonsin but probably would not be serious enough to destabilize the government.

We believe there is still some chance that Argentina will fail to conclude an agreement with the IMF, causing the collapse of debt talks with foreign banks. In addition, a rapid rise in interest rates could result in a new clash with lenders over repayment terms, with similar consequences. In this scenario, the inevitable payments moratorium could snowball into an outright debt repudiation with grave consequences for the Argentine economy, the civilian government, and world bankers.

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Beyond 1984, Argentina will remain vulnerable to the resurgence of cash problems:

- We expect that Buenos Aires will be clearly out of compliance with the Fund stabilization program by early 1985.
- This breach would again cut Argentina's access to fresh flows of foreign exchange, resulting in another moratorium on debt payments.
- Our research also indicates that Argentina will probably face a large bulge in payments during 1986-87 when government bonds covering private-sector debt come due, which will only add to the increasing interest burden resulting from past heavy borrowing.

Even under favorable economic conditions, we expect Argentina's borrowing needs would exceed bankers' willingness to provide new loans. Consequently, we believe bankers may need to voluntarily offer Argentina substantially stretched out repayment terms in order to avoid demands from Buenos Aires for some innovative form of relief from interest payments.

We believe Buenos Aires expects the US Government to bolster Argentine democracy by taking extraordinary steps to help resolve its financial difficulties, such as restraining interest rates and soliciting cooperation from US bankers. If the Argentines perceive that Washington is being supportive, we believe this would increase their willingness to make compromises necessary to keep financial talks on track. Under these conditions, US bankers would benefit from the normalization of payments, US exporters would probably have easier access to the Argentine market, and bilateral ties would be strengthened.

Alternatively, a rapid rise in interest rates or the perception that the United States is pressing Alfonsin to adopt economic policies he regards as politically detrimental could lead to trouble. In these cases, Buenos Aires could retaliate against US interests, resulting in diminished trade, strained political ties, and a cutoff in payments to US banks. Alfonsin would probably also seek to gain a following of other Latin American debtors to act in concert against lenders.

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Argentina's Debt: Financial Imperatives in a Struggling Democracy

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Introduction

In December 1983 the popularly elected government of Raul Alfonsin and the Radical Civic Union took office in Argentina, ending eight years of military rule. Among the most pressing problems facing the civilians was managing the \$45 billion foreign debt inherited from their military predecessors. President Alfonsin and his Economy Minister Bernardo Grinspun soon followed through on campaign pledges to seek easier repayment terms and use the savings to stimulate the economy. Foreign bankers, meanwhile, were pushing for an austerity program they believed necessary to cut inflation and improve Argentina's ability to repay its debt. These differences have yet to be resolved and have nearly precipitated an international financial confrontation.

and World Bank reports, the total foreign debt rose 50 percent to \$12 billion as the government undertook a major public investment program to diversify the economy. On top of this, the Argentines increased borrowing during 1979-81 to cover persistent payments deficits. In this period, Buenos Aires deliberately held exchange rate devaluations below prevailing inflation to encourage the import competition seen as necessary to revitalize domestic industry. The overvalued peso encouraged private-sector firms to borrow overseas, mainly in short-term markets, to pay for imports. Public-sector corporations also continued borrowing to sustain investments and shore up the external accounts. Consequently, Argentina's foreign debt tripled to \$36 billion by 1981.

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Alfonsin's strong stand against bank-imposed austerity, his continuing criticism of increases in US interest rates, and his role in convening the Cartagena conference¹ have pushed Buenos Aires to the forefront of those LDCs seeking to change borrower-lender relations. With the third-largest foreign debt among LDCs, international lenders fear that an Argentine failure to meet contractual obligations while pushing for unified action against creditors will undermine financial rescue programs worldwide. Bankers, moreover, perceive Buenos Aires—because of its self-sufficiency in food and fuel—as the most likely of the major debtors to repudiate its obligations, thereby forcing large losses on them.

Lender confidence in Argentina began to decline in 1981 in the face of the sharp deterioration in the payments accounts and growing repayment obligations. New loans became harder to obtain, forcing Buenos Aires to draw down reserves from a peak of \$9.5 billion in 1980 to \$3.3 billion in December 1981 to avert payments problems. Moreover, rising world interest rates added to the cost of both old and new borrowing. The London Interbank Offered Rate, the base from which most of Argentina's interest payments are calculated, increased from an annual average of 8.7 percent in 1978 to 16.4 percent in 1981. Taken together, Argentina's debt-servicing burden—principal repayments and interest charges—jumped from \$2.6 billion in 1978, equivalent to 40 percent of exports, to \$6.3 billion in 1981, or 70 percent of export earnings. With exports restrained by the slow pace of devaluation and reserves dwindling, Argentine borrowers became more vulnerable to external shocks.

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Roots of the Debt Problem

Starting in 1976, Argentina became one of the Third World's major borrowers. Financial reforms undertaken by the military—under the previous Peronist government the Argentine economy was characterized by stagnant growth, accelerating inflation and mounting payments problems—restored the country's economic health and reopened access to world capital markets. Between 1976 and 1978, according to IMF

Disruptions stemming from the Falklands war in early 1982 caused the debt to become unmanageable. Embassy reports and the financial press indicated that foreign bankers, unsettled by the war and Argentine

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¹ Latin American foreign and finance ministers met during 21-22 June in Cartagena, Colombia, to discuss their common concerns on international debt questions.

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political turbulence, ceased new lending and demanded repayment of maturing loans. With its exports disrupted by the conflict, Buenos Aires faced serious liquidity strains by August. Argentine Economy Minister Jorge Wehbe set up a financial rescue program under IMF auspices in late 1982, but, because the military government hesitated to remove financial sanctions against British firms, bankers and the Fund delayed loan disbursements. Without these funds, Buenos Aires could not make scheduled interest payments, putting them out of compliance with the IMF accord by September 1983. In October, pressure from Argentine Air Force officers caused a federal judge to rule illegal the model agreement for the rescheduling of the public sector's debt. The US Embassy reported that simultaneously the military relaxed fiscal discipline in its remaining days in office in order to increase public spending and grant wage increases aimed at preventing popular protests against the government. The incoming civilians thus inherited a collapsed IMF agreement, a de facto moratorium, large arrearages, and depleted foreign reserves.

Civilians Take Charge of the Debt

Raul Alfonsin's electoral victory by a 52-percent majority in October 1983 gave promise of political stability, which buoyed world bankers' expectations that the new administration would tackle debt problems decisively. Alfonsin reinforced these expectations by publicly committing the new government to paying the debt. Most observers believed his strong election mandate gave him the opportunity to seize the initiative and impose the austerity measures widely regarded as necessary to begin the financial adjustment process. As a show of support, bankers pledged financial backing even before the new administration took office in December. The honeymoon, however, masked the different approaches both parties brought to the negotiating table.

Alfonsin's Plans. In pre- and postelection speeches, Alfonsin consistently committed his administration to pay all foreign debt properly registered at the Central Bank. The US Embassy reported that Buenos Aires also publicly promised an economic program that seemed to respond to creditor concerns for adjustment. The new administration emphasized, however, that it would not accept recession in return for loans or reschedulings. Instead, Alfonsin indicated that

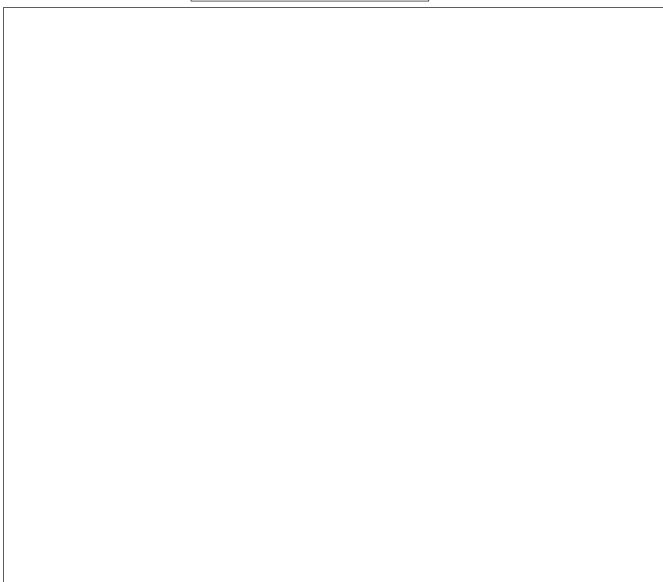
Argentina must generate repayments by stimulating economic growth, which he saw as necessary to preserve political stability. To complement this objective, Alfonsin called for lenders to extend interest rates and other repayment terms on a par with the most favorable agreements achieved by other Latin American debtors.

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In practice, Alfonsin has generally ignored his opportunity to initiate economic adjustments and subordinated debt management to his political goals. According to press and US Embassy reports, he repeatedly stressed that the first 100 days of the new administration were crucial for establishing the institutions of a democratic Argentina. Alfonsin turned his immediate attention to prosecuting military officers for human rights abuses and bringing the armed forces under civilian control, while attempting to break the back of union opposition and reform its leadership. Attention to these efforts, in our opinion, impeded progress in framing and implementing a comprehensive debt management strategy. Indeed, Alfonsin stated in his unprecedented letter in June proposing a program directly to the IMF—instead of to its negotiating team—“Strengthening constitutional freedoms and institutions, and the system of constitutional representation is the main objective of the Argentine government's policy.”

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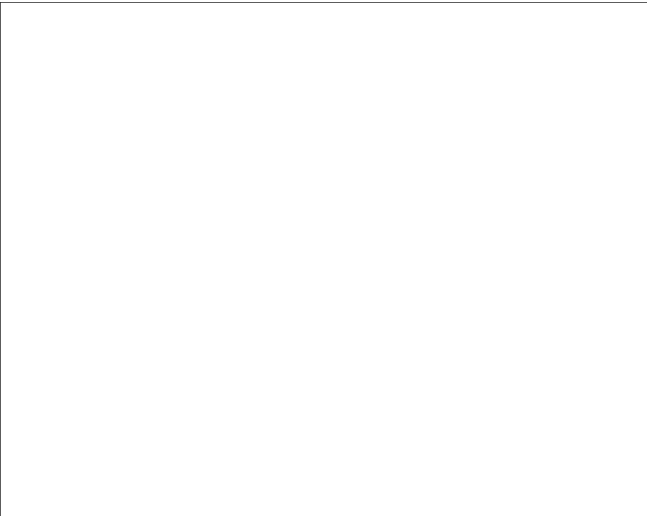
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Alfonsin's view, reports the US Embassy, typifies the Argentine perception—contrary to Western economic thought—that the earning of interest is somewhat immoral. This has translated into Argentine domestic policies aimed at keeping real interest rates negative, and it has drawn the Argentines into conflict with the IMF. Moreover, it has led Alfonsin to seek preferential interest rates from creditors. [redacted]

Finally, a commitment to honesty—while it contributed to the Radical consensus that international debts must be repaid—also led the Radicals to believe that their election produced a more trustworthy Argentina and bankers should show more flexibility in negotiations. According to the US Embassy, the Radicals also believed they deserved an IMF program at least as favorable as that accorded the previous military regime. Because the IMF approved a 5-percent growth target as an integral part of that program, it became a minimum negotiating position for the Alfonsin government. [redacted]

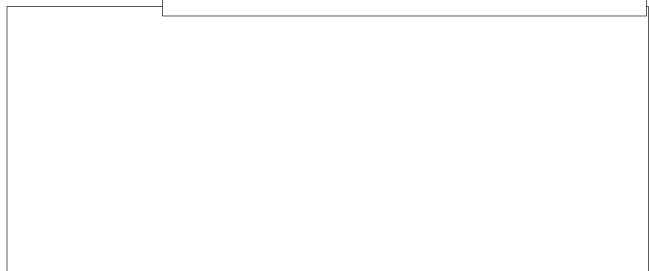
The Roadblocks to Financial Progress

Alfonsin announced upon assuming office his intention to secure a package of new loans and reschedulings under IMF auspices by June. Instead, the government's slow movement toward an agreement with the IMF and an economic plan quickly soured relations with bankers. It also created an image of Argentina as the most recalcitrant of the major debtors, and nearly precipitated a financial showdown. In our view, the social democratic philosophy of Alfonsin's Radical Civic Union, inexperience in dealing with creditors, and domestic political pressures combined to impede progress in resolving debt difficulties. [redacted]

Political Pressures Against Austerity. A public opinion survey taken in mid-May indicates that, despite soaring inflation, the majority of Argentines approved of Alfonsin's management of the economy, especially his belief that IMF remedies would put at risk Argentina's fragile democracy. While boosting his domestic position, he has created high public expectations regarding easier debt repayment, according to various Embassy and press reports. He has been susceptible to political pressures—from within his electoral coalition as well as from rivals—that have generated considerable confusion and administration indecisiveness about debt management. [redacted]

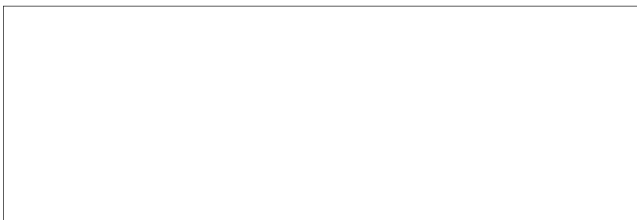
Alfonsin's Sense of Ethics. US Embassy reporting was quick to indicate that Alfonsin and his Radical Civic Union's economic policies operated against an ethical background that would bedevil any quick agreement with the banks and the IMF. For example, Alfonsin's strong commitment to improving the living standards of Argentine workers worked against his willingness to accede to banker demands for austerity. He publicly indicated his belief that the traditional adjustments advocated by the IMF were neither relevant nor politically feasible for Argentina. Instead, Alfonsin believes—as manifest in his speeches—that debt servicing must be reconciled with the need to create more jobs and to raise real wages to maintain social peace. According to the US Embassy, Alfonsin planned to implement these philosophical convictions by increased spending for social services such as health, education, and low-income housing. As a result, devising budget compromises with the IMF would be difficult. [redacted]

Alfonsin's own party is divided over the debt issue, inhibiting coherent policymaking and progress on an IMF accord. [redacted]



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Technical Difficulties and Disagreements Over IMF

Targets. Since coming to office, the Alfonsin government has publicly indicated a willingness to undertake economic adjustments aimed at battling down inflation and reconciling with creditors. According to the US Embassy, Economy Minister Grinspun publicly espoused a set of economic steps—tax increases, reduction in the public deficit, continued devaluations—that were consistent with IMF prescriptions without being seen as a threat to political stability in Argentina. Grinspun stated that such adjustments would enable the Alfonsin government to grant real wage increases and spur growth while reducing inflation and improving the payments accounts.

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The Peronists—the leading opposition party, which is fragmented but dominates organized labor—have been even more troublesome. The US Embassy reports that Peronists in general have vowed to resist IMF and lender pressures for austerity measures and are insisting that Alfonsin honor his commitment to economic growth and real wage increases. In late June, for example, an estimated 90,000 people demonstrated in the streets in Buenos Aires against “international usury” and the IMF. Alfonsin, fearing political unrest, has thus far acceded to their demands for wage increases.

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Grinspun’s ambitious economic plans, however, proved difficult to carry out. For example, according to the US Embassy, the government has been unable to pull together the technical data required to implement these complex financial plans. Economy Minister Grinspun has had to work with little assistance in responding to bank requests for comprehensive information supporting a stabilization plan. The US Embassy also reported that Central Bank President Garcia Vasquez’s poor health also hampered efforts to develop a realistic budget. These difficulties were compounded, according to recent Embassy reports, by bureaucratic resistance to Grinspun’s requests for detailed spending and investment plans from public-sector agencies.

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Even so, opposition to Alfonsin’s economic policies has helped the splintered Peronists at least superficially to unite their party leadership and regain the support of many workers who had defected to the Radicals. As a consequence, according to a variety of reporting, the Peronist leadership has been reluctant to moderate its tough stand against austerity. Labor rank and file has been even more vocal in demanding economic concessions—such as reinstating monthly indexation of wages to offset inflation—and local strikes have increased dramatically since mid-May.

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Since discussions began in February, the IMF has been skeptical about the Alfonsin government’s ability to reconcile conflicting goals. According to various sources, the most difficult issue bogging down the IMF discussions has been the target for the size of the public-sector deficit this year—measured as a share of GDP. Grinspun has abandoned his initial, optimistic position that the deficit could be cut to 4 percent in 1984 in favor of an 8-percent target because of the political difficulties encountered in cutting expenditures and raising taxes. Although the IMF has agreed to a higher target, press and US Embassy reporting indicate that Grinspun has had trouble developing a draft budget acceptable to the Fund.

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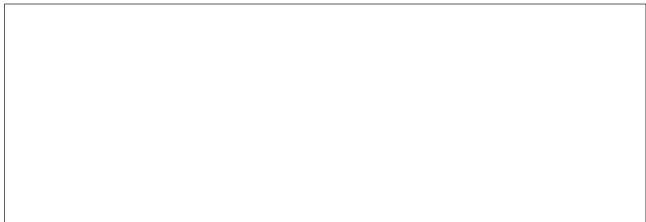
Congress has yet to exercise a direct role in the IMF negotiations but is pressing for increased government spending. In mid-March the administration promised to consult the legislators on debt negotiations and, according to the US Embassy, hinted that they could comment on any IMF agreement. Alfonsin has since backed away from allowing formal congressional review with the right of veto, but he did submit the June letter of intent for legislative endorsement. More important, however, Congress must approve the federal budget, which is the linchpin for any accord with creditors. The budget, as submitted in late June, was already out of line with banker requirements, according to the press, in part because Congress was insisting on increased public spending, especially for social welfare programs.

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Argentine wage policy has proved to be another sticking point. Alfonsin has sought to placate labor by setting monthly salary hikes to fulfill his campaign pledges to boost real wages. Because this policy fuels inflation, it has proved unacceptable to the Fund. According to recent US Embassy reports, presidential adviser Prebisch was sympathetic to IMF arguments and supported a modified wage policy to cut the inflationary spiral, which is now near 600 percent annually. Even the modified wage policy, however, has not been acceptable to the IMF. [redacted]



Buenos Aires has been unable to resolve several other policy disagreements with the Fund. US Embassy and press reporting indicate that these include clashes over exchange rate, credit, and commercial policies:

- Although the policy of small daily devaluations remains in effect, the IMF is pushing for a large devaluation to correct for the overvaluation of the peso caused, in part, by the appreciation of the US dollar.
- Despite the IMF's desire for tight monetary policies, Grinspun contends that credit expansion must be commensurate with supporting economic recovery.
- Because of rules against discrimination among its members, the Fund is insisting that Buenos Aires lift restrictions on remittances to UK banks and businesses and work toward a workable plan for clearing interest arrearages.
- The Fund's request for gradual phaseout of subsidies for exports and controls on imports have also been under discussion. [redacted]

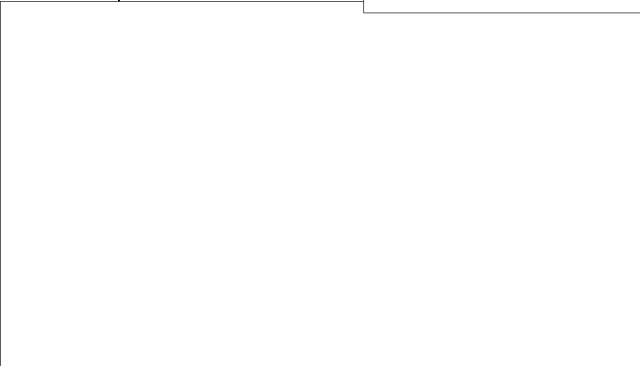
Under pressure, Grinspun has become aggressive and even combative in negotiations. As the 30 March US regulatory deadline for reviewing the status of Argentine loans approached, creditors insisted that Argentina pay past-due interest and set forth a stabilization program. Grinspun reacted angrily, [redacted] and refused to use Argentine reserves to make interest payments. [redacted]

When it became clear that the Argentines would not have an IMF agreement by the end of March, Grinspun announced publicly that Buenos Aires would not be able to repay its overdue interest. In retaliation, creditors refused to bend and disburse the funds. Direct intercession by President Alfonsin, however, and a Latin lending consortium averted a last-minute confrontation that would have caused a collapse in the debt negotiations. [redacted]

Challenges Ahead

Alfonsin's inability to move the IMF discussions along rapidly has precluded any progress in commercial bank negotiations. An accord with the Fund is essential, in our view, for Buenos Aires to reschedule 1982-84 outstanding debts, and raise new loans necessary to close the projected balance-of-payments gap for 1984. The Argentines are continuing efforts to reconcile with the Fund but are still insisting that a stabilization plan must not jeopardize Argentine democracy. [redacted]

Tensions in the Negotiations. [redacted]



The Financial Stakes. [redacted] we estimate the Argentines still have some \$17 billion in external debt that requires rescheduling in order to lengthen the repayment profile to ease foreign exchange outlays in the future. Although Buenos Aires

The Latin Financial Rescue Operation

In March of this year, Mexico devised a \$500 million bridge loan to Buenos Aires to help settle past-due interest payments and avert a confrontation with US banks over past-due interest payments. Press and US Embassy reporting indicate that Mexico and Venezuela contributed \$100 million each while Brazil and Colombia provided \$50 million each. The bank steering committee also contributed \$100 million, while the Argentines used \$100 million from their reserves. The US Treasury agreed to loan Argentina \$300 million against a firm IMF letter of intent to assure the Latin lenders of a more rapid repayment.

While the rescue package solved an immediate problem for US banks—and resulted in a big boost for US-Argentine relations because of the favorable publicity—it did not result in a quick reconciliation with the Fund. Negotiations for an IMF-endorsed stabilization program have dragged on since March. Because bankers refused to resume new lending and the United States canceled the guarantee in June, the Argentines were moved to try to resolve the stalemate with the IMF.

has publicly agreed to honor the terms of the model debt rescheduling plan arranged last year for the state airline, the government will probably press for a more lenient restructuring of the remaining public-sector debt. We expect the Argentines will request a stretchout of repayment terms to 10 years with five years of grace, comparable to terms for other Latin debtors such as Peru and Brazil. We also believe the Argentines will petition for a reduction of front-end fees and the interest rate spread in order to blunt higher US interest rates.

We expect the Argentines also will request about \$3.5 billion in new money this year, although the US Embassy calculates that as much as \$4.5 billion might be required to cover the payments deficit. At a recent banking conference, most lenders recognized the need to extend fresh credit but indicated that any new lending would only be in support of an IMF program. Even so, these bankers also believe that it will be quite

Table 1

Argentina: Current Account Statistics

| | 1982 | 1983 | 1984 ^a |
|---|-------------|-------------|-------------------|
| <i>Billion US \$</i> | | | |
| Trade balance | 2.3 | 3.5 | 3.3 |
| Exports (f.o.b.) | 7.6 | 7.7 | 8.0 |
| Oil | 0.5 | 0.4 | 0.4 |
| Nonoil | 7.1 | 7.3 | 7.6 |
| Imports (f.o.b.) | 5.3 | 4.2 | 4.7 |
| Oil | 0.8 | 0.5 | 0.5 |
| Nonoil | 4.5 | 3.7 | 4.2 |
| Net services and transfers | -4.8 | -5.5 | -5.5 |
| Interest payments ^b | -5.3 | -5.5 | -5.5 |
| Other | 0.5 | 0 | 0 |
| Current account balance | -2.5 | -2.0 | -2.2 |
| Arrearages | 2.9 | 2.5 | 0 |
| Principal repayments ^c | 2.7 | 0 | 12.0 |
| Foreign financing requirements ^d | 5.2 | 4.9 | 16.7 |
| <i>Percent</i> | | | |
| Ratio of: | | | |
| Debt servicing to export ^e | 105 | 71 | 219 |
| Interest payments to exports | 70 | 71 | 69 |
| Interest payments and arrears to exports | 108 | 104 | 69 |
| Current account deficit to GDP | 4 | f | f |

^a Embassy estimates.

^b Scheduled interest payments minus arrears.

^c Principal repayments of medium- and long-term debt.

^d Foreign financing requirements equals current account balance plus the previous year's interest arrearages plus principal repayments on medium- and long-term debt.

^e Interest payments and principal repayments.

^f These ratios are probably not meaningful given the sharp inflation and exchange rate movements as they would heavily reflect monetary changes.

difficult to get all 320 banks in the consortium to agree to any substantial increase in exposure because of the ill will toward the Argentines stemming from past negotiations.

Reconciling With the IMF. Although bankers continue to report that an agreement with the IMF is essential to breaking the financial impasse, President Alfonsin's unprecedented move to propose a program directly to IMF management in June has made a resolution more difficult. The US financial press tended to view the Argentine move as a "take-it or leave-it" proposition, but we judge it was merely another unconventional negotiating tactic aimed at extracting concessions on IMF conditionality. Argentine press reports also indicate the letter was meant to serve as a basis for continuing negotiations for a standby program. Moreover, we believe Alfonsin's proposal was intended to bolster his domestic position against Peronist critics of the administration's position on the debt and give him leverage with the IMF.

[Redacted]

To avoid undermining incentives to cooperate with the Fund, however, the IMF Executive Board refused the proposal. Instead, another round of negotiations was begun in mid-June to resolve technical disputes, probably centering on Argentine wage policy and the size of the budget deficit. President Alfonsin indicated toward the end of the month that he would be more flexible in order to reach an IMF accord.

[Redacted]

We judge the Argentines are willing to make additional compromises necessary to reconcile with the Fund. On 29 June, for example, the Central Bank announced a sharp increase in interest rates as the first concrete measure taken in support of Alfonsin's efforts to reach an agreement with the IMF. This move was followed by hikes in gasoline prices and transport fares aimed at eliminating subsidies to public-sector corporations. Although he continues to assure workers that their interests will be protected, Alfonsin also announced a 12-percent ceiling on private-sector pay raises for July, an increase that we

expect to fall well below prevailing inflation. We believe the IMF will compromise with the Argentines on wage increases—the Fund acceded to Brazil's more generous wage settlements last year—but will insist on additional spending cuts to control the deficit. In the end, we believe this stumblingblock will be hurdled through higher taxes.

[Redacted]

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A Hard Sell at Home. We and the US Embassy believe that convincing the Argentine electorate to accept any IMF agreement will be very difficult. We believe it will require substantial expenditure of Alfonsin's political capital and almost certainly entail concessions to Peronist labor bosses. He will be under pressure to demonstrate that the program is growth oriented—a tactic the military used to sell the 1983 IMF agreement—and leaves room for real wage increases and social welfare spending. Hints of Alfonsin's emerging strategy surfaced in late June, when a new round of high-level talks with Fund officials began following the Cartagena debtors conference. In a national address, Alfonsin claimed that further public sacrifices would be required to resolve debt problems, but he stated that the adverse impact of any austerity measures would be blunted for the poor.

[Redacted]

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We expect Alfonsin's carrot and stick strategy to buy him the maneuvering room required to reconcile with the IMF. His personal popularity—90 percent of those polled in early May approved of his performance—and appeals for national unity will give him some protection from opposition attacks. Additional concessions to labor bosses probably will also temper their opposition to an IMF program. Moreover, the Peronists are badly fractured and suffering from a tarnished public image. Thus, we judge that the Peronist factions will disagree over whether to try to block an IMF accord and leave themselves vulnerable to charges of destabilizing Argentina by blocking access to funds needed to sustain economic recovery.

[Redacted]

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Outlook for Debt Negotiations

The Alfonsin government's current willingness to compromise makes an IMF accord likely. We believe formal approval will be time consuming, and the

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Argentines may even falter temporarily when it becomes necessary to enact legislation to secure final approval of the Fund program. Consequently, we judge it may be necessary for creditors to provide another bridge loan at the end of September to prevent writeoffs of Argentine credits. Even when an IMF accord is finally in hand, however, we believe that progress in completing debt agreements with commercial banks will be slow and uneven. In the meantime, Buenos Aires will continue to struggle to keep its payments current in order to maintain access to trade financing. [redacted]

Bank Negotiations Drag On. We believe there is a strong chance that the Argentines will be unable to conclude their debt restructuring and new money negotiations with commercial banks in 1984. Even if an accord with the IMF is reached before the end of September—when US bankers will be legally obligated to set aside loan loss reserves—serious talks with the bank advisory committee will likely be only beginning. We expect, however, that, as soon as a letter of intent is agreed upon in principle, bankers would probably release frozen loans to enable Buenos Aires to settle past-due interest payments. The immediate cash transfusion would also enable Buenos Aires to increase imports to reactivate industry. The completion of a “growth-oriented” IMF program would also provide a temporary lift for the government by moderating opposition attacks on adjustment policies. At this point, however, the foreign bank advisory committee would then begin to develop a plan for providing new financing in support of the Argentine IMF program, which we believe will prove difficult to assemble. [redacted]

Even if both sides cooperate fully, the restructuring of some \$12 billion in loans will require protracted negotiations, because the Argentines have already indicated publicly they expect softer repayment terms. Should bankers resist substantial easing of terms, Alfonsin, dismayed at recent interest rate hikes, would probably toughen his negotiating stance. We believe that only partial progress would be made in completing debt rescheduling this year. [redacted]

Similarly, negotiations for new money will be tough. As noted, the size of the package will prove to be contentious, and the loan will be difficult to syndicate.

This year, Brazil, Mexico, and Chile—all complying with Fund programs—have encountered long delays in assembling new credits, mainly because of the reluctance of smaller banks to take part. In Argentina’s case, numerous regional bankers already have reported that they will refuse to participate in such new lending. [redacted]

Protracted negotiations for new money will impede domestic economic recovery in 1984. Difficulties in obtaining trade financing would continue to curtail imports necessary for industrial reactivation and increased employment. The country would experience temporary cash flow difficulties in the face of seasonal export declines. The Argentines would probably again resort to temporary suspension of payments to ease financial strains later in the year. [redacted]

Politically, we believe that protracted debt negotiations would erode Alfonsin’s popular support and limit his maneuvering room on a range of noneconomic issues. With an electorate anxious for economic improvements, the Peronists could profit from an apparent financial deadlock. Labor and the media would probably begin to question the wisdom of continuing economic sacrifices for few apparent benefits. Members of Alfonsin’s own party may also press him to abandon the program to preserve social peace and avoid losses in the congressional elections in November 1985. They would also probably argue that squandering his limited political capital on the debt issue would prevent him from pressing his case in Congress in such areas as military reform and foreign policy. Governing would become more difficult for Alfonsin, although the strains probably would not be serious enough to destabilize the government. [redacted]

Debt Talks Collapse. We believe there is still some chance that the Argentines will be unable to conclude an IMF agreement, causing its debt talks with foreign banks to collapse. The major danger, in our view, stems from the Argentine penchant to react impetuously to unanticipated events. If the volatile Grinspun has trouble concluding an IMF accord, he could in a fit of pique advise Alfonsin to halt negotiations abruptly. The President will also remain vulnerable to congressional attacks on the IMF agreement during [redacted]

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spreads and lending charges for new loans and for rescheduling of 1982-84 maturities. We judge that bankers will be only partially responsive to such requests, because they typically offer eased repayment terms only as a reward for successful economic adjustments. Under these circumstances, the chances that the Argentines would walk out of the talks to force concessions would increase materially. 25X1

A breakdown in financial negotiations—probably accompanied by a temporary moratorium—would entail major dangers, in our opinion. Alfonsin's inclination to attack lenders would probably increase, straining foreign bank and IMF willingness to support the rescue program. We judge that he would also become more assertive in coordinating joint action by Latin American debtors, further increasing tensions with bankers. Because these developments probably would cause banks to resist new lending at a time when cash strains would be mounting, Argentina would be further encouraged to employ tough tactics. The likelihood that Buenos Aires would repudiate its debt would increase sharply. The Argentines might first publicly threaten such an action in an effort to convince banks to extend new credit needed to cover interest payments. Although bankers have gone to great lengths in the past to avoid declaring a default and may cut a deal with Buenos Aires, we believe that such a threat would only heighten the current ill will bankers privately express against Argentina. Under these conditions, we fear bankers would be increasingly likely to declare Buenos Aires in default and seek to attach Argentine assets abroad. In the worst case, the groundwork would be laid for an economic war that could easily involve other Latin debtors and threaten to disrupt the international financial system. 25X1

the period before its formal approval by the Fund's Executive Board. Resurgent labor unrest could cause Alfonsin to scuttle a wage policy favored by the IMF. Without an IMF program, we believe foreign lenders would drag out financial discussions in an effort to press the Argentines to submit to IMF discipline—a tactic still being employed against the Venezuelans. Consequently, the Argentines would again be forced into a de facto moratorium. 25X1

Continued rises in international interest rates could also cause financial negotiations to collapse. President Alfonsin and the leaders of other major parties recently attacked the increases in the US prime rate as a danger to their democracy and social peace. If rates continue to rise, we believe Argentine negotiators will exert even stronger pressure on creditors to reduce

A collapse of the Argentine financial program would probably result in creeping paralysis in the domestic economy. Although Argentine agricultural exports would be difficult to disrupt by legal action and some may even be redirected toward the Soviets, we believe that import bottlenecks would exert an increasingly adverse impact on the economy. Even with substantial foreign exchange earnings and reserves, we believe 25X1

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Argentine businesses would have difficulty maintaining a consistent flow of imports because of a near cessation of trade financing and legal actions taken to seize Argentine assets. We expect that industrial activity in the chemicals and metals sectors—heavily dependent on inputs from abroad—would begin to contract and cause disruptions in manufacturing, while spot shortages of key imported commodities would add to inflation. Moreover, the lack of external funds for investment would probably lead the government to undertake excessive monetary expansion to buoy the economy. Although these stimulants would probably sustain economic activity temporarily, they would contribute to hyperinflation that would paralyze the economy in the longer run. In our view, Argentine businesses would react to monetary expansion and runaway inflation by again diverting investment into speculation and away from production.

[Redacted]

Should there be a major confrontation with creditors, we believe that Alfonsin would quickly mount a domestic political campaign to rally support by attacking international lenders. He would probably call for greater sacrifices from workers in an economic war with what he would portray as outside forces trying to destabilize Argentina. This approach would probably succeed, at least in the short run, in uniting various political groups behind the government's stand. We believe, however, that the unity would quickly give way to political dissension, resulting in a return of political instability over the longer run.

[Redacted]

Longer Range Prognosis

Given the challenging economic goals common to Fund programs, we expect that Buenos Aires will remain vulnerable to cash flow problems beyond 1984. We believe that the Alfonsin government will have trouble meeting IMF targets and is likely to be seriously out of compliance early in 1985. Failure to receive IMF drawings would in turn probably stall bank disbursements and cause payments to be suspended. Once such a self-perpetuating process began, it would probably lead to another prolonged payments moratorium.

[Redacted]

Even if Argentina can reschedule its 1982-84 maturities and eliminate its current interest arrearages, we believe the external debt will remain a problem

throughout the rest of the 1980s. Several studies by Chase Econometrics, Data Resources, Inc., and Wharton Econometrics project that interest payments alone will continue to outstrip yearly trade surpluses, thus necessitating substantial new bank lending.² While bankers expect developing countries to be net borrowers, we do not believe [Redacted] that they will favor continually increasing their exposures in Argentina solely to keep interest payments current.

Instead, we expect bankers to maintain pressure on Buenos Aires to enact austerity measures in hopes of reducing projected new borrowing needs. Gaining cooperation on the Argentine side will be difficult. Buenos Aires has a history of being unable and unwilling to maintain austerity policies and could easily require a greater flow of foreign funds than current projections indicate.

We believe that the present approach to handling the debt crisis shows little promise of long-run success for Argentina. The continuous need for new borrowing to pay interest suggests that measures beyond the re-scheduling of principal payments will probably be necessary to prevent insolvency. In our opinion, banks may voluntarily have to forgo a portion of their expected interest earnings and extend repayment periods well beyond the terms currently offered. Failure to do so, in our opinion, would set off sharp reactions to force easier repayment terms by Buenos Aires. As noted, the political climate in Argentina cannot endure continuous austerity to meet foreign financial obligations without generating stronger antilender reaction. Given Argentine nationalism, the Alfonsin government may yet [Redacted] close the economy to the West—including debt repudiation, closer ties with the Communist Bloc, and willingness to rely on cash purchases of necessary imports.

² Estimates of Argentine debt figures by econometric services do not take account a future bulge in foreign payments that could precipitate a second-round crisis. During 1981-82 the government offered exchange rate guarantees for private debts, thereby acquiring an obligation to provide the foreign exchange to cover some \$9 billion in payments for which they have issued bonds. As the bonds mature in 1986-87, they will put pressure on Argentina's exchange position and its ability to meet its rising debt servicing. This bulge in repayments will renew the need for extraordinary foreign assistance.

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Table 2
Argentina: Debt Projections ^a

Billion US \$

| | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|--|------|------|------|------|------|------|
| Data Resources, Inc. ^b | | | | | | |
| Current account balance | -1.4 | -1.1 | -0.6 | -0.9 | -0.5 | -0.8 |
| Total external debt | 44.8 | 45.4 | 45.4 | 45.6 | 45.4 | 45.4 |
| Debt service | 21.9 | 22.2 | 21.9 | 21.7 | 21.2 | 20.8 |
| Of which: | | | | | | |
| Interest | 5.3 | 5.5 | 5.3 | 5.1 | 4.9 | 4.8 |
| Trade balance | 3.5 | 3.4 | 3.7 | 3.7 | 4.3 | 4.2 |
| Chase Econometrics ^c | | | | | | |
| Current account balance | -3.2 | -3.4 | -2.8 | -2.4 | -1.0 | -0.1 |
| Total external debt | 47.3 | 51.0 | 54.3 | 56.3 | 56.9 | 56.4 |
| Debt service | 16.0 | 16.0 | 19.9 | 21.9 | 20.2 | 18.7 |
| Of which: | | | | | | |
| Interest | 6.6 | 7.2 | 7.0 | 6.5 | 6.0 | 5.7 |
| Trade balance | 2.8 | 3.0 | 3.3 | 3.2 | 3.8 | 4.1 |
| Wharton Econometrics ^d | | | | | | |
| Current account balance | -1.5 | -2.5 | -2.4 | -2.2 | -1.1 | -1.1 |
| Total external debt | 42.5 | 44.7 | 46.7 | 48.6 | 49.5 | 50.7 |
| Debt service | 15.8 | 19.1 | 16.6 | 16.4 | 17.1 | 17.8 |
| Of which: | | | | | | |
| Interest | 5.3 | 6.1 | 6.4 | 6.4 | 6.1 | 6.5 |
| Trade balance | 2.7 | 2.0 | 2.2 | 2.2 | 2.7 | 3.0 |
| CIA Projections ^e | | | | | | |
| Current account balance | -3.5 | -3.2 | -2.9 | -3.3 | -3.6 | -4.1 |
| Total external debt | 46.5 | 51.0 | 54.8 | 58.9 | 63.3 | 68.2 |
| Debt service | 18.8 | 21.7 | 23.6 | 25.9 | 28.5 | 31.0 |
| Of which: | | | | | | |
| Interest | 4.8 | 5.0 | 5.2 | 5.3 | 5.4 | 5.4 |
| Trade balance | 3.0 | 2.6 | 2.6 | 2.6 | 2.4 | 2.4 |

^a Projections based on varying sets of assumptions.

^b Published April 1984.

^c Published March 1984.

^d Published May 1984.

^e Favorable economic conditions scenario published by the Office of Global Issues.



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Implications for the United States

We believe that Buenos Aires expects the US Government to help bolster Argentine democracy by taking extraordinary steps to resolve its financial difficulties. In our opinion, the Argentines believe Washington has the power to elicit cooperation from bankers and to control the interest rates banks charge. We believe this perception made Buenos Aires responsive to US demarches in March and June to take actions to prevent the debt talks from collapsing. On the other hand, as the negotiations progress unevenly, developments that the Argentines perceive as detrimental to their financial or democratic interests—such as a rapid rise in interest rates—could cause Buenos Aires to attempt to take retribution against US banks.

Bank and Commercial Interests. Should Argentina reach an IMF agreement by 30 September, we would expect interest payments to get back on track and remain reasonably current through the end of the year. The earnings of US banks and the integrity of the international financial system would escape serious damage. Even under these conditions, however, we are concerned that large money center banks will face growing pressure to lend more to Argentina. Small banks with relatively limited exposures are increasingly tempted to write down their loans, leaving the task of meeting Argentina's borrowing needs too concentrated in large banks. Alternatively, if the IMF financial program derails, US banks would see only a trickle of payments from Buenos Aires and would probably begin writing off Argentine credits, a move we believe would impose significant, but not critical, losses on some US money center banks.

Trade and Investment. Under our most likely scenario, we expect a greater availability of financing for bilateral trade. This would enable US exporters to retain their share of the Argentine import market, which was about 20 percent last year. Direct investment, however, would probably continue to languish because of economic uncertainties, persistent high inflation, and continuing problems with dividend and profit remittances stemming from tough exchange controls. If the refinancing program collapses, however, we would expect trade with the United States to diminish because of a lack of credit and Argentine

retaliation. Communist nations might then be somewhat more successful in their attempts to expand trade—from a negligible base—with Buenos Aires, particularly the USSR, which is seeking sales to Argentina to offset the large exchange imbalance resulting from grain trade.

Political Ties. The 30 March rescue loan drew public praise from President Alfonsin and the media for the constructive US role. More recently, however, rising US prime rates have produced strong criticism of Washington from a cross section of the Argentine populace. Despite this, we agree with the US Embassy that Buenos Aires is likely to be generally supportive on political issues. If a bank or IMF confrontation arises, however, and Alfonsin believes that the United States is not moving strongly enough to help the fledgling democracy, he would probably reduce bilateral and multilateral cooperation with the United States on a range of issues.

The Cartel Issue. Should Argentina and its creditors reach a financial impasse, we expect Alfonsin would quickly call on other Latin debtors to act in concert against lenders. We believe that he would receive support from hardliners in several Latin countries—such as Bolivia, Ecuador, and Peru—although Mexico and Brazil would probably continue to resist radical actions. In the worst case, Alfonsin would be successful in forming a limited cartel embracing some Latin American debtors to work in concert against lenders.

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