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DIRECTORATE OF INTELLIGENCE

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Latin America: Prospects for a Debtors' Cartel [redacted]

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Summary

We believe Latin American debtors probably will begin soon to develop new tactics to try to ease their repayment burdens, but in our view there is little near-term potential for these countries to organize a debtors' cartel or to mobilize collective action to force concessions from creditors. Our judgments are based on limited recent reporting and on the results of a simulation exercise we conducted. The Latin debtors' new tactics are likely to include intensified collective lobbying for increased official assistance and greater pressure by individual countries on commercial banks to provide financial relief. These tactics, in our opinion, will be aimed at drawing Washington directly into efforts to solve the region's debt difficulties. We believe that selective financial concessions by commercial lenders and governments can continue to defuse the potential for radical action. [redacted]

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Factors that could alter this outlook and raise the odds that debtors might resort to collective action include a dramatic deterioration of external economic conditions, an upsurge in domestic political instability, or perceived intransigence on the part of creditors. The decisive roles, in our view, will continue to be played by the top leaders of the major debtor states, especially the presidents of Mexico, Brazil, and Argentina. [redacted]

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State Dept. review completed

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This typescript memorandum was prepared for the staff of the National Security Council, by [redacted],
[redacted],
OALA, and [redacted] OGI.

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Introduction

Sentiment among Latin American countries for collective action to obtain debt relief--including the possibility of forming a debtors' cartel--first surfaced in 1982, then waned late last year after the major countries dramatically improved their trade performance, rescheduled their debt obligations, obtained new commercial and institutional lending and saw interest rates fall. There is evidence that such sentiment is surfacing once again, but we currently lack extensive reporting on the willingness of key debtors to support collective action. To assess the potential threat, we simulated a Cartagena group meeting, a consultative mechanism on debt issues organized in 1984 by eleven Latin American countries.* We employed experienced country and financial analysts in the roles of Latin American foreign and finance ministers and Western bankers, respectively (see appendix for details). The group drew on what little fresh evidence is available and filled in gaps with our own analysis and informed opinion on the political and economic factors that would prove decisive in new deliberations. We considered forming a debtors' cartel and then discussed other collective action to force repayment concessions from creditors. Finally, the group surfaced a third alternate plan: collective propagandizing and lobbying with creditors to obtain easier repayment terms and reduced trade barriers. [redacted]

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Debtors' Cartel

[redacted]
[redacted] US bankers still remain apprehensive about the Latin American debtors forming a cartel and repudiating their debt. We believe that some governments, such as Bolivia, and Cuba may fuel this concern by advocating a cartel. Our simulation persuaded us, however, that there is only a slight possibility that such a group could coalesce:

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- The divergence between the economic interests of the larger, more moderate governments and the smaller more radical debtors fragmented efforts to organize a cartel. Although La Paz and Lima argued there was little to lose, the larger debtors

*Argentina, Bolivia, Brazil, Chile, Colombia, Dominican Republic, Ecuador, Mexico, Peru, Uruguay, and Venezuela. [redacted]

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challenged this assertion. For example, Buenos Aires argued that confronting creditors would undermine efforts to obtain the \$4.2 billion credit now in syndication while Brasilia contended that radical actions would impede its efforts to finalize its multiyear debt rescheduling. As the simulation progressed, we saw a consensus that the economic costs of radical action by debtors would be too high. The largest and most influential debtors remain concerned about protecting recent financial gains, such as multi-year reschedulings and future access to new credit. A cartel, the group decided, might provoke retaliation from industrial governments, resulting in the potential loss of foreign aid and export markets.

- Mexico, Brazil, and Ecuador played key moderating roles in our simulation. Mexico City--fearing the cessation of trade credits and damage to its improving relations with the United States--counseled against radical action by emphasizing potential losses. Brasilia advocated moderation in order to maintain good relations with banks and to head off OECD protectionism against exports, both keys to resolving its debt difficulties. Quito, a strong advocate of market-oriented policies, philosophically rejected outright confrontation with creditors. [redacted]

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Collective Action for New Repayment Schemes

According to the US Embassy in Buenos Aires, the Foreign Ministers of Argentina, Brazil, and Uruguay recently discussed an Argentine proposal for Latin American debtors collectively to reorganize debt payments to commercial banks. The scheme calls for a fixed schedule of repayments for the debtors. [redacted]

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[redacted] this would be achieved by capping interest rates on future debt payments with the IMF and World bank issuing bonds to creditors covering the difference in repayments. In our simulation:

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- The Latin American nations found the idea of a fixed, predictable repayments schedule attractive and considered raising the issue in future discussions with creditors. The debtors were unable to agree formally to force such a scheme on banks, however, because most were concerned that it would alienate creditors, causing the immediate loss of trade lines and new lending as well as derailing the possibility of negotiations on future concessions. The debtor representatives also were sobered by the technical difficulties of formulating a specific plan. No major debtor country currently felt that foreign exchange strains were intense enough to justify a unilateral reduction in interest payments.
- Mexico, Brazil, and Chile each played a key role in our

deliberations, but their positions were conditional. Although Mexico prefers to maintain its good reputation with creditors, it indicated that a drop in oil prices combined with political pressures could push it to threaten a capping scheme. Similarly, Brazil and Chile rejected the proposal because it would hurt their good relations with creditors, but if their exports and reserves drop markedly, each would likely reconsider their positions. []

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Over the past several weeks, Fidel Castro has attempted to ally himself with the Latin debtors by publicly speaking out on their financial plight and suggesting collective action. In numerous speeches, he has argued that Latin American countries will only resume development when creditors cancel their debt. Otherwise, Castro contends that Latin countries should simply refuse to pay. Although some Latin American countries publicly are pleased that he is drawing attention to their financial bind, none has yet endorsed any of his proposals. In our simulation:

- Castro's arguments for regional action against creditors were given short shrift. Some debtors were piqued by his attempt to grab the limelight, while others pointed to his hypocrisy in espousing radical action while privately working out new debt arrangements with creditors. Except for Bolivia, the group simply saw his proposal as another type of collective action that would jeopardize their good relationships with creditors and industrial country governments. []

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Intensified Joint Pressure for Concessions

This third option arose spontaneously in the course of our group discussions. It includes tactics already employed by some debtors, but would represent an escalation because action would be collective. In addition, it was the only proposal that all debtors would accept, because it highlighted the financial problems of each country without jeopardizing the goodwill and cooperation of foreign creditors. This option emerged, we believe, because Latin governments--under domestic political pressure to restore economic growth--feel compelled to find some course that will gain further debt servicing concessions.

- In the simulation, the debtors agreed to use both the press and direct lobbying--in particular with the US Congress and Washington bureaucracies--to publicize the need for easing Latin America's debt burden. They also opted to continue the Cartagena group as a loose confederation to provide mutual support and to share information on successful approaches for gaining concessions. []

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- Some differences still occurred. Throughout the discussion, Brazil and Mexico worked to focus attention on the need to reduce trade barriers and lower interest rates. Conversely, Argentina, Bolivia, and Peru advocated playing the trump card of raising the flag over political instability and resulting economic chaos to nudge creditors toward providing new concessions. [redacted]

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The Imponderables

Although we are confident of our analysis that in the near term no meaningful collective action would occur, over the longer run dramatic changes in the economic and political equation could substantially heighten the prospects for collective action. Comments by representatives of individual countries on the political difficulties of sustaining economic austerity produced the greatest sense of common cause during the entire simulation exercise as well as increasingly strident calls for financial relief. [redacted]

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In our simulation, the debate between debtors and creditors escalated steadily as Latin governments faced with resurgent payments problems and pressured by a population frustrated with "belt-tightening" felt compelled to consider tougher actions on the debt. Bankers, however, remained hesitant to lend and instead suggested reserve drawdowns, tougher import cuts, and tighter austerity. This response heightened frustration among the debtors, producing more credible threats of a moratorium, increasingly contentious financial negotiations, and growing demands by the largest debtors that commercial banks cap interest payments and even forgive some debt. As the bankers claimed inability to extend further concessions, the debtors began to appeal for official intervention, especially greater support from multilateral institutions. [redacted]

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We believe this scenario could occur in time as a result of any of a number of developments:

- Deteriorating external conditions could severely diminish debt service capabilities. Slowed global economic growth, the spread of protectionism in foreign markets, and the collapse of commodity prices--notably oil--could reduce foreign exchange earnings; additionally, rapidly rising interest rates would swell the burden of interest payments.
- Foreign banks and the International Monetary Fund could require more stringent austerity as a condition for new money or debt relief. In the view of debtor governments, such policies would likely lead to unacceptably harsh living conditions and, eventually, political instability.
- Domestic political reverses in one or more countries could encourage key Latin civilian governments to take firmer stands

against foreign creditors in order to rally popular support.

-- The leader of one of the large Latin debtor countries--Alfonso of Argentina seems the most likely case--driven by a personal sense of destiny and ambition may tout revolutionary changes in debtor-creditor relations to increase his own regional stature. Other Latin countries could become more receptive to radical action if a well-respected, major debtor led the way.

-- Collusion by two or more Latin debtors--drawn together by common ideologies or other bonds--on the debt issue could breed wider acceptance of collective action throughout the region. []

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Implications for the United States

The simulation exercise complemented the thrust of recent reporting that indicates the views of the Latin debtor countries are evolving in a more political direction. Although a debtors' cartel remains unlikely, we expect the Latin Americans to mount increasingly frequent and intense joint lobbying efforts to obtain concessions from commercial banks and industrial country governments--especially Washington--that will ease their debt burdens. In the simulation, [] Latin debtors generally have seen their economic fortunes tied closely to trends in the US economy. Our simulated country representatives expressed some concern, however, that US preoccupation with Central America was eclipsing Washington's ability to focus on the debt issue. []

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Latin leaders, in our exercise, also seem convinced that resolution of their financial problems hinged largely on US government policies and actions. For example, the recent decline in international interest rates moved this previously emotional issue to the background in our exercise. Nonetheless, the Cartagena countries remained apprehensive about the prospect of future rate increases, and in such a case probably would press the US to provide official financial relief and to adopt policies to bring interest rates down. []

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So long as the Latin Americans are unable to unify on the debt issue, creditor governments will probably continue to be able to maneuver on a bilateral, case-by-case basis by granting selective concessions. The debtors have been especially disturbed about the prospect of languishing export earnings, and in our simulation trade concessions were found potentially effective in defusing the threat of radical action. In our simulation, well-timed bridge loans by the United States--as well as direct intervention with the IMF to design more realistic adjustment programs--were effective in retaining debtor cooperation and goodwill. Alternatively, the call for increased direct investment--a US-supported initiative--only served to crystallize debtor frustration in the simulation, because the group assessed that depressed economic performance

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and growing nationalism would impede large-scale inflows of investment funds necessary to substitute for bank lending. [redacted]

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Appendix

The Simulation

The forum was a simulated closed-door session of a Cartagena group Ministerial meeting, the typical setting for such deliberations in the past. The analysts played the roles of finance ministers from Brazil, Mexico, Argentina, Chile, and Bolivia as well as foreign ministers from Brazil and Uruguay. We believe that this formulation faithfully incorporated moderate and radical viewpoints on the debt, involved the key decisionmakers as well as maverick elements, and struck a balance between technical financial concerns and broader political considerations. [redacted]

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Because of their focused expertise, we believe the country analysts were good proxies for the Western-educated elites that would actually conduct the negotiations. We also included a representative of a US moneycenter bank. Although this is at odds with Cartagena group deliberations, [redacted] the debtors share information to test their perceptions about banker response to their proposals. Consequently, we built in an automatic feedback mechanism. [redacted]

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In the exercise, the participants were instructed to defend the interests of the countries or groups they represented. The debtors viewed the mandate in terms of reducing the repayment burden while the creditors sought to protect interest payments. Unlike a brainstorming session, where analysts react individually, the simulation forced the group to interact dynamically. Consequently, we believe we were able to consider more variables in making policy recommendations as well as gauge the extent to which more radical rhetoric influenced the interaction among the participants. [redacted]

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