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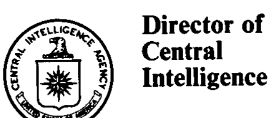

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Latin America: Grappling With the Debt

National Intelligence Estimate

Secret

NIE 80/90/3-85
December 1985

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THE NATIONAL FOREIGN INTELLIGENCE BOARD CONCURS, EXCEPT AS NOTED IN THE TEXT.

The following intelligence organizations participated in the preparation of the Estimate:

The Central Intelligence Agency, the Defense Intelligence Agency, the National Security Agency, and the intelligence organizations of the Departments of State and the Treasury.

Also Participating:

The Assistant Chief of Staff for Intelligence, Department of the Army

The Director of Naval Intelligence, Department of the Navy

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NIE 80/90/3-85

LATIN AMERICA: GRAPPLING WITH THE DEBT

Information available as of 19 December 1985 was used in the preparation of this Estimate, which was approved by the National Foreign Intelligence Board on that date.

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SCOPE NOTE

NIE 3-84, *The Political Repercussions of the Debt Crisis in Major LDCs*, November 1984, examined the political implications of the debt crisis in seven countries—Argentina, Brazil, Chile, Mexico, Nigeria, the Philippines, and Venezuela—and discussed other debtor countries briefly. The Estimate's primary judgment was that "we expect numerous conflicts between debtors and creditors over the next year or two" but that "debtors and creditors are likely to agree on various ad hoc arrangements to ease the debt service burden."

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Recent problems with IMF-supported financial adjustment programs, the slowing recovery in the global economy, and the growing inclusion of the debt issue in the Latin American political arena are putting the case-by-case strategy for resolving the debt problem to a test. This Estimate assesses the likely impact of world economic conditions on the willingness and ability of Latin debtors to continue to service their foreign debts and the prospects for strategies aimed at bringing about fundamental economic reform in these countries. It focuses particularly on eight countries—Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, and Venezuela—that together owe almost 95 percent of Latin American debt and more than 40 percent of total Third World debt

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KEY JUDGMENTS

Since the publication of NIE 3-84 a year ago, there has been a deterioration in the global economic environment and, in some cases, the political will of the debtors to continue the implementation of the current approach to managing the LDC debt crisis. Gains in trade made in 1984 are being eroded, many countries are falling short of economic performance targets negotiated with the International Monetary Fund (IMF), and progress on economic reform has slowed substantially.

External factors account for a large share of these difficulties:

— Economic growth in industrial countries and particularly the United States, which fueled Latin American export growth in 1984, has declined.

— Commodity prices have fallen over the past 12 months, in some cases to the lowest levels in decades.

— Increasingly, protectionism is blocking growth of LDC exports.

— Foreign banks further cut back on new credits for Latin debtors.

On the plus side, dollar interest rates have declined, relieving the repayment burden. Also, debtor countries are reacting favorably to Secretary Baker's announcement of a US initiative to encourage new lending tied to economic adjustment.

Internal conditions among the debtor countries have deteriorated:

— Mexico adopted an expansionary fiscal policy in 1985 and allowed the peso to become substantially overvalued, resulting in a steep decline in the trade surplus, massive capital flight, and a sharp drop in private domestic investment.

— President Sarney and his advisers are stressing a commitment to rapid economic growth and social programs; Brazil decided to avoid a new agreement with the IMF.

— Peru's President Garcia renounced IMF austerity and limited debt servicing to 10 percent of earnings from merchandise exports.

— On the positive side, President Alfonsin announced a major anti-inflation program that, to date, has strong popular backing.

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While making clear that they do not support President Garcia's decision to limit unilaterally debt service, the leaders of many Latin countries have become more vocal about the negative impact of debt service on their domestic economies.

Over the next year, these external and internal trends portend continuing problems between the debtor and creditor countries. Mexico, for example, will need a large infusion of new funds, coupled with a substantial depreciation of the peso, because of de la Madrid's failure to make economic adjustments in 1985, weak oil markets, and the costs of the Mexico City earthquake. Economic conditions in Mexico will deteriorate once again with inflation increasing and per capita income falling. President Sarney, who has maneuvering room because of Brazil's large trade surplus, is likely to avoid restructuring the economy and taking the tough fiscal and monetary steps that creditors and the IMF believe are necessary. Argentine President Alfonsin will face growing pressure from trade unions, and probably members of his own party, as the impact of his deflationary policies reduces real wages and slows domestic growth.

Pressure to find additional solutions to the debt, such as schemes to reduce interest payments or formally capitalize interest, will increase in 1986. This is particularly true in Mexico where President de la Madrid faces acute financial problems, which he will seek to blame largely on factors beyond his control such as the Mexico City earthquake, falling oil prices, and high interest rates. De la Madrid's increasingly hardline stance reflects in part the legacy of economic hardships that has reduced the government's ability to respond to the interests of the ruling Institutional Revolutionary Party's major constituents—farmers, labor, and civil servants—and, hence, has limited the party's options for economic action. In Brazil, President Sarney will be compelled by a weak political base to heed the strong expansionist urgings of his governing coalition while avoiding the constraints of an IMF program.

Although we believe these pressures will fall short of a unilateral decision by one of the three major debtors to limit debt service, there are some risks in this judgment. For one, as the debt problem drags on and debtor countries fail to make substantial economic gains, frustration with the burden of debt service and depressed living standards will grow. It is impossible to predict with any accuracy, however, when this frustration might prompt a debtor to take unilateral action. To a large extent, external events will dictate the degree of pressure on debtors. A

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substantial worsening in economic conditions would cause major debtors to take a much harder line on debt. Such conditions include:

— A significant slowdown in growth in the industrial countries or a sharp rise in dollar-denominated interest rates.

— Failure of creditors to provide adequate new funds under the US initiative.

— A sharp decline in oil prices or another substantial decline in commodity prices.

These events, particularly if occuring together, could cause the existing approach to break down. In that event, we believe debtors and private creditors would cooperatively seek out new remedies including, perhaps, a plan to capitalize interest rates. Should a mutual willingness not prevail, Latin debtors would be likely to feel compelled to take unilateral or collective action to curtail the burden of interest payments.[1]

[1] The Department of the Treasury believes that the tone of this Estimate is too negative. Specifically, Treasury believes that the 1986 economic outlook for industrial countries is good. Growth is expected to continue at or above current rates of about 3 percent, and interest and inflation rates should change little. If oil prices fall, as seems likely, a few debtor countries will be badly hurt, but most will benefit, as will the industrial nations. The likelihood that the debt problem will continue to be successfully managed depends more on the internal policies of the debtor countries than on external factors.

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DISCUSSION

1. By the end of 1984, a number of Latin debtor countries had made considerable strides in overcoming their financial difficulties under a debt strategy that called for a combination of economic adjustments, strong growth of debtor exports, and additional financial assistance by international creditors. The combined trade surplus of the eight major Latin debtors rose 20 percent to almost $40 billion as exports soared to a recovering industrial world, especially the United States. Debt service requirements also fell as international interest rates declined several percentage points in the second half of the year and large amounts of principal repayments were rolled over (table 1). Mexico and Brazil led the Latin countries in implementing adjustments, prompting the IMF to tout them as its model clients. Even Argentina, which had long resisted IMF-prescribed adjustment, came to terms with the Fund in December. Commercial creditors responded late in the year by reaching tentative agreement with Mexico on a multiyear debt rescheduling package that stretched out principal repayments. Similar agreements were nearly concluded with Brazil and initiated with Venezuela and Ecuador.

Table 1
Ratio of Scheduled Debt Service to Exports of Goods and Services, 1980-85

	1980	1981	1982	1983	1984	Estimated 1985
Argentina	46	64	80	70	61	72
Brazil	64	70	84	56	45	50
Chile	44	70	73	54	54	60
Colombia	17	32	30	36	43	47
Ecuador	28	42	54	75	40	44
Mexico	53	56	55	47	38	45
Peru	48	52	47	56	67	62
Venezuela	25	25	35	30	37	47

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2. The successes of the debt strategy were tempered by several negative developments in 1985:

— Slower growth in industrial country economic activity, depressed commodity prices, and mounting foreign protectionism prevented additional export gains for almost all Latin countries. Although lower dollar interest rates eased interest payments, debt service ratios for most key debtors in the region increased mostly as a result of failure to sign agreements to reschedule principal repayments.

— Increased popular resistance to austerity throughout Latin America put strong pressure on governments to restore economic growth and higher living standards, reducing the willingness of some civilian leaders to undertake internal adjustments acceptable to the IMF.

— In large part because of the other problems, bank creditors are increasingly reluctant to supplement IMF adjustment packages with new medium-term loans and to maintain short-term credit lines (table 2).

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Economic Progress Stalls

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3. IMF-coordinated adjustment programs in the two largest Latin debtors are in trouble (table 3). Brazil's negotiations with the Fund hit an impasse over the government's refusal to respond to IMF calls for stronger actions to lower the country's high and rising inflation rate—currently running over 200 percent per year. President Sarney is handicapped by a small political base and feels the need to accommodate widespread pressure for more rapid growth and placate the sizable left-of-center faction within his governing coalition. Accordingly, he has rejected IMF recommendations for deep cuts in public spending, arguing that it is not possible to target an elimination of the federal deficit and that any program must allow for at least 5-percent growth.

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4. Mexico was declared out of compliance with IMF public-sector deficit and inflation targets in September because of the de la Madrid administration's decision to boost economic growth with expansionary measures so that the ruling party would make a strong showing in last July's local and gubernatorial

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Table 2
Latin America: Debt Outstanding, End of 1984

	Total (*billion US $*)	Held by US Banks (*percent*)	Held by UK Banks (*percent*)	Held by German Banks (*percent*)
Argentina	47.8	17	7	5
Brazil	102.2	23	9	5
Chile	21.0	32	10	4
Colombia	11.6	26	7	3
Ecuador	7.2	25	8	4
Mexico	96.7	26	9	4
Peru	13.5	19	5	2
Venezuela	34.0	33	8	6

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Table 3
Key Economic Indicators

	Real GNP Growth (*percent*)				Inflation Rate (*percent*)			
	1982	1983	1984	1985	1982	1983	1984	1985
Argentina	−5.2	3.1	2.0	−3.0	210	434	688	400
Brazil	0.9	−3.2	4.3	6.5	100	211	224	225
Chile	−14.1	−0.7	6.3	1.0	21	23	23	30
Colombia	1.1	0.9	3.0	2.5	25	20	16	25
Ecuador	1.4	−3.1	4.1	2.5	24	53	25	23
Mexico	−0.5	−5.3	3.5	3.5	99	81	59	60
Peru	0.7	−11.8	4.0	1.0	64	111	110	200
Venezuela	0.7	−5.6	−1.4	0	8	7	18	6

	Public Deficit/GDP (*percent*)				Trade Balance (*billion US $*)			
	1982	1983	1984	1985	1982	1983	1984	1985
Argentina	17	17	12	5	2.8	3.7	4.0	3.5
Brazil	14	19	20	25	0.8	6.5	13.1	12.0
Chile	3	3	5	4	0.1	1.0	0.3	0.6
Colombia	7	8	8	5	−2.2	−1.5	−1.3	−0.5
Ecuador	7	1	0	[a]	0.2	1.0	1.1	0.9
Mexico	18	9	6	9	6.8	13.8	12.8	7.0
Peru	9	12	8	8	−0.4	0.3	1.1	1.1
Venezuela	12	5	[a]	[a]	2.8	8.4	8.0	6.4

[a] Denotes a public-sector surplus.

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Latin America's Domestic Economic Situation

GDP for the region increased by 2.4 percent overall in 1984. Per capita income in 1984, however, remained roughly stagnant overall at about the 1976 level and diminished in 13 of the 23 countries for which data are available. The IMF's forecast of 3.2-percent GDP growth for the region in 1985 seems optimistic given first-half export expansion below that of 1984. The decline in investment (both domestic and foreign) portends continued slow growth.

Urban unemployment continues to rise in almost all of the countries for which data are available. With labor forces growing by 3 percent a year in most countries, very high rates of economic growth would be necessary to absorb all new entrants. In addition, inflation increased in 1984 for the seventh straight year (to a weighted average of 120 percent from 100 percent in 1983) and is running about the same for 1985.

elections. Capital outflow picked up as the public lost confidence in the government's economic policies. There are also signs of serious differences among de la Madrid's key economic policy makers that are hindering progress on adjustment.

5. Among the other debtors, Peru—with President Garcia now in office—is refusing to accept the IMF prescriptions for tougher measures to resume its lapsed standby agreement. Chile, too, exceeded fiscal deficit and foreign exchange reserve targets, requiring a waiver from the IMF in November. Argentina, on the other hand, has taken strong action to break inflation and restore conditions for domestic growth. The success of the program, however, will depend on continued strong domestic backing for President Alfonsin in the face of an adjustment-induced recession.

6. Trade balances in many Latin countries are also deteriorating. Slowing economic growth in the industrial countries and the still high international value of the US dollar—to which most Latin currencies are linked—are dampening demand for Latin manufactured products and depressing commodity prices. Growth in the United States in 1985 was less than half that registered in 1984 when US purchases provided the primary impetus to a surge in Latin American exports. Higher prices for exports other than basic dollar-based commodities also eroded competitiveness of Latin goods in European and Japanese markets. On the import side, strong domestic growth and improved price competitiveness of foreign goods led to a rebound in imports. Only the continued easing of world interest rates this year—which reduced interest cost by

Latin American Public-Sector Reform: Dealing With the Parastatals

The progress made by Latin debtors in reducing the large economic role played by state-owned enterprises has come to symbolize the degree of government determination to push public-sector structural reforms and the impediments they are encountering. Latin American state-owned enterprises grew especially rapidly during the 1970s, substantially increasing state control of national production and distribution. By the early 1980s, Latin parastatals, which relied on heavily capital-intensive investment, commonly accounted for more than one-fourth of national gross fixed capital formation. They also have been largely responsible for generating large public-sector deficits in many debtor countries and for contributing major shares of accumulating foreign debt burdens.

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Most Latin debtor governments recently have committed themselves to parastatal divestiture or liquidation programs in efforts to reduce public expenditure, cut public-sector borrowing, and reallocate investment capital to the private sector. To date, however, only modest achievements have been recorded. In the cases of the three largest Latin debtors:

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- In February 1985, the Mexican administration announced its intention to sell, close, or merge 236 of its then 1,155 publicly owned enterprises. Since that time, the government has sold 21 small and unprofitable firms for only $37 million at the current exchange rate.

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- The Brazilian Government began a drive to privatize or eliminate some of its 560 parastatals in 1981. So far, it has privatized, closed, or merged 87 enterprises, all of which were of small-to-medium size and together constituted only a small portion of the country's parastatal sector.

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- Early this year, the Argentine Government publicly stated that it plans to sell many of its 350 state-owned firms, many of which are chronic money losers. No concrete program for divestiture has yet been announced, however, and no successful sales to the private sector are known to have been concluded.

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Further movements toward privatizing significant segments of Latin debtor parastatal complexes will inevitably be slow and cautious. The larger publicly owned firms in key sectors almost certainly will remain under government control. The main obstacles to stronger and more rapid parastatal reform will continue to be the historical bias in the region toward government-led industrialization and development, established arrangements or ties to powerful interest groups, and pressures for public-sector job creation in the face of high unemployment.

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Unfavorable Domestic Investment Environment

Investment in the key Latin American debtors has plunged during the past four financially troubled years, shattering the decades-old trend of sustained investment growth. The contraction of investment in Latin America was more severe than the general slump in economic activity; real GDP in the region fell, on average, about 0.5 percent annually from 1981 to 1984, and the share of GDP devoted to investment fell at least 5 percentage points since 1981 in all but one (Colombia) of the eight largest Latin debtors before bottoming out in 1984:

Gross Domestic Investment [1]

	1981	1982	1983	1984	1985
Argentina	16	15	14	11	10
Brazil	19	18	15	13	16
Chile	23	11	10	14	12
Colombia	21	20	19	19	20
Ecuador	23	25	19	20	23
Mexico	29	21	20	17	20
Peru	22	23	17	16	15
Venezuela	23	26	12	12	14

[1] Percentage of GDP.

The economic adjustment programs—with or without IMF involvement—that Latin debtors had to adopt over the past four years to deal with the financial crisis were largely responsible for the investment slump. These programs required some mix of domestic credit contraction, lower government deficits, real wage reductions, exchange rate devaluations, and deregulation of prices and interest rates. Piecemeal implementation of these adjustment measures in the key debtors and failure to undertake financial market reform have resulted in financing difficulties, economic recession, and heightened uncertainty over economic policy—the key factors in the decline in investor confidence.[a]

some $2 billion for the Latin debtor countries—along with reserve drawdowns and tight import restrictions prevented a resurgence of serious cash problems.

Financial Flows Reflect Nervousness

7. Declining capital inflows reflect banker concern about lack of progress on economic adjustment.In the first half of 1985, BIS statistics showed that commercial lenders actually reduced their exposure to Latin American countries for the first time since data began to be compiled in the mid-1970s. Recent loans in conjunction with IMF programs and debt restructurings for Argentina, Ecuador, and Chile all encountered strong creditor resistance. Smaller banks around the world are dropping out of these new loan packages at a greater rate. Indeed, many of the smaller banks are writing off their Latin debts, selling loans at discounts, and reducing outstanding short-term credit lines. Most creditors remain willing to roll over principal repayments—primarily because the only other major option is to write them off—but have resisted formally restructuring interest payments.

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8. To make matters worse, slowed progress on domestic adjustments and lack of confidence in government policies have precipitated renewed capital flight from several Latin American countries.

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an overvalued peso, rising inflation, and government policy vacillation contributed to an exodus of $2-3 billion from Mexico in the first six months of this year; and the recent sharp decline of the free market peso indicates capital flight has picked up to an estimated $1 billion per month since September. In Argentina, an unrelenting rise in inflation to 1,000 percent at an annual rate and uncertainty stemming from Buenos Aires's slowness in coming up with a coherent adjustment plan, caused a heavy outflow of capital in early 1985. Rapidly expanding inflation, President Garcia's moves to lower domestic interest rates, and private-sector fears of tighter regulatory controls are probably fostering a similar trend in Peru.

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Seeking New Solutions

9. After four years of depressed conditions, Latin American leaders are stepping up their calls for new approaches to the debt problems. A number of Latin officials, led by Brazil's President Sarney, stressed at the opening sessions of the UN General Assembly the need to ease debt burdens to permit renewed economic growth and protect democratic institutions. Earlier this year, Colombian President Betancur enthusiastically endorsed former US Secretary of State Kissinger's call for a "Latin American Marshall Plan." President de la Madrid of Mexico is calling for an "equilibrium" between the amount of debt servicing paid to creditors and a socially acceptable domestic growth. Through the world financial press, officials of most debt-troubled countries—even those that have been the voices for moderation during the past three years such as Mexico and Brazil—are urging interest payment relief, an enhanced role for the multilateral financial

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institutions, and a greater commitment by industrial governments to improve global economic conditions.

10. The Cartagena Group is also becoming more active in discussing innovative debt relief schemes:

- The foreign ministers of Argentina, Brazil, and Uruguay worked out a plan for Latin debtors collectively to stretch out debt payments to banks to allow more funds for economic growth by capitalizing a portion of interest payments.
- The Argentine Government is working on details of a proposal to have banks relend 50 percent of interest payments to debtors to fund new development programs.

11. So far, only Peruvian President Garcia has taken an overtly defiant stand with creditors. He asserted in his inaugural address on 28 July that his administration would implement a stabilization program without IMF involvement, would pursue direct negotiations with commercial banks, and would limit debt service to 10 percent of export earnings. Although Garcia's announced intentions represent a continuation of Peru's unofficial policies in effect for more than a year, most banks are insisting that no debt rescheduling will occur without Peruvian acceptance of IMF involvement. Although a number of other Latin American governments have expressed support notionally for linking debt servicing to exports, none show any inclination to follow Peru's lead at this time.

12. In a propaganda campaign, Cuban President Castro has urged Latin debtors to refuse to pay their debts, sponsoring a series of debt conferences in Havana beginning last July. The governments of the major Latin countries, however, recognized that Castro was trying to exploit the debt issue for his own purposes. They quickly renounced any association with his proposals, preferring to deal with the debt issue on their own.

Potential Difficulties Ahead

13. Even with the new US initiative at Seoul (see inset), several events could make it more difficult for the Latin countries to remain current on their debt. Mexico, Venezuela, and Ecuador are vulnerable to lower oil prices. Each $1 drop in the price of oil reduces export earnings in both Mexico and Venezuela by $500-600 million. If discord among OPEC producers leads to substantial production hikes, the resulting plunge in oil prices—some industry analysts believe a

The US Debt Initiative

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Treasury Secretary Baker announced a new US plan for strengthening the international debt strategy at the IMF/World Bank annual meetings in Seoul. The US initiative proposes a three-point "Program for Sustained Growth." It calls for:

- Debtor countries to adopt macroeconomic and structural reforms to promote long-term growth and balance-of-payments adjustment and to reduce inflation.
- The World Bank and Inter-American Development Bank to take on larger roles in the debt strategy to facilitate longer term structural adjustment although IMF will continue its central role.
- Commercial banks to increase lending to support comprehensive economic adjustment programs in debtor countries.

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The initiative proposes that creditors provide debt-troubled developing countries prepared to implement comprehensive economic adjustment programs with access to a total of over $40 billion in new funds from commercial and multilateral development institutions over the next three years. The intended flow would represent a reversal of the recent downward trend in net lending to these countries

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Latin American debtors generally have welcomed the US initiative on debt. High-ranking government officials in Brazil, Mexico, and Argentina view the proposal as an important gesture, a sign that the US recognizes the needs of debtor countries to restore economic growth and to obtain more foreign capital. They are particularly encouraged by US intentions to promote substantially increased lending by multilateral institutions—the World Bank and the Inter-American Development Bank—and by commercial banks. None of the region's debtors have voiced opposition to the initiative, although Peruvian Finance Minister Alva Castro reaffirmed Lima's position that the debt-related functions of the IMF should be eliminated.

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Considerable skepticism exists in Latin America, however, about the initiative's potential to ease the region's financial burden. Brasilia believes the new approach is modest in scope and doubts the capability of the World Bank or the willingness of the commercial banks to expand significantly loans to debtor countries. Buenos Aires questions the future value of the initiative if interest rates rise or commodity prices fall

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$5 price decline or more is possible within the next year—would have a major impact on the economies of both countries and would severely impair their ability to continue servicing debt. The potential gains to be reaped by the major non-oil-exporting Latin debtors are small in comparison with the harm that would be inflicted on the exporters. Peru is a minor exporter, while Argentina and, at present, Colombia are essentially petroleum self-sufficient and remain unaffected by oil price swings. Only Brazil imports sizable quantities of oil, and would now save about $280 million for each $1 decline in oil prices.

14. A further slowdown in growth among the industrial countries through 1986 would impede the export performance of Latin countries. If combined with a gradual rise in interest rates, projected by some forecasters, the capability of Latin countries to service their debt would be especially constricted. Trade restrictions, which have affected exports of cereals, sugar, steel, textiles, and a number of other important Latin American products, are limiting the possibility for export gains.

15. Although still committed to finding solutions to their debt problems through cooperation with their international creditors, we believe the leaders of Latin America's largest debtors are increasingly vulnerable to building domestic political pressures for greater concessions from creditors. Brazil's President Sarney faces a more assertive Congress, a more active labor movement, an emboldened far leftist opposition, and popular resistance to IMF prescriptions. To consolidate his political power and keep his opponents off balance, Sarney has promised to restore growth and meet neglected social needs in addition to stabilizing the economy. He is demanding that conditions for an IMF or any other program allow for at least 5-percent domestic growth.

16. With half of his six-year term still to go, Mexico's de la Madrid is facing growing opposition to further economic reforms and austerity from major domestic interest groups. Both organized labor and business have indicated to the government that they view an increase in living standards and an improved private-sector environment as vital to their continued support. At the same time, in the aftermath of worsened external payments accounts and a devastating earthquake, Mexico City has made it known that it wants substantial new loans and more generous repayment terms from commercial banks to facilitate reconstruction and restored growth.

17. Both de la Madrid and Sarney will watch closely the impact of the announced decision by Peru's President Garcia to circumvent the IMF in his future dealings with banks and to limit debt repayments to 10 percent of export earnings. Brazil's Foreign Minister Setubal publicly commended Peru for being the first Latin country to link trade and debt payments by its actions. For now, however, the leaders of most major debtors view Garcia's moves as radical actions thwarting the continued cooperation of creditors. A number of Latin Americans reportedly believe that Peru, because of its desperate financial condition, will eventually be forced to undertake tough adjustment measures.

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18. Despite its past ineffectiveness, the Cartagena Group could become a more potent force if Mexico or Brazil decides to take on more activist roles. Both countries, previously disposed toward counseling moderation within the group, increasingly are stressing the need for innovative approaches to the Latin American debt problem. They, together with Argentina, drafted the declaration issued at the conclusion of a Cartagena Group meeting in December. The declaration called for new measures to deal with the Latin debt problem that go beyond the US initiative, which they view as a positive but insufficient first step. The Cartagena proposals call for lower interest rates and an increase in bank lending that would double the amount outlined in the US proposal. The declaration also pointed out that, should economic conditions not improve, some individual countries might be forced to put a ceiling on debt payments linked either to economic growth or to export earnings.

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Country Circumstances and Risks

19. Although we believe the overall Latin debt situation has worsened over the past 12 months, conditions vary widely among countries. *Mexico* currently is facing acute financial difficulties as a result of expansionary economic policies, a downturn in the price of oil, and the need to reconstruct following the September earthquake. High government spending and an accommodative monetary policy have caused the public deficit as a percentage of GDP to nearly double the targeted level and resulted in Mexico's falling out of compliance with the IMF. Moreover, Mexico's trade surplus is down almost 50 percent from last year as falling petroleum prices and an overvalued peso depress exports and swell imports. Mexico City will ask foreign creditors to renegotiate its already rescheduled debt, to grant concessions on interest

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payments, and to provide at least $5 billion in new money in 1986, and substantially more if oil prices drop and capital flight continues. To bolster its bargaining position with the banks, Mexico probably will approach the Fund for a new program to replace the three-year agreement that ran through 1985. In doing so, however, President de la Madrid will argue that additional years of austerity could lead to social unrest in Mexico and insist on easier terms for a new program.

20. To strengthen his weak political standing within his governing coalition, President Sarney of *Brazil* has given highest priority to restoration of rapid economic growth and augmented social programs. Unwilling to accede to IMF requirements for budgetary and financing restraints, the administration announced in November that it was suspending negotiations for a new agreement with the Fund. Brasilia believes it can conclude a multiyear debt rescheduling with foreign banks even if a formal agreement with the IMF is not reached. Equipped with large foreign exchange reserves, Brasilia appears content to hold out for a favorable package. With important national elections scheduled for late next year, Brasilia will be reluctant to make substantially greater adjustment concessions in the coming months. Public expenditures and the money supply probably will continue to rise substantially, causing inflation to rise to or over 300 percent—from the current level of about 225 percent. We believe there is a risk that Sarney's economic policies or some external factors could lead to a deterioration in Brazil's trade account, forcing him to embrace more radical and confrontational debt solutions.

21. In *Argentina,* President Alfonsin agreed to a rigorous IMF stabilization program last summer, but prospects for continued restraint on inflation and compliance with the Fund conditions are not strong. Without signs of an economic recovery in the months ahead, popular support for Buenos Aires's program probably will erode rapidly as the recession fueled by wage restraints deepens. Argentina's powerful labor movement, already voicing its unhappiness with increased unemployment and depressed wages, will press hard for higher pay and other concessions. To avert domestic restiveness, Alfonsin reportedly is considering some economic stimulation and an easing of wage and price controls. If he takes this course, it is likely another renegotiation for IMF targets would be necessary next year. A decision by the banks at that time to withhold new disbursements coupled with a worsening trade balance—resulting in large part from the impact of flood damage to grain sales—could lead to resurgent payments problems and renewed interest arrears.

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22. *Venezuela*'s self-imposed stabilization plan and $14 billion in reserves should enable it to service its debt with little difficulty, barring a large drop in oil prices. Moreover, a public-sector debt rescheduling agreement was concluded with bank creditors last month and probably will be signed by the end of the year. At the same time, President Lusinchi has come under heavy political pressure to raise wages, ease fiscal austerity, and reactivate the economy. Although the administration probably will increase goverment spending to reverse rising unemployment—because of the government's strong ties to labor—Lusinchi is unlikely to permit large increases in imports that could jeopardize Venezuela's strong financial position. A drop of $5 a barrel or more in the price of oil over the coming year, however, would hinder debt servicing and could prompt the government to invoke a contingency clause allowing for reconsideration of the terms of its recent debt agreement. Past differences of view between Caracas and the bankers suggest that opposing interpretations of the loosely defined contingency could provoke a possible confrontation with bank creditors.

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23. The financial prospects of some midsized debtors are generally worrisome:

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— *Peru*'s decision to avoid the IMF and limit annual debt servicing has drawn the ire of creditors, which have severely constricted their trade credit lines. Furthermore, the assessment of Peruvian loans as "value-impaired" by US bank regulators in October probably will preclude any hope of new bank loans for quite some time. Coupled with weak export prices, Peru's deteriorated relations with bankers will cause increasingly severe cash-flow problems for Lima, mounting economic and political problems at home, and perhaps increased Soviet aid and trade ties to Peru.

— *Chile* is headed for another larger current account deficit in 1986 because of depressed commodity export prices, and its reserves have dropped dangerously low. Moreover, recent steps by Santiago to revive Chile's stagnant economy and defuse mounting popular discontent may endanger its IMF-supported austerity program.

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Expeditious disbursement of committed IMF, IBRD, and commercial bank loans will be vital to keep its debt servicing current.

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Outlook for Latin America's Willingness To Service Its Debt

24. We believe debtors will increase pressure on banks and creditor governments in 1986 to make new funds available and reduce the interest burden. Assuming these funds are made available, however, we believe these pressures will fall short of a decision by a major debtor to limit unilaterally the debt service burden. In public and private, most Latin leaders still indicate a willingness to repay their debt, and most admit the need for continuing adjustment efforts. Even some of the civilian governments that briefly dabbled with nationalist policies and confrontational debt tactics—such as Argentina and Bolivia—have come to recognize the importance of making painful adjustments and sustaining creditor cooperation. Indeed, most Latin debtors are reacting favorably to the Baker initiative proposed at Seoul or are, at a minimum, taking a wait-and-see attitude about the willingness of banks to increase lending. Latin debtors also support an enhanced role in the debt crisis for the World Bank vis-a-vis the IMF both to encourage longer run economic reform and to provide development credit on longer repayment terms. They hope that the Bank will provide easier terms and tailor them to individual country needs.

25. Latin spokesmen stress that deteriorating external conditions—a major decline in oil prices, a significant slowdown in growth in the industrial countries, increased protectionism, and a gradual rise in interest rates—would make it almost impossible for a number of Latin American countries to uphold their interest payments. Although we think it unlikely that these conditions taken together will prevail over the next 12 months, they nevertheless present a downside risk to this Estimate. Under such conditions, heavy domestic political pressures probably will compel civilian governments in Latin America to demand additional major concessions from creditors. The leaders of the major debtors—including Mexico, Brazil, Venezuela, and Argentina—would appeal to their principal creditors to join in a search for mutually acceptable new remedies to ease their debt payments, perhaps including formal provision for capitalization of some interest.

26. Foreign bankers clearly would view some innovative schemes for helping Latin American governments more favorably than others. They almost certainly would be receptive to proposals to establish an interest rate facility in the IMF—similar to the current compensatory financing facility for exports—to help debtor countries meet their servicing requirements when global interest rates rise above a given level. Also, banks are indicating they might be willing to

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Financial Prospects of Smaller Latin Debtors

Other Latin American countries also are experiencing major problems with their debt, which, though modest in size, rivals or exceeds gross domestic product in many cases:

— Although *Colombia* has avoided a formal IMF standby accord, a recent tentative agreement by foreign banks to provide $1 billion in new money is contingent on an IMF approval of the Betancur administration's economic program. Bogota's decision, however, to postpone an IMF review until early 1986 because a prematurely leaked Fund position statement is likely to delay final approval of the new money package and further squeeze Colombia's already beleaguered cash reserves.

— *Costa Rica* is implementing an IMF stabilization program to obtain crucial commercial debt reschedulings and balance-of-payments support. Measures taken under the program have succeeded so far in slashing the government's fiscal deficit and reducing inflation. President Monge has encountered difficulty, however, in complying with Fund conditions because of growing opposition in the legislative assembly, wage pressures from public-sector employees, and the presidential election scheduled for February 1986.

— Depressed prices for bauxite and alumina exports have aggravated *Jamaica's* financial condition and forced the government to seek increased foreign financing. Although austerity measures prescribed under its IMF program have led to decreased public waste and higher private savings, domestic protests over retrenchment threaten the stability of the Seaga administration.

— As long as the government sticks to its present policy course, *Ecuador's* financial position will show steady gains. These improvements, however, are vulnerable to external and internal disruptions. If oil prices should drop $5 or more, Ecuador would be hit by a financial squeeze and would be likely to appeal to its creditors for further debt relief. Moreover, although President Febres-Cordero has a majority in Congress, his ability to sustain adjustments could be impaired by embittered leftist adversaries.

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support some variation of an idea widely discussed in Latin America to recycle 50 percent of interest received to fund new development projects.

27. The failure of industrial-country governments and commercial banks to make additional concessions for easing debt burdens would generate strong anticreditor reaction in Latin America and could prompt recourse to radical steps, either collectively or in a succession of unilateral actions. Rising interest rates—as part of worsening global economic conditions—could provide the precipitating event that causes the debtors to coalesce into a unified force. Protectionism disguised as nontariff barriers and an institutional inability of the World Bank to provide immediate assistance would add fuel to the fire. Building on the superstructure of the Cartagena Group, Latin debtors are in a stronger position to reach a quick political decision to take joint action to pressure banks to lend or extend other financial concessions. Even in the absence of organized collective action, major debtors may be emboldened individually to declare their intentions to suspend all further debt servicing payments for a prolonged period. They also could choose to limit debt servicing to a certain percentage of exports.

28. Confrontational actions taken against international banks, in turn, would lead not only to a cessation of new medium-term loans but also a sharp contraction of short-term credits. In most cases, sharp cutbacks in Latin imports would follow, along with an economic decline more severe than previously experienced in this decade. Latin debtors, faced with such bleak prospects, would have little choice but to resort to more populist policies in an attempt to revive their economies accompanied by tighter controls on foreign payments and investments. Deficit spending, large wage increases, and rapid monetary expansion could boost growth in the short run, but at the cost of driving inflation skyward. The eventual economic stagnation that would result from rampant inflation would provide a rallying point for antidemocratic forces.

A View of the Longer Term

29. A number of private forecasters, although admitting that considerable uncertainties and risks lie ahead, maintain that the Latin American countries can meet their debt servicing obligations over the next five years and attain a reasonable rate of growth. This outcome would require sustained debtor country adjustment policies, a reasonably favorable international economic environment, and continued creditor cooperation

30. Some Latin debtors are, in fact, making strides in bolstering their export sectors. For example, Argentina, Brazil, and Colombia undertook major currency devaluations to increase the price competitiveness of their exports. Progress in cutting back the public sector's role and enhancing the efficiency of the private sector in most countries has been slow, however.

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31. Most of the key debtors have also pledged major efforts to trim the spending of their large, entrenched, and influential public corporations. In this area we believe achievements will come only slowly and will fall well short of government promises. We expect to see only limited progress in such key areas as tax reform, labor reform, and the financial reforms required to make long-term funding available to the private sector. For the most part, Latin governments will continue to do only the minimum necessary to secure creditor cooperation because of lack of domestic political consensus, bureaucratic vested interests, and at least a partially enduring commitment to state-led development strategies. Indeed, as debt problems drag on, governments will find it increasingly difficult to convince their people to take short-term sacrifices against the prospect of long-term economic gain.

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32. The debtors increasingly emphasize that economic management in the industrial countries also will have a key impact on the ability of Latin America to expand its exports and meet debt payments. World Bank analysis shows that debtor countries can expand their economic output more than 5 percent a year while steadily reducing their debt-to-export ratios. This optimistic forecast is predicated on the assumptions that over the next five years industrial economies will grow at the yearly rate of 3.5 percent, their real interest rates will decline further, there will not be significant new barriers to LDC exports, and the strength of the US dollar will gradually subside. There are no indications that either the European countries or Japan intend to adopt policies to allow for such a high rate of economic growth, however.

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33. The continued availability of foreign capital also will be crucial to the efforts of Latin American countries to deal with their debt problems and support economic growth. This means not only that more foreign investment has to be attracted to the region by liberalizing onerous regulations on investors but additional foreign credit will be needed. Until such time that voluntary bank lending again becomes possible, creditor banks will be called on to combine their

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resources with those of the IMF, the World Bank, and other multilateral institutions to provide debtors with the minimum amounts of funds they will require to complete their adjustments. Sustained adjustments by debtor countries, evidenced by improved external account performances, will help convince bankers that it is in their interest to undertake new financial commitments. Bankers state that they are at least two to five years away from resuming voluntary lending to Latin America, depending on the country.

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ANNEX

MAJOR DEBTOR COUNTRY RELATIONS WITH THE IMF AND FOREIGN BANKS

Mexico

1. Following more than two years of earning creditor praise as Latin America's model debtor country, Mexico is facing acute financial difficulties as a result of relaxed policy restrictions and a downturn in the price of oil. Tough economic adjustments undertaken by Mexico City during 1982-84 under an IMF program led to a dramatic $20 billion improvement in its current account, a $5 billion increase in official reserves, a cut in the public-sector deficit from 18 percent of GDP to slightly more than 6 percent, and a slash in inflation from 99 percent to 59 percent. Toward the end of 1984, bank creditors rewarded Mexico with an agreement to reschedule $48 billion in debt due during 1985-91. Recent backsliding, however, threatens to jeopardize these hard-won gains.

2. Mexico City fell considerably short in meeting most of the economic performance targets pledged to the IMF for the first half of the year and has been declared out of compliance with the Fund. the government decided sometime in late 1984 that it must speed economic recovery even at the cost of rising prices and overvaluation of the peso to make a strong showing in the July 1985 local and gubernatorial elections. This decision unleashed a sharp rise in public spending during the first half of 1985. Some measures were taken in July to trim the government bureaucracy and spending, but they have had only a marginal impact. On balance, Mexico City is shifting away from its past adherence to policies designed to bring government spending in line with revenues, which had forced the country to sacrifice economic growth to meet its foreign debt servicing obligations. As a result of the government's more expansionary policies, the public deficit as a percentage of GDP—a key IMF program target—will be almost double the level pledged to the Fund.

3. Meanwhile, a weakening balance of payments this year is worrying bankers. Mexico's trade surplus is down almost 50 percent as falling petroleum prices and an overvalued peso have caused exports to decline and imports to surge. As a result of the poorer trade performance coupled with high interest payments on foreign debt, Mexico probably will experience its first current account deficit since the 1982 financial crisis. Moreover, Mexico City's policy vacillation has fueled an acceleration of capital flight. The growing foreign exchange squeeze has forced Mexico City not only to draw down $3-4 billion of its official reserves in 1985 but also to run some arrears on foreign debt payments. So far, the government has managed to persuade international bankers to consider some $2.5 billion in new loans for 1986, far less than Mexico believes will be necessary.

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Brazil

4. Brazil's first civilian government in over 20 years inherited an economy from the military this past March that was making dramatic improvements in its previously hobbled external accounts but was still struggling to stabilize spiraling prices internally. An aggressive exchange rate policy, a successful import-substitution program, and an economic recovery in the industrial world allowed Brazil to expand its trade surplus from less than $1 billion in 1982 to over $13 billion in 1984. As a result, Brazil not only erased its previously massive current account deficit and met all of its debt servicing obligations, but it augmented its foreign exchange reserves by $6 billion. Despite these gains, the IMF suspended its support to Brazil the month before President Sarney took office because the previous military regime failed to comply with end-of-1984 monetary, fiscal, and inflation target conditions. Consequently, foreign banks postponed completion of a multiyear rescheduling of $45 billion in debt maturing over 1985-91.

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5. The Sarney administration has affirmed its hope of negotiating a new stabilization program with the IMF, but only one that would allow at least 5-percent economic growth. He has insisted that slower growth would result in political instability. Brasilia and the Fund held frequent and lengthy talks during the summer, but they were continually stalemated over the size of cuts in Brazil's public-sector deficit. The government recently announced what it viewed as a nonnegotiable economic program for 1986 that is expected to reduce Brazil's public-sector deficit substantially but not as much as asked by the Fund. When

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the IMF balked, the Sarney administration indicated that it would indefinitely cease efforts to reach an IMF accord. Brazil's economic team reportedly believes that an IMF stabilization program aimed at reducing inflation below the current rate of somewhat more than 200 percent would be political suicide for President Sarney. The Brazilians now may seek a formal 1985-86 bank debt rescheduling with informal IMF monitoring, deferring rescheduling of later maturities. In the interim, the government is asking creditor banks for yet another standstill on debt repayments and short-term credits that are due to expire 17 January 1986, to allow sufficient time for debt restructuring to be negotiated.

6. Sarney's major shakeup of the economic policy team in late August has been popular at home but is likely to heighten difficulties with creditors abroad. Sarney ended three months of policy inconsistency and interminable squabbling between Finance Minister Dornelles—who urged large cuts in public spending—and Planning Minister Sayad—who counseled less restrictive policies—by accepting the resignation of Dornelles. Dilson Funaro, Sarney's selection as new Finance Minister, is known to share Sayad's views and has criticized orthodox IMF doctrine as damaging to Brazil's best interests. The revamped economic team has stressed its commitment to rapid growth and social spending and to soft-pedal orthodox inflation-fighting policies. At a minimum, the recent ministerial change has raised widespread concerns about Brazil's prospects for containing its high inflation rate and is making the task of bridging differences with the IMF and creditor banks more difficult.

Argentina

7. Following more than a year of insisting that economic recovery cannot be sacrificed to pay debts and avoiding IMF austerity, President Alfonsin has embarked on a rigorous adjustment program and has convinced the Argentine business community, the Fund, and foreign bankers that he means business. The IMF formally approved renegotiated targets for Argentina's $1.25 billion standby loan in July. Also, foreign banks completed a $4.2 billion loan package. These funds, combined with a trade surplus, have enabled Argentina to meet its debt obligations. Although depressed grain prices are hurting export revenues, Argentina is likely to show a $3.5 billion trade surplus for 1985 with the help of the large devaluation in August. A continuing slump in crop prices as well as agricultural losses to November floods probably will prevent any trade improvement in 1986, however. Reportedly, Buenos Aires believes it will need a further $3 billion in new bank money in 1986.

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8. The adjustment program announced in June features wage and price controls, increased taxes, higher utility rates, cuts in public spending, and monetary reforms. Although the program so far has not adequately addressed the need for structural changes in the economy—such as selling substantial additional numbers of inefficient state-owned firms to the private sector—it does represent the boldest economic step taken by President Alfonsin since he took office. Tightened fiscal policies reduced the public-sector deficit from 12 percent of GDP in 1984 to 5 percent in 1985, the first annual decline in Argentina in this decade. Most Argentines, including labor, continue to support Alfonsin's efforts despite signs of increasing unemployment and falling real wages. A dramatic slowdown in inflation, from 30.5 percent in June to 2.4 percent in November, appears to have been a key factor in maintaining this support.

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Venezuela

9. An almost completed multiyear debt rescheduling agreement, combined with more than $14 billion of official reserves and continuing current account surpluses, should assure Venezuela of a solid basis for coping with its debt servicing obligations, at least over the near term. Participating banks generally have reacted positively to a plan proposed by the Lusinchi administration and endorsed by Venezuela's bank advisory committee that would reschedule $21 billion of public-sector debt due over 1985-89 on reasonably generous terms; they probably will ratify the public debt rescheduling early in 1986. Meanwhile, Caracas continues to buttress its financial position with net earnings from its current account that, despite a $2 billion fall in oil revenues, probably will post a surplus of more than $3 billion for 1985.

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10. Even though Caracas assiduously has avoided subscribing to an IMF program, Venezuela's high reserves and external account surpluses have resulted in large part from tough austerity measures. President Lusinchi has implemented a major retrenchment in imports and sizable cuts in public spending, including curtailed development projects and oil exploration. These policies are contributing to a seventh year of economic stagnation, sharply declining investment, and unemployment near 14 percent. Labor, business, and middle-class discontent has been building over the depressed state of the economy and falling standards

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of living. So far, Lusinchi has effectively deflected criticism because he has achieved low inflation, favorable external payments, and multiyear debt rescheduling.

Peru

11. By the time the previous administration of President Belaunde left office last July, it had lost control of Peru's foreign debt. Over the past three years, high international interest rates combined with stagnant export earnings, resulting from slumping prices for oil and copper, not only forced Peru to trim its imports and economic growth substantially, but also made further debt servicing very difficult. Peru fell into arrears on debt in July 1984; these arrearages have continued to accumulate. Belaunde's reluctance to implement tough adjustment measures also contributed to deteriorating conditions. Although Peru entered into an IMF standby agreement in early 1984, the agreement became defunct by September because the government failed to comply with fiscal discipline targets. As a result, inflation soared over 100 percent in 1983 and 1984 and to an annual rate of 200 percent by midyear 1985.

12. Alan Garcia took over the presidency on 28 July and soon began implementing populist economic policies to boost his domestic popularity and shore up foreign exchange reserves—but at the cost of aggravating Peru's foreign financial relations. He has lowered domestic interest rates, devalued the currency, raised minimum wages, put price controls on staple products, and imposed stiff licensing requirements on a long list of imports. To reduce Peru's foreign dependency, Garcia not only has bypassed the IMF and limited Peru's annual debt servicing, but also is seeking tighter control over foreign investment. As a result of Garcia's actions, the perception that he is unpredictable, and the decision of bank regulators to declare Peru's bank loans as "value impaired," foreign banks are losing confidence in Peru's ability to satisfactorily resolve its outstanding obligations. Many banks have cut their trade credit lines and are writing off their exposure in Peru.

Chile

13. Following long and arduous negotiations, the IMF agreed in mid-August 1985 to provide a three-year, $765 million extended fund facility for Chile. In return, the Pinochet government promised to increase international reserves, limit public-sector borrowing, and cut the government's budget deficit from 4.6 percent of GDP in 1984 to 3.5 percent in 1985. In collaboration with the IMF Fund and with IBRD assistance, Chile's bank creditors promised to lend $1.1 billion for 1985 and 1986 and to reschedule $5.9 billion of debt due during 1985-87.

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14. Despite Chile's positive adjustment record, low prices for Chile's major exports, especially copper, have prevented significant improvement in export earnings and replenishment of reserves. Moreover, the government is having considerable difficulty in adhering to its IMF program. It is worried that public-sector retrenchment and low growth will aggravate unrest and further weaken President Pinochet politically. Accordingly, in the fall of 1985 the economic team boosted the money supply, delayed a devaluation, and raised wages. Although these measures have provided short-term relief, they are likely to worsen the country's problems in 1986 by fueling inflationary expectations, provoking capital flight, and depressing domestic savings.

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Colombia and Ecuador

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15. President Betancur has tentatively reached an agreement with commercial banks for a $1 billion refinancing package, including over $300 million in new money, despite his refusal to enter into an IMF standby accord, but he is encountering political problems domestically. Bogota plans to undertake a self-imposed stabilization program and to permit the Fund to informally monitor Colombia's economic performance on a quarterly basis, which the IMF has approved. Foreign creditors have been pleased by the government's recent accelerated pace of peso devaluations that already has shown signs of increasing the competitiveness of Colombian exports. Still, recent public opinion polls show that the depressed state of the economy and continuing guerrilla violence are badly eroding Betancur's popular standing. Slowing growth coupled with a quickening pace of inflation is ravaging personal real incomes. Continued fiscal retrenchment also may prevent the Betancur administration from implementing its comprehensive publicly financed program—including small business credits, land grants, and provision of government jobs—for ending civil strife.

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16. President Febres-Cordero's market-oriented reforms have strengthened Ecuador's current account, bolstered business confidence, eliminated fiscal deficits, and generally improved the economy since he took office more than a year ago. In February, Quito

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concluded a $105 million standby agreement with the IMF and arranged for the first multiyear rescheduling of debts by the Paris Club. Commercial banks agreed in August to provide a new $200 million loan to help Quito pay its interest arrears and tentatively rescheduled over 12 years of some $4.6 billion public-sector debt maturing between 1985 and 1989. Despite slumping oil prices, renewed capital inflows have more than offset Ecuador's enlarged current account deficit.

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