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The Impact of a Developed Country Recession on the Latin American Debt Crisis

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An Intelligence Assessment

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The Impact of a Developed Country Recession on the Latin American Debt Crisis [redacted] 25X1

An Intelligence Assessment

This paper was prepared by [redacted] Office 25X1
of European Analysis, with contributions from analysts in the Office of Global Issues, the Office of African and Latin American Analysis, and the Office of East Asian Analysis. Simulations using the Linked Policy Impact Model (LPIM) were run by [redacted] Office of European Analysis. [redacted] 25X1

Comments and queries are welcome and may be addressed to the Chief, Issues and Applications Division, EURA, [redacted] 25X1
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The Impact of a Developed Country Recession on the Latin American Debt Crisis

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Key Judgments

Information available as of 12 January 1987 was used in this report.

An important effect of a recession of any magnitude among developed countries during the next two years would be its negative impact on the Latin American debt situation. After four years of attempting to cope with the debt crisis, the capacity of Latin American countries to service their debt remains tenuous and highly vulnerable to adverse economic trends on both the domestic and international scene. A developed country recession would seriously threaten the progress Latin debtors have made during this time in improving their current accounts and place the solvency of many Latin American countries in jeopardy. Meanwhile, commercial banks have grown impatient with the cycle of new lending packages they reluctantly have gone along with in the past to keep Latin debtors afloat. 25X1

A series of simulations using our Linked Policy Impact Model indicates that a developed country recession would have a dramatic negative impact on Latin economies compared with a baseline scenario. The baseline—under which Latin America would need a total of at least $9 billion in new financing during the period 1987-88—represents a consensus forecast of about 3 percent growth for OECD countries in 1987 and 1988. Under an OECD recession, Latin debtors' loss of exports to developed countries would swamp any relief likely to be obtained from lower interest rates, according to our model:

- In the case of a mild recession—OECD growth around 0 percent, or 3 percentage points below our baseline scenario, and assuming no policy action by Latin governments to slash imports and oil prices steady at $15 per barrel—Latin America would need a total of at least $19 billion in new money in 1987-88 to overcome the deterioration in its overall current account.

- In a deep recession—OECD growth 5 percentage points below the baseline, with no restrictions on imports and a drop in oil prices to $10 per barrel—the minimum amount of new money needed by Latin debtors would rise to $30 billion.

- In a worst case scenario—OECD growth 5 percentage points below the baseline, oil prices falling to $10 per barrel, no decline in interest rates, and worsening nonfuel terms of trade for Latin America—Latin borrowing needs would soar to $55 billion.

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In all cases, capital flight—which averaged a total of $15 billion a year for six large Latin debtors during 1980-85—would add to these net financing needs and probably would more than offset the beneficial effect on Latin America's overall current account of any policy-induced cuts in imports. 25X1

The impact of a recession on individual Latin American countries would hinge upon price trends for commodities, particularly oil. For example, the borrowing needs of net oil exporters such as Mexico and Venezuela would rise steeply if oil prices fell. Brazil and other oil importers, however, would receive benefits partially offsetting the damage done by a recession. Nevertheless, a fall in oil prices would aggravate the overall Latin American debt situation because the region is a net oil exporter. 25X1

Under a recession of almost any magnitude, we believe Latin American countries and international commercial banks would have serious trouble sticking to their current approach to the debt problem, which focuses on the negotiation of new lending packages. In our judgment, they would turn increasingly to developed country governments and multilateral lending institutions for help. More specifically, we believe that:

- Even under a mild recession, Latin American governments would demand sharply stepped-up debt relief. If a slowdown were to last more than a year and no major concessions could be negotiated, several debtors probably would unilaterally limit interest payments. Commercial banks with a small stake in the situation would be likely to continue decreasing their exposure, leaving a shrinking number of large banks to bear the brunt of any new lending. Banks still in the game would be likely to press for guarantees or further lending from developed country governments before making any new loans. The IMF and World Bank would come under increasing pressure to provide more money to debtors through such channels as a new IMF facility similar to the oil facility of the mid-1970s.

- Anything more than a mild recession, in our judgment, would threaten to create a rift between Latin debtors and commercial banks that could lead to a large buildup of interest arrearages in Latin America. Latin governments strapped with huge financing needs would move quickly to slash interest payments unless they got massive commercial bank assistance or help from multilateral institutions and developed country

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governments. The large commercial banks with hefty loan-loss reserves—mainly non-British West European banks—would be likely to write off their Latin debt. The banks with low reserves probably would try to save the largest debtors. In a long, deep recession even the vulnerable banks would try to cut their losses by urging their governments to ease regulations so they also could write off their debt. Under these circumstances, the breakdown of the cycle of new lending packages would be likely to precipitate a crisis and compel major actors to consider entirely new approaches to stave off serious damage to the international financial system. 25X1

We expect officials in Western Europe and Japan would cooperate with the United States in pursuing a government-led resolution to the Latin American debt crisis under conditions of a developed country recession but would continue to look to Washington to take the lead in framing any formal initiative. They also would be likely to argue that the United States should provide the lion's share of any assistance to support such an initiative. The priority Western governments would give their domestic economies during a recession could even lead to policies, such as protectionism, that would aggravate the situation. Nevertheless, we believe West European and Japanese governments would favor coordinated action to protect the international banking system if an intensification of the debt crisis endangered the assets of enough banks to threaten the system as a whole. 25X1

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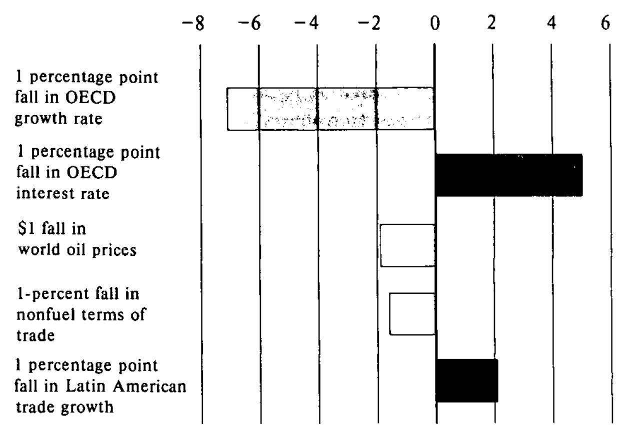
Introduction

Disappointing growth figures for 1985 and the first half of 1986 have engendered fears of a recession among industrially developed countries even though most private forecasters remain optimistic about the continuation of the current recovery. Anxieties have been deepened by concern about the implications this would have for lesser developed countries—many of which are bearing crushing debt burdens—and for the world banking system. This paper uses an econometric model to assess the threat a recession would pose for the Latin American debtor countries and their Western creditors if one were to materialize. It does not examine the prospects and implications for a continuation of the current policies debtors and creditors are pursuing but, rather, focuses on recession scenarios. This paper does not evaluate the chances of a developed country recession and is not intended, in any way, as a prediction that such a recession is imminent.

Figure 1
Latin America: Cumulative 1987-88 Impact of Changes in Key Economic Variables on Its Current Account
Billion US $



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Consequences of a Simulated Recession

A series of simulations run on our Linked Policy Impact Model (LPIM)[1] indicates that a recession among developed countries would have a dramatic negative impact on the Latin American debt situation. One immediate consequence of such a recession would be a sharp cutback in demand for Latin American exports and a severe deterioration in the overall Latin current account. Dwindling export earnings would hamper the ability of Latin American countries to service their debt and limit their access to bank credit. Shortfalls in earnings and a shrinking ability to borrow abroad would slow their economic growth and heighten the risk of potentially destabilizing political and social unrest.

According to our model, falling oil prices and interest rates would do little to cushion the overall impact of an OECD recession on Latin America. For every 1-percentage-point decline in OECD growth, Latin America's current account deficit would increase by about $2.1 billion in 1987 and $5 billion in 1988. A simultaneous fall in oil prices, on balance, would aggravate the debt crisis because Latin America is a net oil exporter. Although lower interest rates might offset some of the damage to Latin America's current account likely to result from a recession, our simulations show that the losses resulting from reduced export earnings would overwhelm these benefits (see figure 1).

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[1] The LPIM is an econometric model of the world. It integrates individual 175-equation economic models of the seven major industrialized economies—West Germany, France, Italy, the United Kingdom, Canada, Japan, and the United States—and smaller models of regional economic groups—the smaller developed countries, OPEC, non-OPEC LDCs, and the centrally planned economies. A Latin American submodel emphasizes trade linkages and debt accounting.

The Current Outlook

To assess the impact of a developed country slowdown on Latin American debtors, we first estimated the likely impact of trends projected by current economic forecasts for the developed countries (see appendix A) on the debt situation. In this baseline case, we assumed OECD growth rates of 3 percent in 1987 and 3.2 percent in 1988, steady oil prices of $15 per barrel, and constant nonfuel terms of trade. Under these conditions, the outlook for the aggregate Latin American current account would improve somewhat in 1987 and 1988 because of sharp increases in exports (see table 1). Latin American countries, however, still would require at least $9 billion in net new lending during these two years.

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In our judgment, this figure probably represents Latin America's minimum credit requirements under the policies creditors and debtors now are following. Although the option to further cut imports significantly in order to reduce foreign borrowing needs still would exist in theory for Latin debtors, we believe fear of political and social repercussions would discourage many Latin American governments from aggressively pursuing this option. In any event, capital flight would be likely to more than offset any import cuts and add to borrowing requirements. This would certainly be the case under worsening economic and political conditions (see inset on Capital Flight). Any decision on the part of Latin debtors to build up foreign exchange reserves or any deterioration in their terms of trade without an offsetting rise in export volume or fall in import volume also would increase their borrowing needs. The debt service ratio (interest and principal payments divided by exports of goods and services), however, would decline gradually during the period 1987-88, if—as we assume—the Latin Americans are able to negotiate a 12-year principal repayment period on new loans and a two-year grace period before beginning repayment of principal.

Table 1
Latin America: Baseline Case

Billion US $ (except where specified)

	Data	Baseline Forecast		
	1985	1986	1987	1988
Current account balance	−4.2	−9.0	−5.7	−3.7
Trade balance	24.0	17.5	18.8	19.4
Exports of goods (f.o.b.)	102.0	94.8	99.9	105.3
Exports of services	32.0	34.2	36.1	38.6
Imports of goods (c.i.f.)	78.0	77.2	81.0	85.9
Imports of services	68.0	65.3	64.6	65.2
Total gross debt [a]	393.9	402.9	408.6	412.3
Total interest payments	32.7	28.2	26.5	25.8
Debt service ratio (*percent*)	34.3	32.5	29.8	27.9
Oil trade balance	23.6	15.0	13.1	12.3
OECD real GDP growth rate (*percent*)	2.7	2.6	3.0	3.2
Latin American exports of goods and services to OECD	110.9[b]	105.6	111.4	117.8
London interbank rate (*percent*)	8.2	6.5	6.0	6.0
Oil price (*$ per barrel*)	27.0	15.0	15.0	15.0
Latin American real GDP growth rate (*percent*)	3.8	1.6	3.5	2.6

[a] Implied total gross debt for 1986-88. Calculations for changes in gross debt are based on estimated current account deficits. Net capital flight, for example, would add to financing requirements beyond the current account deficit, thereby increasing total gross debt accordingly.
[b] Estimate.

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Alternative Scenario 1: Mild Recession

Our model indicates that even a mild recession would damage considerably the overall current account of Latin American debtors. In this scenario we assume OECD growth rates 3 percentage points below the baseline during 1987 and 1988—in other words, little or no growth. We also assume steady oil prices at $15 per barrel, a decline in interest rates, constant nonfuel terms of trade, and no Latin American government moves to cut imports (see table 2). Under these conditions, our model shows that a drop in demand for Latin exports would cause the current account deficit to worsen from baseline projections by

Latin Debtors: Grappling With Capital Flight [a]

Capital flight has bled more than $90 billion from six large Latin American debtors during the period 1980-85. Mexico has been particularly hard hit, losing an average of about $7 billion per year during this period. Argentina and Venezuela also have been victims of massive capital flight, while Brazil has done a good job of holding capital within its borders. Although capital flight has tapered off during the last few years, it remains a major obstacle to the solution of Latin America's financial problems because of the region's diminished access to foreign capital. Since 1980 capital flight has eaten up an increasingly larger chunk of Latin America's falling net borrowing. Lenders have seized on capital flight as a justification for lending cutbacks. Our analysis of past government attempts to stanch capital outflows indicates that tighter capital controls have not been effective in discouraging capital flight and that funds are still being funneled abroad.

Latin American countries, for the most part, are responsible for their own plight. Many of their governments' policies have encouraged capital flight:

- *Overvalued exchange rates have made foreign assets cheap and raised the specter of devaluation.*
- *Fixed nominal interest rates at low levels have resulted in negative returns on domestic assets.*
- *Political reluctance to deal with economic imbalances—growing trade deficits, spiraling inflation, and widening government budget deficits—has caused investors to seek a more stable environment for their funds.* 25X1

We believe the foreign assets accumulated by residents of Latin American countries could potentially play a significant role in resolving the debt crisis if these investors could get competitive returns in their own countries. On the basis of our estimates, residents of six large Latin debtor countries own a stock of foreign assets equal to over one-fourth of their countries' foreign debt. Structural reforms encouraging noninflationary growth, such as paring back the government sector of the economy and getting rid of laws that restrict price movements, would be likely to entice back some of this capital, help relieve balance-of-payments pressures, and cut foreign borrowing requirements. Even if residents were to hold on to their overseas assets and repatriate only the annual earnings, the impact on international accounts would be significant. Without structural reform, however, we believe capital outflows will remain stubbornly high and continue to aggravate the debt crisis.

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about $3 billion in 1987 and $7 billion in 1988. This would precipitate an increase in borrowing needs to at least $19 billion—$10 billion more than the baseline requirement of $9 billion—during 1987-88. Latin American exports of goods and services to OECD countries would fall by about $7 billion in 1987 and $16 billion in 1988 compared with the baseline because of a steep drop in export volume and a decline in prices. In addition, Latin American economic growth would fall off about 1 percentage point from the baseline in 1987. An accompanying 1- to 2-percentage-point drop in interest rates (see appendix B) and a slowdown in imports brought on by lower growth would only partially offset the negative impact of a downturn in export demand for debtor countries. If Latin debtors could raise the $19 billion, the simulation indicates that the combination of lower interest rates, rescheduling of old debt, and the two-year grace period on new debt would lead to a slight decline in the debt service ratio. 25X1

Alternative Scenario 2: Deep Recession

Our model indicates that a deeper recession would do severe damage to Latin America's overall current account, reduce its ability to service its debt, and

Table 2
Latin America: Impact of a Developed Country Recession [a]

Billion US $
(except where specified)

	Scenario 1		Scenario 2		Scenario 3	
	1987	1988	1987	1988	1987	1988
Current account balance	−2.9	−7.0	−8.2	−12.7	−15.6	−30.5
Trade balance	−3.3	−7.1	−9.7	−14.6	−11.0	−18.8
Exports of goods (f.o.b.)	−5.2	−11.9	−17.2	−28.8	−18.3	−32.6
Exports of services	−2.9	−6.6	−5.2	−11.8	−5.2	−11.8
Imports of goods (c.i.f.)	−1.8	−4.8	−7.5	−14.1	−7.3	−13.7
Imports of services	−3.3	−6.7	−6.8	−13.7	−0.6	−0.1
Total gross debt [b]	2.9	9.9	8.2	20.8	15.6	46.2
Net interest payments	−2.8	−5.4	−5.7	−10.9	0.4	2.6
Debt service ratio (*percentage points*)	−0.4	−0.1	0.9	0.6	6.6	15.5
Oil trade balance	0	0	−4.4	−4.1	−4.4	−4.1
OECD real GDP growth rate (*percentage points*)	−3.0	−3.0	−5.0	−5.0	−5.0	−5.0
Latin American exports of goods and services to OECD	−7.1	−16.1	−19.8	−35.2	−20.9	−39.0
London interbank rate (*percentage points*)	−1.5	−2.0	−3.0	−4.0	0	0
Oil price (*$ per barrel*)	0	0	−5.0	−5.0	−5.0	−5.0
Latin American real GDP growth rate (*percentage points*)	−1.1	−0.2	−1.8	−0.3	−1.8	−0.3

[a] Changes from the baseline. The model's export volume elasticity for Latin American goods—a key parameter in the model—is about 1.5 (1.9 for nonfuel goods, 0 for fuel). If, after two years, OECD real GDP is down 6 percent from the baseline—as it is in Scenario 1—Latin America's export volume drops 8.6 percent. Exports of goods in dollar terms, as shown above, decline somewhat more because LDC export prices fall as well.

[b] Implied total gross debt for 1987-88. Calculations for changes in gross debt are based on estimated current account deficits. Net capital flight, for example, would add to financing requirements beyond the current account deficit, thereby increasing total gross debt accordingly.

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sharply raise the borrowing needs of Latin debtors, especially for oil exporters like Mexico, Venezuela, and Ecuador. In this scenario, we assume OECD growth rates 5 percentage points below the baseline (or negative growth of about 2 percent), a decline in oil prices to $10 per barrel, and a sharp drop of 3 to 4 percentage points in interest rates. We continue to assume no change in the nonfuel terms of trade and no government intervention to reduce imports.

Our model indicates that, as a recession among developed countries deepens, the severity of the impact on the Latin American debt situation would increase sharply. In particular, the losses resulting from depressed exports would swamp the benefits of lower interest rates, and Latin American borrowing needs would balloon to $30 billion—approximately $21 billion beyond the $9 billion baseline requirement. The region's current account deficit would grow about $8 billion in 1987 and $13 billion in 1988 beyond baseline projections. This would be the result of a deterioration in exports to OECD countries, which would fall about $20 billion in 1987 and $35 billion in 1988. In this scenario, Latin American growth would decline about 2 percentage points from the baseline in 1987. The drop in Latin American exports would be so steep that the debt service ratio would rise despite lower interest rates.

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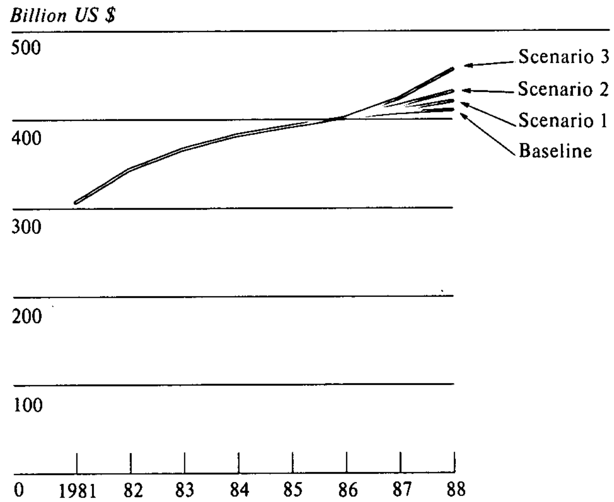
Alternative Scenario 3: Worst Case

If a deep recession struck developed countries and all other economic developments also went against Latin America, our model indicates that the region would no longer be able to finance its current account deficit and many Latin debtors would default on their loans without drastic action on the part of creditors. The current account deficits in this worst case scenario almost certainly would be impossible to finance. Although all factors are unlikely to turn against Latin America simultaneously, unfavorable trends in each are plausible. We assume negative growth of about 2 percent in the OECD (5 percentage points below the baseline in 1987 and 1988), oil prices of $10 per barrel, no decline in interest rates, and Latin American terms of trade worsening by 2 percent in 1987 and 5 percent in 1988. 25X1

Figure 2
Latin America: Total Foreign Debt, 1981-88[a]



[a] Total debt levels are for end of the year. Baseline and all scenarios assume debtors can raise the funds needed to cover current account deficits. Data for 1986 are estimated; 1987 represents LPIM simulations based on assumptions of scenarios.

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Under this scenario, the aggregate Latin American current account would deteriorate from the baseline by about $16 billion in 1987 and over $30 billion in 1988. Exports of goods and services to OECD countries would slump by about $20 billion in 1987 and about $40 billion in 1988. Latin American growth would drop about 2 percentage points below the baseline in 1987. This simulation indicates that Latin debtors would need an infusion of about $55 billion over the next two years—$46 billion more than the $9 billion baseline requirement—to finance these deficits (see figure 2). The steep drop in exports would cause a sharp rise in the debt service ratio.

There would be little that Latin American governments could do to alter their situation if they implement contractionary policies to shrink imports as they have in the past. Our simulation indicates that each 1-percentage-point fall in growth would bolster their overall current account by only $600 million in 1987 and $1.5 billion in 1988. Latin American leaders, in any case, would be hard pressed to pursue this strategy and, in our judgment, would be unable to slash imports enough to make up the shortfall.

Longer Term Consequences

Our simulations indicate that, regardless of its severity, the more prolonged a developed country recession, the more drastic and uniform its impact on Latin American countries would be. In all cases, their aggregate current account would deteriorate substantially more the second year of a recession, and their borrowing needs would be greater. If a recession were to drag on a third year into 1989, the capacity of Latin American countries to meet their debt obligations would deteriorate as scheduled principal payments on new debt came on line. A prolonged slowdown also would tend to wipe out the advantages obtained by oil-importing countries from any decline in oil prices. Consequently, those countries that had not been hit hard the first year would be pushed back, and those already in bad shape would be far worse off. 25X1

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The Oil Factor 25X1

Our simulations indicate that a fall in oil prices would aggravate the Latin American debt situation because the area is a net oil exporter. According to our model, each $1 reduction in the price of oil would mean an additional $900 million in the overall Latin American current account deficit in 1987 and an additional $1 billion in 1988. [redacted]

The impact of oil price trends on individual Latin debtors in the event of a developed country recession, however, would hinge on their oil trade balance. If oil prices remained at $15 per barrel, major oil exporters such as Mexico would not suffer much the first year of a recession. On the other hand, they would be hit hard if the slowdown were accompanied by a decline in oil prices. Conversely, oil importers would receive some offsetting benefits if oil prices were to fall to $10 per barrel during a recession, but would suffer if they hold steady. [redacted]

Mexico, according to our simulations, would experience a relatively minor deterioration in its current account in 1987 compared to baseline projections if oil prices stay at $15 per barrel and if developed country growth falls 3 percentage points below the baseline (see table 3). On the other hand, if oil prices were to fall to $10 per barrel as growth in developed countries dropped 5 percentage points below the baseline, Mexico's current account deficit would soar by $2.4 billion over the baseline in 1987 and $2.9 billion in 1988, while the outlook for economic growth would darken considerably.[2] [redacted]

Similarly, if oil prices hold steady, the Venezuelan current account deficit would increase very little in 1987 in the event of a recession in the developed countries. If oil prices fall to $10 per barrel in a deep recession, however, Venezuela's deficit would swell above the baseline by nearly $2 billion in 1987 and $1.5 billion in 1988. [redacted]

On the other hand, damage to a heavy oil importer like Brazil would be reduced considerably if oil prices were to decline in tandem with a developed country recession. With oil prices at $10 per barrel, Brazil's current account would deteriorate less than $1 billion from the baseline in 1987. Moreover, its growth prospects would hardly dim even under a deep recession. Brazil's economy would suffer a severe setback, however, if oil prices were to hold steady as developed countries sink into a recession. In this case, its current account would fall at least $1.3 billion below baseline projections in 1987 and $3.6 billion in 1988 even in a mild recession. Economic growth, which has been buoyant the last two years, would slow by as much as 2 percentage points.[3] [redacted]

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Reactions to a Recession

Most Latin American countries currently are avoiding confrontation and are negotiating for concessions with their creditors. Several also are implementing programs—such as the Austral Plan in Argentina and the Cruzado Plan in Brazil—designed to introduce economic reforms, improve growth prospects, and dampen inflation. Large commercial banks generally are going along with multiple rounds of so-called involuntary lending to prevent their previous loans from becoming a complete loss. Developed country governments, meanwhile, are providing some assistance through multilateral lending institutions and are encouraging economic reforms to promote growth in Latin American countries in order to enable them to pay back their debt. A developed country recession would endanger this basically cooperative approach to the debt crisis. If a mild slowdown were to drag on for more than a year or if a deep recession were to strike the developed countries, we believe cooperation between Latin debtors and the banks could endure only with substantial new assistance from OECD governments and multilateral lending institutions. [redacted]

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Debtor Reaction to a Mild Recession. We believe that a mild developed country recession would impel Latin American leaders to look to developed country governments and commercial banks to share more of the financial burden. Even a short, mild downturn, in our view, would engender a torrent of calls from Latin American leaders for more concessions from their creditors. Latin governments already are lining up to

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[2] Mexico's predicament probably would be alleviated somewhat by the recent agreements with commercial banks and the IMF that create contingency funds for additional borrowing on the basis of Mexican economic performance and the price of oil (see inset on Mexico's IMF and Commercial Bank Agreements). [redacted]

[3] For some countries, such as Argentina and Colombia, oil prices would not play a pivotal role at present because they export only small quantities of oil. [redacted]

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Table 3
Latin American Debtors: Impact of an Economic Slowdown Among Developed Countries

Billion US $

	Baseline			Scenario 1		Scenario 2		Scenario 3	
	1986	1987	1988	1987	1988	1987	1988	1987	1988
Total Latin America									
Current account balance	−9.0	−5.7	−3.7	−8.5	−10.7	−13.8	−16.4	−21.3	−34.2
Total foreign debt	403.0	408.7	412.4	411.5	422.2	416.8	433.2	424.2	458.4
Debt service ratio [a] (*percent*)	32.5	29.8	27.9	29.4	27.8	30.7	28.5	36.4	43.4
Brazil									
Current account balance	−0.2	0.5	1.0	−0.8	−2.6	−0.3	−3.6	−2.7	−8.3
Total foreign debt	103.0	102.5	101.5	103.8	106.4	105.7	106.9	105.7	114.0
Debt service ratio (*percent*)	34.2	30.2	27.5	29.6	28.1	28.3	27.0	35.4	41.3
Mexico									
Current account balance	−2.6	−1.5	−0.1	−1.5	−0.7	−3.9	−3.0	−6.2	−7.2
Total foreign debt	106.3	107.8	107.9	107.8	108.5	110.2	113.2	112.5	119.7
Debt service ratio (*percent*)	53.9	48.2	45.2	46.6	44.6	51.3	48.9	63.2	72.8
Argentina									
Current account balance	−2.4	−1.9	−2.0	−2.4	−3.1	−2.6	−3.6	−3.2	−5.0
Total foreign debt	52.6	54.5	56.5	55.0	58.1	55.2	58.8	55.8	60.8
Debt service ratio (*percent*)	31.2	27.0	24.4	27.3	26.0	27.1	26.0	31.8	27.4
Venezuela									
Current account balance	−1.2	−0.5	−1.3	−0.5	−1.4	−2.3	−2.7	−3.0	−4.3
Total foreign debt	36.9	37.4	38.7	37.4	38.8	39.2	41.9	39.9	44.2
Debt service ratio (*percent*)	35.7	33.1	31.3	32.5	30.4	37.5	34.0	43.2	47.2
Chile									
Current account balance	−1.0	−1.1	−1.3	−1.2	−1.7	−1.1	−1.8	−1.6	−2.7
Total foreign debt	22.0	23.1	24.4	23.2	24.9	23.1	24.9	23.6	26.3
Debt service ratio (*percent*)	48.4	42.6	38.9	42.1	40.3	40.7	39.5	50.1	57.8
Peru									
Current account balance	−0.5	0	0	−0.1	−0.3	−0.3	−0.6	−0.5	−1.0
Total foreign debt	15.0	15.0	15.0	15.1	15.5	15.3	15.9	15.5	16.5
Debt service ratio (*percent*)	20.4	18.2	16.8	18.0	16.9	18.0	16.7	21.9	26.0
Colombia									
Current account balance	−0.3	−0.4	−0.5	−0.7	−1.1	−0.8	−1.3	−1.0	−1.7
Total foreign debt	12.7	13.1	13.6	13.4	14.4	13.5	14.8	13.7	15.4
Debt service ratio (*percent*)	32.6	29.1	26.8	31.1	30.8	32.6	34.6	34.3	40.2
Ecuador									
Current account balance	−0.7	−0.6	−0.5	−0.6	−0.5	−0.9	−0.8	−1.1	−1.1
Total foreign debt	9.4	10.0	10.5	10.0	10.5	10.3	11.1	10.5	11.6
Debt service ratio (*percent*)	34.9	31.7	29.7	31.4	28.9	35.3	31.8	40.5	44.8

[a] Debt service ratio represents debt service payments as a percentage of exports of goods and services.

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Mexico's IMF and Commercial Bank Agreements

The IMF agreed in August 1986 to relatively easy terms for a $1.6 billion, 18-month standby program for Mexico. The principal goal of the program is to support economic growth. In contrast to the austerity imposed under the 1982 extended fund facility, the Fund agreed to permit Mexico's budget deficit to widen from the 10 percent agreed on previously for 1985 to 16.9 percent of GDP in 1986. Mexico's likely failure to emerge from recession early in 1987 will trigger the release of an additional $500 million contingency fund to allow an increase in government spending. The Fund also agreed to tie some of the targets and balance-of-payments financing to oil prices to compensate for Mexico's sensitivity to swings in the oil market. If the price of oil drops below $9 per barrel, the IMF and commercial banks will be required to make up at least part of the shortfall. The Fund also will adjust the target ceilings for the budget deficit, international reserves, and public-sector credit [redacted]

For their part, commercial banks agreed in November to a three-part financial package for Mexico. This includes new money, an arrangement for contingency money, and conditions for restructuring previous loans. First, banks will lend Mexico $5.7 billion in new funds. The World Bank will cofinance $1 billion of the new loan and will guarantee up to $500 million. Second, banks will provide $500 million—half of which is guaranteed by the World Bank—if Mexico's economic growth flags, and up to $1.2 billion in investment support depending on oil price trends. Third, banks will push back the maturity date on an already rescheduled $43.7 billion debt by eight years and grant Mexico a seven-year grace period. The maturity date for another $8.5 billion borrowed during 1983-84 will remain the same, but repayments will not commence for another three years. Mexico will pay 0.8 percentage point over LIBOR on all the loans, a reduction of 0.3 percentage point compared with the average spread over LIBOR Mexico had paid earlier. Mexico also is seeking bankers' agreement to reschedule again $11.2 billion in private-sector loans and an affirmation of their promise not to cut off $6 billion in interbank credit lines. [redacted] 25X1

[redacted] *bankers believe the Mexicans have no definite plans for economic reform and* 25X1
are skeptical that this rescue operation will do more 25X1
than postpone another debt crisis. They expect that the Mexicans will be back for more money before 1990. In addition, other Latin debtors are already lining up to get concessions similar to those obtained by the Mexicans. Venezuela, for example, is expected to request a link between oil prices and new money, while Argentina intends to ask for a contingency fund based on the prices of its agricultural exports. [redacted] 25X1

make their case for debt relief. Mexico, in its recent negotiations with the IMF and commercial banks, obtained several concessions. These included a reduction of interest rate spreads and a contingency fund based on oil prices. Other debtors watched these talks closely and now are pressing for similar breaks. [redacted]

Latin American leaders undoubtedly would press harder for these types of concessions in the event of a mild developed country recession. They also would be likely to renew calls for preferential trade treatment and more lending by multilateral institutions, especially the World Bank and the Inter-American Development Bank. We believe most, however, would not risk cutting themselves off from trade and development finance by taking unilateral action in the event of a short downturn. [redacted] 25X1

If a mild recession were to drag on, however, we
expect that Latin debtors would increasingly up the 25X1
ante and demand even more generous concessions. Several, in the absence of substantial outside relief, would consider unilaterally limiting their interest payments as Peru already has done. Many Latin governments might well follow Peru's example by

cutting back debt payments to a percentage of exports, or else link them to GNP growth. If some of the more desperate countries took this unilateral step, opposition groups in other countries would press governments in power to do the same. The major Latin debtors so far have avoided this strategy, but they would be unlikely to let their debt burden drag down economic growth for long.

Under a mild slowdown, meaningful joint debtor action would be unlikely. The differing effects on Latin American countries would make a common position difficult to achieve. Moreover, the largest debtors—especially Brazil and Mexico—probably would not want to sacrifice their ability to maneuver quickly and independently in negotiations with their creditors, for the limited increase in leverage that joint action would bring.

. . . to a Deep Recession. Almost all Latin American countries, in our judgment, would drastically step up their demands for debt relief while threatening to break off negotiations with their creditors if a deep recession were to hit developed countries. Latin American leaders almost certainly would blame creditors for their countries' mounting economic woes. If Latin governments failed to make a deal with their creditors to drastically ease their burden, several probably would break off talks altogether and act unilaterally to limit debt service payments. If developed countries did not snap back after a year of deep recession, we expect the few Latin American countries remaining in decent financial shape would be pushed into the same dire economic conditions as all the rest, provoking almost all debtors to independently consider similar actions. We believe these debtors, in the absence of generous concessions, would tie debt payments to growth or exports. Although Latin governments, even under these circumstances, would find it difficult to take joint action, they probably would use the Cartagena Group—their forum for discussing debt-related matters—more actively to share information.

The exact threshold where individual Latin American debtors would turn away from cooperation with their creditors toward confrontation in the face of a developed country recession would hinge on the economic conditions of each country at the time of the recession, the skill of government leaders in handling the resulting internal political situation, and the willingness of creditors to make concessions. In any case, we do not expect Latin debtors to move in lockstep. For example, the largest debtors—Brazil and Mexico—would have considerably more leverage than the rest to win concessions because of the damage they could inflict 25X1
on the international banking system. The nature of the recession also would influence the behavior of Latin debtors. A downturn induced by tight monetary policy among developed countries, loading Latin debtors with higher interest payments in addition to 25X1
hitting them with lower export earnings, would significantly raise the likelihood of radical action.

In spite of the many factors influencing the threshold, we believe anything more than a mild recession— 25X1
0-percent growth during 1987-88, as portrayed in our simulations—would trigger a move to a much harder line among Latin American leaders. Even the second year of a mild downturn could provoke such a move. We expect Argentina, where President Alfonsin is under heavy domestic pressure, and Brazil, noted for its prickly negotiating stance, would be the Latin debtors most apt to take unilateral action similar to what President Garcia has done in Peru if substantial relief were not forthcoming. Other Latin American countries, in turn, would be likely to try comparable measures creating a spillover effect where all debtors would end up taking similar action even in the absence of a formal debtors' cartel. The longer and deeper the recession, the greater the chances of this spillover effect taking place, particularly if Latin American leaders believed developed country creditors were not sensitive to their plight. All of these leaders, in any case, would encounter heightened political pressure to take a get-tough attitude toward their creditors. 25X1

Country Reactions. Mexico's ability to withstand a developed country recession has been bolstered by the refinancing package worked out with the IMF and the 25X1
bank advisory committee, and the outlook is for slow Mexican growth at best for the shorter term. Moreover, the current regime is well entrenched politically.

An Emerging Swap Market

Creditors and debtors are increasingly active in a growing "swap market" for LDC debt. There are two types of swaps involving LDC debt. One type allows creditors to redesign their portfolios by trading debt owed by different countries or with different maturities. The other type of swap enables banks to sell troubled LDC loans at less than their face value to investors who trade this debt for equity in firms operating in the LDCs. Bankers are expanding their use of swaps to limit risks, reduce exposure in a given country, and strengthen their balance sheets. For some smaller banks, swaps have provided an opportunity to eliminate LDC exposure completely. For other banks of various sizes, they have offered a way to concentrate or consolidate loans within a preferred geographic region. West European banks and smaller US banks are particularly active in this market. [redacted]

Purchase prices for debt vary widely from about 20 cents on the dollar for Peruvian debt to 75 cents for Brazilian exposure. Other examples of prices include 65 cents for Argentine loans, 58 cents for Mexican loans, and 66 cents for Chilean loans. [redacted]

The debt-for-equity programs instituted by debtor countries, such as Chile and Mexico have benefited them by reducing their external debt level from what it otherwise would be and lowering the interest payments. They also have served as a stimulus for foreign investment:

- *Chile's debt-to-equity scheme has converted about $1 billion of outstanding debt.*
- *Mexico has just developed a system to handle the swapping of public-sector debt for equity in private Mexican companies. For example, a major US bank arranged a debt-to-equity swap worth about $40 million to finance expansion of Nissan's Mexican operations.* [redacted] 25X1

Peru has established the goal for 1987 of using more than $200 million worth of processed goods in a debt-for-exports scheme currently under discussion with its major creditor banks. Under the most recent version of the plan, a bank willing to market specified Peruvian goods would be able to use half the proceeds to liquidate debts owed by Peru. [redacted] 25X1

Some observers believe that swaps could lighten the debt burden, but we believe the current system of swaps and conversions provides only a marginal solution. In our view, both creditor and debtor reluctance to use these techniques will limit the overall impact. We expect most banks to try to limit participation in it, particularly larger US banks, which are constrained by accounting standards that require a bank that sells a portion of its debt at a discount to write down its remaining loans to that borrower. We share the reservations of observers who doubt that there would be enough buyers for large-scale debt purchases unless the loans were substantially marked down. Moreover, if the market for discounted paper continues to grow, regulators would be likely to face the issue of whether banks should be forced to value their entire loan portfolios at the lower market rate. [redacted]

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Mexico's movement toward internal economic reform has been disappointingly slow, but the government is somewhat more receptive to foreign investment than it has been in the past. For example, it has begun a program with its foreign creditors to swap debt for equity invested in the country. On the basis of the results of our model simulations:

- In a *mild* recession, we would not expect President de la Madrid to take the lead on any coordinated Latin American action to halt debt payments, in part because of Mexico's new refinancing package. Nevertheless, he would be likely to curry domestic political favor by blaming developed country governments for any hardships and to call on the United States to boost its imports from Mexico.
- In a *deep* recession—especially one in which oil prices fell and the refinancing package became inadequate—we believe de la Madrid would be likely to take action to ease Mexico's debt burden. [redacted] 25X1

Brazil's relatively solid economic performance over the last few years probably has made it the Latin debtor most able to handle a developed country downturn over the long haul. Nevertheless, cracks in its recovery program—the Cruzado Plan—are dimming its short-term prospects. The plan's price controls are causing shortages and slowing investment, and the November price adjustments harmed President Sarney's standing with the public. Moreover, Brazil's trade surplus plummeted in recent months, resulting in a rapid drawdown in international reserves to meet debt servicing obligations. Brasilia has kept the IMF at arm's length and already has made clear its unwillingness to sacrifice growth to satisfy its debt obligations:

- Under a *mild* recession, however, the Sarney administration might be lured back to the IMF bargaining table by hope of obtaining the concessions Mexico got and by a deteriorating domestic economic situation. In any event; we would expect it to decry the damage inflicted on the country's ability to service its debt and to permit only a limited drawdown of its reserves.

- Under a *deep* recession which threatened to wipe out its trade surplus, we believe Brasilia would seriously consider limiting debt payments. Given its more favorable long-term economic prospects and the leverage the size of its debt gives it, Brazil probably would continue to set its policy course without consulting other Latin debtors.

Argentina's improved economic performance brought on by the Austral Plan probably would be halted by a developed country recession. The Argentine economy's increasing dependence on exports to sustain growth makes it particularly vulnerable to such a recession. Buenos Aires, under these conditions, would face narrowing policy options as labor unions and other constituencies pressed the government to take a radical stand on debt:

- If a *mild* recession hit developed countries, President Alfonsin probably would continue negotiations with the IMF and commercial banks for new money. He would be unlikely to take unilateral action as long as he believed prospects were good for Argentina to get enough to finance its trade deficit. Even in a mild recession, Alfonsin could well resort to inflationary government spending to boost his party's chances for success in next November's election.

- If a *deep* recession struck and commercial banks refused to lend Argentina additional money, we believe Buenos Aires would run up interest arrears and seriously consider stringent limits on debt payments. Over the longer term, such a recession would be likely to overturn Alfonsin's plans to foster a more open, export-oriented economy. 25X1

Other countries also would be prone to adopt a radical position. ***Peru*** already has taken unilateral action to cut its debt load and would be unlikely to seek any form of reconciliation with its commercial bank creditors or the IMF under any kind of developed country recession. ***Venezuela*** has caused its bankers fits with its slow-moving negotiating style and abrupt policy reversals on schemes to repay its extensive private debt. It almost certainly would become even tougher to deal with under a recession—especially one accompanied by lower oil prices. 25X1

Of the other large Latin debtors, only ***Colombia*** does not seem likely to pose major problems. Its recent economic performance has been relatively good because of the windfall it received from the rise in coffee prices in 1986. In addition, its external debt is small in terms of the size of its economy, and government management of the economy has been somewhat effective. 25X1 These factors make Colombia more capable of withstanding a developed country downturn compared with other Latin debtors. Even here, however, a severe recession could provoke a radical shift in attitude. 25X1

Chile, for its part, has done more to promote internal economic reform than other Latin debtors and has been successful in swapping debt for equity. Nevertheless, it has the highest per capita debt of the major Latin debtors, and its poor human rights record could cause multilateral institutions to delay new loans in the future despite the country's progress.

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Bank Reaction. We would expect international commercial banks, under conditions of a developed country recession, to have great difficulty establishing common positions on new lending packages for Latin American countries. The steps commercial banks are taking now to protect themselves from widespread default in Latin America are likely to enable some of them—especially non-British West European and smaller US regional banks—to assume a tougher stance with debtors in the future. For example, banks are shoring up their balance sheets by increasing their loan-loss reserves while making few new loans to troubled debtors. Many regional banks, in the United States and elsewhere, have reduced their exposure by writing off the relatively small sums they have lent Latin debtors or selling off Latin loans at a discount. Large non-British West European banks—encouraged by generous tax breaks and accommodating regulations—have been much more vigorous than other banks in building up their reserves against bad loans. Thus, these banks would have more maneuvering room than their counterparts in the United States, Japan, and the United Kingdom.

In the event of a mild recession, a small number of big banks would have to provide the lion's share of any new lending. Commercial banks that could afford to—because of low exposure or hefty loan-loss reserves—would try to gradually extricate themselves from the situation by continuing to write off their debt. Regional banks with little at stake would be likely to bail out in growing numbers. We believe that even many large banks would have to be prodded to go along with new packages of so-called involuntary lending because of their concern about Latin American creditworthiness. They probably would continue to insist that the IMF and other multilateral organizations chip in with more new lending and that developed country governments provide guarantees on new loans. Moreover, the banks' varying degrees of portfolio vulnerability and the differing regulatory environments in which they operate almost certainly would divide them and make loan packages much more difficult to put together than in the past.

A deep recession would lay waste the common front commercial banks have tried to maintain. Depending on the strength and length of the downturn, some commercial banks probably would try to save the largest debtors—in particular, Brazil and Mexico—by making more concessions while taking a rigid stance toward the rest. A growing number, however, probably would come to view the debt situation as a lost cause. Some West European banks and small US regional banks, in our view, would be the first to jump ship. Large continental banks in Western Europe with hefty reserves—already having absorbed much of the cost of default—then would be in a position to threaten to leave major banks in the United States, Britain, and Japan holding the bag if arrangements for new lending did not suit them. These more vulnerable banks, in the event of a deep recession, would be likely to increasingly turn to their governments to rescue the debtors or to enhance their own ability to write off the debt by easing banking regulations. 25X1

If a deep recession dragged on, we believe that commercial bank support for involuntary new lending to Latin American countries would disintegrate, particularly if OECD governments did not step in with assistance. 25X1 Bankers already are chafing at the demands of Latin debtors. We expect that non-British European commercial banks with adequate reserves would write off their debt. Banks with low reserves then would face the costly choice of writing off their debt also or caving in to debtor demands. These banks, in our view, would strongly press their governments to alter banking regulations in order to allow them to write off their debt without dire damage to their financial status. Under these circumstances, it would be almost impossible for commercial banks to achieve the critical mass among their ranks necessary to support new lending packages. 25X1

Implications for US Debt Strategy

Even a short, mild economic slowdown among developed countries undoubtedly would hamper the US debt strategy, which is aimed at getting commercial banks and multilateral institutions to step up lending while encouraging debtor countries to adopt market-oriented growth policies. Developed country governments and multilateral banking institutions, however, 25X1 probably still would be able to activate enough resources in addition to further concessions from commercial banks in order to prevent a financial crisis in Latin America. A new IMF facility geared to troubled debtors—similar to the oil and compensatory financing facilities—probably would be seriously considered. The World Bank probably would take a bigger role also. It already is considering providing more medium-term financing not attached to specific projects. Other organizations—the Bank for International Settlements and the Group of Ten—might have to provide short-term emergency financing again to tide debtors over a short downturn. Governments in Western Europe and Japan would be likely to go along with such plans because concern over the debt situation would override reluctance to increase world liquidity. For their part, most commercial banks currently involved in the situation probably would put up more new money only if governments and international organizations were willing to expand their role.

In the event of a recession, we believe that, although Western governments would try to cooperate to resolve the debt crisis, it would not be easy for them to formulate long-term strategy on the problem or to put together short-term rescue packages for Latin America. Other governments, in our view, would look to the United States to take the lead and to provide a major portion of any emergency financing. They would be likely to argue once again that the greater vulnerability of US banks and the United States' proximity to the region make the Latin American debt crisis more a US than a European or Japanese problem. Furthermore, their ability to deal with the crisis would be more politically hemmed in than usual. The main economic concern of Western leaders during a recession almost certainly would be their domestic scene. They would want to avoid the appearance of bailing out big banks or foreign countries at the expense of their own constituencies. Indeed, officials almost certainly would come under pressure to adopt such policies as protectionism in the name of bolstering their own economies despite the negative effect these policies would have on Latin debtors.

A long, mild developed country slowdown or a deep recession would encourage Latin debtors and commercial banks to adopt progressively more uncompromising positions that eventually would threaten to overturn the current debt strategy. Latin debtors, as well as those commercial banks that could afford to, would be likely to try to break loose from the situation. Most Latin leaders, already coping with several years of sluggish growth, probably would be uncooperative or even hostile toward their creditors. Some leaders undoubtedly would blame commercial banks and developed country governments for their countries' economic problems. Latin American leaders almost certainly would fear turmoil in their own countries if they attempted to assert any kind of economic discipline. 25X1

We believe developed country governments, under these circumstances, would have to mount a series of major financial rescue operations to stave off financial crisis in Latin America. Developed countries probably 25X1
would consider falling back on some major new scheme to take over the debt of Latin countries, either through existing multilateral banking institutions or a new agency established for that purpose. In our judgment, West European countries generally, as well as Japan, would be open to such an arrangement to avoid a massive default in Latin America that could endanger the international banking system. Nevertheless, the task would not be easy, if only because the efforts of national leaders to ensure that their respective countries not bear a disproportionate share of the burden inevitably would produce friction.

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Appendix A

Uncertainties in the Outlook for Developed Countries

Most private international economic forecasters remain generally optimistic about the continuation of the current recovery among developed countries. Many, however, are backing away from the projections for strong short-term growth they made after the drop in oil prices in early 1986, revising growth figures for 1986 downward, and reducing the odds against a recession in 1987. They now believe their earlier forecasts were too optimistic about the effect of lower oil prices and the ability of developed countries to rectify the imbalances lurking behind the scenes of the recovery. In addition, slow expansion in the United States during the second quarter of 1986 has raised questions among some forecasters about the health of the US economy.

Growth among OECD countries is now expected by most forecasters to weaken slightly in 1986 to 2.6 percent from 2.7 percent in 1985, and then rebound in 1987 to about 3 percent:

- Growth in the *United States,* according to the consensus of private forecasters, will remain sluggish at about 2.5 percent in 1986 but recover sharply to more than 3 percent in 1987. The weakness in 1986 is attributed to a downturn in business investment because of uncertainty over tax reform and a lopsided deficit in the current account. They project a comeback in 1987 propelled by consumer spending, improved performance by US exporters, and business investment.

- *Japanese* growth is expected to slow to 2 percent in 1986—the lowest rate since 1975—as the strong yen forces exporters to trim investment spending. Growth is forecast to recover to 3 percent in 1987 as the real income benefits of the yen's rise take hold and business steps up investment in nonexport industries. Forecasters believe Tokyo's recently announced stimulus package is unlikely to have any effect in 1986, and probably will provide only a mild fillip to growth in 1987.

- *West Germany* is projected to experience moderate growth rates in the short term because it is already undergoing a similar transition away from export-led growth. After a disappointing first quarter in 1986, forecasters believe the West German economy appears to be bouncing back. They think its growth—bolstered by tax cuts—should hold steady at about 2.5 percent in 1986 and 1987.

- Growth in *France* and other major OECD countries is expected to be about 2.5 percent overall in both 1986 and 1987, as consumer spending holds up demand and disciplined fiscal policy encourages investment in most countries. Growth in the *United Kingdom,* however, may be somewhat lower if lower oil prices continue to depress the energy industry. 25X1

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Although most forecasters view the current low growth among developed countries as a pause rather than an end to the recovery, some trends are making them nervous. The US economy is a particular source of concern. They believe that, if US policymakers fail to deal effectively with the budget deficit, government borrowing will push interest rates higher and crowd out private investment. Moreover, many are worried that the slump in US business investment in 1986 may drag on and fret that policies designed to cut interest rates are more likely to reignite inflation than revive real domestic demand. Given these fears, along with the prospect that the public-sector stimulus to the economy will decline, many forecasters believe any slide in currently strong consumer confidence would deal a hard blow to US growth. 25X1

Forecasters, however, are most troubled by international trade problems. The dollar's slide was supposed to give US exporters a lift and turn back mounting US current account deficits. It is starting to hurt Japanese and West German exporters, but newly industrialized country exporters rather than US firms are reaping the benefits. 25X1

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Developed countries, furthermore, are experiencing difficulty coordinating economic policies. Tokyo was slow and Bonn remains reluctant to stimulate economic growth by cutting interest rates to boost demand. Consequently, rather than making up for the slowdown in US demand that occurred in the second half of 1985, domestic demand actually fell in Japan and West Germany in the first quarter of 1986. 25X1

Forecasters remain relatively optimistic, but the elements hindering growth could sweep developed countries into a recession and buffet other economies if they persist. If factors other than exchange rates are behind the US current account deficit, they might continue to stymie attempts to put US exporters back on their feet. In addition, most forecasters see little room for US policymakers to maneuver if the domestic economy begins to slip. Tokyo and Bonn, meanwhile, appear intent on waiting for proof of a downturn before taking serious action to stimulate their economies. A sharp appreciation of their currencies probably would speed them up, but Tokyo's fiscal tightness and Bonn's overall cautious policies run the risk of choking off growth in their own countries. This would fuel protectionist sentiment among their trading partners and induce a contraction in world trade. Whatever its source, a developed country slowdown undoubtedly would have serious implications for the entire world economy. 25X1

Appendix B

Impact of an Interest-Rate Decline

We estimate that a 1-percentage-point fall in interest rates would reduce total Latin American debt service during the first year by over $2.5 billion. Because of a $500 million fall in interest earnings on Latin floating-rate deposits, the net improvement in the overall Latin American current account position would be about $2 billion. The full effect of an interest-rate decline would not be felt immediately because base interest rates on floating-rate notes generally are set only every three to six months.

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