Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

EXECUTIVE SECRETARIAT

Routing Slip

TO:

		ACTION	INFO	DATE	INITIAL
1	DCI				
2	DDCI		X		
3	EXDIR				
4	D/ICS				
5	DDI				
6	DDA				
7	DDO				
8	DDS&T				
9	Chm/NIC				
10	GC				
11	IG				
12	Compt				
13	D/EEO				
14	D/Pers				
15	D/OEA				
16	C/PAD/OEA				
17	SA/IA				
18	AO/DCI				
19	C/IPD/OIS				
20	NIO/ECON		✓		
21					
22					

SUSPENSE _______________ Date

Remarks:

25X1

Executive Secretary

4/27/83

Date

3637 (10-81)

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

CONFIDENTIAL
Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

Executive Registry
83-1457/1

April 27, 1983

MEMORANDUM FOR THE HONORABLE
WILLIAM P. CLARK
ASSISTANT TO THE PRESIDENT
FOR NATIONAL SECURITY AFFAIRS

Subject: SIG-IEP Review of U.S. Approach to the International Debt Problem

As directed by NSSD 3-83 and your memorandum of March 14, 1983, the Senior Interdepartmental Group on International Economic Policy has completed its review of the U.S. approach to the international debt problem. Its report is attached.

Donald T. Regan

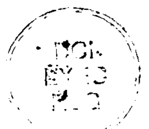
cc: The Vice President
The Secretary of State
The Secretary of Defense
The Secretary of Agriculture
The Secretary of Commerce
The Director, Office of Management and Budget
✓The Director of Central Intelligence
The United States Trade Representative
The Assistant to the President for Policy Development
The Chairman, Council of Economic Advisers

Attachment
As stated.

L-118

CONFIDENTIAL

NSSD-83



Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

CONFIDENTIAL

DECLASSIFY: OADR

April 25, 1983

APPROACH TO THE INTERNATIONAL DEBT PROBLEM

A POLICY OVERVIEW

Final Report of the
Senior Interdepartmental Group on
International Economic Policy

CONFIDENTIAL

DECLASSIFY: OADR

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

CONFIDENTIAL

NSSD-3

APPROACH TO THE INTERNATIONAL DEBT PROBLEM, A POLICY OVERVIEW

Executive Summary

1. Dimensions of Debt Problem and Implications for the United States

   A. Mandate and Previous Work
   B. Scope of Problem
   C. Implications for United States

2. The Current Strategy and Operational Difficulties

3. Basic Assessment

   A. Progress in Applying the Strategy
   B. Future Prospects and Potential Problems

      i. Macro-economic
      ii. Political
      iii. Trade

   C. Alternative and Fundamentally Different Approaches

4. Conclusions

   A. Prospects for Success of the Strategy
   B. Suggested Measures to Strengthen the Strategy

      i. Trade Policy
      ii. Strengthening Framework to Deal with Debt Problem
      iii. Improvement of Data Systems and Dissemination

   C. Future Work

Appendices: (Executive Summaries of Working Group Reports*)
   A. Political and Security Considerations
   B. Implications of Alternative Scenarios for Global Recovery and U.S. Domestic Economy
   C. Implications for International Trade and Trade Policy
   D. Alternative Proposals for Dealing with the Debt Problem

   (Other)
   E. Evolution of the G-10 Approach to Debt Problems

*Reports circulated separately.

CONFIDENTIAL

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Executive Summary

Although the first phase of the international debt problem on the whole has been successfully dealt with, major difficulties requiring complex U.S. policy choices can be expected in the coming months as debtors implement adjustment plans and as external financial difficulties reach crisis stages in additional countries.

- Additional countries, especially oil exporters like Venezuela and Nigeria, are seeking debt relief and other financial assistance.

- Banks here and abroad will continue to be reluctant to add to their exposure in a long list of countries.

- The combination of internal adjustment and loss of financing may cause a further contraction of debtor country imports and consequently of U.S. exports.

Problems such as these will require difficult U.S. policy decisions, sometimes involving tradeoffs among policy objectives. Specifically, the U.S. Government may have to consider:

- Whether and how to meet further requests for significant bilateral emergency financial assistance.

- To what extent continued cooperation from other governments, central banks, and the private banking system can be counted on to assure availability of needed financing.

- In particular, how to deal with the likelihood that governments will have to increase their assistance in the face of reluctance of banks to maintain their high relative share of financing, and with associated problems of burden sharing.

- How to react if debtors resort to export subsidies in lieu of adequate domestic economic stabilization in order to achieve balance of payments objectives.

- How to deal with the possible need of some debtor countries to renegotiate their IMF-approved stabilization programs.

There appears to be no good alternative to handling problems such as these on a flexible, country-by-country basis. More radical proposals to deal at one stroke with the short-term liquidity problems faced by all or groups of debtor countries fail to discriminate among country situations, which differ enormously, and generally would weaken both the incentive of borrowers to adjust and the willingness of creditors

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

to continue lending, as well as entailing costs to governments of prohibitive economic and political dimensions. Moreover, these alternative proposals appear to have no official support in the industrial countries and as yet little support even in those LDCs with large debt problems.

We believe, therefore, that adapting the current strategy to changing circumstances is the best way to proceed. Improvements should be sought, however, in the availability of data on debt problems and in U.S. and international monitoring procedures, including exploration of use of the G-10, G-5, the IMF, or other fora to monitor and review debt and financing problems.

The debtors' ability to resume economic growth while servicing their debt depends mainly on a rapid expansion of exports, which in turn will depend on the strength and soundness of their internal adjustment programs. This growth of exports can be achieved if there is reasonable, sustained growth in the industrial countries, as seems likely, and if their markets are kept generally open. Nevertheless, there are uncertainties, including risks of political instability in countries of special concern to the United States:

- The Western recovery may not be as strong and sustained as expected;
- Major oil exporters, such as Mexico and Venezuela, face the prospect of a painful, multi-year adjustment process if oil markets remain soft;
- A few LDCs, Brazil in particular, may have to accept several years of austerity if they are to reduce substantially the debt service burden;
- There will be political resistance in the industrial countries to a rapid expansion of imports from LDCs.

In the debtor countries, political resistance to necessary but distasteful adjustment may build over time and become better organized. Although the odds are strongly against a full-scale revolution or an outright repudiation of debt in any of the major debtor countries, there is a risk of both political disorder in the major countries and attempts to achieve rescheduling agreements that provide relief from some or most of the interest payments due, e.g., by capitalizing them.

In view of these uncertainties and the large U.S. economic, political, and security interests at stake, the United States, in cooperation with other major industrial countries, needs to closely monitor evolution of the international debt problem. The operation of the strategy in the near-term is likely to be turbulent. It should be assessed on a continuing basis, and adaptions made flexibly in light of specific problems, in the framework of the basic approach. Success in the medium-term

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

will depend importantly on effective adjustment by borrowers and achievement of reasonable, sustained growth in the industrial countries. The prospect for such growth now appears good. Should this prospect not materialize in the medium term, examination of basic alternatives to the strategy might be warranted. But persistence and policy predictability will be required to permit the strategy to work; attempts to undertake further work on basic alternatives within the U.S. Government in the nearer term would raise unwarranted expectations. This could create disincentives for borrowers to implement the economic adjustments that are essential and for banks to supply the financing that will be required while adjustment takes place, undermining fundamental elements of the strategy.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

U.S. APPROACH TO THE INTERNATIONAL DEBT PROBLEM A POLICY OVERVIEW

1. DIMENSIONS OF THE PROBLEM AND IMPLICATIONS FOR THE UNITED STATES

A. Mandate and Previous Work

This study was mandated to review the U.S. approach to the international debt problem outlined as follows: "The current international economic environment and financing constraints are requiring substantial economic adjustments by borrowing countries entailing in part reductions in the pace of economic growth, and inhibiting their ability to adjust through export expansion. The consequences and management of the current world financial situation affect other areas of critical concern to the United States and other industrialized democracies, including the international trading system, economic recovery and employment prospects and international political stability."

The starting point for this review is the analysis and strategy developed under the auspices of the SIG-IEP entitled International Debt Situation and Its Impact on the World Economic/Financial System. Using this as a base, four working groups were established to consider and prepare reports on: (a) political and security considerations; (b) implications of alternative scenarios for global recovery and the U.S. economy; (c) implications of the debt situation for international trade and trade policy; and (d) alternative proposals for dealing with the debt problem. Executive Summaries of the reports prepared by each working group are attached.

B. Scope of the Problem

This memorandum provides a policy overview in the context of a burgeoning increase in the debt of a number of developing countries and their inability to service it. This includes borrowing from both official and commercial sources. In recent years, the share of bank lending increased, and there was a run up in the short-term debt of many major non-OPEC developing countries (LDCs). By way of historical perspective, new net borrowing by these countries from banks increased from a cyclical low of under $15 billion in 1977 to about $48 billion in 1981. By the end of 1982, the stock of debt owed to private Western banks by non-OPEC developing countries totalled about $270 billion, of which roughly $180 billion was owed by Latin America. If Venezuela and Ecuador (OPEC countries) are included, the Latin American debt to private banks exceeds $200 billion. U.S. banks have about 40 percent of total bank claims on these countries.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

In the 1970s, a combination of oil price shocks, inflation, ample liquidity, and ambitious growth policies added to the LDCs' debt levels. In the 1980s, high interest rates, world recession, reduced export earnings and disinflation in industrial countries served to increase the debt servicing burden of many LDC borrowers, which nonetheless had resisted taking necessary adjustment measures. The results were predictable. However, some countries, particularly in Asia, did make adjustment and are not currently experiencing debt problems; most of the countries in Latin America, East Europe and Africa did not begin adjusting until faced with a financing problem.

In the period 1976-1980, 11 countries completed debt relief negotiations with official and/or private creditors. Since then, 25 countries have completed such negotiations and another 5 to 10 countries are negotiating arrangements. The earlier restructurings involved smaller, low income countries (except Turkey). Those in 1982 included some of the largest borrowers (Mexico, Brazil and Argentina). Reschedulings in 1983 will include some OPEC members (Ecuador, Venezuela and probably Nigeria).* The exposure of U.S. banks to Mexico, Brazil and Argentina exceeds $55 billion. Bankers report that the only country in Latin America that is "current" with debt payments is Colombia. Eastern Europe (including Yugoslavia) is also having difficulties servicing debt, but the magnitude of the total commercial bank debt outstanding is less, about $65 billion; U.S. banks have less than ten percent of total bank exposure.

C. Implications for the United States

(i) Political and Security

In some cases, the adjustment effort required of the LDCs could so strain their political systems as to create pressures in key countries that could trigger civil unrest, possible changes in government, or adoption of policies inimical to U.S. interests. The seriousness of the potential impact will of course differ for each country. There is need to examine the potential of selective country-by-country U.S. responses for the furtherance of U.S. foreign policy and national security goals.

(ii) Macro and Financial

The difficulties experienced by some LDCs in servicing their debt in turn could pose problems for the U.S. economy in general and the financial system in particular. The attempts of LDCs to improve their trade balances have contributed to the temporary widening of the U.S. trade deficit, possibly with some effect in delaying the recovery. More important, the large exposure of major U.S. banks in all problem LDCs together

* See Appendix E.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

-- often exceeding 100 percent of capital -- means that, in the worst case, a crisis leading to de facto repudiation of debt by some major borrowers could threaten the solvency of major U.S. banks and, potentially, the stability of the U.S. financial system. Maintenance of the integrity of the financial system is crucial for the long-run health of the U.S. economy.

(iii) Trade

The international debt crisis has implications for both U.S. trade and the international trading system. For example, in 1982 U.S. exports to the six major debtors in Latin America fell by $8.7 billion and are continuing to decline. If financing is not available to permit smooth adjustment, the sharp drop in U.S. exports to those markets (which totalled $22.7 billion in 1982) will continue.

As for the implications for the trading system, there is some danger that the debtor countries will adopt further protectionist, discriminatory trade measures, although those countries obtaining IMF programs must agree not to adopt new restrictions or intensify existing ones. Any trend toward such measures would prompt protectionist actions by developed countries, setting back U.S. efforts to liberalize world trade.

2. THE CURRENT STRATEGY AND OPERATIONAL DIFFICULTIES

The core U.S. strategy is designed to deal with debt problems in a flexible manner. It is based on adjustment, reasonable economic expectations and financing adequate to allow orderly adjustment and avoid triggering political problems and reactions that could damage U.S. interests.

The IMF plays a key role in providing official medium term assistance to troubled borrowers, and its resources need to be increased.

Commercial banks, must also increase their own lending in borrowing countries following appropriate adjustment programs, though many are reluctant to do so.

Central banks and treasuries must be willing to provide immediate liquidity support, when necessary, to aid selected borrowers which are working out adjustment programs with the IMF, but, with the likely reduction in the growth of commercial bank lending, official and governmental lenders will be called upon to provide a larger proportion of total finance to LDCs.

The need in the U.S., Europe and Japan for resumption of credible economic expansion is the final element in the existing U.S. strategy to deal with LDC debt problems. As a concomitant,

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

protectionism must be avoided to enable LDCs to find export markets for their products.

Operational Difficulties

As noted, the magnitude of the difficulties far overshadows those experienced in the 1970s, and there is no single formula that meets every debtor's case or needs. Several more countries are likely to seek rescheduling, IMF assistance, and/or bridge financing. A number of those which have established IMF adjustment programs will probably fail to meet some IMF targets.

There will be a series of "phase two" reschedulings that will put strain on the willingness or ability of the existing private sector participants to further increase exposure to troubled borrowers. However, if they did not increase exposure, they would be less likely to receive interest payments and would probably have to increase provisions for bad debt, thus suffering reduced profits.

In some LDCs, the public sector has received preferential access to foreign exchange for servicing external debt. The private sector has not been able to obtain foreign exchange to keep current even on interest payments. This development obviously is making foreign lenders and suppliers reluctant to advance new funds. It also raises concern about the private sector's future access to funds, vis-a-vis public sector borrowers.

Shortfalls in supplier credits and trade finance lines could affect country financial packages and handicap the ability of some debtors to carry out normal trade transactions, weakening their ability to fulfill key IMF targets.

Belt tightening -- adjustment -- by LDCs cannot be avoided, but there also could be requests for additional financing for troubled LDC borrowers that might have to be met from official sources (governments, IMF, IBRD, etc.).

If the alternative to such financing is even further belt-tightening, there is a danger that there could be still greater pressure for adoption of non-market orientated trade policies.

Up to the present, the major countries have coordinated their approach to debt problems in an ad hoc fashion centered on the Paris Club in which official and officially-guaranteed credits are rescheduled. The limitations of the Paris Club approach began to be visible in the case of Turkey in 1980, and became more apparent in the case of Poland in 1981. Then, in 1982, the problem of Mexico and Brazil required an approach by the major countries completely separate from the Paris Club

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

because of the relative unimportance of official credits compared to commercial bank credits. (A more detailed discussion of the evolution of this approach is provided in Appendix E.)

3. BASIC ASSESSMENT

A. Progress in Applying the Strategy

The initial elements of the debt strategy have been successfully meshed for several major debtors. Adjustment programs have been initiated, largely in cooperation with the IMF, and financing arrangements have been made by official institutions and private lenders.

In debtor countries, IMF agreements have entered into force. In Mexico, Argentina, Brazil, Yugoslavia and elsewhere, adjustment efforts are underway, but even more countries are encountering problems in meeting their payments and obtaining new commercial bank borrowing.

Agreement has been reached on a significant increase in IMF quotas and GAB resources. The U.S. administration is making a major effort to obtain Congressional approval -- which won't be easy. IMF quotas will be increased by 47 percent, an increase from SDR 61 billion to SDR 90 billion (in current dollar terms, an increase from $67 billion to $99 billion). The proposed increase in the U.S. quota is SDR 5.3 billion ($5.8 billion at current exchange rates) representing 18 percent of the total increase.

The Group of Ten, working with the IMF's Executive Board, has agreed to an expansion of the IMF's General Arrangements to Borrow from the equivalent of about SDR 6.5 billion at present to a new total of SDR 17 billion, and to changes in the GAB to permit its use, under certain circumstances, to finance drawings on the IMF by any member country. Under this agreement, the U.S. commitment to the GAB would rise from $2 billion to SDR 4.25 billion (equivalent to about $4.7 billion). The target date for entry into force of these agreements is November 1983.

This expansion and revision of the GAB offers several important attractions and, as a supplement to the IMF's quotas, greatly strengthens the IMF's role as a backstop to the system: GAB credit lines are primarily with countries that have relatively strong reserve and balance of payments positions. They can provide more effectively usable resources than a quota increase of comparable size. Since the GAB will not be drawn upon in normal circumstances, this source of financing will be conserved for emergency situations. By demonstrating that the IMF is positioned to deal with severe systemic threats, an expanded GAB should provide confidence to private markets to

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

ensure that capital continues to flow, thus reducing the risk that the problems of one country will affect others.

Official balance of payments assistance on a bilateral basis from governments has also been provided in some cases as a supplement to IMF programs.

With commercial banks, there is a new wrinkle; they are being called on to agree to new commercial lending in conjunction with IMF programs. Our estimates suggest a decline in the growth of net new commercial bank lending to non-oil developing countries, from about $48 billion in 1981 to $20-25 billion in 1982. The outlook for net new bank lending in 1983 to these countries is in the $20 billion range, of which over half -- about $11 billion -- already appears spoken for by Mexico ($5 billion), Brazil ($4.4 billion) and Argentina (about $1.5 billion). The IMF program in Yugoslavia will require roughly another $600 million in new bank lending.

Unfortunately, some banks in Europe, possibly Japan and U.S. regionals, have been unwilling even to maintain existing exposure. As a result, other banks have had to increase their exposure even more in order for the various adjustment programs to be successful. There is a burden sharing problem: among banks; between banks and official lenders; and among official creditors.

Some Comments on Bank Lending

-- Most current data from the Bank for International Settlements (third quarter 1982) show a pickup in international interbank market operations -- the gross aggregates -- but a sharp slowdown in underlying expansion of lending outside the industrialized countries of the immediate BIS area (from $20 billion in second quarter to $4 billion in third quarter. LDCs are having an increasingly difficult time in holding or obtaining interbank deposits; their run-off has pushed Brazil and Yugoslavia into liquidity problems. LDCs are also having trouble in obtaining new loans.

-- Exporters are significantly scaling back the volume of supplier credits granted to buyers in financially-troubled developing countries. Apart from placing critical export targets in further jeopardy, a cut in supplier credits could lead to an increased need for external bank loans.

-- More reschedulings can be expected, including additional countries or likely "second phase" difficulties; some disturbing developments should be anticipated, but action to deal with them must by nature be on a case-by-case basis, although within the context of the main elements of the existing strategy.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

-- In addition to rescheduling, commercial banks where justified are encouraged to increase exposure -- i.e., in the context of IMF programs and meaningful domestic adjustment programs in debtor countries.

Some banks have already written off portions of their loans to Poland, Zaire and the Sudan. The extent of writeoffs to these and other countries may increase. However, bank regulators may have to make some allowance for loans by banks to problem debtors that are made in conjunction with IMF adjustment programs. Otherwise, the banks' managements could reach a point where they no longer sanction such loans, given the obvious deterioration in many countries' economic performance and foreign exchange generating capacity.*

-- Some decline in the growth of commercial bank lending is a natural concomitant to reduced LDC deficits, lower inflation and interest rates, and increased banking prudence, but substantial financing gaps are expected to develop that will require further tightening of LDC adjustment programs and/or increased official lending.

The likely increase in government involvement will bring with it a greater degree of influence over commercial bank lending decisions. Governments will not willingly allow commercial banks to reduce the growth or levels of their exposure to LDCs while official lending is being increased. Experience with the strategy points up the need for a clear idea of what constitutes "fair burden sharing." For the same reason, commercial banks will increasingly insist on appropriate levels and categories of official lending.

Central banks and Treasuries have been willing to engage in short-term bridge finance on a selective basis, but the availability of these funds may be limited in the future.

U.S. economic recovery is well underway, and there are signs of an upturn in other key OECD countries. Several recent developments will be helpful in easing LDCs' debt service problems. Interest rates have fallen substantially since last autumn, which should reduce the interest payment burden. Finally, prices of industrial raw materials, a major export item for many LDCs, have risen rather sharply so far this year and are likely to continue to rise in the near term.

* There is considerable desire in Congress for legislation parallel to the IMF quota/GAB legislation which would impose limits on foreign lending and require other measures in the regulatory area. On April 11, the bank regulatory agencies submitted to Congress a package of measures they proposed to institute so as to take these concerns into account without legislation, but they were also asked to prepare, and have prepared, draft legislation.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

However, the debt problem is not resolved and will be with us for some time. Further restructuring in some countries will be necessary. Already, questions are raised about the ability of Argentina and Chile to meet their IMF targets. An upturn in the world economy has not yet taken firm hold; lower oil prices, while generally beneficial and counter-inflationary, will help most problem debtor countries, but severely worsen the situation in a few. Case-by-case analysis rather than generalization is needed.

The most important element in the strategy is adequate adjustment by the borrowers; without it, there cannot be an improvement in their situations. Yet, they don't want to restrain their growth or take unpopular domestic measures.

The debt burden of LDCs will engender political problems. Venezuela, for example, has proposed a debtors' conference. It is unlikely that a coordinated debtors' moratorium will occur or that a major borrower will repudiate debt; the degree of interdependence among nations is too great. The result for the borrower would be barter and autarky, but the idea of repudiation has appeal in some political quarters in Latin America.

There obviously is room for improvements and refinement within the parameters of the strategy, such as greater coordination among creditors and strengthening cooperation between trade and finance officials. Moreover, some observers question whether existing financing will be adequate and the degree to which a higher percentage of official support will be needed; others suggest that the strategy as presently structured may not result in a satisfactory outcome and that supplementary contingency planning is therefore required.

In sum, however, the strategy so far has worked; it has contained the damage and started the major debtors on adjustment programs in connection with IMF and other official lending.

B. Future Prospects and Potential Problems

(i) Macroeconomic

Among alternative strategies, the one chosen is agreed on as offering the best prospects of a satisfactory outcome, although this result is by no means assured. There will be continued problems in implementing it, at least through the end of 1984.

In 1983 and 1984, most observers agree that many adjustment programs and financial arrangements will have to be modified. While substantial progress has been made in meeting IMF conditions, there is a high probability that both Brazil and Mexico

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

will require additional financing in 1983. Failure to meet internal targets is likely for several countries. The result will probably be renegotiation of IMF agreements and further rescheduling of bank debt. There is always a risk, however, that such renegotiations will not succeed because of unwillingness of countries to make adjustment or of creditors to provide sufficient additional liquidity.

In the medium term (1985 through 1987), prospects for a substantial improvement in financial positions of major debtors are quite good. The major reason for this is the expectation of a sustained recovery in the industrial countries; as slack capacity is taken up, these countries should grow at around 3-4 percent for several years, allowing rapid growth in the exports of major debtors provided that there is not a turn towards protectionism. Medium term scenarios suggest that, with an industrial country recovery and growth in the range of three to four percent, growth in exports will be sufficient to allow both a steady reduction in debt service ratios and a resumption of growth in debtors, albeit at rates below that of the 1970s. Failure of the industrial countries to achieve a sustained recovery, on the other hand, would require major revision of the debt strategy.

(ii) Political

A primary continuing concern is the effect of the debt problem on the political situation in debtor countries. Many of the high debt countries experienced rapidly rising living standards during the 1970s. They have already taken sharp cuts in these standards, and will take further cuts in 1983. Even with a resumption of moderate growth, it could take many years before per capita consumption in Brazil and Mexico reaches its pre-crisis levels.

The cumulative effect of this downturn in economic performance could be political instability. The longer the economies of the debtors remain depressed, the greater will be the chances of major political changes and unrest in these countries. As signs of political resistance and unrest multiply, it will become increasingly difficult for the IMF to hold the debtor countries to their commitments. Although most of the major LDC debtors have authoritarian governments, they nevertheless must take domestic political interests into account in order to reduce the risks of violent unrest and to build popular support.

The above comments pertain primarily to Latin America. The political dimensions of the debt problem are different in Eastern Europe. The impact on the U.S. economy of Eastern European debt problems is minimal.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

(iii) Trade

Even if the strategy results in a satisfactory outcome, the U.S. trade balance with the countries experiencing debt-servicing problems will deteriorate further. As a result, the Administration will face pressures to restrict LDC imports and to facilitate exports. U.S. efforts to liberalize world trade and investment will be made more difficult. To the extent the strategy is unsuccessful in making possible smooth adjustment by the debtor countries, these trade problems will be intensified.

If the six major debtors in Latin America (Mexico, Brazil, Argentina, Venezuela, Peru, and Chile) hit their trade targets, the U.S. trade balance with these countries will deteriorate by at least $5 billion in 1983.* The dislocation in U.S. export and import-competing sectors caused by this swing will generate protectionist pressure.**

To date, such pressures have been muted because most of the trade swing has been due to reduced U.S. exports, and exporters are less prone to call for retaliatory actions than import-competing industries. However, U.S. exporters have suffered not only due to lost sales, but because of problems in receiving payments for goods already shipped.

If adjustment programs in the LDCs are successful, the future deterioration in the U.S. trade balance is likely to be

---

* Department of Commerce reports that, due to financing problems, Mexico, Brazil and Argentina are currently importing at levels well below those implied by IMF adjustment programs. Besides causing further contractions in trade, this may adversely affect each country's ability to sustain export capacity at the necessary levels. The Defense Department concurs. Other agencies agreed that such a trend in their imports, if it continued, could adversely affect export capabilities but that it is too early to extrapolate full year 1983 results and that the link between imports and export capability is difficult to specify.

** OMB believes that focusing on bilateral trade with specific LDC debtors is too narrow a measure of the impact of current problems on the U.S. economy. Offsets are possible in world-wide trade, e.g., a reduction in exports to one country, or group of countries, can easily be made up by higher exports elsewhere. While these offsets may be small over the next year or so, they are likely to be quite significant over the longer term. Other agencies agree with OMB that bilateral trade analysis can be misleading but believe: (a) concurrent declines in import demand by many LDCs will reduce total demand for U.S. exports; and (b) there is no automatic offset to this decline.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

primarily on the import side, thereby heightening pressures. Moreover, since the export subsidies and the import restrictions now being used by countries with large external debt may be grounds for the imposition of import restrictions under U.S. trade laws, the Administration will have to deal with specific requests to restrict imports from the debtor countries. In some cases, such as foreign subsidies, the President has virtually no flexibility. Increases in U.S. trade barriers as a result of these laws will be seen by the debtors as protectionist U.S. measures hampering their adjustment measures. There is thus a strong likelihood of trade conflicts with the debtors.

Contractions in the availability of trade finance will lead to difficulties in normal trade transactions and to the use of such measures as countertrade and clearing arrangements.

Another area of tension will be international trade discussions. The continuing vulnerability of the debtors, which include some of the major LDC traders, will make them more strident in demanding special treatment for LDC exports, and even more wary of U.S. initiatives to negotiate further trade liberalization (such as the proposed North-South round) and to extend GATT disciplines.

C. Alternative and Fundamentally Different Approaches

A number of proposals have been made in recent months for alternatives for dealing with the current debt situation, some of which are perceived as supplemental to the current strategy, and some of which address perceived shortcomings of the basic strategy. As such, these proposals can be separated into two categories: (a) those that deal with the immediate liquidity problem faced by debtor countries and which might be needed should the current strategy fail; and (b) those that deal with the longer-term structural deficiencies which some believe have been highlighted by the current crisis, but which are not addressed by the current strategy.

The proposals in the first category would provide temporary debt relief, or lengthen the maturity of existing debt, on the assumption that once economic recovery is underway in the OECD countries, debtor countries will be able once again to service their debt. These proposals are somewhat lacking in that they are not selective, treating all LDCs equally rather than on a case-by-case basis. In addition, several of these proposals neglect or miscalculate the potentially adverse effect on commercial banks, which is especially relevant in light of the element of the basic strategy which calls for maintenance of commercial bank lending.

Proposals made in the longer-term structural context assume that, even with an upturn in world economic activity, many debtor countries will be unable to meet their debt payments.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

These proposals range from relatively simple mechanisms, such as encouragement of a secondary market for LDC debt, to creation of new institutions, such as a developing country debt corporation, to entirely new approaches to debt restructuring, such as a system of Exchange Participation Notes.

The shorter-term and some of the longer-term proposals lack country-by-country selectivity and adequate assessment of the impact on commercial banks. In addition, the longer-term proposals have more serious administrative difficulties and political complexities than the short-term proposals, which make successful negotiation and implementation particularly unlikely. Although there is broad support for reform among the LDCs, none is pushing for radical measures, and there is no evidence of official interest in industrial countries for any of these schemes.

Finally, the alternative solutions proposed to date assume that the creditors must bear a substantial part of the principal burden of enabling LDCs to survive the current debt crisis. As such, these alternatives would entail a departure from the present strategy's premise that the crux of any effort to remedy the debt problems of LDCs in a lasting way must be domestic adjustment efforts by the countries themselves.

4. CONCLUSIONS

A. Prospects for Satisfactory Outcome of the Strategy

In the near term (through end-1984), the working out of the debt strategy, although it has a reasonable prospect for a satisfactory outcome, is likely to be turbulent. Some countries may miss targets in IMF-sponsored adjustment programs, and additional financing will probably be required from both official (i.e., from governments as well as the IMF) and private sources. The risk of an unravelling of the strategy cannot be dismissed. The most likely outcome, however, is that a series of case-by-case measures will succeed in avoiding a global crisis.

In the medium term (1985-1987), prospects for an improvement in debtors' financial positions are quite good, under the assumption of a satisfactory outcome in the near term. A recovery in industrial countries should allow rapid growth in LDC exports, providing an opportunity simultaneously to reduce debt service ratios and resume economic growth. This estimate will, however,

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

change sharply if industrial countries fail to achieve a sustained recovery. And even with a steady recovery there will be a risk of political instability in LDCs.*

B. Suggested Measures to Strengthen Strategy

(i) Trade Policy

Domestically, the Administration, recognizing the need for the debtors to improve their current balance, should continue to emphasize its commitment to maintaining an open U.S. market, while assuring U.S. interests that U.S. trade laws will be applied fairly. Given general U.S. trade policy and limitations imposed by trade law, special trade treatment should not be given to countries because of debt difficulties.** Rather, decisions involving trade with debtors should continue to be made on traditional trade policy grounds such as the standards in our countervailing duty law.

Internationally, our trade policy objectives are (a) to discourage any increase in market distorting import protection and export subsidies by the debtors or the developed countries that could create long-term distortions in world trade, and (b) to ensure that the liberalization that should be possible once the adjustment programs begin to work does in fact take place and becomes the basis for further liberalization of world trade and investment, and improvements in the trading system.

With these goals in mind, the United States is proposing joint meetings of trade and finance officials to re-emphasize the link between their areas of responsibility, emphasizing the importance of adequate finance to avoid unnecessary trade restrictions and the need to avoid protectionism.

The Summit and the OECD Ministerial also will be used to discourage protectionism and to begin to lay the groundwork for future liberalization. In addition, the United States will work on improving coordination among the IMF, World Bank, and GATT on trade matters.

---

* The NSC and Defense Department believe that medium term prospects for an improvement in debtors' financial positions are poor, due to new bank attitudes and regulations, the continuing inability to fund past balance of payments loans and the additional burden of repayment of bridging and refinancing loans.

** USDOC feels that the steps these countries will take to meet the financial objectives of the adjustment strategy (trade balance improvements) could increasingly result in policies that conflict with U.S. trade policy objectives (i.e., mandated counter-trade, import restrictions, export subsidies, etc.).

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

(ii) Strengthening The Framework for Managing Debt Problems

Procedures developed over the years for coordinating official measures to address the debt problems of individual countries -- largely in the Paris Club framework for official debt reschedulings -- have worked reasonably well most of the time. Since mid-1982, however, there has been a sharp increase in the number of debt problems, in their magnitude and potential significance to the international monetary system, and in their complexity. The approaches worked out (and still being worked out) in the Mexican, Brazilian, Argentine and Yugoslav cases, for example, reflect the dominant role of private financing and the marginal role (if any) played by official reschedulings of the type traditionally handled in the Paris Club framework. To one degree or another, these cases have involved arrangement of short-term "bridge" financing by monetary authorities in the major countries; the negotiation and adoption of major IMF programs; temporary stand-stills on principal payments on commercial bank debt; longer-term restructurings or reschedulings of maturing commercial bank debt; provision of net new financing by the commercial banks; and programs of extraordinary longer-term official financing to complete the financing package.

Rapid responses, by both monetary authorities and commercial banks, have frequently been required; the complexity and interrelated nature of the financing packages have at times made it difficult to proceed on individual elements without assurance that all elements were reasonably in place; and there have been frictions among governments, among commercial banks, and between governments and banks related to issues of "burden sharing." The Paris Club framework* is not appropriate to these cases and has not been used; and the increasing number of official debt reschedulings and the need at times to integrate them into more complex financing packages raises questions about the continued ability of the Paris Club structure to manage official reschedulings.**

---

* The initial purpose of the Paris Club was to provide an informal process or procedure -- not creation of an institution, which was not wanted -- to facilitate the negotiation of debt relief loans extended by or guaranteed by the leading creditor governments (i.e., basically the G-10). The Government of France offered to provide meeting facilities and secretarial services for such negotiations, and the other G-10 countries accepted.

** The State Department believes that this conclusion is not justified. The Paris Club has not been used in these cases because the borrowing countries did not request rescheduling of their official debt. There is no evidence that the increased number of reschedulings has taxed Paris Club resources; nor is the need to integrate official reschedulings into larger packages germane to the issue of the Paris Club's ability to manage official reschedulings *per se*. In State's view, the Paris Club has functioned efficiently, and such problems as do exist (e.g., data collection) would not be solved by a change in venue.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

These problems, and the expectation that there will be similar new cases and/or repeats of old cases, have suggested the adoption of more systematic arrangements among the major creditor countries for anticipating future problems, dealing with them as they arise, and assessing the management of individual cases. The existence of more formal arrangements could provide greater assurance to the markets that individual debt problems would be managed smoothly, and thus inhibit actions by the commercial banks that would precipitate such crises. Such arrangements could provide a channel for rapid official transmittal of information and decision-making, for communications between the IMF and the monetary authorities of the creditor countries, and, possibly, for organized communications between official creditors and the private banking community. At the same time, in considering the establishment of more systematic creditor arrangements to address debt issues, there is a need to avoid creating incentives for undue recourse to such arrangements; to maintain the capacity for speed and flexibility in dealing with problem cases; and to assure maintenance of the IMF's role as the central source for official balance of payments financing.

On the basis of these considerations, it is suggested that the United States explore with officials of other major creditor countries possibilities for more organized creditor consultations and decisions on key debt issues, as they relate both to questions of general policy approach and to individual problem cases. The G-10 is one possibility, consisting of the finance ministries and central banks of the United States, Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom and recently Switzerland. This group includes the countries with principal interests in and responsibilities for the international monetary system; those in a position to provide the bulk of any official balance of payments financing that may need to be mobilized; and those countries whose banks are most involved in international lending. The G-10 is also the entity for any decisions on activation of the General Arrangements to Borrow.

Other possibilities include the "G-5", a smaller and less formal group consisting of France, Germany, Japan, the United Kingdom and the United States, which meets from time to time at deputies and ministers (including central bank governors) levels to consider current international financial and economic issues and attempt to formulate coordinated views within the group for use in larger forums; and reliance on the IMF as a main locus for coordination among creditors.

Among the steps that could be pursued by creditors are the following:

-- Review the various data collection efforts under way in the IMF, the BIS, the OECD and the World

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Bank in the lending/debt area; determine whether there are significant omissions in the collection effort and recommend any desirable improvements.

-- Monitor and assure rapid transmittal to creditor governments of relevant information, with a view to anticipation of emerging problem cases and providing data needed for decisions.

-- Review developments in the bank regulatory and supervisory area and problems of consistency in regulatory treatment that may need to be addressed.

-- Review the experience with individual cases, and consider policy questions arising from such reviews.

-- Coordinate creditor approaches to individual problem cases, maintaining contact as appropriate with the IMF and other major elements of borrowers' financing arrangements.

The need for speed, discretion and flexibility in decisions on financing arrangements in some cases may argue for a division of responsibility: for example, use of the G-10 structure for actions in the data and review area, and contacts focused within the G-5 or the IMF for coordination of creditor action on financing programs.

(iii) Improvement of Data Systems and Dissemination

A number of developments are in train that will increase the quality and availability of information on debtor countries which the U.S. should strongly urge G-10 members to support.

Efforts to construct debt profiles of individual countries are presently handicapped by the difficulty in synthesizing the various reporting systems in place. For instance, data collected by the World Bank generally leave out all short term debt, and also omit medium/long-term debt of the private sector that is not guaranteed by the debtor's government. The IMF is pursuing a major effort to identify and eliminate the gaps in reporting, but it will not be possible to achieve rapid progress.

Availability since the mid-1970s of information on bank lending by banks in the BIS area has added a new dimension. A large part of the IMF's effort is aimed at expanding the reporting area beyond the participating BIS countries. One of the BIS systems will be shifted to a "consolidated" basis of reporting, which means that countries report the global position of their indigenous banks wherever located, rather than only those banks within their borders. This system will improve our ability to identify the country at risk in bank lending.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

The newly formed Institute for International Finance (IIF) is expected to devote most of its efforts to improving the flow of information from individual debtor countries to the banking community. The IMF should be encouraged to make available to the banking community non-sensitive data on debtor countries. Such data flows should entail much more timely information than what is now collected by the World Bank from these countries. An important point is that, in addition to debt data, statistics on growth, prices, trade/current account balances and trade finance are essential elements in making appraisals of a country's prospects.

C. Future Work

The evidence is that the existing strategy is working, although some aspects of that strategy could, and should, be strengthened as indicated above. To date, no proposals have been made which could improve on the current strategy, in particular as we have recommended it be strengthened. Specifically, none of the alternative proposals meets the fundamental criteria of a desirable strategy -- that they deal with the problem on a country-by-country basis; that they involve the commercial banks in such a way as to encourage their continued participation in the international financial system; and that administrative and political difficulties not be such as to render negotiation or implementation virtually impossible. More fundamentally, none of the alternatives proposed sufficiently meets the underlying criteria of encouraging LDCs to adjust. Some alternatives would, in fact, enable LDCs to avoid adjustment altogether.

This is not to suggest that the strategy being followed is certain to produce acceptable results. As noted above, the operation of the strategy in the near term is likely to be turbulent. It should be assessed on a continuing basis, and adaptations made flexibly in light of specific problems, in the framework of the basic approach. Success in the medium term will depend importantly on effective adjustment by borrowers and achievement of reasonable, sustained growth in the industrial countries. The prospect for such growth now appears good. Should this prospect not materialize in the medium term, examination of basic alternatives to the strategy might be warranted. But persistence and policy predictability will be required to permit the strategy to work; attempts to undertake further work on basic alternatives within the U.S. Government in the nearer term would raise unwarranted expectations. This could create disincentives for borrowers to implement the economic adjustments that are essential and for banks to supply the financing that will be required while adjustment takes place, undermining fundamental elements of the strategy.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Appendix A

Political and Security Considerations

Executive Summary

The adjustment effort required of the LDCs is placing an unavoidable strain on their political systems with implications for many of our foreign policy objectives, including matters of regional peace and security, North-South economic relations and cooperation with our European allies.

Of particular concern is the danger that the pressures on the political/economic systems of key countries could spark changes in governments, changes in policies, and/or changes in a country's ability to influence events. To the extent these countries are unable to resolve their problems, or find the solutions excessively painful, or perceive that the industrialized nations are unable or unwilling to provide needed resources, they may begin to look for alternative solutions inimical to U.S. interests.

For instance, in the Middle East, Egypt plays a key role in the peace process, but unless the Egyptian Government takes strong remedial action, it is likely to undergo severe balance of payments difficulties in the next few years. As a result, Egypt's economic difficulties are going to make its participation in the peace process more expensive for the U.S. and, if it is required to seek assistance elsewhere, possibly more unpredictable.

In the Caribbean and Central America, U.S. and Venezuelan foreign policy has coincided in recent years. Venezuelan aid has provided many countries of the region with much needed balance of payments support and has supported the move towards a democratic government in El Salvador. While Venezuela's current economic and debt problems probably do not affect that country's stability -- at least in the short run -- they will limit the resources available to Venezuela to continue to play its positive role in the region.

In addition many of the LDCs are going to look for solutions to their problems on a collective basis through changes in the international economic system. Pressures from the LDCs for greater concessions by the industrial nations on North-South issues are likely to increase, particularly if their debt situation remains unresolved. We can, for example, expect increased demands in UNCTAD for new and more generous commodity arrangements. We may also see increased demands for a debt moratorium perhaps unilateraly declared by the LDCs.

Many of the consequences of the current situation will be country specific. We will continue to receive many requests for assistance, and with a limited resource capability to respond to those requests we are likely to see increasing and often

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

unpredictable strains in bilateral relationships. Both the Philippines and Liberia may use their economic difficulties to try to extract a higher price for our facilities based in their countries. Even when our direct bilateral interests are less involved, we cannot be indifferent to the possibility that internal disorders arising out of economic difficulties in a given country could cause disruption in several others. Nor can we ignore the possibility that some governments might try to divert public attention from internal difficulties by external adventures. Nigeria is a possible candidate for the first concern, while Argentina is a good candidate for both possibilities.

A solution to these problems is beyond the abilities and resources of the United States and will reqire assistance from our allies.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Macroeconomic Aspects of LDC Debt

Executive Summary

Many developing countries now face serious problems in servicing their external debt. In large measure these problems are part of the severe worldwide adjustment to disinflation, which led to high interest rates and a decline in the price and volume of the LDC exports. However, some nations have come through the adjustment period relatively well, while others have fared more poorly.

The basic cause of individual difficulties lies in the failure of some countries to pursue sound fiscal and monetary policies. This led to extraordinarily high rates of inflation, not adequately offset by exchange depreciation, and a loss of competitiveness on world markets. When the external environment temporarily worsened due to disinflation in the industrial countries, the current account deficits of these countries widened. By 1982, private lenders became unwilling to finance further rapid growth in debt. As a result, a number of countries have sought official financing and/or rescheduling of private and public debt.

Short-Term Financing and Adjustment

Most problems debtors have entered into agreements with the IMF and their creditors. These agreements combine a plan for adjustment by the debtor with a financing package consisting of both official and private lending. Thus the initial elements of a resolution of the debt problem have been successfully meshed.

Some problems remain, however, and 1983 and 1984 are likely to be marked by many small crises. Several additional countries are likely to request IMF programs and/or rescheduling of private and public debt. At the same time, many of these countries with existing adjustment programs will probably fail to achieve their targets. Mexico and Brazil, in particular, are likely to require additional financing in 1983 even though they have made substantial improvements in their external position. Several countries will probably fall short on their targets for internal measures, such as reducing budget deficits.

It is likely that these problems will be worked out in a "second phase" series of reschedulings. Additional bridge financing may be necessary in some cases to avoid a payment moratorium during negotiations with the IMF or the commercial banks. The possibility of a serious unravelling of the agreements cannot be ruled out, but does not appear to be the most probable case.

Effects of the Economic Recovery in the Industrial Countries

A resolution of the debt problem requires effective adjustment by debtors, but it also depends on a sustained recovery

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

in industrial countries which allows debtors to increase their earnings of foreign exchange.

The Working Group concluded that the most likely medium-term prospect for the industrial countries as a group is for recovery compatible to that envisioned in the Administration forecast for the United States: that is, for several years of growth at about four percent, as slack capacity is brought into use. A recovery at this rate would permit a growth in debtor country exports sufficient to combine gradual improvement in debt service ratios together with a resumption of growth in the debtor countries themselves -- albeit slower growth than that of the 1970s.

A failure of the industrial countries to achieve a sustained recovery, on the other hand, would imply much slower export growth. A major revision of the current debt strategy, probably involving a significant writedown of debt, would then become inevitable.

Effects on the U.S. Economy

The major U.S. economic stake in the debt problem is financial. Major U.S. banks hold extensive claims on problem debtors, in some cases exceeding 100 percent of capital. A crisis leading, in the worst case, to a de facto repudiation of some substantial part of these claims could threaten the stability of the U.S. financial system.

The other major effect is the forced improvement in LDC trade balances, a substantial part of which is reflected in the U.S. trade balance and which thus contributes to the temporary widening of the U.S. trade deficit. LDC debt problems helped delay the beginning of U.S. recovery. If contractions in trade continue, the external sector could continue to be a drag on U.S. GNP growth. However, if the adjustment process is successful, LDC import should increase in the medium term from current levels.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Implications for International Trade and Trade Policy

Executive Summary

A. Trade Flows

-- The United States has important trade interests with major LDC debtor countries, most of which are Latin American.

-- Those debtors will have to improve their current account balances; the U.S. will absorb about half of the swing in their trade accounts, primarily because of the large U.S. share of Mexican trade. (The debt problems of Eastern Europe and Africa will more directly affect Europe.)

-- U.S. exports to Mexico, Brazil, and Argentina this year may be reduced more than envisioned under their IMF programs. Apparently, private, short-term trade finance is drying up, hampering U.S. exports, delaying or preventing payments to suppliers and increasing Exim bank loan loss risks. U.S. subsidiaries are having difficulty in importing necessary inputs.

-- There is therefore a possibility that the debtors will import considerably less than planned as part of IMF adjustment programs. Besides reducing U.S. sales, this may hamper the debtor's ability to export at necessary levels. The import and export problems are encouraging more distortive trade policy measures (i.e., counter trade, import restrictions, etc.).

-- Substantial trade adjustment took place in 1982. U.S. exports to the six major Latin American debtors were $22.7 billion, a decline of $8.7 billion from 1981. As a result, the overall U.S. trade balance with these countries declined from a surplus of $4 billion in 1981 to a deficit of over $4 billion in 1982.

-- In 1983, the projected increase in the trade deficit with those countries is about $5 billion, compared to projected overall increase in the U.S. trade deficit of about $30 billion.

-- As the adjustment programs in these countries take hold and the U.S. economy recovers, U.S. imports from these countries should increase while U.S. exports to them should recover more slowly.

-- Should there be additional adjustment or financing problems, the trade balance loss would be greater than the one projected above; U.S. exports could be hurt drastically, with trade deteriorating to a cash-and-carry basis or barter.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

B. Dangers of Present Situation

-- In their efforts to cut back imports and increase exports, the debtors could adopt additional import restrictions and export subsidies, further distorting trade. By creating vested interests, such measures threaten to become long term.

-- The increasing sense of vulnerability by major LDCs will make them more strident in their demands for preferential treatment and more wary of U.S. efforts to liberalize trade and improve the trading system (such as the proposed North-South Round and the services and high technology initiatives).

-- To date, the protectionist pressures against debtor LDCs have been muted, perhaps because most of the trade impact has been on the export side, and exporters are less prone to call for protection than are import-competing sectors. There are, however, increasing pressures to facilitate payment for exports.

-- As the debtors' adjustment shifts from import reduction to export expansion, protectionist pressures will be more likely, particularly if the LDCs don't begin to open their markets.

-- Since the export subsidies and import restrictions adopted by debtors may justify imposition of import restrictions under U.S. trade laws, the Administration will have to deal with specific cases filed under these laws. In some cases, such as those against foreign subsidies, the President has virtually no flexibility.

-- Should the U.S. take action to restrict their trade, the debtors will see this as U.S. protectionism frustrating their efforts to adjust.

-- There is thus a strong likelihood of increasing trade disputes on individual products with the debtors.

C. Policy Proposals

1. Domestic

-- The Administration, recognizing the need for debtors to improve their current account balances, should:

- continue to emphasize its commitment to maintaining an open market,

- assure U.S. interests fair application of U.S. trade laws.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

-- Given general U.S. trade policy considerations and limitations imposed by U.S. trade law, special trade treatment should not be given to countries because of their debt difficulties. Rather decisions involving trade with debtors should be made on traditional trade policy grounds. (If an important economic partner gets into major difficulties, this policy may have to be reconsidered.)

-- Trade objectives should be one element considered by the U.S. during the negotiation of bilateral bridge financing.

2. International

-- While continuing to pursue our broader trade policy objectives, our international objectives with high debt countries should be to:

° discourage increases in import protection and export subsidies by the debtors or developed countries that could create long term distortions in world trade,

° ensure that trade liberalization in debtor countries actually takes place once the adjustment programs create the necessary economic conditions.

° seize the opportunity created by the debtors' eventual trade liberalization to further open and improve the world trade and investment system.

-- We should get finance and trade officials of the major countries together to discuss the linkages between adjustment, open markets, and finance, thereby reemphasizing their mutual responsibilities to maintain the international economic system.

-- In addition, we should develop policy proposals:

° to improve GATT/IMF/World Bank cooperation,

° to liberalize North-South trade.

-- To discourage those LDCs experiencing debt-servicing problems from adopting additional trade distorting measures and to encourage liberalization when possible, we should use our influence in the IMF, GATT, and World Bank.

-- The OECD Ministerial and the Summit provide further opportunities to advance U.S. policy.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Alternative Proposals for Dealing with the Debt Situation

Executive Summary

The Working Group on Alternatives for Dealing with the Debt Situation reviewed a number of proposals for supplementing the current debt strategy, with a view towards describing those proposals and providing a brief analysis of the advantages and/or disadvantages of each. The Group was not requested to reach a final conclusion or make any recommendations regarding further work on any of the proposals. The Group did not examine all possible alternatives, but dealt only with certain proposals which have been cited frequently in recent months.

A brief description of each of the proposals studied by the Group follows:

(1) One Year Grace on 1983 Debt: Two proposals have been made, one for public debt and one for private debt. Both would provide a one or more year grace period on principal and possibly on all or some portion of interest, with a balloon payment due in 1989 or later.

(2) Retroactive Terms Adjustment: As already authorized under 1961 Foreign Assistance Act as amended, dollar-denominated principal and interest due on official U.S. assistance would be converted to local currency.

(3) Large-scale Debt Restructuring: Commercial bank credits to developing countries would be purchased at a discount by a new international instituion and rescheduled into longer-term claims at a reduced rate of interest.

(4) Buyout of Small Creditors: Official sources of finance would be used to pay off small regional banks anxious to withdraw from foreign markets.

(5) Exchange Participation Notes: Debtor country central banks would issue negotiable notes with repayment tied to future foreign exchange earnings.

(6) Developing Country Debt Corporation: Future lending to developing countries would be in part through a new quasi-public institution that would package and guarantee LDC obligations for sale to private investors, such as non-bank financial institutions.

(7) Safety-Net for Commercial Banks: Banks would contribute amounts equal to a small percentage of foreign loans to a central fund, to be drawn on if a loan goes bad and the bank encounters financial difficulties as a result.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

(8) Debt Commission: A neutral body, with representatives from creditor- and debtor-country governments, would monitor debt conditions, establish uniform criteria for debt rescheduling, and help prevent debt crises by encouraging appropriate advance actions.

(9) Secondary Market for Trade Paper: Guarantees by national export credit insurers and an international institution would be used to provide sufficient backing for paper to be resold on capital markets.

Although each of the proposals reviewed had its own particular set of advantages and disadvantages, many of these advantages and disadvantages were, in fact, common to all or a majority of the proposals. The advantage of removing uncertainty and building lender confidence, for example, was cited as an advantage of the proposals for a large-scale debt restructuring, buyout of small creditors, developing country debt corporation (although this proposal is meant as a device for healthy borrowers), safety-net for commercial banks, debt commission, and a secondary market for trade paper.

Likewise, an important disadvantage common to many of the proposals, as described, was that they did not require economic adjustment on the part of the borrowers. For example, the proposals for a one-year grace on debt, retroactive terms adjustment, large-scale debt restructuring, buyout of small creditors, safety-net for commercial banks, and secondary market for trade paper are actions that would be implemented by creditors. Although these proposals would not preclude inclusion of some means of leveraging debtors to adjust, this is an area in which several of the proposals need more work.

Finally, some of the proposals were seen to be inappropriate because they would be little more than a bailout of the commercial banks. (Some observers, of course, believe that virtually any actions taken to ease the current LDC debt burden would be a bank bailout.) Proposals falling in this category include large-scale debt restructuring (unless bank debt were purchased at a substantial discount, in which case the banks themselves might be reluctant to participate), buyout of small creditors (albeit a bailout of smaller banks only), and a safety-net for commercial banks.

There are a number of factors which need to be addressed in any analysis of supplementary or alternative proposals for dealing with the LDC debt situation, such as selectivity (countries should be addressed on a case-by-case basis), ease of negotiation or implementation, and cost. Some of the proposals studied by the Working Group did, in fact, address these concerns; others did not.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Ultimately, the decision to proceed with any new proposal will depend on the current financial situation, an assessment of the current debt strategy, and the need to have or desirability of having supplementary or alternative mechanisms in place before the situation becomes a crisis. Advantages and disadvantages acquire different weights depending on the nature of the problem one is addressing.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Appendix E

Evolution of the G-10 Approach to Debt Problems

It is possible to distinguish four stages in the evolution of the G-10 approach to the debt problems of specific countries.

STAGE I: Rescheduling Export Credits, 1956-65

The first debt crisis of the post-WWII era was that of Argentina in 1955-56. The other countries that sought debt relief in this period were also among the most advanced LDCs: Turkey, Brazil, and Chile. (See Table.) In each case, except Brazil's, debt servicing problems followed a period in which credits from the G-10 countries, primarily export credits had expanded rapidly. In the late 1950's, adverse cyclical export trends were also an important factor leading to debt-servicing difficulties. In the early 1960's, however, export trends were generally favorable, and the problems related to bunching of debt service payments and to poor economic management.

The procedure created to ensure equitable burdensharing among the various export credit agencies came to be called the "Paris Club", an ad hoc forum chaired by an official from the French Treasury, in which payments falling due on direct credits and guaranteed credits were rescheduled over seven to 12 years. (The Turkish rescheduling was handled in the OECD aid consortium rather than in the Paris Club.) Concessional credits were explicitly excluded from rescheduling. There was little parallel relief from commercial banks, except in the 1961 case of Brazil where additional credits were arranged informally.

STAGE II: Aid Reschedulings, 1966-76

The second stage was dominated by rescheduling operations involving India and Pakistan. In both of these cases, export credits were explicitly excluded. Payments on ODA loans were rescheduled on highly concessional terms, i.e., a grant element of up to 62 percent. Another innovation was the use of debt relief deliberately as a substitute for aid, since in several instances the countries were not in a position of default or imminent default.

This stage also brought the first large-scale debt "work-outs." Indonesia's debt was rescheduled over thirty years, with no interest charged on the rescheduled amounts. Ghana's debt was rescheduled over twenty-eight years. Institutionally, the India and Pakistan reschedulings were done in aid consortia, and the rest were mostly done in the Paris Club.

The countries involved were generally not the most advanced LDCs, but they were all in the upper half. During this stage, foreign aid from the G-10 countries and from multilateral institutions was growing rapidly and was being coordinated within consultative groups or aid consortia.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

While some countries had sought relief from a small number of banks prior to the mid-1970's, there do not appear to have been any significant commercial bank reschedulings during this stage.

STAGE III: Mixed Rescheduling, 1976-1980

Zaire developed serious debt problems in 1976; it presented the first case in which burdensharing between official and private creditors became a serious issue. The commercial banks (led by Citibank) argued that they should be preferred creditors. The G-10 governments refused to accept this position and conditioned debt relief in 1979 upon "comparable" debt relief from banks. The banks finally gave in.

This period saw a rash of reschedulings linked to the OPEC oil-price increases, related OECD recession, and economic mismanagement. The first of a long line of small, low-income commodity exporters from Africa came to the Paris Club: Sierra Leone, Togo and Liberia. Most of the countries encountering debt problems in this period sought relief in the London Club as well as the Paris Club.

The big rescheduling of this period was Turkey: the first in which the G-10 countries rescheduled more than $1 billion in official credits, the first in which "special pledging" of balance of payments assistance from donor governments was required, and the first in which commercial banks had to provide as much debt relief as the governments (although they were not required to provide new financing). The burden of coordinating the inter-related financing operations (including almost $900 million of structural adjustment loans from the IBRD) fell primarily on the IMF, but the job was facilitated by the OECD which provided a forum for both the special pledging and the official debt relief.

During this period, both the Paris Club and the London Club, "hit their stride." Some modest improvements in Paris Club procedures were adopted which preserved, however, its ad hoc case-by-case character in the face of LDC demands for institutionalizing debt relief. Significantly, the existing approach to debt relief received a form of international endorsement in a debt resolution adopted by the UNCTAD Trade and Development Board in 1980.

The approach to Nicaragua's debt problem was an important departure from the usual approach in this period. On the official side, the G-10 could not agree to linking debt relief to an IMF arrangement, and three countries proceeded to negotiate <u>bilateral</u> relief arrangements. On the commercial bank side, the London Club agreed for the first time to capitalize some interest payments.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

STAGE IV: Problems Everywhere Except Asia, 1981-1983

In Stage III, 11 countries completed debt-relief negotiations with official and/or private creditors. Since then, 25 countries have completed such negotiations, and another 5 to 10 countries are negotiating arrangements. More importantly, some of the world's biggest debtors experienced difficulty in this period, notably Mexico, Brazil, Argentina, and Poland.

Up to this stage, an informal and ad hoc approach has been adequate, and preferable to a more organized approach that could encourage countries to seek recourse to debt relief. The number of negotiations underway, and the amounts involved, now appear unmanageable without a more coordinated approach. On the private bank side, an important step has been taken with the establishment of the Institute of International Finance. The major shortcoming at the present time seems to exist on the official side.

The only existing mechanism for coordinating official action in response to debt problems is the Paris Club. In theory, the Paris Club could be upgraded to assume a larger role. This possibility was discussed at length within the Paris Club in February 1983, but strong resistance to the idea was expressed. In particular, it was felt that the Club would be most effective if it remained as a technical body with a "debt-collection" orientation. It was pointed out that decisions on debt relief and decisions on new aid tend to be made in different parts of the creditor-country governments. Furthermore, it was considered important for the official creditors to negotiate separately from commercial banks since the interests of each group could be quite different.

There are also administrative considerations. As the frequency of negotiations has increased, the burden of preparing for them has multiplied. This burden now falls entirely on the French Treasury which has difficulty coping with the present workload. In particular, it has not been able to analyze options or establish an effective exchange of debt-servicing information in advance of negotiations. A final concern is that the Paris Club gives the government of France a disproportionate influence over the outcome of debt negotiations.

An approach which allowed different countries to take the lead in the more complex cases, and which was supported by a staff undistracted by other responsiblities, could provide more effective coordination of action by G-10 countries, leaving the Paris Club to handle the "normal" cases where the debt problem could be solved without bridging operations or special aid pledges or coordinated action with private banks, or extraordinary debt relief.

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Debt Problems Since 1956

COUNTRY	YEAR	OFFICIAL RELIEF ($ millions)	BANK RELIEF ($ millions)
STAGE I: Rescheduling Export Credits, 1956-1965			
Argentina:	1956	$500	no data
	1962	$240	"
	1965	$76	"
Turkey:	1959	$400	"
	1965	$220	"
Brazil:	1961	$300	"
	1964	$200	"
Chile:	1965	$76	"
4 countries	8 negotiations	$2012	
STAGE II: Aid Rescheduling, 1966-75			
Ghana:	1966	$170	"
	1968	$100	"
	1970	$25	"
	1974	$290	"
Indonesia:	1966	$247	"
	1967	$95	"
	1968	$85	"
	1970	$2100	"
Peru:	1968	$58*	"
	1969	$70*	"
India:	1971	$92	"
	1972	$153	"
	1973	$187	"
	1974	$194	"
	1975	$167	"
Pakistan:	1972	$234	"
	1973	$103	"
	1974	$650	"
Cambodia:	1972	$2	"
Chile:	1972	$258*	"
	1974	$462*	"
	1975	$230*	"
7 countries	22 negotiations	$5972	

* = atypical for the stage

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

COUNTRY	YEAR	OFFICIAL RELIEF ($ millions)	BANK RELIEF ($ millions)
STAGE III: Mixed Rescheduling, 1976-1980			
India:	1976	$200*	
	1977	$110*	
Zaire:	1976	$270	
	1977	$210	
	1979	$1040	
	1980	-	$402
Sierra Leone:	1977	$39	
	1980	$37	
Jamaica:	1978	-	$63
	1979	$300	$149
Turkey:	1978	$1300	
	1979	$1200	$2760
	1980	$3000	
Peru:	1978	$420	$386
	1980	$487	$340
Sudan:	1979	$480	
Togo:	1979	$260	
	1980	-	$69
Liberia:	1980	$35	
Bolivia:	1980	-	$156
Nicaragua:	1980	(bilateral)	$562
11 countries	23 negotiations	$8608	$4887
STAGE IV: Problems Everywhere Except Asia, 1981-1983			
Nicaragua:	1981	-	$180
Jamaica:	1981	-	$89
Bolivia:	1981	-	$416
Pakistan:	1981	216	
Togo:	1981	232	
	1983	100e	

* = atypical for the stage

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6

COUNTRY	YEAR	OFFICIAL RELIEF ($ millions)	BANK RELIEF ($ millions)
Poland:	1981	$2200	$2300
	1983	-	$2300
Madagascar:	1981	$140	
	1982	$107	
	1983	-	$195
CAR:	1981	$72	
Zaire:	1981	$500	
Senegal:	1981	$75	
	1982	$74	$77
Uganda:	1981	$30	
	1982	$19	
Liberia:	1981	$30	
	1983	-	$50e
Turkey:	1982	-	$2900
Sudan:	1982	$80	$400e
	1983	$536	
Guyana:	1982	-	$14
Romania:	1982	$234	$1600
Malawi:	1982	$25	$42
Mexico:	1982		$18500
Costa Rica:	1983	200e	
Brazil:	1983	-	$4700
Cuba:	1983	-	$1000
Ecuador:	1983	-	$2050
Argentina:	1983	-	$9000
Chile:	1983	-	$2600
Yugoslavia:	1983	-	$1400
25 Countries	38 negotiations	$4870	$49813

Sanitized Copy Approved for Release 2011/05/17 : CIA-RDP90B01013R000300530001-6