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FILE

Central Intelligence Agency

DIRECTORATE OF INTELLIGENCE

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Brazilian Debt Moratorium: Potential International Financial Repercussions. [redacted] 25X1

Summary

Brazil´s decision to suspend interest payments indefinitely on its medium and long-term debt is fraught with risks. Given its potential repercussions, we have analyzed the likely impact of this move on Brazil, on the other key debtors, and on their creditors. Our analysis has been developed by using the experience of our country analysts, international financial experts, and the Directorate´s most-seasoned economists. We are projecting the consequences of the Brazilian move during a six month time horizon. We have also identified the key factors that could condition the outcome. [redacted] 25X1

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Following Brazil's unilateral moratorium on interest payments, we believe:

-- Brazil's economy will continue to grow for several months despite higher inflation and more difficulties in conducting trade;

-- This action will shock financial markets--it immediately drove down bank stock prices--but probably not lead to destabilizing financial panic.

-- Other key Third World debtors will not initially follow the Brazilian move, despite rhetoric to the contrary, nor band together to answer a call for multilateral debtor action.

-- Rather, the debtors will carefully monitor creditor response--particularly ones showing retaliation against Brazil and willingness to negotiate--for signals that they should reevaluate their debt management strategies.

-- International cooperation in resolving debt problems could be derailed by a series of swing factors--sudden shifts in economic teams, volatile domestic political events, imitative behavior, sudden economic deterioration, and a hostile creditor response.

-- Successive debt payments suspensions by other key Third World debtors could occur if debt rescheduling and new money negotiations break down. [redacted] 25X1

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<u>The Motives</u>

On 20 February, President Sarney announced that the country would suspend interest payments on Brazil's $65 billion medium-and-long term debt to commercial bankers for an unspecified period. He indicated that the suspension was necessary to preserve Brazil's foreign exchange reserves, which have plunged since September and are currently reported to be from $1.5 to $3.9 billion [redacted] Moreover, we concur with a recent Embassy assessment that an overvalued cruzado and shortages of key components for exports will mean the trade surplus will not likely recover from its recent monthly level of $100 million before April. In addition, we know of no significant capital inflows programmed for Brazil through March. In addition, we believe Sarney was unable or unwilling to fend off intense 25X1

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inflows programmed for Brazil through March. In addition, we believe Sarney was unable or unwilling to fend off intense political pressure from several groups within Brazil--including the left, labor, and some influential members of the ruling coalition--to suspend payments. [redacted] 25X1

Impact on Brazil

According to initial US Embassy reports, the unilateral action against creditors has met with general public approval, although it has drawn some critical response from the conservative press in Brazil. According to the Central Bank, interest payments will be held in a blocked account in Brazil while the suspension remains in effect. Initially, we believe, Brasilia will accumulate these payments as a war chest of additional reserves. Consequently, the suspension of payments would add some $800 million per month to the Central Bank's coffers. [redacted] 25X1

We also believe that Brasilia will soon be tempted to use this cash windfall to support growth-oriented policies--the major economic priority of the populist Sarney government. With the funds saved by suspending payments, Brasilia will probably seek to increase imports in an attempt to alleviate domestic shortages of key foreign intermediate and producer goods and sustain growth. Within a month or two, we anticipate Brazil will encounter increased difficulty in conducting trade, except on a cash-and-carry basis. Because trade will become more expensive, inflation will begin accelerating in the subsequent six-month period. [redacted] 25X1

Immediate Financial Impacts-The System Holds

The unilateral Brazilian moratorium on interest payments hits world financial markets at a time when several other Latin American debtors are in the process of negotiating new financial packages. A review [redacted] indicates that: 25X1

-- Mexico has yet to complete its $7.7 billion new money package from commercial banks.

-- Argentina has begun negotiations for $2 billion in new bank loans.

-- Venezuela is in the midst of negotiations for lower interest rate spreads, a reduction in scheduled principal payments and $400-600 million in new financing.

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-- Ecuador is bargaining for an immediate loan to cover its cash-flow difficulties. [redacted] 25X1

In cases where negotiations are nearing agreement on rescheduling and new money, we anticipate talks will proceed. For example, Chile agreed with bankers on 23 February to reschedule $12 billion of extensive debt and retime its interest payments to save $535 million. Given stronger institutional arrangements than were in place in 1982, creditors are unlikely to "cut-and-run" or retract short-term credit facilities. Nevertheless, with $25 billion in US loans at risk, Wall Street was shaken by the Brazilian announcement, with bank stocks declining on 23 February. Prior to Sarney's announcement, press reports indicated that bank stocks dropped slightly in West Germany and Japan. [redacted] 25X1

Banker Reaction

The scanty public reaction so far from international banks indicates they are hopeful that new negotiations can lead to an agreement to lift the moratorium on interest payments. According to a press report, Brazil's Bank Advisory Committee will request that Brasilia obtain an IMF program in return for financial assistance. Other press commentary indicates that Brasilia is preparing to table proposals for major financial concessions, but we cannot confirm or deny these reports. Brazil's bank advisory committee (BAC) has already set a date in early March for financial negotiations. Some banks, especially smaller US and foreign banks, are likely to try to cut trade and interbank lines, but Brasilia has contingency plans in place to freeze these facilities to prevent a major runoff. Full scale banker retaliation, however, would occur only if Brazil completely stops servicing its debt for an extended period. [redacted] 25X1

Spillover Effects

Mexico stated it will continue to service its debt and not follow Brazil in declaring a debt moratorium. We believe President de la Madrid will continue to adhere to the rules of the game in order to get promised credits needed to expand the economy as the 1988 elections approach. [redacted] 25X1

Argentina indicated it would suspend interest payments on its debt if western banks refuse to provide new loans, but we believe it will not initially follow suit. We judge that President Alfonsin would not jeopardize recent progress on inflation, structural reform and World Bank and IMF loans. Nevertheless, we interpret the Argentine statement as exerting maximum pressure on commercial banks for $2 billion in new money,

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a risky gambit. We believe Alfonsin will continue to rhetorically support Brazil, but will stand firm in the face of political pressure for radical action on its debt for the immediate future. [redacted] 25X1

Although Brasilia claims that Caracas has cabled its private support, Venezuela's President Lusinchi will be slow to react publicly, seeking consensus before making any moves and assessing creditor response to Brazil's action. [redacted] 25X1

In the Philippines, Finance Minister Ongpin is likely to advocate continued negotiations with creditors to avoid jeopardizing financial packages now in place and nascent economic recovery. [redacted] 25X1

Egypt is unlikely to experience any near term adverse impact. The Mubarak government recently moved closer to reaching an agreement with the IMF over the terms of a standby agreement. Moreover, with most of Egypt's external debt in the form of public and publicly guaranteed obligations, the major portion of the debt rescheduling exercise will take place within the relatively congenial confines of the Paris Club. [redacted] 25X1

Creditors' Unfolding Response

Because Brazil's move is unlikely to create an immediate bandwagon effect with other debtors, creditors will most likely focus their energies on Brazil. Last year, for example, Mexico's financial predicament caused creditors to postpone other negotiations. If discussions became protracted, negotiations with other debtors could be pushed aside for many months. [redacted] 25X1

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Brasilia must tackle its basic economic problems before new funds will be forthcoming, we anticipate most major banks will initially take a hard line.

- -- The BAC will continue to demand an IMF-supported program to obtain new bank credits and a restructuring agreement even if Brasilia initially refuses to cooperate with the Fund.
- -- The BAC will closely scrutinize and contest Brazil's economic and financial data.
- -- The BAC will resist agreeing to concessions similar to those Mexico received.

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-- The BAC will insist that raising new medium-term credit will be extremely difficult, in part because smaller banks will refuse to participate.

-- European and Japanese creditors will be unwilling to put up substantial new funds for Brazil; they can resist Brazil's demands because of reserves against troubled loans. 25X1

Swing Factors-The Signs to Watch

Events could unfold in a very different manner if the debtor governments' and private creditors' assumptions were different from those we postulated. In the event pivotal swing factors came into play, the world financial system could be rocked by successive debt payment suspensions. 25X1

Shifts in Economic Teams. We have identified at least one instance where a ministerial shift could result in a policy change adverse to US interest. According to our Philippine analysts, if current negotiations with the banks break down and confidence in the economy falls, Ongpin may lose President Aquino's confidence and a harder line might prevail. In that event, Manila will be more likely to look to the other debtors for support in forging a new financial deal. If an agreement with the commercial banks does not appear likely and Brazil calls on debtors to join together and press the banks for a better deal as a group, then Manila might join. 25X1

Internal Political Pressure. Several analysts spotlighted internal politics as a crucial and volatile swing factor. For example, our Ecuadorean analysts observe that Febres-Cordero has swung from one of the most financially responsible nations in South America in honoring its foreign debt obligations into technical default. He has been on the defensive since his temporary abduction by Air Force paratroopers last month and he does not want to be seen slashing reserves to satisfy foreign economic interests. According to US Embassy reporting, he has been angered by bank demands for assurances that Ecuador will not seek recourse to new money to meet February debt service repayments. He feels Ecuador deserves special consideration, given his administration's responsible debt payment record. 25X1
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In another assessment, the analyst for Venezuela speculates that strong public opinion against debt repayment could cause Lusinchi to change Venezuela's course. Lusinchi's political opponents have already capitalized on the administration's relations with creditors, claiming the president is bowing to foreign interests in the current negotiations. 25X1

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<u>Imitative Behavior.</u> The situation could be made worse if other debtors imitated Brazil. According to our experts, elements within both the Egyptian government and the political opposition who are opposed to what they see as intervention by the IMF, may be emboldened by a Brazilian debt moratorium. They could attempt to block final approval of the standby program, which could force a de facto payments suspension. 25X1

<u>Creditor Response.</u> We judge this is potentially the most important factor. Bankers are growing weary over the many protracted negotiations and are divided over how to handle debtors. If bankers continue their hardline with Brazil and it spills over to other debtors, these factors could lead to long delays in reaching agreements for new money and rescheduling. If other key debtors then experienced financial crises, these governments would reconsider their strategies. For example, according to our country expert, Mexico's stance over the longer term likely would be affected by the way creditors responded to Brazil. The strategy of de la Madrid or his successor almost certainly would change if creditors failed to retaliate against a Brazilian moratorium of if Brasilia appeared to gain by its actions. 25X1

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