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DEFENCE AND OVERSEA POLICY (OFFICIAL) COMMITTEE

SUB-COMMITTEE ON THE SOUTH ATLANTIC AND THE FALKLAND ISLANDS

ARGENTINA: ECONOMIC IMPACT OF THE FALKLANDS CRISIS

Note by the Secretaries

The Sub-Committee will recall that an assessment by the Joint Intelligence Committee (JIC) of Argentina's vulnerability to economic and financial pressures was circulated at ODO(SA)(82) 21 and that a Note by the Foreign and Commonwealth Office examining the scope for United States pressure in this area had been circulated at ODO(SA)(82) 8. Attached for the Sub-Committee's information is a note by the JIC assessing the impact of the crisis on the Argentine economy and considering the short-term economic outlook.

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Cabinet Office

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ARGENTINA: ECONOMIC IMPACT OF THE FALKLANDS CRISIS

1. This note assesses the impact of the present crisis on the Argentine economy and considers the short-term economic outlook. It up-dates JIC(82)(N) 32 Argentina: Economic Vulnerability of 15 April 1982.

2. It is too early to assess fully the effects of the crisis on the Argentine economy, particularly since it was already on a downward path. But it seems clear that the economy has faced mounting external and domestic pressures in recent weeks, and that the government's economic strategy is in some disarray. Prior to the crisis, attempts to cut public expenditure and the size of the public sector in order to reduce inflation and improve the external position were meeting with some success, albeit at the cost of deepening recession and increasing popular discontent. Foreign lenders remained concerned about the size of the external debt, but their confidence had been bolstered by the regime's domestic economic policies.

3. Since the invasion there has been a major loss of confidence both internally and abroad. In part, this reflected the immediate psychological impact of the crisis; but there has also been considerable concern about the effects of trade and other sanctions, and the implications of the crisis for the regime's domestic economic programme.

External Developments

4. The wide-ranging series of trade measures implemented by the EC and other important trading partners will need some time to take effect, particularly as they do not apply to imports under existing contracts. The measures are summarised in Annex I. If sanctions are maintained, the loss of markets for up to a quarter of Argentine exports will be beginning to make itself felt in the next few weeks. But the full impact may not be felt for some months; some diversion of trade to unaffected countries will in any case limit its effect. The restrictions on export credits will also have some impact on Argentina's capacity to import.

5. In the specific case of arms supplies, the action taken by major exporting countries has seriously reduced Argentina's ability to procure much of the more advanced equipment she was seeking. The crisis has led to a very extensive search by Argentina for equipment, spare parts and ammunition which had been given added urgency by the outbreak of hostilities. Since 1 April approaches are estimated to have been made to military equipment suppliers in 30 countries, including Argentina's traditional suppliers in countries operating the embargo. Almost all enquiries are now believed to be to private dealers. This suggests that the embargo is being effectively enforced. Such arms as Argentina is able to acquire from private dealers will undoubtedly cost more than she would normally pay; particularly as many of the items being requested are sophisticated ones such as missiles and spares for aircraft and helicopters. Assuming that the embargo holds and Latin American countries maintain a largely neutral stance, Argentina may be prepared to accept communist arms for the first time, offered as they often can be on easy credit terms, or under barter arrangements.

6. The invasion of the Falklands and likely effects of trade and other sanctions on Argentina's external financial position have been major factors in the growing concern in international banking circles about the country's creditworthiness. Despite repeated professions of confidence by the Argentine authorities, foreign lenders remain extremely worried that a growing shortage of foreign exchange may result in Argentina failing to meet its debt commitments. The regime fully recognises the need to retain banking confidence: interest and capital payments on existing debt have continued to be made to all but United Kingdom banks. (The United Kingdom element is reportedly being paid over into a blocked account in New York; but the existence of this account remains in doubt.) Most lending banks appear to have agreed to roll over short-term credits which have fallen due since the invasion, although some lenders are charging higher interest rates. But a number of banks are actively seeking to limit their exposure to Argentina, and are unwilling to replace longer-term loans falling due, or offering only short-term accommodation in exchange. Argentine borrowers have made a number of unsuccessful requests for new loans: there is no evidence to suggest that significant amounts of new money have been made available to

major Argentine borrowers since 2 April. The attitude of United States' banks remains particularly important. Immediately after the invasion some United States banks did permit full drawdown of existing credit facilities; but since the announcement of United States measures against Argentina there is evidence that the stance of some lenders may now have hardened. Most lenders, however, are very keen to avoid pushing Argentina into default.

7. Faced with declining foreign exchange reserves and difficulty in finding new sources of foreign borrowing, the Argentine authorities have implemented a series of measures aimed at stemming foreign outflows. There are now extensive controls on foreign payments, including a 45 day suspension of imports of luxury goods, prior Central Bank authorisation for all permitted foreign exchange transactions, the recall of existing import licences, and an issue of 'external bonds' to replace cash payment of profits, dividends royalties and technical assistance. On 5 May, the peso was devalued by almost 15 per cent to try to encourage exports and further restrict imports; the rate of levy on foreign exchange receipts from exports has also been raised. But the authorities have probably been unable to end capital flight completely; and delays in repatriating export receipts have also been adversely affecting the foreign exchange position. After falling by around \$400 million during March, the reserves fell by some \$500 million in April. The authorities claim that reserves increased by over \$100 million during the first week of May; but even if true, this is likely to be temporary and the situation remains precarious. Total foreign exchange reserves, must now be less than \$2 billion. In addition, there is some \$1.5 billion of gold at current market values.

8. In the early weeks of the crisis there was substantial precautionary switching of private Argentine foreign balances out of Western European and Caribbean centres into the United States. Since the United States declaration of support for Britain, however, a large part of Argentine official and private balances are believed to have been moved again so as to avoid the possibility of any freezing action. Most of the government's liquid official balances may now be in Switzerland.

Domestic Developments

9. Since the invasion, the already shaky Argentine banking system has experienced a substantial loss of deposits as large numbers of people responded to the growing uncertainty by withdrawing their holdings. The outflow was heavy during the first two weeks of the crisis. It has continued since, (although apparently at a slower rate), reflecting continuing concern about the possibility of government action to freeze deposits or even nationalise the institutions. A number of financial institutions were known to be in difficulties before the present crisis: seven collapsed in the early stages of the crisis, including the country's largest and third largest finance houses. The collapses have caused some damage to domestic confidence. Interest rates have risen sharply and would have risen further if the authorities had not relaxed reserve requirements in stages from 18 to 15 per cent. The number of pesos in circulation is reported to have risen by 50 per cent during April. The authorities have sought to reassure depositors and have made general appeals to patriotism; but at the same time they have taken the somewhat risky step of announcing the progressive dismantling of the existing system of state guarantees for bank deposits in private banks.

10. The economy was already in deep recession prior to Argentina's invasion of the Falklands, with bankruptcies running at very high levels, and growing unemployment. But while the recession may have been beginning to bottom out in the first quarter of 1982, there are some indications that the initial impact of the crisis has been to push the economy back onto a downward trend. In recent weeks there has been evidence of hoarding of foodstuffs and heavy buying of other consumer items, notably motor cars. But lay-offs in key sectors - in particular, the car industry - have continued, and the government has asked companies not to suspend any more employees while the crisis lasts. Not all the effects of the crisis will be adverse, however: factors such as the recent increases in consumer spending and probable reductions in imports may in the longer term help industrial output to recover.

11. The invasion and military confrontation are also having serious effects on the government's finances. Planned cuts in public spending cannot now be achieved. The problem was ignored in the latest budget, presented since the crisis but substantially unaltered from what was intended prior to it. The

impact on public expenditure remains impossible to quantify. The authorities have produced a series of fiscal measures to recoup at least part of the cost. In addition to the higher export levies, the duty on petrol has been increased by 30 per cent together with other increases in indirect taxes, including those on cigarettes and alcohol. But these are unlikely to cover more than a small part of the additional costs facing the government; the planned cut in the public sector deficit from 6 per cent of GDP in 1981 to just 2 per cent this year must now be unattainable.

12. At the same time, the government's anti-inflation strategy has suffered a serious reverse: increases in the money supply, higher interest rates, and the effects of devaluation and the fiscal measures have all added to inflationary pressures. The authorities succeeded in reducing the month on month inflation rate from 12 per cent in January to under 4 per cent in March; but the trend has been reversed in April with a published figure of 4.2 per cent. However this figure seems improbably low, and there must now be doubts about the reliability of much of what the government will publish regarding the performance of the economy.

Prospects

13. Export receipts are normally seasonally strong in the second and third quarters of the year, the peak period for grain exports. The decision by Lloyds to cancel with effect from 24 May policies which apply to ships damaged within the TEZ is apparently causing some disruption to this trade. But we continue to believe that critical shortages of foreign exchange may not occur for some months, even if sanctions are maintained. In addition to its foreign exchange and gold holdings, Argentina is still able to draw on credit lines with other Latin American Central Banks, and on non-conditional borrowing from the IMF. But no significant new commercial borrowing will be on offer while the crisis lasts. While a gradual deterioration in the external financial position seems most likely, a sudden foreign exchange crisis, resulting either from further capital flight or a collapse in banking confidence, cannot be ruled out. Most banks may be expected to remain keen to avoid an Argentinian default. Even if a single lender sought to declare a default, it is far from certain that major banks would follow suit. We believe that the authorities for their part will continue to do all they can to service their debt regularly. But even if the crisis ends soon, it is increasingly likely that Argentina will have to seek some form of debt relief later in the year.

14. The outlook for the domestic economy remains bleak. Inflation in particular seems certain to rise: even so, it should remain for some time yet well below the very high levels of the second half of the 1970s (500 per cent in 1976). Further tough fiscal action will be necessary to maintain confidence and pay for the war. The government's free-market strategy has been pushed well off course and may not survive long. But while the announcement of sanctions and other economic measures came as a shock to the Junta, there is no sign so far that economic factors have had a decisive effect on their attitude to the crisis. Popular attention seems so far to have been diverted away from economic grievances, as the Junta no doubt calculated would happen. The regime's internal and external economic difficulties are likely to continue to intensify; but we do not at present foresee such a sudden sharp deterioration in the economy over the next month or so as might be expected to have a significant impact on the Junta's handling of the crisis. However far more serious problems are looming for the later months of the year.

15 May 1982

ANNEX

SUMMARY OF ECONOMIC SANCTIONS TAKEN AGAINST ARGENTINA

1. Commonwealth countries. Canada, Australia and New Zealand have banned imports from Argentina and will grant no new export credits. New Zealand has also banned exports. Canada and New Zealand have embargoed military supplies. Hong Kong, the only Dependent Territory with significant trade links with Argentina has banned imports.
2. European Community. The EC banned imports (excluding imports under existing contracts) with effect from 16 April for an initial period of one month; they also banned arms exports and agreed that in practice no further export credits would be made available.
3. United States. The United States has banned military exports to Argentina (though there are some loop-holes in the measures) and suspended new export/import bank credit and guarantees. It has also suspended commodity credit guarantees.
4. Japan. Japan has issued advice to the Japanese business community designed to prevent any actions by Japanese firms which would undermine trade sanctions by other countries. We understand that in present circumstances no new official credits will be given for exports to Argentina.
5. Other Countries. The response from other states to requests for non-circumvention of economic sanctions has generally been encouraging: Norway has banned imports; Switzerland, Portugal, Sweden, Austria have banned arms exports. Further export credit from Switzerland and Sweden is most unlikely in the present circumstances. Portugal has undertaken to consider further action in the economic field. Saudi Arabia has reacted sympathetically, Spain has been non-committal, Korea has cancelled a forthcoming trade mission to Argentina.