ODO(SA)(82) 21

COPY NO 86

15 April 1982

CABINET

DEFENCE AND OVERSEA POLICY (OFFICIAL) COMMITTEE

SUB-COMMITTEE ON THE SOUTH ATLANTIC AND THE FALKLAND ISLANDS

ARGENTINA: ECONOMIC VULNERABILITY

Note by the Secretaries

Attached for the Sub-Committee's information is a copy of the Joint Intelligence Committee's assessment of Argentina's vulnerability to economic and financial pressures (ODO(SA)(82) 2nd Meeting, Item 3 and ODO(SA)(82) 6 refer).

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ARGENTINA: ECONOMIC VULNERABILITY

1. This Note considers the present state of the Argentine economy, with particular reference to trade and payments aspects, and assesses Argentina's vulnerability to economic and financial pressures.

2. Argentina, with a population of some 27 million, has a quite diversified economy, with a strong agricultural base and a substantial industrial sector. It is a substantial food exporter; it is virtually self-sufficient in oil, gas and coal and has extensive hydro-electric resources. There are also adequate supplies of many industrial raw materials. The structure of the domestic economy is set out in Table 1. Despite these advantages the country has experienced growing economic problems; these were the major factor behind the coming to power last December of President Galtieri. His predecessor's unco-ordinated attempts to stabilise the economy and reduce the rate of inflation had pushed the economy into severe recession. Rising unemployment (particularly in the towns), wide income disparities and annual inflation at some 130 per cent at the end of 1981 (among the highest rates in the world) contributed to domestic unrest. The public sector deficit increased substantially. Under President Galtieri stricter austerity measures are being attempted; inflation has risen further, living standards have continued to fall and popular resentment has increased. The government is making vigorous attempts to cut the size of the public sector deficit, notably through sales of public sector assets.

3. On the external side, there was a sharp improvement in Argentina's trade accounts in 1981, thanks to an excellent grain harvest and a reduction in the overvalued exchange rate. But the invisibles account remained in substantial and growing deficit, mainly reflecting over $3 billion of interest payments on external debt. As a result, as shown in Table 2, the current account deficit fell only slightly in 1981 to approximately $4 billion. Under President Galtieri the exchange rate has been allowed to float, and has depreciated rapidly; exchange controls were liberalised (although since the Falklands crisis this has been reversed). Provisional estimates drawn up before the current crisis

suggested that the current account might show further modest improvement in 1982 with the deficit falling to some $3 billion: there are, however, some indications that imports in the early months of the year may have fallen quite sharply, with the current account improving rather more rapidly than expected.

4. Argentina's balance of payments problems over the last few years caused a considerable loss of confidence in the currency and repeated bouts of capital flight. The volatility of capital flows, together with the funding of substantial current account deficits, and interest rate considerations, resulted in a rapid growth of the country's external debt. From some $12.5 billion at the end of 1978, it increased to some $34 billion by the end of last year, including nearly $10 billion in short-term loans. This is equivalent to about one-quarter of GDP. Over half the debt is owed by public sector bodies; around 70 per cent of the total has been borrowed from commercial banks. Much of the bank debt is to United States banks, but there has also been substantial lending by European and Japanese banks. United Kingdom-registered banks have some $3 billion at risk.

The importance of foreign trade

5. Foreign trade is important to the Argentine economy: in 1980, exports represented 8 per cent and imports 11 per cent of GDP. Exports are primarily of agricultural produce (70 per cent of the total in 1981), with cereals, notably wheat and corn, predominating. Imports are mainly intermediate manufactured goods for the country's substantial industrial sector. (Manufacturing represents around a quarter of GDP.) The country is a small net oil importer: imports, mainly of heavy crude and specialised products cost around $1 billion last year (representing some 15 per cent of domestic consumption) while some $0.5 billion of domestic lighter crudes were exported. Table 3 shows a commodity breakdown of trade.

6. The United States, the EC and the Soviet Union are all major trading partners. In 1981, the United States took an estimated 12 per cent of Argentina's exports while providing almost one-quarter of imports. The EC is the source of some 27 per cent of Argentina's imports and in 1981 provided a market for some 23 per cent of the country's exports. Following President Carter's grain embargo on the USSR, Argentina has become a key supplier of

the Soviet Union's agricultural needs, and has agreed to sell grain over a number of years. In 1981 the USSR took some 36 per cent of Argentina's total exports - representing at least 12 million tons of grain. The link is extremely important to both partners, providing the Soviet Union with around a third of its grain shortfall, and a market for three-quarters of Argentina's grain exports. Soviet exports to Argentina, however, remain negligible, although the USSR has been trying for years to increase its share of the market. In Latin America, Brazil is Argentina's major trading partner, taking some 12 per cent of exports and providing nearly 10 per cent of imports. A further breakdown of Argentina's trade is given in Table 4.

7. United Kingdom trade is relatively small: in 1981 we bought an estimated $280 million (3.1 per cent of their total exports) and supplied imports worth some $308 million (some 3.4 per cent of the market). Around half of Argentine exports to the United Kingdom are beef, beef products and other food stuffs, with industrial raw materials (mainly wool) accounting for a further quarter of the total. Our exports to Argentina are mainly machinery and transport equipment (over half the total) and other manufactured goods.

Vulnerability to Sanctions

8. Because of the near self-sufficiency of the Argentine economy in the critical areas of food and fuel, trade sanctions alone would not be expected to cause serious economic problems in the short-term. But the longer term effect of action by major trading partners would be of considerable concern to the regime. Loss of part of Argentina's export markets would have serious implications for the country's payments position: details of the measures announced by EC and Commonwealth countries, together with the United States' and Japanese positions, are given in an Annex to this note. In total, almost one-quarter of Argentina's exports may be affected; but since most action applies only to new as opposed to existing contracts, the financial effects of the measures may be relatively slow in making themselves felt. If action were extended to cover imports also, loss of essential semi-manufactures and spare parts could within a few months create some problems for Argentine industry as stocks dwindled, with consequent risks for employment. There could be considerable difficulties in replacing some

suppliers of high technology capital goods. But Argentina could probably absorb quite large cuts in imports without suffering serious economic damage: imports in recent years have been swollen by the effects of the over-valued exchange rate and the policy of opening up the previously heavily protected industrial sector to foreign competition. The Argentines could look to their domestic industries to provide additional supplies of many, mainly consumer, items. In any case, purely trade sanctions will inevitably be extremely leaky; and the Soviet Union may be keen to import more (for example meat) as well as increase its exports to Argentina. A physical blockade of Argentina's ports could create quite serious disruption of trade flows in the short-term. But with extensive land borders with five countries, four of which could be expected to be sympathetic towards Argentina, the likelihood is that re-routing of both imports and exports would quite quickly be arranged, although this would present problems in the case of grain. In addition, a blockade raises the prospect of involving the Soviet Union directly in the crisis.

9. Argentina's defence industries although fairly broadly based are of limited capability and most major equipment and spares are imported. Local production is in any case heavily dependent on foreign designs, components and technical expertise; but local capacity could provide considerable maintenance and support towards sustaining their existing equipment in operations short of full-scale hostilities for some weeks or even months. Loss of imports would, therefore, be likely to be important only in the event of sustained fighting. Much of Argentina's military equipment is of United States' origin, although increasing amounts have come in recent years from the Federal Republic of Germany, France and Israel. Spares and components for more advanced systems could cause considerable problems. If regular suppliers and uncompleted contracts were blocked (as some already have been) the Argentines would seek other sources, probably including neighbouring Brazil and the private arms market. In the short-term, smaller and simpler items could undoubtedly be provided in substantial quantities provided finance were available. And in the longer term the Soviet Union would be extremely interested in becoming a major arms supplier to Argentina.

Financial vulnerability

10. On the financial side, the implications of the crisis are more immediately worrying to the regime. International banking confidence, which had improved considerably on consideration of the Junta's domestic economic programme, has already been impaired. A significant proportion of Argentina's $34 billion international debt is known to be short term ie less than 1 year, much of it financing trade flows. Bank of England estimates of the end-1981 position were that the Argentines had some $9.7 billion of short-term debt which they would require to renew during 1982. Up to 70 per cent of the total short-term debt may have been borrowed from United States and United Kingdom banks; a large part of the total is believed to fall due during the final quarter of the year. But the regime has been attempting to improve its debt profile and may have succeeded in the early months of this year in replacing part of the short-term total with longer term loans. A further $4.7 billion of medium and long term debt is believed to fall due this year. In addition the authorities were expecting to run a current account deficit of some $3 billion (mainly on account of debt interest): it was hoped that capital inflows in respect of oil exploration would fund part of the deficit, but these receipts must now be less likely. The Argentines are, therefore, heavily dependent on international credits and the economy would be highly vulnerable to a withholding of foreign loans. Banking reactions remain uncertain, although the rolling over of much of the short-term debt would in normal circumstances be virtually automatic. The change in market sentiment, however, may restrict the amount of short-term money on offer, and will have considerably reduced the regime's chances of getting all the medium and long-term money it would have wished. In the circumstances the Argentines will be forced to take action to improve their balance of payments position, notably by restricting imports.

11. The Argentines have implemented strict exchange control measures but there remains the possibility of further capital flight putting pressure on the reserves. United Kingdom action to freeze Argentine assets may have sterilised around a quarter of the country's assets in Western countries. This includes a portion of their foreign exchange reserves (which totalled $2.8 billion as at end-February), but the bulk of the reserves is probably held in

the United States. In addition, the government has gold reserves worth some $1.5 billion at current market values; and virtually unconditional IMF drawings could provide a further $0.7 billion. The current quarter is a good one for Argentina in terms of export receipts. Even so, because of the drying up of new credits and possible attempts by banks to reduce the level of their existing exposure, it is possible that Argentina may find itself unable to meet servicing obligations on existing debt. In such a case or if the Argentines decided (as they appear to have done) not to make scheduled interest or capital payments to United Kingdom banks, a default could be triggered within a matter of weeks. As a result of cross-default clauses, much of their outstanding debt could fall due for immediate repayment. Argentina is one of the largest debtors in the world (larger than Poland) and such a default would have very serious implications for international banks and for the international banking system as a whole. Given the very low levels of Argentine assets held in most Western banks, most creditors would be extremely unwilling to consider such a course of action.

12. Faced with growing inability to raise funds in international markets, the Argentines might initially consider repudiating existing debt, since by stopping the payment of interest and capital, foreign exchange outflows would be much reduced. But default would not be an easy option for Argentina: their financial advisors have considerable market expertise and will be well aware of the serious implications of a default. Argentina would be certain to be excluded from international capital markets for a number of years: and more importantly, few countries would be prepared to trade with them on anything other than a cash basis. The result could be very serious dislocation of their trade.

Conclusions

13. Argentine attempts to lower the rate of inflation have led to a low level of industrial activity, rising unemployment, a flight of speculative capital and a sharp depreciation of the exchange rate. The public sector deficit has increased substantially and finances will be under further severe pressure this year. In these circumstances and given inflationary expectations and the level of domestic economic confidence, it is likely that the rate of inflation and economic hardship will increase.

14. The regime will be concerned about these possibilities as well as the implications of a loss of export markets as a result of sanctions or a blockade. Both these pressures are longer term, however. The immediate difficulties for Argentina stem from her difficulty in raising new external loans against the relatively low level of foreign exchange reserves in an economy prone to capital flight. The regime may have to reduce imports severely; there is scope for domestic substitution of many imports, although this could add to inflationary pressures. We do not believe that either the lending banks or the regime would wish to precipitate a default which would have very serious long term implications; but the possibility of a default cannot be ruled out. These immediate financial pressures as well as the longer term economic dangers, are factors which the Argentine government will have to weigh carefully in deciding whether to seek a negotiated settlement or risk military confrontation.

15 April 1982

DATA ON ARGENTINE ECONOMY

TABLE 1

COMPOSITION OF GDP IN 1981 (ESTIMATES)

Agriculture, forestry and fishing	14.0
Mining	2.5
Manufacturing	23.3
Construction	7.6
Electricity, gas and water	3.7
Commerce	13.6
Transport and Communications	10.9
Finance and banking	9.4
Government	9.5
Other	5.5
	100.0

Source: IMF SM/81/239

TABLE 2 BALANCE OF PAYMENTS - CURRENT ACCOUNT

	1978	1979	1980	1981	Forecast 1982
Exports fob	6.4	7.8	8.0	9.1	10.3
Imports cif	-3.8	-6.7	-10.5	-9.2	-9.0
Trade balance	+2.6	+1.1	-2.5	-0.1	+1.3
Net services and transfers	-0.8	-1.6	-2.2	-3.8	-4.5
Current account balance	+1.8	-0.5	-4.7	-3.9	-3.2

Source: IMF and Bank of England

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TABLE 3 COMMODITY COMPOSITION OF TRADE: 1980

		percentages
Exports		
Major agricultural products		49.8
of which: Wheat	10.1	
Corn	6.3	
Seeds and oil seeds	7.6	
beef	7.2	
Other agricultural products		18.9
Mineral products		4.5
Industrial products		26.8
of which: hides, skins and leather	6.5	
metal manufactures	4.1	
machinery	4.0	
		100.0
Imports		
Capital goods		21.9
Public sector	7.6	
Private sector	14.3	
Consumer goods		15.2
Intermediate goods		62.9
Fuels and lubricants	10.2	
Other	52.7	
		100.0

Source: IMF SM/81/239

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Source: IMF SM/81/239

TABLE 4

SOURCE AND DIRECTION OF TRADE

percentages

	1980		1981 where known
Exports			
United States		8.5	12.4
EC		27.7	23.0
of which: West Germany	6.9		5.5
Netherlands	6.3		4.0
Italy	5.6		4.8
United Kingdom	2.9		3.1
France	2.7		2.9
Other industrial countries		7.6	
of which: Japan	3.0		3.2
Spain	2.7		2.7
Oil exporting countries		4.2	
Non-oil developing countries		33.9	
of which: Brazil	12.5		11.6
Uruguay	3.5		
USSR and Eastern Europe		18.1	
of which: USSR	15.1		36.2
		100.0	
Imports			
United States		22.6	24.4
EC		28.2	26.8
of which: West Germany	11.0		11.2
Italy	6.1		4.8
France	4.0		4.3
United Kingdom	3.4		3.4
Netherlands	1.8		1.7
Other Industrial countries		20.2	
of which: Japan	9.5		9.4
Oil exporting countries		3.8	
Non-oil developing countries		24.4	
of which: Brazil	8.3		9.7
USSR and Eastern Europe		0.8	
		100.0	

Sources: 1980 figures are from IMF Trade Statistics
1981 are mainly OECD, except Brazil (USLO) and USSR (Soviet Foreign Trade Statistics)

ANNEX

ARGENTINA - COMMERCIAL AND FINANCIAL REACTIONS

EC: Trade: Embargo on imports.
Suspend GSP benefits.

Government Credit Insurance: further export credits most unlikely.

Banking credits: Most say that provision of new loans is unlikely.

(Germany: No new export credits and government will 'nudge' banks to avoid new loans).

Canada: Trade: imports banned.
Government Credit Insurance: No new export credits.

Australia: Trade: imports banned.
Government Credit Insurance: No new export credits.

New Zealand: Trade: imports and exports banned.
Government Credit Insurance: no new export credits.

Hong Kong: Trade: imports banned

US: Trade: No action
Government Credit Insurance: avoiding new commitments until policy clarifies.

Banking credit: defensive, but might roll over existing credits if past ones repaid.

Japan: Trade: no action as yet. But warning that economic relations with Argentina could be affected if dispute continues.