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Implications of the LDC Debt Problem

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National Intelligence Council Memorandum

Information available as of 22 October 1982 has been used in the preparation of this report.

This Memorandum was discussed with experts in the Central Intelligence Agency, the Treasury Department, and other government agencies. It reflects many of their suggestions as well as private-sector perspectives. The opinions, however, are solely the responsibility of the National Intelligence Council. Comments are welcome and may be addressed to its authors, Maurice C. Ernst, National Intelligence Officer for Economic[redacted] 25X1

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Implications of the LDC Debt Problem

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Scope Note

This paper focuses on the LDC debt problem and its implications for the health and stability of the LDCs themselves, the world economy, and the international financial system. The debt problems of Communist countries are also dealt with as a contributing factor to international financial concerns, but the consequences of these problems for the Communist countries and East-West relations are not developed.

Key Judgments

A crisis of confidence in international lending is curtailing the flow of capital to less developed countries (LDCs). At a minimum many LDCs will have to make strenuous economic adjustments. At worst these required adjustments may be so severe as to disrupt economic activity and spur a political backlash against Western governments and financial institutions.

For the first time, most of the handful of LDCs that account for the bulk of the group's borrowing from foreign banks either cannot or are in the imminent danger of being unable to meet their debt service obligations. LDCs have been hit hard by the lengthy industrial country economic recession and high real interest rates. Some oil exporters—Mexico, Venezuela, Nigeria, and Ecuador—face serious financial difficulties because of inability to adjust their profligate spending habits to the new oil market realities. The plight of others, especially Argentina, has been made worse by political instability and economic mismanagement. Under the best of circumstances, it will take many LDCs at least two years, and in the case of Mexico and Argentina probably longer, to regain a strong enough foreign financial position to allow sustained economic growth.

Events in Argentina and Mexico have transformed the debt problem from one that could be treated purely as reflecting deficiencies of policies and management in a few countries to one that involves the health of the entire international financial system and the performance of the world economy. Bankers are curtailing loans to countries like Brazil not just because their assessment of Brazil's domestic policies has turned negative, but also because they are extremely nervous about a high degree of exposure in the present world environment. They are carefully watching their exposure not only to problem countries, but to all of Latin America, and even to LDCs as a group.

Communist countries have been virtually cut off from new Western bank credit, except that under government guarantees. Gross economic mismanagement forced debt rescheduling in Romania and virtual default in Poland. The near absence of Soviet support for these countries destroyed confidence in the so-called Soviet "umbrella" over Eastern Europe, while the souring of East-West political relations greatly increased the perceived political risk of lending to Soviet Bloc countries. All East European countries are being forced to cut imports sharply. Even so, Yugoslavia, East Germany, and Hungary may have to reschedule their debts.

LDC financial problems could become much worse, especially if the economic recession persists. In any event, financial markets are so nervous that bad news, such as a continuation of the present uncertainty of economic policy in Mexico, or the immediate prospect of rescheduling in Brazil, could bring net new lending to most LDCs to a halt. The consequences would include:

- A further sharp cut in LDC imports, leading to a dramatic decline in LDC economic activity and having a significant impact on the economies of the industrial nations.
- A turn to protection and bilateralism in LDCs that could do lasting damage to world trade.

Either in reaction to the curtailed loans or to its own financial difficulties, a major LDC borrower, such as Argentina or Brazil, might declare a moratorium on its debt service payments and the move could be widely imitated.

Such a drastic debtors' reaction would greatly increase the chances of an international financial panic, although these are still small. In spite of ambiguities and uncertainties in the support system, central banks, if faced with a major threat to the financial system, would almost certainly provide massive funding to their private banks to maintain their liquidity because the economic consequences of not doing so would be too severe. Even so, some banks without clear parents or nationality would be vulnerable; the Eurodollar market could sharply contract; and trade could be disrupted, not only in the LDCs but also in industrial nations.

Politically, severe LDC economic difficulties would probably trigger nationalistic, often anti-US, reactions, especially in Latin America. These reactions are unlikely by themselves to bring to power a Marxist or Soviet-leaning government in any major country, although they would probably include flirtations with the USSR and anti-US stands on international issues. Pressures on Mexico's ruling Institutional Revolutionary Party (PRI) would increase. In the unlikely event of breakup of the party, widespread turmoil and damage to US interests could follow.

The chances are that major economic or political disasters will be avoided. Even so, US and Western policymakers will have to deal with troublesome trends resulting from the large-scale rescheduling of existing debt and the contraction of new credit:

- Foreign bank credit will become a much smaller source of capital inflow for LDCs than in recent years.
- LDC pressure for debt relief will build as more major countries face two or more years of little or no growth.
- The North-South dialogue will be acrimonious; pressure for increased bilateral and multilateral economic assistance will be strong.
- The financial position of major banks would be weakened by extensive and sometimes repeated reschedulings.
- The banks will seek reassurance from central banks as to likely support in emergencies and help from governments to deal with the more basic financial difficulties.

Emergency financial measures, such as creation of a special International Monetary Fund (IMF) facility, are unlikely to solve the problem by themselves. Coherent programs to facilitate long-term adjustment in many LDCs will be needed, with the IMF probably playing a key role. Longer term, confidence-building measures, such as expansion of multilateral financial facilities and steps to assure market access for LDC products in industrial countries, are also important. Beyond specific steps such as these, a steady recovery of the economies of industrial countries, together with lower real interest rates, is indispensable if LDC economic and financial health is to be restored in a reasonable period of time. If it is not, not even a combination of measures is likely to prevent recurrent crises.

Implications of the LDC Debt Problem

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The Developing Crisis

A crisis of confidence in international lending is drastically curtailing the flow of capital to less developed countries (LDCs). The inability of Mexico and Argentina to meet their debt service obligations has made it extremely difficult for any Latin American country, including Brazil and Venezuela, to obtain new credit. Those few countries in Africa which have relied heavily on bank borrowing also are in trouble, as is the Philippines, although most Far Eastern countries are doing relatively well. East European countries have been virtually shut out of the medium-term market for nonguaranteed loans since early 1981, and this year have been experiencing a contraction of short-term bank credit.

The nervousness of financial markets is being reflected in:

- A virtual withdrawal from the LDC market by medium-size US banks and some large foreign, especially Japanese, banks.
- An increase in the charges (spreads and front-end costs) on loans to LDCs to take account of the increase in perceived risks.
- A flight of short-term capital to the United States, which is widely viewed abroad as the most secure place.

Importance of Commercial Bank Debt for LDCs

Non-OPEC LDC debt climbed 19 percent a year between 1973 and 1981. The private portion of that debt rose most dramatically—22 percent a year—mainly reflecting the expansion of funds borrowed from commercial banks (see table 1). In fact, such private borrowing provided nearly 80 percent of new non-OPEC foreign debt. The debt is highly concentrated. Seven countries (Argentina, Brazil, Chile, South Korea, Mexico, Peru, and the Philippines), each of whose private debt exceeds $5 billion, have 75 percent of the total private non-OPEC debt, and two—Mexico and Brazil—account for about 45 percent (see table 2).

Table 1
Gross Foreign Debt of LDCs and Eastern Europe

Billion US $

Borrowers	Source of Funds				Total	
	Official		Private [a]			
	1973	1981	1973	1981	1973	1981
Total LDC	55	160	75	360	130	520
Non-OPEC	40	130	60	280	100	410
OPEC	15	30	15	80	30	110
Eastern Europe (including Yugoslavia)	5	25	10	55	15	80
Total	**60**	**185**	**85**	**415**	**145**	**600**

[a] Includes both medium- and short-term loans from commercial banks and other financial institutions, bonds, and supplier credits. Banks and other financial institutions account for 80 to 85 percent of total private lending.

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In some 20 percent of 84 non-OPEC LDCs, private debt constituted more than three-fifths of total debt (table 3). Although a few dynamic Asian countries have managed their finances well despite the troubled times—notably Hong Kong, Malaysia, Singapore, South Korea, Taiwan, and Thailand—other LDCs have encountered severe financial difficulties—notably Argentina, Brazil, Chile, Mexico, Peru, and the Philippines.

About 40 percent of 84 non-OPEC LDCs obtain less than 20 percent of their foreign capital inflows from private sources and have an outstanding private debt of less than $2 billion. Most of these countries, which

Table 2
Foreign Debt of Selected LDCs

Billion US $

	1973		1981	
	Total	Private	Total	Private
Non-OPEC				
Brazil	14	11	71	60
Mexico	10	8	68	63
Argentina	5	4	34	31
South Korea	5	3	31	21
Philippines	3	2	18	15
Chile	5	3	14	12
Peru	3	2	11	7
OPEC				
Venezuela	2	1	28	27
Nigeria	2	1	8	6
Ecuador	1	0.5	6	5

are located in Africa and Southeast Asia, are among the poorest and slowest growing LDCs. Their development problems have little to do with debt servicing constraints, since most of the foreign financial assistance they receive is in the form of grants or highly concessional loans. Their interest payments have remained low.

Another 40 percent rely on private credit for 20 to 60 percent of their financial inflows, and almost all have outstanding private debt of less than $2 billion. Within this group, many have borrowed a sharply increasing share of their capital inflows from commercial banks in recent years and now find themselves facing severe difficulties servicing debt. These strains often arise from economic mismanagement (sometimes political turmoil). Many in these groups were particularly hard hit by the decline in foreign sales, as they depend heavily on products whose prices have plummeted—copper, sugar, and so forth. About one-third of the countries in this group have asked for and received debt rescheduling in the past three years. They include perennial reschedulers like Zaire and Bolivia, plus many from the Central American/Caribbean region and Africa.

OPEC countries also have been large borrowers on foreign private markets. Most, however, have foreign assets far larger than liabilities—for OPEC as a whole, liabilities are less than half of assets. The exceptions are Ecuador, Nigeria, and Venezuela, whose foreign debt substantially exceeds their foreign assets and who are in a difficult financial position.

Major Forces at Work

The strained financial situation is partly an outgrowth of the dramatic shift from inflation to disinflation in economic policy. Inflationary trends in the 1970s made large-scale borrowing highly profitable for both the recipient and the lender while disguising potential risks. The sharp turnaround in the inflation trends, accompanied by a prolonged economic recession, has brought high real interest rates, low demand for LDC products, and the lowest level of real prices of some raw materials since the great depression. Political problems, especially in East-West relations and in Argentina, and political indecision in Mexico also precipitated and exacerbated the financial problems.

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The rapid increase in bank debt, combined with low or negative real interest rates and expanding world trade, greatly assisted many LDCs in adjusting to the two OPEC oil shocks. Only a handful of small LDCs, which suffered from severe political and economic mismanagement, encountered debt problems. Until 1982 the amount of rescheduled loans by commercial banks to those smaller chronic problem countries accounted for less than 2 percent of total bank loans to LDCs and Communist countries.

Commercial banks found lending to LDCs and Communist countries to be more profitable and less risky than their domestic operations. The so-called sovereign risk was virtually ignored, as commercial bank officials felt governments would husband foreign exchange if necessary to maintain access to credit.

Table 3
Non-OPEC LDCs: Relative Importance of Private Debt [a]
(Outstanding Loans From Private Institutions
as a Share of Total Loans, 1981)

Less Than 20 Percent	20 to 59 Percent	60 to 100 Percent
Bahrain	Barbados	**Argentina** [c]
Bangladesh	Bolivia [b]	**Brazil**
Benin	Cameroon	**Chile**
Botswana	**Colombia**	Costa Rica [c]
Burma	Congo	**Hong Kong**
Burundi	Dominican Republic [b]	**Ivory Coast**
Central African Republic [b] [c]	Fiji	**Malaysia**
Chad	Guinea [b]	**Mexico** [c]
Comoros	Guyana [b] [c]	**Panama**
Egypt	Honduras [c]	**Peru**
El Salvador	Jamaica [b]	**Philippines**
Ethiopia	Jordan	**Singapore**
Gambia	Kenya	**South Korea**
Ghana	Lebanon	**Taiwan**
Guatemala	Lesotho	**Thailand**
Haiti	Liberia [b]	Trinidad and Tobago
India	Madagascar [b]	Uruguay
Maldives	Malawi [c]	Zimbabwe
Mali	Mauritania [b]	
Nepal	Mauritius	
Pakistan [b]	**Morocco**	
Rwanda	Nicaragua [b] [c]	
Seychelles	Niger	
Somalia	Oman	
Sri Lanka	Papua New Guinea	
Swaziland	Paraguay	
Syria	Senegal [b]	
Tanzania [c]	Sierra Leone [b]	
Upper Volta	Solomon Islands	
Western Somoa	Sudan [b]	
Yemen AR	Togo [b] [c]	
Yemen PDR	Tunisia	
	Uganda [b] [c]	
	Zaire [b] [c]	

[a] Boldfaced countries have a private debt in excess of $2 billion at the end of 1981.
[b] Rescheduled since 1979.
[c] Rescheduling likely in near future.

Market attitudes began to change in 1981, and pessimism has deepened since then as a result of:

- De facto default in Poland, which shook the comfortable bankers' views of sovereign risk and reverberated throughout Eastern Europe.
- The collapse of commodity prices.
- A shift to a soft oil market and a major downward revision in expected oil prices, which hurt some LDCs badly even though most others benefited to some extent.
- Continuing high interest rates.
- The length and depth of the global economic recession.

As the depression of commodity markets deepened while real interest rates remained stubbornly high, the LDCs were caught in a severe and persistent economic squeeze. Major LDC borrowers paid 12- to 14-percent interest on their total outstanding debt in 1981 compared with 6 to 8 percent in 1973-79. For some borrowers, the cost of new funds rose to near 20 percent. Real interest rates were over 10 percent. With exports stagnant or falling, the burden of interest payments rose to over one-third of total foreign earnings and over one-half of merchandise exports for countries like Mexico, Brazil, and Argentina (see table 4).

As the financial markets became more wary of lending to LDCs, a far greater share of new loans was extended on a short-term basis. Between 1979 and 1981, the short-term debt of 10 major LDCs nearly doubled, while their total debt increased less than 50 percent. Although short-term debts are normally renewed automatically and have traditionally been ignored in assessments of debt service capability, they are vulnerable to sudden changes in market confidence. Refusal to renew short-term lines of credit, as well as capital flight, quickly transformed a fundamental debt problem in Argentina and Mexico into an immediate liquidity crisis. To cover interest obligations and both long- and short-term debt falling due in 1982 would take 1.2 to 1.6 times the total earnings from exports of goods and services of Mexico, Argentina, and Brazil—obviously an impossible task.

Although the LDC debt problems were already a source of growing concern, it was not until the crises

Table 4
Foreign Debt Burden in Selected LDCs (as a Percent of Exports of Goods and Services)

	1975	1979	1981	1982 [a]
	Interest			
Argentina	14	12	29	47
Brazil	19	29	38	47
Chile	17	17	31	31
South Korea	7	7	13	14
Mexico	17	23	27	37
Peru	12	15	19	26
Philippines	6	11	18	23
Ecuador	NEGL	12	27	34
Nigeria	NEGL	3	4	8
Venezuela	1	6	11	18
	Repayments on Medium- and Long-Term Debt			
Argentina	25	20	32	39
Brazil	21	38	29	34
Chile	27	28	30	27
South Korea	8	9	7	8
Mexico	17	54	29	23
Peru	35	17	38	34
Philippines	10	13	11	13
Ecuador	9	24	10	14
Nigeria	2	NEGL	1	4
Venezuela	5	6	8	10
	Short-Term Debt			
Argentina	78	53	89	126
Brazil	20	28	32	40
Chile	56	43	48	56
South Korea	41	36	40	40
Mexico	44	31	50	77
Peru	59	29	36	35
Philippines	25	63	82	90
Ecuador	9	32	47	55
Nigeria	8	7	8	21
Venezuela	5	55	49	64

[a] Projected.

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in Argentina and Mexico occurred that general confidence in lending to LDCs was shaken. Mexico, with a debt exceeding $80 billion, was the critical factor.

In Argentina, which was in the throes of a severe austerity program, the Falklands fiasco forced out the Galtieri government and greatly undermined the credibility of the broader military leadership, which led to an easing of austerity to reduce popular opposition. Current Argentine economic policies are vacillating and inconsistent, reflecting the government's fundamental lack of confidence and political weakness. A rescheduling of debt is being negotiated.

For Mexico, a severe adjustment to a soft oil market was inevitable, following four years of headlong economic expansion and the mortgaging through debt accumulation of projected future oil earnings that did not and are unlikely to materialize. Although stabilization steps were taken earlier this year, including a large devaluation, the Lopez Portillo government has lacked the political will to carry out the adjustment in a systematic way. Wage increases offset the impact of devaluation, and announced budget cuts were not implemented. Reacting to political drift and economic mismanagement in Mexico, foreign lenders and Mexican citizens pulled out their capital and thereby triggered the crisis, which is still far from being resolved.

The East European Problem

The Polish near default, which occasioned little Soviet assistance to Poland, punctured the widely accepted theory about a Soviet umbrella over Eastern Europe. At the same time, the end of East-West detente greatly increased the element of perceived political risk in lending to both the USSR and Eastern Europe. The growth of outstanding Western credits to the Soviet Bloc, which had already greatly slowed during 1977-80 following a fourfold increase in the earlier part of the decade, came to a virtual halt. And in the first quarter of 1982, East European bank debt declined as short-term lines of credit were not renewed. Hungary, East Germany, and Yugoslavia, as well as Poland and Romania, which have already rescheduled their debt, are having serious financial difficulties (see table 5).

Table 5
Eastern Europe:
Hard Currency Debt, 1981

Billion US $

	Source of Funds		Debt Service Ratio [a]
	Total	Private	
Poland	25	14	146 [b]
Yugoslavia	19	13	25
East Germany	15	12	58
Romania	10	7	27
Hungary	9	8	37
Czechoslovakia	5	4	21
Bulgaria	3	2	33
Total	**86**	**60**	

[a] Percent of exports of goods and services.
[b] Represents debt service owed. Amount actually paid equaled 80 percent of exports.

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Future Concerns

The loss of confidence in LDC and East European lending is contributing greatly to the general unease in financial markets which also reflects questions raised by the failures of such financial institutions as Penn Square, Dreyfus Government Securities, Banco Ambrosiano, and Lombard Wall. These failures created uncertainties about the quality of loans, the management of banks, and the circumstances in which financial authorities are willing to provide support.

The nervousness of the financial markets makes the situation volatile and projections hazardous. Even if bankers' confidence returns, outstanding loans to LDCs are unlikely to increase as rapidly in the next several years as in the past decade. An annual rate of growth of 5 to 10 percent—or less than the rate of growth of total bank assets—can reasonably be expected. This would mean an annual net capital inflow of some $15-30 billion to the non-OPEC LDCs. In comparison with 1981, when the net inflow of private loans was about $45 billion, there would be an overall loss of 5 to 10 percent in import capacity.

International financial problems could quickly worsen, especially if industrial country economic activity stagnates well into 1983. There is also a serious risk that bad news will trigger a collapse of market confidence in major LDCs, leading to a drying up of credit. Smaller banks and some large foreign banks are trying to reduce their exposure by not renewing loans when they come due. A continuation of the present political uncertainty in Mexico, or an imminent prospect of rescheduling in Brazil, could hasten this withdrawal. It would be difficult for large banks to offset such a withdrawal without weakening their own position in financial markets. Most LDCs would then be faced with little or no increase in net bank lending, and some would experience a net outflow of bank funds.

Table 6
Selected LDCs:
Importance of Net Private Loans

	Net Borrowing From Private Sources As a Percentage of Imports, 1981
Mexico	75
Argentina	67
Brazil	44
Ecuador	33
Peru	32
Venezuela	32
Chile	30
Philippines	22
South Korea	12
Nigeria	6

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LDC Adjustment Problems

Many LDCs will have to make severe economic adjustments to meet their debt service obligations. Table 6 illustrates the magnitude of the adjustment problem for major selected LDCs. In 1981, net borrowing from private sources covered three-fourths of imports in Mexico, two-thirds in Argentina, 45 percent in Brazil, and about one-third in Chile, Ecuador, Peru, and Venezuela. (Venezuela, however, had a current account surplus.)

Many LDCs have already substantially cut imports in response to the economic recession as well as to reduced lending (table 7). The volume of imports of the non-OPEC LDCs as a group will fall in 1982. Additional import cuts are likely in 1983 in many of the countries:

- Mexico and Argentina have been hit by capital flight as well as reduced net lending. Imports will be down about one-third for 1982, and the current account deficits will be substantially reduced. In recent months, import cuts in Mexico have been even steeper. Output also has fallen. Both countries are trying to reschedule their debt. With some growth of exports likely, especially in Mexico, and, if the financial situation is stabilized to allow some new net lending, additional import cuts should not be necessary in 1983.

- Brazil, which had planned a moderate economic recovery this year, following a recession in 1981, is beginning to put the brakes back on in order to curb imports, as exports have fallen. New credit has nearly dried up in recent weeks, and severe austerity will be required if bankers' confidence does not return. In any event, the current account deficit probably will have to be reduced by several billion dollars in 1983, requiring a large reduction in imports.

- Chile has made large import cuts; Ecuador, the Philippines, and Peru, however, have only just begun their economic adjustment. In addition, Ecuador has asked for a rescheduling.

Table 7
Payments Trends in Key LDCs, 1981-82

	Current Account Balance (billion US $)		Percent Change from 1981 to 1982 [a]	
	1981	1982 [a]	Exports	Imports
Mexico	−12.9	−7.5	8	−34
Argentina	−4.1	−3.0	−22	−39
Brazil	−11.7	−13.8	−10	−9
Ecuador	−1.1	−1.4	−4	0
Peru	−1.6	−1.8	0	0
Venezuela	4.0	−1.3	−18	10
Chile	−4.9	−3.0	15	−21
Philippines	−2.6	−3.1	−6	5
South Korea	−4.2	−2.9	5	−2
Nigeria	−5.0	−5.3	−13	−6

[a] Projected.

- South Korea has been able to reduce its current account deficit without significantly cutting imports because of continued, though slower, export growth, and should be able to continue this process. Relatively good export prospects in turn are likely to allow continued net borrowing.

- Venezuela's main problem is one of debt management because almost half its debt is short term. Even if it is successful in rescheduling its short-term debt, some austerity will be required.

- Nigeria does not yet have a large debt burden, but its debt has been increasing at a rapid rate because of large current account deficits due to uncontrolled spending. Imports are beginning to be curtailed, and further reductions will be needed.

The magnitude of the economic adjustments LDCs will have to make in the next year or so and the duration of the period of austerity will be strongly affected by major international economic trends, especially the timing and speed of economic recovery in industrial countries and the changes in interest rates.

If the economies of industrial countries begin to grow at a moderate rate (2 to 3 percent) early next year, as is now generally expected, LDC export earnings also will begin to recover. But imports in most LDCs are unlikely to begin to rise until 1984 at the earliest, because increases in export earnings will probably be used first to reduce current account deficits and to rebuild depleted foreign exchange reserves. A continued economic recession would further depress LDC exports and postpone their recovery. By the same token, a more rapid upswing of the business cycle would push up both the volume and probably the prices of LDC exports.

A substantial further reduction in interest rates also could help to speed up LDC recovery. Every 1-percent decline in interest rates would free up funds equal to 3 to 4 percent of the imports of the 10 major LDC debtors. Declining interest rates will be reflected in new loan agreements, however, only after a lag of several months. Moreover, much of the interest rate decline in recent months has been offset by increased bank charges (spreads and front-end costs) to take account of the higher perceived risks. 25X1

Country-specific factors, such as the export mix, the quality of economic management, and the political strength and will of the government, also are important to LDC economic prospects:

- Exporters of manufactures, such as South Korea, will be in a good position to take advantage of a revival in industrial country demand.

- LDCs dependent on exports of raw materials other than oil will take longer to recover. Commodity prices usually do not move up significantly until excess production capacity is sharply reduced—a process that could take two years or more. Near-term prospects for most agricultural exports also are not bright, although the picture could change quickly if weather conditions turned poor.

- LDC exporters of petroleum (for example, Mexico, Venezuela, Ecuador, and Nigeria) must make fundamental changes in economic development policies to take account of stagnating or falling oil prices. They will probably have to constrain imports for at least several years.

- Should there be a substantial absolute fall in oil prices—a reasonable possibility—many of these countries would face a disastrous situation, requiring deep additional cuts in imports. For example, a $5 a barrel drop in oil prices would require a *further* import cut of 15 to 20 percent for Mexico, Venezuela, Nigeria, and Ecuador. LDC oil importers would receive compensating benefits, but those benefits would be spread among many countries, while losses would be concentrated in a few countries.

- Countries that are mismanaged economically, such as Argentina, or that must contend with domestic political upheavals will probably not achieve a manageable foreign payments position in the foreseeable future.

- Communist countries are unlikely to take full advantage of a Western economic recovery because of their rigid form of economic management. Moreover, the East European countries are being squeezed both by the near cessation of Western lending and by imposed cuts in imports of Soviet oil. Their economic prospects are poor.

The Repercussions of Excessive Adjustment

Although substantial economic adjustment by LDCs is inevitable and, for some countries, is desirable, the process will create economic problems for the Western countries themselves, political resistance in the LDCs, and possibly policy shifts damaging to US and Western interests. There is also a risk of debtors' reactions so strong as to threaten the stability of the international financial system. These problems and risks already exist; they would be substantially increased if the flow of net private credit to LDCs should cease.

Industrial countries will be hurt by the economic problems of the LDCs. A $15-25 billion decline in LDC imports would reduce OECD GNP by about 0.5 percent. In addition, there is a high risk that, faced with a drying up of international lending and a severe economic contraction, LDCs will turn increasingly to bilateral trade and payments relationships and to internally oriented economic policies, such as heavy protection of domestic producers. Such a trend would severely damage the long-established US policies of fostering an open, multilateral world economy.

Many LDCs will try to reduce the necessary import cuts through debt rescheduling. In some countries, there may be a succession of reschedulings. Some countries, moreover, may be tempted to stop payment of interest as well as capital.

A drying up of or a major reduction in bank credit would also bring a strong political response from LDCs, especially a loud and insistent chorus of LDC demands for a general restructuring of debt. Although such demands have been expressed before, they had little political impact on countries borrowing heavily from banks, in part because real interest rates were low or negative. The response is likely to be far more positive and vehement under present circumstances.

There is a possibility, especially if the financial situation deteriorates, that this rhetoric will stimulate specific actions by LDCs that amount to some form of debtors' revolt. The debtors realize that formal default would cut them off from bank capital in the future and force them to finance trade on a strictly cash basis. On the other hand, the prospect of continuing interest payments at the cost of lower income and employment in the near term and lack of economic growth for several years is difficult to accept, particularly for large debtors who are aware that their actions can also do great harm to their creditors. Moreover, most of the big debtors, including Mexico, Argentina, and Brazil, are running surpluses on their current account transactions, excluding interest, so that they could see the prospect of increasing import capacity if interest were not paid.

A debtors' revolt would most likely begin with announcement of a debt moratorium by a major country, which could trigger a chain reaction. Brazil's role is probably crucial. Brazil has followed responsible economic adjustment policies. It can legitimately blame its recent, increasingly serious funding difficulties to a substantial extent on the spillover effect of other countries' financial problems. Although not under severe domestic political constraints, the Brazilian Government could choose to respond to nationalistic, populist currents, and to a desire to play a leadership role internationally. Mexico, Argentina, and other Latin American countries would almost certainly follow a Brazilian lead. Brazil is more likely, however, to try if necessary to meet its obligations through rescheduling.

Argentina also could be the instigator, given the country's political history. The widespread political appeal of Peronism, coupled with the discrediting of the military leadership, make it likely that some populist policies will be adopted. There is, moreover, a significant possibility that a radical populist regime will come to power. Such a regime would be tempted to declare a moratorium on debt service payments as a means of freeing up foreign exchange for economic development. The regime could argue that Argentina normally has a surplus on its trade account and, therefore, would be in good shape, if it were not for the enormous debt burden.

There is little doubt in any case that severe and prolonged economic disruptions and unemployment, which could be attributed to the actions of foreign bankers, would spur strong nationalistic reactions in many countries, notably in Latin America, possibly including restrictions on US firms, and anti-US positions in foreign affairs.

It is highly unlikely that hard times would lead to the coming to power of Communist or extreme Marxist governments in any major LDC in the near term, although leftwing insurgencies, such as those in Central America, would become even more difficult to contain. In most LDCs, the military is the final arbiter of power and would take the responsibility to either impose or reestablish order. Although in most countries the military would not promote social revolution, it would be at times inclined toward narrow, inward-looking nationalism and flirtations with Moscow on such matters as arms purchases. In the longer term tough military rule, coupled with the likely failure of nationalist economic policies, might become a breeding ground for the growth of revolutionary movements.

An extended economic downturn would put great strain on the political system in Mexico, in the continued stability of which the United States has an enormous stake. Although the Mexican political system has been stable, strong, and resilient, there is a risk that bad times will so polarize the left and right wings of the PRI as to eventually cause a breakup of that dominant political institution. There are few signs that such a trend is in progress but the possibility cannot be wholly discounted, and in any event cannot be ignored because the consequences would be too serious. Widespread violence, threats to US persons and property, massive border crossings, and the potential for eventual radical leftwing takeover all would be within the realm of possibility.

Potential for a Panic

The LDC and Soviet Bloc debt problems are likely to weaken the position of many Western banks. Massive reschedulings, such as those in Mexico and Argentina at a minimum, will reduce bank flexibility, hamper individual bank financing, and force adjustments in other parts of their asset portfolio. The total external debt of the LDCs and Communist countries that have rescheduled or will soon do so is about $200 billion, and countries with another $100 billion or more of external debt are having difficulties. The amount of this debt that is held by major banks probably exceeds their capital and constitutes nearly 5 percent of their assets. Should LDC problems prove so difficult as to require repeated reschedulings in major countries, rates of return on assets would decline because of the need to increase loan loss reserves and the likely deferment of some interest income. The weakest and most exposed banks would have to pay higher interest rates for deposits.

With their financial position weakened by both international and domestic developments—many domestic firms are in poor shape—and, with the intense nervousness in financial markets, the risks of a major financial panic have greatly increased, although they are probably still small. There is great concern that a major shock—such as default by a large international borrower—could trigger a large-scale withdrawal of deposits from exposed banks, placing these institutions in jeopardy and threatening a chain reaction.

How effectively such a crisis would be contained would depend on the actions of central banks. There are potential gaps in the coverage of the central bank support net and ambiguities as to the circumstances in which support would be provided.

Central banks are prepared to provide support in a liquidity crisis, not to bail out insolvent banks. In a crisis, when action must be taken immediately, it is not always possible to determine whether a bank is solvent or not. The chances are, however, that a clear-cut threat to the international financial system, such as default by a major borrower, would trigger immediate action by the central banks. They would provide enough funds to keep the banks operating. Solvency, legal, and bank management issues would be tackled later.

Even so, some banks would not be covered and would probably fail:

- LDC central banks may lack sufficient foreign exchange to support their commercial banks in case of trouble.

- Responsibility for supporting jointly owned banks and subsidiaries is often unclear.

- Although the central banks of the major industrial nations have accepted fairly clear-cut responsibility for supporting the foreign branches of their national banks, there is still uncertainty for some central banks about whether they or the central bank of the host country are responsible for supporting subsidiaries.

The major dangers to the stability of the international financial system would come from the following types of developments:

- ***If central banks were unwilling to act quickly and in unison in an emergency.*** The unwillingness of the Group of Ten to act in unison in the face of a major threat to the international financial system is the least plausible of these dangers, although the most serious. Such a division would almost certainly require a profound divergence of policies among the governments of the Group of Ten countries, especially the United States, West Germany, France, and the United Kingdom. Moreover, political splits in all but the most extreme cases would sooner or later give way to a common desire to avoid a global economic calamity.

- ***If central banks were unable to prevent a panic from starting.*** For example, the sudden impact of some massive triggering event may not give central banks adequate time to sort out the problems of national responsibility for overseas banks, thereby making a rescue operation more difficult. Central banks might also delay in providing sufficient liquidity to commercial banks because of their concern that the increased money supply would spark inflationary tendencies.

- ***An undercutting of the informal codes of conduct that sustain confidence in the international financial system***—for example, an indeterminate moratorium on debt and interest payments, such as was discussed above.

- ***A confluence of a number of major events.*** Most likely such a situation would involve the inability of several major countries to meet foreign exchange obligations and some large-scale bankruptcies of companies within the industrial world.

A financial panic would do considerable damage to the world economy; it probably would not lead to a 1930s-type depression. The consequences would include:
- A drastic shrinking of the Eurodollar market and the failure of a number of Eurobanks.
- A near halting of credit to LDCs, forcing even more severe import cuts.
- A serious disruption of trade, especially if debt default were involved.

- A sharp increase in the demand for liquid assets in Western countries, which would result in reductions in credit and economic activity.

Implications for Policy
US and Western policies designed to deal with the LDC and Soviet Bloc debt problem will have to take into consideration the following likely developments:

- Bank credit will probably be a much smaller source of foreign capital inflow to LDCs than in the past decade. Since official aid is unlikely to grow much, if at all, the total capital inflow to LDCs is likely to shrink substantially. For most countries, economic growth will tend to be slower. Soviet Bloc countries will be able to get bank credit only under government guarantees.

- Western banks and governments will be under strong political pressure from LDCs to reschedule debt on a massive scale and on easy terms. The North-South dialogue will be acrimonious and debtors' threats more believable than in the past. Although case-by-case solutions are essential if reasonable discipline is to be imposed on borrowers, some slippage of discipline may occur. Reschedulings are likely to be messy, and some will not stick.

- Large Western banks will have no choice but to hold, and even to increase, outstanding LDC loans which the financial markets consider to be of low quality. Banks will try to reduce this undesirable exposure and, failing this, will seek assistance from governments, arguing that their problems are due partly to having been used as instruments of public policy.

The three key parties coping with LDC debt issues—industrial country governments, LDC governments, and commercial banks—have a common stake in resolving the debt problem. They all want the debtor countries' financial health to be restored in a way that avoids excessive austerity measures while allowing payment of interest. But although this coincidence of general goals provides the glue for agreement, the negotiations as to how the parties will split the burdens involved will be fierce and prolonged.

The LDC debtors realize that, if they fail to take sufficient belt-tightening actions, foreign banks and other financial institutions will be reluctant to provide fresh funds or significant debt service relief. In that case, the debtor countries would have to cut imports anyhow. On the other hand, if the debtor countries become convinced that they would receive little or no increase in funds no matter how much austerity is imposed, they would have less to lose by imposing a debt moratorium.

Major commercial banks want to reduce their exposure to most LDCs but are generally unable to do so. When necessary to avoid formal default, they have provided new funds which, in effect, have capitalized interest payments. In some cases, they also have little choice but to offset the withdrawal of funds from smaller banks which have much less to lose in the event of default. Formal rescheduling of LDC debt can be advantageous to the major banks, as well as to the LDC governments, because it locks in the smaller banks.

Industrial country governments have two key goals in regard to the debt issues. They want to prevent financial strains in debtor countries from causing political-economic turmoil and they want to retain confidence in the financial system. In doing so they have two lines of defense. The first involves propping up the LDC financial position by supplying fresh funds through official sources—for example, through a special IMF emergency fund—thereby allowing debtor countries to service their foreign bank debt without excessive austerity measures. That effort would be successful only if (1) the debtors did not loosen their belt-tightening policies too much and (2) the banks did not use the opportunity to reduce their exposure. The second line of defense involves providing the banks with sufficient liquidity to retain the confidence of depositors in the safety of financial assets in the face of substantial LDC moves to reduce their debt burden. Although ambiguities and uncertainties in the lender-of-last-resort function are inevitable, some clarification of responsibilities may be feasible in order to build market confidence.

Emergency financial measures could be reinforced by longer term, confidence-building measures, such as expansion of multilateral financial facilities and even more explicit policy commitments to maintaining market access for LDC products in industrial countries. Beyond specific steps such as these, a steady recovery of the economies of industrial countries, together with lower real interest rates, is indispensable if LDC economic and financial health is to be restored in a reasonable period of time. If it is not, not even a combination of measures is likely to prevent recurrent crises.

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CIA	ADDRESS	:	001/205/0300/0050027 [redacted] DEPUTY EXECUTIVE SECRETARY ROOM 7E12, HQS.	(A-1)	1	104	104
CIA	ADDRESS	:	001/210/0131/0052018 ICS/PAO VIA: BW09 [redacted]		1	105	105
CIA	ADDRESS	:	001/230/0610/0054001 JAMES H. TAYLOR INSPECTOR GENERAL HQS.		1	106	106

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25X1

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CIA	ADDRESS	:	001/233/0370/0055055 [redacted] CHIEF, DDI/CSS ROOM 2F42, HQS.	1	107	107	25X
CIA	ADDRESS	:	001/216/0300/0058010 [redacted] COMPTROLLER/INTELLIGENCE GROUP ROOM 4E06, HQS.	1	108	108	25X
CIA	ADDRESS	:	001/231/0351/0060200 ROBERT M. GATES DDI ROOM 7E44, HQS.	1	109	109	
CIA	ADDRESS	:	001/231/0131/0060203 DIXON DAVIS ASST. TO DDI FOR CURRENT SUPPORT ROOM 7E44, HQS. VIA DDI REGISTRY	1	110	110	
CIA	ADDRESS	:	001/231/0131/0060212 [redacted] (A-1) A/DDI/SD ROOM 3E63 HQRS	1	111	111	25X1
CIA	ADDRESS	:	001/231/0131/0060214 HELENE BOATNER CHIEF PRODUCT EVALUATION STAFF(PES) VIA BARBARA WINGFIELD ROOM 7F24 VIA CPAS REGISTRY	1	112	112	
CIA	ADDRESS	:	001/231/0405/0060216 DDI REGISTRY (A-1) DDI STAFF AND NIC DISSEMINATION ROOM 7E47, HQS.	1	113	113	

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CIA	ADDRESS	:	001/231/0372/0060234 DDI/SRP ROOM 5GOO, HQS.	1	114	114
CIA	ADDRESS	:	001/219/0131/0060502 AC/NIC VIA DDI REGISTRY ROOM 7E47 HQRS.	1	115	115
CIA	ADDRESS	:	001/219/0131/0060504 EO/NIC VIA DDI REGISTRY ROOM 7E47 HQRS	3	116	118
CIA	ADDRESS	:	001/219/0532/0060525 CONSTANTINE MENGES NIO/LA VIA: DDI REGISTRY ROOM 7E47, HQS.	1	119	119
CIA	ADDRESS	:	001/219/0530/0060543 VC/NIC VIA: DDI REGISTRY ROOM 7E47, HQS.	1	120	120
CIA	ADDRESS	:	001/219/0537/0060546 NIO/W VIA: DDI REGISTRY ROOM 7E47, HQS.	1	121	121
CIA	ADDRESS	:	001/219/0527/0060555 DR. LINCOLN GORDON NIO AT LARGE VIA DDI REGISTRY ROOM 7E47, HQS.	1	122	122

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CIA	ADDRESS	:	001/219/0527/0060557 NIO/ECONOMICS STAFF VIA DDI REGISTRY		1	123	123	
CIA	ADDRESS	:	001/219/0525/0060565 NIC/AG VIA DDI REGISTRY ROOM 7E47, HQS.	(2)	2	124	125	
CIA	ADDRESS	:	001/232/0374/0060614 DDI/CRES/RSG ROOM 3E58, HQS.		1	126	126	
CIA	ADDRESS	:	001/232/0131/0060618 [redacted] CRES/ASPG ROOM 3E59, HQS.		1	127	127	25X1
CIA	ADDRESS	:	001/231/0131/0060669 DDI/TTIC/COMEX STAFF 903 KEY BLDG NOTE: (NID FOR DAVE HARTMANN)		1	128	128	
CIA	ADDRESS	:	001/235/0131/0060701 CPAS/SOO STAFF ROOM 7F33, HQS.		1	129	129	
CIA	ADDRESS	:	001/235/0730/0060703 [redacted] CURRENT INTELLIGENCE CENTER/CPAS ROOM 7F30, HQS.		1	130	130	25X1

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CIA	ADDRESS	:	001/235/0379/0060705 FOREIGN LIAISON STAFF/CPAS ROOM 7G33, HQS.	1	131	131	
CIA	ADDRESS	:	001/235/0380/0060732 CHIEF, PUBLICATIONS CENTER (6) CPAS/PDG ROOM 7G30, HQS. (IEEW--4 CYS FOR TPB; 2 CYS FOR ESB)	3	132	134	
CIA	ADDRESS	:	001/235/0469/0060741 [redacted] CHIEF, INFORMATION MANAGEMENT CENTER ROOM 7G25, HQS.	1	135	135	25X
CIA	ADDRESS	:	001/235/0384/0060744 [redacted] DEP CH, INFORMATION MANAGEMENT CENTER ROOM 7G25, HQS.	1	136	136	25X
CIA	ADDRESS	:	001/235/0722/0060745 [redacted] SPECIAL ASSISTANT FOR DISSEMINATION ROOM 6F44, HQS.	1	137	137	25X
CIA	ADDRESS	:	001/235/0131/0060748 CHIEF, CARTOGRAPHY AND DESIGN GROUP ROOM GH08, HQS.	1	138	138	
CIA	ADDRESS	:	001/235/0131/0060780 [redacted] (A-1) CHIEF CPAS/STATISTICAL ANALYSIS CENTER(SAC) ROOM 6F44, HQS.	1	139	139	25X

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CIA	ADDRESS	:	001/260/0784/0061015 [redacted] OCR/DSD ROOM GF18, HQS.	(A-5) (NIC DRAFTS-1)	5	140	144	25X1
CIA	ADDRESS	:	001/274/0405/0061251 OSWR REGISTRY ROOM 5G15, HQS.	(A)	5	145	149	
CIA	ADDRESS	:	001/266/0423/0061377 CHIEF, PROCUREMENT BRANCH OCR/MLD/P DOOR 91		1	150	150	
CIA	ADDRESS	:	001/266/0423/0061381 [redacted] CHIEF, REFERENCE BRANCH MAP SERVICES DIVISION DOOR 91		1	151	151	25X1
CIA	ADDRESS	:	001/270/0405/0061400 OIA OFFICE OF THE DIRECTOR ROOM 3N100 [redacted]		1	152	152	25X1
CIA	ADDRESS	:	001/270/0425/0061405 OIA STAFF ROOM 1S506 [redacted]		1	153	153	25X1
CIA	ADDRESS	:	001/246/1031/0075006 OFFICE OF SOVIET ANALYSIS REGISTRY [redacted]	(A-69/14) (OSWR/SOV-28) (OTHER/EUR-28)	11	154	164	25X1

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			001/250/1276/0085001			
CIA	ADDRESS	:	OFFICE OF AFRICAN & LATIN AMERICAN ANAL. DIRECTOR HQS. (NID'S VIA OPCEN FOR FRANK REYNOLDS)	1	165	165
			001/250/1280/0085006			
CIA	ADDRESS	:	OFFICE OF AFRICAN & LATIN AMERICAN ANAL. PRODUCTION STAFF (A-6/1) HQS.	1	166	166
			001/250/1291/0085015			
CIA	ADDRESS	:	OFFICE OF AFRICAN & LATIN AMERICAN ANAL. MIDDLE-AMERICA CARIBBEAN DIVISION HQS. (A-4/1)	1	167	167
			001/250/1297/0085021			
CIA	ADDRESS	:	OFFICE OF AFRICAN & LATIN AMERICAN ANAL. SOUTH AMERICA DIVISION (SA) (A-4/1) HQS.	1	168	168
			001/250/1303/0085027			
CIA	ADDRESS	:	OFFICE OF AFRICAN & LATIN AMERICAN ANAL. WEST & EAST AFRICA DIVISION (A-4/1) HQS.	1	169	169
			001/250/1309/0085033			
CIA	ADDRESS	:	OFFICE OF AFRICAN & LATIN AMERICA ANAL. SOUTHERN AFRICAN DIVISION (A-4/1) HQS.	1	170	170
			001/250/1278/0085042			
CIA	ADDRESS	:	OFFICE-AFRICAN & LATIN AMERICAN ANALYSIS ALA/RD HQS.	1	171	171

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CIA	ADDRESS	:	001/249/1229/0090034 OFFICE OF EAST ASIAN ANALYSIS (OEA) PRODUCTION OFFICER (18/6) HQS. (SW/8-OEA RELATED)	6	172	177
CIA	ADDRESS	:	001/248/1176/0095001 OFFICE OF NEAR EAST-SOUTH ASIA ANALYSIS DIRECTOR HQS. (A-5/1)	1	178	178
CIA	ADDRESS	:	001/248/1184/0095008 OFFICE OF NEAR EAST-SOUTH ASIA ANALYSIS ARAB/ISRAELI DIVISION HQS. (A-4/1)	1	179	179
CIA	ADDRESS	:	001/248/1191/0095014 OFFICE OF NEAR EAST-SOUTH ASIA ANALYSIS PERSIAN GULF DIVISION HQS. (A-3/1)	1	180	180
CIA	ADDRESS	:	001/248/1197/0095020 OFFICE OF NEAR EAST-SOUTH ASIA ANALYSIS SOUTH ASIA DIVISION HQS. (A-4/1)	1	181	181
CIA	ADDRESS	:	001/248/1197/0095030 OFFICE OF NEAR EAST-SOUTH ASIA ANALYSIS PRODUCTION OFFICER HQS. (A-6/1)	1	182	182
CIA	ADDRESS	:	001/247/1100/0100000 OFFICE OF EUROPEAN ANALYSIS (OOE) PRODUCTION OFFICER (O/EUR) (A-4/2) HQS.	2	183	184

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CIA	ADDRESS	:	001/247/1101/0100001 OFFICE OF EUROPEAN ANALYSIS (OOE) DIRECTOR (A-4/2) HQS	1	185	185
CIA	ADDRESS	:	001/247/1108/0100005 OFFICE OF EUROPEAN ANALYSIS (OOE) WESTERN EUROPE DIVISION (A-4/2) HQS	1	186	186
CIA	ADDRESS	:	001/247/1114/0100011 OFFICE OF EUROPEAN ANALYSIS (OOE) EASTERN EUROPE DIVISION (EE/D) (A-4/1) HQS.	1	187	187
CIA	ADDRESS	:	001/247/1120/0100017 OFFICE OF EUROPEAN ANALYSIS (OOE) EUROPEAN ISSUES DIVISION (EI/D) HQS. (A-4/2)	1	188	188
CIA	ADDRESS	:	001/251/1328/0115000 OFFICE OF GLOBAL ISSUES (OGI) (A-32/7) REGISTRY ROOM 3F50, HQS.	7	189	195
CIA	ADDRESS	:	001/280/0405/0270101 DDO (COLL-18) STAFF (CODEWD-8)	18	196	213
CIA	ADDRESS	:	001/280/0812/0270102 [redacted] IMS/MPG/RMB DDO	1	214	214

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CIA	ADDRESS	[redacted]		1	215	215
CIA	ADDRESS	: 001/281/0455/0381506 OT&E/IT [redacted]		1	216	216
CIA	ADDRESS	: 001/268/0425/0490156 NPIC/IB BRANCH [redacted]		1	217	217
CIA	ADDRESS	: 001/268/0131/0490167 NPIC/WPFD DIVISION [redacted]		1	218	218
CIA	ADDRESS	: 001/268/0476/0490210 NPIC/TWFD DIVISION [redacted]		1	219	219
CIA	ADDRESS	: 001/268/0131/0490211 NPIC/GPB BRANCH [redacted]	(A-1)	1	220	220
CIA	ADDRESS	: 001/228/0348/0490301 PHILIP K. ECKMAN DIRECTOR OF RESEARCH & DEV. ORD REGISTRY [redacted]		1	221	221

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CIA	ADDRESS	:	001/277/0405/0490403 FBIS [redacted]		1	222	222
CIA	ADDRESS	:	[redacted] [redacted]	(A-1)	1	223	223
CIA	ADDRESS	:	001/287/0348/0496600 OSO/PAS ROOM 1011 [redacted] [redacted]		1	224	224
CIA	ADDRESS	:	001/231/0300/9065996 AUTHOR THIS PAPER VIA: OFFICE PROD. STAFF	(A)	60	225	284 [redacted]
CIA	ADDRESS	:	001/235/0352/9065997 FILE COPY / SOURCED COPY PRODUCTION FOLDER CPAS/IMC/CONTROL BRANCH ROOM 7G07, HQS.	(A)	2	285	286 287 288 289 [redacted]
CIA	ADDRESS	:	001/235/0928/9065998 EXTRA COPIES CONTROL BRANCH ROOM 7G07, HQS.	(25)	25	290 - ~~287~~	311 ~~311~~
CIA	ADDRESS	:	001/223/0928/9065999 SUPPLEMENTAL DISSEM VIA: AGENCY RECORDS CENTER	(A)	116	~~312~~ 387	- ~~427~~ 427

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