PO-CH/NL/0390

PART A

Part. A.

SECRET

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Begins: 12/1/89.
Ends: 1/2/89.

PO -CH /NL/0390

PART A

Chancellor's (Lawson) Papers:

CHANCELLORS MEETING WITH THE NEW AMERICAN TREASURY SECRETARY BRADY TO DISCUSS INTERNATIONAL DEBT

DD's: 25 Years

8/12/95

PO -CH /NL/0390
PART A

BILATERAL WITH BRADY

pso.j

SECRET

Thanks. I wd only add that I was profoundly unimpressed by Brady's attitude on Budget deficit — the fact are [illegible] need to do is fudge the GRH figures, & [illegible] any deficit within them figures [illegible] for higher PX on 'a kinder, gentler America' — & somewhat contemptuous by the confusion [illegible] deficit reduction & the [illegible] Govts, rather than [illegible] planning [illegible] policy [illegible]

From: SIR PETER MIDDLETON

Date: 12 January 1989

CHANCELLOR

cc Sir T Burns
Mr Wicks
Mr Lankester
Mr H Evans

CONVERSATION WITH MR BRADY

1. You and Mr Brady, the US Treasury Secretary, met for an informal discussion on 10 January, in the US Treasury, Washington. Mr Mulford and I were present.

2. Mr Brady thanked you warmly for taking the trouble to come to see him at the start of the new administration. The following subjects were discussed.

The US Budget etc

3. Mr Brady gave a rather uncertain account of US budgetary policy. He was clearly concerned about the growth of federal expenditure especially on Medicare which by 2002 was predicted to equal the size of the social security programme, and by 2020 was likely to equal both social security and defence. He thought that an acceptable budget in line with Gramm Rudman Hollins could be produced for 1990, but given the nature of Congress the measures might have more of a Democrat flavour than some would wish. Vice President Bush would devote far more attention to dealing with Congress when he became President than had President Reagan. He was indeed planning to address both houses of Congress on his ideas. Meanwhile the line would be that Gramm Rudman had to be met - by sequestration if necessary.

G7

4. Mr Brady said that dates had been arranged for a G7 meeting

[illegible]

PEM TO CX 12 JAN

but that he had not yet issued formal invitations. He wanted your views first. It was pretty clear however that he wished to hold the meeting for four reasons. First, it seemed a natural thing to do at the start of the new Presidency. Second, the collegiate nature of the G7 meant that one should respond to colleagues who strongly wanted a meeting such as the Germans and the French. Third, it would be useful to clear lines on debt issues before the April meetings. Fourth, it would be desirable for everyone to meet the new Japanese Minister.

5. After some discussion, it became clear that it was not worth trying to dissuade Brady from holding the meeting; he might well have agreed to do so had you put it to him but it would not have been a sensible favour to ask when there might be other more important things on which we should need his help. You did however stress the market dangers of such a meeting and you made it clear that you would only agree to it on the understanding that there would be no communique and that this should be stated in advance. It was eventually agreed that it should be explained to Stoltenberg (the Germans were asking for "no substantive communique" which was unacceptable) in these terms and to the other G7 members. An announcement might be made next week to distance it from the Washington visits of Lawson and Stoltenberg.

6. We subsequently suggested to Mulford on the 'phone that there should be a G5 meeting before the G7 dinner on 2 February.

<u>Adjustment</u>

7. <u>Mr Brady</u> then offered some thoughts on adjustment. He would like to achieve stability within the G7 if possible at the present exchange rate; he certainly did not want to see the dollar pushed down at present and the US had done some intervention to prevent the dollar rising. But he was worried that the external deficit would begin to look permanent and that would cause trouble at some stage in the markets. He was concerned that the German trade surplus remained massive and the Japanese surplus appeared to be

rising again. Mulford who took up this theme seemed quite obsessed with the German surplus; he did not seem to mind whether it was dealt with by a higher DM rate or a budgetary expansion - or pay much account to the fact that the German surplus was primarily with Europe and not the United States. There were, moreover, lots of supply side measures which he thought the Germans should be taking.

8. You said that it remained important for the US to deal with its Budget deficit. Provided the deficits were moving in the right direction the US would not have a financing problem. The German economy looked strong at present and it was difficult to imagine that it should be expanded further or that the German authorities would contemplate this. There was no market pressure pushing up the mark. It might be more appropriate to tighten policy in the United States where exports might be being limited by the demands of the home market.

9. Brady replied that he did not think the US was close to capacity, otherwise there would be signs of rising inflation which was clearly not the case. He did however respond favourably to two ideas you put forward. One was to consider some rebasing against the yen. The other was to engage in some foreign currency borrowing now that the Reagan era was passing; he was surprisingly forthcoming in saying he would think about that one.

Debt

10. Most of the discussion concerned debt issues with long expositions from Brady and Mulford who played a disproportionate part in the proceedings. Brady has clearly still not come to a definitive position but feels himself under pressure from a combination of Congress, the State Department and Latin American countries - especially Mexico which has been asking for $7+ billion a year assistance for the next few years.

11. He was emphatic that the Treasury was in the lead on debt issues; but he clearly needs to come up with a set of proposals.

12. The Brady line is roughly as follows. The banking system in the US is now much sounder - the number of important banks facing difficulties was down to one or two. The debtor countries on the other hand saw their debts growing, were getting weary with the present arrangements, and saw standards of living declining. There was a risk that much of the present assistance to these countries simply financed capital flight. He did not want to see bank debts baled out by public money; indeed, he wished to arrest the slide to the taxpayer. He did not favour large additions to Bank/Fund resources. We needed some sort of agreement among the larger countries about how to handle the issue. This might involve measures to reduce the debt service burden of the better placed who were taking the right steps - "actually doing something"; there was simply not enough money in the West to deal with the whole problem. He was not thinking of a grand new plan, but a new presentation and new approach on which we could all agree.

13. Mulford spelled this out as follows. Fund/Bank exposure was already so large that their own credit rating was at risk. It was essential not to simply reschedule from the banks to international institutions. So we should concentrate our help on those countries which were willing to adjust and, equally important, to co-operate with the banks in voluntary debt reduction (defined as debt/equity schemes, exit bonds and the like). The proposals would then need to be packaged so they were acceptable to the third world, to Congress and the banks.

14. You said that you agreed with this broad approach which seemed in line with the present strategy and appeared to amount to three things: no transfer of responsibility for debt from the banks to the public sector; no huge global plan; not letting the Bank and Fund become increasingly like part of the international aid programme. You would also support any efforts to measure capital flight though this was inherently difficult. And you certainly agreed that nothing should be done to suggest to the banks that governments might make money available to enable them to avoid dealing with third world debts to the banking system.

15. There is more to come on the precise proposals from the Americans, but the general lines of their thinking seem clear. You suggested to Mr Brady that a short paper from the US at the G7 meeting (handed out and collected back at the meeting) might be a good idea. You said that he could rely on your support for his general approach.

16. There was then some discussion about the attitude of Germany and Japan. Brady was surprised by both countries. He thought Japan's approach had been disoriented by their desire to get the number 2 spot in the Fund. You cautioned against opposing a greater Japanese presence in debt matters; we wanted them to play a larger role - especially perhaps the Japanese banks who were now the largest in the world. But it must be properly directed.

G77

17. Mulford raised two other issues. First, he expressed surprise that we were sponsoring a resolution for a G77 debt conference. We expressed ignorance, but it subsequently turned out that the subject was sub-Sahara debt.

1992

18. Second, he was fussed about reciprocity in UK legislation but much more so as it might be enacted in European legislation for 1992. You explained that we had never used our domestic legislation; that we were opposed to the present European proposals - so were a lot of others - and you expected it would turn out all right.

Rover

19. As a little quid pro quo, you said that reclassifying Range Rover as a truck would be badly received in the UK and it was amazing that the US had a 25% duty on anything. Mr Brady took note and said he would look into it.

PEM

P E MIDDLETON

chex.md/aa/19 **SECRET**

FROM: A C S ALLAN
DATE: 16 January 1989

PY

SIR P MIDDLETON

cc Sir T Burns
Mr Wicks
Mr Lankester
Mr H Evans

CONVERSATION WITH MR BRADY

The Chancellor was grateful to you for your minute of 12 January recording the discussions with Brady. He would only add that he was profoundly unimpressed by Brady's attitude to the Budget deficit - ie that all they need to do is fudge their way to the Gramm Rudman figures, and if they find any daylight within these figures use it for higher public expenditure on a 'kinder, gentler, America'; and he was somewhat concerned by the confusion in Brady's mind over debt reduction and the role that Governments, rather than commercial banks, should play in this. Clearly, our policy must be to take the toughest practicable line in the IMF and other IFIs, so as to force the commercial banks to negotiate debt reductions on the best terms they can secure, without any Government involvement. Brady is sympathetic to this, but the Chancellor is not sure he is tough enough or clear enough in his mind to outface the pressures from Congress, the State Department and Latin America to which he feels he has to respond somehow.

ACSA

A C S ALLAN

ACSA
TO
PEM
16 JAN

DEPARTMENT OF THE TREASURY
WASHINGTON
15TH & PENNSYLVANIA AVE, N.W.
WASHINGTON, DC 20220

FACSIMILE COVER SHEET

DATE 1/18/89

FAX MESSAGE NUMBER: 3743

NUMBER OF PAGES TO FOLLOW: 2

TO: The Right Honorable Nigel Lawson, M.P., Chancellor of the Exchequer, H.M. Treasury, London

ADDRESSEE'S FAX NUMBER: 9011 ~~001~~4418392029

ADDRESSEE'S CONFIRMATION NUMBER:

FROM: Nicholas F. Brady

SENDER'S FAX NUMBERS: (202) 566-8066 OR (202) 535-3807

SENDER'S CONFIRMATION NUMBER: (202) 566-8114

COMMENTS/SPECIAL INSTRUCTIONS:

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ANNEX D

THE INDICATORS

Forecasts

1. The tables at the end of this annex summarise the forecasts of the main indicators for the G7 as a whole and for the US, Japan, Germany and the UK. The forecasts submitted by national administrations and those prepared by the IMF Staff are shown together with the relevant figures from the OECD's December Economic Outlook and from the January WEP forecast. The UK's national figures are of course based on the Autumn Statement forecast and not on the recent January forecast.

INDICATORS BRIEF

2. Several points are worth noting on the forecasts. The IMF's forecast is based on the conventional assumption of no policy changes, and this may explain some of the differences between it and the other forecasts, including our own. The IMF forecast assumes no further tightening of US monetary policy and no changes in real exchange rates; its assumption for oil prices ($13.20 per barrel average for 1989) looks very low in the light of recent developments.

3. The various forecasts for the G7 as a whole (Table 1) look very similar - there is a soft landing in all of them. The IMF's forecast landing is very soft indeed.

4. The IMF's forecast is alone in predicting a widening in the external balances (in nominal dollars) of both the US and Japan after 1988. Even as a percentage of GNP, the US and Japanese imbalances barely decline from their 1988 level. The national and OECD forecasts are considerably more optimistic about the prospects for external adjustment.

5. The US forecast of its own economy (Table 2) is unrealistically optimistic. GNP growth remains above 3 per cent, yet inflation declines slightly to 3.7 per cent while the current account deficit falls to $110 billion by 1990. All of this is achieved with a cut in the fiscal deficit to 1.7 per cent of GNP

by 1990 and a much easier monetary policy. Short-term interest rates (not shown in the table) fall to 5½ per cent, or less than 2 per cent in real terms, by 1990. The US arguments for strengthening the indicators exercise, turning the medium-term indicators into "objectives" and establishing "monitoring ranges" around them, sit very oddly with the unrealistic set of figures the US authorities have actually put forward for the current exercise.

6. The Japanese national forecast (Table 3) is typically conservative, with lower growth and higher inflation in 1989 than any of the other forecasts (which are remarkably similar to each other). The current account surplus, however, falls by 10 per cent in 1989 and declines further in 1990 even in nominal terms.

7. The forecasts are unanimous in predicting a slowdown in growth in Germany in 1989 and a pickup in 1990 (Table 4). This pattern is probably based on the announced swing in fiscal policy stance, but it should not be relied upon despite the apparent unanimity of view.

Commodity Prices

8. The IMF paper includes the now standard charts of changes and levels of commodity prices, both including and excluding oil. Both measures show some easing in the rate of increase of commodity prices during the second half of 1988, with only a small re-acceleration towards the end of the year. There are however reasons for thinking that the IMF indices provide too sanguine an indicator of the underlying inflationary pressures in the G7 as a whole.

9. On the IMF's index excluding oil (Chart 1), prices for the latest month are about 7 per cent higher in SDRs than a year earlier. However, on the Economist index of commodity prices, which is also based on SDRs, the annual increase is as much as 20 per cent. The difference can be largely explained by:

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(i) the 10 per cent weight for gold in the IMF's index, as against a zero weight in the Economist index. Gold prices have fallen by almost 7 per cent in SDR terms since January 1988. The UK has of course consistently argued against the inclusion of gold in the commodity price index to be used in G7 surveillance;

(ii) a lower weight for metals prices in the IMF index - 14 per cent as against 29 per cent in the Economist index. Metals prices have increased by about 40 per cent since a year ago.

10. Because of the distorting influence of gold, the Economist index may well be a better indicator of potential inflationary pressures in the world economy than the IMF index. The index including oil has a lower weight for gold - 5 per cent - though the oil price itself may reflect demand pressures less than other commodity prices do. On 20 January, spot oil prices peaked at more than $5 per barrel higher than before the OPEC production agreement of 26 November, but have since fallen back about $2½ a barrel.

11. This suggests the following line to take:

(i) IMF commodity price indices no cause for complacency on prospects for inflation - recent increases may be distorted downwards by inclusion of gold with a much higher weight than level of consumption warrants;

(ii) Need to watch commodity prices closely, particularly if further substantial rises in non-gold component accompanied by stronger oil prices.

TABLE 1

FORECASTS FOR TOTAL G7

(December 1988/January 1989)

	Real GNP/GDP growth (%)			Real domestic demand growth (%)			Current account ($billion)		
Forecast	1988	1989	1990	1988	1989	1990	1988	1989	1990
National	4.0	3.3	-	4.2	3.2	-	- 47	- 36	-
UK (WEP)	4.2	3.1	2.6	4.4	3.3	2.6	- 33	- 25	- 14
OECD	4¼	3¼	2¾	4¼	3¼	2¾	- 50	- 36	- 35
IMF Staff	4.2	3.3	3.1	4.4	3.3	3.2	- 34	- 35	- 43

	Consumer price inflation(%)			Fiscal balance (% of GNP/GDP)		
National	3.1	3.3	-	-	-	-
UK (WEP)	3.1	3.8	3.6	- 2.3*	- 1.8*	- 1.9*
OECD	3¼	3½	3¾	- 1.9*	- 1.7*	- 1.6*
IMF Staff	3.1	3.8	3.4	- 1.9*	- 1.6*	- 1.3*

- not available

* general government balance

TABLE 2

FORECASTS FOR US

(December 1988/January 1989)

	Real GNP/GDP growth (%)			Real domestic demand growth (%)			Current account ($billion)		
Forecast	**1988**	**1989**	**1990**	**1988**	**1989**	**1990**	**1988**	**1989**	**1990**
National	3.8	3.3	3.2	2.9	2.8	2.6	- 135	- 115	- 110
UK (WEP)	3.9	2.8	1.9	2.9	2.5	1.7	- 132	- 125	- 125
OECD	3¾	3	2½	3	2½	2¼	- 132	- 116	- 108
IMF Staff	3.9	3.0	2.9	2.9	2.5	2.7	- 123	- 125	- 137

	Consumer price inflation(%)			Fiscal balance (% of GNP/GDP)		
National	3.9	3.9	3.7	- 3.2	- 3.2	- 1.7
UK (WEP)	4.1	4.7	4.7	- 2.0*	- 1.8*	- 1.7*
OECD	4¼	4½	4¾	- 2.8	- 2.6	- 2.3
IMF Staff	4.1	4.7	4.5	- 3.2	- 3.3	- 2.6

- not available

* general government balance

TABLE 3

FORECASTS FOR JAPAN

(December 1988/January 1989)

	Real GNP/GDP growth (%)			Real domestic demand growth (%)			Current account ($billion)		
Forecast	1988	1989	1990	1988	1989	1990	1988	1989	1990
National	4.9	4.0	3.7	6.7	4.7	4.2	78	71	66
UK (WEP)	5.8	4.7	4.2	7.9	6.2	4.7	82	80	84
OECD	5¾	4½	3¾	7½	5	4¼	79	77	72
IMF Staff	5.8	4.8	4.3	7.8	5.3	4.8	79	86	93

	Consumer price inflation(%)			Fiscal balance (% of GNP/GDP)		
National	0.7	2.0	1.5	- 2.4	- 1.8	-
UK (WEP)	0.4	1.5	1.8	0*	0*	0*
OECD	0	1	1¼	-	-	-
IMF Staff	0.7	1.4	1.0	-	-	-

- not available

* general government balance

TABLE 4

FORECASTS FOR GERMANY

(December 1988/January 1989)

	Real GNP/GDP growth (%)			Real domestic demand growth (%)			Current account ($billion)		
Forecast	1988	1989	1990	1988	1989	1990	1988	1989	1990
National	3.4	2.5	-	3.7	2.5	-	48	48	-
UK (WEP)	3.6	2.7	2.9	3.9	2.3	3.2	52	60	63
OECD	3¾	2½	2¾	4	2	2¾	45	51	52
IMF Staff	3.5	2.4	2.8	3.7	2.2	3.2	49	52	53

	Consumer price inflation(%)			Fiscal balance (% of GNP/GDP)		
National	1.2	2.3	-	- 2.6	- 2.1	-
UK (WEP)	1.3	1.7	1.0	- 2.0*	- 1.5*	- 2.0*
OECD	1¼	2¼	2	- 2	- 1¼	- 2
IMF Staff	1.2	2.4	2.4	- 2.6	- 2.0	- 2.2

- not available

* general government balance

TABLE 5

FORECASTS FOR UK
(December 1988/January 1989)

Forecast	Real GNP/GDP growth (%) 1988	1989	1990	Real domestic demand growth (%) 1988	1989	1990	Current account ($billion) 1988	1989	1990
National(AS)	4.5	3.0	-	6.0	3.0	-	- 23	- 20	-
OECD	4¼	3	2	5¾	3¾	2½	- 23	- 26	- 29
IMF Staff	4.4	3.5	2.0	6.2	4.5	1.2	- 25	- 31	- 30

Forecast	Consumer price inflation(%) 1988	1989	1990	Fiscal balance (% of GNP/GDP) 1988	1989	1990
National(AS)	6.3*	5.0*	-	2.0	2.0	-
OECD	4½	5¼	4¾	-	-	-
IMF Staff	4.9	7.3	5.8	2.4	2.7	2.5

- not available
* RPI

E

UK SUPPLY SIDE POLICIES

UK SUPPLY SIDE POLICIES

Considerable progress has been made in the pursuit of structural policies designed to promote the flexible operation of markets. These policies together constitute a strategy designed to create a framework which will encourage enterprise, and help to increase output and create jobs.

2. The strategy embraces a wide range of individual measures covering four main areas:

a) the labour market
b) the operation of the financial system
c) capital markets and industrial investment
d) the markets for goods and services.

The Labour Market

3. To improve personal incentives, the following important measures were introduced:

i. Reduction of income tax rates. Since 1979, basic rate of tax reduced in stages from 33 per cent, reaching 25 per cent in 1988 Budget. Government has set new basic rate target of 20 per cent. In 1988 Budget, four higher rates were abolished leaving single top rate of 40 per cent.

ii. Income tax thresholds were increased by twice the rate of inflation in 1988 Budget and are now nearly 25 per cent higher in real terms than in 1978-79.

iii. Capital Gains Tax: 1982 Budget introduced indexation of all post-1982 gains. 1980 Budget rebased the tax to 1982, taking all pre-1982 gains out of tax.

? supply side reform.

iv. Approved employee share schemes extended in 1986 Budget. In 1988 the Government provided for relaxation in the tax treatment of unapproved schemes which will particularly benefit unquoted companies.

v. **Major reform of NICs**. Employees' NICs were reduced in October 1985 for those on lower rates of pay. Outside estimates of the number of jobs created as a result of these changes are as high as 400,000.

vi. **Social Security Act 1985** ensured that occupational pension arrangements did not create a barrier to labour mobility, by requiring occupational pension schemes to offer "early leavers" the choice of having their accrued rights revalued, or having an equivalent sum transferred to their new pension scheme.

vii) **Social Security Act 1986** further improved pension provision. Also, replaced Family Income Supplement with Family Credit in April 1988.

viii) **The Housing Act 1980** provided a right for public sector tenants to buy their own homes.

ix) **The Housing Act 1988** introduced further major reforms to increase the availability, diversity and flexibility of housing, particularly in the private rented sector.

x) **The Employment Act 1988** further strengthened the rights of individual trades union members and improved unions' internal democracy.

xi) **The Education Reform Act 1988,** provides for the introduction of a national curriculum underpinned by assessment and testing. This will enable schools to respond more effectively to the needs of employers. Other measures, such as the TVEI, PICKUP, INSET, YTS, the Inner Cities Initiative and the Restart programme continue to provide training and retraining to get the unemployed into work,

xii) **The Employment Training Programme** was introduced in September 1988 to provide a mix of training, work experience and job search suited to individuals' needs and abilities. ET will cost nearly £1.4 billion a year and will provide training for around 600,000 longer term unemployed.

xiii) **Deregulation.** In November 1988, the Government published a White Paper, 'Releasing Enterprise'. This is the fourth in a series of progress reports each setting out proposals for deregulating business activities, by simplifying or abolishing complicated or obsolete regulations.

xiv) **Profit Related Pay.** Introduced in 1987 Budget.

<u>**The Financial System**</u>

4. Within the financial markets, a wide range of legislative and other controls on activity has been abolished. For example:

i) **Foreign exchange controls** were abolished in 1979. The Exchange Control Act was repealed.

ii) **Dividend controls** were abolished in 1979.

iii. **Hire purchase controls** governing the time period of consumer contracts, and the size of down payments were abolished in 1982.

iv) **The Building Societies Act 1986** gave societies new lending powers. Following a review of Schedule 8 of the Act, new powers came into effect in August 1988 allowing societies to provide a wider range of services designed to enable them to compete more effectively in the primary markets.

v) **The Financial Services Act 1986** set up a new system of regulation for UK securities, financial futures and life assurance businesses to protect investors' interests.

<u>**Capital Market and Industrial Investment**</u>

5. Action has been taken to make the allocation of capital more responsive to market signals.

i) **Removal of physical controls.** Government suspended (1981) and then abolished (1986) Industrial Development Certificates.

ii) **Government support for industrial innovation.** In January 1988 the Government announced a Business Development Initiative providing subsidised consultancy to smaller firms across a range of management functions.

iii) **Regional Policy.** The DTI's 'Enterprise Initiative' embodies a significant change towards a more selective and cost-effective regional policy, taking account of economic recovery in regions, providing: higher levels of grant consultancy services; grants for investment and innovation; an end to the automatic Regional Development Grants; and a continuation of Regional Selective Assistance.

iv) **Reform of Corporate Tax System.**

Main CT rate, per cent:	1984-85	45
	1985-86	40
	1986-87	35
	1987-88	35

v) **Small Firms.** Schemes such as the Business Expansion Scheme and Loan Guarantee Scheme to facilitate the supply of finance to small firms. Also, a package of VAT changes to help small businesses was announced in the 1987 Budget.

Markets for Goods and Services

6. In March 1988 the Government published a Green Paper on **Restrictive Trade Practices** and a DTI paper on **Mergers Policy**. Action has been taken to encourage competition not just within goods markets, but also in the provision of services, including professional services.

7. **Privatisation.** To date, nineteen major businesses and some smaller concerns have been transferred to the private sector, involving around 750,000 employees and reducing the state-owned

sector of industry by above 45 per cent. The Government believes that businesses function most efficiently in the private sector, and this is borne out by the improved performance of the privatised companies.

THE US DEBT TRAP

F

1. This annex presents charts and tables showing the evolution of the US deficit, the stock of debt outstanding and the associated burden of interest payments. It also considers how things would change under two alternative scenarios for the Federal deficit.

2. The US does not have a particularly large debt burden by international standards. Table 1 presents ratios of net general government debt, net interest payments and deficits to GNP. The definition used in the table is chosen for purposes of comparability, but it is for general government rather than federal deficits. For the US this allows inviolable state and local government surpluses to offset Federal government deficits, but the underlying picture remains the same.

US DEBT TRAP

Table 1: International comparisons of general government deficits and debts in 1987

Per cent of GDP/GNP	Actual budget balances		Net debt	
	Total deficit	Deficit as a per cent of revenue	Level	Interest payments
United States	**-2.4**	**-7.4**	**30.7**	**2.3**
Japan	-0.2	-0.6	25.8	1.7
Germany	-1.7	-3.8	22.9	2.2
France	-2.3	-4.6	26.5	2.0
Italy	-10.6	-26.5	90.2	7.4
Canada	-4.6	-11.8	36.1	3.8
United Kingdom	-1.4	-3.5	43.6	2.6

Sources: OECD estimates.

3. Chart 1 shows the gross stock of Federal debt outstanding (strictly the stock of debt held by the public, a definition used to eliminate the effects of the large holdings of debt by 'on budget' trust funds), and how this would evolve under two scenarios for the future path of the Federal deficit. These

scenarios, deliberately chosen to illustrate two opposite cases, are:

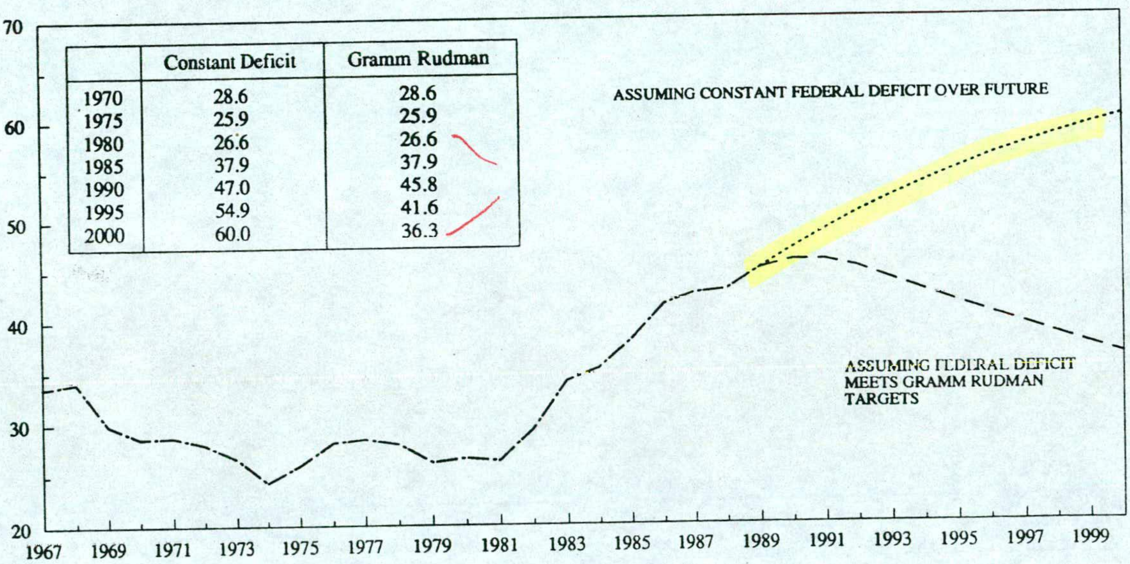
- complete compliance with the Gramm Rudman targets, involving the achievement of Fiscal balance by FY 1993, and

- no change in the nominal balance for the next decade.

Our own forecast suggests that the second of these is more likely to be closer to the eventual outcome. We estimate that the deficit would have to average about $65bn over the next decade (compared with a likely $160bn in FY 1989) in order to stabilize the stock of debt at the current proportion of GNP.

Who will have higher debt as % then — UK or US?

CHART 1 US FEDERAL DEBT AS PERCENTAGE OF GNP



	Constant Deficit	Gramm Rudman
1970	28.6	28.6
1975	25.9	25.9
1980	26.6	26.6
1985	37.9	37.9
1990	47.0	45.8
1995	54.9	41.6
2000	60.0	36.3

4. The stock of debt is already of such size as to result in net interest payments which alone account for more than the entire Federal deficit. In other words, the primary budget, i.e. the total deficit excluding interest payments, is currently about in balance. This is illustrated in charts 2 and 3, which show the deficit, the primary deficit and net interest payments as a proportion of GNP. A gradual, but not insignificant increase in the primary budget surplus is required just to avoid any further deterioration in the Federal deficit. Under Gramm Rudman a

substantial primary surplus is required in the short to medium term, although eventually lower net interest payments would allow higher expenditure within a balanced budget.

CHART 2 US FEDERAL DEFICIT AS PERCENTAGE OF GNP ASSUMING CONSTANT DEFICIT OVER FUTURE

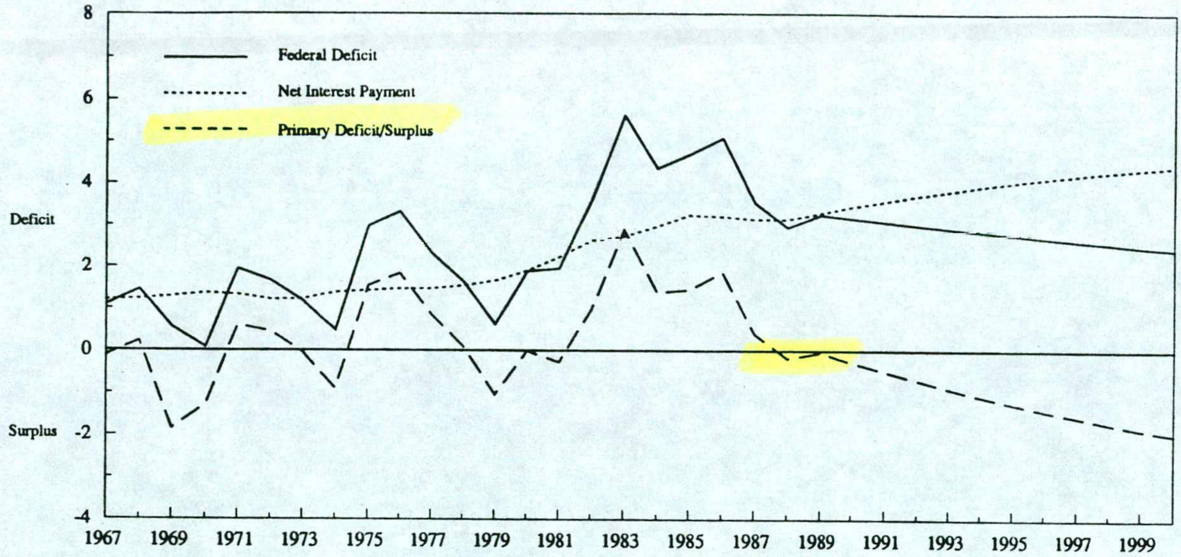
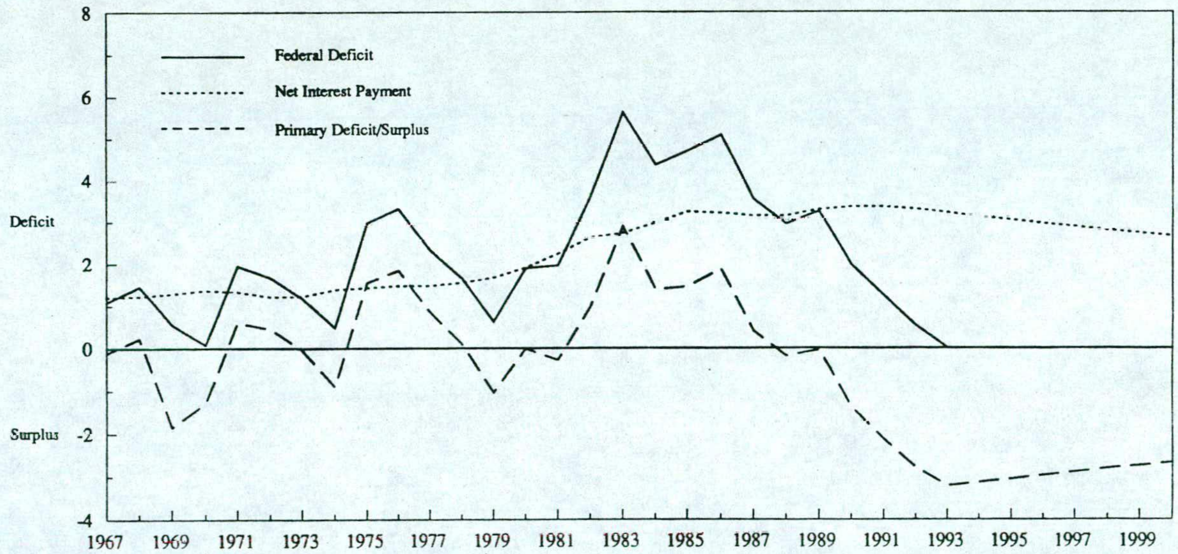


CHART 3 US FEDERAL DEFICIT AS PERCENTAGE OF GNP ASSUMING DEFICIT MEETS GRAMM RUDMAN TARGETS



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H

SHORT-TERM PROSPECTS FOR DEMAND IN UK

RECENT DEVELOPMENTS

Consumer demand

2. There are increasing signs of some slow-down in recorded spending, and evidence of much weaker sentiment about the outlook for the near future. These are illustrated in Table 1 and Charts 1-4. In summary:

- **Retail sales** growth slowed in the fourth quarter of 1988 (Chart 1).

- **New car registrations** (seasonally adjusted) fell in the fourth quarter (Chart 2); there was virtually no growth between 1987Q4 and 1988Q4.

- **Consumer confidence** as measured by the EC/Gallup survey has fallen steeply since July (Chart 3).

- And from the same survey, the balance of those thinking that now is a **good time to make major purchases** (household durables, cars etc) has also fallen precipitately since July - to the same record low level of May 1975 (Chart 4). Both movements are clearly correlated with the increase in interest rates since the summer.

OUTLOOK FOR UK

- The latest **CBI/FT Survey** of retailers and wholesalers is also consistent with an expected easing off in consumer spending growth. The responses to nearly all the questions have sagged noticeably in the latest survey, in some cases to the lowest values recorded since the Survey began in 1983. Together, they suggest a much weaker expected outlook for 1989.

- Provisional figures for **consumers' expenditure** in the fourth quarter were published on 20 January. These show continued, but slackening, growth (Chart 3).

Mmth base

- MO growth has slowed significantly in recent months.

3. The **housing market** also shows clear signs of topping off. **Building society mortgage lending commitments** have fallen markedly from the high levels of the summer. This partly reflects the ending of double MIRAS relief; and both lending and commitments are still high relative to 1984-86. Nonetheless, there is increasing evidence from the major building societies and reports by the Royal Institute of chartered Surveyors that house prices in London have stabilised, though prices re still rising in the regions. If anything the prospects for personal sector investment in dwellings is likely to be more sluggish than envisaged at the ~~two of~~ time of the Autumn Statement.

Company Sector

4. Provisional estimates for total business gross domestic fixed capital formation in the third quarter which were published in December show a fall on the second quarter. We are, however, disposed to discount these figures. Given the growing divergence between the different measures of GDP and the past record of upward revisions to fixed investment, it is felt that investment may well be under-recorded in the official statistics. Indeed, the December **DTI Investment Intentions Survey** suggests that industrial investment may continue to grow - by as much as 10 per cent in 1989 on 1988, slightly higher than the Autumn Statement forecast of 7 per cent.

Output

5. There is some evidence that the growth of output may already have began to moderate. Chart 5 shows that CBI Quarterly Trends Survey figures for general business optimism and their correlation with manufacturing output growth. The recent fall in optimism should presage a fall in output growth. Indeed, provisional monthly figures for manufacturing output in October and November show two (small) consecutive falls in output. These provisional estimates are, of course, subject to later revision, and on past experience the revisions may be upward. Even so they are consistent with some easing of output growth.

FORECASTS

6. A copy of the IMF's forecast is attached. We believe it contains a typing error; the growth of imports in 1989 in the Autumn Statement forecast should be 4.7 per cent not 4.1.

Consumer demand

7. The latest indicators of consumers' demand are more consistent with the sharper slow-down in consumer spending in 1989 projected in the Autumn Statement (3½ per cent year on year, 2½ per cent between 1988Q4 and 1989Q4) than the more muted deceleration in the IMF's forecast (5½ per cent growth, 1989 on 1988).

Balance of payments

8. The Fund's projection of a £3 billion deterioration in the current account looks rather pessimistic, even allowing for the relatively high growth rate of domestic demand in their projections for 1989. The Fund's forecast has imports continuing to grow at more than twice the rate of growth of domestic demand. Given the probable easing of capacity constraints and no significant further deterioration in competitiveness, this looks particularly implausible. The evidence of a recent slow-down in consumer demand is more consistent with the Autumn Statement forecast for the current account than the Fund's assessment.

Inflation

9. The Fund's forecast for consumer price inflation (presumably for the RPI, which includes the effect of mortgage interest payments), looks high (at 7.3 per cent) for 1989. It does not look to be a central view if growth of output and consumer spending are set to ease.

TABLE 1 : RECENT INDICATORS OF CONSUMER DEMAND

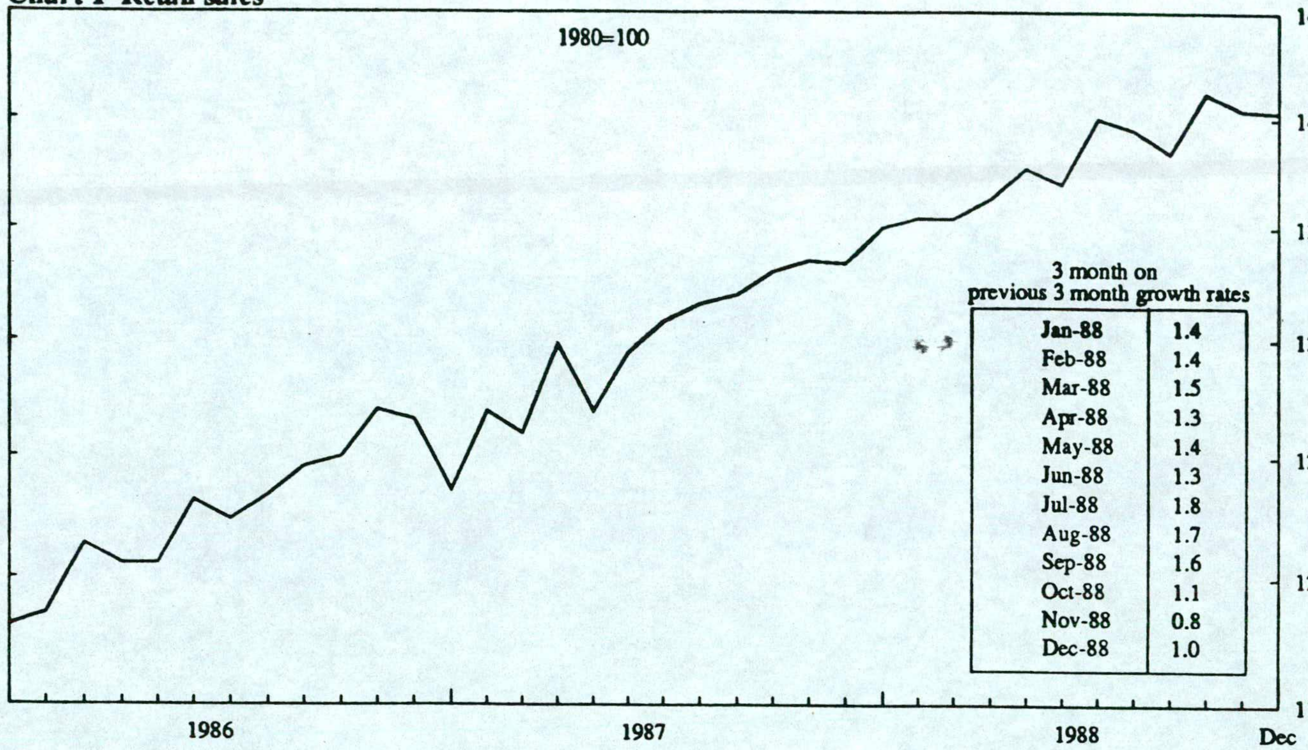
	Consumers expenditure (£bn 1985 prices, CSO data, s.a.)	Retail sales (1980=100)	Retail sales 3 mnth on prev 3 mnth (percent) s.a.	CBI/FT survey (Percent balance)*	EC/Gallup Consumer survey (balances) Confid-ence	EC/Gallup Consumer survey (balances) Attitude to major purchases	New car registrations (Annual Percent Change)	Consumer credit** (£million)	Building Societies commitments (monthly averages, £billion, s.a.)	Building Societies lending (monthly averages, £billion, s.a.)
1984	207.9	111.3		63	-4	31	-1.2	n/a	2.1	1.2
1985	215.3	116.4		60	-10	24	3.4	n/a	2.3	1.2
1986	227.7	122.6		54	-7	24	3.0	199	3.2	1.6
1987	240.5	129.8		54	5	24	7.3	322	3.1	1.3
1988	255.4	138.1		54	2	23	10.0		4.4	2.1
1987Q1	58.4	125.5	-0.6	51	-1	22	4.9	326	2.6	1.3
1987Q2	59.5	128.8	2.6	56	7	20	3.5	356	2.9	1.2
1987Q3	60.7	131.5	2.1	55	7	29	10.9	291	3.1	1.2
1987Q4	61.9	133.3	1.4	54	5	22	9.6	315	3.5	1.4
1988Q1	62.8	135.3	1.5	50	5	31	11.5	345	4.5	1.8
1988Q2	63.0	137.0	1.3	51	7	33	10.0	361	4.9	2.1
1988Q3	64.3	139.2	1.6	63	2	22	10.0	379	4.3	2.4
1988Q4	65.3	140.6	1.0	54	-7	6	1.1		3.7	1.9
Jan		135.0	1.4	40	7	32	14.2	288	4.0	1.6
Feb		135.4	1.4	58	3	30	6.1	321	4.4	1.6
Mar		135.4	1.5	51	5	31	14.3	426	4.9	2.3
Apr		136.3	1.3	43	5	32	12.8	281	4.5	1.9
May		137.7	1.4	58	8	33	12.9	365	4.7	2.1
June		137.0	1.3	53	9	33	4.6	438	4.9	2.4
July		140.0	1.8	57	7	31	9.2	298	4.9	2.5
Aug		139.5	1.7	61	2	24	15.4	518	4.1	2.7
Sept		138.4	1.6	70	-2	10	5.9	321	3.9	2.1
Oct		141.2	1.1	55	-5	10	-0.5	81	3.9	2.0
Nov		140.4	0.8	51	-3	13	3.5	402	3.8	1.9
Dec		140.3	1.0	56	-12	-4	0.4 +		3.3	1.7
Jan				26						
Percentage change, latest 3 months on:										
previous 3 months	2.2	1.0					-8.9			
a year earlier	6.0	5.5					1.1			

* Balance of retailers expecting volume of sales next month to be higher than a year earlier

** Change in amount outstanding, average per month

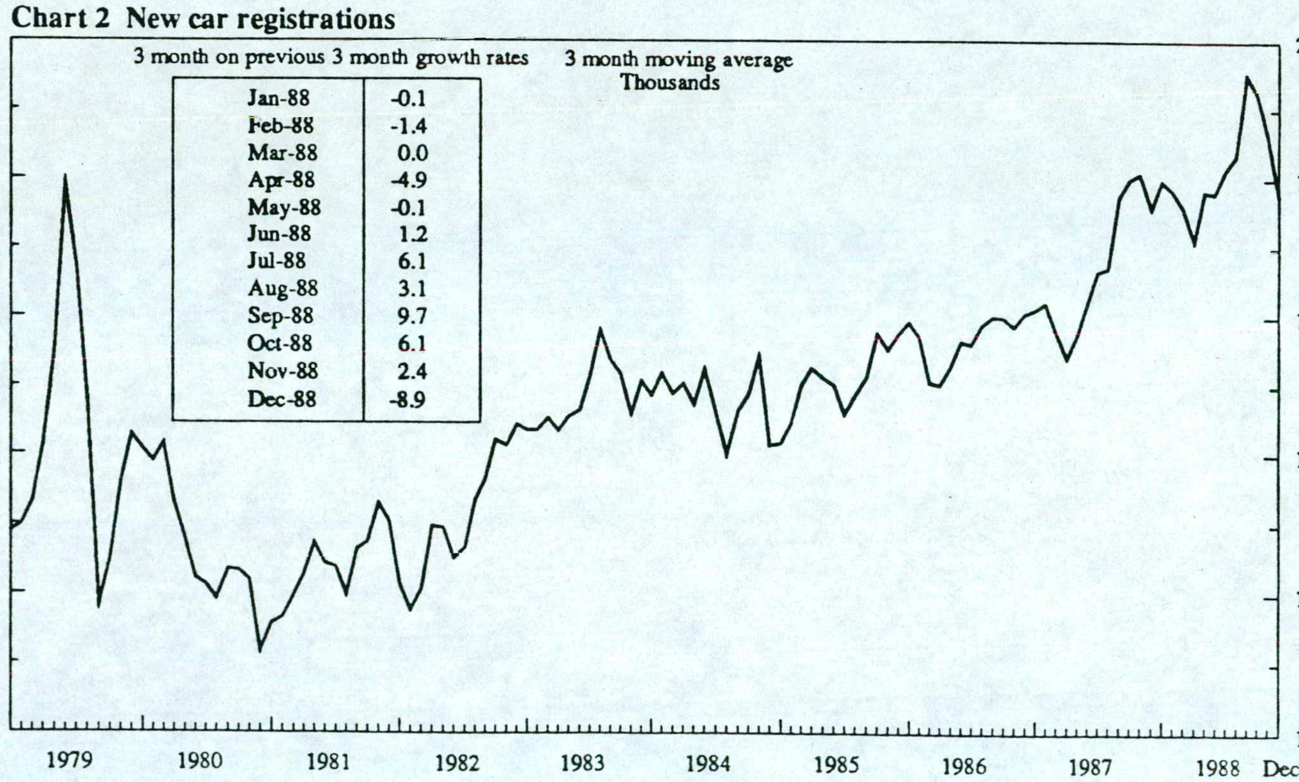
\+ Based on SMMT figures

Chart 1 Retail sales



3 month on previous 3 month growth rates	
Jan-88	1.4
Feb-88	1.4
Mar-88	1.5
Apr-88	1.3
May-88	1.4
Jun-88	1.3
Jul-88	1.8
Aug-88	1.7
Sep-88	1.6
Oct-88	1.1
Nov-88	0.8
Dec-88	1.0

Chart 2 New car registrations



3 month on previous 3 month growth rates	
Jan-88	-0.1
Feb-88	-1.4
Mar-88	0.0
Apr-88	-4.9
May-88	-0.1
Jun-88	1.2
Jul-88	6.1
Aug-88	3.1
Sep-88	9.7
Oct-88	6.1
Nov-88	2.4
Dec-88	-8.9

Chart 3 Consumer confidence and total consumer spending

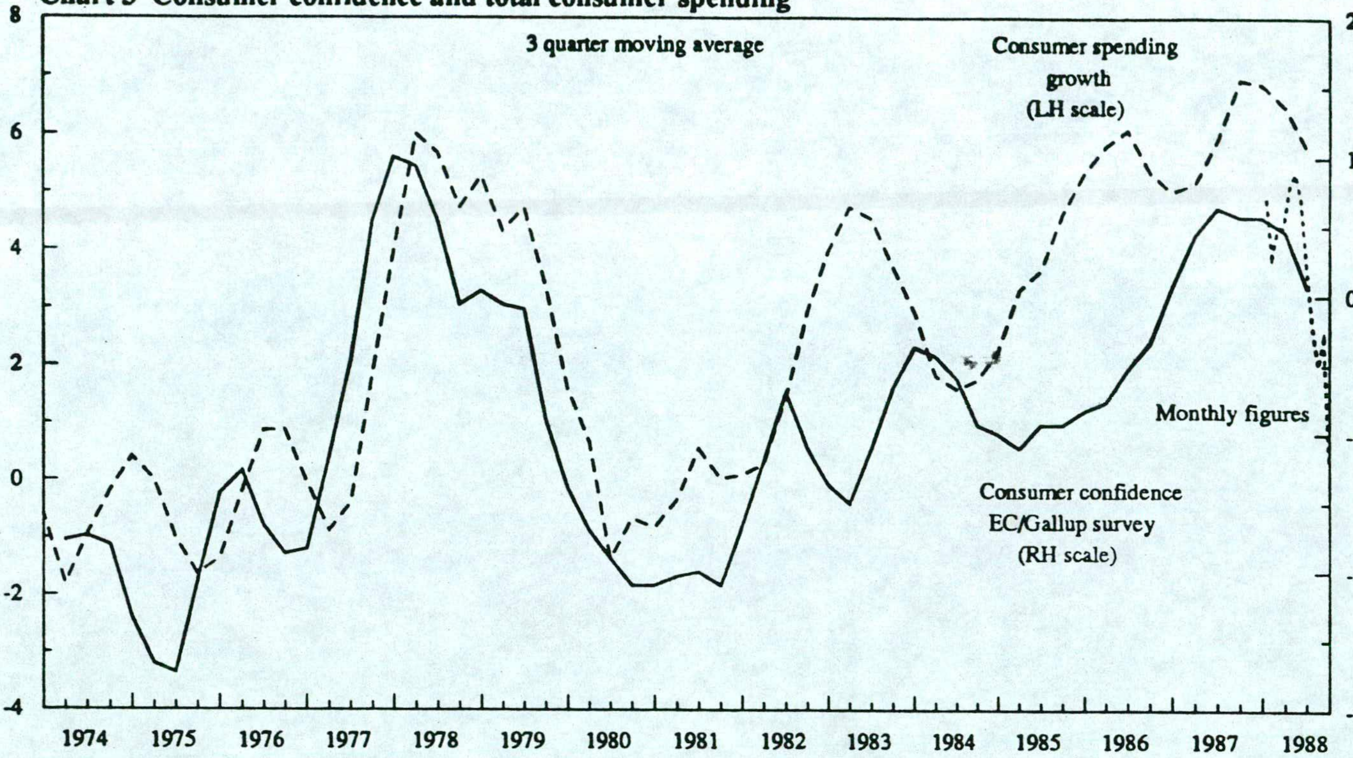


Chart 4 Attitude to major purchases and durables spending

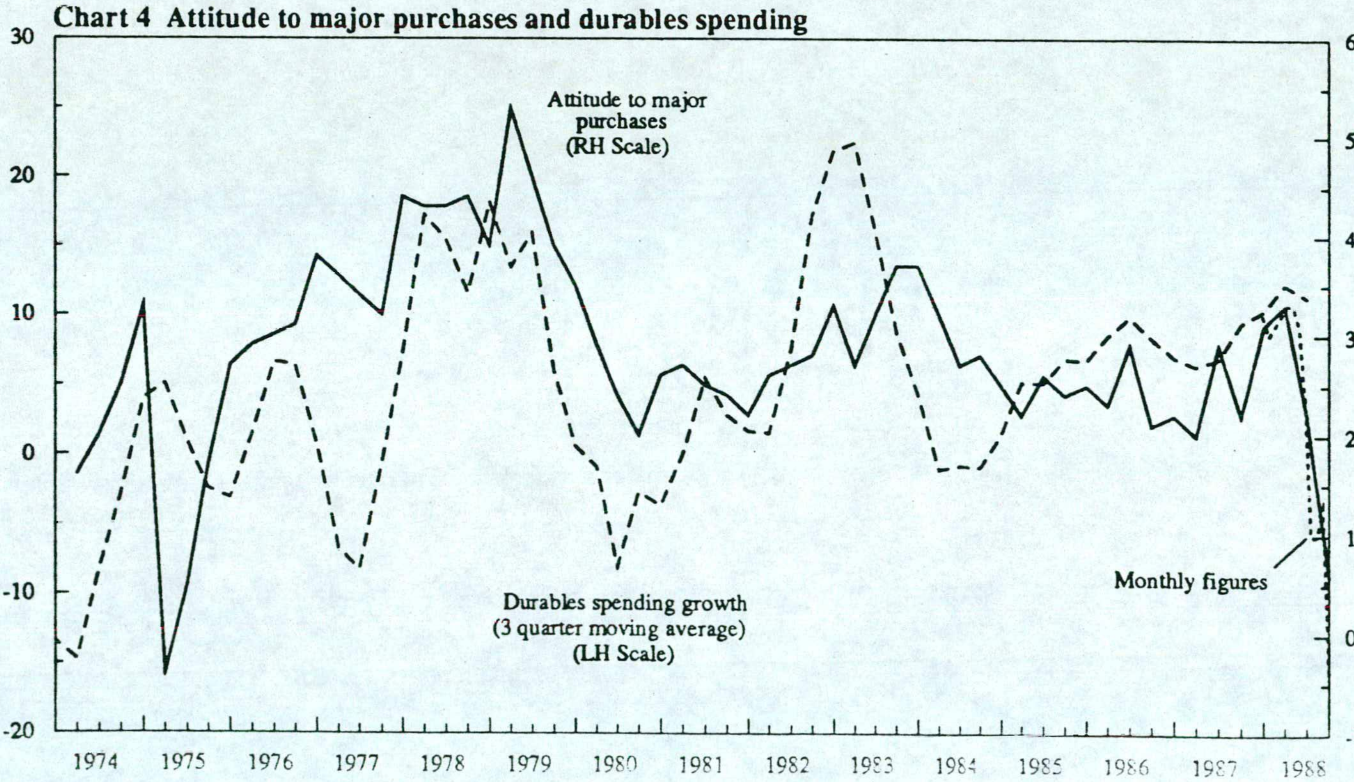
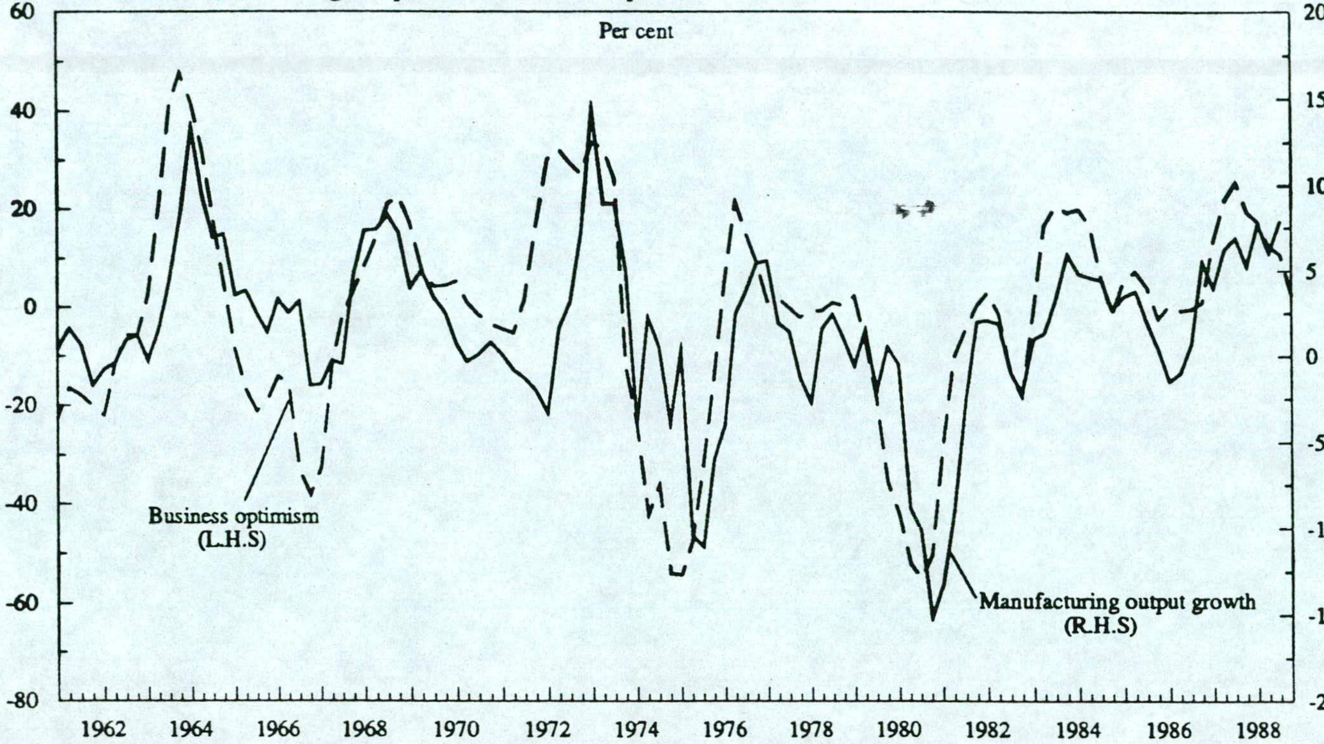


Chart 5 Manufacturing output and business optimism



Manufacturing output : percentage growth on period a year earlier
Business optimism : percentage balance (centred 3 quarter moving average)

United Kingdom: Key Elements of the Staff's Forecast

(Percentage change)

	Forecast of December 5, 1988			Forecast of January 17, 1989			Official 2/
	1988 2nd half 1/	1988	1989	1988 2nd half 1/	1988	1989	1989
Domestic demand	6.6	6.3	5.6	6.4	6.2	4.5	3.0
Consumption	6.0	6.0	6.5	5.8	5.9	5.2	3.6
Investment	15.2	12.5	6.9	15.8	12.5	7.0	5.6
Real GDP 3/	4.9	4.6	3.9	4.7	4.4	3.5	3.2
Net exports 4/	...	-3.6	-2.5	...	-3.3	-1.5	0.1
Imports	13.0	12.9	11.0	13.0	12.8	9.4	4.1 ← should be 4.7
Earnings	...	7.9	11.6	...	8.0	10.0	...
Retail price index	...	4.9	7.6	...	4.9	7.3	5.0 5/
Current account balance 6/	...	...	...	...	-14.2	-17.2	-11.0

1/ Relative to first half of the year, at annual rates.
2/ Autumn Statement.
3/ Average measure.
4/ Contribution to growth.
5/ Fourth quarter.
6/ In billions of pounds sterling.

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THE SECRETARY OF THE TREASURY
WASHINGTON

CH/EXCHEQUER
REC. 19 JAN 1989
~~ACTION~~ PS/EST
COPIES TO Sir P Middleton
Sir T Burns
Mr Wicks
Mr Lankester
Mr Scholar
Mr H P Evans, Mr Peretz, Mr Gieve

January 18, 1989

Dear Colleague:

Changed to Anderson House, 2118 Massachusetts Avenue

Based on consultations with each of you, there appears to be a consensus in favor of a meeting of the Group of Seven on Thursday and Friday, February 2 and 3, 1989, in Washington. I would be pleased to host a working dinner for the Group on Thursday evening, February 2, at 7:00 p.m., at ~~Blair House, 1651 Pennsylvania Ave., N.W.~~ Our discussions would resume the next morning, at 9:30 a.m., at the Treasury Department, 15th Street and Pennsylvania Avenue, N.W., continue through a working lunch and conclude by 4:00 p.m.

The meeting will provide an opportunity to conduct an initial review of our economic performance and policies and to develop the indicators and objectives for the economic policy coordination process. In addition, I would hope that we could undertake a comprehensive examination of the international debt strategy, including the role and size of the IMF.

To this end, the agenda and organization for our meeting could be as follows:

- February 2, 7:00 - 8:30 p.m.: Multilateral surveillance review of economic performance and exchange market developments, including consideration of the economic indicators and objectives for 1989 (with IMF Managing Director).
- February 2, 8:30 - 10:00 p.m.: Discussion of key policy issues.
- February 3, 9:30 - 11:00 a.m.: Continue discussion from previous evening if necessary.
- February 3, 11:00 a.m - 12:30 p.m.: Current status and key issues relating to the international debt strategy, including major problem countries.
- February 3, 12:30 - 2:00 p.m.: Working lunch to continue discussion of international debt strategy.
- February 3, 2:00 - 3:30 p.m.: Implications of debt strategy review for the role and size of the IMF.
- X February 3, 3:30 - 4:00 p.m.: Consideration of our approach to the press.

Our Deputies will provide background material on the economic situation and key issues for the economic policy coordination discussion. I would propose that Managing Director Camdessus join us at the working dinner for the first agenda item. As you will recall, we have agreed that this meeting would be a low-key, informal affair, with no communique.

Please advise me at the earliest opportunity of your acceptance of these arrangements and inform your central bank colleague of this invitation.

Sincerely,

Nicholas F. Brady

Nicholas F. Brady

CC: Messrs. Wilson, Lawson, Stoltenberg, Beregovoy, Murayama, and Amato

THE SECRETARY OF THE TREASURY
WASHINGTON

~~Alex~~

January 18, 1989

I think you are already aware of this. Deidre is arranging accommodation at the residence, but the Ambassador will be in New York attending to the Princess of Wales. (no loss!) Julie

Dear Colleague:

You are cordially invited to a meeting of our small group on Thursday, February 2, 1989, from 4:00 - 6:00 p.m. at the Treasury Department, 15th Street and Pennsylvania Avenue, N.W., Washington, D.C. The discussion will focus on recent exchange market developments.

Please advise your central bank governor of these arrangements.

Sincerely,

Nicholas F. Brady

Nicholas F. Brady

cc: Messrs. Lawson, Stoltenberg, Beregovoy, and Murayama

BRADY TO G7 18 JAN

NEXT STEPS ON INTERNATIONAL DEBT

CONFIDENTIAL

FROM: N L WICKS
DATE: 20 JANUARY 1989

CHANCELLOR

cc CST
FST
EST
PMG
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Lankester
Mr Scholar
Mr H P Evans
Mr Odling-Smee
Mr Mountfield
Mr Bottrill
Mr Walsh
Mr Tyrie

Mr Cassell (Emb)

US role
Confusion over 'debt reduction'
Public sector (IFI) taking on assets
? how-sale [illegible] (? Jap sales)
Time of move to a market solution
IFI purchase of discounted debt???
Also Schultz scheme

NEXT STEPS ON INTERNATIONAL DEBT

For our discussion on Monday, we have prepared the paper attached, for which I am indebted to IF1. There is a useful introduction and summary of the conclusions in paragraphs 1-14. The paper concentrates on debt reduction since this topic is likely to feature prominently at G7 Deputies next week and at your G7 meeting the week following. The paper is generally, and rightly in my view, extremely cautious about further public sector involvement in debt reduction, and indeed in the international debt strategy generally.

2. The points which lead to this conclusion are:

(i) Following the success of your Sub-Saharan African initiative, attention is now focusing on the problems of the middle income debtors, effectively the Latin Americans and the Philippines (Poland and Nigeria are particular cases). Though UK banking exposure is considerable in these countries, our diplomatic, strategic and commercial interests there are relatively small (see paragraph 14(vii) of the paper). So there is no particular UK interest for us to take a forward role in discussions of middle income debtors, though clearly we should ensure that the outcome of discussions reflects the three points set out at (ii) and (iii) and (iv) below.

(ii) The key to progress with the debt problem lies in adjustment in the debtor countries. Chile, Ghana and several South East

WICKS TO CX 20 JAN

Asian countries show the progress that can be made if the right economic policies are adopted. We must ensure that this principle is kept to the fore and that if there are new initiatives, they foster faster adjustment.

(iii) Another clear principle is adumbrated in the Interim Committee's communique:

> "... the Committee agree that the menu approach should be broadened further, including through voluntary based market techniques which increase financial flows and which reduce the stock of debt <u>without transferring risk from private lenders to official creditors</u>."

The underlined words, apparently straightforward, do not provide a clear operational rule. The paper suggests in paragraph 47 a more precise specification in the following terms.

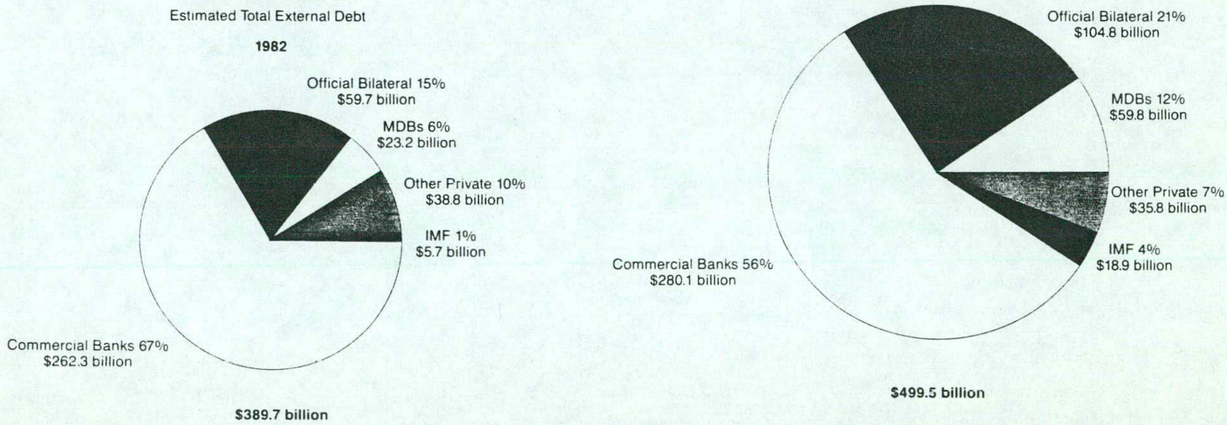
> "No public sector participation in financing packages involving a net increase in its relative risk. Under this definition, extra net lending by the public sector (including IFIs and other official creditors) as a percentage of its 1988 exposure should not be more than the percentage increase in the net lending of the commercial banks. In cases which involve debt reduction by the commercial banks, the amount of debt service reduction achieved would be taken fully into account by putting it onto a basis equivalent to the provision of new money."

In fact, we have breached this rule as (v) below demonstrates.

(iv) There will be suggestions that the IFIs, especially the World Bank, should become involved in schemes to facilitate debt reduction. We need to be cautious here. World Bank risks fall, at one remove, on national exchequers; the World Bank is already at its (self imposed) lending limits with some debtors, including Brazil; any significant scale of debt reduction would swamp the World Bank's balance sheet; and the Bank's management find it difficult to resist political pressure to confine any "special facility" to the deserving cases, as the Argentinian loan demonstrates.

(v) The banks have played their hand skilfully. Their net new lending has been close to zero and they have, by and large, received their interest due, though in some cases after some delay. The following figure shows that compared to the banks, the public sectors of creditor countries (through export credit, aid, World Bank etc and IMF lending) have assumed a greater share of external debt. This figure is striking evidence that the Interim Committee's dictum "without transferring risk from private lenders to official creditors", as defined in paragraph (iii) above, has not been observed. We need to halt this drift to public sector financing as well as doing all we can to ensure that taxpayers' money disbursed through ECGD is recovered.

Figure 2
Baker Plan Countries
Estimated Total External Debt



(vi) The paper describes in paragraphs 10(iv) (and in greater detail in paragraphs 75-79) an approach, reportedly espoused by former Secretary Schulz which might halt this growing public sector financing burden. It would involve agreeing to IMF programmes in cases where there is a financing gap - because the banks have not put up new money - in the expectation that if this new money does not come forward, the country will run up arrears to the commercial banks. Though the approach deserves further thought, I find difficulty with it: how can we be sure that the arrears would accrue to the banks and not to the public sector? it requires considerable creditor solidarity which may not last when push comes to shove; the politics in the debtor country would be very difficult if it embarks on the painful measures in an the IMF programme only "to run out of money" through no fault of its own; and there is something a little disingenuous in signalling to the world, through IMF agreement, that a country has a viable programme when an important element, its financing, is not in place.

(vii) Of course, in an ideal world the banks should not be in the business of balance of payments support for developing countries - that is not banking business. The private sector, through bond, equity etc issues should take more of the burden. But the prospects for that on any scale look bleak. So limitation on the growth of the public sector's share of the financing burden will require a greater response from the banks. Such a response needs to be voluntary, and not the result of government pressure and inducements. Yet there is a case for the IFIs and governments within the constraints (ii), (iii) and (iv) above, to facilitate and promote <u>truly</u> market based debt reduction.

<u>Conclusions</u>

2. If you agree, I suggest that I should be guided by the following at the G7 Deputies discussion next week:

- the three principles outlined at (ii), (iii) and (iv) above remain key;

- while debt reduction by the banks will not by itself "solve" the debt problem, it is well worthwhile and while refraining from pressure or inducements, we should be ready , within the three constraints listed above, to facilitate and promote truly market-based reductions;

- while avoiding giving the impression on the world stage of Scrooge, we need to ensure that the US (because of State Department pressures and "hemispheric" considerations), the Japanese (because they want to cut a dash in the world) and the French (because of their perennial practice of running after the LDCs) do not land us with "imaginative" schemes which simply add to public sector burdens and do not produce greater creditor adjustment.

3. I recognise that this is not an exciting or innovative menu, but I think it is the right one.

N.L.W.

N L WICKS

MIDDLE INCOME DEBT: MARKET DEVELOPMENTS AND STRATEGY

PAPER
MIDDLE
INCOME
DEBT
MARKET
DEVELOPMENT
+
STRATEGY

IF1 DIVISION
HM TREASURY
20 JANUARY 1989

INDEX

MIDDLE INCOME DEBT: MARKET DEVELOPMENTS AND STRATEGY

INTRODUCTION

1. When the debt crisis broke in 1982, and for some years afterwards, the aims of creditor governments were threefold, to achieve:

   i. the safety of the world commercial banking system;

   ii. full servicing of official debt;

   iii creditworthiness and sustainable growth for the debtors.

a small number of

2. (i) has been very largely achieved: the banks still at risk are US money centre banks with sizeable domestic bad loans; (ii) has been mostly achieved for the IFIs; only partly for official debt. On (iii) we recognised last year that the poorest countries needed debt relief; and we have recognised privately - as have the secondary markets - that creditworthiness through full debt servicing including principal repayments was not likely for most middle income debtors either. Sustainable growth has eluded most debtors, partly because of inconsistent policies. The search is on for methods of debt reduction which can be tied to better policies and which avoid the moral hazards of governments telling their banks what to do.

3. Revised aims for creditor governments, which must now take into account the likelihood of substantial debt reduction in middle income countries at some stage, are as follows:

   i. Maximum servicing of official debts, and, though less important, maximum servicing of banks' debt.

   ii. Ultimate creditworthiness and growth for the debtors.

These aims may of course conflict.

4. The protagonists for public sector involvement, which applies both to new lending and to debt reduction, argue that many debtors would eventually be capable of servicing their debts in full if they were given/lent some extra resources (or had their debts reduced) for a time; and if they used the extra resources for productive investment.

5. Because of free rider problems - small banks on bigger banks, private sector on the public sector - what is in the interest of creditors as a whole is not necessarily in the interests of individual creditors and therefore may not get done. So potentially creditworthy countries may fail to get the finance and adjustment they need.

6. In very broad terms, the questions for creditor governments are:

i. do we want to provide <u>more</u> official resources which could be used either to postpone debt reduction or encourage it through, for example, the finance of buybacks? Or should we provide <u>less</u> official resources because of an excessive rise in the burden borne by the public sector?

ii. do we want to encourage more or faster debt reduction by the commercial banks by: our actions at the IFIs and/or Paris Club; by inducements to the banks; or by offers to facilitate?

by [illegible]

iii. how far do we want the creditor governments and the IFIs to co-ordinate the process of debt reduction - or can we leave it to the debtors and the commercial banks?

7. The commercial banks see a large margin of uncertainty about the potential return on their third world bank debt. They are unwilling to give up the possibility of something like full interest service (which they have achieved to a surprisingly large extent over the past six years) except in return for extra

security on written down debt. That extra security could come from the debtors, either running larger trade surpluses in order to buy back their debt or making more use of existing domestic and overseas assets in order to cancel debt (as Chile is doing with its privatisation programme).

8. Alternatively, that security could come from Western governments in one or more of the following ways:

i. providing more resources to the debtors: by loans, grants, or SDR allocation. Loans can be direct (government to government) or through the IFIs. The extra resources could enable the debtors to guarantee a level of debt service, or to buy more debt back from the banks; or

ii. issuing guarantees, directly or through the IFIs, to the commercial banks either directly or through trust funds.

9. Other suggestions for possible public sector interventions include:

iii. encouraging the commercial banks by changes in tax and regulatory treatment, to write down debt, or removing obstacles to debt reduction;

iv. setting an example of debt reduction through the Paris Club, as in SSA;

v. persuading the commercial banks;

vi. refusing to allow Fund programmes to go ahead without a bigger contribution from the commercial banks, but if that proves impossible,

consider

vii. allowing Fund programmes to go ahead in some circumstances without insisting on financing assurances, leaving the banks to provide new money or face growing arrears.

10. We dismiss: more IFI resources for the debtors except in return of stronger adjustment programmes; SDR allocations; setting an example for debt reduction through the Paris Club; and radical change or harmonisation of tax and regulatory regimes. The paper examines the various possibilities of World Bank involvement, and how to secure better burden-sharing with the commercial banks by refusing to allow the public sector to be the residual source of finance.

11. There is a paradox in the present position: while bank debt continues to be almost fully serviced, the message from the banks' provisioning moves, from the low general level of secondary market prices, and from analysis of the debtors' economies is that at some stage the debt will be much less than fully serviced. The present position is not in fact sustainable indefinitely: the gap between the market value of debt and its face value will close either by debtors maintaining a high record of servicing (in which case the market value will rise) by buybacks leading to higher prices or by write downs in the face value of debt.

12. At some stage official creditors are likely to be faced with demands for yet larger contributions, with the alternatives of default or moratorium. Filling gaps - by some combination of extra official finance, extra bank finance, more adjustment - may become still more difficult. In these circumstances, and anxious to secure more equitable burden-sharing, the IMF can try to fill gaps by encouraging private sector contributions in a number of ways. If that proves impossible, then the next step could be for the Fund to go ahead without the gap being filled. This possibility is explored further in the section on possible extensions to the public sector role.

13. The paper and its conclusions consider in more detail the suggestions for possible public sector involvement. In addition, Annex 1 looks at the French and Japanese debt schemes, and Annex 2 at the Stern proposal for Mexico.

CONCLUSIONS

14. Our analysis below points to the following broad conclusions:-

Current Developments

i. The commercial banks are still being paid almost **full interest** on their holdings of the debt of middle income countries. But they are disappointed with both the efforts of and prospects for the debtors (confirmed by a continuing decline in the prices of secondary market debt) and there is no sign of an early revival in lending.

ii. It is in the commercial banks' own interest to extract as much debt service as possible out of their debt holdings. They will not favour debt reduction on any scale unless there is an **inducement** such as increased security on the asset with a reduced face value which they are offered in exchange for debt.

or no alternatives

iii. Debt reduction financed from debtor countries' own internal resources is taking place **only slowly**. This is because of the lack of reserves on a sufficient scale to provide inducements and unwillingness to mobilise other resources (such as domestic or overseas assets). While the banks could afford to provide debt reduction to the smaller debtors without inducements, they may be inhibited from doing so for fear of setting a precedent for larger ones.

iv. **Debt/equity swaps** have been the main driving force behind the rapid expansion in the secondary LDC debt market since 1984. Banks have largely adjusted their portfolios and the demand for debt from this source is now relatively unimportant. Debt/equity swaps will continue to provide a useful amount of debt reduction especially in the stronger debtor economies. This is despite current difficulties with absorptive capacity in terms of suitable investments, doubts about the additionality of the investment generated, and the monetary effects of swaps. But all of these factors are limitations on the scale of debt/equity schemes.

Basic Strategy

v. The economic argument that debt reduction can be in the interests of all creditors - since it provides the liquidity-constrained debtor with the opportunity to invest more - runs into **formidable practical obstacles:** many of the debtors are not likely to put extra resources to good use; the public sector has been providing large scale resources for some years and yet progress has been slow; and the banks could free-ride even more on the public sector.

vi. The exact specification of the G7/Interim Committee decision that there should be no **transfer of risk** from the private sector to the public sector is not easy. An attempt is made in paragraph 47 below.

vii. There are **no systemic or very strong economic or trade arguments** for G7 governments providing further financial support for debt reduction. As far as the UK is concerned, the Baker 15 accounts for only about 3 per cent of our total exports; and the same proportion of our overseas assets is located there. A refusal of further assistance on the part of G7 could lead however to the middle income debtors (further) reducing their interest service to official creditors as well as banks.

viii. There are political arguments for giving more help, perhaps by inducing debt reduction to the main Latin American countries, many of whose governments face political problems or elections in the next year or so. But the political arguments are mainly **hemispheric** and apply much more to the **United States** than to the United Kingdom.

ix. An increasing proportion of exposure to middle income debtors is in the **public sector** (including both bilateral official creditors and the international financial institutions) and there is **no case** for stepping up their new lending simply to fill in the gap left by the commercial banks or to compensate for increased repayments from debtors of IMF loans made during the early 1980s. More new lending would only be justified in return for more adjustment.

don't too young

x. Too strong advocacy or pressure by the public sector for debt reduction by the commercial banks could give rise to pressure for an **extension of such reduction to official creditors** such as ECGD. Such pressure could arise anyway if the banks reduce debt spontaneously.

Evaluation of Possible Extensions of the Public Sector Role

xi. The public sector has already given **substantial encouragement** to debt reduction by the Chancellor's Sub-Saharan Initiative for the poorest; by welcoming the banks' provisioning for middle income debtors and so endorsing the judgement that not all debt will be recovered; by calling for market related solutions, and by accepting that debt reduction is a part of the menu.

xii. **World Bank intervention** (guarantees, finance for buybacks, or cross-default clauses on the servicing of bank debt) sufficient to induce the banks to offer debt reduction could be very **expensive**; would create serious moral hazard problems vis-a-vis banks and the debtors; and would give rise to serious problems of eligibility among types of bank debt (why only third world debt?), and among debtors (Argentina and not India?).

xiii. If a direct public sector contribution to debt reduction for middle income countries is desired, it should be kept to a **minimalist role** such as issuing the zero coupon bonds to collateralise debt exchange schemes or co-ordinating debt reduction for particular countries, eg the IMF's role in the buyback organised for Bolivia (provided debtors and private creditors want this).

xiv. There are two linked options which the public sector could use to encourage debt reduction for good adjusters at no **direct** additional cost:-

(a) G7 governments could concert and **refuse to pass** programmes through the IMF Board unless the banks made an adequate contribution to closing the financing gap. This would mean holding up progress despite a willingness of the debtor country to adopt an adjustment programme. It might induce the banks to make new money or debt reduction available. (This is in accordance with current UK policy although we have not always resolutely carried it out).

(b) In the cases where the commercial banks were not willing to provide an adequate contribution even where (a) has been tried, the public sector might nonetheless be able to force an adequate bank contribution by allowing IMF programmes to pass through the Board with the **financing gap not filled and with commercial bank arrears outstanding.** The aim would be to have such programmes financed in part by a building up of bank arrears unless they offered new money or debt reduction. This form of pressure would be a major departure from existing policy which is to insist on financing gaps being filled to avoid putting IMF money at risk. Provided the IMF and other official creditors obtained preferred status over the banks, however, it could be argued that the risks are manageable even if there were an IMF disbursement. Faced with a choice between providing yet more finance for adjustment, or accepting that our banks would receive less interest, we should be choosing the latter under this option. It might be especially applicable to small debtors such as Costa Rica. This idea is worth **further consideration**, but it would be difficult to ensure that official creditors in fact achieved preferred creditor status. If they did not, then there would be an adverse risk transfer.

xv. The commercial banks clearly wish to have the trade surplus of debtor countries devoted mainly to servicing interest on their commercial bank debt. Buybacks organised from **external sources of finance** therefore are not only less of a burden on the debtor country, they are more acceptable to the banks. If against our recommendation the public sector were directly to finance debt reduction, the simplest and most efficient form of such reduction might be straightforward buybacks.

xvi. Harmonisation of the **regulatory framework** cannot in general be expected to greatly encourage debt reduction, although marginal improvements might be possible. In anticipating the form of debt reduction that the commercial banks might choose, it has to be remembered that Japanese banks have provisioned at only the 10 per cent level. Debt reduction in the form of interest reductions would suit them better than reductions in principal. Secretary of State Baker's statement during his confirmation hearing indicates that the US authorities may be contemplating more liberal treatment for **interest capitalisation** by banks.

Does this matter?

xvii. We have examined the role of the UK tax system at an earlier stage. This already provides matrix-related tax relief for provisioning and full tax relief for debt writedown. Charitable contributions of debt also receive tax relief subject to the normal rules. There **is no case for changing our tax system** to give privileged treatment to the special category of commercial debt owed by LDCs, nor for withholding tax relief from provisioning and making it contingent on writedown.

RECENT DEVELOPMENTS

Commercial Banks

15. The commercial banks have become increasingly reluctant to provide new money to middle income debtors. The focus of the strategy has thus turned to methods of debt reduction. However, there has been little sign so far that the banks are willing to negotiate debt reduction schemes on a major scale. Debt reduction to date has involved quid pro quos - equity, cash (in the case of buybacks) or other assets (as in the case of exit bonds). There have been very few examples of debt forgiveness. (One recent example was Midland Bank's decision to donate $0.8mn of Sudanese debt to UNICEF).

16. Since 1982, as the table below shows, the Baker 15 have managed on average to service virtually all of their interest payments due to banks. During this period there has been very little <u>net</u> lending by the banks to the Baker 15: there have been some new money packages but because of repayments the net figure has been close to zero. It is thus not true that banks have had to lend substantial amounts in order to allow the debtors to keep current.

Interest Paid and Due to Banks: Major 15
($ Billion)

	(1) Interest Due to Banks	(2) Interest Payments to Banks
1982	35.0	34.0
1983	25.1	22.0
1984	32.1	33.4
1985	29.7	30.9
1986	25.9	25.3
1987	24.5	19.9
1988	25.7	27.6
Average	**28.3**	**27.6**

General Source: IIF

17. The strong record of the middle income LDCs in paying interest in full on their debt may partially explain why many banks have apparently regarded this debt as a better asset than existing secondary market prices would indicate. It is true that some banks have been looking for opportunities to reduce their exposure to problem debtors and their attempts have met with some success. But most banks are probably not willing to offload a significant part of their debt at secondary market prices, particularly where large-scale selling would depress prices further. The improvement since 1986 in the Baker 15 debt/export ratios may indicate to the banks that the long-run capacity to repay of some of these countries is increasing, making the banks less likely to part with their assets at a discount. A major reason for banks continuing to hold LDC assets without providing new money is that they have collectively become "free riders" and are relying on public sector creditors effectively to pay shortfalls of interest. The banks probably do not believe (despite some statements to the contrary) that they will be repaid principal in full, but nonetheless intend to extract maximum debt service.

Market Mechanisms for Debt Reduction

18. The following mechanisms involve no direct cost to the public sector.

Debt-Equity Swaps

19. Debt-equity swap programmes have been adopted by several debtor countries, with most activity in Argentina, Brazil, Chile, Mexico and the Philippines. But programmes have also taken place in Costa Rica, Ecuador, Honduras, Jamaica, Nigeria, Uruguay, Venezuela and Yugoslavia. An example of a typical exchange is as follows. A debtor government allows specified debts, up to a certain limit, to become eligible for conversion into equity. Under the programme, debt is exchanged for local currency at a redemption discount which may be determined through an auction. Highest priority investments might be exchanged at par while lower

ranked investments might receive, say, local currency worth up to 70 percent of the full dollar value of the debt. The currency obtained may only be used for authorised investment purposes. (Although the equity is denominated in local currency, dividend remittances and capital repatriation are allowed after an interval, normally of several years). The foreign investor, often a multinational firm (though sometimes a bank), purchases the required amount of LDC debt through an intermediary in the secondary market, extracting the market discount in the process. This is then exchanged for the local currency and the equity purchase is made. The attached diagrams illustrate the mechanisms. If, for example, the secondary market discount was 50 per cent, the redemption discount 15 per cent and the intermediary's fee 3 per cent, the foreign company would be able to obtain 60 per cent more local currency for its investment than would be available via the official exchange rate. In effect, the foreign investor is offered a significant subsidy in order to participate in authorised investments. (In some cases, known as debt-peso swaps, residents are allowed to participate. The aim is to repatriate flight capital).

Repatriate

20. Debt-equity swaps can offer a number of advantages:-

i. To the investor:

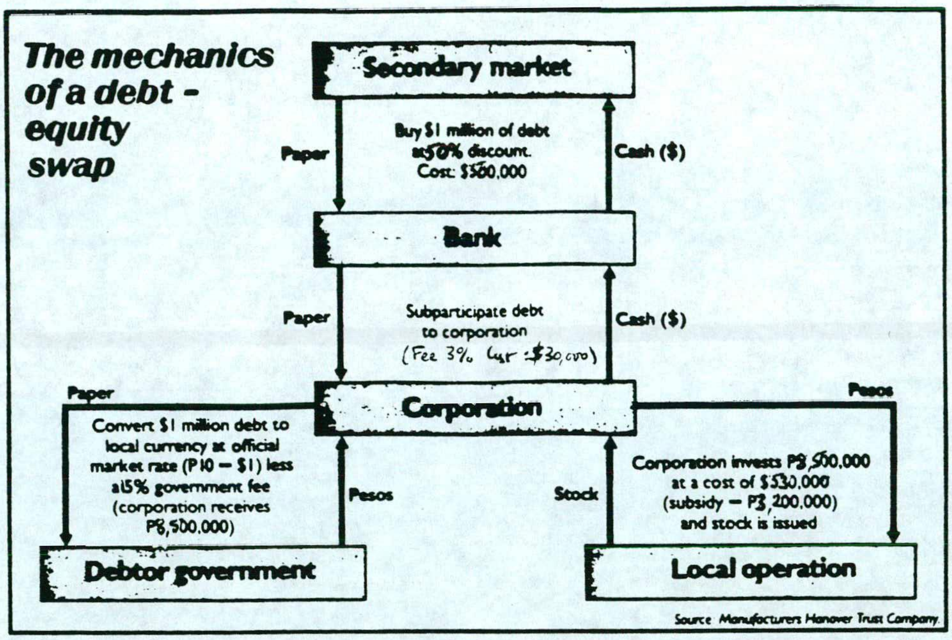
- a subsidy on the investment
- the potential for earnings and capital gain
- voluntary participation
- (where privatised assets are involved) additional investment opportunities

ii. To the debtor:

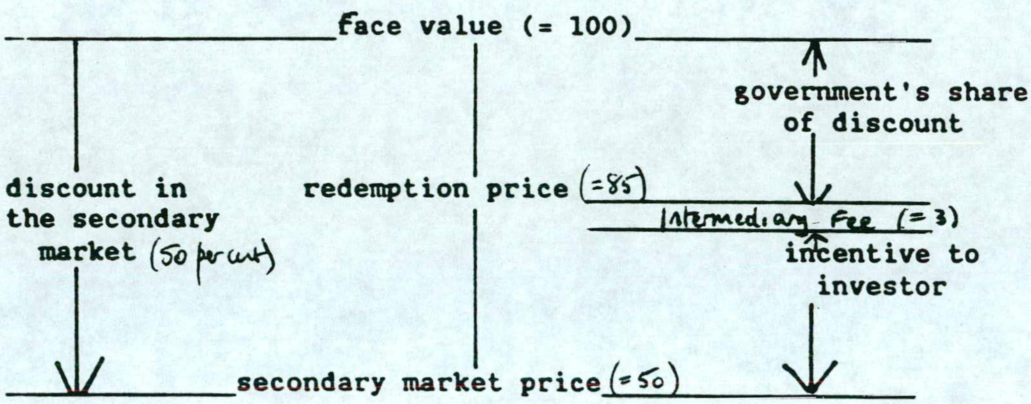
- some debt reduction
- some short-term relief from hard currency outflow
- potential breathing-space to facilitate macroeconomic improvements
- increased productive capacity and technical know-how

Debt-Equity Swaps

(i) Mechanics



(ii) The Division of the Proceeds



- higher output and employment
- (under privatisation) improved fiscal position and, where competition is increased greater efficiency in asset use.

21. Eventually, foreign investors expect hard currency returns. As the original debt has been replaced by an equity liability, this outflow will depend on the success (or otherwise) of these investments and on any improvements to the macro-economy resulting from the breathing space offered by reduced short-run obligations.

22. There are a number of limitations to debt-equity swaps from the debtor's point of view.

i. **Additionality:-** The problem that the investment might have taken place anyway. A recent IFC report estimated from a sample of 104 debt-equity swap transactions in Latin America, that while virtually all investments made by banks were additional only one-third of multinational company investments were truly additional. (A further 10 per cent of these investments were brought forward by the debt-equity programme).

ii. **Inflationary consequences:-** (This was a factor behind the suspension of the Mexican programme last year). Where large-scale additional investment increases the money supply, inflation is a possible outcome. Bond issues can be used to sterilise this effect but there remains the problem of servicing the increased domestic debt. Debtors find this difficult when fiscal constraints are in operation; it can be expensive, particularly when domestic interest rates exceed foreign rates. An alternative route (as undertaken by Chile) is to privatise state assets.

iii. **Misallocation of resources:-** Distortions to investment can occur because of external debt retirement may not necessarily be the best use of resources (eg when new money is required while debt is being reduced).

iv. **'Round-tripping'**:- Debt-equity programmes require the use of more than one exchange rate and thus encourage arbitrage. Capital outflows can be engineered (eg by distorting invoicing) and the money brought back into the country at the more favourable exchange rate available under debt-equity swaps. This 'round-tripping' has a cost in terms of official reserves as capital flight implies depletion but, on return, the foreign currency is used up in cancelling the external debt.

v. **Sovereignty**:- Debt-equity programmes are sometimes regulated to accommodate political desires concerning the amount of foreign ownership of capital.

Securitisation

23. Two examples of securitisation are examined here: the Mexican Zero-Coupon Bond (ZCB) Scheme and Brazilian Exit Bonds.

(i) The Mexican Zero-Coupon Bond Scheme

24. Under the Mexican scheme, the authorities used foreign exchange reserves to purchase non-marketable zero-coupon 20-year US Treasury bonds. These securities were used to back a 20-year marketable Mexican bond at a spread over LIBOR of $1^{5}/8$th per cent (double the spread on rescheduled Mexican bank debt) and were offered in exchange for eligible Mexican debt. Ex-ante financial analysis, based on secondary market prices prevailing at the time, suggested that the implicit discount on the new bond was between 22 and 37 per cent. In the event, 139 banks made bids covering $6.7bn of old debt with a range of discounts from 11 to 52 per cent, with the majority between 29 and 35 per cent. Mexico accepted bids from 95 banks for $3.7bn of claims. These claims were exchanged for $2.6bn in new bonds at an average discount of

30 per cent and at a cost of approximately \$0.5bn in foreign exchange reserves. Mexican external debt was reduced by \$1.1 billion.

25. At a price of approximately 70, the bonds reflected the sum of the secondary market price for Mexican debt plus the net present value of the ZCBs. Virtually no enhancement to the value of Mexican risk debt was achieved by the use of the collateral. Since the greater part of the net present value of such a bond is the interest stream, it has been suggested that credit enhancement of the interest payments could be necessary to achieve more successful results. This would clearly increase the cost.

26. The interest service saved in the ZCB scheme appears to have been virtually nil. At a LIBOR of 8 per cent and a margin of 13/16, the debt retired of \$3.7 billion would have carried interest payments of \$326 million per annum. The new bonds at the same LIBOR, but with higher margins, carry interest obligations of \$285 million. Allowing for interest forgone on the use of \$0.5 billion reserves, the total interest due is \$320 million. Mexican external debt will however be reduced by \$3.7bn when the ZCBs mature in 20 year's time.

(ii) Exit Bonds

27. The commercial bank financing package agreed for Brazil last year combined new money with debt reduction techniques, including exit bonds. Exit bonds are designed to allow banks with small exposures to reduce base exposure and thereby allow exit from future new money or restructuring requirements (although this is not guaranteed). The Brazilian arrangements provided for conversion of existing exposures to the new instruments which carried a coupon of 6 per cent with a 25-year term (10 years grace). A maximum amount of debt convertible into exit bonds was set at \$5bn, with individual banks limited to \$15m. The bonds were made additionally attractive (and more easily tradeable) by allowing conversion into domestic government long-term index-linked Treasury bonds. They were also made eligible for debt-equity conversions via the official auction. It is estimated that

\$1.2bn of exit bonds were taken up. (This was well below the maximum principally because the yield was not considered high enough).

28. The advantages of exit bonds to debtors and major creditors are clear but their use may be limited. To date, exit bonds have only been tried in Argentina and Brazil, with limited success. For the debtor, they operate as concessional long-term rescheduling and capture part of the secondary market discount. For the banks, the advantages lie in the reduction of base exposure, the improved security of service and the tradeability of the bond. This has to be weighed against the cost of the discount and the fact that for major bank creditors base exposure is reduced only marginally. Use of exit bonds is likely to remain small-scale and confined to bank portfolio reorganisations rather than debt reduction.

Buybacks

29. Two sorts of buyback operation need to be distinguished. Where buybacks are achieved through the use of debtors own reserves, trade surplus or assets their value to both debtor and creditor may be limited. On the other hand, resources donated for buybacks are clearly advantageous to the debtor.

Creditor govts [illegible] Banks

30. The Bolivian buyback involved the use of foreign currency donated by creditor governments to buyback Bolivian commercial bank debt at 11 cents to the dollar. Commercial banks were happy with this arrangement since it did not jeopardise the prospects of servicing the remaining debt (it may even have enhanced it since the effect was to halve Bolivia's commercial bank debts to \$330m). As the price of Bolivian debt rose from an average of 6 cents to the finally accepted price of 11 cents while rumours of the buyback operation circulated, the banks may have judged the exchange ratio attractive.

31. In general, banks are unwilling to accept buybacks where resources are pre-empted from use in servicing bank debts; and even more so where a new money package is likely to be needed. An

NB: Creditor agency to buy debt @ discount example of a buyback which was achieved with the use of the debtor's own resources occurred recently in Chile. Arrangements were made under the 1988 amendments to their commercial bank agreement to allow the use of additional reserves arising from higher copper prices for debt repurchase. In November $168m of reserves were used to purchase $299m of debt at an average discount of 44 per cent. After allowing for the loss of interest on the reserves used, the net interest saving to Chile was around $15m.

32. Debtor buybacks where the purchase is made out of their own resources are limited by the fact that they do not per se generate net foreign exchange in the long-run. However, they can ease debt servicing in the short-run. This may help the balance of payments and improve the fiscal position and in so doing put the debtor on an improved growth path. The implicit high yield in buying back debt at a discount may appear a good use of resources to debtors where they believe the secondary market prices are undervalued. Improvements could also occur where buybacks are associated with major changes of policy which would not otherwise have occurred. One example (not yet adopted) would be the sale of public assets in exchange for debt (although this is perhaps closer to a debt-equity exchange than a pure buyback).

<u>Secondary Market Developments</u>

33. One of the key developments in the last few years has been the emergence of and rapid growth in the secondary market for LDC debt. The paper of most sovereign debtors is involved but the market is highly segmented and illiquid; active trading mostly involves Brazilian, Chilean and Mexican paper. The market comprises cash transactions and straight debt swaps. Activity involves a chain of swap transactions as final buyers and sellers are matched. (The IBRD estimate that there may be 2-3 connected swaps involved in matching final users of the claims with the type of claim they require and in the quantity they need). There is no single authorative source of information on swap activity. All we have are broad estimates. The most recent IBRD estimates of market turnover for straight debt swaps in 1988, based on discussions

with market participants (who may be inclined to exaggerate the value of trades), put this at $25-30bn. Trades undertaken in exchange for more liquid assets, including cash, may have amounted to about $16bn. Together with the estimate for swaps this would give an overall figure for market activity in 1988 in the region of $40-45bn.

34. Market growth has been rapid over the last few years, with volumes approximately doubling each year since 1984.

TABLE 1: ESTIMATED ACTIVITY IN SECONDARY MARKET LDC DEBT

$bn	**1984**	**1985**	**1986**	**1987**	**1988f**
Turnover	2	4-5	6	15-20	40-45
of which Final Demand	3/4	1 1/4	1 1/2	8	16

Source: IMF/IBRD

35. The expansion of the market has been fuelled by two factors: debt conversion and portfolio reorganisation. Such reorganisations have been influenced by the desire by banks to concentrate their portfolios in areas of major business interest; by the need to diversify exposure to limit country-specific price risk; by varying assessments of country risk; by arbitraging opportunities; by differences in provisioning requirements; and by tax, accounting and regulatory considerations. Swap activity has generally resulted in a greater regionalisation in the pattern of claim holders as banks have aimed to consolidate their holdings in line with their strategic interests, as well as to reduce minor holdings in an effort to limit the cost of restructuring the loans and to avoid new money calls. It is likely that for the most part creditor banks have achieved their major portfolio objectives by now. More recently, many have taken opportunities to reduce their overall exposures.

36. Under debt conversions, external claims (which may have been purchased at a discount in the secondary market) are converted

into another form, reduced or extinguished. This activity expanded rapidly in 1987 and 1988. To date, debt conversions have mostly taken the form of debt-for-equity swaps. But other mechanisms have been used, notably the Mexican debt exchange scheme, debt buybacks by Bolivia and Chile and exit bonds in Brazil. Unofficial swaps, where debt is repaid at a discount through the exploitation of discrepancies in parallel and official exchange rates, have also emerged; and significant amounts of private sector debt owed to banks have been eliminated through prepayments at a discount. It is debt conversion activity which now gives the impetus to the secondary market.

37. Estimates of the cumulative face value of commercial bank debt converted in the period 1984-88 are set out in Table 2 below. They represent strictly the upper limit of commercial bank debt reduction - actual debt reduction will be lower than this for some of the conversion activity is into other, but more secure, forms of debt. The figures in the second column show the total debt outstanding to private sector creditors (mainly banks) at the end of 1987 and the last column sets out the proportion of debt converted in relation to this total. By the end of 1988 the total value of debt converted since 1983 could be about $27bn, roughly 10 per cent of outstanding debt to private creditors for these countries.

Table 2: Estimates of Cumulative Debt Converted during 1984-1988:

Major Countries

$bn	(1) Amount of Original Debt Converted *	(2) Debt Outstanding to Private Creditors at end-87	(1)/(2) %
Argentina	1.2	42.9	3
Bolivia	0.4	1.3	28
Brazil	7.3	88.1	8
Chile	4.4	15.2	29
Mexico	11.9	78.3	15
Philippines	1.5	15.9	10
Venezuela	0.6	32.2	2
TOTAL above	27.3	273.9	10

* Debt converted into equity, securitised debt (eg exit bonds) or cash (at a discount).

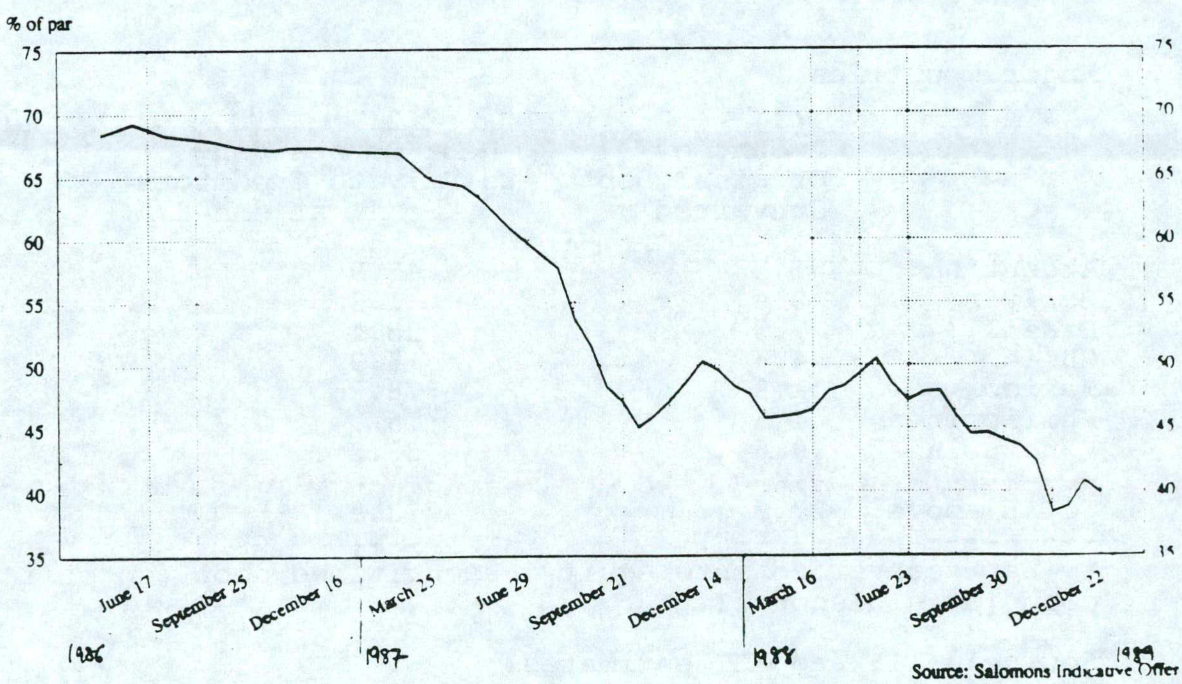
Source: IIF and HMT estimates.

38. There is a broad correlation among middle income debtors between proportions of bank debt converted and the economy: debt-for-equity swaps in relatively strong countries are more attractive to investors than in weak ones.

39. Average secondary market prices (Chart 1 below) have fallen by about 8 percentage points since the summer. For the Baker 15 countries as a whole prices now average 40 percent of par, compared with 50 percent a year ago and 67 percent a year before that. The sharp drop in prices in 1987 was largely due to banks' provisioning decisions and the Brazilian debt moratorium. The recent fall is more difficult to explain. It probably partly reflects increased provisioning but also sales by banks who participated in the recent Brazilian new money package since they have been concerned to prevent exposure increasing, and even to reduce it. In a thin market, even small amounts of sales can have a large effect on prices. It is possible too that a deterioration in economic prospects among a number of countries, eg Argentina, Mexico, increasing political uncertainties and concern over the possible suspension of the Brazilian debt-equity programme have undermined prices.

CHART 1 **LDC* Debt**

Secondary Market Prices



*: Baker 15

Source: Salomons Indicative Offer Prices
secmark1.cht

Conclusions

40. Prospects for market-based debt reduction remain good although the rate of growth of the secondary market could slow if debt-equity programmes lose momentum. Objections to debt-equity swaps, including the problem of additionality, could however be overcome if regulations were made less restrictive and if sound macroeconomic policies were adopted. Debtors could also achieve benefits by offering assets, through privatisation, in exchange for debt.

41. Buybacks too offer some scope for debt reduction. If banks were to find this acceptable voluntary debt reduction could proceed apace. To the debtor the high yields may prove an attractive way of allocating resources - but attractiveness depends on the debtor's true intention with regard to servicing the debt. If the market price reflects the true probability of repayment the debtor may be better off finding other ways of spending export earnings.

42. Debt service reduction so far by all means of debt conversions may amount to $1 billion and perhaps less taking into account the dividend flow stemming from debt/equity schemes. There must be doubts about whether negotiated debt reduction without use of public sector resources can be on a sufficient scale to achieve significant savings to the middle income debtors, especially given that exit instruments might have to be collateralised or carry higher interest rates than conventional bank debt and that "own resources" buybacks use up reserves. There are also doubts about how far the banks would be willing to provide new money in circumstances where they are also providing some debt reduction to a given country. It is not true that they would not provide any new money in such circumstances as the recent case of Brazil illustrates.

43. The conclusion reached by John Williamson in his "Voluntary Approaches to Debt Relief" was:-

> "These figures make it clear that voluntary debt relief is no panacea. If the debt crisis evaporates quickly and painlessly in the next 5 years, it will be because the value of debtor-country export surges as the higher recent primary product prices stabilise, or because interest rates have fallen again without a deterioration in the debtors' terms of trade. If a new upsurge in interest rates causes a new recession, then voluntary debt relief is not likely to counter the damage. But it could nonetheless play a useful role in the intermediate scenarios in which world growth is maintained with no decisive changes in interest rates and some relapse in the terms of trade."

This conclusion seems about right.

PUBLIC SECTOR ROLE IN THE DEBT STRATEGY

44. At the meeting of G7 Ministers on 24 September, the following was included in the final communique:-

> "The Ministers and Governors encouraged the further development of market-based and voluntarily agreed financing options under the menu approach in order to facilitate new financial flows. In this connection they reiterated their opposition to transferring risks from the private to the public sector."

45. At the Interim Committee on 26 September, the prohibition on the transfer of risk was extended explicitly to debt reduction:-

> "While recognising that new money continues to be of primary importance in financing packages for countries undertaking adjustment, but remains difficult to secure, the Committee agree that the menu approach should be broadened further, including through voluntary market-based techniques which increase financial flows and which reduce the stock of debt without transferring risk from private lenders to official creditors. Banks should be encouraged to provide adequate refinancing and not only rescheduling of amortisation

payments. The Committee encourages creditor countries to explore whether their tax and regulatory regimes are consistent with the continued broadening of the menu approach."

46. We have taken the G7 and Interim Committee decisions to mean that the direct assumption by the public sector of the risks on the existing stock of commercial bank debt is prohibited. Even on this narrow interpretation, the Mitterand proposal (described at Annex 1) should be ruled out. But the public sector share of the overall country risk is rising without direct risk transfer, since it has been increasing its exposure while the private sector has been holding off.

47. Against this background more than one interpretation of the Interim Committee's decision is possible. It may be helpful for our own purposes to specify the Interim Committee's decision more precisely. A possible rule would be:-

i. **No public sector participation in financing packages involving a net increase in its relative risk. Under this definition, extra net lending by the public sector (including IFIs and other official creditors) as a percentage of its 1988 exposure should not be more than the percentage increase in the net lending of the commercial banks. In cases which involve debt reduction by the commercial banks, the amount of debt service reduction achieved would be taken fully into account by putting it onto a basis equivalent to the provision of new money.**

not [illegible]

and possibly

ii. In no case should the public sector advance any more money unless the **increase in risk** thereby incurred was offset by at least an equivalent increase in the mathematical expectation that public sector debt would be serviced or repaid.

This would involve a **major** change from present practice: the public sector has so far been putting in nearly all the new money, with a minority of the exposure.

48. In practical terms we need to consider our attitude to schemes which increase or transfer risk bilaterally. Both the Japanese scheme described in Annex 1 and Ernest Stern's "Mexico" proposal (see Annex 2) raise the possibility of debt reduction involving higher risks for Japan, or possibly America, without necessarily accelerating the exposure of the multilaterals or other individual creditor states. It would be hard to resist such bilateral risk transfers if the multilaterals were genuinely unaffected, even though it may give rise to some pressure for the UK to follow suit.

OPTIONS FOR AN ENHANCED PUBLIC SECTOR ROLE

Additional IFI Resources: Funds for Buybacks

Option

49. We dismissed in paragraph 10 the case for additional IFI funding. But it is worth commenting on proposals for the direct use of existing IFI resources for buybacks. It has been suggested that the rate of return on buybacks at secondary market prices from problem debtors would constitute a cost-effective use of World Bank funds.

Assessment

50. A buyback financed by the World Bank at a discount of 50 per cent of a $100 bond which saved interest at 10 per cent a year would yield a certain return of 20 per cent, better than the average World Bank project. Also banks prefer funds for buyback to come from sources not related to the country's own foreign exchange earning capacity, which they believe should be devoted to interest repayments. World Bank funding, if regarded as "extra", would satisfy this criterion.

51. World Bank financed buybacks would constitute direct public sector funding for a buy-out of risks from commercial banks. It would also implicate the public sector directly in pricing the buyback, and thus the distribution of the benefit between creditors and debtors. Since the benefit would take the form of debt service saved, there would be less immediate funding available to finance essential imports for any given use of World Bank capital than there would be under a direct loan. Thus the amount of reform that could be achieved might be less. (This is a specific case of the general point that debt reduction provides less immediate balance of payments assistance than direct lending of new money for any given level of assistance).

Agrees (there must be some price!) [Also short cuts]

Conclusion

52. We would reject this option.

Too hasty

Additional IFI Resources: Interest Rate Caps

Option

53. A further possible use for additional World Bank resources sometimes suggested would be to reactivate co-financing facilities which automatically make funds available if interest rates rise above a critical level (as suggested by John Williamson). If interest rates rose by say 1 per cent above existing levels this might cost the 15 major debtors perhaps an extra $2 billion a year. Lending of all or part of this amount from the World Bank jointly with banks to help finance excess interest costs might be a feasible proposition, with repayments made when rates fell below the critical level. Interest would of course be payable on the deferred interest payments.

Assessment

54. Many of the major debtors are getting towards their ceilings for lending from the World Bank. The most extreme case of this is Brazil, which is now above its limit. To the extent that new lending from the World Bank to cover interest rate increases was

not additional to new fast-disbursing, policy-based lending, the country concerned would be no better off than it was before. Using their World Bank borrowing to pay back bank interest might not be popular with borrowers. It would also take some of the pressure off banks to capitalise interest or provide new money to help finance interest payments, running counter to the ambition for more equal burden sharing. Any widespread use of a World Bank facility would also cut across the IMF's CCFF which, in certain circumstances, provides funding for excess interest costs.

Conclusion

55. It would be better to leave this form of balance of payments support funding to the IMF rather than the World Bank in terms of their respective functions under the debt strategy.

World Bank Guarantees for New Money

56. The World Bank's present practice is only to grant guarantees for **new** commercial bank lending or rescheduling - the last such guarantee in a concerted lending package was for Mexico in 1986, when late maturities of lending by the commercial banks of $1.5 billion were covered by a guarantee of $750 million (it had a net present value of $225 million). As with all World Bank guarantees, the Mexican ones will score against the Bank's capital dollar for dollar in the period when they are callable.

Guarantees for Debt Reduction

57. Recently the Americans have vetoed all proposals for World Bank guarantees. But the World Bank staff (and within G7 the Canadians and Italians) are beginning to support guarantees for **debt reduction**. They argue that debt reduction schemes are now an accepted item on the menu; money is fungible: and so guarantees in support of debt reduction schemes are no different in principle from guarantees on loans to debtors who can use the proceeds to support such schemes. Also, well designed debt reduction schemes would enhance the debtors' longer-term capacity to repay and ultimately enhance the World Bank's loan portfolio. It is also

argued that a gradual shift in risk is happening anyway, with a growing proportion of debt being owed to public sector bodies.

Options

58. Specific ways in which the World Bank could propose guarantees in the context of debt reduction packages include:-

i. To partly back any securities issued by donors in Mexico-type exchange schemes in cases where the country concerned had insufficient resources even to purchase AAA zero coupon bonds to collateralise principal repayments.

ii. To provide a rolling or short period interest guarantee on new lending or on securitised debt in exchange schemes.

Assessment

59. The possibility at i. is discussed in the section on support for conversion bond issues below.

60. The possibility at ii. is that the World Bank would guarantee interest in each year t+1 provided interest had been fully serviced in year t (or interest could be guaranteed for one or two years only). Covering interest for a short period could be a relatively inexpensive way of providing some additional security on either new lending or converted debt. If the latter, it would complement schemes such as the Mexico conversion scheme which collateralised principal but not interest. But it still would constitute a clear transfer of risk, and a guarantee of only one year's interest might not be highly valued by the banks.

61. If guarantees were implemented by the World Bank, we would certainly want to insist on a stringent application of the agreed rules for their issue:-

i. Sound adjustment programme in place.

ii. Within exposure limits.

iii. Appropriate burden sharing.

iv. One part of overall negotiated settlement.

v. Essential to close deal.

We should also insist that the guarantees be small in relation to the size of debt reduction and the World Bank's balance sheet.

Conclusion

62. The UK attitude towards World Bank guarantees in support of debt reduction must continue to be very cautious. Guarantees cannot readily be squared with the G7's opposition to transferring risks from the private to the public sectors unless used in conjunction with debt reduction that would not otherwise occur. There is a distinction between World Bank provision of guarantees and the more indirect facilitating of commercial bank debt reduction which is made possible by World Bank guarantees for new lending or by policy-based loans from the Bank itself. While we may find a purely intermediary role for the World Bank in debt reduction acceptable, the issue of guarantees would be a major departure. They might have some role for small middle income debtors, however, as a catalyst.

Support for Conversion Bond Issues

Option

63. So far the main type of market mechanism for debt reduction other than debt/equity swaps is the issue of conversion bonds at a reduced face value compared to the existing debt. (Whether such bonds are "exit" bonds in the sense that responsibility for interest capitalisation/new money is bought out is a matter for the relevant commercial bank steering committee to determine). Given that collateralisation or other methods to enhance the

status of such bonds involves a cost, it could be argued that they are not likely to make a sufficiently large contribution to debt reduction because of the need for the issuing country to pay these costs. Collateralisation, guarantees or seniority of the bonds might be provided instead by an outside agency, which is usually suggested to be the World Bank.

Assessment

64. Exit bonds **collateralised** by an external agency may not be a very efficient use of IFI capital. A more efficient possibility could involve the issue of World Bank **guarantees** to cover some of the risks on exit bonds. One idea would be to set the value of the World Bank's guarantees so as to make the present value of the exit bond roughly equal to the price in the secondary market. This would result in exit bonds and loans being swapped at close to par. The attraction of the exit bond to banks would be the non-requirement to capitalise interest or to provide new money as well as the fact that the World Bank guaranteed the repayments. As with the Mexico scheme, it would be possible to fix the annual coupon payment on the exit bond and the maximum number of bonds to be issued, and allow the banks to bid for them - the discount being fixed by market forces.

65. Further refinements could be possible: for instance the bonds could be on a repayment mortgage basis with 16-year maturities. The first eight payments could be guaranteed by the World Bank and the remaining eight subject to cancellation one year at a time as the first eight were paid off on schedule. The debtor would then have a strong incentive to maintain service of the bonds and thus the probability that the Bank's guarantees would be called would be reduced.

Application of Conditionality

66. Various mechanisms have been suggested for tying bond conversion schemes or other forms of debt reduction more closely to continued adjustment by debtors. Where debt reduction takes the form of sub-market interest rates, this can readily be

achieved by stipulating a reversion to market rates if adjustment performance falls short. Other possibilities include debt reduction by phased tranches, or exchange for bonds whose face value would be written down by steps, linked in both cases to adequate adjustment. Given that there is already a link to adjustment through IMF and IBRD programmes, it is not clear however that these devices would significantly enhance the incentives to adjustment, or the security of the new instruments without some other source of credit enhancement, eg IBRD guarantees.

Conclusions

67. The main argument against such an exit bond scheme is the large scale of the operation given that the potential demand for the 17 highly indebted countries could amount to as much as $45 billion if one-third of their debt were converted into exit bonds. Such a development would transform the balance sheet of the World Bank and would mean a major change in its role. A change in its Articles might be required. This rules it out.

68. A much more restricted facilitating role might however be envisaged for the World Bank: for instance, it could issue the zero coupon bonds to collateralise debt exchange schemes which would be bought for cash by the debtors themselves.

Informal Cross Default

Option

69. It might be possible to make bond conversions (or new lending) senior without having any direct impact on the balance sheet of the public sector. An informal arrangement could be reached between the lending banks and the World Bank which could provide that the Bank would withhold all new lending from countries that are in default in servicing a defined set of conversion bonds held by the commercial banks. The knowledge that future funding from the World Bank would not be forthcoming if a

country was in default might be a considerable incentive to stay current on the "senior" bonds.

Assessment

70. The justification for the privileged treatment of bank debt provided by a cross-default clause would be much stronger in the case of conversion bonds than new lending because the banks would have offered debt reduction to receive it. Such informal arrangements, which would have to be agreed by the World Bank Board, might have a role to play in particular cases. They have a close analogy in the existing arrangements for B-loans at the Bank, where optional cross-default clauses can operate when there is commercial bank co-financing of Bank projects. But cross-default would lower the status of the World Bank as a preferred creditor and reduce its leverage if a cross-default provision caused it to receive a net inflow of debtor funds. It would also dilute the preference the Bank enjoys as a source of new funds: by making common cause with the banks it effectively transfers some of their risk to the Bank.

Conclusion

71. This option probably does not provide a sufficient inducement for large-scale debt reduction and has disadvantages for the Bank which make it unacceptable.

Senior Status

Option

72. To give new bank lending or written down debt "senior status".

Assessment

73. It is usually impractical to change the legal arrangements which mean that new debt cannot be made legally senior to existing debt because all the banks involved have to agree to this. But it

would be possible for particular bank advisory committees to encourage new lending by, for instance, colluding with the debtor countries so that back interest to free riders under concerted lending packages is given deferred treatment. This is the so-called "novation" idea proposed for the Cote D'Ivoire. In general such proposals are best worked out entirely without the assistance of the public sector.

Conclusion

74. There is no practical way to make one category of commercial bank debt legally senior to another category. But there seems no reason why the IMF or World Bank should intervene, for example, to protect non-contributing commercial banks by refusing to agree to new programmes unless all bank arrears are treated on an equal basis. If an advisory committee is content to provide for disparity of treatment, the IMF and the World Bank should be willing to go along with this.

A CHANGE IN PUBLIC SECTOR STRATEGY IN THE CONCERTED LENDING PROCESS

Option

75. A more radical departure (reportedly espoused by Secretary Shultz) would be to allow IMF programmes to proceed without any clearance of bank arrears, and with a financing gap left open, when commercial banks refuse to provide new money. This has already been done for Costa Rica, although there is no question of Costa Rica actually drawing on its standby.

Assessment

76. This proposal would in effect compel the banks to provide finance through the accrual of arrears and put pressure on them to put up new money or grant debt reduction. It would obviously change debtor/creditor/IMF relations and would raise strong objections from the banks. As a preliminary to such a radical measure, pressure could first be brought simply by more

steadfastly refusing to agree an IMF programmes before an adequate commercial bank contribution is made, even if the financing gap could be filled from public sector resources. This would be tantamount to a return to the way the strategy operated in 1982, with the key difference that the banks' contribution could come either from new money <u>or</u> from debt reduction. If this failed to achieve results the World Bank/IMF would then go ahead regardless, leaving the residual financing gap unfilled.

77. The advantage of this scheme is that it puts pressure on the banks for more equal burden-sharing, though without pushing them overtly towards any individual option on the menu. Bringing pressure to bear through our actions in the IFIs, rather than through moral suasion, also avoids the moral hazards implicit in the latter.

78. It has to be recognised however that willingness to leave the financing gap unfilled would be a reversal of the position that we have taken in the IMF Board. So far we and other G7 have usually insisted on fully-financed Fund programmes to protect Fund and other public sector resources. This objection would be less in the case of an undrawn "classical" SBA, but there is no way of prohibiting a drawing once a programme is approved. If this technique were used in the case of an IMF programme with disbursements, it would be vital that the IMF and other official creditors obtained preferred creditor status over the banks. Debtors might be pressured by banks to maintain service on their bank debt using withdrawal of access to trade credit lines or other leverage. At first sight, there seems no simple way to ensure that official creditors actually would be serviced. This strategy also depends on a high degree of cohesion between public sector creditors.

Conclusion

79. Worth further study.

ANNEX 1

JAPANESE AND FRENCH DEBT SCHEMES

1. The French and Japanese schemes both reflect increasing interest in debt reduction and the role which the official sector might play.

2. The two schemes share a number of features:

- both aim to encourage further debt reduction by the banks;

- both aim to achieve this via credit enhancement in at least a portion of the stock of debt, utilising the mechanism of a frozen account (or accounts) at the IMF;

- both are associated with, or involve, increased official assistance.

3. Both schemes are claimed to fit in with the existing strategy - case by case, no risk transfer to the public sector, adequate conditionality - though the French scheme appears to fail at least the first two requirements.

4. However, the differences are significant:

(a) **The French scheme**

- is on a very ambitious scale, with potential costs to match;

- would be hard to ring-fence, despite the French claim that it could be operated case by case;

- involves a clear transfer of risk from the private to the public sector;

requires new multilateral official resources (an SDR allocation);

(b) **The Japanese scheme**

- is intended only as an extra item on the menu, and could be more easily assimilated into the case by case approach;

- is not intended to cover all the debt of any one country, still less all the debt of the middle income countries;

- does not entail a direct transfer of risk (though there might be an indirect effect);

- would involve no additional multilateral resources (though the Japanese have offered an associated increase in bilateral finance).

DETAIL

The French scheme

5. The French scheme was floated by President Mitterand at the UN General Assembly in September, shortly after the Berlin meeting of the IMF/IBRD. Many details remain unclear. In outline:

i. There should be a major SDR allocation (perhaps SDR 20 billion) at the Fund.

ii. The industrialised countries share of this (64 per cent of the total) is transferred to a separate Trust Fund or to a separate account at the IMF itself.

iii. On a case-by-case basis eligible middle income debtor countries with an internationally approved adjustment programme enter into securitisation deals with the banks to transform their bank debt into either bonded debt or equities.

iv. As part of (iii) some or all of the interest or dividend payments on the securities created are guaranteed by the Trust Fund/IMF.

v. The banks, for their part, agree some form of discount or sub-market interest rate on the interest-guaranteed debt.

<u>**Comment**</u>

6. Our main objection is the unacceptable transfer of **risk** from the commercial banks to taxpayers in industrialised countries (despite French claims to the contrary). Other major objections are:-

- The potential **cost**, both directly if guarantees are called and indirectly in adding to world inflationary pressures (contributors to the Guarantee Fund might also have to make interest payments);

- <u>**Moral hazard**</u>. Interest guarantees would increase the risk of default on debt service unless incentives against default could be constructed;

- <u>**Effectiveness**</u>. The value to the debtors would depend on the discount they could capture, and the interest rate on the new instruments created. The new bonds would be capital uncertain, so the banks would probably drive a harder bargain than in, eg, the Mexican debt exchange scheme.

<u>**The Japanese scheme**</u>

7. This was put forward shortly before the Toronto Summit and again during the Berlin meetings. Again, many details remain

unclear though it is clear that a global scheme is not intended. The plan merely adds to the existing menu. In outline:

i. The debtor country agrees a medium term adjustment programme with the IMF (probably an EFF);

ii. It then negotiates with the banks to transform a part of the stock of bank debt into bonds fully backed as to both interest and principal; the remainder, which would be partly backed, to be rescheduled on concessional terms;

iii. The negotiations between the debtor and the banks would largely centre on the relative proportions of the two tranches of bank debt and on the terms of the rescheduling applied to the latter;

iv. The first tranche of debt would be subject to guarantee by the foreign reserves of the debtor country deposited, in cash, in an IMF account. The banks would receive bonds drawn directly on the special account which would guarantee that they would be repaid their principal and interest;

v. An agreed proportion of future foreign exchange earnings would be hypothecated to a second account at the IMF which would be used to partially back the remaining portion of the debt, which would be rescheduled at concessional rates.

vi. Separately, Japan would offer an increased flow of bilateral finance (untied Eximbank loans).

<u>**Comment**</u>

8. The Japanese scheme is less evidently objectionable than the French, but there must be considerable doubt about how effective it could be. The major debtors simply do not have the reserves necessary to achieve the enhancement of a significant proportion of their debts in this way (Mexico might manage $3 billion out of $68 billion). It is hard to believe that the kind of inducement

proved by (vi) alone

which could be afforded would be sufficient to trigger a worthwhile degree of concession from the banks in the envisaged rescheduling.

9. The main substance in the proposal lies in the parallel financing proposal, which is undoubtedly inspired by Japan's desire for a larger role at the Fund. While no financing from any source should be rejected outright, we have preferred multilateral deals where possible (the Americans are similarly cautious, and have blocked discussion in the Fund Board).

10. A further worry is that there would inevitably be calls for corresponding finance from other G7 countries which would be hard to resist. To the extent that parallel financing assisted debtors to build up reserves in the two IMF accounts, there would also be an indirect transfer of risk from the private to the public sector.

Conclusion

11. Neither scheme is yet sufficiently clear for a final judgement. But on the basis of what we know so far the very cautious line we have taken is justified.

12. The French scheme should be rejected as breaching the Interim Committee agreement that there should be no risk transfer. But a general response to both schemes could be that debt reduction is already taking place on an increasing scale without public sector participation, and that it is not clear that public sector participation is necessary, or could be justified as a cost-effective use of taxpayers' money. Debt reduction is essentially a matter for debtors and the commercial banks to agree amongst themselves.

ANNEX 2

A COLLATERALISED EXIT BOND

1. Mr Stern (SVP Finance at the World Bank) has suggested the following exit idea for inclusion in a package for Mexico, provided it continues with its adjustment efforts.

2. Outstanding Mexican external debt is about $100bn, of which $68bn is owed to the commercial banks. Stern's suggestion is that one half of the bank debt, $34bn, be converted at the secondary market price (50 is assumed for convenience) to new bonds of value $17bn. The principal on the new bonds would be collateralised (as was the earlier Mexican debt exchange scheme); this would be done through the purchase by the Mexicans of 30-year zero-coupon bonds. The interest paid on the bonds (assumed to include the same margin over LIBOR as before the exchange) would be subject to a guarantee, possibly a rolling 1-year guarantee. It may be that official creditors (possibly the Japanese) would lend the capital for the bond purchase and/or for the collateralisation of interest. Stern envisages that the size of the debt reduction would allow an exit for the banks from any further 'new money' calls.

3. An estimate of the interest service reduction achieved is set out below.

<u>Estimated Interest Service Reduction from Stern Scheme</u>

	Interest saved on $17bn written-off:	**$1.7bn**
<u>less</u>	**Interest cost of ZCB purchase:**	**$0.1bn**
	Net Interest Saving per annum:	**$1.6bn**

In this table the <u>main assumptions</u> are:

(a) Libor of 9 3/16 per cent; margin on bank loans of 13/16ths, ie bank interest is 10 per cent, official borrowings are made at 9 3/16 per cent;

(b) Exchange takes place at a price of 50;

(c) \$17bn of 30-year ZCBs can be purchased at a discount rate of Libor for \$1.2bn.

(d) Interest guarantee not called (and is therefore costless). Each time it is called the Mexicans in effect borrow a further \$1.7bn, costing \$0.15bn per annum interest.

Sensitivity

4. Interest saved would be reduced to \$1.4bn if a ZCB of 20-year maturity rather than of 30 years was purchased. Interest saved is very sensitive to movements in the price of the exchange. If, for example, the price was 70 rather than 50, interest saved would be \$0.95bn.

Assessment

5. The recent worsening of the Mexican balance of payments position, the likelihood of a further deterioration on current account and the serious decline in reserves has meant that the Mexicans are looking for substantial amounts of external finance from both official and bank creditors. After allowing for a generous public sector contribution (including an IMF programme) and for rescheduling of remaining principal due to banks, the 'new money' requirement from commercial banks in 1989 could amount to \$3.5bn. The Stern scheme, which could save up to \$1.6bn in interest payments, thus falls well short of the immediate requirement. If the promise of a complete 'exit' for the banks was to be fulfilled, a further \$2bn from the public sector could be required this year to fill the gap.

6. A possible solution would be to confine the 'exit' to the new bonds alone (as in other exit bonds). The banks would thus be required to contribute 'new money' on the \$34bn of original debt remaining. This would provide (roughly) the \$2bn needed without additional public sector support. However, in this event the attractions of the scheme for the banks are considerably reduced. Voluntary involvement on a big enough scale would probably imply a higher exchange price (perhaps at least 70), with correspondingly lower interest savings for the Mexicans.

PERSONAL & CONFIDENTIAL

Pmg

FROM: N L WICKS
DATE: 27 JANUARY 1989

CHANCELLOR OF THE EXCHEQUER

cc EST
Sir P Middleton
Sir T Burns
Mr Lankester
Mr Byatt
Mr H P Evans
Mr Mountfield
Mr Odling-Smee
Mr Bottrill
Mr Gieve
Mr Walsh
Mr Tarkowski
Mr Tyrie

Mr Loehnis - B/E

For debt meeting

NEXT STEPS ON INTERNATIONAL DEBT

Mulford duly exposed the US Treasury's thinking on international debt at yesterday's G7 Deputies' meeting. He emphasised that Secretary Brady was not committed to the ideas he described, nor had they been cleared with other agencies, let alone the President. They were being considered in the greatest secrecy and there would be enormous embarrassment if news of them leaked out; hence the classification of these papers.

2. The scheme outlined by Mulford involves the use of IFI, especially World Bank and Fund monies, to permit debtor countries to finance the buy-back of bank debt. The G7 Deputies were reasonably sympathetic to the proposals. I was more cautious.

3. The details of the scheme are given in paragraph 7, (6) of the note of the discussion attached. I apologise for its length, but Secretary Brady may well not provide a paper for the G7 meeting, and certainly, according to Mulford, not before you arrive in Washington; hence the detail.

N.L.W.

N L WICKS

WICKS TO CX 27 JAN

PERSONAL & CONFIDENTIAL

NEXT STEPS ON INTERNATIONAL DEBT

Mulford said that the US Treasury had not completed their review of debt strategy. Brady had had some discussions with the President (before Christmas) and with Baker, but had not cleared proposals with them. Before coming to conclusions, he wanted G7 views. Everything was being handled in the greatest secrecy and he asked us to return the paper he circulated at the meeting which described the background to the US approach.

THE BACKGROUND TO THE US APPROACH

2. Mulford's paper made the following points.

(i) Despite some progress in debtor countries, the debtor nations were tiring of the effort required for reform, though there had been good progress in some countries, such as Chile. The commercial banks were reluctant to provide new finance. They had undertaken a significant amount of debt reduction.

(ii) There were, however, significant problems*. There was a "political perception" that the debtor nations were in as difficult a position as they were a few years ago; policy reforms had not been implemented with sufficient vigour; growth had been too slow to sustain the political will to continue economic reform efforts and to generate new funds; export earnings were not high enough to reduce debt; debt, debt service burdens and arrears had increased; investment had declined by on average 25 per cent; and IFI exposure was increasing as the commercial banks pulled out.

(iii) The outlook was not promising. The prospects were for further partial reforms in the debtor countries which will become more difficult; anaemic growth; continued withdrawal by the commercial banks; increasing involvement by the Fund and the Bank in new lending leading to the loss, perhaps soon, of their preferred creditor status and their eventual need to reschedule; further ad hoc responses which would provided temporary "band

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* Attached are some statistics circulated by Mulford on Debt Developments in the Baker 15.

aids" but no long-term solutions; and harm to the progress towards democracies within the debtor countries.

3. Mulford went on to say that the political interest in the USA in international debt was rising. By 23 February the US Treasury had to submit an interim report to Congress, explaining why it had decided not to proceed with the creation of a "international debt facility". By the same date, the three bank regulators (the Fed, FDIC and Office of the Comptroller of the Currency) had to produce a report on regulatory impediments to debt reduction with recommendations for action (though there was a prospect that this report may be delayed). On 1 March the Treasury had to provide a note for Congress on what the World Bank was doing to facilitate debt reduction following the GCI.

DEPUTIES' COMMENTS

4. My colleagues agreed generally with the gloomy US assessment. Gyohten though that the banks could be persuaded to capitalise interest and to everyone's surprise, he commented that the reality was surely that the IFIs would have to reschedule debt before too long. Trichet, speaking for everyone, said that it would be a "total catastrophe" if the IFIs had to reschedule. He observed a paradox; the banks had already provided for the very action which the debtors' situation required. The need now was for a device whereby the debtors could take advantage of the room for manoeuvre created by the banks. The consequence of present policies was that we were bailing out the banks. I said that we should avoid giving any expectation that whereby 1988 had been the year when Governments had helped Sub-Saharan Africa, so 1989 was the year when Governments would help the middle-income countries. The problems of the two areas were different in nature. Governments were the main creditors in African debt. This was not the case in Latin America. Governments were already making a large contribution, through export credit. Mulford's presentation, and the figures which he had circulated before the meeting, neglected Governments' contribution through export credit. Latin America was not all gloom, as Chile demonstrated.

THE THINKING BEHIND THE NEW APPROACH

5. Mulford then described the new approach under the consideration in the US Treasury. He stressed that Brady was not committed to it and it had not been cleared with the President. The approach would only succeed if it enjoyed G7 support. It was as follows.

(i) The fundamental principles of the debt strategy remained sound: a need for stronger growth and reform in the debtor nations; external financial support; and case by case. Interestingly, Mulford said that "no transfer of risk" was not an original principle of the debt strategy. They certainly rejected any solution which involved providing additional official resources. This would only "finance out" the banks; saddle the debtors with a rising stock of debt; transform the role of IFIs so that before long they would be the major holders of debt, lose their preferred creditor status and have to reschedule. The outcome of providing more official finance would be to place the IFIs in the dangerous position the banks were in in 1982.

(ii) The better approach was to find a solution which placed responsibility for servicing bank debt on the banks and the debtors while giving them incentives at the same time to reduce the stock of debt. This would require legal, tax and regulatory barriers to be removed, and a greater use of the IFIs' policy based loans but in a way which did not insert the IFIs "into the management of the problem". Above all, banks and debtor countries should be encouraged to reduce debt through debt/equity, buy-back etc schemes. This process should take place within the following guidelines:

a. debtors had to be convinced that it was in their interests to reform economies and to undertake policies which attracted new investment and returned flight capital;

b. we had to abandon the pervasive philosophy of "gapology" where public sectors were landed with the task of bridging residual financial gaps. Too often the consequence was that public sectors financed flight capital; debtors were encouraged to exaggerate their financing needs; and the IFIs expanded their exposure effectively financing out the banks;

c. the debtors needed new loans, but only provided that they could be balanced by a reduction in debt service. Interest rate capitalisation, which simply bought time, was a dead end;

d. debtors needed to be encouraged to work intensively with the commercial banks on debt reduction;

e. the approach needed to be attractive to all participants.

A POSSIBLE US PLAN

6. These guidelines led Mulford to describe the following plan.

(i) A medium-term (3 year) perspective should be developed with an emphasis on debt reduction linked to the return of flight capital and new financial flows. The commercial banks would need to give two waivers of restrictive clauses in bank lending agreements which inhibited debt reduction. The first waiver concerned "the sharing provision" whereby banks in a syndicate pledged themselves to share equally payments of interest and principal. Without a waiver this provision exposed a bank selling a loan for cash to the possibility of a law suit from syndicate members after seeking share of the proceeds. Such a waiver had been given in the case of Mexico and Chile. The second waiver concerned "the negative pledge" whereby banks agreed that any security seized by one bank should be applied to the benefit of all banks in the syndicate. (Apparently these two waivers are not needed for debt equity swaps or to exit bonds, but are required for most other debt reduction techniques.) Without such waivers widescale debt reduction would be impossible. So, the first element was for G7 Governments to persuade their banks to give such waivers, where this was necessary.

(ii) The second element was to provide a new source of finance for debt reduction. The IMF and the World Bank could be required to segregate a portion of their fast disbursing money, say between

25-40 per cent, in a special account. This would only be released to the country on evidence that that country had spent an equivalent amount on debt reduction. In Mulford's words, the country would "bring a chit to the window and get reimbursed if they had a real debt reduction plan". He emphasised that <u>the IFIs should be passive players</u> in this process, simply releasing money on evidence of debt reduction; they would not have any role in pricing. The onus would be on the banks and the debtors to devise schemes. Resources provided by the IFIs for debt reduction would be found from within their already planned allocations - there would be <u>no additional money</u>. The IMF would continue its pre-eminent role in ensuring macro-economic conditionality, placing renewed emphasis on liberalising capital markets, encouraging the return of flight capital.

push up stn intl price

(iii) The approach would encourage <u>the abandonment of "gapology"</u>, and focusing the IFIs', the banks' and the countries' attention on debt reduction.

(iv) It needed to be coupled with the removal of <u>legislative, regulatory and tax inhibitions</u> which discouraged debt reduction, an aspect which the US was still exploring.

<u>SOME QUESTIONS</u>

7. The following points emerged in general discussion of Mulford's approach.

(i) There was considerable uncertainty about <u>the attraction to banks</u> of this approach, and in particular whether they would be ready to give the two waivers. Some banks would be ready to contemplate a viable course which removed developing country debt from their books. The problem of free riders was noted. Mulford said that the US Government would be ready to twist the arms of the US banks. The US would consider encouraging banks to participate in the arrangement by altering their tax code so that banks giving waivers could offset foreign losses against domestic income, something not allowed under present tax law.

(ii) There was some feeling that the IFIs would need to involve themselves in the details of debt reduction arrangements more than

Mulford had envisaged. Otherwise there would be scope for fraud and trickery (Trichet). There would be enormous pressure to provide the IFIs with additional funds. A key element in the arrangement was that it would be for the IFIs to decide the proportion of monies segregated, not the country.

(iii) To provide any significant financing relief for the debtors, the scheme would need to be implemented on a massive scale, involving substantial IFI money. There were suggestions that debt/equity swaps were more efficient in reducing debt service than debt buy-back arrangements of the sort envisaged.

(iv) The approach would have two inevitable arithmetic consequences. First, industrialised countries' public sectors, including IFIs, would hold a higher percentage of debtor country debt while the commercial banks reduced their proportion. To that extent the scheme breached the Interim Committee's principle of "no transfer risk to the public sector". Mulford accepted this, but argued that public sector risk would not increase in absolute terms provided the IFIs were not given additional funds. Most important in his view, the approach would avoid the situation which he foresaw whereby the IFIs would be the largest creditors in a few years time. The second arithmetic consequence was that the debtor countries would, in the short-term, be worse off in terms of cash flow since the reduction in their receipts from the IFIs (as a result of the money going to the banks for debt reduction) would initially be greater than the reduction in debt service (as a result of debt reduction). Obviously as time went on this disadvantage would diminish as debt service reductions built up.

(v) Mulford, in his campaign to abandon gapology, would be prepared to sanction Fund programmes where there was a financing gap in the expectation that any arrears would accrue to the commercial banks. Other Deputies, particularly Trichet, were more cautious.

DEPUTIES' FIRST REACTIONS

8. In a tour de table, Deputies gave their first reactions to Mulford's approach.

Trichet (France) - a first very important step in a good direction. Certainly time to concentrate on debt reduction. The IFIs would need additional resources to make the approach work. A priori reservations on the cash buy-back aspect of the proposals because such buy-backs gave less leverage than other debt reduction schemes. An alternative approach would be to concentrate on debt equity swaps. Not ready to abandon gapology since there needed to be an a priori diagnosis whether a country's balance of payments could be financed (to which Mulford replied that gapology simply financed capital flight).

Sarcinelli (Italy) - the scheme deserves all our attention. But there were a number of question marks: what was the incentive for the banks to join the scheme? The reaction of the debtor countries was uncertain and indeed might prompt them to an unhelpful response, like a moratorium.

Dobson (Canada) - the scheme would provide hope, but would not satisfy the creditor countries' expectations. Its advantage was that it placed some of the responsibility back onto the banks. It was open to abuse. But it undoubtedly could change the culture of the debt scene.

Gyohten (Japan) - an interesting idea. He acknowledged a greater role by the IFIs but could not see that the scheme would be attractive to Japanese banks. He made other discouraging noises which conveyed caution, but not much else.

Tietmeyer (Germany) - it would add an additional element to the present strategy, but would not solve the problem. A step in the right direction. Certainly public funds were involved, but they would not be additional. It would help countries improve the structure of their debt. It was essential to avoid any scheme which amounted to the IMF bailing out the banks. He had doubts whether banks and countries would use the scheme to any large extent. The precise role of the Fund and the Bank in the arrangement needed much greater consideration.

Wicks (UK) - agreed with the need to stop the transfer of risk to the public sector and to encourage the banks to play a greater role. Supported truly market based debt reduction arrangements. But was more cautious than other Deputies on Mulford's proposal because it involved a direct use of public funds for debt reduction, it would involve the IFIs and in his view to a greater extent that Mulford had suggested; and would sacrifice important principles of the debt strategy without the prospect of significant benefits for debtor countries unless it was implemented on a massive scale.

9. Summing up the discussion, Tietmeyer said that there seemed to be general agreement that the Baker strategy had run out of steam and that the banks were not providing their share of finance. There was a common position that bankers should be encouraged in debt reduction. Ministers should discuss at their February meeting the Miyawaza and Mitterand plans as well as the approach outlined by Mulford. (It was unclear whether Brady would circulate a paper at the meeting, as the Japanese requested, or would confine himself to an oral presentation.)

[Action: **Mr Evans** to provide an assessment of the approach outlined by Mulford and briefing on Miyawaza and Mitterand plans.]

January 23, 1989

15 MAJOR DEBTORS
DEBT DEVELOPMENTS
1982-88

Total Debt

- Increased from \$386 billion in 1982 to \$502 billion in 1988, an increase of \$116 billion.

Growth

- Debt strategy (Oct. '85) aimed for 5% growth rate by 1988.
- For the group as a whole, growth improved through 1985-86, but fell in 1987-88. These figures are affected by lower growth in Brazil, Argentina, and Venezuela since 1986. Mexico had negative growth in 1986, very low positive growth in 1987, and declining growth in 1988.

Average growth for the group as a whole:

	All	Without Brazil
'82	-0.5%	-0.9%
'83	2.7	-3.2
'84	2.3	0.9
'85	3.9	0.9
'86	3.8	1.8
'87	2.4	2.4
'88	1.7	2.3

- For the group as a whole, per capita income declined sharply in 1981-83 and has risen only slowly since then. (It declined in 1988). Standards of living generally are below the early 1980s level. Average per capita growth for the full group:

'82	-2.8%
'83	-4.9
'84	0.1
'85	1.7
'86	1.5
'87	0.1
'88	-0.6

Per capita income data in 1980 local currency units for selected debtor countries:

	1982	1987
Argentina	864	859
Brazil	99	105
Chile	84,930	97,712
Mexico	66,083	58,834
Philippines	5,412	5,058
Venezuela	15,997	14,140

Exports

o Fell by nearly $20 billion in 1986, but returned to 1984 level in 1988 ($126 billion).

	($ billions)
'82	112
'83	111
'84	123
'85	119
'86	99
'87	113
'88	126

Debt Ratios

o Debt/export ratio for the group remains well above 1982 level: it peaked in 1986, but is now improving:

'82	268%
'83	291
'84	272
'85	290
'86	348
'87	337
'88	308

o Debt/GDP ratio for the group is also above 1982; it peaked in 1987, but is now improving:

'82	42%
'83	47
'84	46
'85	46
'86	47
'87	50
'88	47

- Interest/export ratio for the group has improved, but rose in '88 as Brazilian interest arrears were repaid. The ratio for 1989 will be adversely affected by rising short-term interest rates <u>and</u> any repayment of interest arrears (6 of the major debtors now have interest arrears).

  Interest/Export Ratios

'82	30.9%
'83	29.2
'84	29.3
'85	28.5
'86	27.8
'87	21.5
'88	26.1

  Rising LIBOR rates are of concern (benefit of reduced interest rates since 1985 may be wiped out): Average annual rates during the period were:

'82	13.6%	
'83	9.9	
'84	11.3	
'85	8.6	
'86	6.9	
'87	7.3	
'88	8.2	estimate
current	9.6	

  New Interest Arrears

	Number of Countries	Amount ($ ml)
'84	4	1,100
'85	3	849
'86	4	1,030
'87	6	5,053
'88	6	2,535

<u>Investment</u>

- Neither investment nor domestic savings have shown much improvement over the period. Investment has declined from an average of about 25% of GDP in 1980-81 to 18% in 1986-88, while domestic savings as a share of domestic income remains near 1982 levels.

	Inv/GDP (in %)	Sav/GDY
'82	22.4	22.0
'83	18.3	20.9
'84	17.9	22.5
'85	18.5	23.1
'86	18.3	21.2
'87	17.7	22.9
'88	18.0	23.3

Exposure by Creditor

- Since 1985, commercial bank debt (expressed as net exposure) has declined by $1 billion, while IMF/IDB/World Bank net exposure has increased by $30 billion.

	Banks ($ billions)	IFIs
'82	245	27
'83	274	36
'84	273	40
'85	281	52
'86	290	65
'87	290	80
'88Q2	280	82

- As a result, there has been a shift in relative exposure; growing IFI exposure as commercial bank exposure declines. This is due to both higher net lending by the IFIs than commercial banks and debt reduction by the commercial banks (the IFIs don't reschedule or restructure debt). Continuation of current trends will accelerate this shift in relative exposure increasing relative risks of the IFIs.

- As share of total debt:

	Commercial Banks	IFIs
'82	64%	7%
'83	67%	9%
'84	64%	9%
'85	64%	11%
'86	62%	14%
'87	58%	16%
'88	56%	16%

- All developing countries' arrears to the IMF and World Bank have been increasing:

	IMF	World Bank
	(ml $s)	
'82	32	20
'83	64	73
'84	182	63
'85	630	86
'86	1,214	325
'87	1,265	630
'88	3,443	1,026

Net Lending

- The debt strategy called for $20 billion in net new lending by commercial banks during 1986-88, roughly equivalent to a 2.5-3% annual increase in commercial bank exposure.

- However, net new lending (expressed as new disbursements minus repayments of principal) in 1986-88 for the full group totaled $9.4 billion, based on country reports. (IMF staff and US regulators are trying to obtain more precise information based on bank reports, which don't now provide these data.)

- Although the World Bank only accounts for 13% of total debt to the major debtors, compared to 57% for commercial banks, its net lending for 1985-87 significantly exceeded that of commercial banks.

Net Lending

	Banks	IMF	World Bank
		($ millions)	
'85	2,500	1,669	2,407
'86	-1,385	-118	3,406
'87	3,646	-1,222	2,420

(In 1988, commercial bank lending exceeded World Bank lending due to the new Brazilian bank package and World Bank reorganization.)

Net Transfers

o If interest payments on commercial bank debt for the group are included, net resource transfers have been negative every year since 1983. Net commercial bank transfers for the major debtors since 1985 are:

	Disbursements	Total Payments	Net Transfers
'85	6.6	31.7	-25.1
'86	4.2	26.9	-22.7
'87	6.2	21.4	-14.9
'88	10.1	26.1	-16.0

Debt Reduction

o Net exposure of banks (as discussed above) actually declined in this period due to debt sales, debt/equity swaps, and other debt conversions. U.S. banks reduced exposure in these countries by $15 billion between 1985 and 1988, largely in the last 18 months.

Annual Debt Reduction

	Number of Countries	Debt/ Equity	Buy Backs ($ millions)	Other Conversions
'82	1	1		
'83	1	452		
'84	2	777		
'85	4	1,266		115
'86	6	1,335		1,071
'87	7	3,559	333	1.5 - 5 bn
'88	9	7,059	300	9,506

Secondary Market Prices

o Secondary market prices (average for the group) have fallen precipitously since early 1987 (triggered initially by Brazilian moratorium and Citibank reserving actions).

o Average market price (as share of face value) has fallen from about 67 cents on the dollar in early 1987 to 39 cents on the dollar at the end of 1988. (See attached graph.)

Why so?

- The price at which debt has been exchanged for equity in debt/equity swaps in Brazil has also fallen (to about 50 cents per dollar on average during the last auction).

Inflation

- Inflation for the group has advanced dramatically, due in major part to a resurgence of inflation in Argentina, Brazil and Mexico. For the period, inflation was:

'82	55.9%
'83	91.6
'84	118.4
'85	121.8
'86	77.2
'87	116.3
'88	222.9

Fiscal Deficits

- Total fiscal deficits for the major debtors improved temporarily in 1984-85, but have risen again.

	($ billions)
'82	5.9
'83	5.0
'84	3.6
'85	3.4
'86	4.8
'87	6.5
'88	5.1

PERSONAL & CONFIDENTIAL

FROM: N L WICKS
DATE: 27 JANUARY 1989

CHANCELLOR OF THE EXCHEQUER Thanks

cc Sir P Middleton

PRESIDENT BUSH, SECRETARY BAKER AND SECRETARY BRADY AND THE US INTERNATIONAL DEBT STRATEGY

Mulford provided some interesting background to current Administration discussions about the evolution of the debt strategy.

2. Mulford stressed, perhaps predictably, that the US Treasury were in the driving seat in managing the debt strategy. Jim Baker could be expected to take an informed interest, but he did not envisage that he would encroach on Treasury turf, partly because he was too astute a politician and partly because he would be too busy at State. The White House might take more interest, and perhaps unhelpfully so, in debt issues. President Bush was an acknowledged expert in foreign policy with contacts at Head of State/Government level throughout the world. He had much less knowledge of economic, financial and debt issues. There was a real possibility that Heads of State/Government would use their contacts with Bush for direct level appeals. These could cause problems if not properly handled. A great advantage here was that Brady was a "very close friend" of Bush. Tietmeyer chimed in to say that there was a similar risk of Head of Government involvement in Germany. Chancellor Kohl was susceptible to high level approaches, eg from people like President Mabaruk. I refrained from comment.

3. Mulford made two points about Secretary Baker's attitude to debt issues, neither of which may be new to you. First, he believed strongly that the existing strategy, which he had helped to devise, was right. He was violently opposed to using Government money for bank or other bail-outs. If the US Treasury espoused the approach on debt described by Mulford to the Deputies, their hardest task would, in his view, be to persuade Jim Baker to go along with it.

WICKS TO CX 27 JAN

4. Baker had an extremely negative view of the IFIs. Camdessus had handled his relationships with him very badly. The Fund was "running out of control". Relationships with the World Bank were unhappy, but they thought that they could manage Conable. Brady had still to come to a view.

N.L.W.

N L WICKS

chex.rm/jmt/82 PERSONAL AND CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 30 January 1989

MR WICKS

Sir P Middleton

PRESIDENT BUSH, SECRETARY BAKER AND SECRETARY BRADY AND THE US INTERNATIONAL DEBT STRATEGY

The Chancellor was grateful for your note of 27 January.

J M G TAYLOR

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pmp

NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM, HM TREASURY, AT 11AM ON MONDAY 30 JANUARY 1989

Present: Chancellor
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Byatt
Mr Lankester
Mr H P Evans
Mr Mountfield
Mr Odling-Smee
Mr Bottrill
Mr Gieve
Mr Tarkowski
Mr Tyrie

DEBT

Papers: Mr Wicks' note and enclosure of 20 January; Mr Wicks' note of 27 January.

The Chancellor said he was grateful for Mr Wicks' notes. We needed to consider the proposals against our overall objectives on the debt front. These included: to get the commercial banks to reduce the indebtedness of the debtor countries, by crystallising the provision they had already made, in the most beneficial way in terms of the world economy. The existence of a secondary market was the key to this.

NOTE OF MEETING DEBT 30 JAN

2. The Chancellor said there were various possible approaches. First, there was the US proposal as set out by Mulford. It was odd that this proposal concentrated on debt buybacks rather than debt/equity swaps. Buybacks had been less common in earlier schemes, and were less effective - they did not, for example, play a role in the repatriation of flight capital. Furthermore, there was the risk that if all IFIs provided money to buy back debt, the

result would simply be to force up the price which banks would ask for the debt. Nonetheless, the US proposal warranted consideration.

3. A second way of achieving the same objective - which was a variant of the Schultz proposal - was for the IFIs to carry on as now, but in a more discriminating way so that pressure was maintained on the commercial banks. It was important to avoid any risk of moral hazard.

4. A third possibility was for the IFIs - or at least the Fund - to act as a buyer of last resort of debt from the banks. The IFIs, and possibly Governments, should indicate that they would be prepared to take the debt, but only at a heavy discount. This could be combined with the US proposal.

5. Mr Wicks said it was possible to devise a framework for allocating the burden of debt between creditors. But it followed from this that a lot of debtor countries would be worse off. The political pressures in the United States, however, were in the direction of greater softness towards the debtor countries. It needed to be recognised, therefore, that the more hard headed approach proposed by Mulford might not meet the political imperatives.

6. The Chancellor said that the arithmetic of the Mulford approach did seem to lead to debtor countries being worse off in the short-term. But this rested on the assumptions that: a debtor country would not be assisted by a reduction in its indebtedness, but only by a reduction in its interest payments; that it would get the money anyway (ie that the funds provided would not be additional). Both of these points were arguable.

7. Mr Wicks said there would certainly be great pressure for additional funds. It would be important, therefore, to define the

payments in such a way that they appeared additional, although the reality might be that they were not. One possibility might be to allocate the debt so that the public sector's share did not increase.

8. The Chancellor said that the Schultz proposal had some attractions. Preliminary agreement that the Paris Club was no longer a "swing producer" would need to be reached. One advantage of this approach was that it would draw a cleaner distinction between public and private sector credit. The approach did, however, require iron discipline within the public sector and amongst the IFIs. It would also still require a case-by-case approach.

9. The Chancellor invited officials to prepare a paper in advance of G7. The Mulford plan would look more attractive if debt equity swaps were used instead of buyback. Nor did he rule out the possibility of the public sector buying debt at a (very large) discount. It would be important to ensure that the countries concerned still pursued sensible economic policies. This approach would mean that the commercial banks would take the real loss. Although it would appear to breach the "no transfer of risk" rule, that rule had been breached already. Even if nothing were done, the public sector would eventually end up with 100 per cent of the debt. So this option should not be ruled out on these grounds. He could envisage the IFIs using some of their funds for debt reduction. One possibility might be to set up a small institution of creditors to monitor the process; though this had obvious disadvantages.

10. The Chancellor asked for the paper to be prepared in time for this week's G7. At that meeting, he would propose to set out a clear analysis of the situation, underlining the difficult nature of the issues concerned, and suggest that further work should be done in line with that analysis. He noted that the UK could

afford to be relatively relaxed in these discussions; there was no great UK interest in settling the problem, although it was important for us to ensure that the position was not further undermined.

J M G TAYLOR
31 January 1989

<u>Distribution</u>
Those present

Object

To get the Banks to reduce the indebtedness of the debtor countries, by crystallising the provision they have already made, in a way that is most beneficial to the world economy. [SOMEWHAT MISS THE POINT]

US proposal: IFIs lend new money to debtor countries, provided it is applied to debt reduction (apparently thro' buy-backs rather than debt/equity swaps).

→ debt/equity swaps attract banks first capital

D/E swaps [illegible] buy-backs, [illegible]

NB: Why concentrate on buy-backs? (so-called [illegible] effect of swaps [illegible]) What makes banks play ball? Will not this push up price of 2nd-hand debt, counterproductively?

Other ~~proposals~~ possibilities: IFIs get meaner, more discriminating (at present they take pressure off banks)

Could work cumulatively

Allow Fund programmes to go ahead without waiting for financing packages (Schulz) & with commercial bank arrears outstanding. IMF SLS [illegible] proposed status.

diff between buy-backs & D/E swaps

[not negotiated? Offends paper-walls? Japanese]

IFIs buy debt direct from banks at a heavy discount (short cut). [preferred status] (Cd they then securitise & market it?

Japan: encourage bilateral deals (both Govt & banks)

Bangs of Paris version

FROM: HUW EVANS
DATE: 1 FEBRUARY 1989

CHANCELLOR*

cc Economic Secretary
Sir P Middleton*
Sir T Burns*
Mr Wicks*
Mr Lankester
Mr Peretz
Mr R I G Allen
Mr Gieve*
Mr Mclliss
Mr Hood
Mr A Allan*
Mr Tyrie

Mr Cassell (UKDEL)*

*with attachments

BRIEFING FOR WASHINGTON

1. This minute and attachments cover most of the items on your agenda, with the exception of debt and market developments which are being covered separately. The timetable, taken from Brady's letter of 18 January, ~~at A,~~ below is:

Thursday, 2 February

4pm - 6pm (G5):	recent exchange market developments;
7pm - 10pm (G7):	surveillance including indicators and objectives; market developments; policy issues.

Friday, 3 February

9.30am - 11am :	continued discussion on surveillance and policies (if necessary);
11am - 3.30pm :	international debt strategy;
3.30pm - 4pm :	consideration of approach to the press.

EVANS TO CX 1 FEB

Paper

2. Ministers and Governors will have the following papers in common:

(i) Camdessus' paper on World Economic Situation and Policy Issues, ~~at B~~. in world economy section

(ii) Deputies' paper on economic developments, with key issues questions, ~~at C~~. in world economy section

(iii) There may be a US paper on debt.

Surveillance and all that

3. IMF staff have put together forecasts - national and IMF - together with their policy issues in the Managing Director's paper ~~at B.~~ I attach ~~at D~~ notes by Mr Hood on the IMF paper and ~~at E~~ a list of UK structural reforms. (in world economy section

4. As we discussed on Monday, the Americans are all too likely to try to use this item to put pressure on Japan and Germany to adopt more expansionary fiscal policies. The arguments against, apart from the usual ones against fine-tuning, are that Germany and, especially, Japan are more likely to need to tighten macro policies. The Fund argument that making the Japanese and German economies more flexible through structural reforms can be a "decisive" element in reducing current account surpluses is far from proven, and we should, while welcoming structural reforms, resist making this close connexion. The IMF paper emphasises the need to reduce industrial subsidies in Germany: fair enough, but not as an aid to external adjustment which is more likely to be served by deregulation and reduced protectionism in the services sector. Our line is that we can live with current account surpluses and deficits (and indeed have no choice for some time) provided suitable policies are followed; and that US/Fund concerns about imbalances are overdone and too short term.

5. We should not allow the US to dismiss the threat of higher inflation in the world: while it should be contained if we are prepared to tighten policies, it could be on a clearly rising trend if we followed the US prescription. And we should not be too comforted by the modest rise shown by the IMF's commodity prices indicator, which underplays the risks, partly because the (!) Americans and the French insisted on a 10 per cent weight for gold (the price of which has been falling). Moreover, the IMF's argument that higher interest rates have a particularly depressive effect on business investment, compared with other components of demand, is not confirmed by recent UK experience.

6. You asked for data on the fiscal debt trap in the United States and for figures of debt interest payments by governments as a percentage of GDP. These are attached ~~at F~~ in world economy section. The main message is that the US position is getting worse, but very slowly: armageddon is not round the corner.

7. On the questions posed by deputies, I attach a brief ~~at G~~ in world economy section, expanding on our discussion on Monday.

<u>Fund forecasts of the UK</u>

8. Fund staff have revised their forecasts of the UK which are now less extreme than the version they discussed with us in December. You should look at the results which are shown in a table attached to Mr Hibberd's brief ~~at H~~. The major difference between their forecast and ours is that they have longer lags before higher interest rates affect consumption, GDP and the balance of payments so that their forecast for 1989 has substantially higher growth, external deficit and inflation.

9. This is an unwelcome forecast and we have been trying, in both G7D and Washington, to change it. Mr Cassell gave the Fund staff a note on recent UK indicators, with evidence of a slowdown in the growth of demand. Fund staff are not, however, prepared to make changes now, so that their current forecast will be in the Fund Article IV paper on the UK shortly to be circulated.

10. This paper will be discussed in the Fund Board on 3 March. It is not, of course, published and (unlike the WEO) not usually leaked. Just before 3 March, the Fund staff will put round a short update, which may include an updated forecast if they judge that new evidence requires it.

11. We shall continue to take the line with Fund staff that their forecast of the UK for 1989 would be improved by a sober look at the most recent evidence. By mid March, when we have more data and a published FSBR forecast, we will be looking very closely at the forecasts of, and commentary on, the UK which appears in the draft World Economic Outlook before its publication at the time of the Spring meetings.

Future surveillance discussions

12. In the current surveillance exercise for G7, Fund staff are using their forecast, as well as our Autumn Statement numbers. By March/April, we shall have FSBR numbers; they will probably have revised their numbers. Another surveillance exercise seems to be on the cards for April. This would have better UK numbers but is likely to mean a lot of duplication in your discussions. One or other meeting will need to be seen to establish the objectives and projections for each country.

Trade

in 'trade' section

13. You will have seen the message from Mr Hawke to the PM, urging greater flexibility in the EC's negotiating position on agriculture. Deputies discussions focussed on the US Treasury's misgivings about the handling of financial services in the GATT: our line is that, with a framework agreement reached at Montreal on services, it would be premature to remove any particular sector from the GATT before the end of negotiations.

14. Deputies were also concerned about reciprocity in banking services; and the need to see more involvement of finance ministers in settling negotiating lines for trade and agriculture.

in "Trade" section

15. I attach ~~at J~~ briefs by EC and FIM covering these points.

Press

16. No communique; but there will be large numbers of press in Washington and a common line for finance ministers to use will be needed. The following points can be made again:

(i) Valuable discussions well in advance of April meetings when communique can be expected.

(ii) Opportunity for new US administration to explain its thinking on economic policies.

(iii) Opportunity to get to know new Japanese finance minister, Murayama.

(iv) Discussions covered debt, and world economic developments and policies.

17. This is all very familiar. The UK press in Washington will be looking for something much more substantial on the Friday morning, before their deadlines soon after lunch. No doubt the French and others will be briefing. Possible lines for Mr Gieve to take, staying clear of exchange markets, are:

G7 economic policies

Right for G7 to raise interest rates in 1988, need to be prepared to raise further if control of inflation requires. Key in US, for adjustment and for markets, is credible path for US fiscal deficit. Against pressure on Japan or Germany to adopt expansionary economic policies.

Debt

We could let the press have the flavour of our analysis: banking crisis mainly over, need to look again at burden sharing (give figures); and at removing obstacles to debt reduction techniques.

18. You may prefer to say little until the G7 meeting is over. One comment that will need to be made then is that Ministers are broadly content with current exchange rates.

H.P.E.

H P EVANS