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Internation Committee on Debt Management.

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FROM: J M G TAYLOR
DATE: 1 June 1989

MR WICKS

IMF/IBRD: DEBT STRATEGY

... The Chancellor has seen UKDEL Tel no 159 (attached).

2. He would be most grateful if you could provide advice on the handling of this issue in the light of (a) this telegram and (b) his bilateral with Secretary Brady.

3. (My note to Mr Mountfield on the Paris Club outcome is also relevant).

J M G TAYLOR

141277
MDHIAN 6965

CONFIDENTIAL
FM UKDEL IMF/IBRD WASHINGTON
TO DESKBY 310800Z FCO
TELNO 159
OF 302300Z MAY 89
AND TO DESKBY 310800Z PARIS

PARIS PLEASE PASS TO EVANS (OECD MINISTERIAL MEETING)
PERSONAL FOR WICKS, LANKESTER AND EVANS (TREASURY)

IMF/IBRD: DEBT STRATEGY

1. IT MAY BE HELPFUL TO OFFER YOU A FEW COMMENTS FROM WASHINGTON NOW THAT WE HAVE BEEN THROUGH THE MAIN DISCUSSIONS ON DEBT IN THE FUND BOARD AND DEALT WITH TWO KEY CASES, THE PHILIPPINES AND MEXICO.

2. AS YOU WILL HAVE SEEN FROM THE TELEGRAMS, WE HAVE BEEN QUITE SUCCESSFUL IN SETTING LIMITS TO THE FUND'S ACTIVITIES. WE NOW HAVE THE SAME STRUGGLE IN THE BANK BOARD, WHERE THE AMERICANS ARE PRESSING FOR ''FLEXIBILITY''. THE REASON FOR OUR SUCCESS IS THAT WE HAVE BEEN ABLE TO HOLD TOGETHER A COALITION OF THE GERMANS, DUTCH, NORDICS, ITALIANS AND (AT TIMES) THE AUSTRALIANS AND BELGIANS, AND GAIN SOME SYMPATHY (IF NOT ACTUAL VOTES) FROM SOME OF THE LDCS OUTSIDE LATIN AMERICA.

3. IN REGIONAL TERMS, WE HAVE A GROUPING HERE THAT CONSISTS OF THE WHOLE OF EUROPE EXCEPT FRANCE, OR HALF, AND SOMETIMES MORE, OF THE G10. THIS COALITION IS CLEARLY WORRYING CAMDESSUS. IT ENABLED US ON FRIDAY TO THWART THE MEXICAN REQUEST, BACKED BY THE US, FOR OUTRIGHT APPROVAL THEN AND THERE OF A FULL 40 PER CENT OF QUOTA FOR INTEREST SUPPORT. CAMDESSUS ADMITTED THAT HE DID NOT WANT A DEEPLY DIVIDED BOARD ON THE FIRST TWO BRADY CASES. THUS THE STAND THAT WE TOOK ON THE PHILIPPINES UNDOUBTEDLY HELPED US TO HOLD THE LINE ON MEXICO.

4. NONETHELESS, I WAS DISTURBED AT THE COURSE OF THE DISCUSSION ON MEXICO EARLIER IN THE DAY. WHAT THE MEXICANS WERE ASKING FOR WAS PATENTLY IN BREACH OF THE GUIDELINES THAT HAD BEEN AGREED EARLIER IN THE WEEK. THEY SOUGHT A PRE-COMMITMENT OF THE FULL 40 PER CENT OF QUOTA WITHOUT MEETING THE CONDITIONS THAT HAD BEEN SET OUT IN THE MANAGING DIRECTOR'S SUMMING-UP OF THE DEBT STRATEGY. DESPITE REPEATED REQUESTS FROM MYSELF AND OTHERS, THE MEXICANS COULD GIVE NO INDICATION OF WHAT WOULD BE ''THEIR OWN EFFORTS TO CONTRIBUTE RESOURCES, AS FEASIBLE, IN SUPPORT OF THE OPERATIONS''. YET FOUR OF THE G7 SUPPORTED THE REQUEST OF THE MEXICAN DIRECTOR. THE

AMERICANS' SUPPORT WAS WHOLLY, OF COURSE, IN TUNE WITH THEIR CURRENT ATTITUDE, THE JAPANESE SIMPLY WANTED TO BE NICE (AND ALSO FOLLOW THE AMERICANS), THE FRENCH--WHO PROBABLY AGREED WITH US ON SUBSTANCE--ARE OBVIOUSLY PURSUING A GENERALLY OPEN-HANDED POLICY WITH THEIR EYE CLEARLY FIXED ON THE SUMMIT. NO DOUBT THE FRENCH SEE ALL THIS AS OPENING THE WAY TO A MITTERAND-TYPE ISSUE OF SDRS AND, AS YOU REPORTED FROM YOUR OWN MEETING IN NEW YORK, HINTS ARE BEING DROPPED OVER HERE THAT THE AMERICANS MAY SEE A ROLE FOR THE SDR IN THIS CONTEXT.

5. THAT LEAVES THE CANADIANS. THEY WENT ALONG HAPPILY WITH MEXICO'S REQUEST ON FRIDAY AND SEEM TO BE INTENT ON ALLYING THEMSELVES WITH THE US ON THESE DEBT ISSUES. THEIR BEHAVIOUR IS AS DISAPPOINTING AS THE ITALIANS' HAS BEEN PLEASING.

6. WE HAVE RECEIVED NO SUPPORT IN THE BOARD DISCUSSIONS FROM ANY OF THE G7 ON OUR REFERENCES TO BURDEN SHARING, ON MEXICO I KEPT OUR POINTS FAIRLY GENERAL AND AVOIDED THE SORT OF QUANTIFICATION THAT WE HAD USED IN THE PHILIPPINES' DISCUSSION, SINCE IT WAS BY THEN CLEAR THAT WE HAD NOT HAD MUCH SUCCESS IN PARIS. NOR DID ANY OF THE G7 COME FORWARD TO ENDORSE MY PLEAS THAT MEXICO (AND OTHER POTENTIAL BENEFICIARIES OF BRADY) SHOULD BE TAKING STEPS TO SIGN THE MIGA CONVENTION.

7. IN THE VARIOUS DISCUSSIONS YOU WILL BE HAVING OVER COMING DAYS, YOU MIGHT LIKE TO MAKE A PARTICULAR POINT OF CONSOLIDATING OUR RECENT ALIGNMENT WITH THE ITALIANS--WHICH HAS BEEN VERY USEFUL--AND ALSO EXPLORING WHY THE CANADIANS ARE BEING SO WET. WE SEEM TO HAVE BEEN MOST EFFECTIVE HERE (ON THE FUND SIDE) WHEN DEPLOYING ARGUMENTS ABOUT THE NEED TO STICK TO THE GUIDELINES AGREED LAST WEEK SO AS NOT TO UNDERMINE THE CREDIBILITY OF THE INSTITUTION.

8. OUR AIM OF COURSE WILL BE TO HOLD TOGETHER THE EUROPEAN COALITION OVER HERE AND IN THIS IT WILL BE IMPORTANT TO KEEP THE ITALIANS ON SIDE IF WE CAN. BUT OBVIOUSLY IF WE CAN ALSO GET THE CANADIANS TO COME CLOSER TO US, THIS WOULD BE HELPFUL. QUITE APART FROM THE ADDITIONAL VOTES IT BRINGS, THE WIDER THE COALITION THE LESS WE OURSELVES APPEAR TO BE TAKING A NEGATIVE LINE.

9. FCO AND PARIS PLEASE PASS TO PERSONAL ADDRESSEES ONLY.

CASSELL

YYYY

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MDHIAN 6965

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MAIN 145

MONETARY MCAD
ERD[-]
SEAD

NNNN

FROM: J M G TAYLOR
DATE: 1 June 1989

b/f. 8/6

MR MOUNTFIELD

cc PS/Economic Secretary
Sir P Middleton
Mr Wicks
Mr Lankester
Mr Evans
Mr Bottrill
Mr Walsh
Mrs Thomson
Mr Tarkowski
Mr Call
Mr Cassell, UKDEL

MAY PARIS CLUB

The Chancellor was grateful for your note of 31 May.

2. He has commented that we continue down the slippery slope. There seem to him to be two sorts of braking device which we might seek to put in place. The first is to try and get US support for the IMF quota increase to be as small as possible, and delayed as long as possible. The second (and harder) is to devise ways in which the UK can "opt out" of packages of which we disapprove.

3. He would be most grateful for a note on both points.

J M G TAYLOR

FROM: HUW EVANS
DATE: 7 JUNE 1989
EXT: 4430

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Mr Wicks
Mr Lankester
Mr Mountfield
Mr Bottrill
Mr Walsh
Mr Melliss
Mr Kilpatrick
Mr Lazar
Mr Tyrie

Mr Cassell (UKDEL)

* Ch/ Content for Frank to adopt this line ~~tomorrow?~~ today?

OK

IMF QUOTAS

1. The Fund Board returns to the question of IMF quotas on Monday. This minute proposes a line the UK should take at the Board and in lobbying beforehand, and responds to your question (raised in Mr Taylor's minute of 1 June to Mr Mountfield) about the need to get support for the quota increase to be limited.

2. Fund staff continue to press for a doubling of quotas. There are two main arguments:

(i) Keeping pace with the expansion of the world economy - whether measured in terms of GDP, trade, or reserves - and especially in order to maintain the same relationship between quotas and the world economy as existed 5 or 10 years ago, requires a doubling of quotas. Our response is simple: Fund quotas in the post-war period have never kept pace with the expansion of the world economy. They have not needed to. This is clear from the fact that Fund liquidity is currently at an all time high, despite the ratio of Fund quotas to eg world activity continuing to fall.

(ii) The Fund staff set out, on heroic assumptions, a medium term financing framework for debtor countries to 1994. This involves an expansion of Fund credit of some SDR30 billion, compared to SDR7½ billion over the whole period 1983-89. It also compares with a projected SDR14 billion for the banks over the same 1990-94 period. Such projections of demand, especially when based on such a skewed burden sharing between the Fund and the banks, simply do not provide a basis for decisions on the appropriate supply of Fund liquidity.

3. Our own approach is to observe that a moderate increase in quotas (which we illustrate with a 25 per cent increase) will be enough to allow for Fund lending to expand, **if enough good cases present themselves,** from a current stock outstanding of some SDR 25 billion up to over SDR40 billion by the mid-1990s. This could be achieved while phasing out borrowing and while keeping the future liquidity above its long run historical average, and allowing access of developing countries to be increased.

4. The Fund can do all this with a moderate quota increase essentially because it is starting from such a favourable liquidity position: the current ratio is 117 per cent, compared with an average of 64 per cent over the past 12 years, and a liquidity ratio just after the last quota increase of only 71 per cent.

5. We have also looked at the consequences of a zero quota increase, while holding liquidity close to its long run average. This will allow little increase even in nominal terms in Fund lending over the period to the mid-1990s, unless there were to be a large rise in borrowing by the Fund. I do not think we could persuade others (or indeed ourselves) that this would be a sensible way to go into the 1990s.

6. I see a strong case for sticking to our line, which we have been advocating for a year or so, and well before the Brady proposals emerged, that a moderate increase would be all that is required. We need to try and get more support, especially from the Germans, the Netherlands, the Saudis, Australia and the US. The US position in public is that they are not able as yet to make any decision on the appropriate size of the Fund, implicitly keeping Camdessus on a string while the "strengthening debt strategy" evolves. As Brady said to you last week, the US will eventually go along with some increase. We have all signed up to

the Interim Communique which commits us to a decision by the end of 1989. So far the US have made noises about not seeing the need for any quota increase, and have cited the usual difficulties with Congress. Their final decision is unpredictable. I would like us to influence that view as much as possible, while seen to be ourselves taking a consistent line, most calculated to win support elsewhere. As you know, all countries except the US and the Saudis (including Germany at this stage) have come down in favour of a quota increase of 50 per cent or substantially more. If we are to get something appreciably lower, we shall <u>either</u> need American support <u>or</u> we have to persuade the Germans to support us together with the Saudis.

7. There is of course also the question of the Japanese desire to move up to number 2 (which the Americans are clearly going to support as a quid pro quo for Japanese support and money for the Brady proposals but which has so far attracted little support from others). On this, we propose to continue to take the line that a decision can sensibly be considered only when we are much closer to a decision on the overall increase. We agreed in April that our own objectives put the limitation of the total increase in Fund quotas ahead of achieving a particular position for ourselves in the Fund, though we are of course determined not to slip below fourth place.

8. Mr Cassell would like to put round a buff to the IMF Board setting out the UK line in the way summarised in this minute. He needs to do this tomorrow. Are you content for him to go ahead tomorrow?

HPE

H P EVANS

aef.tp/mountfield/min/611

FROM: P MOUNTFIELD
DATE: 7 JUNE 1989
EXT : 4479

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Mr Wicks
Mr Lankester
Mr Evans
Mr Bottrill
Mr Walsh
Mrs Thomson
Mr Tarkowski
Mr Call
Mr Cassell, UKDEL

INTERNATIONAL DEBT AND BURDEN SHARING

You asked us (Mr Taylor's minute of 1 June, headed "May Paris Club") for a note on ways of avoiding the slippery slope which faced us after the Philippines and Mexico defeats in the Paris Club.

2. Mr Evans is dealing separately with the first point (IMF quota increases). This note is about the second, which goes a little wider than the Paris Club itself. It is on lines discussed and agreed with Mr Wicks and Mr Lankester.

3. You suggested that we should seek to devise ways in which the UK could opt out of packages of which we disapprove. The first step is to define the package.

(a) The IMF programme itself (since all the rest is built around that). We are trying to ensure that IMF

[might have been good if IMF lending for debt reduction & interest support had come from separate fund (like ESAF), but water under bridge] documents, in future, clearly set out the "burden sharing" implications of their proposals. This would make it perfectly possible for the UK to abstain on a scheme which did not meet our criteria. In practice, unless we could rally more support than we did last time on Philippines, the programme would still go ahead. Conclusion: ineffective in isolation; needs to be reinforced. We need therefore to consider refusing to play our part in the related bits of the support operation.

(b) Conventional donor groups. These are convened by the World Bank, and attended by the bilateral aid agencies. They involve "pledging" future aid flows. The issue of burden sharing has never formally arisen in the past. Since most of the beneficiary countries (Nigeria apart) are so poor that they have little bank debt outstanding, it is not a major issue. On Nigeria, it would be very difficult indeed for the UK to contract out of the September Donor Group meeting, on the grounds that the banks were not doing their fair share. (We shall be making a separate submission about Nigeria later this month.) Conclusion: not really relevant apart from Nigeria.

(c) Special support operations. Guyana, last month, will probably be the first of a series: Zambia and Sudan are the next two most likely candidates. Burden-sharing would only become a serious problem with Sudan, which has quite a lot of Bank debt. In principle, it is perfectly possible for the UK to refuse to play in such cases. Once again, the politics may be difficult. In the rather similar case of the Philippines, the UK has been invited to attend the Donor Group, but it is recognised all round that we shall not be a participant. Conclusion: useful but limited.

(d) Middle income rescue cases. The precedents are Poland (1981) and Yugoslavia (1982, 1983 and 1984). In these cases, Paris Club rescheduling was part of a wider operation, involving pledging of direct

Government-to-Government loans and - in the earlier instances - of export credit. Subsequent experience has shown that pledging export credit is a big mistake, and we no longer tried to do this. However, it is possible that there will be a similar attempt to construct a new package for Poland: you are going to the Prime Minister's meeting on this tomorrow. The political pressures in that case demonstrate the difficulty of "opting out" in all such cases, though it will sometimes be possible to do so. Conclusion: useful but limited.

(e) Export credit. Quite apart from such "pledging" operations, the UK could refuse to provide further export credit in cases where this would involve increasing the public sector risk relative to the private sector risk. As you know, ECGD are prepared to provide this (called "DX cover") in suitable cases where a country has rescheduled but is on the recovery path. Where the UK is a major potential source of export credit, the IMF will usually try to establish our likely cover policy in advance of putting together a programme. We could always use this opportunity to threaten to withhold export credit cover in such cases, unless the burden were more fairly distributed. However, with the possible exception of Nigeria, it is unlikely that this threat would make much difference to the final outcome. The UK is not normally a big enough factor. It would also lead to protests from the industrial lobby, such as we had recently over Brazil (where the reason for withholding cover was purely prudential). Conclusion: worth trying, but unlikely to be very effective.

(f) Paris Club rescheduling. This raises the burden-sharing problem in the most acute form. The underlying question is whether we should reduce the scale of Paris Club rescheduling to compensate for increased exposure by the IFIs. Could the UK refuse to do its bit in a Paris Club operation? This could be dangerous. The whole purpose of multilateral rescheduling is to ensure that no one creditor steals a march on the others by securing more favourable terms; and conversely, that no one creditor is unduly disadvantaged. Since the Paris Club has no set voting rules, and has to proceed by consensus, the UK can hold up rescheduling. But in the end, the other creditors can always decide to go ahead without us. In that case, we would have no defence if the debtor country selectively defaulted against the UK (and it is unlikely that we would get much support from others in the IMF Board in such a case). Conclusion: however attractive the "opting out" approach looks, it would probably hurt the UK more than it would benefit the general policy on burden-sharing.

4. Overall, this is a rather negative set of conclusions. The real trouble is that other countries do not share our perception of the burden-sharing problem (ie, that one should compare the banks with the total public sector). In isolation, we cannot enforce our own view.

5. We do better, therefore, to go on arguing the case, as persuasively as possible. Mr Wicks tells me that there was little support for the UK view at the G7 Deputies (indeed it was hardly discussed). Your letter to Brady might provide another opportunity. Failing that, we must be prepared to fall in with the majority view.

6. If we do so, however, we need to make sure that we do at least secure fair burden-sharing on the narrower definition (Paris Club creditors versus banks). This requires some procedural changes both in the Paris Club and at the IMF, which were set out in the paper we circulated to both institutions last month. The main objective is to ensure that the Paris Club defines, in advance of an IMF meeting, how much rescheduling it is prepared to do. This should mean that the Club will no longer be regarded as the residual source of finance. If you agree, I intend to go on arguing strongly for these procedural reforms, which already have a good deal of support, at the meeting on 22 June.

PM

P MOUNTFIELD

ec.jn/Symes/madrid

PS/CHANCELLOR

FROM: SUSIE SYMES (EC1)
DATE: 8 JUNE 1989

x4441

MR H P EVANS

cc: Mr Wicks
Mr Lankester
Mr R I G Allen
Mr Mountfield
Mrs M E Brown
Mr Walsh
Mr Kilpatrick
Mr Tarkowski

MADRID EUROPEAN COUNCIL: DEBT

You should see the attached telegram no 579 from Madrid.

2. The reference at ⊗ in paragraph 3 to a specific proposal to be discussed at Monetary Committee and the 19 June ECOFIN is news to me. I understand that at COREPER lunch yesterday Hannay emphasised that debt should be left to member states (UKREP Telno 1945, Frame General, no named Treasury advances). (below)

3. We may need a brief for the 19 June ECOFIN. Could we consider after Mr Wicks returns from Monetary Committee? Could you and Mr Wicks please note that I would need the brief by 1700 on Wednesday 14 June (sent to the late night pool as well as to me, please) so as to meet the Chancellor's office deadline.

Important that you join with Dutch & Let the Chancellor kill this stone dead.

SUSIE SYMES

SUSIE SYMES

Find. Frame General 1945
Speak to Bostock
Bostock checking with Dixon on Friday about Commission plans.

Q SPAIN.

RESTRICTED

166754
MDADAN 1786
c Mr Wicks
Mr Lankester

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MADRID EUROPEAN COUNCIL: DEBT

SUMMARY

1. SPANISH OFFICIALS CONFIRM THEY ARE PREPARING FOR A SUBSTANTIVE DECLARATION ON DEBT AT MADRID.

DETAIL

2. WHILE WELCOMING THE BRADY PLAN, SPANISH OFFICIALS SAY THAT IT DOES NOT GO FAR ENOUGH AND THAT ADDITIONAL RESOURCES FOR DEBT REDUCTION ARE ESSENTIAL TO ITS EFFECTIVE IMPLEMENTATION. THEY BELIEVE THE PLAN NEEDS TO BE GIVEN POLITICAL IMPETUS AT THE EUROPEAN COUNCIL IN TIME FOR THE 4 JULY G7 SUMMIT.

3. THEIR INTENTION SEEMS TO BE A DECLARATION WHICH LISTS PROPOSALS FOR THE COORDINATION OF POLICY AMONG THE TWELVE AND G7 RESPECTIVELY TOWARDS MIDDLE-INCOME DEBTOR COUNTRIES. IT WAS DECIDED ONLY RECENTLY TO TABLE A PROPOSAL IN THE MONETARY COMMITTEE, FOR DISCUSSION AT ECOFIN ON 19 JUNE, FOR THE ESTABLISHMENT OF A EUROPEAN FUND, ON THE LINES OF THE JAPANESE EXAMPLE, TO BE ADMINISTERED BY THE IMF TO ASSIST DEBT REDUCTION SCHEMES BETWEEN EC BANKS AND DEBTOR COUNTRIES. CONTRIBUTIONS MIGHT BE RELATED TO NATIONAL EXPOSURE. DESPITE SOME SUSPICIONS THAT FRANCE MAY TRY TO DELAY ANY SERIOUS DISCUSSION OF DEBT UNTIL ITS OWN PRESIDENCY, SPANISH OFFICIALS HOPE FOR FRENCH SUPPORT FOLLOWING MITTERAND'S INITIATIVE IN DAKAR. THEY DO NOT BELIEVE THE COMMISSION IS PREPARING ANY SEPARATE NEW INITIATIVE ON DEBT.

4. AT A SEMINAR ON 5 JUNE (ATTENDED, INTER ALIA, BY EX-PRESIDENT OF MEXICO DE LA MADRID) FELIPE GONZALEZ REITERATED SPANISH POLITICAL SUPPORT FOR LATIN AMERICA IN EC AND OTHER INTERNATIONAL FORA. AFTER ADDRESSING A SEPARATE MEETING HERE THE SAME DAY OF THE INTERNATIONAL MONETARY CONFERENCE (ATTNEDED BY SIR LEON BRITTAN) BRADY WAS CRITICISED BY BANKERS INCLUDING JEREMY MORSE OF LLOYDS FOR NOT URGING THE IFIS TO SUPPORT A GREATER SHARE OF THE WORLD DEBT BURDEN.

166754 /
MDADAN 1786 |

5. THE MEXICAN FINANCE MINISTER IS REPORTED TODAY TO HAVE HELD DEBTREDUCTION NEGOTIASTIONS IN MADRID WITH CREDITOR BANKS CHAIRED BY JOHN REED OF CITIBANK.

GORDON LENNOX

YYYY

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MR R ALLEN TREASURY
MS S SYMES TREASURY
MRS M E BROWN TREASURY
MR M. MERCER, TRSY
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MR P KENT HM CUSTOMS
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NNNN

FROM: D I SPARKES
DATE: 8 June 1989

MR HUW EVANS (IF)

cc PS/Economic Secretary
Sir P Middleton
Mr Wicks
Mr Lankester
Mr Mountfield
Mr Bottrill
Mr Walsh
Mr Melliss
Mr Kilpatrick
Mr Lazar
Mr Tyrie

Mr Cassell - UKDEL

PWP

IMF QUOTAS

The Chancellor was grateful for your minute of 7 June concerning the proposed increase in IMF quotas. He is content for Mr Cassell to adopt your suggested line today.

D.C.

DUNCAN SPARKES

RESTRICTED

FROM: A C S ALLAN
DATE: 9 June 1989

MS S SYMES (EC1)

cc **Mr Wicks**
Mr Lankester
Mr R I G Allen
Mr Mountfield
Mrs M Brown
Mr Walsh
Mr Kilpatrick
Mr Tarkowski

MADRID EUROPEAN COUNCIL: DEBT

The Chancellor has seen telegram no.579 from Madrid. He feels it is important that we join forces with the Germans and Dutch to kill stone dead the proposal for the establishment of a European Fund, on the lines of the Japanese example, to assist debt reduction schemes.

ACSA

A C S ALLAN

FROM: D I SPARKES
DATE: 12 June 1989

MR P MOUNTFIELD (AEF)

cc PS/Economic Secretary
Sir P Middleton
Mr Wicks
Mr Lankester
Mr H P Evans
Mr Bottrill
Mr Walsh
Mrs Thomson
Mr Tarkowski
Mr Call

Mr Cassell - UKDEL

PMP

INTERNATIONAL DEBT AND BURDEN SHARING

The Chancellor was grateful for your (unclassified) minute of 7 June on the above subject. He is content for you to argue for the procedural reforms you suggest at the meeting on 22 June.

D.S.

DUNCAN SPARKES

91 5211583 02

El Ministro de Economía y Hacienda

Madrid, 14th June 1989

CH/EXCHEQUER

REC. 15 JUN 1989

ACTION MR WICKS 15/6

COPIES TO PS/EST, Sir P Middleton, Sir T Burns, Mr Lankester, Mr RIG Allen, Mr HP Evans, Mr Mountfield, Mr Grieve, Mr Walsh, Ms Symes, Mr Tarkowski, Mrs Chaplin

Mr. Nigel Lawson
Chancellor of the Exchequer
Her Majesty Treasury
Parliament Street
LONDON SW 1P-3AG

Dear Colleague,

I am enclosing a draft with some ideas on the debt crisis which I would like to discuss, at lunch, during the next Ecofin Council on Monday June 19th.

Sincerely.

Carlos Solchaga

Ch

EST needs to be briefed to reject this firmly (he'll need briefing on Community competence too)

Very much so.

I.- Introduction

Despite strong adjustment efforts made by many of the most heavily indebted countries, their situation has hardly improved since the start of the debt crisis in 1982.

After almost seven years of economic stagnation, most middle-income indebted countries face an economic future so overshadowed by difficulties and uncertainty that their internal social cohesion and political stability are at risk as recent events in Venezuela and Argentina clearly show.

It has become more urgent to deal effectively with the situation for at least three reasons:

- political and social developments show that time is running out;

- failure to deal with the problem has resulted in a transfer of risk from the private to the public sector.

- expectations have been raised following the recent proposals, aimed at strentheging the international debt strategy.

The Community countries could as a group productively contribute to solve the present situation. The problem is one for the global economy, but the Community countries together could play a significant role for a number of reasons:

- The problem of the middle-income countries debt is much more complex than that of the poorest countries, due to the diversity of their debt structure, and the different proportion of public and private creditors. The historical, cultural and trading relationship between EC countries and indebted countries offers an opportunity for a special approach to the problem.

- Once the international community has agreed that a reduction in debt and debt-servicing must play an important role in the cooperative debt strategy, both a flow of financial resources and an adequate mechanism have to be secured.

The IMF and the World Bank have taken a decisive step by reshaping their financial assurances policies. Notwithstanding these efforts, a larger amount of resources is needed to deal efficiently with the situation.

- The resources that international institutions can provide are limited, even if the capital increase of the World Bank and the important increase in the IMF quotas expected to take place during 1989 are considered. The necessary conditionality requirements further lessen the scope of the debt reduction to be covered by the new mechanism.

The granting of loans and guarantees by the IMF and the World Bank implies an uneven international distribution of risks since the member states' contributions do not generally correspond to the risks to which their respective banking systems are exposed.

Concern about the transfer of risk from private to public hands should not be used as an argument by creditor countries to discard a scheme geared to the gathering of additional resources.

In fact this transfer of risk is implicit in the actual working of the cooperative strategy set up since 1983, and this can be seen in the strong increases in exposure taken by the international organisations and creditor governements towards the indebted countries as well as in the positive net financial transfers made by the official creditors compared to the commercial banks' negative ones.

If the accounting, legal and fiscal regulations of the provisions in certain countries are taken into account, there is no doubt that the transfer of risk has already happened, possibly due to the fact that all countries were aware, since the beginning of the crisis, that one of the main responsabilities of the governments was, and still is, to avoid a general banking crisis.

In order to solve some of these problems (insufficient resources, inadequate schedule of disbursments and unbalanced international distribution of the transfer of risk) the Spanish authorities have decided to promote an agreement between the governements of the member countries of the EC in order to establish a European Guarantee Fund that could strengthen the effectiveness of the efforts made by the IMF and the World Bank.

II.- SOME PRINCIPLES AND A PROPOSITION FOR A COMMUNITY ACTION: THE EUROPEAN GUARANTEE FUND:

One of the major positive points of the debt strategy has been the fact that since 1982 all those involved have been cooperating and sharing a joint responsiblity. The Spanish authorities consider it essential to maintain a multilateral approach to the problem, and so any European action must be seen as a mechanism designed to support the Bretton Woods Institutions, and never as a mechanism designed for settling bilaterally the debt which middle-income countries have vis-à-vis the European Community countries.

The objective of any complementary action could be to normalise relationships between creditors and debtors while allowing adequate economic growth in the highly indebted countries. This requires scrupulously abiding by the case by case principle. It also means a double conditionality.

In the first place debtor countries should adopt realistic adjustment programmes. Contributions from the IMF must be conditional upon a programme worked out with the Fund.

Secondly commercial banks should bear their share of the burden. Over the last years, the banks have succeeded in transferring risk to the public sector. There have also been delays in the implementation of ideas put forward for the reduction of debt and debt service.

Against this background, the Spanish authorities propose that consideration should be given to setting up a European Guarantee Fund.

Its institutional structure could resemble the General Agreement to Borrow (GAB), and like the GAB it could form part of the International Monetary Fund or a similar institution.

The European Fund would provide guarantees and resources for destocking and debt-servicing operations in those countries in which the IMF adjustment program has envisaged this type of mechanism. The resources provided would have to be concentrated upon the initial stage of the programme, in order to enable major operations for reducing the debt burden to be launched.

Once the financial requirements of the operations for reducing the debt burden have been quantified and the contribution to be made by the European Fund has been identified, the allocation or contributions among the countries participating in the European Fund could be established on the basis of the risk to which their respective national banking sectors are exposed in respect of the debtor country in question. If the European Communities decided to take part as an institution in the scheme, the possibility of Community funds being used for that purpose could also be considered.

The guarantees offered by the European Fund would not have actually to be paid out, and it would be sufficient for the participant governments and/or their Treasuries to undertake to disburse them in the event of default by the debtor country.

The Fund could obtain, its financial resources from issues in ecus and/or in other currencies from the participating countries' Treasuries.

- In creating the European Fund, the EC member countries and, it is hoped, the Community Institutions themselves would provide unequivocal proof of a European approach towards a problem which, it can be said without being unduly dramatic, is really threatening the world political and economic stability.
- The European initiative, by supplementing alternative schemes such as those announced by the Japanese Goverment and by backing the IMF's and World Bank's efforts, would also give increased force to he mechanisms for reducing the debt burden, and would provide a major political incentive to other industrialized countries to engage in this type of scheme.

- The European Fund would ensure that the transfer at international level of private-sector risk to the public sector would be more balanced.

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In any event, the major objective ot the European Fund would undoubtedly be to help prevent the seven years of stagflation and hyperinflation in the indebted countries from leaving the same historical and political legacy than we inherited from our recession in the twenties.

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FRAME GENERAL

COREPER (AMBASSADORS) : 7 JUNE : PREPARATION FOR EUROPEAN COUNCIL

SUMMARY
1. PRESIDENCY OUTLINE THEMES FOR DISCUSSION AT THE EUROPEAN COUNCIL ON FAMILIAR LINES. MAIN SUBJECTS, EMU AND SOCIAL DIMENSTION. SHORT DISCUSSIONS ENVISAGED ON DEBT AND ENVIRONMENT. CONCLUSIONS ALSO TO COVER INTERNAL MARKET (INCLUDING TAX), AUDIOVISUAL, FRONTIERS, RESEARCH, CITIZENS EUROPE AND EXTERNAL MATTERS. SOCIAL DIMENSION DISCUSSION TO BE PREPARED BY SOCIAL AFFAIRS COUNCIL ON 12 JUNE.

DETAIL
2. WESTENDORP (PRESIDENCY) SAID THAT A RATHER THAN LONGER TIME THAN USUAL WAS BEING PROVIDED FOR THE EUROPEAN COUNCIL TO PERMIT IN DEPTH DEBATE ON THE MOST IMPORTANT QUESTIONS. THE PRESIDENCY SAW THREE CATEGORIES OF SUBJECTS FOR THE EUROPEAN COUNCIL:

A. PRIORITY QUESTIONS FOR FULL DEBATE. THERE WERE TWO SUBJECTS IN THIS CATEGORY: EMU, ON THE BASIS OF THE DELORS REPORT AND THE INFORMAL MEETING OF FINANCE MINISTERS AT S'AGARO: AND THE SOCIAL DIMENSION. THE LATTER WOULD TAKE ACCOUNT OF VARIOUS ELEMENTS INCLUDING THE COMMISSION'S DRAFT CHARTER AND THE CONCLUSIONS OF THE SOCIAL AFFAIRS COUNCIL ON 12 JUNE. THE CHAIRMAN OF THE SOCIAL AFFAIRS COUNCIL HOPED HIS COLLEAGUES WOULD BE READY FOR A DEBATE ON THE SOCIAL DIMENSTION IN PREPARATION FOR THE EUROPEAN COUNCIL. IN ADDITION THE COMMISSION WOULD BE PRODUCING REPORTS ON CONDITIONS OF WORK AND ON THE SOCIAL INTEGRATION OF IMMIGRANTS, WHICH WERE RELEVANT TO THIS ITEM.

B. SUBJECTS FOR SHORT DEBATE LEADING TO BRIEF CONCRETE CONCLUSIONS. IN THIS CATEGORY FELL THE QUESTION OF MIDDLE INCOME DEBT AND THE ENVIRONMENT. ON THE LATTER SUBJECT THE PRESIDENCY WOULD EXPLAIN WHAT HAD BEEN ACHIEVED AND THE COMMISSION WOULD GIVE A PRESENTATION ON THEIR PROPOSALS FOR AN ENVIRONMENTAL AGENCY.

C. SUBJECTS WHICH WOULD BE DISCUSSED ONLY IN THE CONTEXT OF THE CONCLUSIONS ON THE MORNING OF 27 JUNE. THESE WERE: THE INTERNAL MARKET (BALANCE SHEET OF WHT HAS BEEN DONE AND WHAT REMAINS TO BE DONE INCLUDING TAX QUESTIONS), AUDIOVISUAL (WORK ON THE CONFERENCE ON AN AUDIOVISUAL EUREKA), PHYSICAL FRONTIERS (TO TAKE NOTE OF THE REPORT OF THE COORDINATORS GROUP), RESEARCH (TO TAKE NOTE OF THE FRAMEWORK PROGRAMME), CITIZENS EUROPE (BALANCE SHEET AND WHAT REMAINS TO BE DONE), AND EXTERNAL MATTERS (EFTA, EASTERN COUNTRIES, URUGUAY ROUND, ACP NEGOTIATIONS AND PERHAPS OTHER POINTS).

3. THERE WOULD ALSO BE CONCLUSIONS ON POLITICAL COOPERATION, DETAILS OF WHICH WOULD BE AVAILABLE AFTER THE CURRENT MEETING OF THE POLITICAL COMMITTEE. THE PROPOSED 'SYNTHESIS' PAPER ON EASTERN EUROPE WAS BEING PREPARED BY THE POLITICAL COMMITTEE AND BY THE COUNSELLORS' GROUP. COREPER AND THE POLITICAL COMMITTEE SHOULD HAVE A JOINT LUNCH ON 26 JUNE TO APPROVE THE PAPER. THE CHAIRMAN OF THE EUROPEAN COUNCIL WOULD CONTINUE HIS CONTACTS WITH COLLEAGUES AND WOULD THEN WRITE ROUND ON THE THEMES FOR DISCUSSION AND HOW HE INTENDED TO HANDLE THEM.

4. TROJAN (COMMISSION) SAID THE COMMISSION WOULD CONTRIBUTE SUCH PAPERS AS THE PRESIDENCY WISHED. THE DELORS REPORT WAS ALREADY ON THE TABLE. HE CONFIRMED THAT FACTUAL REPORTS ON CONDITIONS OF WORK AND ON THE INTEGRATION OF IMMIGRANTS WHICH HAD BEEN REQUESTED BY THE HANOVER EUROPEAN COUNCIL WERE ON THE AGENDA OF THE COMMISSION TODAY AND WOULD BE TRANSMITTED TO THE COUNCIL BEFORE 26 JUNE. THEY WOULD PROVIDE USEFUL BACKGROUND BUT WERE NOT REPORTS TO THE EUROPEAN COUNCIL AS SUCH.

5. UNGERER (GERMANY) ASKED WHETHER THERE WOULD BE A DOCUMENT ON AUDIOVISUAL QUESTIONS. WESTENDORP SAID THAT THE PRESIDENCY'S INTENTION WAS FOR THE EUROPEAN COUNCIL TO TAKE NOTE OF WHAT HAD BEEN DONE (IN PARTICULAR AT THE FIRST MEETING OF CO-ORDINATORS IN MADRID ON 5 JUNE) AND WHAT REMAINED TO BE DONE. THERE WAS NO NEED FOR A DOCUMENT. TROJAN SAID THERE WERE TWO IMPORTANT ASPECTS WHICH NEEDED TO BE CONSIDERED, THOUGH NOT NECESSARILY AT THE EUROPEAN COUNCIL: THE QUESTION OF GREATER COOPERATION WITH THE US OVER STANDARDS FOR HDTV, A DECISION ON WHICH HAD BEEN POSTPONED AT THE LAST MEETING OF THE CCIR: AND THE QUESTION, WHICH WAS MAINLY FOR THE FRENCH, OF WHICH COUNTRIES SHOULD BE INVITED TO PARTICIPATE IN THE AUDIOVISUAL CONFERENCE IN PARIS. DELORS MIGHT SAY MORE ABOUT THESE POINTS AT HIS LUNCH WITH AMBASSADORS TOMORROW.

6. ESPER LARSEN (DENMARK) ASKED WHAT CONCLUSIONS THE PRESIDENCY

ENVISAGED AT THIS EUROPEAN COUNCIL ON THE SOCIAL DIMENSION. HE UNDERSTOOD THAT THE COMMISSION'S INTENTION WAS TO SEEK AGREEMENT ON THE SOCIAL CHARTER UNDER THE FRENCH PRESIDENCY. WOULD THE CONCLUSIONS OF MADRID BE GUIDELINES FOR FURTHER WORK? WESTENDORP SAID HE HAD NO INFORMATION AT THIS STAGE. THE MATTER WOULD BE DISCUSSED IN THE SOCIAL AFFAIRS COUNCIL ON 12 JUNE.

7. I SAID THAT THE QUESTION OF DEBT WAS IN OUR VIEW PURELY A MATTER FOR MEMBER STATES, NOT FOR THE COMMUNITY. I HOPED THAT THIS DISTINCTION WOULD BE MADE CLEAR IN ANY DOCUMENTS OR PRESENTATIONS BY THE PRESIDENCY. OTHERWISE THERE WAS A RISK OF AN INSTITUTIONAL DEBATE. WESTENDORP CONFIRMED THAT THE PRESIDENCY HAD TAKEN THIS POINT ON BOARD. I SAID THAT THE PRIME MINISTER WAS STILL REFLECTING ON WHETHER TO RAISE THE QUESTION OF FRAUD. THE OUTCOME OF THE ECOFIN DISCUSSION ON 19 JUNE WOULD BE IMPORTANT. IF WE WERE INTENDING TO RAISE IT WE WOULD INFORM THE PRESIDENCY. WESTENDORP SAID HE HOPED THAT THE ECOFIN COUNCIL WOULD REACH SATISFACTORY CONCLUSIONS ON THIS SUBJECT. COMMENTING ON THE PRESIDENCY'S THIRD CATEGORY OF SUBJECTS I SAID WE WERE AVERSE TO THE IDEA OF INCLUDING IN THE CONCLUSIONS MATTERS WHICH HAD NOT BEEN DISCUSSED AT ALL. WESTENDORP SAID THERE WAS NO QUESTION OF INCLUDING CONCLUSIONS WHICH HAD NOT BEEN DISCUSSED. THESE ITEMS WOULD BE DISCUSSED ON THE BASIS OF THE DRAFT CONCLUSIONS ON THE SECOND DAY. FINALLY I SOUGHT CONFIRMATION THAT THE DOCUMENTS ON CONDITIONS AT WORK AND SOCIAL INTEGRATION OF IMMIGRANTS WERE PURELY BACKGROUND PAPERS PROVIDED IN ACCORDANCE WITH THE REMIT GIVEN AT HANOVER AND THAT THEY WOULD NOT BE DEALT WITH IN THE CONCLUSIONS. WESTENDORP AND TROJAN CONFIRMED THAT THIS WAS THE INTENTION.

7. CALAMIA (ITALY) SAID HE HOPED HEADS OF GOVERNMENT WOULD NOT BE ASKED TO TAKE POSITION ON MATTERS IN THE DRAFT CONCLUSIONS WHICH WERE SENSITIVE AND WHICH HAD NOT BEEN DISCUSSED BEFOREHAND. THIS WAS A DANGEROUS PROCEDURE. WESTENDORP SAID THAT THE PRESIDENCY HAD NO PROCEDURAL INNOVATIONS IN MIND.

8. NIEMAN (NETHERLANDS) ASKED WHAT GROUND DELORS WOULD COVER IN INTRODUCING THE DISCUSSION ON THE ENVIRONMENT. TROJAN SAID THERE WOULD BE NO DOCUMENTS. DELORS WOULD GIVE A SHORT INTRODUCTION WHICH WOULD COVER THE PROPOSED ENVIRONMENTAL AGENCY AND PROBABLY TROPICAL FORESTS, THOUGH THIS WOULD DEPEND ON THE COMMISSION'S DISCUSSION TODAY.

9. DE SCHOUTHEETE (BELGIUM) SAID THAT THE REPORT BY THE COORDINATORS ON FREE MOVEMENT OF PEOPLE SHOULD GO TO COREPER AND THE

FOREIGN AFFAIRS COUNCIL BEFORE GOING TO THE EUROPEAN COUNCIL.

10. MATHIAS (PORTUGAL) SAID THAT IF THE SYNTHESIS PAPER NEEDED DISCUSSION THIS SHOULD TAKE PLACE AT A SEPARATE MEETING, NOT AT LUNCH. ESPER LARSEN AGREED. WESTENDORP SAID THE DOCUMENT WOULD HAVE BEEN PREPARED WELL IN ADVANCE BY THE POLITICAL COMMITTEE ON THE ONE HAND AND BY THE COUNSELLORS GROUP ON THE OTHER. COREPER WOULD DISCUSS IT ON 15 JUNE. HE DID NOT ENVISAGE SUBSTANTIVE DISCUSSION OVER THE LUNCH ON 26 JUNE.

11. NIEMAN AND I ASKED WHAT THE PRESIDENCY HAD IN MIND ON THE RESEARCH FRAMEWORK. I POINTED OUT THAT THE COMMISSION'S PROPOSAL ON THE FUTURE OF THE FRAMEWORK WAS NOT DUE UNTIL THE END OF JULY. ANY CONCLUSIONS ADOPTED BY THE EUROPEAN COUNCIL WOULD HAVE TO AVOID PREJUDGING THE OUTCOME ON THIS QUESTION. WESTENDORP SAID THAT THE PRESIDENCY HAD IN MIND A VERY GENERAL CONCLUSION WHICH WOULD NOTE THE EXTENT OF WORK DONE AND ENCOURAGE THE COUNCIL TO GET ON WITH THE JOB OF CONSIDERING FUTURE OF THE FRAMEWORK.

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FROM: A R H BOTTRILL
DATE: 6 JULY 1989
EXT: 4720

pp Bowes

1. MR EVANS
   Copies attached for
   PS/Chief Secretary
   PS/Economic Secretary
   Sir P Middleton
   Mr Anson
   Sir T Burns
   Mr Wicks

Ch. Content?
JS 6/7

2. MR J M G TAYLOR

cc Mr Scholar
Mr A C S Allen
Mr Mountfield
Mr H Walsh
Mr P Davis
Mr C Melliss
Mr Cress
Mr Cassell (UKDEL/IMF)

INTERNATIONAL DEBT SCENE

I attach a draft letter to No 10 covering international debt. It would be useful to let No 10 have this ahead of the weekend in preparation for next week's Economic Summit.

OK

A R H BOTTRILL

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DRAFT PS LETTER TO CHARLES POWELL NO 10

INTERNATIONAL DEBT SCENE

I attach our quarterly report on developments in international debt. This will form the basis of briefing for the Economic Summit in Paris next week.

The policies of the main heavily indebted countries this year are very mixed: some such as Mexico, Venezuela and Nigeria are trying (with some difficulty) to comply with IMF adjustment programmes, while others such as Brazil and Argentina slide into ~~increased~~ ever greater political and economic difficulties. The prospects for the world economy are for continued and substantial growth of output at over 3 per cent, compared to over 4 per cent last year. 1989 is expected to be another year of buoyant trade growth but higher world interest rates are adding to countries' debt servicing burdens. Against this background, the IMF and IBRD have now agreed the conditions under which they will support operations to reduce countries' debt or debt service following the initiative by the US Treasury Secretary, Mr Nicholas Brady. The first negotiations between Mexico and the commercial banks have been difficult and protracted, and are still unresolved. Others are also likely to be time-consuming.

The slightly slower expansion in world output and trade this year, compared to the exceptional rise in 1988, seems likely to make for somewhat slower growth in developing countries' exports with perhaps some

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further slowdown next year. Commodity prices are not showing any further strengthening – if anything some weakening – ~~major changes,~~ following the general rise in 1988.

The Baker 15 heavily indebted countries seem likely on average to run larger current deficits in 1989, partly because an increased share of their export earnings will need to be devoted to interest payments, compared with last year. Their ability to cope will depend partly on their willingness to adhere to firm policies and their ability to negotiate debt reduction with their creditors. This will help create the conditions for resumed growth. The recidivist Argentine and Brazilian economies probably face no recovery unless and until their domestic political difficulties are resolved and new teams can implement policies that creditors can support.

The IMF and World Bank Executive Boards have been putting in place the main elements of the agreements on support for debt reduction reached by Finance Ministers at the Spring meetings. These include:

- 25 per cent each of IMF programme finance and IBRD policy-based lending to be available for reducing debt principal through the debtor either buying back debt or exchanging it at a discount for a new liability.

- Up to 40 per cent of countries' IMF quota or 15 per cent of IBRD lending over three years to be available for operations to support reductions in interest payments.

- The total amount available from each institution is unlikely to be more than $12 billion. This is, intentionally, modest in relation to heavily indebted countries' total debt to commercial banks of about $250 billion and their annual interest payments of close on $30 billion.

- The IMF will be prepared, on certain conditions, to approve adjustment programmes for debtors before agreements with banks are reached. In these circumstances, the Fund will be prepared to tolerate arrears to banks, although not to official creditors.

An important part of our concern in the discussions in the IMF and IBRD has been to ensure that the use of the international financial institutions' resources for debt reduction is subject to prudent conditions and does not involve an unacceptable transfer of risk to the official sector. Our cautious approach to both the general discussions and the first country cases ruffled US feathers but some of our reservations were shared by other countries, such as West Germany and the Netherlands, and subsequent events have. The IMF Board has approved programmes for Mexico, the Philippines, Venezuela and Costa Rica which include provision for debt reduction although no negotiations with banks have so far been concluded.

Arrears of the IMF now exceed 10 per cent of total credit outstanding and the Interim Committee last autumn endorsed a collaborative approach to handling arrears cases, involving the establishment of Support Groups. The first such Group, under the Chairmanship of Canada, has put together a package for Guyana.

fully vindicated our ~~[illegible]~~ concerns.

The aim will be to clear IMF and World Bank arrears and put the country on the path of reform. The Italians have now set up a similar group for Somalia, and we have said that we shall join and contribute to a limited extent subject to satisfactory progress on human rights. The French may be asked to chair a group for Vietnam. We are being asked to chair one for the much larger case of Zambia, but a decision on this is best deferred until Zambia shows that it is firmly committed to reform and it is clear that there is widespread support in the donor community.

In addition to the discussions in the IMF and IBRD, we have also been concerned to try to ensure that creditor governments are not asked to shoulder an unduly large share of the burden as a result of Paris Club reschedulings. In particular, we have argued that industrial countries' governments which form the bulk of Paris Club creditors, should be given due credit for the resources that they provide through the IFIs and should not be asked to contribute again in the Paris Club especially through excessive rescheduling of interest payments due to them. We have so far had little success and the recent reschedulings for Mexico and the Philippines were concluded on terms which we considered placed an undue burden on official creditors. Discussions in the Paris Club continue on the appropriate treatment of burden sharing.

Commercial banks have reacted warily to the IMF and IBRD programmes for debt reduction. The sums on offer are undoubtedly less than they would have liked but the recognition that the banks' claims are not worth their full face value is leading them reluctantly to make concessions. The negotiations with Mexico are proving harder than the US government had hoped and it is putting pressure on US and other banks. UK banks have apparently been among the toughest negotiators but we have insisted that, despite US pressure, they must make their own commercial decisions without government interference.

Commercial banks initially argued that supervisory and provisioning regulations might be an obstacle to debt reduction but a meeting of experts from G7 governments and central banks in May concluded that, except possibly in Japan, there were no general obstacles. In the UK, losses on both principal and interest accounts are allowable for tax purposes.

Middle-income <u>debt</u> will be a major item on the agenda of the Economic Summit next week. Our aim will be to endorse what has already been agreed at the IMF and World Bank Boards, and to resist any calls for further official resources, whether through SDRs or in any other way, because of our objections to any further ~~takeover by~~ burden on the taxpayer and because any such calls would be wholly counterproductive in the context of negotiations between the banks and debtors.

Much will depend on the negotiations between the Mexicans and the banks. If, over the next week or so, both sides are seen to be making progress to a settlement, then the Americans will content themselves with extolling the Brady approach. But if these negotiations were to break down, ~~then the US are liable to~~ there is a real risk of the US espousing further schemes such as the French proposal for an SDR allocation, which we and the Germans are strongly against. Debtor countries have made no further progress in agreeing a joint position. At a meeting of the 26 countries in the Latin America Economic System (SELA) the Brazilians rejected suggestions for a joint approach to debt reduction on the grounds that debtors' requirements differed. SELA, however, is to examine the question of debt to the multilaterals and to Paris Club governments.

In the case of the poorest countries the Paris Club has now rescheduled the debts of 13 African countries on the terms agreed after the Toronto Summit which endorsed the Chancellor's original initiative.

Mexico reached agreement on an IMF programme at the end of May and subsequently secured rescheduling of its official debt in the Paris Club. Talks between the Mexicans and the banks are still continuing. The banks' latest reported offer, includes a 30 per cent discount on $39 billion of pre-1982 loans and a 20 per cent discount on $15 billion of post-1982 new money. The Mexicans have rejected this and demand a 45 per cent discount. Domestically, the Salinas administration has negotiated an extension of the Pact of Economic Stability and Growth (PECE) until next March. This will continue the system of wage and price controls, and gradual devaluations of the peso. It should make more feasible the government's target for inflation of around 22 per cent. Real interest rates are high at 30-40 per cent and as long as uncertainty over the debt negotiations makes the external situation vulnerable to capital flight there is little possibility of lowering them at present. Reserves are falling and the finance Minister, Mr Pedro Aspe, has warned that if a financial package with creditors were not agreed there would be cash flow problems later in the year.

The Philippines was the first country to have debt-reduction mechanisms built into its IMF programme. As such we decided to treat it as a test case of the post-Brady debt strategy when it came to the May Paris Club. Our objective was to hold any Paris Club deal at a level that ensured fair burden sharing between private and total official sectors. We were quickly isolated and the eventual agreement gave an unacceptably high share to the official side. Talks with the commercial banks have not begun: attention is at present on the outcome of the Mexican negotiations.

The IMF approved a strong programme for Venezuela on 23 June incorporating debt reduction. The chief danger is now that of inflation; the achievement of positive real interest rates is essential to the success of the programme. The main issue of contention in the IMF Board discussion was the request that additional resources for interest support be approved outright. Our line has been not to support this since Venezuela is close to creditworthiness, and in the event outright approval has not been granted. Negotiations with the Commercial banks have not been concluded, as attention is focused on the outcome of the Mexican talks.

The Government of Brazil's economic policies are increasingly incoherent. The present 18 month Stand By Arrangement which expires at the end of February 1990 is now substantially off track. The Summer Plan was a failure: inflation is on the rise

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again (~~May's was~~ Prices rose 10 per cent in May alone, with a further 22 per cent ~~is~~ forecast for June),

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and GDP has declined by 0.7 per cent in the twelve months to March. The operational public deficit looks ~~like it~~ as if it will be twice the 2 per cent originally agreed with the IMF. Commercial banks and the IMF and IBRD have suspended disbursements of $2.4 billion in fresh loans. A huge monthly trade surplus has not prevented the? reserves from dwindling. As bankers had been fearing, on 3 July the Brazilians suspended for an unspecified period all payments of interest and principal (as well as all remittances of profits and dividends, and capital repatriation). This is being presented not as a formal long term "moratorium" but as a short term measure to bolster reserves".

In <u>Argentina</u>, Alfonsin has stepped down and Menem will be sworn in as President on 8 July. The recent leadership vacuum has exacerbated the country's uncontrolled hyperinflation (retail prices rose by 226 per cent in the first five months of 1989 and a June figure of 150-200 per cent is forecast) and deepening recession. Tax income is ~~at present~~ now less than half of public? expenditure. The new administration will need to take tough measures. The future Economy Minister, Roig, has promised a three-month adjustment period, including wage and public tariff increases, a high official dollar exchange rate, tax reform and drastic public sector cuts. Though there is a continuing trade surplus interest arrears alone are about $4 billion (reserves are dwindling). US banking regulators have formerly declared Argentina as "value impaired". A loan from the governments of Brazil, Mexico and Venezuela has allowed Argentina's arrears to the IMF to be cleared. An IMF team is at present in Buenos Aires to consider Roig's planned economic measures. The new government is expected to seek a $350 million bridging loan from the US and other industrial nations.

Nigeria's progress with the adjustment programme agreed with the IMF earlier this year has been mixed. The Nigerians appear to have maintained reasonable control over public spending but have failed to curb liquidity adequately. Inflation, therefore, has risen sharply to 50 per cent or more at an annual rate. Interest rates are heavily negative in real terms and the black market exchange rate remains at a 30 per cent discount to the official rate. Higher imports and interest payments seem likely to offset increased oil revenues so that the current external deficit may be larger than expected. Nevertheless, the Nigerians have now taken quantitative measures to curb liquidity, and the IMF management has decided to give them the benefit of the doubt and complete the first review of the programme. The next is in October. Bilateral negotiations with Paris Club creditors are moving slowly, partly because of creditors own delays but also because the Nigerians are seeking interest rate concessions and postponement of payments due under the bilaterals. We have encouraged them to speed the process in time for negotiations on next year's programme and rescheduling. At this point, the Nigerians are likely to seek Toronto terms from the Paris Club and Brady terms from the banks. Both will need careful consideration at the time.

Poland seems unlikely to be able to agree an IMF programme before the end of the year, and the credibility of any measures is likely to hinge at least partly on the extent to which Solidarity is involved in their preparation and is ready to assume some responsibility for their implementation. Arrears continue to mount to Paris Club creditors but the rationale for agreeing an interim rescheduling ahead of a Fund programme in order to try to pre-empt banks securing unduly favourable treatment has how gone since the banks have concluded a new agreement. In the wake of Solidarity's success at the polls, Western governments have been encouraging the Poles to adopt reforms with President Jaruselski's visit to London and the visits by President Mitterand and President Bush to Warsaw. Chancellor Kohl is also poised apparently to visit Warsaw. The amount of new money or export credits, however, which countries are ready to provide is very small and for the most part depends on the Poles agreeing an IMF programme, for which we are seeking exacting but ~~not in~~tolerable conditions.

Egypt continues to negotiate with the Fund on a new SBA, and there have been some suggestions that a Letter of Intent could be signed next month. Although this may be optimistic, the Egyptians have shown signs of moving towards the Fund on a number of key issues, including pricing, interest and exchange rate policy, and the budget deficit. Agreement with the Fund would pave the way for a Paris Club agreement necessary to clear arrears, now totalling an estimated $4.7 bn, and to reschedule maturities falling due at least to the end of 1989.

Among the smaller countries, consideration of Jordan's Fund programme has been delayed by a last-minute claim by the Jordanians that their financial position is worse than expected. The Jordanian Finance Minister called earlier this week on Treasury officials who urged him to agree a basis for the programme to clear the way for discussion by the IMF Board and the Paris Club at which we would play a positive role.

We are monitoring closely several smaller countries. Algeria which agreed an IMF programme in May, faces very heavy debt service obligations. It is opposed to rescheduling but might be forced to do so if the oil price weakens again. Bulgaria's foreign debt has been rising rapidly and in the absence of policy corrections gives cause for concern. Hungary's IMF programme ha been suspended at least temporarily as the authorities have been unable to meet the Fund's budgetary targets, and the external balance of payments has remained weak. The new ruling quartet may be in a stronger position to carry through reform. Following Sudan's military takeover on 30 June, the IMF has decided to reopen negotiations on an adjustment programme to tackle the country's substantial economic problems. Western governments have pledged considerable financial assistance if and when the civil war is ended.

I am copying this letter to Richard Gozney (FCO) and to Paul Tucker (Bank).

JMG T—
P— S—

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FROM: COLIN MOWL
DATE: 6 JULY 1989
EXTN: 5130

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Wicks
Mr Scholar o/r
Mr Sedgwick
Mr Riley
Mr Peretz
Miss O'Mara
Mr Watts
Mr Gieve
Mr Bush
Mr Patterson
Mrs Todd
Mrs Ryding

Ch/ Content with briefing?
JF 6/7

Thanks. OK.

NATIONAL DEBT AT 31 MARCH 1989

The outturn for the National Debt at end 1988-89 is published today in the June issue of Financial Statistics. Given the low profile means of publication it is unlikely to attract any immediate outside comment. Nevertheless we need to have a briefing line available.

2. The National Debt at end 1988-89 was £197.2 billion, only £0.2 billion lower than at the end of the previous year. Relative to GDP, however, the National Debt fell sharply from 44 per cent to 39¾ per cent. (Table 1 attached gives a long run of historical figures.)

3. The National Debt barely fell in absolute terms in 1988-89, despite a central government net debt repayment, as measured by the CGBR, of £7 billion. Table 2 provides a provisional reconciliation.

4. The difference between the change in National Debt and the CG net repayment is more than accounted for by an £11 billion rise in official holdings of debt ie by an increase in debt held by central government itself. Around half of this rise in official holdings was due to buying-in of gilts by the Issue Department. Such buying-in does not reduce the National Debt until the stocks

in question are redeemed. The remainder is mainly due to an increase in the holdings of the National Debt Commissioners and the Banking Department, and an increase in NLF indebtedness to other official holders through overnight deposits.

5. Apart from official holdings there are three main elements in the reconciliation:

(i) the CGBR measures cash transactions but the outstanding stock of the National Debt can also change when there are **valuation changes** eg in 1988-89 the sterling value of the foreign currency component rose because sterling depreciated against other currencies;

(ii) the National Debt does not cover all central government borrowing eg it excludes notes and coin;

(iii) the National Debt is a gross debt concept, the CGBR is a net debt concept. The CGBR measures borrowing net of changes in central government's holdings of short-term assets such as the foreign exchange reserves and the Issue Department's holdings of commercial bills. The latter fell by about £6 billion in 1988-89. On its own, this would have permitted the National Debt to have fallen by more than the CG net debt repayment but it was more than offset by the rise in official holdings.

6. The importance of official holdings and items (ii) and (iii) above highlight some of the deficiencies in National Debt as a measure of government indebtedness. We have consistently said in public that "net public sector debt" (NPSD) is a superior measure but the outturn for NPSD will not be available until the autumn.

7. I attach some briefing for use in the event of press or other queries. Although there is a helpful positive point, I suggest that we do not go out of our way to publicise the availability of the National Debt figure, given its conceptual deficiencies.

Colin Mowl.

COLIN MOWL

PRESS BRIEFING

Factual

National Debt at end 1988-89 was £197.2 billion compared with £197.4 billion at end 1987-88.

Positive

Relative to GDP National Debt fell sharply in 1988-89 (from 44 per cent to under 40 per cent), to the lowest level since World War One.

Defensive

Why has National Debt not fallen despite PSDR of £14.4 billion?

National Debt covers central government debt only. About half of public sector net repayment in 1988-89 accounted for by local authorities and public corporations.

Even so fall in National Debt much less than central government net repayment of £7 billion, because latter largely took form of buying-in of debt by Bank of England Issue Department. Such buying-in reduces market holdings of National Debt but increases official holdings, leaving total unchanged.

Because it includes official holdings (and for other reasons eg does not cover whole public sector), National Debt not particularly appropriate measure of government indebtedness. "Net public sector debt" a better measure, but outturn not available until November.

Forecast in Budget that net public sector debt would fall £14 billion in 1988-89.

psf.sp/docs/4.6.7 **Unclassified covering**
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TABLE 1

NATIONAL DEBT AND NET PUBLIC SECTOR DEBT

	NATIONAL DEBT		NET PUBLIC SECTOR DEBT	
End-March	Cash £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)
1855	0.8	105.0		
1860	0.8	98.7		
1865	0.8	81.4		
1870	0.8	71.5		
1875	0.8	59.0		
1880	0.8	58.0		
1885	0.7	57.2		
1890	0.7	47.4		
1895	0.7	42.6		
1900	0.6	32.3		
1905	0.8	36.7		
1910	0.7	31.9		
1915	1.1	35.3		
1920	7.8	130.9		
1925	7.6	163.6		
1930	7.5	159.4		
1935	7.8	165.2		
1940	8.9	118.7		
1945	22.4	277.8		
1950	25.8	199.5		
1955	26.9	141.0		
1960	27.7	108.6		
1961	28.3	104.3		
1962	28.7	100.6		
1963	29.8	99.6		
1964	30.2	92.4		
1965	30.4	85.8		
1966	31.3	82.8		
1967	32.0	80.1		
1968	34.2	80.0		
1969	34.0	73.3		
1970	33.1	65.7		
1971	33.4	59.5		
1972	35.8	57.3		
1973	37.2	51.7		
1974	40.5	50.5		
1975	46.5	46.5	59.5	59.6
1976	56.6	47.3	71.8	60.0
1977	67.2	47.9	81.3	57.9
1978	79.2	48.8	87.9	54.2
1979	86.9	46.2	95.3	50.6
1980	95.3	42.6	102.1	45.6
1981	113.3	45.7	116.5	47.0
1982	118.6	43.6	127.2	46.7
1983	128.2	43.2	135.0	45.5
1984	143.1	44.9	147.3	46.2
1985	158.3	45.6	160.7	46.3
1986	171.6	46.1	166.8	44.8
1987	185.7	45.9	171.1	42.2
1988	197.4	44.0	171.3	38.2
1989	197.2	39.8	[157]*	[32]*

* Budget forecast.

TABLE 2

RECONCILIATION OF CHANGE IN NATIONAL DEBT AND CGBR IN 1988-89

	£ billion
Change in nominal National Debt	-0.2
less change in official holdings(1)	-11.3
Change in market holdings of National Debt	-11.5
National Debt valuation changes with no associated cash transaction	
less premia/discounts on gilts, and adjustment for change in cash balances	0.5
less capital uplift on indexed linked gilts	-1.0
less increase in £ value of foreign currency debt	0.6
Central government borrowing outside National debt	
Notes and coin	0.8
Net indebtedness to Bank of England Banking Department	0.4
National savings other borrowing(2)	-0.7
Other	0.3
Changes in CG holdings of short-term assets financing CGBR(3)	
less increase in foreign exchange reserves	-1.6
less reduction in Issue Department commercial bills and other ST assets	6.2
Other adjustments(4)	0.1
CGBR	-6.9

(1) On a cash basis.

(2) Change in National Savings accrued interest outstanding not included in National Debt, plus net investment in ordinary accounts.

(3) National Debt is a *gross* borrowing concept, while CGBR is gross borrowing *net* of charges in short-term assets ie a *net* borrowing concept.

(4) Mainly removing changes which contribute to, rather than finance, CGBR.

FROM: D I SPARKES
DATE: 7 July 1989

MR C MOWL cc Mr Bush

pmp

NATIONAL DEBT AT 31 MARCH 1989

The Chancellor was grateful for your minute of 6 July concerning the outturn National Debt figures published yesterday. He had no comments on your briefing line.

D.S.

D I SPARKES