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PART A

Part .A.

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Begins : 19/2/87.
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Chancellor's (Lawson) Papers:
Financial Developments In The United States of America

DD's: 25 Years

24/5/96.

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DEBT

13

FROM: P MOUNTFIELD
DATE: 19 February 1987

PS/CHANCELLOR

cc Sir G Littler
Mr Lavelle
Mr Evans
Mrs Lomax
Mrs Case
Mr P Davis

LUNCH WITH THE GOVERNOR

There are two points on my side which the Chancellor may wish to raise.

Brazil

2. Latest reports from Brasilia suggest that Brazil is now seriously considering a suspension of payments; the trade surplus has fallen drastically (to $100m last month, from almost $1bn) and reserves are at a very low ebb. We are preparing fuller briefing for the weekend, in case Secretary Baker wishes to raise the question with the Chancellor. Meanwhile he may want to ask the Governor:

(i) how he rates the chances;

(ii) potential damage to British banks, and to the banking system more generally;

(iii) likely US response;

(iv) what, if anything, the Bank and HMT should do. (In practice, there is very little we could do).

GATT: Trade in (financial) services (only if time allows)

3. Ministers committed for GATT Round to major initiative for liberalisation of trade in services. US strongly supports.

City interests canvassed three years ago and appeared to assent. The Bank may now be having second thoughts. They say lower barrier elsewhere may limit attraction of London as a centre and increase competition facing UK banks already established behind barriers overseas. The Chancellor could ask the Governor if he agrees. Surely the balance of UK interest still favours liberalisation?

PM

P MOUNTFIELD

2563/21

FROM: P MOUNTFIELD
DATE: 29 JULY 1987

PS/CHANCELLOR

Ch.
I understand that Sir G Littler has spoken to you as at X. The 6-weekly report is, in fact, not attached – we are chasing Mr Mountfield. But you should see this now pre-Balladur.
30/7

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Lavelle
Mr Evans
Mrs Lomax
Mr Walsh
Mr P Davis
Mr Pitcairn

Mr Lankester-UKDEL

INTERNATIONAL FINANCIAL SCENE

Not attached

I attach a draft slightly-revised version of the letter to No.10, covering the usual 6-weekly report from the Bank of England, which was discussed in Mr Lavelle's interdepartmental debt group on 22 July. It incorporates changes suggested by Mr Lavelle and Mr Evans.

2. In this report we have not gone in detail into the fate of the Sub-Saharan debt initiative, on which I reported separately on 22 July. The line suggested here assumed that, once he has Sir G Littler's views, the Chancellor accepts the suggestions about lobbying put forward in my minute of 22 July.

P MOUNTFIELD

pse type for my signature
AT
31/7

DRAFT LETTER FROM PS/CHANCELLOR OF THE EXCHEQUER TO PS/PRIME MINISTER (Charles Powell).

INTERNATIONAL FINANCIAL SCENE

I enclose the usual 6-weekly report from the Interdepartmental Debt Group. This will be the last report before the summer holiday: the next one, in early September, will be an extended report setting the scene for the Annual Meetings of the IMF and IBRD, which this year will focus very largely on debt problems.

Economic activity in the main industrial countries in the early part of this year was running about 2½ per cent up on a year earlier, and we expect a similar figure for the year as a whole. The slightly gloomier note struck by the OECD in their latest economic outlook is not being echoed elsewhere. In Japan, for example, partly because of the fiscal package, quite strong growth of domestic demand is expected to continue. And there has been a distinct stiffening in commodity prices, especially in metals and oil, in recent months. So there are reasonable prospects of growth in 1988 at about, or perhaps a bit above, the 2½ per cent mark.

The report deals with current proposals for enlarging the Structural Adjustment Facility of the IMF, and with the Chancellor's debt-relief proposals for Sub-Saharan Africa. There is not much support for the latter yet; as the Chancellor said in his speech to the All-Party Development Group last week, most creditors are taking a very short-sighted and unrealistic view of the problem. The joint IMF/IBRD meeting in Paris on 10 July was very disappointing; so was the follow-on discussion in the Paris Club. The Chancellor currently considering how best to take this forward in the remaining weeks before the Annual Meetings, and will be making direct approaches to some of the key Finance Ministers concerned.

The other main development since our last report has been the continued move towards <u>greater</u> <u>provisioning</u> by the Commercial Banks against Third-World debt. ~~All four banks~~ The big four
London clearing banks (now all)
~~So far, Nat West, Lloyds and Midland~~ have followed the lead of Citibank and other major American banks. ~~Barclays have yet to declare their results and explain their provisions~~. This change of policy by the British banks is of course welcome, and in line with the greater realism which the Chancellor has urged for some time.

Turning to the position of the largest debtors. Mexico seems at present to be in a fairly healthy state with very high reserves and rising exports (even before the recent increase in the oil price). No new debt negotiations are due this year.

Argentina is in a much more unhappy situation. Although the banks have recently completed an agreement covering 1987 maturities, the IMF programme has gone badly wrong and has been revised. The UK has reluctantly supported a new and weaker programme, warning however that we shall not be prepared to support any further waivers if the new targets are not met. The tactics of the Fund, and indeed of the banks, appear to be to settle the Argentine problem and isolate it from the case of Brazil. Here there are serious difficulties ahead.

Brazil declared a moratorium on payments to the banks in February, which has recently been extended to the government creditors in the Paris Club. Although informal talks with the IMF have begun, and a major new economic reform programme has just been announced, it is not clear yet whether this will be acceptable to the Fund (or to major creditors like the UK), or that the Brazilian government will be prepared to go back on political opposition to a drawing from the Fund. However, the banks are reported to be pressing for a Fund agreement as a precondition of any new debt settlement, and the Paris Club creditors have agreed to stand firm on the same demand. Meanwhile most (but not all) government creditors have suspended export insurance cover in an attempt to persuade Brazil back to the negotiating table. ~~(This will leave Ministers with an awkward decision on the Westland Helicopter bid, which may have to be settled shortly)~~.

Among the medium-sized debtors, the <u>Nigerian</u> programme is showing signs of strain, and we may need to exert some diplomatic pressure on the government there to reinforce it.

<u>Yugoslavia</u> is belatedly recognising that foreign exchange problems are not merely short term cash flow ones but reflect deeper structural difficulties. They have suspended repayment of debt to the banks, and seem likely to ask the Paris Club for further relief too. Once again, the UK (with support from most other creditors) will be seeking to steer Yugoslavia to the IMF.

The Polish problem is as intractable as ever. The US has just changed its position, opening up the chance of a negotiation covering all debt maturities up to the end of 1988 (ie after the US Presidential Election). But this has taken so long that the banks seem likely to steal a march on government creditors and sign an agreement in September which will take up most of the funds Poland has available for debt service. In the longer term, we see the only solution to the Polish economic problem as lying in a strong IMF adjustment programme. The US, for what appear to be domestic political reasons, is strongly opposed to such a programme and as a result the IMF is dragging its feet. The UK, with support from France and Germany, is mounting a diplomatic campaign to persuade the US to modify its opposition.

Finally, Turkey, which has been a model debtor in recent years, is showing signs of returning strain. Inflation is increasing and foreign earnings coming under pressure. There are reports of corrective economic measures about to be taken, but until there is hard evidence of these, we shall have to watch fresh lending to Turkey with great care. The possibility of a further debt restructuring begins to look a real one.

I am sending copies of this letter to the Private Secretaries to the Foreign Secretary, the Secretary of State for Trade and Industry, the Secretary of State for Defence and the Governor of the Bank of England.

191/18

CONFIDENTIAL

Ch / Content for me to send summary as drafted?

AS 18/9

FROM: MRS A F CASE
DATE: 18 September 1987

1. MR LAVELLE
2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Evans
Mrs Lomax
Mr Mountfield
Mr Culpin
Mr Davis
Mr Walsh
Mr Pitcairn

Mr Lankester - UKDEL

INTERNATIONAL FINANCIAL SCENE

I attach the regular report on developments in the international debt scene, following the meeting of the interdepartmental group earlier this week. This report is the "full" version, intended as background for the annual meetings. However, I enclose only the summary for transmission to No 10.

MRS A F CASE

(Item 25) C41.

DRAFT LETTER TO ~~NO~~ 10 C Powell, No 10.

cc PS/Foreign Secretary
Secretary of State for Trade and Industry
Governor - Bank of England

INTERNATIONAL FINANCIAL SCENE

I attach the regular report on developments in the International Debt Scene. This report is intended as background for the Autumn series of international meetings - Commonwealth Finance Ministers, Annual Fund and Bank meetings and Commonwealth Heads of Government. An important ~~The main~~ theme of discussion at the annual meetings will be how to help the poorest indebted countries, especially those in sub-Saharan Africa.

2. The meetings are taking place at a time when the debt strategy remains under strain. However, ~~unilateral~~ action by the debtor countries to restrict debt servicing has so far been limited, tactical and unconcerted. This year's meetings will provide an opportunity for a major push to increase the resources available to the poorest and most heavily indebted African countries. An important element in this is the Chancellor's own initiative, together with the complementary proposals from the Fund and Bank. We are, however, unlikely to get agreement on the essential interest relief component of the Chancellor's scheme this time round. The proposals remain an

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important factor in our ability to manage this part of the debt problem.

3. In order to keep the focus clearly on sub-Saharan Africa, it will be necessary to ensure that the difficulties and problems of middle income debtors are ~~kept to the sidelines~~ not allowed to dominate the discussions.

The UK line on middle income debtors will be, as it was at the April meetings, the continuation of the case by case strategy, emphasising the need for conditionality (additional creditor support linked to appropriate adjustment programmes) and for debtors and banks to work out market-related solutions.

4. The economic background as it affects the evolution of the debt problem has shown little change over the past two months. There is some improvement in the prospects for LDC exports, together with a slight strengthening of non-food commodity prices, compared with the very low levels of last year. On the other hand dollar interest rates have strengthened recently and further increases could well be needed if the US stands by the Louvre agreement to maintain the dollar at around present levels.

5. On individual countries, there are few bright spots. The performance of <u>Mexico</u> and some smaller Latin American debtors continues to be encouraging. On the other side <u>Brazil</u> remains the major problem.

As the report notes the radical Brazilian proposal that one half of its commercial bank debt should be securitised (on terms which represented a significant discount on face value and would have led to wide spread write downs) was withdrawn following intervention by US Secretary Baker. He apparently said, in persuading the Brazilians to retreat, that new bank lending to cover interest arrears could become available without Brazil's acceptance of an IMF programme, although such a commitment would still be required for any rescheduling by Government creditors in the Paris Club and for any further "new money" from the banks next year. This, if true, would be an unwelcome weakening of the present strategy. It remains to be seen what the banks make of this. For the moment they (and the UK banks in particular) seem set on a harder line requiring a Fund programme for the arrears, Brazil's intentions in relation to the Fund remain unclear. The Managing Director's summing up of the recent Article IV discussion of Brazil clearly amounted to a negative assessment of current economic measures but the latest indications are that Bresser Pereira has been persuaded to go for an IMF Standby. New formal debt proposals will be presented to the banks on 25 September.

and the Chancellor does not believe we should lean on the UK banks to soften ~~their~~ line they whatever the right solution of taking, even though the US is likely to press us to do so.

6. Despite the signature of the commercial bank lending package in August, developments in <u>Argentina</u> have been adverse. The country is off track on its new, weaker Fund programme and following the Peronist

victories in the elections, a more confrontational aspect to debt issues seems to be emerging. On 9 September Alfonsin announced a decision to seek the "freezing of interest rates at historic levels". This appears to be a warning shot for the future rather than an immediate attempt to unpick the commercial bank package.

7. Elsewhere, there are a number of countries in Eastern Europe (Yugoslavia, Poland and Hungary) where an improvement in deteriorating economic performance depends on negotiations for a Fund programme. The Hungarians hope to negotiate a sizeable programme to reassure their creditors and to avoid rescheduling. Government creditors will make a new Fund programme for Yugoslavia a precondition of further rescheduling. Such a programme remains a precondition for any long term approach to Polish debt problems, but is not an immediate prospect, so that an interim settlement is needed and now seems likely.

8. In Africa, the Nigerian position has deteriorated. The present programme is now effectively dead, although the Fund are formulating a new programme for next year. This ~~is likely to~~ could cause financing difficulties ~~as~~ if it delays disbursement under the commercial bank ~~passage~~ package and negotiation of a further World Bank loan. Among Commonwealth countries in Africa there are a number (eg Tanzania, Ghana) who have Fund programmes and

eh?

are therefore candidates for the Chancellor's sub-Saharan initiative. Others, like Malawi and Siera Leone, could become so were they to reach an agreement with the Fund. Zambia, on the other hand, for the moment looks set to remain outside the fold.

9. Finally, the Egyptians, surprisingly, seem to have met IMF requirements at the first review of their SBA in September. However there remain very serious doubts about the Egyptian ability to strengthen the programme as promised.

10. I am copying this letter to Tony Galsworthy (FCO), Tim Walker (DTI) and John Footman (B/E).

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CONFIDENTIAL

INTERNATIONAL FINANCIAL SCENE

1 Debt discussions at the forthcoming IMF/IBRD Annual Meetings will be taking place at a time when the current strategy is under strain. Creditors' confidence in the ability of major debtors to adopt and sustain appropriate economic policies has been sapped, and the banks' reluctance to provide new money appears to be growing as their balance sheets strengthen. Most debtors still see their long term interests as being best served by accommodation with their creditors, and unilateral action to restrict debt servicing has, so far, been limited, tactical and unconcerted. There is, nevertheless, a perception among borrowers that they are being required to bear an unfair share of the costs of a solution. They see a disproportionately large part of their future output being committed to debt servicing, seemingly for years ahead. Moreover, growing trade surpluses, partly necessitated by a much reduced scale of external inflows, represent a net transfer of real resources to creditors which has been largely matched internally by cuts in investment that are likely to restrict future debt servicing capacity. The continuing Brazilian moratorium is the clearest sign of the gulf between the two sides.

2 With apparently irreconcilable issues of principle at stake, there seems little prospect of the complex problems faced by middle income debtors and their largely commercial bank creditors being resolved in the near future. In contrast, the chances of achieving a consensus among official creditors on the need to grant significant, but conditional, debt relief to the poorest debt-distressed countries, particularly in sub-Saharan Africa, may be improving, although difficult negotiations lie ahead. While the direct financial costs of such relief will be relatively small, the UK and other creditor governments, with an eye to the reaction of middle income countries, will be anxious to quash any move to make concessions to any but the most deserving cases.

3 The signing of the Argentina debt package on 21 August, within 4 months of agreement in principle, contrasts favourably with the prolonged negotiations with other major debtors (eg Mexico and Nigeria) over the past year. While the relatively swift completion of the agreement owes much to the flexibility and innovation of the "menu" offered to creditors and to the smaller number of banks

involved, pressure to complete before the commencement of negotiations with Brazil, which promise to be much more difficult and protracted, has also been an important factor. Argentine and Brazilian authorities were in close contact throughout. Overall, the record of commercial debt negotiations since the Baker initative has not, however, matched earlier hopes. Although most of the Baker 15 have successfully rescheduled, new money has been agreed in principle in only 6 cases. On the basis of IMF figures, ldcs with debt problems made net repayments of $11 bn to banks in 1986, including net repayments of $3.5 bn by the Baker 15.

4 Recent developments in the run-up to the banks' negotiations with Brazil emphasise that country's pivotal role. Posturing by both sides prior to the commencement of negotiations was only to be expected, but attitudes have, if anything, hardened in recent weeks, with the Brazilians refusing to make a token payment of interest arrears. Brazil's radical proposal that one half of its commercial bank debt should be securitised on terms which represented a significant discount on face value and which would have led to widespread write-downs, met a cool response from the banks and was effectively withdrawn after only a week following discussions with the US Treasury. (What now remains of the plan appears to be merely the inclusion of Argentina style exit bonds in the "menu".) The US authorities, while persuading the Brazilians to retreat, indicated that they would not stand in the way of any agreement between the banks and Brazil to provide new money to cover this year's interest arrears which did not require Brazil's acceptance of an IMF programme. Such a commitment would still be required in any approach to the Paris Club and for any further "new money" from the banks next year. The banks, however, appear to be sticking to their insistence on a full programme in order that the financing burden be more evenly spread.

5 On 20 August interest payments on Brazilian debt fell more than 180 days overdue. If there is no change in the position by late October US regulators may classify these loans as "value impaired", requiring the banks either to establish special "Allocated Transfer Risk Reserves" (ATTRs) or to write down the value of their loans using loss reserves such as those substantially boosted by provisioning in the second quarter. Either course of action has the effect of reducing a bank's primary capital, but it also renders losses on such lending eligible for tax relief. Although US banks' capital asset ratios have risen significantly since the early eighties, Citibank, again stealing a march on its competitors, announced a common share issue intended to restore its common equity:assets ratio. Canadian banks, who had already established 15% mandatory reserves against problem ldc loans, have now been required to raise their provisioning to 30-40%. In the UK, all the major clearing banks have now announced increased provisions against ldc loans which

cumulatively now amount to about 30% of their exposure to problem debtors. Supervisors have circulated banks with details of a matrix of factors which they will use to judge the adequacy of provisions. The Inland Revenue has also advised the banks that, while its general policy regarding the tax treatment of loan losses remains unchanged, it will regard the matrix methodology as relevant in determining the extent to which specific loss provisions against sovereign loans are tax deductible, with the caveat that the level of provisioning allowable for tax may be somewhat lower than that recommended by the supervisors.

6 After being declared in formal default on loans of US$750 mn last month - the first such instance in recent times - North Korea has now agreed to sign a debt rescheduling accord with two bank syndicates led by Morgan Grenfell and the ANZ Banking Group. This will spread debt repayments over twelve years with four years' grace.

7 US regulators have relaxed limitations on investment by bank holding companies in non-financial companies in ldcs. The lifting of rules which restricted such investment to 20% of a holding company's capital is likely to boost demand for debt:equity swaps. Although much has been made of the contribution these transactions can make to restructuring debtors' external liabilities, debt conversions since mid-1984 total only around $4.5 bn, or about 2% of the commercial bank debt of countries with active conversion schemes. (Chile has, however, converted around 13% of its debt.) While Citibank has recently announced its intention of swapping a third of its $1.5 bn of Argentine loans for equity over the next 1 1/2-2 years, it is difficult to see how conversions by all banks on this scale could be absorbed. Banks with large exposures will remain reluctant to participate if, following the sale of loans at a discount, accounting rules require them to "mark to market" the remainder of their portfolio. Widespread conversions would tend to depress prices in the secondary market where turnover, expected to rise to $10-$15 bn this year, still remains small in relation to the the value of debt outstanding. Recent sharp falls in secondary market prices following second quarter provisioning (which raised expectations that banks would significantly increase the supply of loans) are shown in Chart 1. Both demand and supply to the market are heavily influenced by technical factors and trading is thin. Most transactions are in the obligations of Mexico and Chile which have active conversion programmes. Currently, monthly trading in Brazilian debt is thought to be as little as $20 mn.

8 Close co-operation between Argentina and Brazil apart, recent efforts by debtors to establish a united front have met with little success. At UNCTAD VII, Brazil, Venezuela and others who had been seeking a radical change in the debt strategy,

including a commitment to a larger volume of non-conditional finance, were unable to enlist the support of the poorer countries who did not wish to prejudice progress on the various initiatives to alleviate the acute debt problems of sub-Saharan Africa. The text of the conference's Final Act presented few problems for creditor governments. A call by some African countries at the OAU summit (where the UK initiative was well received) for a limitation on debt servicing was similarly deflected, although the Organisation still plans to hold a conference in December to establish a common negotiating position. In a recent national address the Mexican President rejected "populist measures that postpone effective progress", an apparent dismissal of Peru's unilateral limitation of debt servicing, and also suggesting a reluctance to follow any radical moves from Brazil.

9 The joint IMF/IBRD initiative to expand the resources available to the poorest debt distressed countries, including an expansion of the SAF, additional multilateral disbursements and cofinancing, and interest relief, is currently being discussed with major creditors. Support for the Chancellor's initiative is also being actively canvassed in G10 capitals and with the French in particular. While there is a consensus that special action is required, potential donors remain divided as to which form this should take. The IBRD hope to call a meeting in October to co-ordinate progress.

10 An important element in the current strategy is an expanded role for the World Bank and regional development bank (MDBs). The Baker plan called for MDB lending additional to previous plans, of $3 bn per annum to highly indebted countries over 1986-88. In 1986 gross MDB lending to the Baker 15 rose $1.9 bn (World Bank +$1.7 bn), and between FY1985 and FY1987 IBRD commitments to these countries have risen $2.2 bn, with quick-disbursing policy based loans accounting for more than a third of the total. Co-financing commitments by MDBs, however, fell sharply in 1986. The importance attached to MDB financing in the debt strategy was reaffirmed at the Venice summit with support for the IBRD's General Capital Increase (GCI). While most countries support an increase at the top end of the $40-$80 bn proposed, opinions differ as to the size of the paid-in component. While Congressional support for IDA's Eighth Replenishment and the GCI may be forthcoming, the US Administration's continuing difficulties with Congress over appropriations to MDBs have led to delays in the payment of US subscription to IDA and IFC, thereby holding up disbursements as well as encouraging late payments by other donors. The issue of voting rights and concerns over the effectiveness of lending policies have also led the US to take a hard or critical line in negotiations for the IDB's Seventh Replenishment, the fourth GCI for the African Development Bank (agreed in June), the fifth replenishment of the African Development Fund, and the forthcoming fourth GCI for the Asian Development Bank.

11 Japan has announced details of its $20 bn recycling scheme to follow its $10 bn programme last year. Apart from a build-up of oda, $8 bn will be made available through MDBs, $9 bn through the OECF (Overseas Economic Cooperation Fund) in the form of direct lending and co-financing, and $3 bn in the form of direct lending by Japan's EXIM bank. The size of the contribution expected from Japanese commercial banks to the package remains unclear.

12 Recent economic developments in the major debtors have been mixed. Trade surpluses, with some exceptions, have been strengthening, with an encouragingly strong non-oil performance by Mexico. This trend represents the fruits of more realistic exchange rate policies and supply side reforms as well as what may prove to be only a temporary surge in non-food commodity prices. Doubts remain, however, about the sustainability or adequacy of fiscal and financial policies in a number of countries (eg Brazil and Argentina), and in most countries inflation rates have begun to rise again.

13 During most of August spot prices for non-food commodities continued to rise strongly. More recently, however, metal prices have begun to fall back as supply disruptions have eased. The recovery of industrial material prices this year may largely be in reaction to sharp falls in the latter part of 1986 which appeared to be overdone in relation to the underlying supply/demand balance; low stock levels may also have heightened the response of prices to temporary shortfalls in supply. If this is the case, further increases are likely to be limited as underlying demand growth is probably modest while supplies are thought to be plentiful. Food prices, important to many ldc exporters, have not shared in the recovery. Oil prices have fluctuated in sympathy with tensions in the Gulf. Evidence of production well in excess of OPEC quotas led to a $2 pb decline in spot prices which have since stabilised on news that OPEC's price monitoring and production committees would meet to try to restore OPEC discipline.

14 Demand and activity in the main markets for ldc exports recovered strongly in Q2, with signs of further growth in Q3, especially in the US and Japan. The recent weakness of the US dollar, in combination with the recovery in commodity prices, has revived inflation expectations leading to some strengthening of US interest rates. The relative strength of the DM and Yen has, however, led to some reversal of earlier upward pressure on long rates in Germany and Japan.

15 Since mid-July, capital market borrowing by ldcs has been largely confined to Asian borrowers. After some months of relative inactivity, S Korea returned to the market with borrowings by industrial and commercial companies of $850 mn including an FRN issue with a finer spread than of late. Three borrowings by Taiwan totalled

$510 mn, including two in the form of Euro-commercial Paper Programmes (ECPs) for banks. ECPs were also arranged for Korea's Goldstar and ICICI, India's Industrial Credit and Investment Corporation.

16 On 2 September, judgement was given in the High Court in favour of Libyan Arab Foreign Bank in its action against Bankers Trust to recover $292 mn frozen in London and New York following President Reagan's blocking of Libyan assets in January 1986. The judge ruled that LAFB's London account was governed by UK law and LAFB was entitled to payment of $131 mn blocked in London in cash, either in US dollars or in sterling. LAFB was also entitled to payment of $161 mn of which should have been transferred, under a cash management facility, from New York to London immediately prior to the freeze order on 8 January 1986. The verdict, which sets a significant precedent for the conduct of banking in London and has important implications for the Euro-dollar market, is likely to be appealed.

Further details on individual countries are given below.

Latin America and Caribbean

17 The IMF Board discussed Brazil's Article IV report on 14 September. While the report was generally favourable as regards the direction of economic policy, it expressed clear concerns over the adequacy of the measures taken, particularly the control of public sector finances [the PSBR in H1 amounted to 13-14% of GDP (1.9% operational)] and was not presented as the basis of a formal Fund programme. The MD's summing up is not thought to have been sufficiently positive to be taken as the "seal of approval" required by the Paris Club as a condition for rescheduling principal due in H1 1987. The Brazilians' attitude to the Fund remains ambivalent; there are signs that they would eventually be prepared to accept some form of monitoring. Brazil will be discussed among Paris Club creditors at the end-September meeting although no formal arrangements have yet been made for a meeting with the Brazilian authorities. Negotiations with Brazil's commercial bank creditors are due to begin on 23-24 September, following the Fund Board's discussion. A series of informal meetings to present the authorities' macroeconomic plan to creditor banks took place in early September. Brazil proposed the securitisation of half its debt at a discount reflecting the level of provisioning recently made by the banks but following discussions with the US Treasury the plan has been dropped. (See also para 4 above.) US commercial banks' attitudes to Brazil are thought to have hardened recently as a result of the Brazilian authorities refusing to make even a token interest payment before 20 August, the date on which interest on medium and long-term debt fell 180 days

overdue. UK banks also continue to take a firm line, stressing the need for Brazilia to seek a fully funded IMF programme to ensure that the financing burden is shared with official creditors.

18 Despite the freeze introduced in mid-June, prices rose 3% in July and by a reported 6.4% in August. Overnight interest rates have risen from 10% a month at end-July to 13% at end-August, and the real test of whether inflationary pressures have been significantly dampened will come as price controls are eased from end-August. It does not seem likely that additional fiscal measures announced at end-August will have much impact. There are more encouraging signs on the external front. The cooling-off of the domestic economy, and a more competitive exchange rate policy, have limited import demand and freed resources for exports: a July trade surplus of $1.42 bn, the highest ever, brought the total for January-July to $4.9 bn (cf $7.2 bn January-July 1986). If this performance continues the authorities will meet their $8.6 bn target for the annual trade surplus comfortably.

19 The final stage of Mexico's 1986-87 financing package was reached on 14 August with the start of the signature of the $9.7 bn FICORCA private sector restructuring arrangement. The terms are as for the public sector debt (20 years/7 grace, Libor +13/16%). It is now unlikely that the remaining $2.5 bn commercial bank financing for 1986-87 will be drawn because of the high level of gross reserves (an estimated $15 bn at end-July, cf $7 bn at end-1986). The preliminary trade surplus in H1, at $4.8 bn, was $200 mn higher than that for the whole of 1986, and strong oil prices have so far also precluded the need to draw on the banks' $1.2 bn oil contingency loan. In addition, non-oil exports have also performed well, rising 24% in January-May compared with January-May 1986. The H2 trade surplus is likely to be lower in response to the short term adverse impact of trade liberalisation, a slower rate of exchange rate depreciation and rising domestic demand. Although industrial production for January-May was 2.6% lower than in the first five months of 1986, manufacturing output has shown signs of a revival, with a 4.2% year-on-year rise reported for June. While the authorities appear to be united in the view that economic growth must come second to the control of inflation, the fiscal deficit (16.6% of GDP forecast for 1987) remains a major influence on inflation despite a sharp recovery in oil revenues, and the current policy stance seems unlikely to bring any immediate benefit. Prices rose 133.3% in the year to July (126.6% in the year to June), although an 8.1% rise in July is likely to have reflected the raising of the minimum wage level by 23%.

20 Commitments to the full \$1.95 bn of the new money loan for Argentina were received by 20 August, allowing the deal to be signed on 21 August. The package comprises a \$1.05 bn medium-term loan, a \$0.5 bn cofinancing with the IBRD, and a \$0.4 bn trade credit and deposit facility; in addition there is a \$2 bn money market standby facility and a \$30 bn restructuring of public sector and private sector debt. A few of the smaller banks have still not agreed to commit new money on the basis of their fair share, and the revised exit bond scheme, which permits banks to convert up to \$30 mn into bearer bonds at a 4% interest rate, has attracted take-ups by only 3 banks. However it appears that some banks (with, perhaps, Citibank taking the lead), will take advantage of the debt-equity conversion scheme in the package. The achievement of the critical mass of commitments for the bank package activated the SDR 1113 mn SBA, which had been approved in principle in February. By July, however, Argentina was significantly off track under the original programme and a revised programme for 1987, with substantially weaker targets for inflation and the PSBR, was approved by the Fund Board on 23 July. Recent economic developments have continued to be discouraging and the end-August performance criteria are almost certain to have been breached. Prices rose 13.7% in August, bringing the year-on-year inflation rate to 126.4% (cf the revised IMF target of 90% by end-year). An economic package introduced on 20 July to restructure public sector finances has met with little enthusiasm, with even those who support the package being sceptical about the authorities' will and capacity to implement the measures envisaged. Doubts will have been reinforced following Peronist gains in the September elections and by a hard line speech directed against the IMF by President Alfonsin shortly afterwards in which it was suggested that Argentina might seek a "cap" on real interest payments. However, the authorities subsequently sent telexes to the banks confirming that they will continue to service their debts normally, pending further negotiations. The external trade account continues to be adversely affected by an overvalued exchange rate: the trade surplus in H1 1987 was only \$610 mn (cf \$1.4 bn in the same period in 1986).

21 Against a deteriorating economic background, Venezuela continues to make slow progress towards signing the \$21.1 bn commercial bank MYRA. The cabinet and central bank have approved the amendment to the MYRA and the Advisory Committee and the authorities began signing on 18 September, with other creditor banks due to sign in time for the new October deadline for signature to be met. The authorities have had some minor success in obtaining new credits when, in July, Banco Indosuez headed a syndicate of mainly French and Spanish banks which provided Alcasa (the state aluminium entity) with a \$30 mn loan to prefinance imports; the loan was, however, associated with a major export credit package. Rumours that US banks are putting together a \$2 bn new money package for Venezuela seem unfounded, although the

authorities held preliminary discussions with banks in August on the possibility of financing on this scale following the signature of the MYRA. The Article IV mission, which visited Venezuela in June under the enhanced surveillance agreement, has not yet presented its report to the Board; it was concerned, however, about the direction of economic management and will be holding further talks with the authorities. Prices rose by 5.2% in July, despite the 120-day price freeze on essential goods introduced in May, bringing the cumulative increase in the first seven months of the year to 24.2% and the year-on-year rate of inflation to 31.8% (cf 10.1% at end-1986). Stronger domestic demand, particularly following wage increases in May, has more than offset the beneficial impact of high oil prices on the trade balance. Overall, reserves have fallen $0.9 bn to $8.6 bn since end-1986.

22 Chile's satisfactory economic performance under the IMF EFF continues, and the July review was successfully completed with all criteria having been met. In August, a World Bank mission visited Chile to study patterns of savings and investment in advance of negotiating a third SAL which would be scheduled for disbursement in November. Meanwhile it appears that buoyant domestic demand has led to a rise in inflation to 20.8% at end-August compared with the IMF's projection of 16% for end-1987. The tightening of controls on bank credit and the rise in domestic interest rates imposed at end-March has yet to curb demand pressures. The upturn in demand has, moreover, already been reflected in the external trade accounts. Imports in H1 at $1.9 bn, were 35% higher than in H1 1986. Thus despite the rising price of copper, which contributed to a 14% increase in exports in H1 1987 compared with H1 1986, the H1 trade surplus was only $530 mn, (cf $730 mn in H1 1986).

23 When Ecuador's SBA was cancelled in June because of a failure to meet performance criteria as a result of the earthquake, the authorities stated their intention of negotiating a new Fund programme. Finance Minister Espinosa held informal meetings with Fund staff in Washington in August and formal discussions have just started. Negotiations with the banks are now expected not to begin before early October. Oil production and exports have resumed. In compensation for output losses between March and August, OPEC has agreed to allow Ecuador to produce up to 320,000 bpd until end-1987 rather than the revised H2 production quota of 210,000 bpd. The authorities have also requested an extension to the payback period on oil loans from Venezuela and Nigeria to twelve months from December 1987 instead of seven. Meanwhile domestic inflation continues to rise, reaching 30.3% year on year at end-May (cf 27.3% at end-1986).

24 On 31 July the IMF completed its third review of Peru's arrears, which have now risen to SDR 306 mn, an increase of SDR 92 mn from the 13 February review. Debt service arrears to other creditors rose $1.2 bn in H1 1987 to $5.9 bn at end-June. Although an IMF mission visited Lima in early June, and the Fund hopes for an early completion of Article IV consultations, the authorities seem unlikely to agree to a rapprochement in the near future. Arrears to the World Bank reached $69 mn in July. Disbursements ceased earlier this year when payments fell more than 90 days overdue, and, after a lapse of 180 days, loans were placed a non-accrual basis on 3 August. Signs that creditor bank cohesion is crumbling have begun to appear, with Midland Bank announcing a countertrade agreement with Peru which is intended to clear $9 mn of the bank's exposure to Peru. President Garcia has adopted a significantly tougher stance towards the private sector and foreign creditors. His perception of the alleged unwillingness of the private sector to support plans for investment outside Lima is believed to have been behind the announcement of the nationalisation of the financial sector. Although legislation has been passed by the Chamber of Deputies and is currently with the Senate, an interim Presidential decree to intervene in the banks was ruled unconstitutional. Foreign banks are not at present included, but legislation could be amended to affect them too and Chase, one of six with local operations, had already begun negotiations to close its office. Political violence has increased further, and the President's nominee for Central Bank President was assassinated in August.

25 Although Colombia's trade balance has been affected by weaker international coffee prices, an increase in nontraditional exports has in part compensated. On the domestic side inflation has shown a slight upturn, to 26.7% year-on-year at end-July (cf 14.1% in July 1986) largely because of rises in prices of agricultural products. The authorities have reached an agreement in principle with a group of commercial bank creditors on the terms of a new money loan of $1.06 bn for 1987 and roadshows to market the loan were held in mid-September. The banks have asked for the release of the Fund's Article IV consultation documents. The IMF Staff, currently in Bogota, regard the general direction of policy as remaining acceptable. Bolivia's poor economic performance in H1 1987 prevented the authorities from making the last two purchases due under the SBA which expired in July. However, following an IMF mission to La Paz, a Letter of Intent forming the basis of an SBA or EFF has been agreed. There has been little progress on the commercial bank debt buy-back scheme, as the Fund has yet to agree to its involvement and most creditor governments remain reluctant to commit themselves. Uruguay's economic performance continues to be stable, and in July the IMF approved a request for enhanced surveillance in support of its MYRA until end-1989. Inflation remains the major domestic problem: although the rate of increase slowed

during the first half of the year, the IMF target of 50% by end-1987 is still in jeopardy. Despite the downturn in demand in Brazil and Argentina, export revenues are up on last year. Commercial banks have requested a postponement of Costa Rica's refinancing talks until after the Annual Meetings in order to have more time to consider the authorities' "menu" of options, which includes variable annual amortisation and interest capitalisation. IMF Staff are considering a request for an SBA before the conclusion of an agreement with the banks.

26 In early August the IMF Board discussed Jamaica's first review under the SBA. Although all performance criteria were met, those for public sector finances were close to the target ceilings and the Fund has agreed to modifications of the programme to allow increased capital spending. Prime Minister Seaga's debt plan announced in March, which primarily targets reductions in the debt service ratio for small, middle income debtors and calls for an enhanced role for the IBRD, may be tabled at the meeting of Commonwealth Finance Ministers meeting in Barbados. A Paris Club task force visited Cuba from 9-12 July to prepare a draft economic report in preparation for the next round of rescheduling talks. The report is generally gloomy and detects few signs of structural adjustment.

South and East Asia

27 In the Philippines, output continues to recover with a year-on-year increase in H1 of 5.1%, a significant improvement on last year's 1.5% and an 11% fall between 1983 and 1985. The official growth target for the full year has, nevertheless, been scaled down to 5.8% from an ambitious 6.8%, and even this could prove to be optimistic given heightened uncertainty following the latest coup attempt. All the cabinet has offered its resignation and Ongpin has been replaced as Finance Minister by Vicente Jayme, also thought to be a moderate on the debt issue. The current account moved into a deficit of $230 mn in the first half of 1987 compared with a surplus of $435 mn in the comparable period last year. Higher imports combined with lower services receipts appears to be the main explanation. A recent IMF mission agreed to recommend to the Board that year-end targets for reserves and the current account surplus be scaled down. The inauguration of the new Congress has been marked by hawkish statements on the debt issue by both the President and some members of the pro-Aquino majorities in both Houses, and at least three draft bills proposing either selective repudiation or limitation of service payments have been tabled. Barclays has been singled out for particular criticism following its insistence that commitments by the Marcos regime to debts incurred by a fertiliser company, Planters Products Inc, be honoured.

28 Firmer oil and commodity prices, combined with an increase in exports of manufactures, are helping to foster a tentative recovery in the Malaysian economy. Current estimates point to trade surplus in the order of $4 bn in 1987, compared with a $3.3 bn surplus in 1986. The current account may be in balance, or even register a small surplus in 1987 - the first in 8 years. Although projections for GDP growth in 1987 hase been revised upwards to 3%, this compares poorly with the 8%-9% average for the 1960s and 1970s.

29 Despite higher oil prices and some evidence of successful diversification into non-oil exports, external prospects for Indonesia remain fragile. A drastic liquidity squeeze initiated to stem capital flight has apparently succeeded in attracting back about half the outflow that took place between May and early July. Indonesia remains, nevertheless, vulnerable to panic outflows and reserves are now 1/3 lower than at end-1986.

Eastern Europe

30 Poland has reached agreement with its commercial creditors on the broad outlines of a six year, two stage MYRA which will consolidate all of its medium and long term commercial debt under one agreement and reschedule it over fifteen years at Libor +15/16%. The banks have also agreed to extend the final maturity of the $1 bn revolving credits by two years to 1991. Official creditors, who have indicated their willingness to reschedule all arrears outstanding and all payments due until end 1988, hope that the Poles will attend the Paris Club in October.

31 Confronted with an external financing gap in excess of $1 bn in 1987, and the prospect of a very tight liquidity position in 1988, Yugoslavia has concluded that it cannot continue to service its external debt and has decided to develop a programme for longer term stabilisation of its external payments position. Following a 90 day moratorium on the payment of $240 mn principal to the commercial banks, negotiations were originally due to recommence in September but have been postponed to October. Initial approaches to major official creditors have already been made, and a formal approach to the Paris Club is expected in October. Neither set of negotiations is likely to be successful without an IMF standby. Although the IMF is due to return to Belgrade in September to discuss a package of adjustment measures, it is by no means certain that the government will be reconciled to a Fund programme. Creditor confidence will have been further dented by the financial scandal over Agrokomerc, the 24th largest company in Yugoslavia, which has been found to have issued illegally up to $500 mn or more of uncovered promissory notes, affecting 63 banks across the country. Though similar practices are widespread

throughout Yugoslavia, this scandal has implicated leading politicians and businessmen and led to the resignation of the country's Deputy President, while the National Bank is apparently prepared to let a small local bank at the heart of the matter go bankrupt.

32 Hungary's economic performance remains poor and the policy response by the authorities continuing to be disappointing. The convertible-currency current account deficit in H1 is estimated at $0.8 bn, some $50 mn less than H1 1986, but there are signs that easy access to the capital markets is ending - the latest $400 mn credit experienced difficulty in syndication despite the higher margin (Libor +3/8% against Libor +1/4% in February). At Hungary's request, an IMF mini mission visited Budapest in mid-August and formal discussions on a SBA are expected to begin in September. The banks' steering committee has reached agreement with Romania on a reduction in the spread on the 1986 re-rescheduling agreement (from Libor +1 3/8% to Libor +7/8%) and hope that they can proceed with selling the agreement now that arrears to the IBRD have been reduced.

Southern Europe

33 In Greece disappointing economic performance in the first half of the year has led to a pessimistic revision of targets for inflation and the current account deficit. The authorities have acknowledged the need to continue the austerity policy into next year. A $100 mn credit was raised at the end of July by the Public Power Corporation on slightly finer terms than for a comparable loan last year, and was followed by a DM 150 mn bond in September by the same borrower.

34 Developments in Turkey continue to give some cause for concern. A high level of inflation persists and the likelihood of measures to restrain the rapid expansion of the economy in the run up to the election called for November is remote. Whilst in the six months to June the trade balance had shown some improvement, July's outcome eliminated earlier gains with a substantial leap in imports and weaker exports. Despite improved invisible receipts, it now seems unlikely that Turkey's current account this year will show any significant improvement over the $1.5 bn deficit in 1986.

Sub-Saharan Africa

35 The Nigerian financing package is under considerable strain. A recent IMF mission was unable to complete the already delayed SBA review because of slippages in fiscal policy. The Fund staff will concentrate on formulating a new programme for next year. Foreign exchange market reforms have had, however, some success.

Negotiations for the World Bank's Trade and Investment Loan have been held up for lack of an effective programme and signature of the commercial bank 1986/7 rescheduling agreement has been delayed. The situation has been additionally complicated by Nigerian proposals for rescheduling promissory notes. The proposals include the immediate termination of the verification process and terms which, in the opinion of LDTC, will be unacceptable to the noteholders it represents. LDTC has responded with counter-proposals and awaits the Nigerian reply. There is a risk that trade creditors who have not yet received promissory notes in respect of their claims will take legal action. This could trigger a parallel response from noteholders which in turn could lead to a seizure of assets as well as potentially triggering cross-default clauses on bank loans.

36 The moratorium in Cote d'Ivoire shows no immediate sign of easing. The August meeting with the London Club went badly with no definite date being set for new negotiations. The timetable for a Fund Board discussion on a new SBA (including a CFF and possibly a SAF) has now slipped to 10 December and any eventual programme still seems likely to be a soft one. The Ivoriens do not seem to be unduly perturbed and may well be awaiting the outcome of events in Brazil. Meanwhile economic conditions continue to deteriorate. Although the dollar/CFA Franc rate has stabilised, cocoa and coffee prices remain weak. Recent figures show that the trade surplus shrank by a third in the first eleven months of 1986 whilst real GDP is expected to fall by one percent this year. In mid-August the authorities in Zambia finally announced their much-delayed alternative New Economic Recovery Programme (NERP). While the programme aims to achieve growth from Zambia's "own resources", it remains heavily dependent on assumed capital inflows from donors. The programme seems doomed to failure. Ingredients include an exchange rate of \$1=K8 (over K4 below the mines' current break-even point), production and growth targets which are clearly optimistic, unsustainably high levels of investment with a misplaced emphasis on industry rather than agriculture, and no measures to reduce the budget deficit.

37 In Zimbabwe, the budget for 1987/88 fails to address major problems. The budget assumes no growth (in contrast, local Zimbabwean sources expect GDP to fall by 3%-4%) and aims for a virtually unchanged deficit (11% of GDP in 1986/87). Its measures fall well short of those envisaged by the IMF in the recent Article IV discussions as necessary for medium-term sustainable growth.
The economic recovery in South Africa is not continuing as strongly as first hoped. The Reserve Bank has said that GDP growth in 1987 is unlikely to reach the government's target of 3% - the third year in which growth targets have not been reached.

38 After more than two years of inconclusive contacts, Sudan and the IMF have reached agreement on adjustment policies which could provide the basis for an IMF programme. The draft programme includes the reduction of domestic subsidies, devaluation, exchange rate unification and parastatal reform. However, many details have yet to be worked out, not least the substantial assistance which will be required from donors to repay IMF arrears (now over $500 mn), reschedule offical debt, finance immediate supplies of essential commodities, and provide new money to meet large financing gaps in 1987 and beyond. There are also uncertainties about Sudan's ability to carry out the politically very sensitive adjustment measures, particularly given the serious dissensions within the coalition government.

Middle East & North Africa

39 As expected, Egypt is likely to have considerable difficulty in meeting IMF requirements at the first SBA review in September. Credit ceilings have probably been breached and the budget for FY87-88 lacks credibility in the absence of further, revenue-raising measures. While reforms to the exchange system have increased the flow of foreign exchange through official channels, the new regulations have effectively prevented branches of foreign banks, including Lloyds, from doing business, and the authorities have yet to respond to their complaints. Questions remain over the financing of the SBA and little, if any, progress has been made in bilaterals under the May Paris Club agreement. IMF staff are doubtful of Egypt's ability to strengthen the programme as earlier promised. Morocco's IMF programme still appears broadly on track, although the delay in signing the banks' rescheduling agreement - not now expected until October - may require a further waiver on external arrears. Algeria has continued to benefit from firmer oil prices and has managed to secure new official and commercial credits. But banks remain cautious, and further substantial inflows are still needed if Algeria is to honour amortisation payments of around $4 bn this year as well as finance its current account deficit.

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INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1986*	End-Dec 1986	End-March 1987 [2]	End-March 1987 [3]
Latin America				
Argentina	52	3.0(0.2)	0.2	0.2
Brazil	110	6.6(1.4)	1.0	1.9
Chile	19	1.3(0.1)	-	0.1
Colombia	15	0.6(0.1)	0.1	0.1
Costa Rica	4	0.1(-)	-	-
Ecuador	8	0.5(0.1)	0.1	0.1
Jamaica	4	- (-)	-	-
Mexico	98	6.3(0.7)	0.7	1.3
Peru	15	0.3(-)	0.1	0.2
Uruguay	4	0.3(-)	-	-
Venezuela	36	2.1(0.1)	-	-
Far East				
Indonesia	42	0.8(0.3)	0.9	1.8
Malaysia	21	1.1(0.3)	0.1	0.1
Pakistan	15	0.2(0.2)	0.1	0.1
Philippines	29	1.3(0.2)	0.1	0.2
Eastern Europe (convertible currency)				
Bulgaria	5	0.3(0.1)	-	0.1
Hungary	15	0.3(-)	-	0.1
Poland	34	0.6(-)	1.3	1.4
Romania	6	0.2(-)	0.3	0.4
Yugoslavia	19	0.8(0.1)	0.7	0.9
Southern Europe				
Greece	20	1.2(0.2)	0.1	0.3
Turkey	31	0.5(0.3)	0.2	0.6

[1] Defined as consolidated external claims including portfolio investments with a contractual repayment date, adjusted for certain inward and outward risk transfers in respect of guaranteed loans, plus any net claims on local residents in local currency. Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans. Other portfolio investments in these 36 countries amounted to $8.9 million at end-December 1986.

[2] Defined as ECGD-guaranteed loans disbursed, plus political claims paid and claims under examination.

[3] Defined as ECGD-guaranteed loans (disbursed and undisbursed) and contractual interest, plus political claims paid and claims under examination.

* Current estimate.

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INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1986*	End-Dec 1986	End-March 1987 [2]	End-March 1987 [3]
Sub-Saharan Africa				
Cote d'Ivoire	9	0.3(-)	0.1	0.1
Kenya	4	0.1(0.1)	0.2	0.5
Nigeria	20	1.3(0.2)	2.5	3.5
South Africa	22	3.6(0.6)	0.9	2.5
Sudan	11	- (-)	0.2	0.2
Zambia	6	0.2(-)	0.2	0.2
Zimbabwe	2	0.2(0.2)	0.2	0.3
Middle East and North Africa				
Algeria	27	0.4(0.1)	0.2	0.4
Egypt	45	0.2(0.2)	0.3	1.3
Iraq	55[4]	0.1(-)	0.6	1.6
Israel	32	0.4(0.1)	0.1	0.2
Morocco	18	0.2(-)	0.2	0.3
Oman	3	0.1(0.1)	0.7	1.9
Saudi Arabia	14[5]	0.6(0.2)	0.2	0.3

[4] Includes $30 bn from Arab countries.
[5] Excludes unguaranteed non-bank claims.

OVERDUE FINANCIAL OBLIGATIONS TO THE FUND*

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding as at 14.8.87 (SDR mn)
Kampuchea	13 March 1975	30.3
Guyana	31 May 1983	59.9
Viet Nam	6 February 1984	73.7
Sudan	12 July 1984	481.1
Liberia	25 January 1985	151.4
Peru	9 September 1985	305.8
Zambia	30 April 1986	242.4
Nicaragua	15 September 1986	0.3
Sierra Leone	16 January 1987	12.3
Somalia	2 July 1987	6.6
		1,363.8

NB The above figures are derived from Fund papers issued with respect to individual country complaints. There will have been further overdue obligations falling due subsequently, so the figures are not completely up-to-date. A Fund source indicates that total arrears were SDR 1,380.3 mn as at 24.8.87, but this figure is not divided country by country.

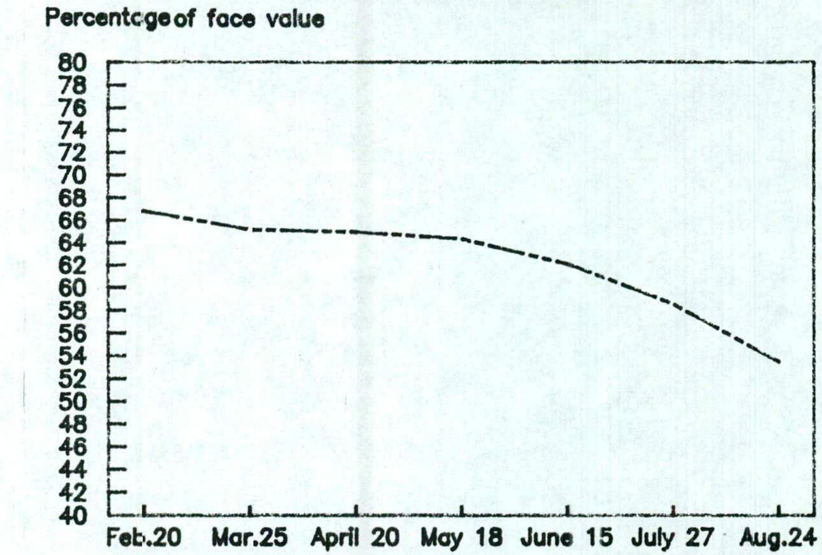
* For members with at least one obligation with respect to repurchases or charges overdue for more than one month.

Guyana, Viet Nam, Sudan, Peru and Liberia are ineligible. Kampuchea is out of contact with the Fund. Zambia will be declared ineligible at end-September unless it has given firm indications of an intention to clear arrears in the interim.

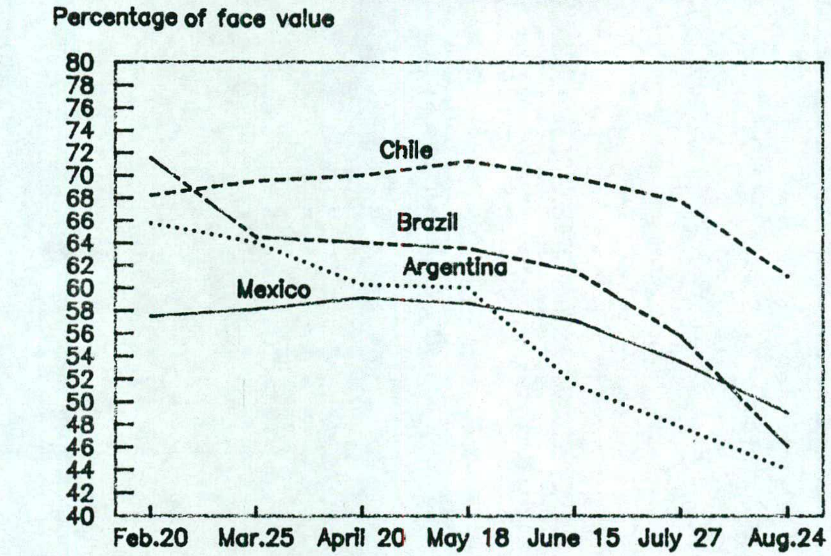
CHART 1

SALOMONS SECONDARY MARKET PRICES

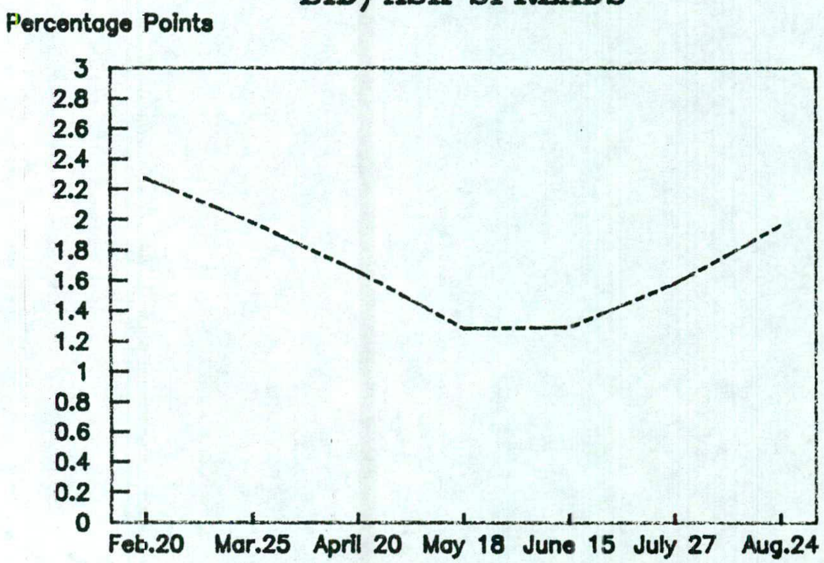
ALL IDR COUNTRIES (WEIGHTED AVERAGE)
MIDDLE PRICES



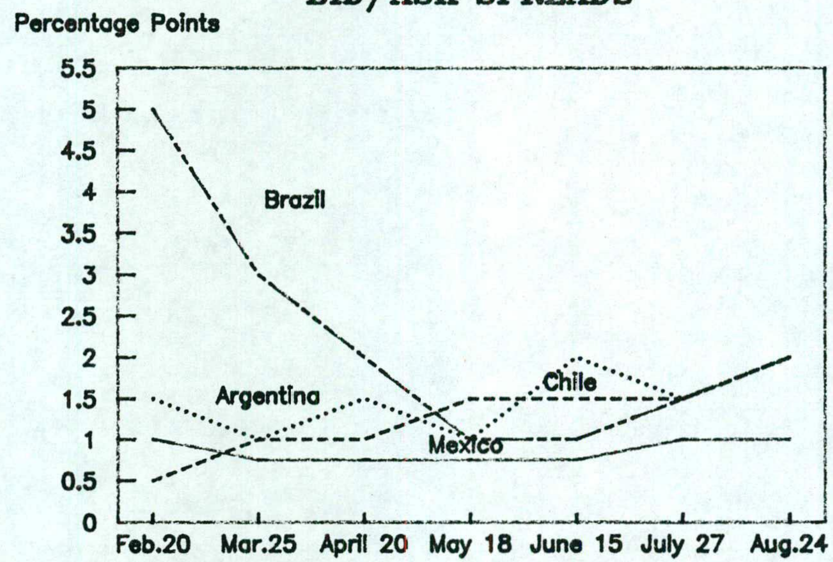
SELECTED MAJOR DEBTORS
MIDDLE PRICES



BID/ASK SPREADS



BID/ASK SPREADS



Ch/
Content for me to write as proposed?
AF 10/2

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Revised version attached.

FROM: MRS A F CASE
DATE: 9 February 1988

draft slightly amended
AL

1. MR LANKESTER
2. CHANCELLOR OF THE EXCHEQUER 10/2

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Scholar
Mr Evans
Mrs Lomax
Mr Mountfield
Mr Allen
Mr Davis
Miss Higgins
Mr Cassell - UKDEL/IMF

OK as amended, subject to checking the point I have marked re Community proposals. NL

INTERNATIONAL FINANCIAL SCENE

I attach the final version of the Bank of England's paper reflecting discussion in your Group on the international debt scene, together with the usual draft letter to No 10.

MRS A F CASE

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~~DRAFT~~ LETTER TO ~~No 10~~

C Powell Esq.
No 10
Downing Street

cc PS/Foreign Secretary
PS/Secretary of State for Trade & Industry
PS/Governor

INTERNATIONAL FINANCIAL SCENE

I attach the first regular report of 1988 on developments in the international debt scene.

2. The economic outlook for 1988, as it affects the evolution of the debt problem, remains essentially unchanged since our last report. Industrial countries' growth is expected to be just under 3%, although slowing towards the end of 1988 and in 1989; with sustained growth in world trade. US dollar interest rates have remained broadly unchanged over the past few weeks, kept down for the moment by fear of recession in an election year; and real commodity prices overall have continued to rise, ~~This~~ which should benefit debtor countries. However, there are some ~~downside~~ risks, in particular the implications for trade and growth if there were to be renewed downward pressure on the dollar.

is this really true (see later para of commodity prices)?

3. Over the next few weeks there will be important discussions of the debt problem in the run up to the April meetings in Washington. These will take account of current developments, in particular the tendency for the commercial banks to become more

fragmented in their approach, their reluctance to participate in new money packages, and the emergence of market based ideas such as the Mexican buy-back scheme. We will be looking to these new ideas to develop the existing strategy rather than overturn it. Thus, we will continue to emphasise the need for appropriate policies and strong adjustment on the part of the debtors, and the need for the banks to continue to have the prime responsibility for the working out of their debt problems. The April Meetings - and the Summit if the Canadians have their way - will focus more on the middle income debtors than on the poorest. The impact of debt problems on the world economy will be on the agenda for the OECD Ministerial meeting in May.

4. Turning to individual countries, the ~~very~~ most recent developments in Brazil look more encouraging. The Brazilian Government appears to have re-evaluated the costs of the confrontational approach and is now seeking normalisation of ~~their~~ its relations with the international financial community. As a first step ~~they~~ the Brazilians have made an unconditional payment to the commercial banks of some 1988 interest due in order to get negotiations on a medium term package moving ahead. The Government has also said that it will negotiate a programme with the IMF and a deal with Paris Club creditors. Among G7 Governments there is agreement that such an IMF programme must

precede any Paris Club rescheduling or a resumption of export credit cover. But the real test will be whether the Government of Brazil is prepared to adopt realistic measures to strengthen its economy.

5. For Mexico, the main focus is on the outcome of the debt buy-back scheme. This involves bank creditors swapping rescheduled debt for higher yielding 20 year bonds whose principal (but not interest) is backed by US Treasury securities. The likely outcome of the operation is difficult to judge at this stage. It seems unlikely that the US majors will bid, although the US regional banks may well treat the offer as an exit bond. UK banks seem unlikely to make more than token bids. Once we can evaluate the success of the Mexican operation, we will need to consider whether it - or versions of it - would provide a useful addition to the strategy. Other debtors may well come forward with similar proposals. Only Chile so far has asked its commercial bank creditors for changes in existing agreements to give ~~them~~ it the flexibility to contemplate a similar arrangement in the future.

6. The outlook for several other major debtors is poor. Argentina appears to be fast running out of money. The Argentines are being asked by the Fund to adopt additional measures to prevent the existing Fund programme from collapsing. In the

meantime bridging finance is likely to be needed and the Argentines have looked to the US for help. If Brazil really does re-establish relations with its creditors, the US authorities may be more inclined to lean on the Argentines to implement a stronger programme.

7. The Yugoslav liquidity position is also becoming acute. They may turn to the BIS for a bridging loan in the near future. The Paris Club has emphasised the need for a strong IMF programme as a pre-requisite for any rescheduling of official funds. However a recent Fund mission made no progress. Despite their anxiety to conclude an early Standby Arrangement, the Yugoslavs seem unwilling and unable to engage in serious discussion.

8. Egypt too continues to pose problems. It was clear from President Mubarak's recent talks with UK Ministers that the Egyptian authorities are unlikely to agree to the necessary measures to enable the current IMF programme to continue. He seems to have taken the same line in his talks in Washington and Bonn where he was also urged to reach early agreement with the Fund. We shall want to keep up pressure on the Fund to ensure adequate conditionality in the Egyptian (and other) programmes. We will be keeping in close touch with Fund staff

on this and with the Executive Directors of other G7 countries.

I am copying this ~~le~~ letter and enclosure to Robert Culshaw (FCO), Jeremy Godfrey (DTI) and John Footman (Bank).

JMG T—
P— S—

BF 11/4

British Embassy
3100 Massachusetts Avenue NW Washington DC 20008
Telex Domestic USA 89-2370/89-2384
Telex International 64224(WUI)/440015(ITT)
Telephone (202) 462-1340

Mrs J R Lomax
HM Treasury
1 Parliament Street
LONDON SW1P 3AG

Your reference

Our reference

Date 22 March 1988

Dear Rachel

PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS

1. You may be interested to see the attached release giving the official notification of the establishment of the Baker Working Group on Financial Markets.

2. I am sending a copy of this letter to David Green in the Bank of England and David Smith in DTI.

Yours
Richard

R C PRATT

cc: D W Green Esq, Bank of England
David Smith Esq, DTI

PPS

cc. PS/EST
Sir P. Middleton
Sir G. Littler
Mr Wanless
Mr Scholar
Mr Walt
Mr Peirson

We will give the Chancellor some (short) defensive briefing, in case Baker [illegible] on eg current [illegible] in the margins of the April meetings.
RL. 28/3

10/9/29

THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release March 18, 1988

EXECUTIVE ORDER

\- - - - - - - -

WORKING GROUP ON FINANCIAL MARKETS

By virtue of the authority vested in me as President by the Constitution and laws of the United States of America, and in order to establish a Working Group on Financial Markets, it is hereby ordered as follows:

Section 1. Establishment. (a) There is hereby established a Working Group on Financial Markets (Working Group). The Working Group shall be composed of:

(1) the Secretary of the Treasury, or his designee;

(2) the Chairman of the Board of Governors of the Federal Reserve System, or his designee;

(3) the Chairman of the Securities and Exchange Commission, or his designee; and

(4) the Chairman of the Commodity Futures Trading Commission, or her designee.

(b) The Secretary of the Treasury, or his designee, shall be the Chairman of the Working Group.

Sec. 2. Purposes and Functions. (a) Recognizing the goals of enhancing the integrity, efficiency, orderliness, and competitiveness of our Nation's financial markets and maintaining investor confidence, the Working Group shall identify and consider:

(1) the major issues raised by the numerous studies on the events in the financial markets surrounding October 19, 1987, and any of those recommendations that have the potential to achieve the goals noted above; and

(2) the actions, including governmental actions under existing laws and regulations (such as policy coordination and contingency planning), that are appropriate to carry out these recommendations.

(b) The Working Group shall consult, as appropriate, with representatives of the various exchanges, clearinghouses, self-regulatory bodies, and with major market participants to determine private sector solutions wherever possible.

(c) The Working Group shall report to the President initially within 60 days (and periodically thereafter) on its progress and, if appropriate, its views on any recommended legislative changes.

more

(OVER)

Sec. 3. Administration. (a) The heads of Executive departments, agencies, and independent instrumentalities shall, to the extent permitted by law, provide the Working Group such information as it may require for the purpose of carrying out this Order.

(b) Members of the Working Group shall serve without additional compensation for their work on the Working Group.

(c) To the extent permitted by law and subject to the availability of funds therefor, the Department of the Treasury shall provide the Working Group with such administrative and support services as may be necessary for the performance of its functions.

RONALD REAGAN

THE WHITE HOUSE,
March 18, 1988.

# # #

THE GOVERNOR'S PRIVATE SECRETARY HO-P
THE DEPUTY GOVERNOR'S PRIVATE SECRETARY HO-P
MR LOEHNIS HO-P
MR GEORGE HO-P
MR W A ALLEN HO-P
MR ALTHAUS HO-G
MR A F BUSHELL HO-4
MR CHARKHAM HO-4
MR T A CLARK HO-M
MR COLEBY HO-P
MR FOOT HO-2
MR GILL HO-3
MR GREEN HO-3
MR J G HILL HO-G
MR LATTER HO-2
MR KIRBY HO-3
MR PLENDERLEITH HO-P
MR PRICE HO-3
MR SMEETON HO-2
MR TOWNEND HO-P
MR WARLAND HO-1
MR ARROWSMITH HO-3
MR BAILEY HO-2
MISS C M BALFOUR BB-4
MR BRIAULT/
MR M E F JONES HO-G
MR BROOKES HO-4
MR CARTER HO-M
MR CLEWS HO-4
MR COLLINS HO-M
MR DE HOEST HO-4
MR DORRINGTON HO-4
MR G I EVANS HO-2
MR EXETER HO-2
MISS T A GRAY HO-G
MISS HOPKINSON HO-3
MR ILES HO-3
MR JENKINSON HO-2
MR M R LEWIS HO-3
MS M V LOWTHER HO-G
MR MACKIE HO-4
MR McCONNACHIE HO-G
MR C M MILES HO-2
MR MILNE HO-G
MR MORTIMER-LEE HO-G
MR PAGE HO-2
MR SAGAR HO-3
MR I D SAVILLE HO-2
MRS SERGEANT HO-3
MR SHEPPARD HO-4
MS STONEFROST HO-M
MR THORP BB-1
MR TUCKER HO-G
MR URWIN HO-2
MR R G WARE HO-3
MR R P WEBSTER HO-3
MR P A D WRIGHT HO-4
DEALERS GIMLET HO-2
GROUP 9, ID HO-2
GROUP 11, ID HO-2
GROUP 12, BSD HO-2
LORD RICHARDSON PADS

US FINANCIAL DEVELOPMENTS

The latest weekly summary of developments in monetary policy and the financial markets is attached.

NS X – v. similar to BoE PR last week!
(also Y – NS "at present")

International Division
Group 1, HO-3
2 November 1988

R T Thorne (4385)

RTT

SUMMARY: 24-31 OCTOBER

- The Fed reportedly intervened this week for the first time since the dollar's latest decline began last month, apparently confirming market expectations of concerted intervention if the dollar fell below Y125.

- Treasury note and bond yields fell by 10-15 bp last week in response to further signs of a slowdown in economic growth and something of a flight to quality from other US markets.

- The Treasury Department issued the first of a newly mandated six-monthly series of reports to Congress on international economic policy. In it, the Treasury forecast that the trade deficit would decline by an unspecified amount in 1989, even if the dollar remained at current levels. It also officially accused South Korea and Taiwan of manipulating their currencies in order to maintain large trade surpluses, and is seeking talks with the two countries. Hong Kong and Singapore were deemed not to have manipulated their currencies.

- In Greenspan's replies to Congressional questions:

(i) he said that, while the dollar was an important factor in monetary policy, it was not the major factor;

(ii) he claimed that pessimistic forecasts of the trade deficit do not take into account all the factors influencing the supply of exports; N.B.

(iii) he said there was no need at present for the Treasury to issue foreign-currency-denominated securities;

and (iv) he rejected the idea that monetary policy could be based on Manuel Johnson's three financial market indicators.

- Bank reserves data indicate an unusual unwillingness of banks to borrow from the discount window, which might necessitate a rather higher Fed funds rate for the present in order to meet the same Fed discount window borrowing target. Alternatively, the FOMC could decide to reduce its borrowing target at this week's meeting, for purely technical reasons, in order to leave the Fed funds rate target unchanged.

POLICY

(a) <u>The dollar and US trade</u>

1 <u>The Fed apparently intervened</u> on Monday and Tuesday for the first time since the dollar's latest decline began last month, in a co-ordinated action with the Bank of Japan. It reportedly bought $200-300 mn on Monday, but we have not seen reports of the amount of purchases on Tuesday. The move seemed to confirm market expectations that concerted intervention would take place if the dollar fell below Y125, and that the bottom of the G7 target (at least in the short-term) had thus been found. The dollar dipped below Y125 on both days, but rebounded somewhat following each intervention.

2 The day's events illustrated the greater market impact intervention has had this year compared with last, a fact recognised in a <u>Treasury report to Congress</u> published last week. "Intervention can be more helpful than previously thought", according to the report, which is the first of a new six-monthly series of reports on international economic policy mandated under this year's trade law. The report also forecast a $30 bn decline to $130 bn in the trade deficit this year and a $20 bn decline to $134 bn in the current account deficit, and said that the trade deficit would continue shrinking in 1989 even if the dollar remained at current levels. (The report is dated 15 October, but is not known what, if any, specific levels were taken by the Treasury as "current".) However, one House Banking Committee member criticised the Treasury for not putting figures on its forecasts for future years, as he claimed Congress had intended that it should when instituting the report.

3 The Treasury report also officially accused <u>South Korea and Taiwan</u> of manipulating their currencies in order to maintain large trade surpluses. As mandated by the new trade law, it is now seeking talks with both countries to persuade them to revalue their currencies and will report back to Congress in six months. The Treasury decided, however, that although <u>Hong Kong and Singapore</u> also had large trade surpluses, they had not manipulated their currencies. <u>Japan and West Germany</u> were given credit for moving from export-led to domestic-demand-led growth, but Japan

more so than West Germany. Separately, Assistant Treasury Secretary David Mulford was quoted in the Japanese press as saying that a further dollar fall is needed to adjust the trade deficit, but this has not been confirmed.

4 Fed Chairman Greenspan also discussed the dollar and trade in written answers to questions submitted to him at his July Humphrey-Hawkins testimony. His remarks attracted a good deal of market attention, but not too much should be read into their timing. The answers were dated 17 October, but the questions replied to were of course dictated by Congress in July. (In the same way, Greenspan's remarks on LBOs were prompted by Congressional questions rather than recent weeks' events.)

5 He attracted the most attention by saying that the dollar is an "important" consideration in monetary policy and that it has at times been accorded very high priority in policy decisions. Not only was the remark's timing of no particular significance, but many commentators omitted to mention his qualifying remark that even during 1987, when the dollar was given a great deal of weight in policy, it was not the exclusive, or even the major, factor behind the rise in interest rates and the slowing of monetary growth during that period. Instead, the major factor was concern about a resurgence of inflation more generally. Thus, the bottom line seems to be that the dollar is subsidiary to domestic economic conditions when deciding policy.

6 Greenspan also seems to believe the large foreign debt of the US has less effect on US monetary policy than Volcker had thought while he was Chairman. "The key factor making monetary management sensitive to international considerations is the high degree of international market integration rather than the net debtor status, per se, of the US." (Volcker tended to stress more the risk that foreign confidence in dollar investments could be eroded by a sustained trade deficit.) International integration was a theme Greenspan took up in a Wall Street Journal article, arguing that the process was inevitable as new technology increased the ease with which cross-border trade could take place, and that co-ordination of international economic policies was thus bound to expand.

7 Greenspan backed up the Treasury's view on the external deficit, saying that there was no reason to believe that the current account deficit would not continue to narrow at prevailing exchange rates. He criticised economic models which suggested that the deficit might begin to deteriorate in the 1990s if exchange rates were to remain unchanged, saying that the unprecedented size of exchange rate movements in recent years made prediction particularly difficult, and that the models did not take account of factors such as a likely increase in US productive capacity and future actions to cut the budget deficit. However, he conceded that some of the Fed's own models predicted a deterioration in the deficit in the 1990s.

(b) Foreign-currency-denominated bonds

8 Greenspan also told the Senate Banking Committee that there does not appear to be any need at present for the US government to issue foreign-currency-denominated securities. He said that generally speaking the only purpose for issuing such securities would be to obtain foreign exchange funds for intervention, but that there were many alternative sources of such funds. Also, if the Treasury were not to use the funds immediately for intervention, it would end up borrowing long-term and investing short-term, thus leaving itself open to losing money on the spread if rates remained close to current levels.

(c) Monetary Policy

9 Greenspan gave no real clue about the current stance of domestic monetary policy. Although some commentators tried to find some significance in his denial that monetary policy is excessively tight at present, he could hardly have said otherwise. Certainly there does not seem to be any prospect of an imminent easing, despite the slowdown in the economy implied by the Q3 GNP figures. The Administration said that it believes there is no need to tighten at present, a signal that it is so confident that there will be no change in policy resulting from the 1 November FOMC Meeting that it feels such a statement is uncontroversial.

10 Greenspan indicated that the Fed was still pursuing an eclectic policy and, in reply to a specific query, he rejected the idea that monetary policy could be based on a limited series of "price" indicators such as Vice Chairman Manuel Johnson's financial market indicators - the dollar, commodity prices and the yield curve. While these indicators did convey some useful information, he said, "even if all these three indicators, along with others, were all moving in a consistent direction and all were reflecting the recent tightening of monetary policy, that information alone could not answer the question of whether monetary policy was becoming too tight". Johnson himself has in the past backtracked on the importance of these indicators, but Greenspan's remarks may still constitute something of a rebuff to those Fed Governors most convinced that the Fed's tightening this year has already slowed the economy satisfactorily.

(d) Boston Fed President

11 Richard Syron has been appointed to succeed Frank Morris, who has been President of the Boston Federal Reserve Bank since 1968. Morris is said to have been grooming Syron for a regional Fed Presidency since 1975. Syron is currently President of the Boston Federal Home Loan Bank, and has previously been Deputy Assistant Treasury Secretary (1979-80) and assistant to Volcker at the Fed Board (1981-2). While as a Volcker and Morris protege he can be assumed to fit in with the "old style" policies advocated by several regional Fed Presidents, as opposed to the views of several Fed Governors, little is directly known abut his monetary policy views.

MONEY

13 M2 and M3 both rose by 0.2% in the week ending 17 October, their second consecutive week of solid growth. M1, however, fell by 0.2%, thus continuing its weakness in recent months.

RESERVES AND POLICY IMPLEMENTATION

14 Average adjustment and seasonal borrowing from the Fed's discount window fell $189 mn to $411 mn in the week ending 26 October. The level of borrowing was the lowest since June,

and well under the Fed's perceived fortnightly maintenance period target of $600 mn. It contrasted sharply with the 8.29% average Fed funds rate, which has remained for several weeks distinctly above the previously perceived 8 1/8% target.

15 Analysts have become increasingly convinced that the explanation of this apparent paradox is that Fed policy has remained unchanged but banks are unusually unwilling to go to the discount window at present. This may be partly because banks borrowed heavily from the Fed at the end of Q3 and want to preserve their ability to borrow again at year-end by not going to the discount window much in the intervening period. Whatever the reason, if the Fed wants to hit its fortnightly target, it must force borrowing of $800 mn in the current week, and analysts suggest that the Fed funds rate may have to rise to 10% on the final day of the week to accomplish this.

16 In the longer term, if this borrowing pattern persists for a while, a higher average Fed funds rate (of 8 1/2% according to one suggestion) may be needed to achieve the borrowing target, or the FOMC might even decide at its 1 November meeting to lower the borrowing target in order to achieve an average Fed funds rate closer to 8 1/8%.

MARKET DEVELOPMENTS (24-28 October)

17 Treasury note and bond yields fell by 10-15 bp last week in response to further signs of a slowdown in economic growth and something of a flight to quality from other US markets. The 2.2% Q3 GNP growth figure was 1% point below expectations, but the effect of this on bond yields was muted by the dollar weakness which the GNP figure also caused, and by the unhelpful breakdown of the figure. The personal consumption component showed continued strength, as did the GNP deflator, while weaker components included net exports and potentially one-off factors such as farm inventories and defence spending. Still, the separately released weak September personal income and consumption data and durable goods orders supported the message of the overall GNP data.

18 Both stock market weakness and, particularly, the continuing anxieties over LBOs in the corporate debt market also increased the relative attractiveness of Treasury securities. However, the 30-year bond underperformed the market by close to 5 bp now that Congress has allowed the long bond to be part of next week's refunding auction (provided the President signs the tax technical corrections bill).

19 The dollar weakened only slightly over the week as a whole, as technical short-covering partly balanced longer-term bearishness. The market also remained cautious about concerted intervention, which was thought by many analysts to be likely to be triggered if the dollar were to fall to DM1.75 and Y125. (The suspected yen trigger was borne out by this week's events so far).

TREASURY AUCTIONS

Monday	31 October	Auction of $14.4 bn of three- and six-month bills, raising $600 mn of new cash.
Tuesday 8 - Thursday 10 November		Quarterly refunding auction
Thursday	17 November	One-year bill auction

ECONOMIC INDICATORS

Tuesday	1 November	Leading indicators; September Construction spending; September
Wednesday	2 November	Factory orders; September New home sales; September
Friday	4 November	Employment and unemployment; October
Monday	7 November	Purchasing managers survey; October Consumer instalment credit; September
Thursday	10 November	Producer price index; October
Tuesday	15 November	Industrial production; October Retail sales; October
Wednesday	16 November	Merchandise trade; September Capacity utilisation; October Business inventories; September
Thursday	17 November	Housing starts; October

OTHER DATES

Sunday	30 October	US clocks went back. The temporary four-hour difference between London and New York reverted to five hours.
Tuesday	1 November	FOMC meeting
Friday	4 November	September FOMC meeting minutes released
Tuesday	8 November	Presidential and Congressional elections
Friday	11 November	Veterans Day Holiday

0341c

US: MONEY AND BANKING STATISTICS

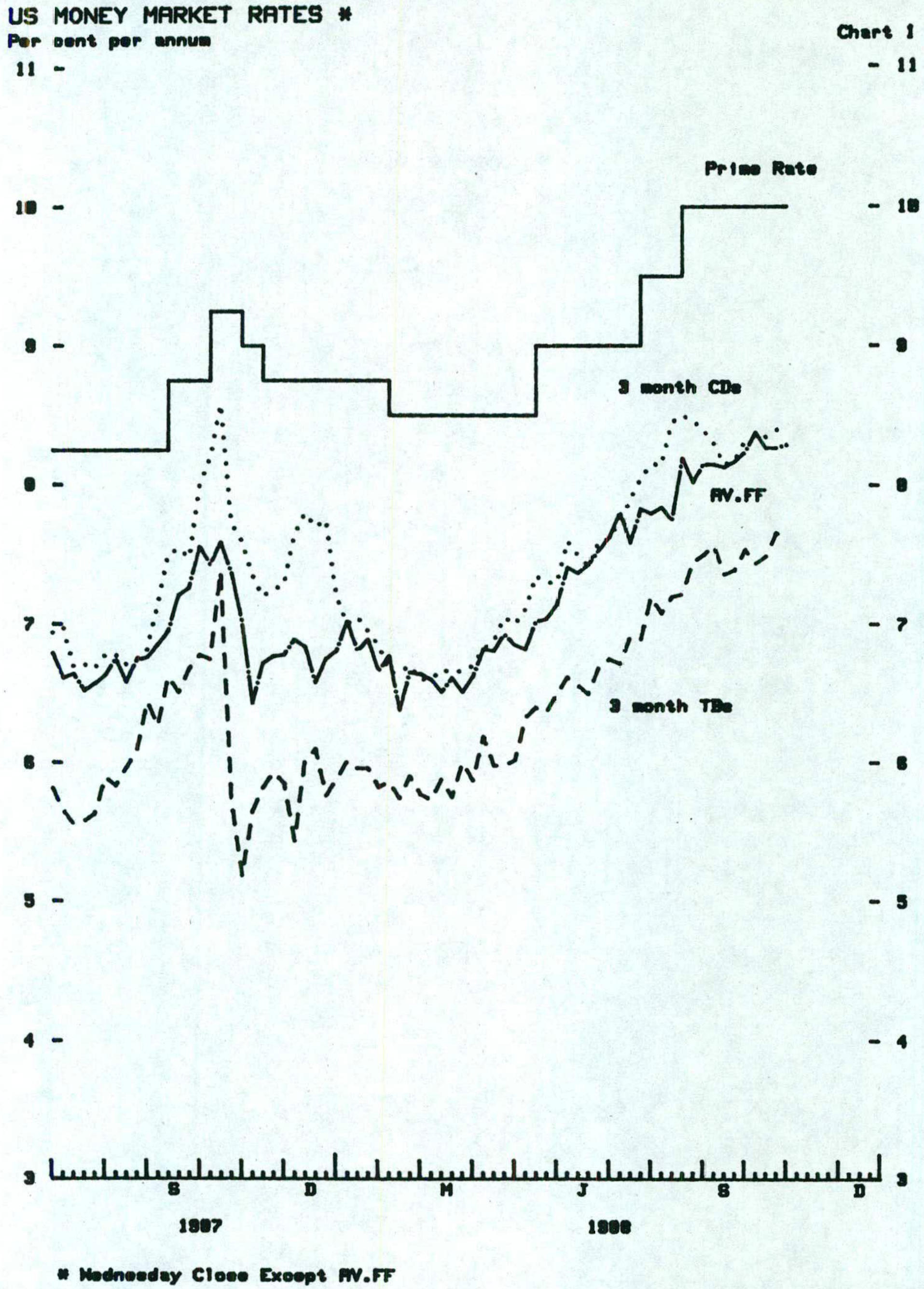
1 MONETARY AGGREGATES	Level ($ bn)	Change in level ($ bn) Latest week/ month	Previous week/month	% change (ar) Latest 4 weekly average over: Previous 4 weeks	weeks ended 13 weeks ago	target base	target range (1988) % growth	$ bn
M1 (17.10.88)	783.6	- 1.2	+ 2.5	+ 0.6	+ 1.7	+ 4.5		
M2 (17.10.88)	3,043.1	+ 7.0	+ 5.1	- 0.1	+ 1.7	+ 5.4	4-8	3013.2-3129.1
M3 (17.10.88)	3,870.5	+ 5.8	+ 8.6	+ 2.8	+ 5.1	+ 6.3	4-8	3802.3-3948.6
Credit Aggregate (Aug)	8,727.1	+53.5	+54.3	+ 7.7	+ 8.0	+ 8.3	7-11	8793.7-9122.4

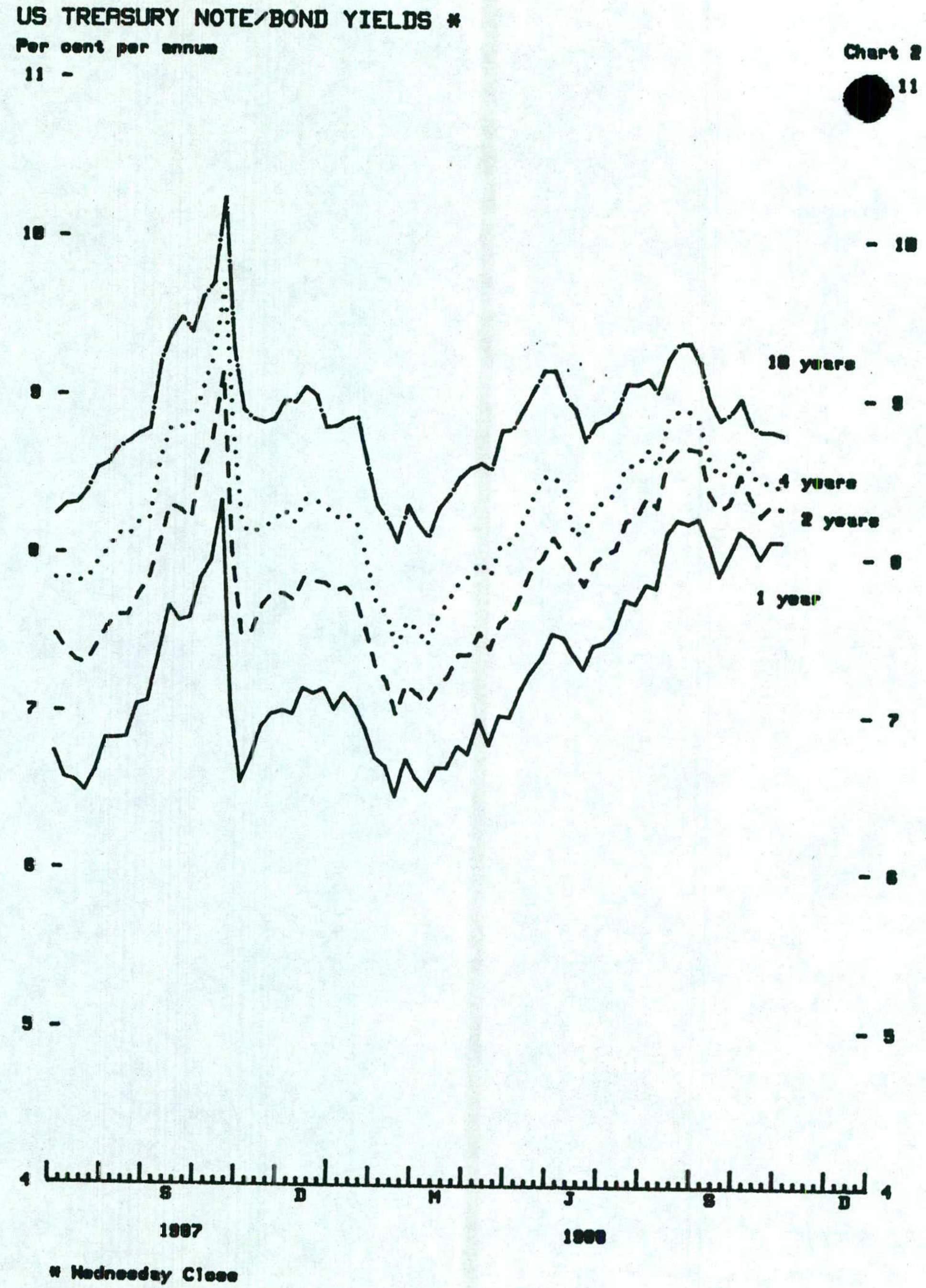
2 FINANCIAL STATISTICS	Level ($ bn)	Change in level ($ bn) Latest week	Previous week	% Change (ar) Latest 4 weekly average over: Previous 4 weeks	4 weeks ended 13 weeks ago
Business loans# (19.10.88)	298.5	+ 0.3	- 0.4	+ 5.0	- 2.9
Commercial Paper (19.10.88)	425.8	+ 1.7	+ 0.1	+10.8	+ 7.7
Money Market Mutual Funds (19.10.88)	268.8	+ 1.2	+ 0.4	+ 3.2	+ 3.2

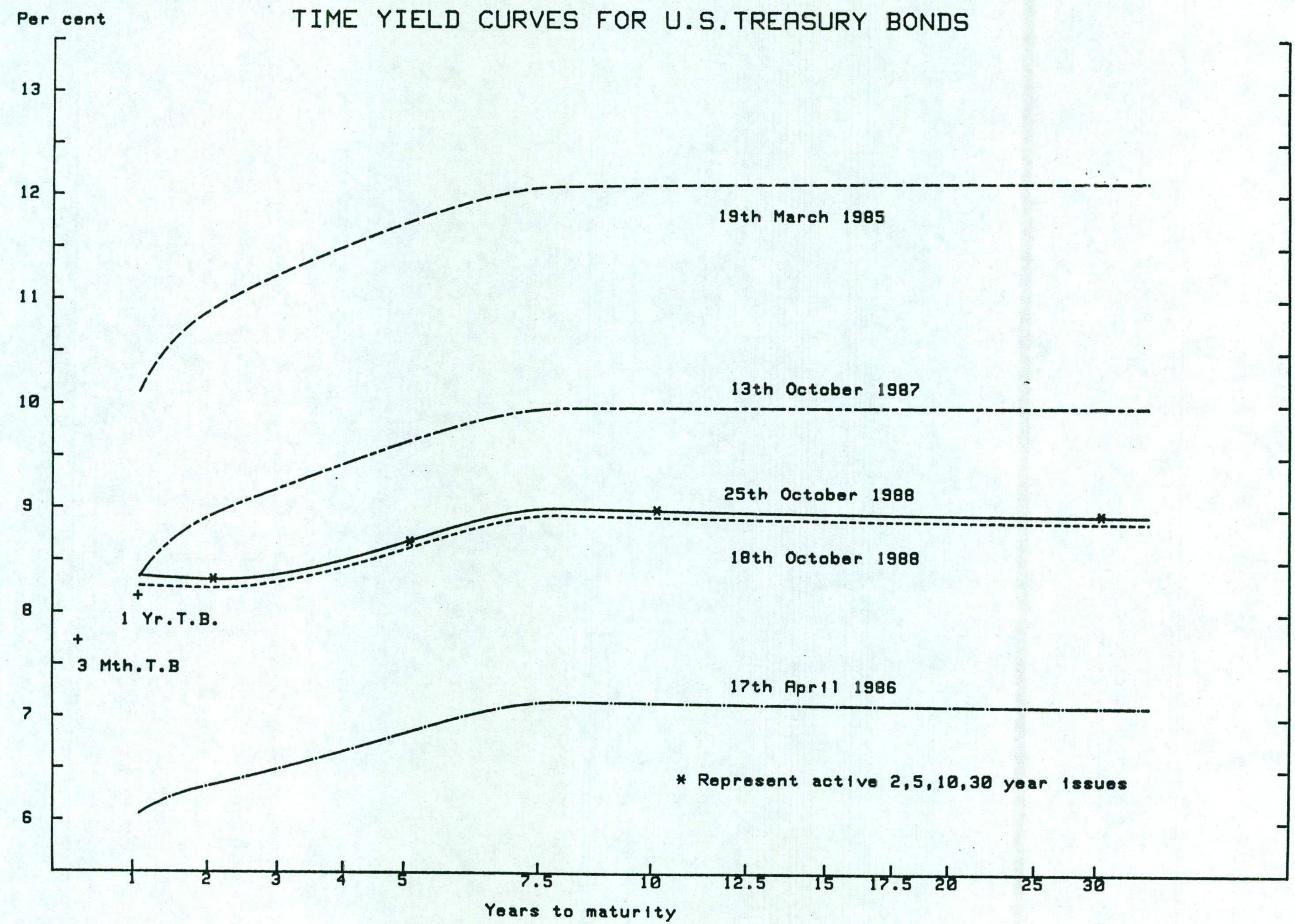
3 RESERVES	TWO WEEK PERIOD TO 19 OCTOBER Level ($ mn)	Change in level ($ mn) Latest accounting period	LATEST WEEK TO 26 OCTOBER Level ($ mn)	Changes in Level Latest Week
Discount window borrowing	2,204	- 234	2,359	+ 76
of which adjustment and seasonal borrowing	523	- 211	411	- 189
extended credit	1,681	- 23	1,948	+ 265
Net free (borrowed) reserves	478	+ 31		

Target bases (1987 Q4 averages)
M2 2897.3
M3 3656.1
Credit aggregate 8218.4

Major commercial banks


US MONEY MARKET RATES *
Per cent per annum
Chart 1
Prime Rate
3 month CDs
AV.FF
3 month TBs
S
D
M
J
S
D
1987
1988
* Wednesday Close Except AV.FF


US TREASURY NOTE/BOND YIELDS *
Per cent per annum
Chart 2
10 years
4 years
2 years
1 year
S
D
M
J
S
D
1987
1988
* Wednesday Close



TIME YIELD CURVES FOR U.S.TREASURY BONDS
Per cent
13
12
11
10
9
8
7
6
19th March 1985
13th October 1987
25th October 1988
18th October 1988
17th April 1986
1 Yr.T.B.
3 Mth.T.B
* Represent active 2,5,10,30 year issues
1
2
3
4
5
7.5
10
12.5
15
17.5
20
25
30
Years to maturity

Chart 3

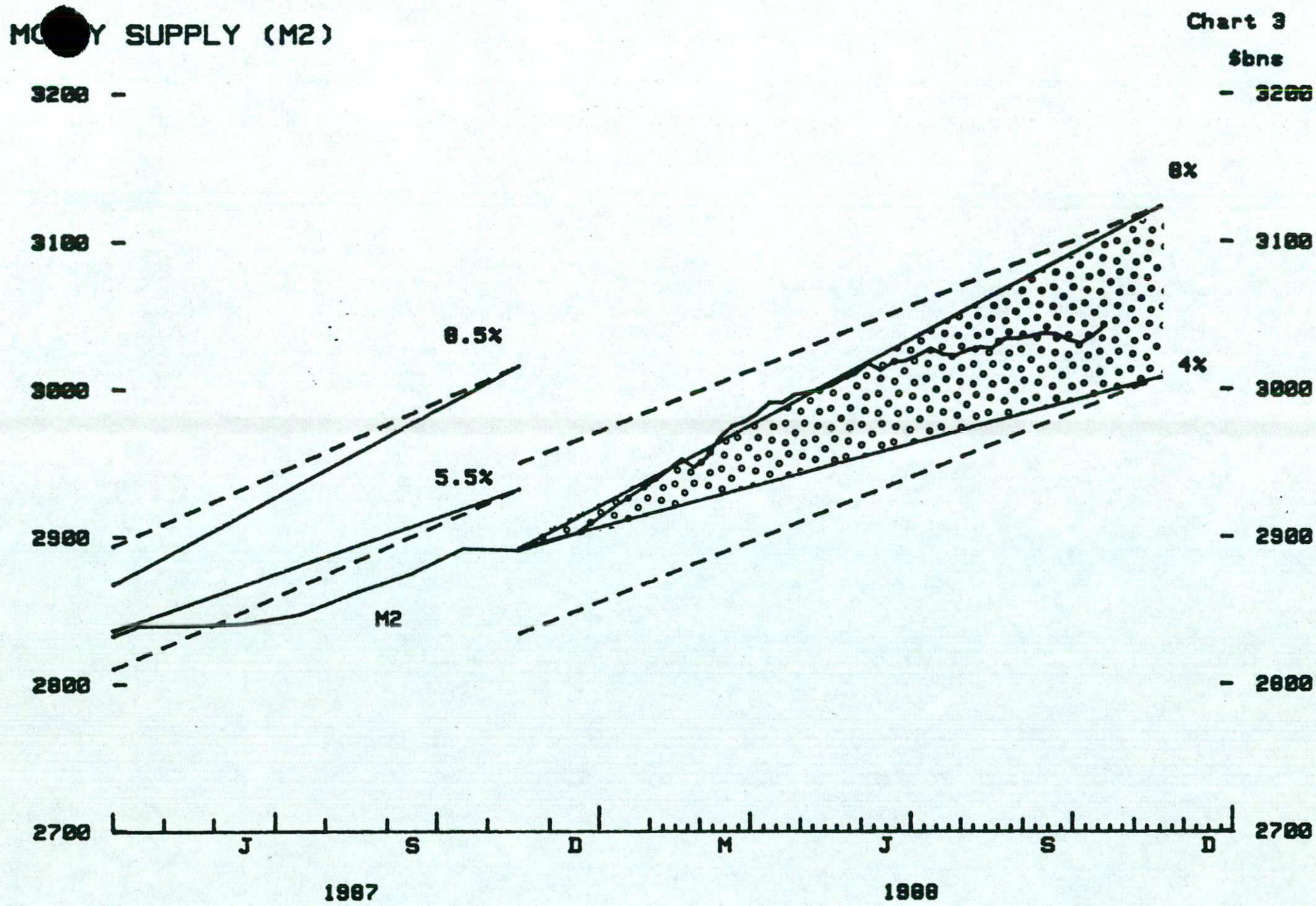
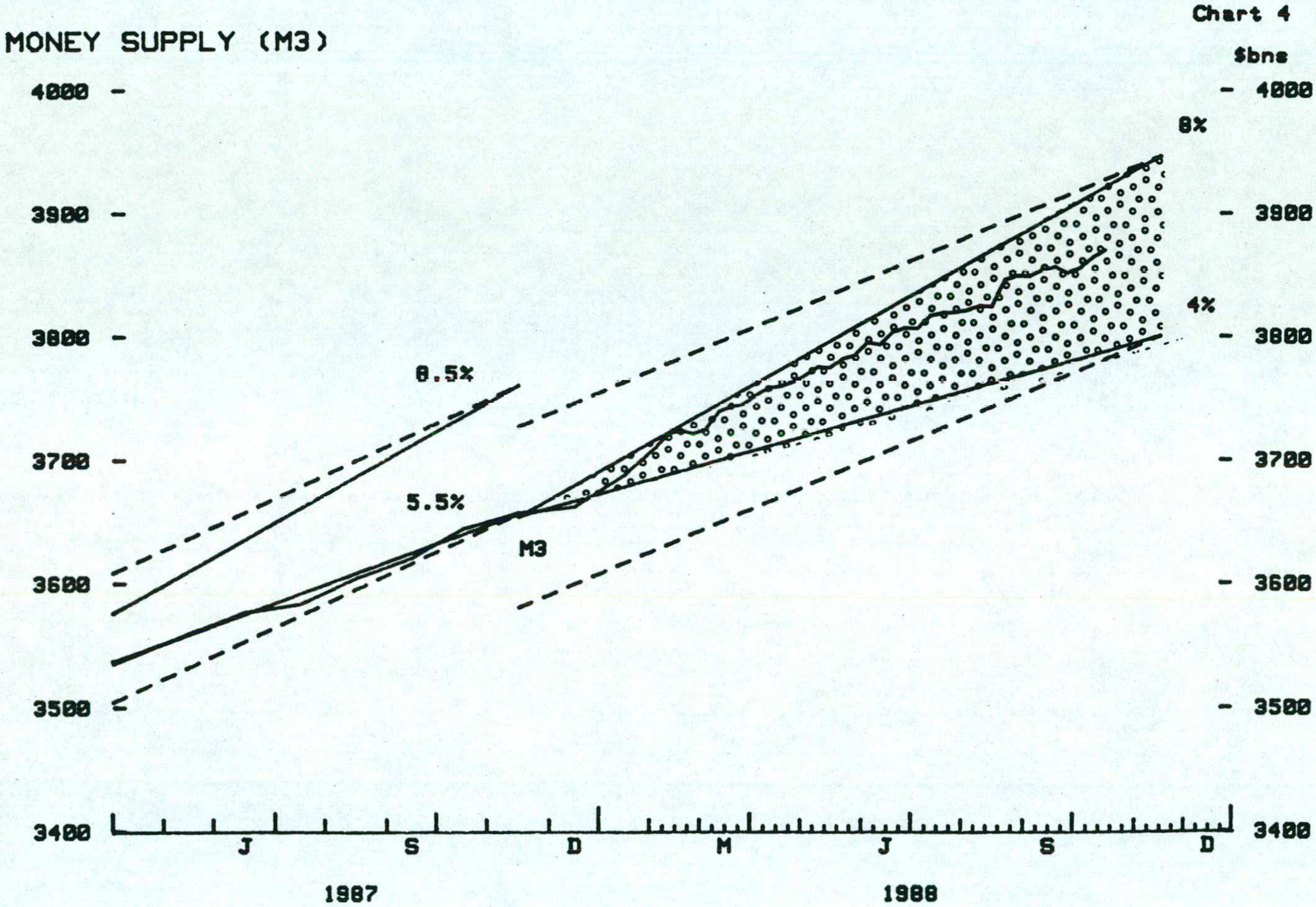


Chart 4



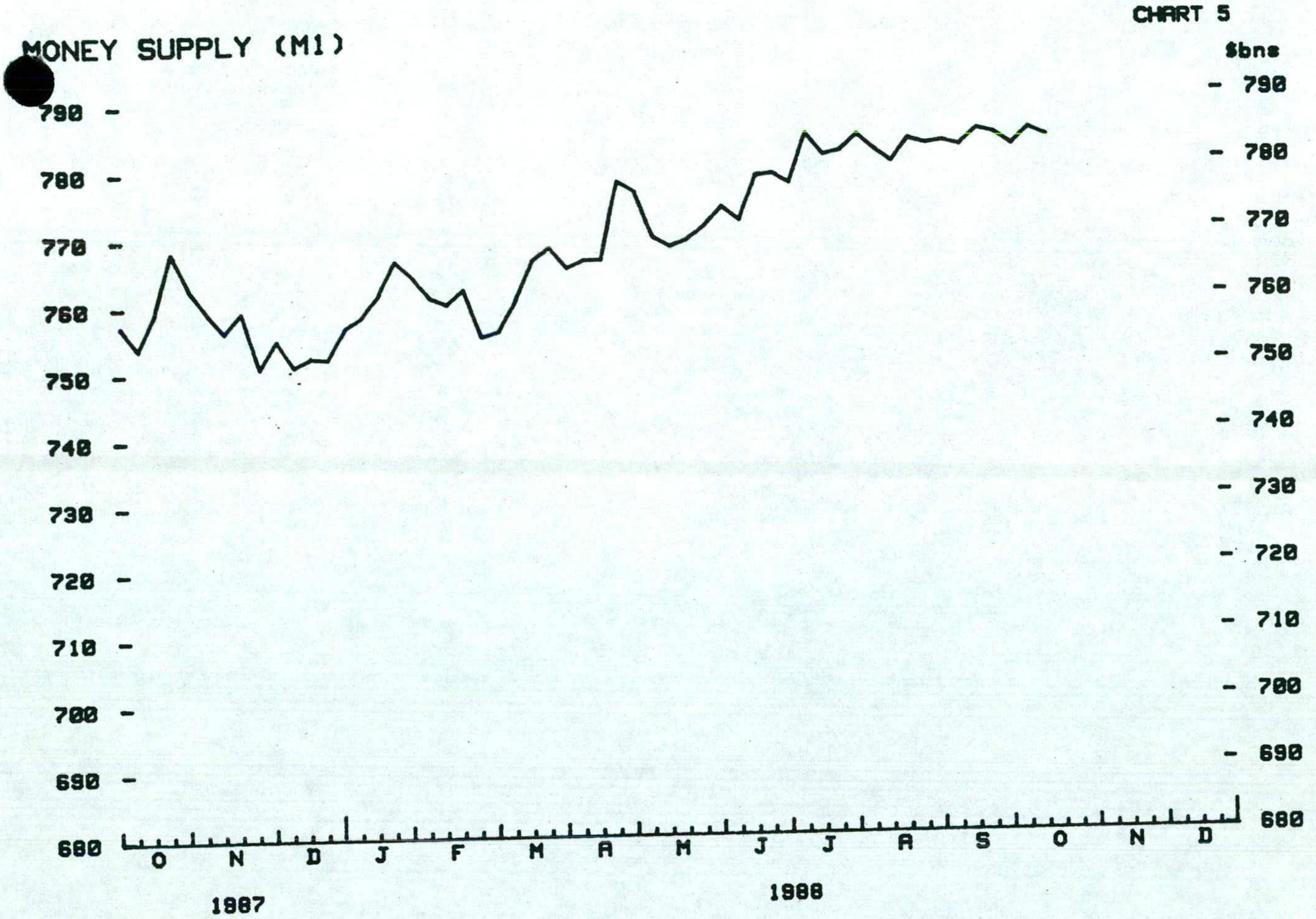


CHART 5
MONEY SUPPLY (M1)
$bns
790
780
770
760
750
740
730
720
710
700
690
680
O
N
D
J
F
M
A
M
J
J
A
S
O
N
D
1987
1988

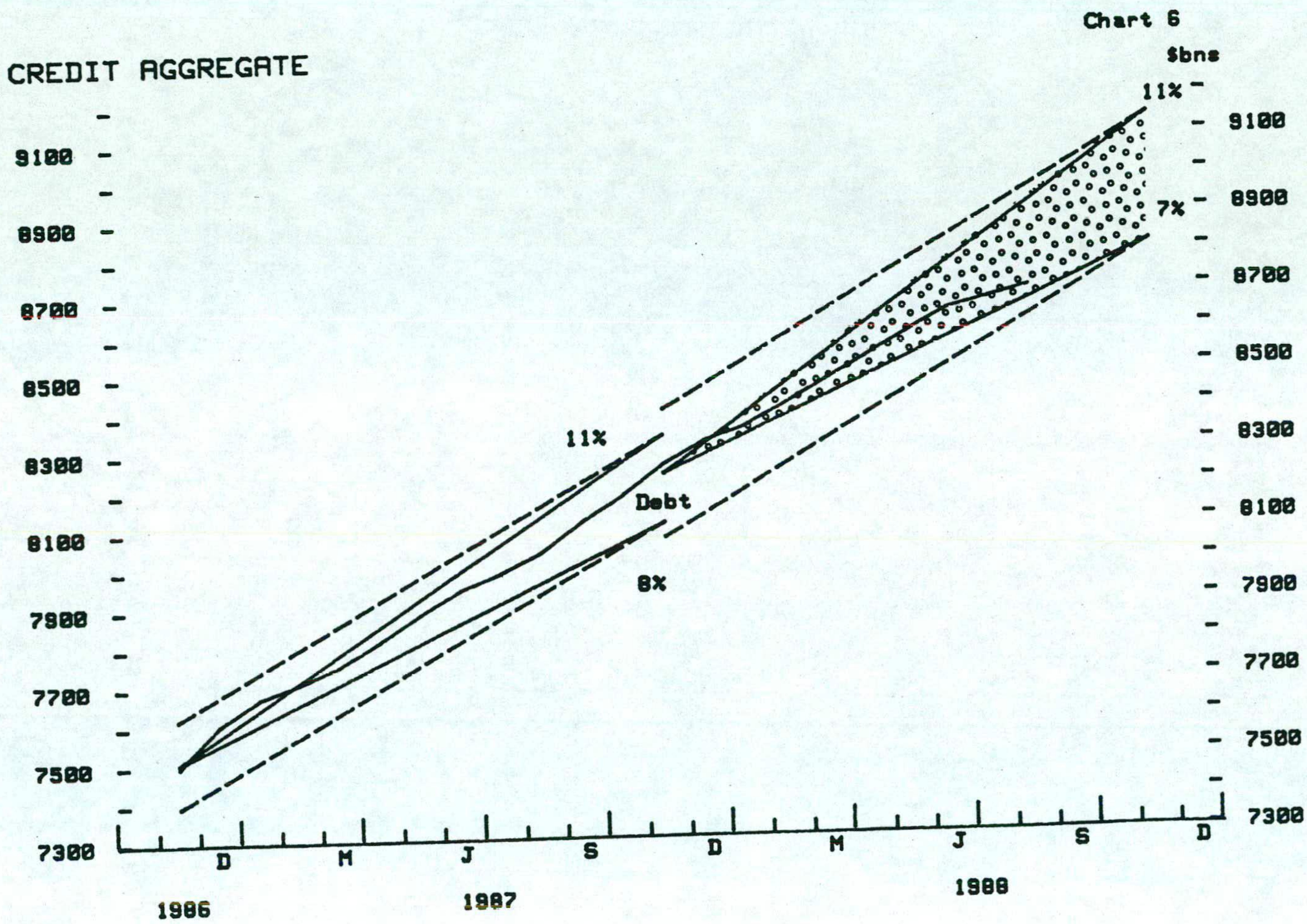


Chart 6
CREDIT AGGREGATE
$bns
11%
7%
11%
Debt
8%
9100
8900
8700
8500
8300
8100
7900
7700
7500
7300
D
M
J
S
D
M
J
S
D
1986
1987
1988

CONFIDENTIAL

FROM: GUS O'DONNELL

DATE: 22 FEBRUARY 1989

CHANCELLOR

Ch
Need to know what other countries' levels are: ie how whose is 2nd to Japan? If noone else above £50bn then line is cast-iron (see X). If noone else above £70bn then can still be pretty confident (see Y).
AA

cc: Sir P Middleton
Sir T Burns
Mr Scholar
Mr Sedgwick
Mr Gieve
Mr Hibberd
Mr Pickford
Mr Owen
Ms Owen
Ms Turk
Mr Cornelius
Mr Curwen

Thanks. But surely X is not so. A reduction in the stock of overseas assets

STOCK OF NET OVERSEAS ASSETS

1. The CSO's estimates of net overseas assets are based only on identified capital flows. On the reasonable assumption that the recent large positive balancing items contain some unrecorded capital inflows, it follows that the CSO figures **overestimate** the stock of net overseas assets.

2. The attached note by Susan Owen calculates that the stock of net overseas assets at the end of 1987 may have been nearer **£70 billion** (on the assumption that the balancing item is split equally between errors in the current and capital accounts) than the figure of £90 billion published by the CSO. Informed commentators should be aware of this point because the November 1988 issue of the Bank of England Quarterly Bulletin contained an article which mentioned this problem. The Bank calculated that if <u>all</u> the post 1975 balancing item were assumed to be unidentified capital inflows, the stock of net assets by the end of 1987 would have been around £54 billion.

Y

X

Publication

3. You decided at your meeting on Chapter 3 of the FSBR that it would be better not to publish any estimate of the net overseas asset stock given the uncertainties in the figures. It is likely, however, that we will be asked (possibly by the Treasury Select Committee) to give our best estimate of the stock. We have also received a number of PQs asking for the same information. And one of the bull points in the Treasury weekly economic brief is that our stock of net overseas assets is second only to Japan.

implies that the balancing item represents capital inflows, & thus that the ct a/c deficit is understated.

4. We could continue to make use of the CSO figure in PQs and briefing while making it clear that the figure refers only to **identified** net overseas assets. However, some way of publishing the CSO figure will have to be found as the FSBR is usually the only place it is announced until the Pink Book appears in September. If pressed we could admit that the stock may well be overestimated but emphasise that the part of the balancing item that does not reflect unidentified inflows must be a measure of unrecorded net exports. In other words the counterpart to any reduction in the stock of overseas assets must be a reduction in the current account deficit.

X

CSO plans

5. Ms Owen and I have discussed the methodological problems with the CSO. We pointed out that it did not make sense for them to say publicly (as in Bruce Buckingham's paper to the Statistics Users Conference) that all the balancing item probably consists of unidentified capital flows and then make the exact opposite assumption when calculating the stock of overseas assets. The CSO seem to be moving away from their position that there are no unrecorded net exports in the balancing item. Indeed their own balanced accounts exercise moves them in this direction. At a minimum they have agreed to make it clear in the tables to be published in the Pink Book next September that the net overseas stock figure reflects only identified capital flows. They are also considering whether they should alter their methodology. (One way of putting pressure on CSO to do something in good time would be for Sir Peter Middleton's ad hoc Working Group on Balance of Payments Statistics to discuss this subject in April or May.)

1988 Figures

6. It looks as if the end 1988 figure (calculated using CSO's standard methodology) will show an increase, perhaps to around £105 billion, from the end-1987 level of £90 billion. This rise is likely to be greeted with some scepticism, given that the current account deficit is estimated to have been over £14 billion. It mainly reflects the faster growth of equity prices overseas compared to the UK. Coincidentally the £15 billion increase in the stock is the same as CSO's very preliminary first guess at the 1988 overseas balancing item (which was £12 billion after the first three quarters of the year).

Gus O'Donnell

A O'DONNELL

ALLOCATING THE BALANCING ITEM ON THE BALANCE OF PAYMENTS

1. This note sets out an attempt to allocate the balancing item on the balance payments to the current and capital accounts.

2. In the national accounts the balancing item is implicity assumed to represent unidentified current flows, so the stock of net overseas assets is not adjusted for possible deficiencies on the capital account. However in a recent paper Mr Bruce Buckingham, of CSO, argues that the balancing item could represent unidentified capital flows and that the positive sign of the balancing item is consistent with the fact that capital inflows have been underestimated. This implies that the UK's net overseas asset position is overstated to the extent that stocks are not measured independently but estimated by cumulating flows, eg portfolio investment.

3. To determine by how much the UK's net overseas asset position could be exaggerated, the balancing item is allocated here according to several assumptions about how much of it represents unidentified capital or current flows. It is assumed in each case that this unidentified capital flow has also been excluded from the corresponding stock figures. This exercise allocates the balancing item from 1966 onwards.

4. The end year stock of overseas assets is made up of the previous year's stock less any net capital inflow to the UK plus any revaluation of assets remaining overseas on account of changes in equity prices and exchange rates. Thus any part of the balancing item allocated to capital flows must also be revalued appropriately (assuming a currency composition similar to the rest of the stock). The size of this revaluation factor is derived here by comparing the measured (Pink Book) end year stocks of assets and liabilities with what those measured stocks would have been in the absence of revaluation effects, ie last year's stock plus this year's flow.

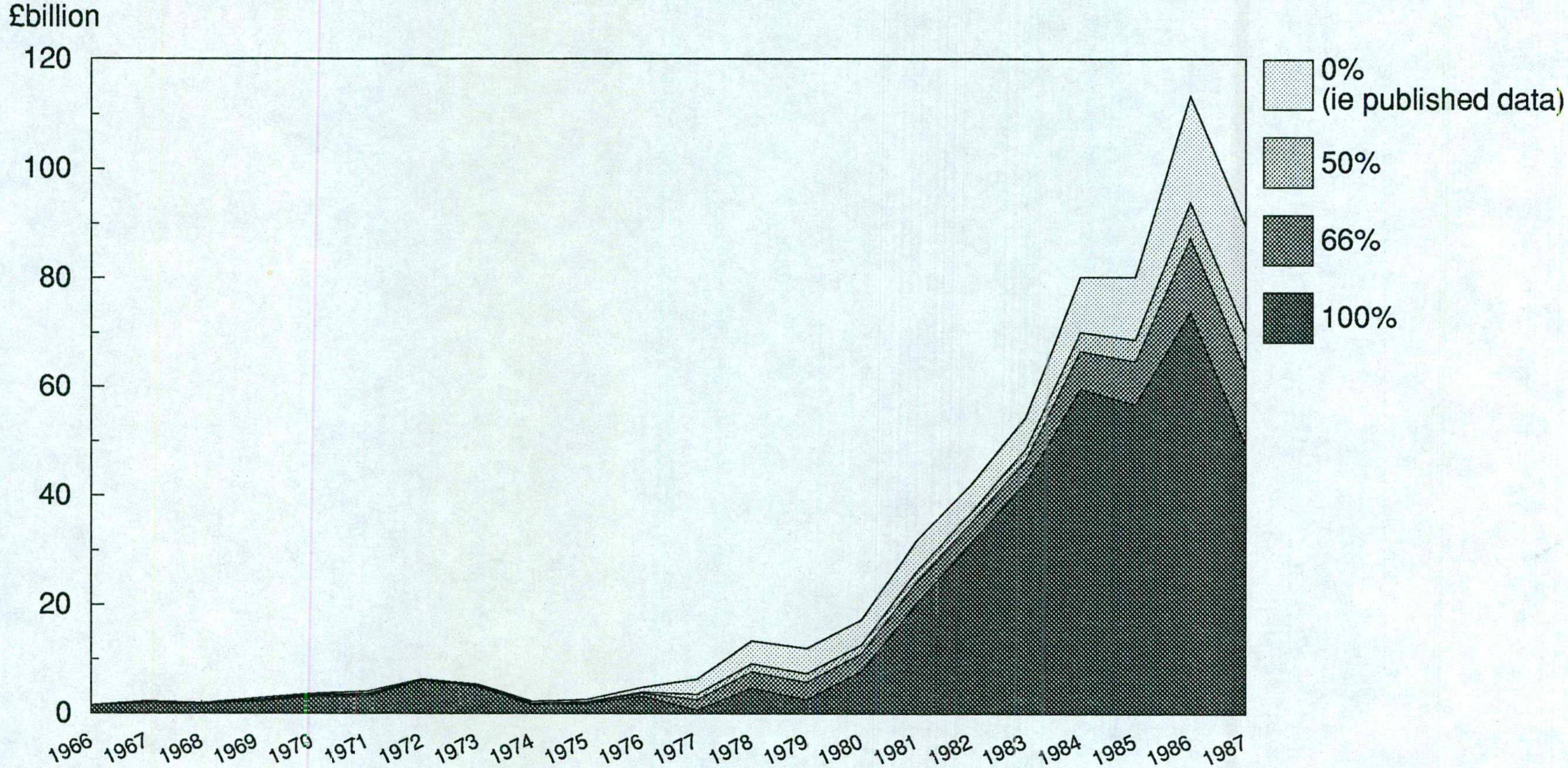
5. The revaluation of current year asset and liability flows, (both identified capital flows and any part of the balancing item attributed there) is problematic as they occur throughout the year and may therefore be valued at different prices and exchange rates to the start year asset stock. A simplifying assumption is made that half of any current year flows occur at start year prices and require full revaluation, and that the other half are transacted at end year prices and do not require valuation.

6. It is also necessary to allow for any effect which altering the UK's net overseas asset position might have on IPD flows. Clearly IPD flows could be affected by unidentified portfolio transactions because earnings on a significant proportion of these assets and liabilities are derived by applying rates of return to estimated stock levels. Thus undetected portfolio transactions are assumed to imply corresponding undetected IPD flows which are generated by applying the average annual rate of return on portfolio assets and liabilities (from the SLIM model) to the previous year's undetected net portfolio transactions.

7. Note that if we assume that IPD flows change this implies that the current account and the balancing item also change each year. A positive balancing item allocated to capital inflows in one period serves to increase IPD net outflows in the next and worsen the current account. With a given capital account, this alters the balancing item in the direction of even more underrecorded inflows.

8. Calculations are shown in Appendix A which examine the effect on the overseas asset stock of allocating 100 per cent or 66 per cent or 50 per cent of the balancing item to undetected capital flows. These are summarised in Table 1. Given that there has been a series of positive balancing items since 1983, the result of this exercise is to reduce the stock of overseas assets considerably as shown in Chart 1. On the extreme assumption that the whole of the balancing item is undetected capital flows, the stock is reduced to 55 per cent of its published level by 1987 and to 78 per cent when we allocate half of the balancing item to such undetected capital flows.

Chart 1: REVISED STOCK OF NET OVERSEAS ASSETS
as implied if the Balancing item is treated as
unrecorded portfolio capital flows



Top line is published net stock overseas assets.
Intermediate lines show decrease implied if various %s of Bal. item allocated to capital flows.

SJO 20/2/89

Table 1: Revisions to Balance of Payments and Overseas Asset Stock implied by allocating the Balancing Item to capital flows, 1985-87

Unrecorded portfolio flows	Percent of balancing item to capital flows*	£ billion 1985	1986	1987
Revised current account	0	3.3	-0.2	-2.7
	50	3.1	-0.3	-3.1
	66	3.1	-0.4	-3.2
	100	3.0	-0.5	-3.5
Revised capital account	0	-8.9	-14.4	-2.3
	50	-6.0	-7.0	0.4
	66	-5.0	-4.5	1.4
	100	-3.0	0.5	3.5
Revised balancing item	0	5.6	14.6	5.0
	50	2.9	7.4	2.7
	66	1.9	4.9	1.9
	100	0	0	0
Revised stock net overseas assets	0	80.3	113.2	89.5
	50	68.8	94.0	69.9
	66	64.9	87.4	63.1
	100	56.7	73.9	49.3
Current account including revised balancing item	0	8.9	14.4	2.3
	50	6.0	7.0	-0.4
	66	5.0	4.5	-1.4
	100	3.0	-0.5	-3.5

* 0% implies published data

9. These results are broadly in line with those reported for a similar exercise in the Bank of England Quarterly Bulletin of November 1988. Using 1975 as the starting year, and attributing 100 per cent of the balancing item to capital flows, an end-1987 figure of £54 billion is given, (compared with the £51 to £53 billion in this note, beginning in 1966).

10. Clearly any part of the balancing item which is <u>not</u> allocated to unrecorded capital flows implicitly represents unrecorded current account flows. Table 1 also shows the effect of adding the remaining balancing items to the current account. Positive remaining balancing items will thus improve the current account, eg the 1987 deficit of £-2.7 billion becomes a surplus of £2.3 billion if the balancing item of £5.0 billion entirely represents current flows. Even so, the 1987 current account remains in deficit under the two intermediate assumptions of how much of the balancing item goes to the capital account. The deficit worsens under the extreme 100 per cent capital flows assumption because none of the balancing item is allocated to the current account to offset the IPD effect (see para 7).

Susan Owen

SUSAN OWEN

APPENDIX A

TABLE 1: ALLOCATING THE BALANCING ITEM TO UNRECORDED CAPITAL FLOWS

£ billion

%B to cap a/c	Revised current a/c Ncrt				Revised capital a/c Ncpt				Revised bal.item* NBt				Other Ot	Rev.stock o'seas assets NNt				Revised current a/c (including rev.Bal.item)			
	0%	50%	66%	100%	0%	50%	66%	100%	0%	50%	66%	100%		0%	50%	66%	100%	0%	50%	66%	100%
1966	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0	-0.0	1.6	1.6	1.6	1.6	0.0	0.0	0.0	0.0
1967	-0.3	-0.3	-0.3	-0.3	0.2	0.3	0.3	0.4	0.2	0.1	0.1	0	-0.1	2.3	2.1	2.1	2.0	-0.1	-0.2	-0.2	-0.3
1968	-0.3	-0.3	-0.3	-0.3	0.7	0.6	0.6	0.5	-0.1	-0.1	-0.0	0	-0.3	2.0	1.9	1.9	1.9	-0.4	-0.3	-0.3	-0.3
1969	0.5	0.5	0.5	0.5	-0.9	-0.7	-0.6	-0.5	0.4	0.2	0.1	-0	0.0	2.8	2.5	2.4	2.2	0.9	0.7	0.6	0.5
1970	0.8	0.8	0.8	0.8	-0.9	-0.9	-0.9	-0.9	-0.1	-0.0	-0.0	-0	0.1	3.7	3.4	3.3	3.1	0.8	0.8	0.8	0.8
1971	1.1	1.1	1.1	1.1	-1.5	-1.4	-1.3	-1.2	0.3	0.1	0.1	0	0.1	4.1	3.7	3.5	3.2	1.4	1.2	1.2	1.1
1972	0.2	0.2	0.2	0.2	0.4	0.1	-0.1	-0.3	-0.8	-0.4	-0.3	0	0.1	6.4	6.3	6.2	6.1	-0.6	-0.2	-0.1	0.2
1973	-1.0	-1.0	-1.0	-1.0	0.9	1.0	1.0	1.0	0.1	0.1	0.0	0	-0.1	5.4	5.2	5.1	4.9	-0.9	-0.9	-0.9	-1.0
1974	-3.2	-3.2	-3.2	-3.2	3.1	3.2	3.2	3.3	0.2	0.1	0.1	-0	-0.1	2.3	2.0	1.8	1.6	-3.0	-3.1	-3.2	-3.2
1975	-1.5	-1.5	-1.5	-1.5	1.5	1.5	1.5	1.5	-0.0	-0.0	-0.0	0	0.0	2.6	2.2	2.1	1.8	-1.5	-1.5	-1.5	-1.5
1976	-0.9	-0.9	-0.9	-0.9	0.4	0.6	0.7	0.9	0.6	0.3	0.2	-0	0.0	4.8	4.0	3.8	3.2	-0.4	-0.6	-0.7	-0.9
1977	-0.2	-0.2	-0.2	-0.2	-3.9	-1.9	-1.2	0.2	4.0	2.0	1.4	-0	0.0	6.4	3.5	2.6	0.6	3.9	1.9	1.2	-0.2
1978	1.0	0.8	0.8	0.7	-2.9	-1.9	-1.5	-0.7	1.9	1.0	0.7	0	0.0	13.4	9.2	7.7	4.8	2.9	1.9	1.5	0.7
1979	-0.5	-0.6	-0.6	-0.6	-0.7	-0.2	0.0	0.5	1.0	0.6	0.4	-0	0.2	12.1	7.5	5.9	2.6	0.5	-0.0	-0.2	-0.6
1980	3.1	3.1	3.1	3.0	-3.9	-3.6	-3.5	-3.2	0.6	0.3	0.2	-0	0.2	17.3	12.7	11.1	7.8	3.7	3.4	3.3	3.0
1981	6.9	6.9	6.9	6.9	-7.4	-7.2	-7.2	-7.0	0.3	0.1	0.1	-0	0.2	31.8	26.2	24.3	20.3	7.2	7.1	7.0	6.9
1982	4.7	4.7	4.7	4.7	-2.4	-3.5	-3.9	-4.7	-2.3	-1.2	-0.8	0	0.0	42.0	36.9	35.1	31.4	2.4	3.5	3.9	4.7
1983	3.8	3.9	3.9	4.0	-4.4	-4.1	-4.1	-4.0	0.5	0.2	0.1	0	0.0	54.3	48.6	46.6	42.4	4.4	4.1	4.1	4.0
1984	2.0	2.0	2.0	2.0	-7.7	-4.9	-3.9	-2.0	5.7	2.9	1.9	-0	0.0	80.3	70.2	66.8	59.7	7.7	4.9	3.9	2.0
1985	3.3	3.1	3.1	3.0	-8.9	-6.0	-5.0	-3.0	5.6	2.9	1.9	0	0.0	80.3	68.8	64.9	56.7	8.9	6.0	5.0	3.0
1986	-0.2	-0.3	-0.4	-0.5	-14.4	-7.0	-4.5	0.5	14.6	7.4	4.9	0	0.0	113.2	94.0	87.4	73.9	14.4	7.0	4.5	-0.5
1987	-2.7	-3.1	-3.2	-3.5	-2.3	0.4	1.4	3.5	5.0	2.7	1.9	0	0.0	89.5	69.9	63.1	49.3	2.3	-0.4	-1.4	-3.5

*implicitly unrecorded current a/c flows

CONFIDENTIAL

FROM: GUS O'DONNELL
DATE: 3 MARCH 1989

PS/CHANCELLOR

cc: Sir P Middleton
Sir T Burns
Mr Scholar
Mr Sedgwick
Mr Gieve
Mr Hibberd
Mr Pickford
Mr Bush
Mr Owen
Ms Owen
Ms Turk
Mr Cornelius
Mr Curwen

STOCK OF NET OVERSEAS ASSETS

1. You asked for the latest figures for other countries' stocks of net assets to see if our claim that we are bettered only by Japan was robust. The net asset positions of the G3 and the UK are shown below.

	1987 $bn	Percent of GNP	Percent of Exports of Goods and Services
US	-380	-8	-114
Japan	240	8	66
Germany	160	12	39
UK (CSO estimate)	160	20	79

Notes: (i) Net Assets exclude gold holdings.
(ii) The data came from national sources which use slightly different methodologies.

2. It is apparent from the above that our claim to be bettered only by ~~to~~ Japan is not at all robust. If any part of the balancing item were allocated to the capital account as unrecorded inflows, Germany would take second place. However, there is very little danger of losing third place in the G7 rankings as France, Canada and Italy all have negative net asset positions.

3. You have decided not to include any estimate of the net asset position in the FSBR. It will therefore be necessary to decide how to handle questions on this subject that might arise. Some suggestions that could be incorporated in the relevant budget brief are given below.

Suggested Line to Take

UK net overseas asset position remains extremely healthy. [CSO estimated that net assets amounted to £90 billion at end of 1987.] But impossible to give accurate estimates given size of the overseas balancing items in last three years.

Why no estimate of net overseas asset position in FSBR as usual?

In last three years balancing items have amounted to over £40 billion. These reflect an unknown mixture of unrecorded net exports and unidentified capital inflows. In these circumstances not sensible yet to give an estimate of net asset position. Figure for end-1988 will be published as usual in the next Pink Book (due out in September).

Are you not hiding the fact that our net asset position is dwindling as a result of huge balance of payments deficit?

No. Indeed the net asset position calculated using the standard methodology would show an increase between the end of 1987 and 1988. (The change in net assets depends not only on the current account deficit but also on revaluations which take account of exchange rate movements and changes in the market values of our assets and liabilities.)

Be sure

Is UK still second only to Japan in terms of net assets?

~~The UK and Germany have net overseas assets of a similar size; other G7 countries have net overseas liabilities~~

Impossible to ~~say~~ given the problems in measuring capital and current account transactions. But UK's net stock of overseas assets ~~undoubtedly substantial.~~ either second or third (to Germany), and first ~~xxxx~~ of all major nations as a share of GDP.

Will the UK face a sterling crisis if balance of payments deficits persist and net overseas assets are used up?

No. Current account deficits reflect imbalance between private sector saving and investment which will correct itself in part as savings recovers in response to higher interest rates. Hence net asset position unlikely to be run down. ~~[Even if it were, it would not be a disaster. Only three of the G7 countries - Japan, Germany and the UK - have more overseas assets than liabilities.]~~

Gus O'Donnell

A O'DONNELL

aef2.jb/bottrill/minute/chance 1

FROM: A R H BOTTRILL
DATE: 19 JULY 1989
EXT: 4720

PS/CHANCELLOR

cc Sir P Middleton
Mr Wicks
Mr H P Evans
Mr A C S Allen
Mr Mountfield
Mr Cress

BOTTRILL → PS/Cx 19/7 MEXICO

MEXICO

The Chancellor asked about the state of play in negotiations between Mexico and the commercial banks. The Bank of England told me this morning that following the meeting of banks' chairmen or CEOs at the weekend the banks formally offered Mexico a package along similar lines to that discussed last week ie 35 per cent discount and a reduction in the interest rate to 6¼ per cent. The important concession from the banks' view was that the US banks dropped their demand for provision for a 'step-up' in the interest rate while UK banks accepted an 18-month limit on interest enhancement. This means that the banks at least were united on the package.

2. The Mexicans, however, have apparently rejected this offer because they are worried that the interest reduction will only be phased in over several years as the funds for interest enhancement become available from the IFIs. The banks, however, want interest enhancement up-front if they are to accept lower interest rates immediately. There are no suggestions yet as to how this gap might be bridged but negotiations are likely to be drawn out over at least several more days.

3. The Bank has no indication yet as to how many banks are likely to choose which options from the menu. Neither we nor the Fund, therefore, can assess the likely effect of this deal on Mexico's cash-flow.

ABottrill

A R BOTTRILL