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808

PREM 19/999

MT

PART 2

Confidential Filing

Indebtedness of various countries and its effect on the Western Banking System

ECONOMIC POLICY

Part 1: August 1982

Part 2: December 1982

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~1.12.82~~		~~24.6.83~~					
~~9.12.82~~		~~1.7.83~~					
~~17.12.82~~		~~6.7.83~~					
~~11.1.83~~		~~8.7.83~~					
~~20.1.83~~		~~11.7.83~~					
~~24.1.83~~		~~15.7.83~~					
~~1.2.83~~		~~15.7.83~~					
~~1.2.83~~		~~25.7.83~~					
~~17.2.83~~		~~27.7.83~~					
~~18.2.83~~		~~3.8.83~~					
~~3.3.83~~		~~8.8.83~~					
~~29.3.83~~		~~11.8.83~~					
~~13.4.83~~		~~15.8.83~~					
~~26.4.83~~		~~17.8.83~~					
~~29.4.83~~		~~22.8.83~~					
~~6.5.83~~		~~23.8.83~~					
~~17.5.83~~		~~9.9.83~~					
~~23.5.83~~		23.8.83					
~~1.6.83~~		←14 Encls					
~~23.6.83~~							

PREM 19/999

● PART 2 ends:-

Brasilia tel: 322 23/8

PART 3 begins:-

HMT to WR 1/9

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC(83) 23rd Meeting, item 2	14/07/1983
JIC(83)(N) 102	23/06/1983
CC(83) 7th Meeting, item 3	03/03/1983
CC(83) 5th Meeting, item 2	17/02/1983
CC(83) 1st Meeting, item 2	20/01/1983

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed J. Gray   Date 25/3/2013

PREM Records Team

M.

CONFIDENTIAL

GRS 390

CONFIDENTIAL

DESKBY 231700Z

FM BRASILIA 231525Z AUG 83

TO IMMEDIATE FCO

TELEGRAM NUMBER 322 OF 23 AUGUST

AND TO IMMEDIATE DTI, ECGD, BANK OF ENGLAND, HM TREASURY, UKDEL IMF/IBRD WASHINGTON, PARIS

AND TO SAVING SAO PAULO, RIO DE JANEIRO

MY TELNO 317 AND PARIS TO FCO TELNO 750: BRAZIL'S FOREIGN DEBT

1. AS FORESHADOWED IN MTUR, DELFIM NETTO'S TRIP TO PARIS HAS TRIGGERED BRAZIL'S RECOURSE TO THE PARIS CLUB. VIA HIS CONTACTS WITH LAROSIERE, IT MAY ALSO HAVE OPENED THE WAY FOR BRAZIL TO RECEIVE FROZEN TRANCHES OF HER PROJECT ONE JUMBO LOAN FROM THE BANKS EVEN BEFORE THE IMF BOARD HAS PRONOUNCED FORMALLY ON THE REVISED LETTER OF INTENT. THE MINISTRY OF FINANCE SPOKESMAN IS QUOTED IN TODAY'S GAZETA MERCANTIL TO THE EFFECT THAT THE GREEN LIGHT HAS INDEED BEEN GIVEN AND THAT BRAZIL THEREFORE EXPECTS TO RECEIVE US DOLLARS 1.27 BILLION IN SEPTEMBER.

2. THE SPOKESMAN CONFIRMED THE STATEMENT BY DELFIM LAST WEEK THAT PAYMENTS OF BOTH PRINCIPAL AND INTEREST ON PARIS CLUB DEBTS ARE IN SUSPENSE PENDING THE NEGOTIATIONS IN THAT FORUM.

3. THE ABOVE DOES NOT SIGNIFY ANY RELAXATION IN THE TERMS OF THE AGREEMENT PAINFULLY HAMMERED OUT BETWEEN THE IMF AND BRAZIL OVER THE PAST WEEKS. APPROVAL OF THE AGREEMENT BY THE IMF BOARD IS STILL EXPECTED IN OCTOBER AFTER CONGRESSIONAL RATIFICATION HERE OF DECREE LAW 2045 PARTLY DE-INDEXING WAGES.

4. DELFIM'S STRATEGY OF PERSEVERING ALONG THE LINES WORKED OUT WITH THE IMF THUS REMAINS IN FORCE, THANKS TO FIGUEIREDO'S SUPPORT, IN THE FACE OF INCREASING OPPOSITION FROM EVER-BROADER AND MORE VOCAL SECTIONS OF INDUSTRY AND THE POLITICAL SPECTRUM. THE MAIN OPPOSITION PARTIDO DO MOVIMENT DEMOCRATICO BRASILEIRO ARE DUE TO PRESENT THEIR ALTERNATIVE STRATEGY TOMORROW IN CONGRESS.

THE MOST SIGNIFICANT GROUP OF SAO PAULO INDUSTRIALISTS HAVE LAUNCHED THEIR OWN ANTI-RECESSION ALTERNATIVE STRATEGY (COPY OF THEIR DOCUMENT IN ENGLISH BY BAG ON 26 AUGUST). NONE OF THESE FRONTAL ATTACKS ON DELFIM'S POLICIES HAVE SO FAR HAD ANY PALPABLE EFFECT.

5. A POTENTIALLY MORE DANGEROUS DEVELOPMENT FOR THE GOVERNMENT IS THE LAUNCHING BY MAIN SAO PAULO NEWSPAPER O ESTADO DE SAO PAULO OF A SENSATIONAL SERIES OF ARTICLES DENOUNCING AS CORRUPT THE WAY IN WHICH DELFIM'S MINISTRY ALLOWED BRAZIL TO CONTRACT A HUGE IMBALANCE IN TRADE WITH POLAND, AS A RESULT OF WHICH BRAZIL NOW HOLDS SOME US DOLLARS 1.8 BILLION IN NON-NEGOTIABLE POLISH PAPER. ACTING PRESIDENT AURELIANO CHAVES (WHO WILL HAND BACK HIS OFFICE TO FIGUEIREDO ON 26 AUGUST) IS REPORTED TO HAVE INSISTED ON IMMEDIATE INVESTIGATION: AND THE INDIVIDUALS AND INSTITUTIONS BEING SWIPED AT BY THE ESTADO ARE SHOWING SIGNS OF BREAKING RANKS IN SELF-DEFENCE.

HARDING

MONETARY
SAMD

CONFIDENTIAL

CONFIDENTIAL

FM PARIS 221600Z AUG 83

TO IMMEDIATE FCO

TELEGRAM NUMBER 750 OF 22 AUGUST

AND TO IMMEDIATE DTI, ECGD, BANK OF ENGLAND AND H M TREASURY

INFO PRIORITY BRASILIA, UKDEL IMF/IBRD WASHINGTON

INFO SAVING UKDEL OECD

MY TELNO 748: BRAZIL: FOREIGN DEBT

SUMMARY

1. THE CHAIRMAN OF THE PARIS CLUB HAS TELEXED TO US THE TEXT OF A REQUEST, RECEIVED TODAY, FROM THE BRAZILIAN MINISTER OF FINANCE FOR THE RESCHEDULING OF PAYMENTS OF PRINCIPAL AND INTEREST ON LOANS FROM OR GUARANTEED BY FOREIGN GOVERNMENTS AND OFFICIAL AGENCIES, TOGETHER WITH ACCUMULATED ARREARS OF SUCH PAYMENTS. (FULL TEXT BY BAG TO STONE, ERD).

DETAIL

2. THE BRAZILIAN MINISTER OF FINANCE, SR GALVEAS, GIVES THE FOLLOWING INFORMATION IN HIS LETTER TO THE CHAIRMAN OF THE PARIS CLUB, WHICH IS DATED 17 AUGUST:

A) THE TOTAL OF THE MAJOR OFFICIAL LOANS GUARANTEED BY OFFICIAL AGENCIES TO BRAZIL AMOUNTS TO ABOUT US DOLLARS 7 BN, TO WHICH SHOULD BE ADDED A SUM FOR OFFICIALLY GUARANTEED SUPPLIER CREDITS, WHOSE VALUE WILL BE KNOWN IN A FEW DAYS

B) THE PAYMENTS DUE FROM 1 AUGUST TO 31 DECEMBER 1983 AMOUNT TO US DOLLARS 685.8MN, COMPRISING US DOLLARS 493.9MN OF PRINCIPAL AND US DOLLARS 191.9MN OF INTEREST

C) FOR THE YEARS 1984, 1985 AND 1986, THE PAYMENTS DUE ARE AT PRESENT SCHEDULED AS FOLLOWS:

US DOLLARS	1984	1985	1986
PRINCIPAL	1042.6	921.1	666.7
INTEREST	419.4	333.0	265.1
TOTAL	1462.0	1255.1	931.8

D) TO THIS TOTAL MUST BE ADDED THE OFFICIALLY GUARANTEED SUPPLIER CREDITS AND ANY OTHER CREDITS OF LESSER IMPORTANCE. THE DETAILED LIST OF THESE WILL BE DRAWN UP BY THE CENTRAL BANK OF BRAZIL AS SOON AS POSSIBLE

E) BETWEEN MARCH AND 31 JULY 1983, ARREARS AMOUNTING TO US DOLLARS 109.11MN ACCUMULATED AS FOLLOWS:

MARCH	US DOLLARS 2.38MN
APRIL	US DOLLARS 5.93MN
MAY	US DOLLARS 20.14MN
JUNE	US DOLLARS 42.18MN
JULY	US DOLLARS 38.48MN

3. GALVEAS WRITES THAT IT IS HIS GOVERNMENT'S INTENTION TO ASK THE PARIS CLUB TO RESCHEDULE THE DEBTS LISTED ABOVE. HE WILL SEND THE PARIS CLUB A MEMORANDUM WITHIN THE NEXT FEW DAYS GIVING A MORE PRECISE ACCOUNT OF HIS GOVERNMENT'S REQUEST.

4. GALVEAS REFERS TO AGREEMENT REACHED WITH THE IMF AT THE TECHNICAL LEVEL AT THE END OF LAST WEEK ON A FINANCIAL STABILISATION POLICY.

5. IN HIS TELEX, THE CHAIRMAN OF THE PARIS CLUB CONFIRMS THAT IT IS HIS INTENTION THAT THE BRAZILIAN REQUEST SHOULD BE DISCUSSED AT THE MEETING OF THE CLUB ON 15 SEPTEMBER. HE ASKS THAT, IN ACCORDANCE WITH BRAZILIAN WISHED, THIS REQUEST SHOULD REMAIN CONFIDENTIAL. HOWEVER, AS ALREADY REPORTED IN TELECON GARSIDE/CASE(HMT), TODAY'S EDITION OF LES ECHOS (BUSINESS DAILY) REPORTS THAT THE BRAZILIAN PLANNING MINISTER HAS HELD TWO MEETING WITH THE MANAGING DIRECTOR OF THE IMF OVER THE PAST WEEKEND AND SEPARATE MEETINGS WITH THE FRENCH MINISTER OF FINACNE AND THE CHAIRMAN OF THE PARIS CLUB, IN ORDER TO DISCUSS THIS REQUEST FOR RESCHEDULING.

FCO ADVANCE COPIES TO :-

FCO - EVANS, J C THOMAS, STONE, SINDALL
HMT - LAVELLE, CAREY, CASE
BANK OF ENGLAND - LOEHNIS, BALFOUR, HALL
ECGD - BREACH, HARDING

PETRIE

MONETARY
S AM D

(ADVANCED AS REQUESTED)

BF.

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

W F S Rickett Esq
10 Downing Street
LONDON
SW1

Note for file

I have spoken to Brian Unwin and Miss O'Mara. The Chancellor will let the PM have a full report on how the negotiations between Brazil and the IMF are proceeding by Wed/Thurs of next week. This will indicate the options open to us for increasing the pressure on Brazil.

WR 23/8

22 August 1983

Dear Willie,

BRAZIL

See note with G of B.

When the Prime Minister discussed current international debt questions with the Chancellor on 8 August, she was aware that a further tranche of Brazil's BIS credit was due for repayment at the end of August. Our expectation was that it was unlikely to be repaid, in which case it would be dealt with in the same way as the postponed 31 May tranche - ie no formal extension but roll-over in practice to 15 September to allow time for Brazil to carry forward its negotiations with the IMF.

The Prime Minister may like to be aware that the BIS have now put that proposition to the Bank of England on a pracautionary basis. Negotiations with the IMF are continuing and repayment on 31 August seems improbable. We and the Bank therefore see no alternative to treating the 31 August tranche in the same way as the May tranche with the same 15 September deadline.

I am copying this letter to John Bartlett (Bank of England).

Yours sincerely,

Margaret O'Mara

MISS M O'MARA
Private Secretary

pa

Indebtedness

CONFIDENTIAL

GRS 200
CONFIDENTIAL
FM UKDEL IMF/IBRD WASHINGTON 172248Z AUG 83
TO ROUTINE FCO
TELEGRAM NUMBER 292 OF 17 AUGUST
INFO BRASILIA

IMF: BRAZIL

1. WE SPOKE PRIVATELY TO REICHMANN (WESTERN HEMISPHERE DEPARTMENT) ON HIS RETURN FROM BRAZIL. HE SAID THAT ALL IN ALL THINGS LOOKED QUITE POSITIVE. FINAL AGREEMENT ON A REVISED LETTER OF INTENT WOULD HAVE TO AWAIT THE MANAGING DIRECTOR'S DECISION ON CERTAIN ASPECTS. THE PROGRAMME FOR THE REMAINDER OF 1983 WAS MORE OR LESS SETTLED BUT THERE WERE CERTAIN BASIC ALTERNATIVES TO CONSIDER FOR 1984.

2. WE ASKED IF MANAGEMENT INTENDED TO HOLD AN INFORMAL DE-BRIEFING MEETING FOR EXECUTIVE DIRECTORS FOLLOWING THE LATEST STAFF MISSION AS HAD BEEN DONE IN JULY (OUR TELNO 259). REICHMANN THOUGHT THE MANAGING DIRECTOR MIGHT WISH TO CALL SUCH A MEETING SOON AFTER HIS RETURN FROM HOLIDAY ON 26 AUGUST.

3. REICHMANN CONFIRMED THAT THE REVISED LETTER OF INTENT WOULD NOT BE PRESENTED TO THE BOARD UNTIL OCTOBER. THE ACCOMPANYING STAFF PAPER WOULD PROBABLY ARGUE THAT, WHILE THE FINANCIAL PROGRAMME FOR 1983 HAD GONE OFF TRACK, CONTINUED FUND SUPPORT WAS APPROPRIATE IN VIEW OF THE MAJOR STRUCTURAL CHANGES ACHIEVED SO FAR (EG ON WAGES AND AGRICULTURE) AND THE STRONG ADJUSTMENT MEASURES ENVISAGED FOR 1984.

4. FCO PLEASE PASS TO DIGGLE (HMT), GILCHRIST (BANK OF ENGLAND) AND APPLEYARD (ERD).

WICKS

MONETARY

S AM D

COPIES TO:

MR DIGGLE, TREASURY

MR GILCHRIST, BANK OF ENGLAND

THIS TELEGRAM WAS NOT ADVANCED

CONFIDENTIAL

pt. International Debt file

CONFIDENTIAL

GRS 150
CONFIDENTIAL
FM UKDEL IMF/IBRD WASHINGTON 172130Z AUG 83
TO IMMEDIATE FCO
TELEGRAM NUMBER 291 OF 17 AUGUST

IMF: THE MANAGING DIRECTOR'S BORROWING INITIATIVE

1. HABERMEIER (TREASURER) TELEPHONED TODAY WITH THE FOLLOWING QUOTE CONFIDENTIAL BUT OFFICIAL UNQUOTE MESSAGE ABOUT THE MANAGING DIRECTOR'S BORROWING INITIATIVE. THERE WAS OFFICIAL NEWS FROM SAUDI ARABIA THAT THEY WERE PREPARED IN PRINCIPLE TO OFFER THE FUND AN SDR3 BN CREDIT LINE PROVIDED THE BIS AND THE INDUSTRIAL COUNTRIES CAME UP WITH THEIR SHARE OF THE PACKAGE AS PROPOSED BY THE MANAGING DIRECTOR.

2. HABERMEIER SAID HE WAS PERSONALLY PLEASED NOT ONLY BECAUSE THE MESSAGE GAVE A POSITIVE TONE TO THE CURRENT DISCUSSIONS BUT ALSO BECAUSE IT MEANT THE FUND WOULD GET MORE FROM SAUDI ARABIA THAN THE SDR4 BN ORIGINALLY HOPED FOR IE SDR3 BN PLUS SDR 1.5 BN IN ASSOCIATION WITH THE GAB. HABERMEIER DOES NOT EXPECT A DIRECT REPLY TO THIS MESSAGE. HE SAID THE BALL WAS NOW IN THE COURT OF THE G10 AND OF THE CENTRAL BANKS IN PARTICULAR.

3. FCO PLEASE ADVANCE TO DIGGLE (HMT), GILCHRIST (BANK OF ENGLAND) AND APPLEYARD (ERD).

WICKS [ADVANCED AS REQUESTED]

MONETARY
ERD

COPIES TO:
ADVANCE ADDRESSEES

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GRS 300

UNCLASSIFIED

Arg / IMF
pm

(FM BERNE 171425 Z)

FM BIS BUENOS AIRES

TO IMMEDIATE FCO
TELNO 706 OF 16 AUGUST
IFNO IMMEDIATE UKMIS IMF/IBRD WASHINGTON   WASHINGTON   UKMIS NEW
YORK   DOT

FINANCIAL SANCTIONS   OUR TELNO 703

1. MINISTRY OF ECONOMY RESOLUTION NO 899 SPANISH TEXT AS
FOLLOWS:
MINISTERIO DE ECONOMIA
DEUDA PUBLICA EXTERNA
DEJANSE SIN EFECTO LAS MEDIDAS DISPUESTAS POR LOS DECRETOS
INOS. 786 Y 787 DEL 20 DE ABRIL DE 1982.
RESOLUCION NO. 899
BUENOS AIRES 10/8/83

VISTO LO DISPUESTO POR DECRETOS NROS. 786 Y 787 DE 20DE
ABRIL DE 1982, Y
CONSIDERANDO:
QUE LA SITUACION ACTUAL PERMITE EL ACCESO AL MERCADO DE
CAMBIOS PARA LA REALIZACION DE TRANSFERENCIAS EN CONCEPTO
DE CANCELACION DE DEUDAS POR UTILIDADES, DIVIDENDOS, REGALIAS
Y ASISTENCIA TECNICA.
QUE AMBOS DECRETOS FACULTAN AL MINISTERIO DE ECONOMIA A DEROGAR
LAS MEDIDAS EN ELLOS DISPUESTAS.
POR ELLO,
EL MINISTRO DE ECONOMIA RESUELVE:
ARTICULO 1 - SE DEJA SIN EFECTO A PARTIR DEL 15DEL CORRIENTE
LAS MEDIDAS DISPUESTAS KVR LOC DECRETOS NROS. 786 Y 787 DEL
20 JHE ABRIL DE 1982.
ARTICULO 2 - COMUNIQUESE, PUBLIQUESE, DESE A LA DIRECCION
NACIONAL DEL REGISTRO OFICIAL Y ARCHIVESE.
WEHBE

2. TRANSLATION OF TEXT AS FOLLOWS:
MINISTRY OF ECONOMY
EXTERNAL PUBLIC DEBT
THE MEASURES TAKEN BY DECREES NO 786 AND 787 OF 20 APRIL 1982
ARE HEREBY CANCELLED.
RESOLUTION NO 899
BUENOS AIRES 10/8/83
IN VIEW OF THE PROVISIONS OF DECREES NOS. U786 AND 787
OF 20 APRIL 1982 AND
CONSIDERING:

/THAT

THAT THE PRESENT SITUATION ALLOWS ACCESS TO THE EXCHANGE MARKET FOR THE REALIZATION OF TRANSFERS TO SANCEL DEBTS FOR SERVICES, DIVIDENDS, ROYALTIES AND TECHNICAL ASSISTANCE.
THAT BOTH DECREES EMPOWER THE MINISTRY OF ECONOMY TO CANCEL THE MEASURES LAID DOWN.
FOR THIS REASON,
THE MINISTRY OF ECONOMY RESOLVES:
ARTICLE 1 - WITH EFFECT FROM THE 15TH OF THE CURENT MONTH THE MEASURES LAID DOWN BY DECREES NOS. 786 AND 787 OF 20 APRIL 1982 ARE HEREBY DECLARED TO BE CANCELLED.
ARTICLE 2 - THIS INFORMATION TO BE MADE KNOWN, PUBLISHED, AND PASSED TO THE NATIONAL DIRECTION OF OFFICIAL REGISTRATION FOR FILING.
WEHBE

3. WE HAVE NOT YET RECEIVED A COPY OF THE CENTRAL BANK CIRCULAR B-757.

JACKSON-HOULSTON

POWELL-JONES

MONETARY
FID
SAMD
ERD
MR GIFFARD
MR URE

GRS 400 **CONFIDENTIAL**

Argentina/IMF
pt

CONFIDENTIAL

(FM BERNE 171425Z)

FM BIS BUENOS AIRES

TO IMMEDIATE FCO
TELNO 703 OF 16 AUGUST
INFO IMMEDIATE UKMIS IMF/IBRD WASHINGTON WASHINGTON UKMIS NEW YORK
DOT

FINANCIAL RESTRICTIONS
OUR TELNO 697 OF 12 AUGUST

1. ACCORDING TO TODAY'S PRESS, THE LIFTING OF FINANCIAL SANCTIONS ON BRITISH ENTREPRISES IN ARGENTINA HAS BEEN CONFIRMED IN A CENTRAL BANK CIRCULAR NO BI-757. THE CIRCULAR EXPLAINS THE TERMS OF THE MINISTRY OF ECONOMY RESOLUTION NO 899, DATED 10 AUGUST, WHICH WITH EFFECT FROM 15 AUGUST ANNULLED THE RESTRICTIVE MEASURES PRESCRIBED BY DECREES NO 786 AND 787 OF 20 APRIL 1982 (COPY AND TRANSLATION FOLLOW BY TELEGRAM). THE RESOLUTION STATES THAT QUOTE THE PRESENT SITUATION PERMITS ACCESS TO THE EXCHANGE MARKET FOR THE REALISATION OF TRANSFERS IN CANCELLATION OF DEBTS SERVICES, DIVIDENDS, ROYALTIES AND TECHNICAL ASSISTANCE UNQUOTE. TEXT AND TRANSLATION OF THE CIRCULAR WILL FOLLOW AS SOON AS THE DOCUMENT IS AVAILABLE TO US.

2. WE HAVE NOW LEARNED THAT THE FIVE TEST CASES CHOSEN BY THE BANK OF ENGLAND (LOCAL SUBSIDIARIES OF SHELL, ICI, RTZ, BAT AND PILKINGTONS) RECEIVED WRITTEN PERMISSION FOR THE REPATRIATION OF DIVIDENDS FROM THE NATIONAL SUPERVISORY COMMISSION ON 10 AND 11 AUGUST. NEITHER SHELL NOR DUPERIAL (ICI) HAD DIVIDENDS TO REMIT, BUT BOTH WERE ALSO GUARANTEEEI LEAVE TO MAKE PAYMENTS FOR ROYALTY OR TECHNICAL ADVISORY FEES. BAT HAVE BEEN GIVEN THE SAME ASSURANCES, BUT INTEND TO POSTPONE THE TRANSFER OF FUNDS BECAUSE OF THE UNFAVOURABLE DISCOUNT RATE ON THE DOLLAR-DENOMINATED BONEX BONDS THROUGH WHICH THEY ASSUMED REMITTANCES WOULD BE MADE. PILKINGTONS HAVE TOLD US THAT THEY EXPECT TO RECEIVE AUTHORISATION FOR BONEX SUBSCRIPTIOJS THIS WEEK. ALL COMPANIES WERE URGED BY THE CENTRAL BANK AND THE ECONOMY MINISTRY TO NOTIFY THEIR LONDON OFFICES OF THESE DEVELOPMENTS. THEY PROMPTLY DID SO AND AT THE PRESENT REMAIN PRIMARILY CONCERNED THAT WE SHOULD NOT CALL INTO QUESTION THE ARGENTINE GOVERNMENT'S GOOD FAITH OR BLOCK LOANS TO ARGENTINA, LEST THEY BE SINGLED OUT FOR REPRISALS.

CONFIDENTIAL

/3.

3. DECREES NO 786 AND 787 STIPULATE THAT REMITTANCES FOR DIVIDENDS, ROYALTIES AND TECHNICAL ADVISORY FEES MUST BE MADE OR HELD IN THE FORM OF BONEX (NELSON'S LETTER OF 28 APRIL 1982 TO OTD, DOT). THEY APPLY TO ALL COMAPNIES IN ARGENTINA, AND THE DESCRIMINATION AGAINST UK FIRMS PREVIOUSLY CONSISTED IN PREVENTING THEIR ACQUISITION OF THE BONDS.

4. THE MINISTRY OF ECONOMY RESOLUTION APPEARS TO RELIEVE ALL ENTREPRISES, INCLUDING PRESUMABLY UK SUBSIDARIES, OF THE OBLIGATION TO USE BONEX, ON THE GROUNDS THAT IT IS NOW POSSIBLE TO PURCHASE FOREIGN CURRENCY WITH WHICH TO EFFECT PAYMENTS. IF THE CENTRAL BANK CIRCULAR DOES NOT SIGNIFICANTLY ADD TO THIS PROVISION, TODAY'S PRESS REPORTS WILL HAVE BEEN MISLEADING. IT REMAINS UNCLEAR WHETHER THE DISPENSATION GIVEN LAST WEEK BY THE NATIONAL SUPERVISORY COMMISSION TO BRITISH COMPANIES WAS A ONE-OFF MEASURE ON A PERMANENT ARRANGEMENT AND WHETHER THERE AS BEEN ANY MODIFICATION TO THE SUBSTANCE OF LAW 22591, WHICH ORIGINALLY INTRODUCED THE RESTRICTIONS OF THE FREE DISPOSAL OF BRITISH ASSETS IN ARGENTINA.

JACKSON-HOULSTON

POWELL-JONES

MONETARY
FID
SAMD
ERD
MR GIFFARD
MR URE

COPIES TO
DTI

CONFIDENTIAL

To Switzerland 15/9 @ 8.p.m.
cc Press Office

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

15 August 1983

Tim Flesher Esq
10 Downing Street

Dear Tim,

ARGENTINA

As foreshadowed in the report we sent you on Friday, the IMF Board discussion took place earlier today and Nigel Wicks has reported by telephone from Washington that the decision went through on a basis which appears entirely satisfactory to us. The essential point is that under the terms of the standby arrangement, Argentina will forfeit her right to any future drawings if she discriminates against the UK either by the introduction or re-introduction of discriminatory measures or by failing to extend to the UK any new measures of payments liberalisation. This therefore meets the condition stipulated by the Chancellor in paragraph 4 of his message to Mr Regan.

Before Argentina can draw on the standby, she will also have to reach agreement with creditor banks about the treatment of bank debt arrears. The current view in Washington is that this matter is unlikely to be settled before early September. This is helpful from our point of view because it gives us more time to establish to our own satisfaction that discrimination against UK firms really has been removed.

The Bank of England have accordingly told the UK banks concerned that the Government would not wish to stand in their way if they were now to decide that signature of the proposed $1.5 billion loan was in their commercial interest.

I am copying this letter to Brian Fall (FCO) and to John Bartlett (Bank of England).

Yours sincerely,

Margaret O'Mara

MISS M O'MARA
Private Secretary

CONFIDENTIAL

cc Press Off

NO 10 TO SWITZERLAND

C O N F I D E N T I A L

PRIME MINISTER FROM TIM FLESHER

YOU WILL ALREADY HAVE HEARD THAT THE OUTCOME OF THE IMF BOARD MEETING WAS SATISFACTORY FOLLOWING IS THE REPORT WHICH THE TREASURY HAVE RECEIVED FROM NIGEL WICKS IN WASHINGTON

BEGINS

ARGENTINA

AS FORESHADOWED IN THE REPORT WE SENT YOU ON FRIDAY, THE IMF BOARD DISCUSSION TOOK PLACE EARLIER TODAY AND NIGEL WICKS HAS REPORTED BY TELEPHONE FROM WASHINGTON THAT THE DECISION WENT THROUGH ON A BASIS WHICH APPEARS ENTIRELY SATISFACTORY TO US. THE ESSENTIAL POINT IS THAT UNDER THE TERMS OF THE STANDBY ARRANGEMENT, ARGENTINA WILL FORFEIT HER RIGHT TO ANY FUTURE DRAWINGS IF SHE DISCRIMINATES AGAINST THE UK EITHER BY THE INTRODUCTION OR REINTRODUCTION OF DISCRIMINATORY MEASURES OR BY FAILING TO EXTEND TO THE UK ANY NEW MEASURES OF PAYMENTS LIBERALISATION. THIS THEREFORE MEETS THE CONDITION STIPULATED BY THE CHANCELLOR IN PARAGRAPH 4 OF HIS MESSAGE TO MR REGAN.

BEFORE ARGENTINA CAN DRAW ON THE STANDBY, SHE WILL ALSO HAVE TO REACH AGREEMENT WITH CREDITOR BANKS ABOUT THE TREATMENT OF BANK DEBT ARREARS. THE CURRENT VIEW IN WASHINGTON IS THAT THIS MATTER IS UNLIKELY TO BE SETTLED BEFORE EARLY SEPTEMBER. THIS IS HELPFUL FROM OUR POINT OF VIEW BECAUSE IT GIVES US MORE TIME TO ESTABLISH TO OUR OWN SATISFACTION THAT DISCRIMINATION AGAINST UK FIRMS REALLY HAS BEEN REMOVED.

THE BANK OF ENGLAND HAVE ACCORDINGLY TOLD THE UK BANKS CONCERNED THAT THE GOVERNMENT WOULD NOT WISH TO STAND IN THEIR WAY IF THEY WERE NOW TO DECIDE THAT SIGNATURE OF THE PROPOSED DOLLAR 1.5 BILLION LOAN WAS IN THEIR COMMERCIAL INTEREST.

I AM COPYING THIS LETTER TO BRIAN FALL (FCO) AND TO JOHN BARTLETT (BANK OF ENGLAND).

ENDS

15 AUGUST 1983

NO 10 TO SWITZERLAND

C O N F I D E N T I A L

PRIME MINISTER FROM TIM FLESHER

YOU WILL ALREADY HAVE HEARD THAT THE OUTCOME OF THE IMF BOARD MEETING WAS SATISFACTORY   FOLLOWING IS THE REPORT WHICH THE TREASURY HAVE RECEIVED FROM NIGEL WICKS IN WASHINGTON

BEGINS

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I AM COPYING THIS LETTER TO BRIAN FALL (FCO) AND TO JOHN BARTLETT (BANK OF ENGLAND).

ENDS

15 AUGUST 1983

Miss Harrison to see
(Given a monetary distribution from MCAD)
CBlege 15/8.

OT
WONFO 009/13

TT FCO

GRS 650

RESTRICTED

TELELETTER NO 56

FROM SIR CRISPIN TICKELL, MEXICO CITY

FILE REFERENCE 092/1 OF 12 AUGUST 1983

FOLLOWING FOR B O WHITE ESQ, MCAD, FCO
COPIED TO WASHINGTON AND UKDEL IMF/IBRD WASHINGTON

MINISTRY OF FINANCE VIEW OF MEXICAN ECONOMY

1. IN MY TELELETTER NO 55 I GAVE YOU A BANK OF MEXICO VIEW ON RECENT DEVELOPMENTS IN THE MEXICAN ECONOMY. ON 11 AUGUST I TOOK SIR ALFRED SHERMAN TO CALL ON FRANCIS SUAREZ (DEPUTY MINISTER OF FINANCE) FOR A DISCUSSION ON THE SAME THEME. YOU MIGHT CARE TO HAVE A NOTE OF THE MAIN POINTS.

2. WE DISCUSSED THE RECENT RISE IN THE US PRIME RATE. LIKE GHIGLIAZZA (BANK OF MEXICO) SUAREZ SAID THAT THE RISE WAS MANAGEABLE. HE REPEATED GHIGLIAZZA'S POINT THAT THE MEXICANS HAD MADE THEIR CALCULATIONS FOR THE IMF ON THE BASIS OF A STILL HIGHER RATE, BUT HE ADDED THAT THE MEXICAN EXTERNAL FINANCIAL POSITION WAS NOW STRONG, AND THAT INTERNATIONAL OIL PRICES WERE NOW FIRMER. BUT HE HOPED VERY MUCH THAT THE US PRIME RATE WOULD COME DOWN BEFORE THE END OF THE YEAR. THE REST OF THE WORLD WAS OF COURSE SUFFERING FROM THE SIZE OF THE US BUDGET DEFICIT.

3. WE ASKED ABOUT RECENT REPORTS FROM PARIS THAT SOME LATIN AMERICAN GOVERNMENTS WERE LOOKING AGAIN AT THE IDEA OF A DEBT MORATORIUM. SUAREZ LAUGHED, AND SAID THAT WE HAD ALL HEARD THIS MANY TIMES BEFORE. THE MEXICANS WOULD HAVE NOTHING TO DO WITH SUCH A MORATORIUM. WHEN ASKED WHAT THE MEXICAN POSITION MIGHT BE IF OTHER COUNTRIES ENTERED INTO A MORATORIUM, SUAREZ REPLIED THAT IT WOULD NOT CHANGE.

4. SUAREZ SAID THAT MEXICAN DRAWINGS ON THE CREDITS AVAILABLE TO THEM HAD SO FAR BEEN LESS THAN EXPECTED. FOR EXAMPLE THE PUBLIC SECTOR DEBT HAD INCREASED BY ONLY US DOLLARS 820 MILLION IN THE PERIOD JANUARY TO JUNE 1983. IT WOULD PROBABLY NOW BE GOING UP SOME MORE TO DEAL WITH LAST YEAR'S BIS LOAN. BUT HE DOUBTED IF THE MEXICANS WOULD NEED TO DRAW MORE THAN US DOLLARS

REPLIED THAT IT WOULD NOT CHANGE.

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5. SUAREZ SAID THAT WITHIN THE MEXICAN ECONOMY DEMAND CONTINUED LOW. LIKE GHIGLIAZZA HE SAID THERE WAS NOW ALMOST TOO MUCH LIQUIDITY. SOME OF THIS WAS BEING MOPPED UP BY THE ISSUE OF THREE MONTH TREASURY BONDS (CETES). UNFORTUNATELY BOTH BANKS AND PRIVATE INVESTORS HAD SUCH AN APPETITE FOR THESE BONDS THAT NOT ENOUGH MONEY WAS GOING FROM THE BANKS TO THE PRIVATE SECTOR. INTEREST RATES HAD GONE DOWN A LITTLE, BUT THE GOVERNMENT WAS DETERMINED TO ENSURE POSITIVE RATE OF RETURN IN TERMS OF INFLATION. IN THESE CIRCUMSTANCES THE GOVERNMENT WAS CONSIDERING LOWERING THE BANKS' LIQUIDITY REQUIREMENTS IN ORDER TO GET THEM TO LEND MORE TO THE PRIVATE SECTOR.

6. WHEN ASKED IF ANY OF THE MONEY MEXICANS HAD INVESTED ABROAD DURING THE CRISIS LAST YEAR WAS NOW COMING BACK, SUAREZ SAID THAT RELATIVELY LITTLE HAD RETURNED THROUGH THE BANKS, BUT THE AUTHORITIES SUSPECTED THAT MORE HAD RETURNED THROUGH THE STOCK EXCHANGE. THE REASON WAS THAT MANY INVESTORS FEARED THAT IF THEY CHANNELLED THEIR MONEY THROUGH THE NATIONALIZED BANKS THE TAX AUTHORITIES WOULD COME TO HEAR OF IT. SO INSTEAD THEY WERE OPERATING THROUGH THE STOCK EXCHANGE AND THROUGH IT BUYING BOTH TREASURY BONDS AND INDUSTRIAL SHARES.

7. SUAREZ SAID THAT IN GENERAL THINGS WERE MUCH BETTER. NO-ONE KNEW WHETHER THE PRESENT RELATIVE SOCIAL PEACE WOULD CONTINUE BUT IT WAS A REASONABLE HOPE THAT IT WOULD. MANY OF THE DISASTERS WHICH HAD BEEN PREDICTED HAD NOT TAKEN PLACE. AN IMPORTANT POINT WAS THAT ALTHOUGH UNEMPLOYMENT WAS RISING AS MORE LABOUR CAME ON TO THE MARKET, EMPLOYMENT ITSELF WAS STEADY: AND IN DIFFERENT PARTS OF THE ECONOMY THERE WERE ALREADY SIGNS OF ECONOMIC RECOVERY.

8. PLEASE DISTRIBUTE FURTHER AS NECESSARY.

SIGNED: CRISPIN TICKELL

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Bo.f.

10 DOWNING STREET

From the Private Secretary

11 August 1983

Argentina/IMF

As you know, the Prime Minister and the Chancellor spoke twice on the telephone this morning about this. Their conclusions may be summarised as follows:

a) The IMF Executive Board would not be meeting until 31 August; but the signature of the commercial bank loan would probably take place early in the week of 15 August. The Bank of England had indicated to the UK banks involved that the Government would not approve of their signing the loan in advance of the discussion in the IMF Board.

b) Evidence had now been obtained that the Argentines had in fact abandoned their discrimination against UK banks and UK non-banking companies. If this evidence proved watertight, then this was good news.

c) The Chancellor had sent a terse message to Secretary Regan deploring the role of the US Treasury in encouraging the IMF to issue a certificate to the New York Advisory Group in advance of the IMF Board discussion. Nigel Wicks had delivered a formal note of protest to the IMF, and would follow this up with a phone call to Larosiere deploring the actions that the IMF had taken in his absence.

I should be grateful for a copy of the message that the Chancellor has sent to Secretary Regan in due course.

Timothy Flesher

Miss Margaret O'Mara,
HM Treasury.

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10 DOWNING STREET

From the Private Secretary

11 August 1983

Thank you for your letter of 10 August seeking clearance for publication of a White Paper reporting changes in the terms of the Treasury indemnity to the Bank of England in respect of their participation in the BIS facility for Brazil. The Prime Minister has agreed that the text which you enclosed with your letter should be published as a White Paper within the next two weeks.

Timothy Flesher

Miss J.C. Simpson,
HM Treasury.

Ent

10 DOWNING STREET

PRIME MINISTER

Tim Flesher asked me to show you the attached note which was prepared by the Treasury this evening.

Steve Gray

DUTY CLERK

11 August 1983

Good - I agree the Chancellor's approach MT

ARGENTINA

There has been a further development, which seems to result from the firm messages we have been conveying to the United States authorities. They are no longer for the moment pressing us to allow British banks to sign the loan agreement quickly (before the IMF Board decision on the next tranche of IMF lending). Instead, they are trying to accelerate the IMF Board decision. There is a possibility that a Board meeting could be held in the first two or three days of next week.

Meanwhile, you will be interested to know that news is accumulating that transfer payments for all British banks and companies are being authorised in Argentina. It seems probable that, by Monday at latest, we shall have no outstanding complaint of discrimination on transfers already due.

It is difficult to find any good ground on which the UK could object to accelerated consideration by the IMF of the Argentine loan, once it is clear that existing discriminations have in practice been removed. The Chancellor's general reaction is that we should therefore take the opportunity which would seem to be available to insist that, in the interests of getting a decision through quickly, our requirements as to conditions to be imposed by the IMF are fully met. These, you will recall, include a requirement that no new discrimination should be introduced, and a condition that, if new discrimination were nevertheless introduced, there would be no question of future IMF drawings. This would impose the strongest pressure on Argentina. It would also be a valuable quotable achievement.

You may also remember that there has been talk of Argentina introducing a general relaxation of restrictions on 15 August. At an earlier stage we were warned that this would not apply to UK companies. We have more recently been assured that there will be no discrimination, and that UK companies will benefit equally with others. The Chancellor considers that it would be sensible to make sure that this happens before the IMF Board decision, which points to a meeting not before 16 August.

An accelerated decision on these lines would open the way for British banks and others to sign and implement the commercial loan agreement, and the grounds on which we have been restraining British banks would have been removed.

It is by no means clear that an arrangement on these lines will prove practicable, but I thought you would like to know that this is the way things seem at present to be moving.

Prime Minister
This is the message the Chancellor has sent to Secretary Regan.
WR 11/8

DRAFT MESSAGE

To: Don Regan
Secretary
US Treasury

Excellent MT.

Dear Don

I took the unusual step yesterday of instructing our Executive Director of the International Monetary Fund to present the attached formal note of protest to the Acting Managing Director.

2. Argentina has repeatedly failed to implement its undertakings to remove financial discrimination. Whatever ~~ever~~ the pressures on him may have been, the precipitate action by the Acting Managing Director, without consultation with the member country directly concerned, is quite unacceptable.

3. I would like you to understand our position on two points in particular.

4. The first is that the principle~~s~~ of non-discrimination must surely be respected on any resumption of IMF lending to Argentina. To that end, when the question next comes to the Executive Board, I shall have to insist on evidence that existing discrimination has been removed without qualification, and on a clear stipulation in the terms

of resumed IMF lending that no discrimination will be imposed in future. I hope I shall be able to count on the support of colleagues for this application of IMF principle.

5. My second point is that the commercial bank loan really ought - in common prudence if for no other reason - to be available only when IMF lending is resumed, the relevant conditions having been met. I shall continue to discourage British banks from putting their names to a loan before that position has been reached, and I cannot but feel surprised that other~~s~~ Governments should take a different view.

Spare copies

Miss Harrison to see

(Top copy being given a monetary distribution)

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MEX/WASH 008/10

TT FCO

GRS 460

RESTRICTED

TELELETTER NO 55

FROM SIR CRISPIN TICKELL, MEXICO CITY

FILE REFERENCE 092/1 OF 10 AUGUST 1983

FOLLOWING FOR B O WHITE ESQ, MCAD, FCO
COPIED TO WASHINGTON AND UKDEL IMF/IBRD WASHINGTON

BANK OF MEXICO VIEW OF MEXICAN ECONOMY

1. I TOOK SIR ALFRED SHERMAN TO CALL ON THE DEPUTY DIRECTOR GENERAL AT THE BANK OF MEXICO THIS MORNING. WE HAD A DISCUSSION ABOUT THE STATE OF THE MEXICAN ECONOMY.

2. GHIGLIAZZA SAID THAT THE RISE IN THE US PRIME RATE WAS OBVIOUSLY UNWELCOME. BUT PROVIDED IT DID NOT GO ANY HIGHER AND DID NOT LAST TOO LONG, IT SHOULD BE MANAGEABLE. HE ADDED THAT WHEN THE MEXICANS HAD DONE THEIR CALCULATIONS FOR THE IMF LAST YEAR THEY HAD WORKED ON THE BASIS OF A CONSIDERABLY HIGHER US PRIME RATE. THE WAY IN WHICH THE MEXICAN PERFORMANCE HAD SINCE EXCEEDED EXPECTATIONS WAS PARTLY DUE TO THIS. BUT LIKE EVERYBODY ELSE THE MEXICANS HOPED THAT THE US PRIME RATE WOULD COME DOWN IN THE AUTUMN, PROBABLY NOVEMBER.

3. GHIGLIAZZA SAID THAT THINGS WERE GENERALLY LOOKING BETTER. THERE WAS NOW ALMOST TOO MUCH LIQUIDITY, BOTH IN PESOS AND DOLLARS, IN THE MEXICAN SYSTEM, AND THERE WERE THOSE WHO WERE URGING THE GOVERNMENT TO BRING DOWN INTEREST RATES. THE BANK OF MEXICO BELIEVED THAT THIS WOULD BE WRONG IN PRESENT CIRCUMSTANCES, AND BELIEVED THAT PRESIDENT DE LA MADRID SHARED THIS

HIGHER US PRIME RATE. ... HAD SINCE EXCEEDED EXPECTATIONS WAS PARTLY DUE TO THIS. BUT LIKE EVERYBODY ELSE THE MEXICANS HOPED THAT THE US PRIME RATE WOULD COME DOWN IN THE AUTUMN, PROBABLY NOVEMBER.

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4. WHEN ASKED WHY, IF THERE WAS SURPLUS LIQUIDITY IN THE SYSTEM, MEXICO DID NOT ACCELERATE ITS PAYMENT OF FOREIGN DEBTS, GHIGLIAZZA SAID THAT THE BANK'S FIRST PRIORITY WAS TO BUILD UP THE RESERVES, WHICH HAD FALLEN TO ZERO DURING THE CRISIS LAST YEAR. THE DAMAGE DONE TO THE ECONOMY HAD BEEN VERY GREAT, AND THE GOVERNMENT WANTED TO PROCEED STEADILY AND IN PUNCTILIOUS RESPECT FOR THE COMMITMENTS INTO WHICH IT HAD ENTERED.

5. ON EXCHANGE RATE POLICY, GHIGLIAZZA SAID THAT THE AUTHORITIES WOULD ACT WITH FLEXIBILITY. IF IT WAS NECESSARY TO INCREASE THE CURRENT DAILY SLIPPAGE IN THE CONTROLLED RATE, THEY WOULD DO SO. THEY WOULD ALSO BE READY TO MOVE THE SO-CALLED FREE RATE. AT PRESENT THE PRESSURE ON THE FREE RATE WAS IF ANYTHING THE OTHER WAY. HE REMARKED THAT AUGUST WAS USUALLY A BAD MONTH FOR THE MEXICAN ECONOMY AS SPECULATORS HEDGED THEIR BETS ON THE PRESIDENT'S ANNUAL STATE OF THE NATION ADDRESS ON 1 SEPTEMBER: BUT SO FAR THE IN-FLOW OF DOLLARS HAD CONTINUED, SOME DAYS MORE, SOME DAYS LESS. HE DID NOT EXPECT THE CONTROLLED AND FREE RATES TO CONVERGE FOR SOME TIME. THIS WOULD ONLY BECOME POSSIBLE WHEN INFLATION HAD BEEN BROUGHT FULLY UNDER CONTROL, AND ARRANGEMENTS FOR PAYMENT OF MEXICO'S PRIVATE SECTOR DEBTS WERE COMPLETE.

6. PLEASE DISTRIBUTE FURTHER AS REQUIRED.

SIGNED: CRISPIN TICKELL

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Top copy below.

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

10 August 1983

A Jormah

W F S Rickett Esq
10 Downing Street

Dear Willie,

ARGENTINA

We have spoken about the developments last night and today which mean that the note which I enclosed with my letter of 9 August now needs updating. The Chancellor discussed these developments with the Governor today.

First, a correction of one point in my earlier note, which underlines the need for caution. It now appears that no new Law is being introduced in Argentina: there have simply been fresh, and possibly stronger, assurances to the IMF by the Argentine financial authorities that they intend to terminate discrimination forthwith.

IMF Certification

As you know, Geoffrey Littler was in touch with Dale, the IMF Acting Managing Director, yesterday to urge that time for careful consideration and appraisal be taken before any certificate was issued to the New York Advisory Group of Commercial Banks following these new Argentine assurances. Notwithstanding that conversation, and without further contact with the UK, Dale went ahead yesterday with the issue of a certificate that he was satisfied that discrimination against the United Kingdom had ceased, and that he would be so reporting to the IMF Executive Board. We heard of this, via commercial bank channels, around 11.00pm last night (our time). Littler was immediately in touch with Dale again, heard his confirmation of what he had done, and protested. Dale took the line that it was a matter for his judgment, and that he was obliged to accept the good word of the Argentine authorities. Littler expressed astonishment and dissatisfaction, and warned that we would make a more formal protest today.

/Our Executive

1) message from Lawson to Larosière.
2) cc to Dale & ~~Regan~~
3) discussed with PM ~~[illegible]~~
4) separate letter to Regan (at PM's request)
"at a time when IMF seeking more funds"
1) Try to stop
2) Documentary evidence
Any UK bank " who complies: we are disapproval.

Fed discount rate?

15 bn

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Prime Minister
10.8.83

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

10 August 1983

A formal protest must be made at the highest level not

W F S Rickett Esq
10 Downing Street

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?

/Our Executive

Flag A

Our Executive Director is in fact now delivering a formal note of protest. I attach a copy of the main part of the text. (There will be added to it a short passage, which Wicks is drafting, recalling the conditions which we had agreed with the IMF staff would need to be fulfilled in order to dispose of the discrimination problem, before IMF lending was resumed, and seeking confirmation that those conditions are still agreed between us.)

Flag B.

It seems clear,eg from Washington telegram No 2240, which you have seen,that Dale acted under pressure from the United States as well as the Argentine authorities.

Commercial Bank Loan

There was considerable pressure yesterday afternoon and overnight for signature of the commercial bank loan on 12 August. This pressure emanated from the Argentine authorities, US banks and the US Government, and grew as knowledge of Dale's certificate spread. But, after discussions with the Bank of England, the British banks have indicated that they would find difficulty in signing so quickly.

It is still not clear what will now happen. The two main possibilities seem to be:-

(a) that the US and other banks decide to go ahead with early signature, possibly even on 12 August, accepting that the British banks will not be prepared to do so at the same time.

(b) that the whole arrangement for signature is deferred, at least for 3 or 4 days, and possibly until after the IMF Executive Board meeting planned for 24 August.

Deferment until after 24 August is of course what the Chancellor would prefer.

The British banks are in understandable difficulty, anxious not to appear unnecessarily negative with their international colleagues, or to jeopardise their interests in Argentina. But they accept that more time is needed to check that discrimination has genuinely been removed, and they are not anxious to sign unless they have an indication from the Bank of England or the Government that their action will not be criticised.

/As

As a result of talks between officials of the UK and US Treasuries, the latter are trying to work for a postponement of the signature of the agreement, in the hope of finding a date when all banks will be able and willing to sign. We have warned that this is most unlikely to be before 24 August. But the US are anxious to move faster, and non-British banks may in the end go ahead with signature before then.

The Argentine authorities have been in touch with the Bank of England, urging that the British banks should come into line. The Governor and the Chancellor agreed today that the Bank's response should be that the announcement of the ending of discrimination was welcome; and that its translation into practical effect might open the door to a favourable decision in the IMF Board on 24 August; which would in turn open the door to participation in the commercial loan by all the banks involved.

The Facts on Discrimination

We have urged British banks and companies to put in applications for transfers of outstanding dividends, etc. So far, the one piece of news which has resulted has helped our arguments with the IMF and the US Treasury. BBI put in their application and have been told that, while it appears in order, the written procedure for approval will take 72 hours. We do not think this is the usual arrangement for the banks and companies of other countries, and 72 hours will of course extend beyond the 12 August planned signature date.

We shall continue to keep you informed.

I am sending copies of this letter to John Holmes at the FCO and John Bartlett at the Bank.

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

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DRAFT

HMG has been concerned to receive a report that the Acting Managing Director on 9 August issued to certain commercial banks a certificate that, in his judgment, Argentine discriminatory restrictions had been satisfactorily terminated and that this would be his recommendation to the IMF Executive Board. It is the understanding of HMG that such a certificate could be a critical condition for signature and disbursement of a substantial commercial bank loan to Argentina.

2. There has been an unsatisfactory history in recent months of failure by the Argentine authorities to implement undertakings which they have repeatedly given on this matter.

3. In the circumstances, it is the view of HMG that a more proper and prudent course would have been for the IMF to await confirmation of the action promised by the Argentine authorities, including confirmation by the member country directly affected by the discriminatory measures.

4. HMG has conveyed to British commercial banks its judgment that a little more time is needed to obtain adequate confirmation that discriminatory restrictions have indeed been terminated and will not be reimposed.

10 AUG 1983

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FM WASHINGTON 092236Z AUG 83
TO IMMEDIATE FCO
TELNO 2240 OF 9 AUG 83

YOUR TELNOS 254 AND 256 IMF/ARGENTINA : FINANCIAL RESTRICTIONS

1. LELAND (US TREASURY) TELEPHONED ME IN SOME AGITATION THIS EVENING TO SAY THAT HE HAD JUST LEARNED THAT THE BRITISH BANKS HAD SAID THEY COULD NOT APPROVE SIGNATURE OF THE BANK LOAN ON 12 AUGUST. HE COULD NOT UNDERSTAND THIS. DALE WAS READY TO RECALL THE BOARD AND TELEXES WERE ABOUT TO SSUE. COULD I EXPLAIN THE HOLD UP?

2. I DREW ON YOUR TELEGRAMS UNDER REFERENCE TO EXPLAIN THAT THIS HAD BEEN LOOKED AT VERY CAREFULLY TODAY IN LONDON AND THAT HE WOULD SURELY UNDERSTAND THAT WE HAD TO OBTAIN SPECIFIC EVIDENCE FROM THE COMPANIES CONCERNED THAT THEY HAD BEEN ABLE TO REMIT PROFITS BEFORE WE COULD ACCEPT THAT THE DISCRIMINATORY RESTRICTIONS HAD ACTUALLY BEEN REMOVED. WE WERE URGENTLY ASKING THE COMPANIES TO PURSUE APPLICATIONS. BUT WE BELIEVED THAT SIGNATURE OF THE BANK LOAN ON 12 AUGUST WOULD BE PREMATURE. I TOLD LELAND THAT WICKS WOULD BE EXPLAINING THE SITUATION ON THESE LINES TO DALE AS SOON AS POSSIBLE TOMORROW.

3. LELAND SIMMERED DOWN ON HEARING THIS EXPLANATION. BUT HE MAY TELEPHONE LITTLER FIRST THING TOMORROW TO SEE WHETHER THERE IS ANY POSSIBILITY OF SPEEDING THINGS UP. HIS CONCERN WAS THAT DEL SOLAR AND OTHERS HAD PUT THEIR CREDIBILITY ON THE LINE IN BUENOS AIRES AND NOW RISKED ARRIVING IN WASHINGTON ON 12 AUGUST IN AN EMPTY ROOM. HE WONDERED WHETHER THE BEST THING MIGHT BE TO URGE THEM TO DELAY THEIR ARRIVAL BY A WEEK. I AGREED THAT THIS WOULD BE BETTER THAN ARRIVING TOMORROW, BUT SUGGESTED THAT THE BEST COURSE WOULD BE TO PLAN SIGNATURE SHORTLY AFTER THE IMF PROGRAMME HAD BEEN AGREED. LELAND'S REACTION INDICATED THAT THE AMERICANS WOULD STRONGLY RESIST SUCH A LONG DELAY.

FCO PLEASE ADVANCE DESKBY 100830 TO LITTLER, TREASURY

THOMAS

[ADVANCED AS REQUESTED]

MONETARY
ERD
FID
NEWS D
MR GIFFARD
MR URE

COPIES TO
MR LITTLER) TREASURY
MR LAVELLE)
MR CRAWFORD BANK OF ENGLAND
MR OWEN OT5 DTI

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GR 1300 **CONFIDENTIAL**

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DESKBY 110830Z
FM UKDEL IMF / IBRD WASHINGTON 102331Z AUG 83
TO IMMEDIATE FCO
TELEGRAM NUMBER 284 OF 10 AUGUST

YOUR TELNO 257 OF 10 AUGUST

IMF: ARGENTINA - DISCRMINATORY RESTRICTIONS

1. THE FOLLOWING POINTS EMERGED FROM MY MEETING THIS MORNING WITH DALE (ACTING MANAGING DIRECTOR) DURING WHICH I HANDED OVER THE MEMORANDUM IN MIFT RECORDING OUR DISSATISFACTION WITH THE ISSUE OF HIS CERTIFICATE TO THE BANKS.

2. DURING THE DISCUSSION, I EMPHASISED THAT WHILE WE NATURALLY WELCOMED THE MODIFICATIONS TO THE ARGENTINE LETTER AS A USEFUL STEP, ALL EXPERIENCE WITH THE DISCRIMINATORY RESTRICTIONS MADE US CAUTIOUS ABOUT ARGENTINE STATEMENTS. THAT WAS WHY WE ATTACHED GREAT IMPORTANCE TO THE THREE POINTS SET OUT IN MY MEMORANDUM TO DALE OF AUGUST 5 (ALREADY SENT TO LONDON). DALE'S REPLY WAS THAT HIS QUOTE BELIEF UNQUOTE, BASED ON HIS CONVERSATIONS WITH DEL SOLAR AND THE TELEX FROM DEL SOLAR AND WEHBE IN MY TELNO 283 OF 8 AUGUST WAS THAT ARGENTINA WOULD NOW TREAT UK COMPANIES IN EXACTLY THE SAME WAY AS OTHER COUNTRIES' COMPANIES. IT WAS UP TO THE UK TO GIVE FUND MANAGEMENT EVIDENCE THAT THIS WAS NOT THE POSITION. HE ALSO QUOTE BELIEVED UNQUOTE THAT THE LIBERLISATION OF THE PAYMENTS REGIME PLANNED FROM AUGUST 15 WOULD EXTEND TO BRITISH COMPANIES. IF IT WAS DEMONSTRATED THAT DISCRIMINATION CONTINUED, HE WOULD AMEND HIS RECOMMENDATION TO THE EXECUTIVE BOARD.

3. ON THE THREE POINTS, DALE SAID THAT HE HOPED THAT THE SUBSTANCE OF CONDITION C (SUSPENSION OF FURTHER IMF DRAWINGS IF DISCRIMINATORY RESTRICTIONS WERE REIMPOSED) SHOULD NOT CAUSE DIFFICULTY. THIS OUGHT EFFECTIVELY TO BE THE POSITION IN ANY CASE SINCE REINTRODUCTION OF THE DISCRIMINATION WOULD AUTOMATICALLY RULE OUT FURTHER DRAWINGS.BUT THIS NEEDED TO BE CONSIDERED FURTHER BY THE FUND'S LEGAL DEPARTMENT. DALE ADVISED ME IN ANY EVENT TO HAVE THE POINT CONFIRMED ON THE RECORD BY ASKING AN APPROPRIATE QUESTION IN THE BOARD DISCUSSION AND SEEKING TO PROCURE INCLUSION OF THE ANSWER IN THE CHAIRMAN'S UMMING UP. (LEGAL DEPARTMENT'S PRELIMINARY VIEW IS THAT THE TERMS OF THE STAND-BY WOULD LEAD TO THE SUSPENSION OF FURTHER DRAWINGS IF THE EXISTING DISCRIMINATORY RESTRICTIONS WERE REIMPOSED, BUT NOT IF DISCRIMINATION WAS INTRODUCED BY LIBERLISATION NOT EXTENDING TO THE UK. I AM FOLLOWING THIS UP WITH THE FUND LAWYERS.) ON CONDITION B (AN IMF REQUIREMENT ACCEPTED BY ARGENTINA IN WRITING THAT DISCRIMINATORY RESTRICTIONS

CONFIDENTIAL

/WOULD

WOULD NOT BE REIMPOSED AND FUTURE LIBERALISATION WOULD BE EXTENDED IN A NON-DISCRIMINATORY WAY), DALE SAID THIS WOULD RAISE DIFFICULTIES SINCE ARGENTINA HAD ALREADY RECORDED THEIR INTENTION TO TERMINATE THE DISCRIMINATORY RESTRICTIONS (PARA. 10 OF THE ATTACHMENT EBS/83/143 AS AMENDED) AND HE, DALE, REGARDED QUOTE TERMINATE UNQUOTE AS A STRONG WORD IN THIS CONTEXT. I SAID THAT ARGENTINA'S UNWILLINGNESS TO BE EXPLICIT ABOUT THEIR FUTURE INTENTION WAS BOUND TO MAKE US SUSPICIOUS. DALE REPLIED THAT IT MIGHT BE POSSIBLE TO INCLUDE IN THE STAFF PAPER THE STAFF'S BELIEF THAT THE RESTRICTIONS WOULD NOT BE REINTRODUCED AND THAT FUTURE LIBERALISATION WOULD BE NON-DISCRIMINATORY. I PRESSED HIM FURTHER AND HE AGREED TO ASK THE FUND'S EXCHANGE AND TRADE RLATIONS DEPARTMENT TO CONSIDER WHETHER THERE WERE ANY APPROPRIATE PRECEDENTS FOR THE FUND MANAGEMENT SEEKING AN UNDERTAKING FROM A MEMBER COUNTRY IN SUCH TERMS. IF NO PRECEDENT COULD BE FOUND, THE ARGENTINES COULD, HE ARGUED, BE ON GOOD GROUNDS IN ARGUING THAT THEY SHOULD NOT BE ASKED FOR SUCH UNDERTAKINGS. ON CONDITION A (EVIDENCE THAT DISCRIMINATORY RESTRICTIONS HAVE CEASED ETC) DALE REPEATED THAT IT WAS UP TO THE UK TO PRODUCE EVIDENCE REBUTTING ARGENTINA'S CONTENTION.

4. DALE THEN SAID THAT THE EXECUTIVE BOARD DISCUSSION WOULD PROBABLY SLIP FROM AUGUST 24 TO THE END OF THE MONTH OR POSSIBLY INTO EARLY SEPTEMBER FOR A VARIETY OF REASONS. THE DISCUSSION COULD THEN TAKE ACCOUNT OF CERTAIN ECONOMIC MEASURES WHICH THE ARGENTINES MIGHT (UNDERLINE LAST WORD) SOON INTRODUCE, BRACHET (MISSION LEADER) WOULD NOT BE RETURNING FROM SOUTH AMERICA UNTIL AUGUST 28, AND PERHAPS , MOST IMPORTANT, THE DELAY WOULD PERMIT THE POSITION ON ARREARS TO BE CLARED UP. THE STAFF'S PAPER BRINGING EBS/83/143 UP TO DATE WOULD PROBABLY NOT BE CIRCULATED BEFORE WEEK COMMENCING AUGUST 22. I SAID THAT WE WOULD HAVE HAD NO OBJECTION TO A DISCUSSION ON AUGUST 24. WE THOUGHT IT IMPORTANT FOR THE BOARD TO HAVE COMPLETED THE REVIEW BEFORE THE COMMERCIAL BANKS SIGNED THE LOAN AGREEMENTS. WHILE WE DID NOT THINK THERE COULD BE A DISCUSSION BEFORE AUGUST 24 (BECAUSE THIS WOULD NOT PERMIT TIME TO CHECK THAT THE DISCRIMINATORY RESTRICTIONS HAD BEEN REMOVED), POSTPONEMENT FOR MORE THAN A DAY OR SO MIGHT CAUSE DIFFICULTIES WITH THE COMMERCIAL BANK LOAN.

5. I HAVE ALSO BROUGHT MY G10 AND AUSTRALIAN COLLEAGUES UP TO DATE WITH THE POSITION, EMPHASISING THAT WHILE THE MODIFICATIONS TO THE ARGENTINE LETTER TO THE IMF APPEARED TO BE A STEP IN THE RIGHT DIRECTION, IT WAS ONLY NATURAL, IN VIEW OF PAST HISTORY, FOR THE UK TO PROCEED CAUTIOUSLY BEFORE ACCEPTING THAT ALL DISCRIMINATIONS HAD ACTUALLY BEEN REMOVED.
I ALSO BRIEFLY MENTIONED THE THREE CONDITIONS, REFERRED TO IN PARA. 4 ABOVE, TO WHICH WE ATTACHED IMPORTANNCE. THE ONLY QUESTION OF SUBSTANCE CAME FROM DE MAULDE (FRENCH EXECUTIVE DIRECTOR) WHO ASKED WHETHER THE UK WAS STILL INSISTING THAT ARGENTINA REPEAL THE DISCRIMINATORY LAWS. WHEN I REPLIED THAT

THAT WAS NATURALLY STILL OUR POSITION SINCE WE HAD REPLEALED OUR DISCRIMINATORY LAW, HE SAID THAT HE WISHED TO GIVE ME QUOTE THE IMPORTANT CAUTION UNQUOTE THAT IF WE CONTINUED TO INSIST THAT THE LAW BE REMOVED, FRANCE WOULD NOT BE ABLE TO SUPPORT US IN THE FUND SINCE IT WAS HIS UNDERSTANDING THAT THE FUND WAS ONLY CONCERNED WITH WHAT HAPPENED IN PRACTICE, NOT WITH NATIONAL STATUTE BOOKS.

6. FCO PLEASE ADVANCE TO PS/S OF S, PS/CHANCELLOR, LITTLER AND LAVELLE (TREASURY), GILCHRIST (BANK OF ENGLAND), APPLEYARD (ERD), AND OWEN (OT5,DTI).

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} B/ENGLAND

MR OWENS OTS DTI

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

W F S Rickett Esq
10 Downing Street

10 August 1983

Prime Minister

Agreed

Dear Willie,

TREASURY INDEMNITY FOR THE BANK OF ENGLAND - BRAZIL

This letter seeks clearance for the publication of a White Paper reporting changes in the terms of the Treasury indemnity to the Bank of England in respect of their participation in the BIS facility for Brazil.

In accordance with procedures agreed with the PAC we are required to inform Parliament of any non-statutory indemnities and to keep Parliament informed of any subsequent changes.

We published a White Paper last December (Cmnd 8779) on the terms of the Treasury indemnity associated with the financing arrangements for Brazil. Changes since then - mainly the suspension of IMF drawings and the resulting postponement of BIS repayments - have made it necessary to extend the period of the Treasury indemnity beyond the end of this month. This change is significant enough to require a new announcement.

The Chancellor has approved the attached text. Our intention is to publish it as a White Paper within the next two weeks. I would be grateful for your clearance.

Yours,

Judith

MISS J C SIMPSON
Private Secretary

DRAFT WHITE PAPER

REVISIONS TO THE TERMS OF AN INDEMNITY TO THE BANK OF ENGLAND COVERING THEIR COMMITMENT TO THE BANK FOR INTERNATIONAL SETTLEMENTS IN RESPECT OF A CREDIT FACILITY FOR BRAZIL

Under arrangements agreed with the Committee of Public Accounts (Thirteenth Report, Session 1979-80, paragraphs 14-17) any proposal by a Government department to give a non-statutory guarantee or indemnity involving a contingent liability exceeding £100,000 is required to be the subject of a minute laid before Parliament.

2. In accordance with these arrangements the terms of a Treasury indemnity to the Bank of England covering their commitment to the Bank for International Settlements (BIS) in respect of a credit facility for the Banco Central Do Brasil (Banco Central) were reported last December in a minute published as Cmnd 8779. The purpose of this subsequent minute is to report modifications in the terms of the agreement since then.

3. The original short term facility offered by the BIS amounted to $1.2 billion and was to be repaid in instalments by the end of August 1983. The BIS financed the facility from its own resources but with a right of recourse to participating central banks under a substitution agreement. The Bank of England's contingent liability under this arrangement was for a capital sum of $110 million and any associated interest costs, and this commitment was covered by the Treasury indemnity.

4. At an early stage the total facility was increased to $1.45 billion by the participation of an additional central bank and the repayment schedule was extended to the end of November 1983.

Although this could have the effect of extending the period of the Bank of England's contingent liability it did not affect the amount. The first instalment of $400 million has since been repaid by Banco Central, reducing the total amount outstanding under the facility to $1.05 billion. As a result the capital amount of the Bank of England's contingent liability has fallen to $47,142,857.

5. Following the suspension of IMF drawings for Brazil, the BIS agreed to postpone the second instalment of $400 million due at the end of May, first until the end of June and then until 15 July. The Banco Central then intimated that they were unable to make repayment on that date. No further formal extension has been agreed, but the BIS have decided to take no action for the time being and in particular have not required the participating central banks to meet their commitments under the substitution agreement in respect of that instalment. This decision was influenced by the progress in Brazil's negotiations with the IMF and the expectation that Brazil would be able to resume drawings from the IMF in due course.

6. Since it is now possible that the Bank's contingent liability could extend beyond the end of August the Treasury have confirmed to the Bank that in those circumstances the indemnity will continue to apply.

11 AUG 1983

pm. wh 11/8

DD 091900Z UKDEL IMF/IBRD WASHINGTON
GRS 309
CONFIDENTIAL
DESKBY 091900Z
FM FCO 091721Z AUG 83
TO IMMEDIATE UKDEL IMF/IBRD WASHINGTON
TELEGRAM NUMBER 255 OF 9 AUGUST
MIPT IMF: ARGENTINA - FINANCIAL RESTRICTIONS
YOUR TELNO 283 OF 8 AUGUST.

2. THE LIFTTNG OF FINANCIAL RESTRICTIONS AGAINST UK COMPANIES IS WELCOME SO FAR AS IT GOES. BUT DEL SOLAR'S TELEX IN TUR DOES NOT MAKE IT ABSOLUTELY CLEAR WHAT ARGENTINA IS DOING OR INTENDS TO DO. PLEASE ASK THE FUND STAFF TO FIND OUT EXACTLY WHAT IT MEANS.

3. THE MODIFICATION TO THE LETTER FROM WEHBE MEANS THAT THE PRESENT DISCRIMINATORY PRACTICES ARE BEING ELIMINATED. PRESUMABLY THIS MEANS THAT UK NON-FINANCIAL COMPANIES WILL NOW BE ABLE TO SELL THEIR BONEX (AT A DISCOUNT) IN THE PARALLEL MARKET, AS OTHER FOREIGN FIRMS IN ARGENTINA ALREADY CAN. SO FAR SO GOOD.

4. NO MODIFICATION IS PROPOSED TO PARA 4 OF WEHBE LETTER, WHICH REPORTS ARGENTINA'S INTENTION TO ALLOW FREE ACCESS TO THE FOREIGN EXCHANGE MARKETS FOR FOREIGN-OWNED INSTITUTIONS IN ARGENTINA FROM 15 AUGUST. IF THIS LIBERALISATION IS NOW TO INCLUDE UK COMPANIES AND FINANCIAL INSTITUTIONS, WELL AND GOOD.

5. BUT IT MAY CONCEAL AN INTENTION TO STOP OUR COMPANIES AND BANKS USING THE FOREIGN EXCHANGE MARKETS WHILE ALLOWING THEM TO TRADE THEIR BONEX IN THE PARALLEL MARKETS. IF SO, THIS WOULD CONSTITUTE A NEW FINANCIAL DISCRIMINATION BECAUSE UK COMPANIES WOULD BE GETTING A LESS FAVOURABLE EXCHANGE RATE.

6. WE BELIEVE THAT, WERE THIS TO BE THE CASE, IT WOULD CONSTITUTE A BREACH OF ARGENTINA'S PERFORMANCE CRITERIA (AS CLARIFIED BY DALE'S MEMO OF 28 JANUARY). DO THE FUND STAFF AGREE THIS INTERPRETATION? DO THEY KNOW WHAT ARGENTINA INTENDS TO DO? ARE LAWS 22591 OR 22820 TO BE MODIFIED OR SUSPENDED? ACCORDING TO DEL SOLAR IN A CONVERSATION TODAY WITH

THE GOVERNOR OF THE BANK OF ENGLAND,ARGENTINA HAS INTRODUCED NEW LEGISLATION WHICH CANCELS THE DISCRIMINATORY PROVISIONS OF THE EARLIER OFFENDING LEGISLATION.

RAISON

NNNN

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Mc.

overtaken WR 11/8

~~Prime Minister~~

~~The Americans are still being difficult. Nigel Wicks has been instructed to make quite clear that we consider signature of the Bank loan as conditional on agreement to resumption of the IMF programme.~~

CONFIDENTIAL

GRS 250
CONFIDENTIAL
DESKBY 100830
FM WASHINGTON 092236Z AUG 83
TO IMMEDIATE FCO
TELNO 2240 OF 9 AUG 83

YOUR TELNOS 254 AND 256 IMF/ARGENTINA : FINANCIAL RESTRICTIONS

1. LELAND (US TREASURY) TELEPHONED ME IN SOME AGITATION THIS EVENING TO SAY THAT HE HAD JUST LEARNED THAT THE BRITISH BANKS HAD SAID THEY COULD NOT APPROVE SIGNATURE OF THE BANK LOAN ON 12 AUGUST. HE COULD NOT UNDERSTAND THIS. DALE WAS READY TO RECALL THE BOARD AND TELEXES WERE ABOUT TO SSUE. COULD I EXPLAIN THE HOLD UP?

2. I DREW ON YOUR TELEGRAMS UNDER REFERENCE TO EXPLAIN THAT THIS HAD BEEN LOOKED AT VERY CAREFULLY TODAY IN LONDON AND THAT HE WOULD SURELY UNDERSTAND THAT WE HAD TO OBTAIN SPECIFIC EVIDENCE FROM THE COMPANIES CONCERNED THAT THEY HAD BEEN ABLE TO REMIT PROFITS BEFORE WE COULD ACCEPT THAT THE DISCRIMINATORY RESTRICTIONS HAD ACTUALLY BEEN REMOVED. WE WERE URGENTLY ASKING THE COMPANIES TO PURSUE APPLICATIONS. BUT WE BELIEVED THAT SIGNATURE OF THE BANK LOAN ON 12 AUGUST WOULD BE PREMATURE. I TOLD LELAND THAT WICKS WOULD BE EXPLAINING THE SITUATION ON THESE LINES TO DALE AS SOON AS POSSIBLE TOMORROW.

3. LELAND SIMMERED DOWN ON HEARING THIS EXPLANATION. BUT HE MAY TELEPHONE LITTLER FIRST THING TOMORROW TO SEE WHETHER THERE IS ANY POSSIBILITY OF SPEEDING THINGS UP. HIS CONCERN WAS THAT DEL SOLAR AND OTHERS HAD PUT THEIR CREDIBILITY ON THE LINE IN BUENOS AIRES AND NOW RISKED ARRIVING IN WASHINGTON ON 12 AUGUST IN AN EMPTY ROOM. HE WONDERED WHETHER THE BEST THING MIGHT BE TO URGE THEM TO DELAY THEIR ARRIVAL BY A WEEK. I AGREED THAT THIS WOULD BE BETTER THAN ARRIVING TOMORROW, BUT SUGGESTED THAT THE BEST COURSE WOULD BE TO PLAN SIGNATURE SHORTLY AFTER THE IMF PROGRAMME HAD BEEN AGREED. LELAND'S REACTION INDICATED THAT THE AMERICANS WOULD STRONGLY RESIST SUCH A LONG DELAY.

FCO PLEASE ADVANCE DESKBY 100830 TO LITTLER, TREASURY

THOMAS [ADVANCED AS REQUESTED]

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MR CRAWFORD BANK OF ENGLAND
MR OWEN OT5 DTI

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Prime Minister 2

WR 10/8

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

9 August 1983

W F S Rickett Esq
10 Downing Street

Thank you very much

Dear Willie,

CURRENT INTERNATIONAL DEBT QUESTIONS

You suggested that it would be helpful to the Prime Minister, before she leaves for Switzerland, to have a further short note listing the key dates for forthcoming decisions in respect of IMF and BIS finance for the main debtor countries discussed in my letter of 5 August.

with WR?

I attach a list. Some of the dates are of course by no means immutable, and discussions in advance of decisions will be held at a number of meetings which I have included in the list in brackets.

The list does not mention Argentina, on which I attach a separate short note, in view of developments during the last 24 hours.

Copies of this letter and enclosures go to John Holmes at the FCO and John Bartlett at the Bank.

Yours ever,
John Kerr.
J O KERR
Principal Private Secretary

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INTERNATIONAL DEBT AND IMF FUNDING: KEY DATES

15 August	Mexican drawing under IMF programme.
20 August	Due date for drawing under Argentine IMF programme.
24 August	Possible IMF Board discussion of Argentina.
10 September	BIS - opportunity to discuss Brazil and financing arrangements for IMF.
(10/11 Sept	ECOFIN.)
15 September	Informal rollover of BIS loan for Brazil expires.
(21/22 Sept	Commonwealth Finance Ministers, Trinidad.)
(23 September	G5 Ministers, Washington, IMF issues.)
(24 September	G10 Ministers, Washington, IMF issues.)
25 September	IMF Interim Committee, Washington, IMF issues.
(26 September	Development Committee, Washington.)
(27-30 Sept	IMF/IBRD annual meetings, Washington.)
15 November	Mexican drawing under IMF programme.
20 November	Argentine drawing under IMF programme (subject to renegotiation if necessary).

<u>Country notes</u>

Yugoslavia	IMF mission to review programme in September.
Nigeria	IMF programme likely after election - perhaps in September.
Venezuela	IMF mission to return in mid-August, agreement on programme hoped by early September.
Brazil	Renegotiated IMF programme still to be discussed in Board - possibly in September (or later).

ARGENTINA

Yesterday, 8 August, the Argentine authorities reported both to the IMF and to the representatives of commercial banks in New York that they had removed discriminatory restrictions (and, we understand, met certain other requirements demanded by the commercial banks). Full details are awaited, but the IMF understanding is that a new Law has been or is being introduced which cancels those parts of the Law under which discrimination was imposed against various kinds of payments by UK banks and other companies in Argentina. The IMF are inclined to read this, subject to confirmation, as satisfactorily eliminating existing restrictions and removing the legal basis for future restrictions.

2. In itself, this is satisfactory news. It can be regarded as the result of firmness of the IMF itself and of other leading countries in response to our pressure, fortified by the tough message which the international commercial banks sent to Argentina late last week, as a result of representations by British participants prompted by the Bank of England.

3. Argentina is now pressing for very rapid action both on the IMF standby and on the commercial bank loan:

- On the former, subject to confirmation the IMF staff are proposing to circulate a paper for discussion and decision in the Executive Board on Wednesday 24 August; we have no ground for objecting to that procedure, but shall want to be sure that our conditions are met before approval is given.

- On the commercial bank loan, Argentina has asked for a meeting for signature on Friday, 12 August; this seems to us to be rushing matters far too quickly.

4. The Bank of England will be urging British banks to seek a deferment of the proposed signature meeting, on the reasonable ground that so serious a step should not be taken until the Argentine position with the IMF is further clarified. Indeed, our view is that the commercial banks should not sign ahead of a positive Executive Board decision which cannot occur before 24 August. The Bank of England will hope to persuade British banks to take this view, and persuade their international colleagues, in their own commercial interest. If necessary, however, they will indicate that the Government would consider premature signature ill-advised and be prepared to say so publicly.

5. An element in the commercial bank loan is the requirement for a certificate by the IMF, to the effect that the standby agreement with Argentina is still in operation, before money can be drawn under the loan. Separately, we are asking our Executive Director in Washington to urge the Acting Managing Director not to give any such certificate until the situation is genuinely clear, again probably meaning after the Executive Board discussion on 24 August.

Econ Pol

Intellectuals Pt 2

Prime Minister

X is clearly crucial.

I understand arrangements have been made to test it. WM 9/8

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DESKBY 090830Z

FM UKDEL IMF/IBRD WASHINGTON 082100Z

TO IMMEDIATE F C O

TELNO 282 OF 8 AUGUST 1983.

IMF: ARGENTINA - FINANCIAL RESTRICTIONS

1. DALE (ACTING MANAGING DIRECTOR) INFORMED US THIS AFTERNOON THAT HE HAD HEARD BY TELEPHONE FROM DEL SOLAR AT 12.30 WASHINGTON TIME TODAY THAT THE DISCRIMINATORY RESTRICTIONS AGAINST UK NON-FINANCIAL FIRMS HAD BEEN ELIMINATED. DALE SAID THIS SEEMED TO BE CONFIRMED BY A TELEX THE MANAGING DIRECTOR HAD RECEIVED FROM DEL SOLAR. HE MENTIONED FOR OUR PRIVATE INFORMATION THAT BRACHET (WESTERN HEMISPHERE DEPARTMENT) HAD VISITED ARGENTINA OVER THE WEEKEND AT DEL SOLAR'S REQUEST.

2. DALE SAID THAT IF THE FUND MANAGEMENT WERE SATISFIED THAT THE ARGENTINE CLAIM TO HAVE ELIMINATED THE RESTRICTIONS STOOD UP, HE WOULD WANT TO BRING THE STAFF PAPER ON REVIEW OF THE ARGENTINE STANDBY (EBS/83/143) BEFORE THE EXECUTIVE BOARD PROBABLY ON 24 AUGUST. DALE SAID THAT, IN REACHING THEIR ASSESSMENT, THE FUND MANAGEMENT WOULD TAKE ACCOUNT OF THE FACTORS SET OUT IN MY INFORMAL MEMORANDUM TO HIM OF 5 AUGUST (PARAGRAPH 1 OF OUR TELNO 251).

3. SHORTLY AFTER RECEIVING DALE'S MESSAGE, HUNTRODS (DIRECTOR, LLOYDS BANK INTERNATIONAL) TELEPHONED FROM NEW YORK, TO SAY THE LEAD BANKS HOPED TO TELEX ALL THE BANKS INVOLVED IN THE COMMERCIAL BANK LOAN ON TUESDAY (PARAGRAPH 4 OF OUR TELNO 251). HUNTRODS RANG OFF TO TAKE A CALL FROM DALE ON ANOTHER LINE. HUNTRODS WAS AWARE OF THE ARGENTINE CLAIM TO HAVE ELIMINATED THE RESTRICTIONS AND WAS ANXIOUS TO OBTAIN CLARIFICATION OF WHETHER THIS MET HMG'S REQUIREMENTS. HE SAID THAT THE ARGENTINES WERE PRESSING FOR THE BANK LOAN TO BE SIGNED ON FRIDAY 12TH.

4. WE ARE SEEKING A COPY OF THE TELEX TO THE MANAGING DIRECTOR, MEANWHILE YOU WILL NO DOUBT BE CONSIDERING HOW WE CAN PUT THESE ARGENTINIAN ASSURANCES TO THE TEST. X

5. FCO PLEASE ADVANCE TO PS/CHANCELLOR, PS/EST, LITTLER AND LAVELLE (HMT), GILCHRIST AND LOEHNIS (BANK OF ENGLAND), THOMAS, APPLEYARD (ERD) AND OWEN (OT5, DTI).

WICKS

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GRS 600

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FM WASHINGTON 082330Z AUG 83

TO IMMEDIATE FCO

TELNO 2223 OF 8 AUG 83

UKDEL IMF/IBRD TELNO 282 AND YOUR TELNO 130 TO BIS BUENOS AIRES

IMF/ARGENTINA : LIFTING OF FINANCIAL RESTRICTIONS

1. MCNAMAR (DEPUTY SECRETARY US TREASURY) TELEPHONED ME THIS AFTERNOON TO TELL ME ABOUT THE REPORTED LIFTING OF THE ARGENTINE RESTRICTIONS ON PAYMENTS TO NON-FINANCIAL FIRMS. HE SAID THAT THIS HAD BEEN AN EXTREMELY DIFFICULT DECISION FOR THE ARGENTINIANS AND HE HOPED THERE WOULD BE A POSITIVE REACTION FROM WASHINGTON. (I UNDERSTAND THAT IT HAS NOT YET BEEN DECIDED WHETHER TO MAKE A PUBLIC US COMMENT. BUT IF ANYTHING IS SAID. IT IS LIKELY TO BE IN RESPONSE TO QUESTIONS, AND BE APPROPRIATELY CAUTIOUS, PENDING VERIFICATION. THE LINE WILL PROBABLY BE THAT THIS IS A WELCOME STEP IN THE DIRECTION OF NORMALISATION OF RELATIONSHIPS. MCNAMAR SAID ANY STATEMENT WOULD PROBABLY NOT LINK THE ACTION DIRECTLY WITH THE REQUIREMENTS OF THE FUND).

2. MCNAMAR WONDERED WHETHER THE UK WOULD SEE ITS WAY TO OFFERING ''SOMETHING POSITIVE IN RESPONSE'' TO THE ARGENTINIAN ACTION AND FROM WHAT HE SAID HE WAS STILL HANKERING AFTER THE FISHING ACCESS POINT. IN SPEAKING TO HIS ARGENTINIAN COUNTERPARTS, HE HAD CONFIRMED HIS UNDERSTANDING THAT THE BRITISH WOULD BE PREPARED TO CONSIDER A REQUEST FOR ACCESS BY FISHING VESSELS TO THE EXCLUSION ZONE. HE HAD MADE IT CLEAR TO THEM THAT HE COULD NOT TAKE DISCUSSION OF THAT QUESTION ANY FURTHER AND THEY MUST NOW APPROACH THE MATTER THROUGH THE SWISS. BUT WHAT THEY WERE NOW LOOKING FOR WAS SOME CONFIRMATION THAT THERE WOULD BE A POSITIVE BRITISH RESPONSE TO A SERIOUS APPLICATION.

3. I TOLD MCNAMAR THAT THE LIFTING OF THE ARGENTINIAN RESTRICTIONS, IF IT WAS IMPLEMENTED, WOULD CERTAINLY BE WELCOME IN LONDON. I DISCOURAGED HIM STRONGLY FROM THINKING THAT WE MIGHT OFFER SOMETHING IN RESPONSE TO A STEP WHICH THE ARGENTINIANS HAD ALREADY COMMITTED THEMSELVES TWICE TO UNDERTAKE. I WELCOMED HIS CAUTION OVER FURTHER DISCUSSION OF FISHING ACCESS AND TOLD HIM THAT THE RECENT INCURSIONS BY ARGENTINIAN SHIPS AND AIRCRAFT INTO THE ZONE HAD LEFT IT PRETTY CLEAR THAT THESE HAD BEEN DONE WITH THE KNOWLEDGE, IF NOT THE AUTHORITY, OF THE ARGENTINE NAVY AND AIR FORCE. I WARNED HIM THAT THIS WOULD MAKE IT MUCH MORE DIFFICULT FOR US TO LOOK ON ANY REQUEST FOR ACCESS AS BEING GENUINELY MOTIVATED BY FISHING INTERESTS.

/4. PICKING

4. PICKING UP A REFERENCE TO THE UK EXPORT RESTRICTION ON AN AIRCRAFT SIMULATOR, I DREW ON PARAGRAPH 7 OF YOUR TELNO 130 TO BIS BUENOS AIRES TO SUGGEST THAT THE PROPER CONTEXT FOR DISCUSSION OF TRADE RESTRICTIONS WAS THE PROPOSALS PUT FORWARD BY THE EC ABOUT NORMALISATION OF COMMERCIAL RELATIONSHIPS . IF THE ARGENTINIANS SERIOUSLY WANTED TO PURSUE THE LIFTING OF TRADE RESTRICTIONS, THEY SHOULD RESPOND TO THE VARIOUS APPROACHES WHICH HAD BEEN MADE TO THEM ABOUT THIS, MOST RECENTLY BY THE GREEK PRESIDENCY. MCNAMAR WONDERED IF THIS WAS PROPERLY UNDERSTOOD IN BUENOS AIRES AND SAID THAT HE HOPED EC REPRESENTATIVES WOULD MAKE THE POINT CLEAR BOTH TO THE MINISGRY OF FOREIGN AFFAIRS AND TO THE MINISTRY OF ECONOMICS IF WE SAW THE CASE OF THE SIMULATOR AS PART OF THE WIDER PROBLEM OF ARGENTINE/UK COMMERCIAL RELATIONSHIPS.

5. IN CONCLUSION, MCNAMAR SAID THAT HE RECOGNISED THE PROBLEMS OF ALL THIS FOR US. BUT HE EMPHASISED AGAIN HOW DIFFICULT THE DECISION TO LIFT RESTRICTIONS HAD BEEN FOR THE ARGENTINIANS AND HE HOPED VERY MUCH THAT WE WOULD BE ABLE TO GIVE A POSITIVE REACTION, PERHAPS WELCOMING IT AS A USEFUL STEP WHICH SHOULD HELP TO CLEAR THE WAY TOWARDS NORMALISATION OF RELATIONS. I TOLD HIM THAT IF THE REPORTS WERE SUBSTANTIATED I THOUGHT IT WOULD BE OUR NORMAL INSTINCT TO RESPOND IN THIS KIND OF WAY. I COULD ASSURE HIM IN ANY CASE THAT THERE WOULD BE NO DISPOSITION IN LONDON TO CROW.

6. I SHOULD BE GRATEFUL TO KNOW THE TERMS OF ANY OFFICIAL REACTIONS WE MAY MAKE SO THAT I CAN LET MCNAMAR KNOW. WE WILL REPORT IF ANYTHING IS SAID HERE.

THOMAS

NNNN

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MR CRAWFORD BANK OF ENGLAND
MR OWEN OT5/DTI

Econ Pol
Indebtedness Pt 2

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

5 August 1983

W F S Rickett Esq
10 Downing Street

Dear Willie,

CURRENT INTERNATIONAL DEBT QUESTIONS

The Chancellor thought that, before leaving for Switzerland, the Prime Minister might like a note on current international debt questions. No decisions are required now on any of the points covered: this letter is intended to provide background information.

Argentina

There have been some developments since the note I sent to you on 1 August. US attempts to look for some concession on fishing rights, mentioned in paragraph 8 of the earlier note, began to look like a slippery slope, particularly given the Argentinian incursion into the exclusion zone, and, without rebuffing the Americans, we have told them that this issue will have to be pursued separately, and through more appropriate channels. We have indicated to the IMF our minimum conditions (set out in paragraph 6 of the earlier note) for a further Argentine drawing: they have responded sympathetically, and we are now trying to nail them down on the detail, and to ensure that the US Treasury knows our requirements (which are no more than are needed to ensure that the IMF's own conditions are met and continue to be met).

In spite of further lobbying by Argentina, our impression is that we still have firm support from the IMF, the Americans, most EC colleagues and some others - more than sufficient to block any Argentine move in the IMF Board. (Time for any early move is in any case running out, for the IMF itself takes a two-week holiday from this weekend.)

Meanwhile, contacts between the Bank of England and British banks potentially involved in the commercial loan to Argentina

Redemi -term loan.

have resulted in a clear determination by the British banks not to sign the loan until the IMF position is clarified. (It has also been made clear to them that, if the IMF situation were not satisfactorily resolved from our point of view, the Government would not wish them to sign, and would be prepared to say so publicly.) The British banks appear to have persuaded their colleagues on the international Argentina Advisory Group to their view about signature. We understand that the Group have sent the Argentine authorities a stiff telex saying that it will not recommend signature in advance of a satisfactory response on four outstanding issues, including that of discrimination.

Brazil

The news from Brazil is somewhat discouraging. The external trade performance is good; and the target surplus this year looks attainable. But other economic indicators have been worsening, and inflation in particular is accelerating, with prospects of 140/160 per cent for calendar 1983. Political opposition against the IMF may be strengthening, and there have been suggestions that the important decree which reduces indexation (the key measure, announced and put into effect by the Brazilian government last month, which gave encouragement at the time to the IMF and BIS) may meet opposition in the Brazilian Congress.

The IMF Managing Director is taking a severe line. He was dissatisfied with the likely consequences in 1984 of the terms negotiated by his team in Brazil in the second half of July, and sent them back again to do better. He is nevertheless still confident that a satisfactory agreement will soon be reached.

Meanwhile, although interbank deposits have stabilised, Brazil is in continuous cash-flow difficulty. Arrears on some payments have been increasing and are probably near $2 billion. The risk of a default is that much greater.

A further tranche of the BIS credit is due for repayment at the end of August. It seems unlikely that it will be repaid and in any case the expectation must be that it will be dealt with in the same way as the postponed 31 May tranche. The BIS meeting on 10 September will plainly be critical. It seems best to defer judgement on the action which should be taken then; in the first week of September we shall need to take stock of progress between Brazil and the IMF.

Mexico

Reports continue to be good. It is believed that Mexico is ready and able to make the repayment due shortly to the BIS, which will eliminate the bridging loan.

Venezuela

The IMF mission got nowhere in July, but may try again this month. The Venezuelans, who are trying for unconditional assistance, against much resistance in the IMF Executive Board, are muddling through with successive agreements to postpone immediate banking debts. There seems little chance of the right political and economic decisions being taken until the elections late this year are out of the way. Although the Venezuelan debt is very large (some $34 billion at end-1982), and the conduct of the present government inspires no confidence, the country of course has very substantial assets.

Poland

At a recent meeting of creditor government representatives, the United States indicated that they were now in principle (but subject to release of political detainees) willing to participate in rescheduling, at some stage during the autumn. This is (long overdue) good news.

Hungary

Hungary appears to be contriving some improvement without the need for a major rescue operation. Their temporary BIS support has been completely repaid. They have recently negotiated a $200 million loan from commercial banks, and may well seek another such loan later this year, without calling on special official assistance.

Yugoslavia

A re-appraisal by the IMF is due. Delays on commercial bank credits, which have been agreed in principle, continue mainly because of difficulties in obtaining the waiver of an earlier negative gold pledge clause in an agreement with Kuwait. The waiver would permit BIS to increase its bridging facility to $500 million, which is a condition for disbursement of $600 million of new commercial bank lending. The first $300 million of the BIS facility already made available has been partially repaid, on schedule.

IMF

After strenuous efforts by the US Administration, the legislation to authorise and finance US contributions to increased IMF quotas and the GAB enlargement was eventually passed by the House of Representatives, although with the bare majority of 217 against 211, and with some unhelpful amendments. There remains a reconciliation process to marry this with the different (less amended) version which the Senate passed some weeks ago, but at least we do not now have to face the very difficult problems which could have arisen had Congress rejected the proposals.

At the last BIS meeting in July, attended by the IMF Managing Director, there was some discussion of the possibility of a further financing operation for the IMF, in which the BIS would play a prominent part. This is a little complicated, because it involves an attempt to kill two birds with one stone - helpfully if it can be successfully worked out:

- on the one hand, the IMF does need, for the last few months of this year, before the quota increases are ratified, an arrangement to underwrite future disbursements. This will not require immediate cash financing, but simply a promise that funds would be available if the quota increases were delayed or frustrated. However unlikely the contingency, the IMF are obviously right to be unwilling to enter into commitments until sure that they will have sufficient resources. So the suggestion is that the BIS could offer a standby credit to the IMF, guaranteed by participating central banks (and the governments behind them), which would not need to be drawn until some time in 1984 at the earliest, if at all.

- The second objective arises from IMF attempts to secure a further substantial loan, of perhaps $3 billion, from Saudi Arabia. It is the judgement of the Managing Director that the Saudis will not sign up unless there is some parallel loan from industrial countries, which could however be on a shorter-term basis. G5 countries are considering a German suggestion that this condition be met on the understanding that a new loan from industrial countries would be offset by reductions in the amount which they would otherwise have been prepared to commit under the enlarged GAB.

Further discussion on these two linked issues is needed, but there does in principle seem to be a possibility of a helpful arrangement through the BIS, which would both provide the contingent cover which the IMF believe they will need in the later months of this year, and new resources as an alternative to drawings on the GAB. If a consequence was that the IMF did secure a substantial new Saudi loan, the costs to us of the new arrangement would probably be lower than those of the original GAB arrangement.

These issues will of course be for discussion at the ECOFIN meeting in Greece on 9/11 September, the BIS meetings in Basle on 11/13 September, and the Interim Committee and IMF (and G5, G7 and G10) meetings in Washington on 23/28 September.

I am sending copies of this letter to Brian Fall at the FCO and John Bartlett at the Bank of England.

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

pm

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GRS 280
CONFIDENTIAL
FM UKDEL IMF/IBRD WASHINGTON 052340Z AUG 83
TO PRIORITY FCO
TELEGRAM NUMBER 280 OF 5 AUGUST
INFO TOKYO

IMF: ARGENTINA--DISCRIMINATORY RESTRICTIONS AGAINST THE UK.

1. IN THE LIGHT OF TOKYO TELNO 394 OF JULY 27, I TOOK THE OPPORTUNITY OF A LUNCH TODAY WITH HIRAO (IMF JAPANESE EXECUTIVE DIRECTOR) TO EMPHASISE THAT THERE WAS NO DOUBT THAT THE ARGENTINE PAYMENTS RESTRICTIONS WERE DISCRIMINATORY. THE FUND MANAGEMENT ACCEPTED THAT AND SO DID THE ARGENTINES. INDEED, THE LETTER OF JULY 8 TO THE MANAGING DIRECTOR FROM THE ARGENTINE CENTRAL BANK GOVERNOR AND MINISTER OF ECONOMY, CIRCULATED AS ATTACHMENT TO EBS/83/143, OPENLY TERMED THE RESTRICTIONS AS QUOTE DISCRIMINATORY RESTRICTIONS ON PAYMENTS AND TRANSFERS FOR CURRENT INTERNATIONAL TRANSACTIONS WITH RESPECT TO FIRMS OWNED OR CONTROLLED BY RESIDENTS OF ONE FUND MEMBER UNQUOTE. I URGED HIRAO THAT IF HE HAD ANY DOUBTS ON THIS SCORE, HE SHOULD TALK TO THE FUND STAFF.

2. HIRAO ALSO TOLD ME THAT THE ARGENTINE AMBASSADOR IN TOKYO HAD MADE MUCH OF OUR ALLEGED DISCRIMINATION IN NOT PERMITTING ARGENTINE FISHING VESSELS ACCESS TO THE FALKLANDS ISLANDS PROTECTION ZONE. I EXPLAINED THE BACKGROUND TO THE ZONE, THE ARGENTINE FAILURE TO DECLARE A CESSATION OF HOSTILITIES, AND THE FACT THAT THEY HAD NOT MADE ANY APPLICATION FOR ACCESS TO THE ZONE. HIRAO TOOK NOTE BUT HIS JAPANESE INSCRUTABILITY MADE IT DIFFICULT TO JUDGE WHETHER HE WAS IMPRESSED BY MY POINTS.

3. FCO PLEASE ADVANCE TO LITTLER AND LAVELLE (TREASURY) GILCHRIST (BANK OF ENGLAND) AND APPLEYARD (ERD), AND OWEN (OT5,DTI)

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DESKBY 080900Z

FM UKDEL IMF/IBRD WASHINGTON 052330Z AUG 83

TO IMMEDIATE FCO

TELEGRAM NUMBER 279 OF 5 AUGUST

YOUR TELNO 251 OF AUGUST 4

IMF: ARGENTINA

1. I HAVE SENT THE DEPUTY MANAGING DIRECTOR, ON AN INFORMAL BASIS, A MEMORANDUM OF THE TERMS WHICH WE WOULD EXPECT TO SEE WRITTEN INTO ANY WAIVER OR OTHER NEW AGREEMENT ON THE ARGENTINE PROGRAM (COPY TO LONDON BY BAG).

2. ON THE QUESTIONS IN TELEGRAM UNDER REFERENCE, THE DMD TOLD ME THAT BRACHET (DIVISION CHIEF, WESTERN HEMISPHERE DEPARTMENT) WILL MAKE A SHORT VISIT TO BUENOS AIRES DURING HIS CURRENT MISSION TO URUGUAY IN ORDER TO CHECK PROGRESS OF THE ARGENTINE ECONOMY. BRACHET WOULD PROBABLY REPORT TO MANAGEMENT HERE IN, SAY, ABOUT A FORTNIGHT'S TIME. THE DMD SAID THAT THE FUND MANAGEMENT HAS NOT YET DECIDED HOW TO REPORT TO THE BOARD ANY LATER INFORMATION PRODUCED BY BRACHET'S VISIT, BUT THE MOST LIKELY VEHICLE WOULD BE A PAPER SUPPLEMENTING EBS/83/143. THE DMD WAS GUARDED ON WHETHER ARGENTINA HAD MET THE JUNE 30 CRITERIA. BRACHET'S VISIT WAS INTENDED TO FIND THAT OUT. BUT HIS IMPRESSION WAS THAT THE ECONOMY HAD NOT DETERIORATED SO MUCH BY JUNE 30 THAT THE CRITERIA WOULD HAVE BEEN BREACHED BY THEN. HE DID NOT THINK THAT ARGENTINA WOULD NEED A WAIVER ON THE OTHER CRITERIA TO QUALIFY FOR THE AUGUST 20 DRAWING.

3. ON NOTICE FOR DISCUSSION OF ANY NEW PAPER, I THINK THAT THE POSITION WOULD BE THE SAME AS FOR NOTICE OF DISCUSSION OF EBS/83/143.

4. THE DMD TOLD ME THAT THE LEAD BANKS IN THE ARGENTINE LOAN CONSORTIUM HAD RECENTLY SENT A TELEX TO THE ARGENTINE AUTHORITIES WITH TERMS FOR THE COMMERCIAL BANK LOAN. THIS TELEX INCLUDED A PARAGRAPH ABOUT THE NON-COMPLETION BY THE IMF OF THE REVIEW. IT WENT ON TO EXPLAIN THAT THE CAUSE OF THIS DELAY WAS THE MAINTENANCE BY ARGENTINA OF DISCRIMINATORY PAYMENT RESTRICTIONS AGAINST ONE FUND MEMBER. THE TELEX INDICATED THAT THERE WERE AT LEAST SOME BANKS IN THE CONSORTIUM WHO WOULD NOT BE WILLING TO SIGN THE COMMERCIAL BANK LOAN UNTIL THE IMF REVIEW HAD BEEN COMPLETED. THE DMD THEN SAID THAT THE LEAD BANKS WOULD BE SENDING A SIMILAR TELEX ON MONDAY TO ALL THE BANKS INVOLVED IN THE COMMERCIAL BANK LOAN. THAT TELEX WOULD INCLUDE A SIMILAR PARAGRAPH. HE THOUGHT THAT THERE COULD THEN BE CONSIDERABLE PUBLICITY ABOUT THE DIFFICULTIES CAUSED BY THE DISCRIMINATORY PAYMENTS RESTRICTIONS. HE WOULD BE BRIEFING THE FUND PRESS OFFICE WITH A FACTUAL STATEMENT OF THE POSITION. HE DECLINED TO SHOW THIS TO ME IN ADVANCE, BUT PROMISED ME A COPY WHEN IT IS SENT TO HIS PRESS OFFICE. WE WILL SEND YOU A COPY DIRECTLY IT IS AVAILABLE.

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/S.

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5. FCO PLEASE ADVANCE TO PS/S OF S, PS/CHANCELLOR, LITTLER AND LAVELLE (TREASURY), GILCHRIST (BANK OF ENGLAND) AND APPLEYARD (ERD), AND OWEN (OT5, DTI)

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GRS 200
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DESKBY 040830Z
FM WASHINGTON 032300Z AUG 83
TO IMMEDIATE F C O
TELEGRAM NUMBER 2183 OF 3 AUGUST

YOUR TELNO 1306 OF 3 AUGUST: I M F/ARGENTINA

1. MINISTER (ECONOMIC) SPOKE TO MCNAMAR (DEPUTY SECRETARY, U.S. TREASURY) TONIGHT ON THE LINES OF PARAGRAPHS 2 - 4 OF TELEGRAM UNDER REFERENCE. MCNAMAR DID NOT SEEM DISPOSED TO STIMULATE ACTION ON FISHING ACCESS. HE WAS AWARE OF THE INCURSION. THOUGH HE SAID HE WAS GUESSING, HE DID NOT RULE OUT THAT IT HAD BEEN DELIBERATELY STAGED TO HARDEN ATTITUDES IN ARGENTINA.

2. HE HAD NO PLANS TO CALL DEL SOLAR, BUT THOUGHT DEL SOLAR MIGHT TELEPHONE HIM TOMORROW.

F C O PLEASE ADVANCE TO BUTLER (NO 10), PS/S OF S, ACLAND AND THOMAS (F C O), PS/CHANCELLOR, LITTLER, AND LAVELLE (HMT), PS/GOVERNOR, LDEAHNIS AND GILCHRIST (BANK)

THOMAS

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FM FCO 031715Z AUGUST 83

TO IMMEDIATE WASHINGTON

TELEGRAM NUMBER 1306 OF 3 AUG

YOUR TELNO 2179 AND 2180: IMF/ARGENTINA

1. YOU HANDLED THIS WELL. IT IS USEFUL THAT MCNAMAR HAS ACKNOWLEDGED THE UNDESIRABILITY OF CONFUSING THE TWO SITUATIONS, AND WE PARTICULARLY WELCOME HIS ASSURANCE (PARA 2 OF FIRST TUR) THAT THERE IS QUOTE NO QUESTION OF ANY GIVE IN THE US POSITION UNQUOTE ON REMOVAL OF RESTRICTIONS.

2. PLEASE ASSURE MCNAMAR THAT WE ARE NOT SEEKING TO SHUT DOWN HIS CHANNEL WITH DEL SOLAR. WE RECOGNISE IT MAY WELL HAVE VALUE FOR DISCUSSION OF FINANCIAL QUESTIONS IN THE FUTURE.

3. YOU WILL BE AWARE FROM PRESS REPORTS OF THE INCURSION INTO THE PROTECTION ZONE ON 1 AUGUST BY TWO ARGENTINE FISHING VESSELS. THE CAPTAIN OF ONE OF THE SHIPS IS REPORTED BY REUTER AS SAYING QUOTE WE MADE OUR LITTLE CONTRIBUTION TO SOVEREIGNTY UNQUOTE. THE EPISODE UNDERLINES THE NEED FOR CAUTION ON OUR PART IN PURSUING ANY QUESTION OF ACCESS TO THE ZONE BY ARGENTINE VESSELS.

4. WE ARE TELEGRAPHING SEPARATELY TO HM AMBASSADOR IN BERNE, GIVING HIM THE BACKGROUND AND ASKING HIM TO WARN THE SWISS THAT THEY MAY BE APPROACHED IN BUENOS AIRES ON THE QUESTION OF ACCESS TO THE FIPZ. YOU MAY LIKE TO TELL MCNAMAR THAT WE HAVE THIS IN HAND. BUT, ESPECIALLY FOLLOWING THE INCURSION, WE DOUBT WHETHER IT IS REALISTIC TO ANTICIPATE A BONA FIDE ARGENTINE APPLICATION IN PRESENT CIRCUMSTANCES. IF MCNAMAR SEEMS DISPOSED TO STIMULATE ACTION ON THIS FRONT, PLEASE CAUTION HIM ACCORDINGLY.

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DESKBY 030900Z
FM WASHINGTON 030232Z AUG 83
TO IMMEDIATE FCO
TELEGRAM NUMBER 2180 OF 2 AUGUST

MIPT
IMF: ARGENTINA

1. FOLLOWING THE DISCUSSIONS REPORTED IN MIPT, MCNAMAR TELEPHONED MINISTER (ECONOMIC) ABOUT HIS SUBSEQUENT CONVERSATION WITH DEL SOLAR. HE TOLD MINISTER (ECONOMIC) THAT HE WAS UNSURE WHETHER DEL SOLAR HAD SPOKEN TO HIS PRESIDENT, BUT HIS ASSUMPTION WAS THAT HE HAD.

2. MCNAMAR SAID THAT DEL SOLAR HAD TOLD HIM THAT HE WANTED TO PRESENT THE QUOTE MORE OR LESS FIRM VIEWS OF HIS GOVERNMENT UNQUOTE. HE SAW TWO POSSIBILITIES FOR MOVING FORWARD. THE FIRST WAS THAT THERE SHOULD BE A QUOTE CLEAR-CUT REDUCTION UNQUOTE IN THE EXCLUSION ZONE TO 25 MILES WITH NO ADVANCE NOTICE FOR ENTRY. MCNAMAR TOLD MINISTER (ECONOMIC) THAT IN ACCORDANCE WITH THE BRITISH WISH NOT TO PURSUE DISCUSSIONS WITH DEL SOLAR ABOUT FISHING ACCESS, HE HAD NOT ASKED DEL SOLAR ABOUT WHAT HE MEANT BY THIS. BUT HIS (MCNAMAR'S) IMPRESSION WAS THAT DEL SOLAR HAD IN MIND ALLOWING FISHING BOATS TO WITHIN 25 MILES OF THE COAST NOT WARSHIPS. THE SECOND POSSIBILITY WAS THAT THE BRITISH SHOULD LET THE ARGENTINES HAVE THE FLIGHT SIMULATORS, REFERRED TO IN PARA. 5 OF OUR WASHINGTON TELNO 2158 OR RETURN THE MONEY PAID OVER FOR THEM.

3. MCNAMAR EMPHASISED TO MINISTER (ECONOMIC) THAT HE HAD MADE NO COMMENT ON THESE POINTS, BUT HAD REITERATED THE UK VIEW THAT THERE WAS NO LINKAGE BETWEEN THE BILATERAL UK/ARGENTINE PROBLEMS AND THE MULTILATERAL IMF MATTER. MCNAMAR SAID THAT DEL SOLAR AGREED THAT THESE MATTERS OUGHT NOT TO BE LINKED AND THAT DISCUSSION ABOUT FISHING ACCESS WAS (TO USE MCNAMAR'S WORDS) CONCERNED WITH STEPS TOWARDS NORMALISATION. MCNAMAR ALSO TOLD MINISTER (ECONOMIC) THAT HE HAD EMPHASISED TO DEL SOLAR THAT THE NORMAL CHANNEL FOR DISCUSSING BILATERAL MATTERS WAS THE SWISS AND THAT ARGENTINA SHOULD APPROACH THE SWISS IF THEY WISHED TO REQUEST FISHING ACCESS. DEL SOLAR TOLD MCNAMAR THAT ANY APPROACH TO THE SWISS WOULD BE LIKELY TO COME FROM THE ARGENTINE MINISTRY OF FOREIGN AFFAIRS. MCNAMAR SAID THAT HE HAD GIVEN DEL SOLAR HIS PERSONAL VIEW THAT AN EXAMPLE OF THE SORT OF THING THAT COULD BE DISCUSSED THROUGH THE SWISS WAS THE LIMITS WITHIN WHICH FISHING BOATS MIGHT BE ALLOWED TO OPERATE (EG WITHIN 25 MILES OF THE COAST WITH PRIOR NOTIFICATION AND WITHIN, SAY, 75 MILES WITHOUT NOTIFICATION).

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4. DEL SOLAR HAD SAID THAT THERE COULD BE DIFFICULTIES ABOUT GIVING ADVANCE NOTICE IF THIS ADMITTED BRITISH SOVEREIGNTY. MCNAMAR HAD REPLIED THAT HE THOUGHT THE BRITISH WERE NOT USING THE QUESTION OF FISHING ACCESS TO OBTAIN ANY ADMISSION OF SOVEREIGNTY. NOR DID HE THINK THAT THEIR INSISTENCE ON DISCUSSION THROUGH THE SWISS WAS INTENDED TO DRAW FROM ARGENTINA A PUBLIC DECLARATION OF SOVEREIGNTY. HE SAID HE EMPHASISED DURING THE CONVERSATION WITH DEL SOLAR THE BRITISH WISH TO BE REASONABLE ON ACCESS TO THE EXCLUSION ZONE AND THAT BRITISH MINDS DID NOT APPEAR TO BE CLOSED ON THE QUESTION OF CONTROLLED ACCESS.

5. MCNAMAR ALSO SAID THAT DEL SOLAR HAD SAID THAT HE EXPECTED THE REMAINING BRITISH BANK WHAT HAD NOT YET BEEN GIVEN PERMISSION TO REMIT DIVEDENDS TO BE SO AUTHORISED ON THURSDAY

6. AT THE END OF THE CONVERSATION WITH THE MINISTER (ECONOMIC), MCNAMAR MADE CLEAR THAT IN THE LIGHT OF HIS MEETING WITH ME EARLIER THAT AFTERNOON, HE WAS NOT NECESSARILY EXPECTING ANY RESPONSE FROM HMG.

7. MINISTER (ECONOMIC) MADE NO COMMENT, BUT UNDERTOOK TO REPORT THIS TELEPHONE CONVERSATION.

8. FCO PLEASE ADVANCE TO PS SECRETARY OF STATE, PUS, THOMAS AND APPLEYARD, PS/CHANCELLOR OF THE EXCHEQUER, LITTLER AND LAVELLE (TREASURY), AND TO PS/GOVERNOR, LOEHNIS AND GILCHRIST (BANK OF ENGLAND).

ADVANCED AS REQUESTED

THOMAS

MONETARY
ERD
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MR. GIFFARD
MR. URE

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FM WASHINGTON 030230Z AUG 83
TO IMMEDIATE FCO
TELEGRAM NUMBER 2179 OF 2 AUGUST

YOUR TELNO 1294 OF AUGUST 2
IMF: ARGENTINA

1. MINISTER (ECONOMIC) AND I CALLED ON MCNAMAR THIS AFTERNOON. WE MADE ALL THE POINTS IN PARA. 3 OF YOUR TELNO 1279 AND IN A LONG CONVERSATION REINFORCED THEM WITH THE ARGUMENTS IN PARAS. 3-4 OF TUR.

2. MCNAMAR REPLIED THAT HE THOUGHT THAT IT WAS A MISTAKE TO SHUT-DOWN TOTALLY HIS CHANNEL OF COMMUNICATION WITH THE ARGENTINES. HE CERTAINLY HAD NO WISH TO REMAIN INVOLVED IN THE FISHING ACCESS QUESTION AND HAD DONE SO IN THE FIRST PLACE BECAUSE HE BELIEVED THAT SOME ARRANGEMENT ON FISHING ACCESS COULD BE DEVISED, CONSISTENT WITH OUR PRINCIPLES, WHICH WOULD GIVE THE ARGENTINES THE QUOTE COVER UNQUOTE THEY REGARDED AS NECESSARY IN ORDER TO LIFT THE DISCRIMINATORY PAYMENT RESTRICTION. HE HAD REPEATEDLY EMPHASISED TO THEM THAT THE BILATERAL FISHING POINT AND THE MULTILATERAL PAYMENT RESTRICTIONS (ON WHICH THERE WAS NO QUESTION OF ANY GIVE IN THE US POSITION) SHOULD NOT BE FORMALLY LINKED. WE ARGUED THAT THIS WAS NOT THE WHOLE POINT. YOU DID NOT WISH THE BILATERAL ISSUES TO BE PURSUED ANY FURTHER THROUGH THIS CHANNEL. IF THE ARGENTINIANS WERE SERIOUSLY INTERESTED, THEY MUST BE TOLD THAT THE PROPER CHANNEL WAS THROUGH THE SWISS. MCNAMAR SAID HE UNDERSTOOD THIS BUT IT HAD TO BE RECOGNISED THAT THE UNITED STATES HAD SIGNIFICANT INTERESTS IN SOUTH AMERICA AND THEY WERE DETERMINED THAT BRAZIL, ARGENTINA AND MEXICO SHOULD QUOTE SUCCEED UNQUOTE. IT WAS THAERFORE A LEGITIMATE CONCERN FOR THE UNITED STATES TO SEE WHETHER SOME ARRANGEMENTS COULD BE DEVISED WHICH WOULD MEET THE SITUATION.

3. TO THIS WE REPEATED THAT IT WAS YOUR STRONG VIEW THAT THE FISHING ISSUE SHOULD HENCEFORTH BE PURSUED SEPARATELY. BOTH IN SUBSTANCE AND IN TIMING, AND THAT IT REMAINED OPEN TO ARGENTINA TO APPROACH US THROUGH THE SWISS IF THEY WISHED. IN ACCORDANCE WITH PARA. 3(C) OF YOUR TELNO 1279 OF JULY 29, WE DREW ON PARAS. 2(D) AND 3 OF YOUR TELNO 1265 OF JULY 28 SO AS TO UNDERLINE THAT OUR MINDS WERE NOT CLOSED ON THE QUESTION OF CONTROLLED ACCESS, ALTHOUGH WE WOULD OF COURSE HAVE TO IMPOSE SOME CONDITIONS IF (REPEAT IF) WE WERE TO AGREE TO ANY SUCH SCHEME. WE AGREED THAT HE COULD MAKE HIS UNDERSTANDING OF OUR POSITION CLEAR TO DEL SOLAR ON THIS BASIS BUT SAID THAT HE SHOULD GO NO FURTHER.

4. MCNAMAR REPLIED THAT HE WOULD MAKE OUR VIEW CLEAR TO DEL SOLAR WHEN HE SPOKE TO HIM THIS EVENING AND WOULD SAY THAT IF ARGENTINA WISHED TO PURSUE THE QUESTION OF ACCESS THEY SHOULD APPROACH US THROUGH THE SWISS. BUT HE SAID HE HAD TO RESERVE THE UNITED STATES' RIGHT, IN VIEW OF THEIR SIGNIFICANT INTERESTS IN THE REGION, TO

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KEEP IN TOUCH WITH DEL SOLAR ON THESE MATTERS IN ORDER TO TRY TO FIND A WAY THROUGH. HE ASKED US TO SUGGEST TO YOU THAT THE SWISS EMBASSY IN BUENOS AIRES SHOULD BE GIVEN ADVANCE NOTICE THAT THEY MIGHT RECEIVE AN APPROACH ON THE QUESTION OF FISHING ACCESS. HE PARTICULARLY ASKED THAT THE SWISS BE ADVISED NOT TO BE SURPRISED IF AN APPROACH CAME FROM OTHER THAN THE ARGENTINE MINISTRY OF FOREIGN AFFAIRS. I SAID WE WOULD REPORT THIS SUGGESTION TO YOU.

5. DURING THE DISCUSSION, MCNAMAR RECALLED THE EARLIER CONVERSATION, REPORTED IN PARA. 6 OF OUR TELNO 2141 OF JULY 29, ABOUT OUR POSITION THAT WE WERE SEEKING THE REPEAL OF THE DISCRIMINATORY LAW NOT JUST THE SUSPENSION OF ITS OPERATION. MINISTER (ECONOMIC) SPOKE AS INSTRUCTED IN PARA. 1 OF YOUR TELNO 244 TO UKDEL IMF/IBRD OF AUGUST 2 AND SAID THAT WE HAD MADE A DE JURE REMOVAL OF OUR RESTRICTIONS THROUGH REPEAL OF THE RELEVANT STATUTORY INSTRUMENT AND THAT FAILURE TO REMOVE THE DE JURE DISCRIMINATION WOULD INCREASE THE RISK OF ARGENTINE REINTRODUCTION OF RESTRICTIONS. IN REPLY, MCNAMAR EMPHASISED THAT THOUGH THE UNITED STATES WOULD GIVE THE UK FIRM SUPPORT IN THE IMF BOARD ON THE REMOVAL OF THE SUBSTANCE OF THE DISCRIMINATORY RESTRICTIONS, HE HAD TO RESERVE THE US POSITION ON ANY UK REQUEST THAT THE LAW TOO SHOULD BE REMOVED.

6. MCNAMAR SAID THAT HE WOULD GIVE A FULL REPORT OF OUR DISCUSSION TO SECRETARY REGAN. HE SAID THAT HE HAD ALREADY DISCUSSED THIS MATTER WITH DAM (DEPUTY SECRETARY, STATE DEPARTMENT) WHO ALONE IN THE STATE DEPARTMENT WAS FULLY IN THE PICTURE. HE AGREED THAT I SHOULD BRING DAM UP TO DATE WITH YOUR VIEWS SO THAT HE COULD BRIEF SHULTZ.

7. I SUBSEQUENTLY WENT OVER THE SAME POINTS WITH DAM, AND ASKED HIM TO MAKE SURE THAT SHULTZ WAS MADE AWARE OF YOUR CONCERNS AND THE REASONS FOR THEM. HE FULLY UNDERSTOOD OUR POSITION AND UNDERTOOK TO PUT SHULTZ IN THE PICTURE AS SOON AS POSSIBLE. I LEFT HIM IN NO DOUBT ABOUT YOUR WORRY AT THE RISK OF MISUNDERSTANDINGS AND YOUR CONCERN THAT THE QUESTION OF FISHING IN THE PROTECTION ZONE, IF THE ARGENTINES ARE SERIOUSLY INTERESTED, SHOULD NOW BE PURSUED SEPARATELY THROUGH THE SWISS AND SHOULD NOT BE ALLOWED TO CONFUSE THE THE CLEAR MULTILATERAL POSITION.

8. PLEASE SEE MIFT.

FCO PLEASE ADVANCE TO PS/SECRETARY OF STATE, PUS, THOMAS AND APPLEYARD (ERD), PS/CHANCELLOR OF THE EXCHEQUER, LITTLER AND LAVELLE (TREASURY) AND TO PS/GOVERNOR, LOEHNIS, AND GILCHRIST (BANK OF ENGLAND).

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FROM F C O 021826Z AUG 83
TO FLASH WASHINGTON
TELEGRAM NUMBER 1295 OF 2 AUGUST
INFO SAVING UKDEL IMF/IBRD WASHINGTON
MIPT: IMF/ARGENTINA

1. IT REMAINS IN OUR VIEW VERY UNLIKELY THAT ARGENTINA WILL BE PREPARED TO REQUEST ACCESS TO THE ZONE. AT THE SAME TIME THERE IS THE DIFFICULTY THAT IT IS NOT POSSIBLE IMMEDIATELY TO ANSWER DIRECTLY MCNAMAR'S HYPOTHETICAL QUESTIONS ABOUT THE SORT OF REGIME WE WOULD PERMIT. THE FALKLAND ISLANDS COUNCILLORS WOULD EXPECT TO BE CONSULTED ABOUT CONDITIONS UNDER WHICH ANY 'GESTURE' FROM US MIGHT ENABLE ARGENTINE VESSELS TO OPERATE, AND ISLANDER OPINION WOULD NOT UNNATURALLY BE HIGHLY SENSITIVE TO SECURITY ASPECTS. WE AND MOD, IN ADDRESSING THESE, WOULD NEED TO BE SATISFIED THAT EVEN IF ARGENTINE VESSELS DID NOT POSE A DIRECT THREAT TO THE ISLANDS, THEY WERE NOT FISHING IN SUCH NUMBERS AND LOCATIONS AS TO DIVERT MILITARY RESOURCES FROM THEIR REGULAR ESSENTIAL DEFENSIVE TASKS. SOME PRELIMINARY WORK HAS BEEN DONE WITH MOD, AND ISLANDER OPINION MIGHT PERHAPS BE FAVOURABLY INFLUENCED BY A BONA FIDE ARGENTINE REQUEST. BUT, AS I REMARKED IN MY TELNO 1265, WE CANNOT BE STAMPEDED. IT WOULD TAKE US SOME TIME TO REACH AN AGREED VIEW ON ANY ARGENTINE APPROACH AN THERE CAN OF COURSE BE NO GUARANTEE THAT THIS VIEW WOULD BE SUCH AS TO INFLUENCE FAVOURABLY EITHER THE ARGENTINES OR THE AMERICANS.

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TO FLASH WASHINGTON
TELEGRAM NUMBER 1294 OF 2 AUG
INFO SAVING IMF/IBRD WASHINGTON
YOUR TELS NOS 2L58, 2160 AND 2164: IMF/ARGENTINA

1. THE NEGOTIATION WITH DEL SOLAR THROUGH MCNAMAR IS NOW DRAGGING US INTO DIFFICULTY: I AM PARTICULARLY CONCERNED THAT THE POSSIBILITY OF A PACKAGE, ASSEMBLED ON A BSIS WHOLLY UNACCEPTABLE TO US, IS APPARENTLY TO BE PUT TO THE PRESIDENT OF ARGENTINA.

2. THIS IS EXACTLY THE SORT OF SLIPPERY SLOPE WE HAVE BEEN TRYING TO AVOID. THE MCNAMAR/DEL SOLAR DIALOGUE IS HEADING IN THE WRONG DIRECTION, DISCUSSING A BILATERAL QUESTION WHEN THE ISSUE IS A MULTILATERAL ONE OF PRINCIPLE. THEY ARE CONFUSING THE IMF QUESTION WITH THE SUBSTANCE OF THE FALKLANDS DISPUTE. AND I SUSPECT THAT THE ARGENTINES ARE, BY THUS EMBROILING US, PLAYING FOR TIME AND HOPING TO MAKE IT HARDER FOR THE AMERICANS TO STAND FIRM ON THE IMF PRINCIPLE. IF MCNAMAR CONTINUES THESE SORT OF DISCUSSIONS WITH DEL SOLAR, WE SHALL BE INCREASINGLY IN A FALSE POSITION, WITH THE CONSEQUENT RISK OF CAUSING GREATER OFFENCE TO MCNAMAR WHEN WE HAVE TO CALL A HALT AT A LATER STAGE.

3. I WAS PREPARED TO GIVE YOU THE TACTICAL DISCRETION YOU SOUGHT IN YOUR TELNO 2158 AND TO AGREE TO SOME DELAY IN YOUR SPEAKING TO SHULTZ AND REGAN (MY TELNO 1279). BUT I DO NOT WANT YOU TO PURSUE THESE ISSUES ANY FURTHER WITH DEL SOLAR THROUGH MCNAMAR. PLEASE NOW THEREFORE SPEAK TO MCNAMAR, MAKING ALL REPEAT ALL THE POINTS IN PARAGRAPH 3 OF MY TELNO 1279. YOU SHOULD EMPHASISE THAT I AM GRATEFUL TO MCNAMAR FOR HIS EFFORTS

AND REPEAT OUR READINESS TO LOOK AT THE FISHING ISSUE SEPARATELY. BUT I AM INCREASINGLY UNHAPPY ABOUT HIM PURSUING WHAT IS FAST BECOMING A NEGOTIATION WHICH CONFUSES TWO SEPARATE SITUATIONS: THE QUESTION OF PRINCIPLE AT STAKE IN THE IMF, AND ACCESS TO THE PROTECTION ZONE BY BONA FIDE ARGENTINE FISHING BOATS. ON THE FORMER THE POSITION IS CLEAR: ARGENTINA MUST FULFIL ITS OBLIGATIONS AND WE LLOK TO OUR PARTNERS IN THE FUND TO SUPPORT US. AS FOR THE FISHING ISSUE, IT REMAINS OPEN TO THE ARGENTINES TO APPROACH US THROUGH THE SWISS, BUT THIS IS A SEPARATE QUESTION WHICH SHOULD HENCEFORTH BE PURSUED SEPARATELY BOTH IN SUBSTANCE AND TIMING.

4. PLEASE ALSO ENSURE THAT SHULTZ AND REGAN ARE WITHOUT DELAY MADE AWARE OF WHAT YOU SAY TO MCNAMAR AND OF THE REASONS FOR SO SPEAKING TO HIM. YOU SHOULD OF COURSE ENSURE THAT THEY DO NOT THINK WE ARE TRYING TO SLAP DOWN MCNAMAR: INDEED YOU SHOULD STRESS OUR GRATITUDE TO HIM FOR HIS EFFORTS AND FOR THE FIRMNESW WITH WHICH HE HAS PRESENTED THE FINANCIAL ISSUES TO DEL SOLAR. IT IS ALSO IMPORTANT THAT THEY SHOULD KNOW THAT OUR POSITION REMAINS REASONABLE ON THE ACCESS POINT. BUT IT IS ABUNDANTLY CLEAR THAT DEL SOLAR HAS NO AUTHORITY TO SPEAK ON SUCH MATTERS AND I AM WORRIED AT THE RISKS OF MISUNDERSTANDING THROUGH DISCUSSION ON THIS CHANNEL ABOUT A FACE SAVER TO PERSUADE ARGENTINA TO CARRY OUT AN UNDERTAKING TO WHICH THEY HAVE ALREADY COMMITTED THEMSELVES TWICE. THIS IS NOT ACCEPTABLE TO US AND THE QUESTION OF FISHING IN THE PROTECTION ZONE MUST NO LONGER BE ALLOWED TO MUDDY THE CLEAR MULTILATERAL POSITION.

3. MIPT GIVES FOR YOUR OWN INFORMATION FURTHER BACKGROUND ABOUT THE NEED FOR CAUTION IN THE EVENT OF THE ARGENTINES AFTER ALL DECIDING TO MAKE AN APPLICATION FOR ACCESS.

HOWE

[COPIES SENT TO NO 10 DOWNING STREET]

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DESKBY 030900Z
FM UKDEL IMF/IBRD WASHINGTON 030225Z AUG 83
TO IMMEDIATE FCO
TELEGRAM NUMBER 278 OF 2 AUGUST 1983

YOUR TELNO 244 OF AUGUST 2

IMF: ARGENTINA

1. IN ACCORDANCE WITH PARA. 2 OF TELEGRAM UNDER REFERENCE, I EXPLORED WITH DALE (DEPUTY MANAGING DIRECTOR, IMF) WHAT THE IMF REQUIREMENTS WOULD BE TO ESTABLISH THAT THE PAYMENTS DISCRIMINATION HAD ENDED IN PRACTICE, EMPHASISING TO HIM THAT OUR POSITION REMAINED THAT WE WANTED FOR DE JURE REMOVAL AND THAT OUR DISCUSSION WAS ENTIRELY WITHOUT COMMITMENT.

2. DALE BEGAN BY EMPHASISING WHAT HE SAID WAS THE FUND'S LONG STANDING CUSTOM OF LOOKING AT WHAT HAPPENED IN PRACTICE RATHER THAN WHAT WAS ON THE STATUTE BOOKS. I POINTED OUT THAT WE HAD MADE A DE JURE REMOVAL OF OUR RESTRICTIONS AND THAT WERE THE ARGENTINES TO RETAIN THEIRS, THE RISK OF THEIR REINTRODUCTION WOULD BE INCREASED.

3. WE THEN DISCUSSED, ON AN INTERROGATIVE BASIS, THE CONDITIONS LISTED IN PARA. 4 OF YOUR TELNO 245 OF JULY 29. DALE THOUGHT THAT (B) (AN UNDERTAKING AGAINST FURTHER DISCRIMINATION ETC) AND (C) (SUSPENSION OF FURTHER DRAWINGS IF DISCRIMINATORY RESTRICTIONS WERE REIMPOSED) WERE ENTIRELY REASONABLE. (A) (EVIDENCE THAT BLOCKED PAYMENTS HAD BEEN ALLOWED THROUGH BEFORE RELEASE OF IMF LOAN MONEY) WAS MORE DIFFICULT. FOR THE IMF TO STIPULATE POINT A AS A CONDITION WOULD IMPLY DISBELIEF THAT THE ARGENTINES WOULD NOT DO WHAT THEY SAID THEY WOULD DO. WHATEVER THE PAST HISTORY, THIS WAS A DIFFICULT POSITION FOR THE FUND TO TAKE. HE THEN WONDERED WHETHER ? THIS CONDITION WOULD PROVE A DIFFICULTY IN PRACTICE IF THE BRITISH FIRMS CONCERNED LODGED THEIR APPLICATIONS TO REMIT FUNDS DIRECTLY THE ARGENTINES ANNOUNCED THAT THE DISCRIMINATORY RESTIRCTIONS HAD BEEN LIFTED. A FEW DAYS WOULD THEN HAVE TO ELAPSE BEFORE THE IMF COULD CONSIDER A BOARD PAPER WHICH MIGHT ALLOW TIME FOR THE PAYMENTS TO BE MADE.

4. DALE THEN SAID THAT THE BEST PROCEDURE FOR SEEKING TO TRANSLATE THESE POINTS INTO FIRM CONDITIONS WOULD BE FOR THE UK TO INFORM FUND MANAGEMENT, AS EARLY AS POSSIBLE, THAT WE WOULD EXPECT TO SEE THEM IN ANY FUND UNDERSTANDINGS WITH ARGENTINA. THIS WOULD PERMIT THOSE CONCERNED IN THE FUND TO SEEK TO INCORPORATE THEM INTO THE RELEVANT DOCUMENTS AT AN EARLY STAGE.

CONFIDENTIAL

/ 5. I ALSO

CONFIDENTIAL

5. I ALSO DISCUSSED WITH DALE THE DETERIORATION OF ARGENTINA'S ECONOMY, DESCRIBED IN YOUR TELNO 246 OF AUGUST 1. DALE AGREED THAT THERE WAS A GOOD CHANCE THAT THE PROGRAM WOULD FALL TO PIECES LATER IN THE YEAR SO THAT PERFORMANCE CRITERIA WOULD NOT BE MET. HE DID NOT KNOW WHEN THIS WOULD HAPPEN. BUT AS TIME WENT BY ARGENTINA WAS OBVIOUSLY LIKELY TO FIND HERSELF IN DIFFICULTIES WITH THE FUND PROGRAM ON MATTERS OTHER THAN THE PAYMENTS DISCRIMINATION.

6. IF YOU DECIDE THAT DE FACTO REMOVAL IS ACCEPTABLE, I SHOULD BE GLAD TO KNOW WHETHER YOU WOULD WANT ME TO TELL THIS TO FUND MANAGEMENT, IN STRICT CONFIDENCE, AND SEEK TO HAVE ACCEPTED THE SORT OF CONDITIONS REFERRED TO IN YOUR TELNO 245.

7. FCO PLEASE ADVANCE TO PS/SECRETARY OF STATE, PUS, THOMAS AND APPLEYARD (ERD), PS/CHANCELLOR OF THE EXCHEQUER, LITTLER AND LAVELLE (TREASURY), AND TO PS/GOVERNOR, LOEHNIS AND GILCHRIST (BANK OF ENGLAND).

WICKS

[ADVANCED AS REQUESTED]

MONETARY
ERD
FID
MR URE

COPIES TO:
MR LAVELLE, TREASURY
MR CRAWFORD, BANK OF ENGLAND
MR OWEN, OT5/DTI

CONFIDENTIAL

Prime Minister
WM 9/8
1

As things are, the Argentines will not get the next IMF drawing due on 20 August. If they come under financial pressure, the matters discussed in this note could suddenly come to a crunch.
So are you content with:-

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

i. The line we are taking in the IMF and particularly with our minimum conditions for the next IMF drawing (para. 6)?

ii. The line we are taking with the US, e.g. on the Argentine interest in fishing in the Falklands exclusion zone (para 8)?

iii. The position we would take
(a) in the IMF
(b) with British banks involved in the commercial loan
if unexpectedly support in the IMF swung away from us?

FERB 2.8.

F E R Butler Esq
10 Downing Street
London SW1

1 August 1983

Dear Robin,

ARGENTINA/IMF

The second tranche of Argentine drawings from the IMF under the agreement reached on 24 January this year is due to be available on 20 August, subject to satisfactory economic performance and subject also to the requirement that discriminatory exchange restrictions (against the UK) should have been removed by 31 July. Argentina has met the performance criteria laid down by the IMF, but has not yet fully removed the discriminatory exchange restrictions.

... I attach a note, agreed by the Chancellor and the Foreign Secretary, explaining the present position and proposing the line which HMG should take, both in relation to the IMF loan, and in relation to the participation of British banks in a dependent international commercial loan. We believe that the IMF will not agree to the second tranche drawing, and that the commercial loan will therefore not go ahead, unless and until discrimination is removed, de facto if not de jure. But the note also covers what our policy should be, if things go badly. The Chancellor would be grateful to know if the Prime Minister agrees.

Copies of this letter and the attached note go to Brian Fall at the FCO and John Bartlett at the Bank of England.

Yours ever,

John Kerr

J O KERR

ARGENTINA

Background

The IMF Executive Board agreed on 24 January 1983 to an IMF programme for Argentina supported by a 1.5 billion SDR Stand By Arrangement. The next drawing under this arrangement becomes available on 20 August, conditionally upon Argentina having met the performance criteria laid down by the IMF under the programme. In addition to the normal economic performance criteria the programme required Argentina to have removed by 31 July discriminatory exchange restrictions against the UK. This condition was inscribed at UK insistence, but with the ready agreement of others in the IMF Executive Board, because discrimination in current payments is prohibited as an important IMF principle.

2. The discriminatory restrictions were introduced by Argentina in April 1982, in parallel with the UK action to freeze Argentine assets in this country. They were imposed under Law 22591, explicitly aimed against UK-owned banks and companies in Argentina. When parallel removal of Argentine and UK restrictions was being considered last Autumn, with the Argentine financial authorities anxious to make progress in order to clear the way for IMF assistance, but the military authorities resisting, the best the former could achieve was the enactment of a further Law 22820 which enabled the first Law to be over-ridden. Given evident good will on the part of the Argentine financial authorities, and the international interests in a financial rescue operation which could contribute to saner Government, HMG decided to accept reciprocal removal of restrictions on this basis. (Consideration was briefly given to the possibility of keeping the UK Order in being and over-riding it by general permissions, but this would have been a pointless way of proceeding in dealing with a stock of frozen assets, rather than a continuing flow of transactions, and the UK proceeded by simple revocation of the original Order. We did this, even though we knew that the Argentinians would keep their law on their statute book).

3. The Argentine financial authorities have made some progress - although slowly. Within the last month or two, the restrictions have effectively been over-ridden in favour of UK banks, where the debate locally has doubtless been helped by the desire to encourage the international commercial loan in which UK banks have been expected to play a part. But discrimination appears still to be in full force against UK companies other than banks.

4. There is an additional potential problem of discrimination. Argentina at present maintains considerable non-discriminatory restrictions to limit foreign exchange costs. There have been suggestions of an easement of restrictions to be introduced on 15 August which, however, would not be applied to UK companies and banks. If this happened, an additional element of discrimination would arise, like the first against British interests and in breach of the IMF principle of non-discrimination.

IMF Drawing

5. Formally, the position is that Argentina cannot take a further drawing unless:

- Discrimination has been removed; or

- the IMF grants a waiver.

The grant of a waiver would require approval/acquiescence by a majority of members of the IMF Executive Board, in which the UK alone could not block a decision. There could also be scope for judgment on the first point. The attitudes of the IMF management and of other leading countries therefore matter considerably.

UK Requirements

6. Ideally, the UK would want to see the original Argentine Law 22591 repealed,thus removing the basis for present and future discrimination. This is not only a matter of presentation: it must be judged a little less likely that Argentina would reintroduce discriminatory legislation than resume use of existing legislation

in future. But it has to be recognised that the IMF and other countries, particularly the United States, will be looking for a pragmatic solution, and are therefore likely to be content with de facto removal of discrimination without insisting on repeal of the Law. At present we are continuing to urge on the IMF managing director and the United States Treasury the importance of removal of the Law, particularly in the light of possible renewed discrimination after 15 August. But this may not succeed. In that event, it is important to specify the minimum conditions under which the UK should be prepared to acquiesce in a further IMF drawing. It is proposed that these conditions should be:-

a. Firm evidence in practice that the discriminatory restrictions have been lifted, with payments on behalf of UK companies which are now blocked having been allowed through before any further loan tranche is released.

b. An IMF requirement accepted by Argentina that discriminatory restrictions would not be reimposed. A statement should be required in writing from the Argentine authorities to this effect, with specific reference to future liberalisation being extended in a non-discriminatory way.

c. Agreement in the Executive Board that, if discriminatory restrictions were reimposed, IMF drawings would be suspended (in practice this would mean obstructing the final two drawings due on 20 November 1983 and 20 February 1984).

Attitude of other Countries

7. We have been canvassing vigorously for support of other countries. There have so far been good responses from some important countries, including the United States, Germany, Netherlands. If such support is maintained, we should be able to obtain our minimum conditions, which are in themselves reasonable and fully in accordance with IMF principles. There has been some sign recently that Argentina, which has been attempting

some canvassing on its own account, is aware of considerable strength of support for the UK position. At an earlier stage they seem to have been planning a request for a waiver, whereas recent indications are that they fear that their application would fail.

8. Meanwhile, it is reported that the Argentine external payments position is deteriorating, which will both strengthen pressure on them to come to terms, and also strengthen the desire of some other countries, possibly including the United States, to look for a compromise solution. The US have been active in cultivating contacts with Argentina, particularly exploring possibilities of a concession by the UK on fishing rights as a face-saver to make it easier for Argentina to remove financial discrimination. We have been trying to demonstrate to the United States the reasonableness of our position and our willingness to consider any constructive proposals which do not endanger the security of the Falkland Islands. We certainly do not want to rebuff United States good offices. Our aim should be to get across the point that it is always open to Argentina to seek our agreement to <u>bona fide</u> fishing in the protection zone. But it is not for the UK to make concessions to buy Argentine fulfilment of this long-standing undertaking.

9. We need to consider what our policy should be if we were in fact to lose support.

<u>If the UK were Isolated</u>

10. If the situation arose in which a majority of members of the IMF Executive Board were prepared to let Argentina off the hook, without the kinds of minimum conditions satisfactory to the UK which were set out in paragraph 6 above, there would in principle be the choice:

a. To keep the negotiations in being and seek a fall-back position - presumably involving some further "best endeavours" or revised date for compliance.

b. To force the issue by calling for a vote, formally or informally, in spite of the fact that, in the circumstances, we would expect to lose.

11. On the one hand any undertakings in a fall-back position would not be worth the paper they were written on. On the other hand it would be an uncomfortable break with precedent in the IMF to demand a formal vote. The outcome would inevitably be seen as a defeat for the UK and a technical victory for Argentina. It would be damaging to UK public and Parliamentary opinion towards the IMF, and would inevitably affect HMG's attitude to the IMF.

12. Nevertheless, our judgment is that the UK could not respectably acquiesce and would therefore be obliged to call for a vote and register its protest in that way. The unfortunate consequences are a point which is being made in pressure on the IMF and the United States to continue their support for us and the IMF principle on which we are relying.

British Banks

13. One part of the overall arrangements to help the Argentine economy, with the IMF in the critical central role, was mobilisation by commercial banks of a commercial loan of $1.5 billion, with leading world commercial banks participating in some ratio broadly appropriate to their earlier engagement in Argentina. A number of British banks are involved, with Lloyds and Barclays as the most important, to a total of about $159 million. The loan has not yet been signed. Even after signature, drawings on it are conditional upon a certificate from the IMF stating that performance criteria have been met and IMF drawings are continuing.

14. The British banks have been persuaded to see it as being in their own interest for the time being to refrain from signature. This is likely to continue until the IMF situation is clarified. Arrangements have however also been made to ensure that, if for any reason of external pressure the British banks reached the conclusion that they wanted to sign the agreement, they would give adequate notice to the Bank of England to enable the Bank with HMG to convey a request not to sign, which the banks would be prepared to obey, but would quote to their international colleagues as their reason.

15. It seems right to hold this position until the IMF situation has become clear. At that point, we have two possible scenarios:-

a. If IMF drawings are resumed, UK minimum conditions having been met so that the UK have acquiesced in the IMF decision, it is recommended that HMG would not be in a position to seek to prevent British bank participation. But more general political considerations in relation to Argentina suggest that the Government should distance itself from any decision by the banks on their own commercial judgment to participate. Depending on timing and other conditions, it might also be worth suggesting to the British banks that it would be prudent for them to delay signature to ensure that no additional discrimination was introduced on 15 August. (See paragraph 4 above).

b. If an IMF decision were taken against UK protest, the government would want to prevent the British banks from signing. There is very considerable legal doubt about the power of the government to issue formal directions in a case of this kind, which involves specific commercial business by banks. The banks would certainly prefer to avoid such formal directions. It is suggested that the government should indicate, through the Bank of England, that it would regard participation by British Banks in the circumstances as being ill-judged, and be prepared to say so publicly. This would place the British banks in considerable difficulty, with a conflict of interest in safeguarding their relations with commercial banks of other countries and their existing exposure in Argentina, against the undoubted political embarrassment domestically with government, shareholders and clients.

Other Action

16. We have considered whether, in the event of a vote against the United Kingdom in the IMF, there is other action which could be taken. Only two possibilities seem to be worth memtioning:-

a. One would be to reimpose some or all of the restrictions which were removed last September. This might seem to be an appropriate parallel response to the failure of Argentina to remove restrictions in practice. However, it would have little practical effect, since there would be few, if any, Argentine funds remaining in London. The operation could therefore seem derisory, while giving an excuse to Argentina to continue its restrictions. This possibility should therefore be rejected.

b. The second is diminished cooperation with the IMF, one possible example being refusal to participate in a financial bridging operation which the IMF are likely to need in advance of the flow of additional resources from increased quotas due next year. Such a response could well be forced by Parliamentary and public opinion and will need to be considered at the time. More immediately, its importance may be as an argument to persuade the IMF, United States and others to maintain support for the UK position.

GRS 550
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(FM BERNE 021429Z)
FM BIS BUENOS AIRES
TO IMMEDIATE FCO
TELNO 659 OF 28 JULY 1983
REPEATED PRIORITY BANKO ENGLAND DOT WASHINGTON UKDEL/
IBRD WASHINGTON UKREP BRUSSELS AND UKMIS NEW YORK.

ARGENTINA : COMME

ARGENTINA : COMMERCIAL RELATIONS

1. AT A MEETING OF EC AMBASSADORS ON 27 JULY, THE FRENCH, GERMAN, ITALIAN, DUTCH AND BELGIAN REPRESENTATIVES CONFIRMED THAT THEY HAD BEEN INVITED BY THE MFA TO DISCUSS THE FORTHCOMING REVIEW OF ARGENTINA'S FULFILMENT OF THE TERMS OF THE IMF LOAN UPON WHICH FUTURE ASSISTANCE WITH THE COUNTRY'S EXTERNAL DEBT PROBLEMS WILL DEPEND.

2. THE AMBASSADORS WERE RECEIVED BY FELIX PENA, UNDER SECRETARY FOR INTERNATIONAL ECONOMIC RELATIONS AT THE MFA, WHO EXPLAINED THAT ARGENTINA ANTICIPATED STRONG PRESSURE FROM THE UK AGAINST FURTHER IMF AID IF COMMERCIAL RESTRICTIONS ON BRITISH COMPANIES IN ARGENTINA WERE NOT RELAXED. HE MAINTAINED THAT WHILE BOLSA AND BARCLAYS BANK HAD BEEN PERMITTED TO REPATRIATE DEVIDENDS, IT WAS FOR THE MOMENT POLITICALLY IMPOSSIBLE FURTHER TO AMEND THE SANCTIONS LAW (22.591) IN ORDER TO ALLOW THE SAME DISPENSATION FOR UK NON-BANKING ENTERPRISES. HE APPARENTLY ALLEGED THAT THESE WERE NOT ANYWAY NUMEROUS AND THAT THE SUMS INVOLVED WERE NOT IMPORTANT. FINALLY, HE STATED THAT BY WITHHOLDING SUPPORT, THE IMF WOULD CAUSE ARGENTINA'S ENTIRE ECONOMIC AND FINANCIAL INFRACSTRUCTURE TO COLLAPSE, AND HE ASKED THE AMBASSADORS TO PASS THIS MESSAGE TO THEIR CAPITALS TOGETHER WITH THE REQUEST THAT THE IMF BE INDUCED TO DELAY UNTIL FEBRUARY 1984 JUDGEMENT OF ARGENTINA'S PROGRESS TOWARDS MEETING HER COMMITMENT TO END DISCRIMINATION AGAINST BRITISH COMPANIES.

/3. THE

3. THE AMBASSADORS WERE EVIDENTLY CONCERNED THAT PENA'S FEARS OF NATIONAL BANKRUPTY MIGHT MATERIALISE. I POINTED OUT THAT THERE WERE IN FACT A CONSIDERABLE NUMBER OF BRITISH COMMERCIAL FIRMS AFFECTED BY THE ARGENTINE MEASURES AND THAT LEGISLATION (LAW 22.820) ALREADY EXISTED WHICH WOULD ALLOW THEM TO TRANSFER FUNDS BACK TO THE UK. PENA HAD BEEN EXTREMELY VAGUE ABOUT THE EXACT NATURE OF THE POLITICAL OBSTACLES TO THE LIFTING OF SANCTIONS, ALTHOUGH AMBASSADORS AGREES THAT OBJECTIONS HAD ALMOST CERTAINLY DERIVED FROM THE AIR FORCE RATHER THAN FROM POLITICAL PARTIES.

JACKSON-HOULSTON

POWELL-JONES

MONETARY
FID
S AM D

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

PA

Brazil.

Michael

What do we do about the non-sequitur in your letter of 25/vii?

The Chancellor claims that there was v. little discussion of Brazil with Volcker at the Richardson dinner. But even if he's wrong: so what? We want N. Wicks to talk to the US Treasury.

TBW Mr Kerr)

Go ahead

// Do we go ahead; or do we have to come back to you?

MLS

The Chancellor thinks he'd better discuss it at next week's 'bilateral,' but it would be good to avoid that.

Not needed

[illegible] 27/vii

SECRET

file

9

10 DOWNING STREET

From the Private Secretary

25 July 1983

Dear John,

Brazil

The Prime Minister read with interest the paper on Brazil attached to your letter to me of 21 July.

You suggested that it would be useful for us to share our thinking - as reflected in the paper - with the United States Treasury, through Mr. Wicks in Washington. The Prime Minister has commented that she thinks little will be gained by this, since the substance of the paper was discussed in a small group which included Mr. Volcker at the recent dinner here for Lord Richardson.

I am sending copies of this letter to Brian Fall (Foreign and Commonwealth Office), Jonathan Spencer (Department of Trade & Industry), Richard Hatfield (Cabinet Office) and John Bartlett (Bank of England).

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
HM Treasury.

SECRET

SECRET

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Prime Minister

Agree to X?

MCS 22/7

21 July 1983

Michael Scholar Esq
10 Downing Street
LONDON SW1

There really isn't anything to share. Volcker was in the group at No.10 which briefly discussed these things and they never decided take it much further.

Dear Michael,

BRAZIL

I attach a paper which summarises the results of a study by various Departments and the Bank of England on the implications of a withdrawal of IMF support from Brazil.

As you will see, the judgement is that there are limits on action which the United Kingdom could take against Brazil, but certain contingency work is being put in hand to cover this, as well as to examine the question of possible demands for support for British banks in difficulties.

It is hardly surprising that one conclusion is that action and persuasion by the United States will be much more important than that of any other countries. In this connection, the Chancellor considers that it would be useful for us to share our thinking - as reflected in the attached paper - with the United States Treasury. It would be sensible to discover whether they have a similar appraisal. If the Prime Minister is content, we shall arrange this, via Nigel Wicks in Washington.

Copies of this letter go to Brian Fall (FCO), Jonathan Spencer (DTI), Richard Hatfield (Cabinet Office) and John Bartlett (Bank of England).

Yours ever,

John Kerr

J O KERR
Principal Private Secretary

SECRET

SECRET

BRAZIL: CONTINGENCY PLAN FOR A DEBT MORATORIUM

This note sets out what might happen and what action we might take were the Brazilian debt situation to worsen sharply. Much of the analysis would apply to any other major debtor in similar circumstances. It summarises a longer paper produced by Treasury/Bank/FCO/DTI officials.

Chain of events

2. The most likely trigger would be public impasse in Brazil's negotiations with the IMF together with a decision by the BIS and its constituent central banks to seek prompt repayment of their loan. Initially the most likely reactions would seem to be:-

(i) the IMF would make it clear the door remained open, if the Brazilians had second thoughts.

(ii) The Brazilians would seek to avoid formal default/debt repudiation by a declaration of willingness to resume payments in due course, and to discuss matters with creditors.

(iii) The major creditor banks, while beginning to make provisions, also would tend to hold back from forcing a formal default, because of the more immediate impact of that on their balance sheets. Official export insurers would have to begin to pay out on claims - ECGD facing claims of £220 million by the end of 1984, with a corresponding addition to the PSBR.

(iv) Other debtor countries would watch the situation with interest.

3. This state of de facto moratorium could last for some time; but could be pushed into a formal moratorium/default by one or more banks taking legal action to seek to protect their position, or by action by creditor governments. The situation could also deteriorate rapidly if other debtor governments were tempted to follow Brazil's example.

Consequences of de facto moratorium

4. At first sight Brazil might seem to stand to gain from a period of de facto moratorium. In 1983 Brazil is set for a current account surplus on items other than debt interest. But in practice there would be considerable trade disruption, at least for a period. Trade credit would dry up - and with 180 days credit now available on Brazil's $10 billion a year oil imports this would put a large temporary strain on the balance of payments. Even if foreign exchange flows on imports and exports balanced, in a country like Brazil (in contrast, for example, to Poland) it might be difficult for the authorities to ensure that receipts from exports were available to importers. It could take several months to build up effective alternative trading arrangements.

5. Despite these problems, internal political pressures in Brazil could not be expected in the short-term to be for a return to the international fold; the reverse is more likely. Brazil has few essential imports apart from oil. And it could take some time for longer term difficulties, arising from lack of access to international capital markets and development finance, to build up.

6. As time passed other debtor countries might be tempted to follow Brazil's example; or be forced to do so if banks' concern about Brazilian developments led them to be less accommodating to other borrowers. International banks would have to begin to set aside growing provisions against their Brazilian loans.

Consequences of default/explicit moratorium

7. Once a clear default had been called the consequences for Brazil would be much sharper. A scramble to attach assets could be expected. Brazilian assets abroad that could be vulnerable to legal action and seizure include $4.1 billion of Brazilian bank deposits in Western countries ($2.3 billion in the US; $0.9 billion in the UK). Also vulnerable would be Brazilian ships and aircraft; and any shipments of goods (eg oil) to Brazil that could be deemed to have been paid for, or exports that were still the property of the Brazilian exporter. International payments would have to be made anonymously through bank accounts in friendly banks in third countries, to avoid attachment.

8. No doubt various barter and other arrangements would evolve. Moreover not all Brazilian assets would be accessible to legal action - for example if they did not belong to a specific debtor, or if they were protected by State immunity legislation. But Brazil could expect very considerable disruption for some time through widespread legal action, both to trade and to such external assets as exist.

9. There would also be consequences for international banks. With only modest amounts of attachable assets available in relation to $60 billion of bank loans to Brazil, many international banks would face losses, to be met in the first place out of earnings and then out of capital. There could be severe liquidity problems for the more exposed banks. 10 of the largest US banks account for more than 80 per cent of US exposure, and several of them would lose a half of their capital base, or more. Two London clearing banks would lose around a third of their capital base. The capacity of British banks and other banks abroad to undertake new lending domestically and internationally would be greatly reduced. The authorities in the UK and elsewhere would be faced with having to undertake very substantial support operations.

Conclusions: Options for Action for HMG

10. The UK has an important role, as a large creditor, and through the IMF, the G5 and other groupings of creditor countries. But in relation to Brazil, both for financial and political reasons, the US is bound to be in the lead. We should also avoid unnecessarily prejudicing our political position in Latin America (including the use of Brazil by flights to the Falklands when refuelling fails). Action would need to be agreed with our partners, and the US in particular.

11. There are two conflicting considerations:-

(a) the risk to the international financial system, and to political developments in Latin America, of pushing Brazil to formal default. The US is likely to be particularly conscious of both, given her financial and political interests in the region.

(b) The longer term risk to the financial system if the IMF or creditor governments were seen to let a debtor like Brazil off the hook of economic adjustment. Other countries would quickly try to follow suit; and without adjustment private flows could be expected to dry up, posing a choice between providing larger official flows, or more widespread default.

12. In the end we cannot allow the former consideration to outweigh the latter. But it is right for as long as possible to seek to steer a course between the two: that is to look for ways to maximise the pressure on Brazil without pushing her to default. To this end:-

(i) we must clearly maintain as long as possible the threat of withdrawal of financial support, and assert out willingness to press matters to a point likely to inflict real damage to the Brazilian economy. We must also impress on the Brazilians - with the US likely to be the most powerful persuaders - the risk they would run, eg to their trade, if our support were withdrawn. (The impact of the recent BIS discussion is, as far as it goes, encouraging).

(ii) If a state of de facto moratorium did come about, we should seek to maintain in public as well as private a very sharp distinction between Brazil, where IMF discussions had broken off, and other countries where Fund programmes continued. This is an important message both to seek to discourage other countries from following Brazil's example, and to help ensure a continuing flow of private finance to them.

[illegible]. Beyond that, other practical actions that could be taken against Brazil are:-

(iii) Legal action to attach Brazilian assets to cover overdue payments on the BIS loan. This would be a way to precipitate formal default, if that was what we wanted. It would not seem the right immediate response to a debt service failure, but could be a possibility to hold in reserve.

(iv) A trade embargo. FCO and DTI officials do not believe wide enough agreement could be obtained to make this effective. In any event it would certainly lead to a formal default if one had not occurred already, and would add little if anything to the trade disruption that such a default would bring through the operation of market forces.

(v) Action by the Bank of England to close the operations of Brazilian banks in London. This could not in itself be a major deterrent, but might be worth considering at a stage short of clear default, as a signal of our intent.

(vi) A freeze of Brazilian assets in the UK, by an order similar to that used last year against Argentina. This might serve a useful purpose after a default had occurred, to keep all potentially attachable Brazilian assets within UK jurisdiction.

14. We have put further contingency planning in hand on items (v) and (vi) above. We are also considering further with the Bank the extent to which and on what terms we should be prepared to provide support to British banks in the event of a major international default.

HM Treasury

20 July 1983

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FM WASHINGTON 150402Z JUL 83

TO PRIORITY FCO

TELEGRAM NUMBER 1995 OF 15 JULY

Read in full. MT

MIPT: MEETING WITH REGAN

INTERNATIONAL DEBT ISSUES

ARGENTINA

1. REGAN SAID THAT THE US POSITION WAS THAT THE ARGENTINES WOULD NOT RECEIVE FURTHER IMF MONEY IF THEY DID NOT LIFT THE DISCRIMINATORY FINANCIAL RESTRICTIONS. MCNAMAR SAID THAT THOUGH THE LEGAL POSITION WAS QUESTIONABLE, HE HAD ALREADY TOLD THE ARGENTINES THAT THE UNITED STATES WOULD NOT SUPPORT ANY REQUEST FOR A WAIVER AND WOULD VOTE WITH THE UK IN THE FUND BOARD. THE ARGENTINES WERE IN A DIFFICULT TRANSITIONAL PERIOD. THE PERONISTA PARTY, SUPPORTED BY 29 PERCENT OF THE ELECTORATE, WERE APPARENTLY CATCHING UP THE RADICAL PARTY, WHICH HAD 37 PERCENT SUPPORT. THE US FEARED THAT A PERONISTA GOVERNMENT WOULD ALIGN WITH THE SOVIET UNION AND CREATE DESTABILISATION IN SOUTH AMERICA. THE US THEREFORE WANTED TO PROVIDE A FRAMEWORK FOR A STABLE TRANSITION OF POWER TO THE RADICALS. THE ARGENTINE ECONOMIC MINISTERS NEEDED A GESTURE IF THEY WERE TO PERSUADE THE AIR FORCE OFFICER ON THE CAL TO AGREE TO THE LIFTING OF THE PAYMENTS RESTRICTIONS. THE US REGARDED THE DISCRIMINATORY MEASURES AS A BILATERAL ISSUE BETWEEN THE UK AND ARGENTINA. ALL THE SIGNALS RECEIVED IN WASHINGTON WERE THAT THE ARGENTINES WANTED SOME RATIONALE FOR LIFTING THEM. YOU RECALLED THAT IN LIFTING OUR RESTRICTIONS LAST YEAR, THE UK HAD FULFILLED OUR PART OF THE BARGAIN. THE ARGENTINES HAD REFUSED TO MEET THEIR PART. YOU REFERRED TO THE OPPOSITION TO ARGENTINA'S LOAN DURING MONDAY'S DISCUSSION OF THE IMF LEGISLATION IN THE HOUSE OF COMMONS.

2. MCNAMAR ASKED IF IT WOULD HELP IF THE ARGENTINES DECLARED A CESSATION OF HOSTILITIES. YOU SAID THAT OF COURSE THIS WOULD BE A MOVE IN THE RIGHT DIRECTION. THE PUS ADDED THAT THE UK HAD PUBLICLY STATED THAT IT WANTED A PROGRESSIVE NORMALISATION OF ITS RELATIONSHIP WITH ARGENTINA. THIS NECESSITATED BOTH A CESSATION OF HOSTILITIES AND AN UNDERTAKING THAT ARGENTINA WOULD NOT PURSUE THEIR FALKLANDS CLAIM THROUGH FORCE. MCNAMAR WONDERED ABOUT THE US REACTION IF ARGENTINA UNDERTOOK TO RENOUNCE THE USE OF FORCE WHILE BARGAINING AND NEGOTIATIONS WERE PROCEEDING. YOU EMPHASISED STRONGLY THAT THAT APPROACH WOULD NOT BE ACCEPTABLE. THE ESSENTIAL POINT WAS ARGENTINA'S RELUCTANCE TO TAKE EVEN THE FIRST STEPS IN RESTORING RELATIONS. THE UK THEREFORE HAD TO PROCEED VERY CAUTIOUSLY. EVEN IF THE DISCRIMINATORY PAYMENTS RESTRICTIONS WERE ABOLISHED, THERE WOULD STILL BE CRITICISM IN THE UK ABOUT BRITISH BANKS AND THE IMF MAKING LOANS TO ARGENTINA. MCNAMAR ASKED WHETHER THE GOVERNMENT'S RECENT ELECTION VICTORY WOULD NOT MAKE IT POSSIBLE FOR THE UK ''TO GO THE EXTRA MILE'' IN DISCUSSIONS WITH ARGENTINA. YOU AGAIN REMINDED HIM THAT THE ARGENTINES HAD NOT RENOUNCED THE USE OF FORCE. WHEN THEY DID, THERE WOULD NEED TO BE A PERIOD DURING WHICH THEIR CREDIBILITY COULD BE ESTABLISHED. THE PUS EMPHASISED THAT IT WAS QUITE

/ UNREASONABLE

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UNREASONABLE FOR ARGENTINA TO USE THEIR FAILURE TO LIVE UP TO THEIR ORGINAL UNDERTAKINGS AS A BARGAINING WEAPON FOR EXTRACTING WIDER CONCESSIONS. THERE WERE ALSO DANGERS IN OPENING TALKS WHEN IT WAS CLEAR THAT THEIR PURPOSE IN DISCUSSIONS WOULD BE SO DIFFERENT FROM OURS. TO THE UK, THE TALKS WOULD BE ABOUT THE NORMALISATION OF RELATIONSHIPS. ARGENTINA BELIEVED TALKS SHOULD BE ABOUT THE MEANS OF TRANSFERRING SOVEREIGNTY. THIS WAS TOTALLY UNACCEPTABLE TO THE FALKLAND ISLANDERS AND THE BRITISH PARLIAMENT AND PEOPLE. YOU EMPHASIZED THE DANGER OF ENGAGING IN TALKS WHEN BOTH SIDES HAD SUCH DIFFERENT OBJECTIVES.

3. MCNAMAR THEN ASKED ABOUT THE POSSIBILITY OF A FORMULA TO PERMIT ARGENTINE REGISTERED FISHING VESSELS ACCESS TO THE PROCTECTION ZONE, FOR EXAMPLE, BY MAKING ARRANGEMENTS WITH THE SWISS EMBASSY IN BUENOS AIRES. YOUR REPLIED IT WAS ESSENTIAL TO AVOID ANY INCIDENT. THE PROTECTION ZONE HAD ALREADY BEEN REDUCED FROM 200 MILES TO 150 MILES. THE ARGENTINES HAD NOT APPLIED FOR FISHING VESSEL ACCESS BECAUSE THIS MIGHT BE REGARDED AS RECOGNITION OF BRITISH SOVEREIGNTY. THE PUS RECALLED THAT DURING THE HOSTILITIES, THE ARGENTINES HAD USED THEIR FISHING VESSELS FOR NEFARIOUS PURPOSES. IT WAS OPEN TO ARGENTINA TO MAKE AN APPLICATION FOR ACCESS. BUT ANY REGISTRATION SCHEME WOULD REQUIRE ADEQUATE ARRANGEMENTS FOR RECOGNITION AND VERIFICATION. MCNAMAR SAID THAT HE HAD NOT APPRECIATED THAT IT WAS OPEN TO THE ARGENTINES TO MAKE APPLICATION FOR ACCESS. HE SYMPATHISED WITH BRITISH CAUTION.

4. MCNAMAR SAID THAT HE WOULD NO DOUBT HAVE FURTHER DISCUSSIONS WITH THE ARGENTINE AUTHORITIES AND WOULD KEEP YOU IN TOUCH WITH DEVELOPMENTS.

BRAZIL

5. SECRETARY REGAN REPORTED THAT PRESIDENT FIGUEIREDO HAD ANNOUNCED ON TELEVISION LAST NIGHT ABOUT AN 80 PERCENT DE-INDEXATION. THIS SHOULD PASS THE BRAZILIAN CONGRESS SINCE IT HAD THE SUPPORT OF THE MILITARY. CHAIRMAN VOLCKER WOULD NO DOUBT HAVE TO LEAN ON THE BIS NOW THAT THE BRAZILIANS HAD BITTEN THE BULLET.

POLAND

6. YOU SAID THAT NOW SOME POLITICAL RELAXATION LOOKED IMMINENT, PROGRESS SHOULD BE MADE WITH RESCHEDULING POLISH DEBT. SECRETARY REGAN REPLIED THAT THIS WAS REGARDED MORE OF A POLITICAL THAN ECONOMIC QUESTION IN WASHINGTON, AND DECISIONS WOULD BE TAKEN BY THE NATIONAL SECURITY COUNCIL. THEY WOULD NEED TO EXAMINE CAREFULLY ANY SIGNS GIVEN BY THE POLISH GOVERNMENT IN IMPROVING HUMAN RIGHTS BEFORE PROCEEDING GENERALLY TO DEBT NEGOTIATION. THE US TREASURY WOULD WANT TO ENSURE THAT NO NEW MONEY WAS GRANTED TO POLAND BEFORE SOME OLD MONEY HAD BEEN REPAID.

/7. FCO

CONFIDENTIAL

7. FCO PLEASE REPEAT AS APPROPRIATE AND ADVANCE TO PS/CHANCELLOR, LITTLER (TREASURY), APPLEYARD (ERD), AND PS/GOVERNOR AND GILCHRIST (BANK OF ENGLAND).

WRIGHT

[ADVANCED AS REQUESTED]

STANDARD
ERD
ESID
SAMD
FID
EESD
NAD
MR THOMAS
MR HAYES

No 10 DST

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c.c. Alan Walters

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15 - 7 - 83

From the Private Secretary

Brazil

This is to record some consultation with the Treasury earlier today.

Mr. Littler telephoned to let the Prime Minister know that Mr. de Larosiere and Mr. Leutweiler were recommending, on the basis of what they regarded as a satisfactory change of policy by Brazil, a de facto extension of the BIS short-term facility to Brazil. Their proposal was for no formal extension, but that there would be an understanding between the BIS and Brazil that they would not seek a repayment of the loan, which was due for repayment from today onwards, on the assumption of good behaviour by Brazil, and in any event before 15 September. I consulted the Prime Minister and confirmed to Mr. Littler that she had no objection to our acceding to this proposal: nor to the proposal that the Treasury guarantee to the Bank of England in respect of this facility should be extended to 15 September.

M. C. SCHOLAR

John Kerr, Esq.,
HM Treasury.

CONFIDENTIAL

7

PA

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

BRAZIL: BIS LOAN

I discussed with the Governor this evening the developments in Basle described in the Deputy Governor's letter of 12 July to Michael Scholar.

2. It seems that the determination shown from the outset by the BIS has had some impact on the Brazilian authorities. But I am sure that it is right that there should be no question of any further extension beyond 15 July of the $400 million loan if the Brazilians do not by then provide Larosiere with assurances satisfactory to him.

3. The Governor made it clear tonight that it had not been his suggestion that I should join in any appeal to Secretary Regan to provide United States funds to cover the failure of Brazil to meet repayments of BIS lending if assurances satisfactory to Larosiere were received from the Brazilians. While it would of course be convenient for the Bank - and the Treasury, which has underwritten the Bank - to be repaid, I am not prepared to attempt to bring pressure on Regan to provide funds now. I shall not be ringing him.

4. The Governor and I discussed at some length the curious and complicated arrangement proposed between the BIS, central banks, and Brazil. It is of course contingent on the receipt of assurances satisfactory to Larosiere, and I can well understand Leutwiler's desire to preserve the credibility of the BIS as an

agency confined to short-term bridging finance. But we must also be concerned for the credibility of creditor authorities as a whole, and must not leave the Brazilians under the impression that they have got off the hook. I explained to the Governor that what troubled me in this respect was that the arrangements provisionally agreed at Basle did not incorporate any time-limit; and that I could easily imagine further negotiations between Brazil and the IMF, even after a helpful initial statement from the Brazilian President, dragging on for a considerable period.

5. We know, from contacts with the German Finance Ministry today, that they - and, on reflection, the Bundesbank - share this concern, and had by this evening come to the conclusion that a time-limit was desirable. They were thinking in terms of early September. This may look rather generous, but was designed to take account of not only two or three weeks of further rapid negotiation between the IMF and Brazil but also clearance with due notice through the IMF Executive Board.

6. I discussed this with the Governor, and we agreed that a time-limit was essential, and that it would be right to set a deadline of 15 September - ie two months from the present expiry date, and a few days after the next Basle meeting (10 September). The Governor will now be reporting this to his counterparts - he will clearly get explicit support from the Bundesbank - and will make it plain that only with the addition of the time-limit is the contingent arrangement provisionally agreed at Basle acceptable to HMG.

7. I hope that these conclusions are satisfactory to you. I should perhaps add that the Governor's view is that the chances of the Brazilians providing satisfactory assurances to the IMF by the end of this week are less than evens. If appropriate assurances are not provided, paragraph 2 above of

course applies.

8. I am sending copies of this minute to the Foreign and Commonwealth Secretary, the Governor, and Sir Robert Armstrong.

N.L.

N.L.
13 July 1983

2.10 CONFIDENTIAL ①

Prime Minister

An important paper. Submit again at the weekend?

MCS 13/7

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

13 July 1983

Michael Scholar Esq.
10 Downing Street
LONDON
SW1

Dear Michael,

INTERNATIONAL FINANCIAL SCENE

In his minute of 8 July the Chancellor mentioned that he would this week be sending the Prime Minister a further monitoring report on the international debt situation. I now enclose a text prepared by the Bank of England and discussed with them and other departments in the Treasury's debt monitoring group last week. As usual, a table is attached showing the exposure of ECGD and British banks to the major problem countries.

We are in touch separately about Brazil, and the developments described in Kit McMahon's letter of 12 July to you.

The Chancellor has asked me to draw attention to the following three particular points:

a. The IMF programme for Mexico is going well. The rescheduling of official guaranteed private sector debt was agreed recently in Paris: the ECGD element amounts to £111 million in total, this year and next. Part can probably be covered by a new guaranteed refinancing line of credit - avoiding any PSBR cost - but the remainder, amounting to some £36 million in 1983 and £31 million in 1984, will have to be paid out in claims.

b. No proposal has yet been made - and we hope none will be -to reschedule Brazil's officially guaranteed public sector debt. The potential PSBR cost to us would, of course, depend on the terms and on the scope for refinancing, but on the "worst cast" assumption it might amount to about £220 million in total over this year and next.

c. The question of Argentine discrimination against British firms should come to a head in the IMF between now and mid-August. Discrimination against British banks appears to have ended - the Argentinian authorities are clearly anxious to secure signature of the £1.5 billion commercial bank loan - but there is as yet no sign of an end to discrimination against other British businesses. In these circumstances IMF funds will cease to be available unless Argentina can secure a waiver, for which the IMF Board approval would be required. The IMF Managing Director has so far been commendably firm and the Americans have told the Argentine authorities that they support our case - and his - against a waiver. We are lobbying other Executive directors in Washington, and the FCO are arranging parallel lobbying in capitals. We have asked the Bank and the Department of Trade to try to accelerate some 'test cases' by British non financial companies; and the Bank, at the Chancellor's request, are making clear to the British banks involved in the £1.5 bn commercial loan that we would not wish signature to take place unless and until Argentina satisfies the IMF on the issue of discrimination.

The Treasury wrote to us undertaking to let us know if the banks were close to signing. MCS

And I have reminded them again this evening MCS 13/7

We shall aim to submit the next full report in this series on the normal timetable at the beginning of September. Meanwhile we shall, of course, report on any specific developments as appropriate. We shall also maintain close contact with the JIC (now represented on the Treasury Monitoring Group) which has produced excellent reports recently on the situation in both Argentina and Brazil.

I am sending copies of this letter to Tim Allen (Bank of England) Brian Fall (FCO) and John Rhodes (DoT).

Yours,
Judith

pp. J O KERR
Principal Private Secretary (approved by John & signed in his absence)

INTERNATIONAL FINANCIAL SCENE

General Situation

1 On the positive side international economic developments confirm that recovery is under way in the seven major industrial countries, where first quarter GNP figures show a 1/2% rise over the previous quarter. Also, in the US, second quarter preliminary estimates exceed expectations. On the negative side, however, market concern about a rapid expansion of M1 in the US has contributed to an appreciable rise in short-term interest rates since the end of May. Similar pressures have been felt in Germany. If the upward shift were to continue generally it could aggravate debt service problems of certain countries and even possibly precipitate new ones.

Attitudes towards new lending

2 Latest information suggests that on the international banking markets new lending continues to be low, with the greater part going to developed countries. In the London market second quarter lending has been more depressed than in the first quarter. Interbank lending has also been slowing down, and although probably in part a parallel to the slow down in final lending, banks are still generally being more selective in their dealings. Many banks, British and foreign, are feeling the need to slow down international lending for balance sheet reasons; and they are seeking to return to traditional forms of trade-related finance in place of balance of payments lending to sovereign borrowers.

3 In the US it is only large banks, which are less constrained by capital considerations and very concerned to protect their existing heavy exposure, that are showing much appetite for further international lending, whereas most regional banks are trying to draw back. It is still unclear how the willingness of US banks to participate in further rescue packages will ultimately be affected

by the proposed Congressional legislation. The amended capital adequacy guidelines for the 17 largest US banks announced by the Federal Reserve Board and Controller of the Currency may partly have been designed to assuage Congressional pressures but, while not having any immediate effect on lending policies, the changes have been taken as a sign that the authorities will continue to look for a steady improvement in capital resources, and thus could have some deterrent effect on international lending.

Adequacy of new lending

4 It is now clear that many international banks regard the IMF's earlier projection of a 7 - 8% rise in net new lending to non-oil developing countries in 1983 and 1984 as too optimistic; and, following their own talks with banks the IMF have revised the range down to 5 - 7% (ie $15 - 20 bn). German and Swiss banks are probably aiming to avoid any increase in such lending in aggregate: with the UK banks pursuing cautious policies the Fund's newest forecast which pitches somewhat between the continental and American banks' behaviour seems plausible. It remains to be seen, however, whether an increase in international lending of the size of the revised IMF forecast will be forthcoming or, if it is, sufficient to finance the prospective current account deficits of non-oil ldcs (although the IMF assumes other capital flows will at least partly fill the gap).

5 Again, both the IMF and Institute for International Economics of Washington have been arguing that a 3% GNP growth in industrial countries through this year and next will be sufficient to 'float' off the debt problem, by improving debtor countries' export earnings and also by permitting a higher nominal growth of bank lending to them. The 3% growth figure has now acquired a certain air of validity but more cautious policies being pursued by many international banks leave doubt as to whether, even if this rate of economic growth is achieved, the volume of lending predicated in it will be forthcoming. There is a risk that contributions to financing packages for problem countries will crowd out some of the other ldc borrowers who will then face a need for greater or faster adjustment. This in turn could spread liquidity problems to them.

BIS Issues

6 A satisfactory outcome to the financing difficulties could depend on the solidarity of the international banking community. This may soon be tested by Brazil where the authorities seem to be displaying a lack of political will or of administrative capacity to adopt needed new economic measures. Failure to meet the IMF quantitative targets means that Brazil has been debarred from further drawings until fresh talks with the IMF are successfully concluded. Consequently a $400 mn maturity due to the BIS (originally at end-May) has been postponed to 15 July and a decision will soon have to be taken on rolling over for a further period, or bringing into effect the Substitution Agreement whereby the underwriting central banks will assume the bulk of the BIS' rights and obligations.

7 A tendency too readily to think that the BIS can always spring into action to avert liquidity crises has been dispelled by clarifying remarks made by its President at the June AGM in Basle. Leutwiler pointed out that although future bridging finance was not ruled out such assistance could only be made available to meet temporary liquidity problems which would have repercussions beyond the country in question if not dealt with promptly. He stated that the BIS' resources were limited and that, since they derived from the liquid assets of central banks, BIS credit could only provide bridging finance and then only when it was possible to see the source from which the borrowing would be repaid. Normally, he added, the BIS only gave credit against suitable collateral.

Conclusion

8 It is clear from the foregoing that the international financial system could well face further challenging tests in the months ahead, either because existing programmes threaten to come off the rails or because of greater difficulties in putting together the second year packages for the heavily indebted countries or because the list of problem countries grows by contagion. It is also clear that the banking community is increasingly persuading itself that in

future a greater part of the financing burden ought (as in the case of Yugoslavia) to be carried by official agencies. In some instances, too, the debtors themselves will be obliged to take still more unpalatable measures of retrenchment than is already the case. But there is no brooking the fact that pressure will grow for more rescheduling through the Paris Club of debts officially guaranteed by ECGD and similar bodies; and there will be powerful arguments in favour of their maintaining cover towards the debtor countries concerned in the same way as the banks are expected to increase their net exposure to them.

Problem countries

(i) Latin America

9 As already mentioned, Brazil's financial package is in difficulty and the immediate outlook is uncertain. The liaison arrangements between the banks and Brazil have been restructured with the formation of a Co-ordinating Group of some 60 banks and within it a smaller 14 bank Advisory Group. This latter body has suggested that the country will need approaching $5 bn new money this year and $5 bn in 1984 with a rescheduling of that year's maturities.

10 Argentina's failure fully to remove discriminatory sanctions against the UK threatens her continued eligibility to make purchases under the IMF standby. The deadline is 31 July. Recent official contacts with the Managing Director of the IMF have confirmed that he is maintaining his robust line against discrimination. The Fund Staff are about to circulate a technical paper which, while drawing no conclusions and making no recommendations, is understood to demonstrate clearly that discrimination remains. However, following release of the second tranche of the IMF standby on 31 May and Argentine assurances that the country's proposed new bankruptcy law will avoid any reference to discrimination against foreign banks, the Advisory Group of banks has announced (30 June) final agreement with Argentina on the $1.5 bn new money loan. Signature may therefore take place before the end of July. Although there

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(but see my note on covering letter)

MCS

could still be some further postponement over a technical difficulty, following the amendment of Law 22591 which now gives the authorities discretion to relax discriminatory financial restrictions against UK entities, LBI has been authorised and BBI expects authorisation to export Bonex bonds representing dividends. Any drawdown under the loan may not be possible should Argentina fail (or be expected to fail) to meet the Fund's 31 July deadline for the removal of discriminatory sanctions, since the Fund is first required to confirm that Argentina remains eligible to make purchases.

11 In contrast, Mexico has successfully met all first quarter IMF performance targets and is expected to meet second quarter targets too. The second draw-down of EFF funds at end-May was used to make an unexpected partial repayment to the BIS and to the US.

12 In order to safeguard their ability to pay the balance ($1.5 bn) of these bridging facilities by the final maturity date of 23 August, the Mexicans have refrained from drawing on the second $1.1 bn tranche of the $5 bn medium-term commercial bank loan which has become available. Negotiations to reschedule non-guaranteed public and private sector debts due to banks are progressing slowly and it may be some months before agreements are fully effective. However, multilateral agreement on the restructuring of officially guaranteed private sector debt was reached at an informal Paris Club meeting on 20-22 June.

13 Elsewhere in Latin America the Peruvian rescue package was signed on 30 June and signature of the various packages for Uruguay, Ecuador and Chile is expected within the next month. However, some uncertainties still remain. The Venezuelan talks with creditor banks have been hampered by the emergence of substantial public and private sector interest arrears. Formal rescheduling proposals have now been put to the Advisory Committee; but the original moratorium has been extended for yet another 90 days as progress is likely to be held up until a Fund facility - with conditionality satisfactory to the bankers - is agreed. Venezuela seems very reluctant to enter into conditionality in the run up to next December's Presidential elections. The Venezuelans have however applied for a 100% CFF drawing and they might find it easier to

accept the conditionality that would need to be associated with this, although the question of eligibility is still contentious. A Fund mission will leave for Caracas on 10 July.

(ii) Eastern Europe

14 Recent weeks have been a period of relative calm and even modest progress so far as East European indebtedness is concerned. The Romanian agreement with the commercial banks, rescheduling 1983 maturities, was signed on 20 June; and prospects for a new agreement between Poland and the banks are improved now that the Poles have apparently drawn back from earlier proposals that banking debt maturing up to the end of 1985 should be rescheduled for 20 years and seem instead to be seeking extensive relief for a more conventional period on principal and interest due in 1983. Official creditors will shortly be considering their own position in the aftermath of the papal visit to Poland. Meanwhile, the FRG has offered to guarantee a DM 1,000 mn ($400 mn) five-year credit to the GDR, which faces heavy debt maturities this year, and there are hints of approaches to other creditors for debt relief. On the other hand the international support package for Yugoslavia has not yet been completed: agreement with the commercial banks has been delayed by further negotiations on a number of conditions and the moratorium on debt maturities has had to be extended again to 27 July. Signature is now expected in early August.

(iii) Southern Europe

15 There are no immediate problems in Southern Europe, although several countries are faced with uncomfortably large borrowing programmes to refinance their continuing external deficits. The recent 12% effective devaluation by the new administration in Portugal and the prospect of imminent recourse to the IMF should assist market sentiment after a long period of drift and uncertainty. Meanwhile Portugal has borrowed $400 mn from the BIS against pledged gold and another $300 mn to be repaid out of firm gold sales being undertaken by the BIS.

(iv) Far East

16 Recent developments in the problem countries in the Far East are mixed. On the one hand, in the Philippines, both the underlying situation and market confidence have deteriorated. The balance of payments deficit for the first six months of 1983 is thought to have exceeded the originally projected deficit for the whole year; US regional banks have been reducing their credit lines; and a proposed $100 mn market loan is meeting with difficulties. The peso was devalued by 7.3% against the dollar on 30 June and the deferment of five major industrial projects has been announced. In such a situation of increasing strain a debt crisis before the end of the year cannot be ruled out, although the outlook may be clearer after an IMF Mission now reviewing the standby has reported.

17 On the other hand, South Korea continues to make progress with its adjustment. An IMF standby under negotiation includes performance criterion to freeze short-term debt at its end-1982 level, and the government have set a 1987 target for current account surplus - last achieved in 1965 and 1977; the latest large syndicated loan appears to have met with a favourable response from lenders, after some hardening of terms, in line with the general trend for the region.

18 Market sentiment also remains generally favourable towards Indonesia. Earlier measures aimed at limiting the current account deficit in 1983/84 have been reinforced by steps to reduce imports of capital goods, and the adjustment strategy has been endorsed by a recent IBRD report and by the major aid donors whose new commitments of aid at the mid-June meeting of the Inter-Governmental Group for Indonesia (IGGI) were some 10% higher than last year.

July 1983

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*Brazil: see separate note

Note: An estimate of the country's total external debt is given at the beginning of each note and a statement of ECGD's position and the exposure of UK banks is given at the end.

CONFIDENTIAL

ARGENTINA

Total indebtedness at end-1982 was officially estimated at $39 bn including $2.7 bn in arrears.

Argentina's failure fully to remove discriminatory sanctions against the UK threatens her continued eligibility to make purchases under the IMF standby. The deadline is 31 July. Recent official contacts with the Managing Director of the IMF have confirmed that he is maintaining his robust line against discrimination and has told Argentine Central Bank President Gonzalez del Solar that the IMF Board is unlikely to support a request for the waiver of this condition. However performance under the 15 month standby arrangement was deemed satisfactory for the first quarter of 1983, and the IMF have released the second tranche (SDR 300 mn). This has been well received by creditor banks. Interest arrears, so far only paid to end-April, will be brought up to date by using the last tranche of the bridging loan. This will require a waiver from the banks, as release of the $300 mn involved was originally conditional on the prior elimination of arrears. This money will be placed in an escrow account to enable interest payments to be made and prevent Argentina using the funds for other purposes. A further obstacle to signature of the $1.5 bn medium-term loan (UK share of $159 mn), originally targetted for 31 March has been removed by the issue on 1 June of new regulations for the refinancing of $1.4 bn in foreign currency swaps and private sector loans covered by exchange guarantees, which now concede higher rates of interest than the authorities were formerly prepared to offer. Progress has also been made concerning the problem of discrimination against foreign creditors under Article 4 of the Bankruptcy Law. The Justice and Finance Ministries as well as the central bank all now endorse the implementation of a new law which will exclude any suggestion of discrimination. Following these assurances, the Advisory Group of banks had announced on 30 June that agreement had been reached with Argentina on the medium-term loan, signature of which may now take place before the end of July but according to our sources a number of banks are not happy about the proposal to waive penalty interest which may cause a delay in signature beyond the end of July.

Meanwhile a draft agreement which banks will use as a model in separate refinancing talks with their Argentine public sector debtors is expected to be ready before end-July.

On the IMF requirement that existing discriminatory financial restrictions against UK companies, embodied in Law 22591, be removed in order for further drawings from the Fund to take place after 31 July the authorities have recently opened the possibility of going some way towards this: on 6 June they published an amending law (Law 22820) which allows the Committee of Vigilance overseeing British assets in Argentina to suspend the ban in relation to particular individuals or companies. The law also empowers the government to lift the ban in general terms "taking into account the general interest and equal treatment given to the Argentine Republic". However, in both cases, the ban may be reintroduced.

To date only LBI have received formal authority to remit their dividend by BONEX out of Argentina although it can be expected that BBI will be granted similar permission in the immediate future. Although we have not received official confirmation of the report that all UK non-bank company applications to remit dividends have been refused, Del Solar has repeated on several occasions that any relaxation of restrictions affecting non-banking companies would be linked to UK concessions on the Exclusion Zone. When BBI's application has been approved both British banks will apparently be prepared to proceed with their shares of the new money loan despite the continuing discrimination against UK non-bank companies. However any draw-down under the loan ought not to be possible should Argentina fail (or be expected to fail) to meet the Fund's 31 July deadline for the removal of sanctions, since under the loan agreement the disbursement of each tranche of new money depends on Fund confirmation that Argentina remains eligible to make purchases.

CHILE

Total indebtedness at end-1982 was $18 bn (two-thirds private sector).

At the last count commitments towards the new money target of $1.3 bn totalled around $1.25 bn. Although some smaller creditor banks are reportedly reluctant to give final commitment because of the labour unrest in the country it is believed that the full amount will be reached. The target date for signature of the loan is 21 July. The short-term trade-related facility of $1.2 bn sought has been oversubscribed by some $0.4 bn. The BIS is reported to have increased the $350 mn bridging facility to $400 mn; $250 mn of this had been drawn by the end of June and some, but not all, of the remainder is expected to be withdrawn this month. The Chileans do not expect to have to draw on the bridging loan offered by the Advisory Group (originally $180 mn, subsequently reduced to $60 mn).

A Fund team visited Santiago at the beginning of July to assess economic performance against the revised end-June targets under the SDR 500 mn two-year standby. The IMF Managing Director is scheduled to present a waiver request (of the original targets) to the Executive Board on 27 July.

ECUADOR

Total indebtedness at end-1982 was $6.3 bn ($4.7 bn public sector).

Final agreement on the rescheduling package was reached between the Steering Committee and the Ecuadorians at a meeting on 8 June. Some 400 creditor banks were subsequently asked to ratify the following package by 30 June:

(i) The refinancing, over seven years including one year's grace, at 2 1/4% over LIBOR or 2 1/8% over Prime of both $1.1 bn public sector maturities due 1.11.82 - 31.12.83 and around $950 mn private sector maturities due in 1983 and outstanding on 21. 4.83. Creditors have the option of converting private sector debt into debt of the Banco Central.

(ii) $431 mn new money (representing a 9% increase in exposure for individual banks on levels outstanding at 31.12.82) over six years including 1 1/2 years' grace, at 2 3/8% over LIBOR or 2 1/4% over Prime. Funds to be disbursed as follows: 25% on 15.7.83, 50% on 15. 8.83 and 25% on 15.11.83.

(iii) Maintenance of short-term trade-related lines at level outstanding on 30. 4.83 (around $750 mn).

Disbursements under the SDR 157.5 mn standby (approved in principle on 1 June) are contingent on creditor banks agreeing to the whole package by 15 July.

The rescheduling of "official" debt will be discussed at a meeting of the Paris Club tentatively scheduled for 27-28 July; principal and interest payments on such debt were suspended with effect from 1 June.

MEXICO

Total indebtedness at end-1982 was an estimated $83 bn.

On 23 May, the IMF Board formally acknowledged Mexico's compliance with all first quarter performance targets under the SDR 3.4 bn EFF thereby releasing the second draw-down of SDR 301 mn. This was used by the Mexicans at end-May to make an unexpected advance repayment of $320 mn to the BIS and to the US, reducing the total amount outstanding under the two bridging facilities from $1,850 mn to $1,530 mn; at the same time, the Bank of England's capital commitment (which is covered by HMT's indemnity) has fallen from $140 mn to $115,821,000. The release of IMF funds also opens the way for disbursement of the second $1.1 bn tranche of the $5 bn medium-term commercial bank loan. However, the Mexicans are husbanding their resources and refraining from making an immediate drawing in order to be sure of being able to repay the balance of the BIS and US facilities by the final maturity date of 23 August.

On the economic front, the Mexicans' main success has been with the balance of payments. In the first half of this year, the estimated trade surplus totalled $5.6 bn - well over two-thirds of the forecast outturn for the whole year. Moreover, during the first quarter, net international reserves rose by $1.3 bn compared with the IMF performance criterion that there should be no reduction. The authorities are confident that they will be able to satisfy all second quarter performance targets and that no additional new money will be required for 1983. The international banking community are beginning to share this optimism.

As part of a public relations exercise aimed at speeding up rescheduling negotiations, Gurria, Director-General of Public Credit, toured a number of European capitals, including London which he visited on 23 June. Discussions between the Advisory Group and the authorities on draft documentation covering the rescheduling, over 8 years, of some $19 1/2 bn public sector debt owed to banks are now expected to be concluded by mid-July. However implementation of the model agreement, involving 24 public sector agencies, is unlikely to start much before the beginning of August.

It is perhaps too early to gauge fully the success of the Mexican scheme to reschedule, over a minimum of 6 years, the non-officially guaranteed element of the total of $14 bn in private sector debt owed to banks. The scheme has been in operation since 25 April and stays open until 25 October. Nevertheless, preliminary indications are far from encouraging. So far only $260 mn owed by 70 companies has been rescheduled via forward dollar purchases, with many companies unable to take up any of the repayment options, even where peso loans are made available. The possibility that the scheme may have to be modified can not be ruled out. A third (small) repayment of private sector interest arrears built up between 1 August 1982 and 31 January was made on 1 June, bringing the total of such payments to date to around $130 mn. Outstanding balances, currently totalling over $600 mn, which remain unpaid by 30 September are to be refinanced.

A multilateral agreement on the restructuring of some $1 1/2 bn of officially guaranteed private sector debt was signed at an informal Paris Club meeting on 20-22 June. Under the agreement, 90% of medium-term maturities (including arrears) falling due in the second half of 1983 will be paid over 6 years, including 3 years' grace; arrears at end-June 1983 on short-term debt must be fully paid off within 3 years; short-term maturities due in the second half of this year together with all interest payments on all categories of debt, are to be paid on schedule. Creditors are to negotiate bilaterally either refinancing or rescheduling, as appropriate, and have agreed to consider, in due course, the treatment of some $450 mn in medium and long-term maturities falling due in 1984. The Mexicans are hoping that the agreement will allow the $2 bn package of new official credits to be finalised. To date, a number of important insurers, including France and Japan, have not been offering medium-term cover. By contrast, ECGD's commitment to provide $150 mn has largely been used up.

PERU

Total indebtedness at end-1982 was an estimated $12 bn.

On 30 June an agreement covering the new money and medium-term refinancing elements of the commercial bank rescue package was signed in New York by most of Peru's 300 or so creditor banks. For unexplained reasons the amount to be refinanced has been raised by some $100 mn from the $320 mn originally understood to be involved. Although the $450 mn new money loan is currently over-subscribed by some $80 mn, 14 banks have not yet made commitments and the Advisory Group has sought the support of central banks, including ourselves, in securing as close to 100% participation as possible. Only when this has been achieved will banks receive a rebate to reduce contributions to the $450 mn requested, and the loan be disbursed. The first draw-down of $250 mn is provisionally scheduled to occur before end-July and will largely be used to repay a $200 mn bridging loan advanced by the Advisory Group to enable the IMF's end-June reserves target under the EFF to be met. The balance of the new money will be available in two tranches of $100 mn each in September and December.

As for the rollover of some $2 bn in short-term debt, numerous loose ends remain to be tied up (including the problem of reconciling figures) before this third element of the rescue package is fully signed.

In the four months since the rescue package was conceived Peru's economic situation has deteriorated markedly, with a series of natural disasters at home having contributed to budgetary and inflationary pressures. And although on 20 May, the IMF Board approved disbursement of SDR 187.5 mn for the second year of the EFF, it remains to be seen whether the authorities are able to tighten policy sufficiently in order to continue to meet performance targets in the second half of this year and avoid the need for additional new money.

Against this background, the Peruvians are seeking to restructure over 8 years, including 3 years' grace a total of some $1.2 bn in official debt maturities falling due between 29 April 1983 and 28 February 1985. They estimate that around 90% of this amount is owed to Paris Club creditors who have been asked to reconcile sums involved in advance of a Paris Club meeting on 27-28 July. The rescheduling does not affect maturities covered by the 1978 restructuring.

ECGD are currently not prepared to underwrite business outside the short-term.

VENEZUELA

Total indebtedness at end-1982 is estimated at $34 bn.

Finance Minister Sosa has recently stated that the authorities intend to implement their own economic programme to restore growth and balance of payments equilibrium in two and a half years. They regard the IMF's conditions for a standby arrangement - including a devaluation of the bolivar and corrective fiscal measures - as being too severe in an election year. Indeed, they appear to be stalling on taking any major decisions which would further undermine their election chances. Although Sosa has assured the banks that he has political backing for the rescheduling negotiations, consensus apparently remains to be reached with opposition parties.

Sosa presented Venezuela's formal rescheduling proposals to the Advisory Committee on 6 - 7 June. These involve rescheduling public sector maturities due in 1983 ($13.7 bn) over eight years and those due in 1984 ($2.6 bn) over seven years - both with four years' grace. Little significant progress is likely to be made in the negotiations, however, until a Fund facility - with conditionality satisfactory to the bankers - is agreed. Meanwhile, the original moratorium (which expired on 30 June) has been extended for 90 days. The Advisory Committee has also insisted that public sector interest arrears be brought up to date and that guarantees be given on the provision of foreign exchange to the private sector where interest arrears total around $250 mn. As a result, the system of obtaining dollars from the Differential Exchange Controls Office has been simplified and the government has stated that interest and short-term trade arrears will be paid off by 15 July. This commitment (if it is translated into action) is welcome to bankers who had become concerned that the question of private sector debt (not included in the moratorium) was being neglected in favour of progress on the public sector rescheduling. It has been confirmed that Venezuela is not seeking new money for 1983.

The authorities are to apply for a first credit tranche drawing equivalent to 25% of quota (currently SDR 990 mn) and a CFF of

$1.1 bn; they also intend to withdraw the $1.3 bn available to them unconditionally through encashment of SDR's/reserve position draw-down. The conditionality associated with a CFF might be easier for the Venezuelans to accept, but the question of eligibility remains contentious. A Fund mission will depart for Caracas on 10 July. The 1983 Article IV paper, which was discussed in the Board on 1 July, is highly critical of current policies.

EAST GERMANY (GDR)

Total convertible-currency indebtedness (perhaps as much as $15 bn at end-1981) probably declined in 1982.

Gross debts to BIS area banks (excluding banks in West Germany) fell from over $10 bn at end-1981 to $8.9 bn at end-1982. The GDR gives considerable publicity to its BIS position but the $0.5 bn increase in deposits with BIS area banks to $2 bn at end-1982 probably owed much to window-dressing. Existing undrawn credit facilities remain considerable but inability to raise substantial new medium and long-term credit from Western banks has largely confined the GDR to short-term borrowing. Gross debt maturities (including short-term), which probably exceeded $5 bn in 1982, are unlikely to fall much below that in 1983 and 1984. GDR importing agencies in general have been obliged by the government to seek longer credit terms. ECGD is still on limited cover but has introduced tighter market limits. A substantial improvement in the trade account in 1982 was achieved primarily by drastic import cuts (other than from the FRG, with which there was an increase in bilateral indebtedness after the decline in the earlier part of 1982). At the end of June the FRG government (from which the GDR had sought support for a loan of DM 3,000 mn to DM 5,000 mn in the latter part of 1982) announced that it would guarantee a DM 1,000 mn ($400 mn) balance of payments loan to the GDR. This may mitigate the immediate liquidity position but prospects for the longer term remain uncertain and serious debt-servicing problems and even rescheduling are still possible; indeed, there is a - so far unconfirmed - report that the GDR is already conducting negotiations with some creditor countries on possible debt rescheduling.

At end-December 1982 UK-registered banks' consolidated external claims totalled $1,498 mn, of which $1,393 mn was unguaranteed (cf $1,543 mn and $1,463 mn respectively at end-June 1982). Claims by British-owned banks totalled $906 mn, of which $811 mn was unguaranteed (cf $941 mn and $863 mn respectively). ECGD has £113 mn at risk.

HUNGARY

Convertible currency debt at end-1982 totalled $7.5 bn.

The performance criteria under the one-year IMF standby arrangement are being met and the recent mid-term review passed smoothly. The formal target for the surplus on the convertible-currency current account has been reduced from $600 mn to $500 mn following Hungarian pessimism about the prospects for exports and particularly prices for agricultural exports. However, in view of recent and prospective measures (including further depreciation of the exchange rate, price increases and a wage freeze in the government sector) the IMF staff remain confident that a surplus of $600 mn can be achieved.

Hungary repaid $100 mn to the BIS on 30 June when it became eligible to make a drawing of SDR 83 mn ($89 mn) from the IMF. Two IBRD loans totalling $239 mn have recently been agreed but a review of the methodology of computing per capita GNP may disqualify Hungary from further such borrowings (the question of IBRD procurement in Centrally Planned Economies is also being studied). The capital account remains weak - there was an outflow of $400 mn in the first quarter partly as a result of a reversal of end-year window-dressing - and the financing gap is proving difficult to cover despite IMF drawings and a recent club loan for $200 mn. Negotiations are currently taking place with Arab and Japanese led syndicates for cofinancing loans totalling $250 mn following the IBRD agreement. A further approach to the banks may be made later this year. The liquidity position is unlikely to ease next year when medium and long-term capital outflows are set to rise from $1 bn to $1.6 bn.

UK-registered banks' consolidated external claims, largely unguaranteed, fell from $833 mn at end-June 1982 to $802 mn at end-December 1982. Claims by British-owned banks rose from $488 mn to $527 mn during the same period. ECGD commitments are modest and under tight control with £17 mn at risk at end-December.

POLAND

Total convertible-currency indebtedness is now about $27 bn.

Commercial bank and official creditors both negotiated rescheduling agreements in respect of debts due in 1981. Following the declaration of martial law in December 1981 official creditors agreed to suspend negotiations on further rescheduling of official debt for the time being. In practice Poland has used this as a pretext to stop all payments to governments and so gain 100% de facto relief on both principal and interest (including amounts due under the rescheduling agreement for 1981). Last November the banks signed an agreement rescheduling, over 7 1/2 years, 95% of the $2.3 bn repayments of principal due in 1982. The Poles have continued to meet repayments under both commercial bank agreements; and, under the terms of the second agreement, half the interest due in 1982 has been lent back in the form of new three-year credits.

Negotiations on the rescheduling of official debt due in 1982 and later remain in abeyance, although the consensus in the creditors' group is under some strain. There is to be an inter-governmental meeting in early July to assess the situation following the Pope's visit. In recent discussions with the banks the Poles drew back from earlier suggestions of relief up to 20 years on debt payable during the period 1983/85 and seem now to be concentrating on extensive rescheduling for less than ten years of principal and interest due in 1983 only. Talks are scheduled for 29/30 June in Zurich with a further meeting in Warsaw from 13/15 July. Bankers hope that an outline agreement will be reached by end-July.

At end-December 1982 UK-registered banks' consolidated external claims totalled $1,749 mn, of which $811 mn was unguaranteed (cf $1,839 mn and $791 mn in June 1982 respectively). Claims by British-owned banks totalled $1,449 mn, of which $543 mn was unguaranteed (cf $1,553 mn and $542 mn respectively). ECGD is off cover: the amount at their risk is £821 mn.

ROMANIA

At end-1982 convertible currency debt totalled $9.8 bn.

Commercial bank and official creditors last year rescheduled 80% of 1982 maturities (and 1981 arrears). Both sets of creditors have reached agreement on a less extensive rescheduling for 1983 maturities whereby 30% of principal is to be repaid this year, 10% in 1984 and the balance over 6 1/2 years including 3 years' grace. The commercial banks' agreement was signed on 20 June.

The Romanians have indicated that they expect to avoid the need for further rescheduling, but it is too early to say whether their confidence is well founded. It could be hard to sustain the drastic cuts in imports that have turned their position round and the repayment of rescheduled debt will begin to impose financial strains from 1985 on.

At end-December 1982 UK-registered banks' consolidated external claims totalled $851 mn, of which $582 mn was unguaranteed (cf $840 mn and $598 mn respectively at end-June 1982). Claims by British-owned banks totalled $644 mn, of which $383 mn was unguaranteed (cf $633 mn and $399 mn respectively). ECGD is off cover; its amount at risk is £352 mn.

YUGOSLAVIA

Total indebtedness is about $18 bn and early this year an extensive support operation was mounted involving governments, banks and international institutions.

A memorandum of understanding signed in Berne in January by representatives of 15 creditor countries envisaged governmental funds of about $1.3 bn being made available in medium-term credits (mostly export credits). The first half of a £38 mn financial loan from HMG has been disbursed; negotiations have begun on terms for a £40 mn loan guaranteed by ECGD to refinance payments due to UK exporters.

On 25 March the commercial banks' International Co-ordinating Committee (ICC) reached agreement in principle on a package incorporating refinancing of $1.4 bn medium-term debt and $2 bn short-term credits maturing 1983 and the provision of up to $0.6 bn new money. Negotiations over conditions (the waiving of sovereign immunity and the application of the right of set-off) in the draft agreement have led to some delays and the moratorium has been further extended until 27 July. Following a heated debate in the Yugoslav legislature, compromise formulae have now been agreed and signature of the agreement is expected to be concluded in early August.

Funds totalling $0.4 bn net should be available this year from the IMF/IBRD. An IMF team has recently discussed revisions to the current programme which should go to the Board before end-July, by when negotiations with the banks should be completed. The BIS has granted a $500 mn facility in two tranches; of which $300 mn backed by central banks has been disbursed, including a Bank commitment of $25 mn (to be taken out by disbursement of the second half of the HMG loan on 15 August). Release of the $200 mn gold-backed tranche now looks increasingly unlikely since Kuwaiti banks still appear unwilling to waive their negative gold pledge clause.

At end-December 1982 UK-registered banks' consolidated external claims totalled $1,660, of which $1,301 mn was unguaranteed (cf $1,745 mn and $1,395 mn respectively at end-June 1982). Claims by British banks totalled $1,226 mn of which $899 mn was unguaranteed (cf $1,271 mn and $941 mn respectively). ECGD remains on cover for short-term business, the amount at risk totalling £839.3 mn.

INDONESIA

Total indebtedness is estimated at $26 bn at end-March 1983, excluding short-term debt of the public sector. (A new element in these figures, compared with earlier returns, is an estimated $4 bn of private sector debt.)

The Indonesian authorities plan to limit the current account deficit in 1983/84 to $6.5 bn. To supplement earlier measures taken in support of this objective (a restrictive budget, a wages freeze and a 28% devaluation), they are aiming to make major savings on capital goods' imports. Following the announcement in May of the deferment of four major industrial projects with a total cost of some $5 bn, a review of all projects with foreign exchange costs has been initiated.

Debt service in calendar 1983 is estimated at $2.6 bn. Of the total net financing requirement for 1983/84 of $6.8 bn (which allows for an increase in reserves of $0.3 bn), some $1.8 bn is expected to come from disbursements from the pipeline of existing commitments. The balance of $5 bn in new money is broken down between $2 bn official development assistance (oda), $1.4 bn commercial import-related credit, and $1.5 bn from other market borrowing. Reserves at end-March 1983 stood at $7.6 bn (of which $3.4 bn was held by the state commercial banks).

In a report prepared for the mid-June meeting of the Inter-Governmental Aid Group for Indonesia (IGGI), the IBRD project a foreign exchange requirement of $20 bn over the three years 1983/84-1985/86 to cover estimated cumulative current account deficits over this period - with the deficit assumed to be reduced to $3 bn (3% of GDP) in 1985/86 - together with debt service. The indication of how this financing requirement might be broken down is $1.2 bn use of reserves, $17 bn medium- and long-term loans ($4.9 bn oda, $5.7 bn import-related credit, and $6.4 bn financial markets) and $3.8 bn short-term and other capital (direct investment etc). The IBRD commend the Indonesian Government's policy approach and their debt management record and suggest that, against this background, the proposed level of external borrowing should not present undue difficulties. A similar endorsement of present policies was given by the IGGI meeting which made new aid commitments of $2.2 bn, some 10% more than last year. The IBRD emphasise the uncertainties surrounding even the current account forecast for this year (notably as regards the prosects for OECD recovery and the oil price) and their judgment about Indonesia's prospects needs to be seen in this light.

There have been no major recent tests of market sentiment since the $1 bn syndicated credit earlier in the year (which offered two equal tranches at 1/2% over LIBOR and 0.2% over US prime). Smaller borrowings have however been made, including a D.Fl.100 mn ($36 mn) bond issue in Amsterdam in March, and a ¥24 bn ($100 mn) syndicated yen credit in June. In August a ¥10 bn ($41 bn) samurai bond issue is planned. Indications are that market sentiment, while cautious, remains generally favourable to Indonesia and, in the absence of a collapse in the oil price, Indonesia should get through this year without a payments crisis.

As at end-March 1983, ECGD had an estimated £209.1 mn at risk under Section 1 and £802.4 mn under Section 2. At end-December 1982 UK-registered banks' consolidated external claims in Indonesia totalled $1,159 mn; claims by British-owned banks totalled $1,014 mn of which $598 mn was unguaranteed.

THE PHILIPPINES

Total indebtedness at mid-1983 is estimated at up to $25 bn, including an additional $4-5 bn of short-term banking debt which was not included in earlier estimates.

The latest indications are of a deterioration in the external position in recent months and a weakening of international banking confidence. Governor Laya has said that balance of payments performance so far this year has been disappointing and, although no figures have been published since the first quarter, official sources are reported to be anticipating an overall deficit of some $0.8 bn for the first six months of 1983 compared with an originally projected deficit of $0.6 bn for the whole year. Leads and lags appear to have contributed towards this result. There is evidence that US regional banks have been reducing lines of credit to the Philippines and there are signs that this may already be causing liquidity problems. Margins between the official and the black market rates for the peso have been widening. An additional adverse factor which may affect export earnings next year from major crops (sugar, coconuts, grain) is a long drought.

In this situation, the peso was devalued by 7.25% against the US dollar to 11.00 on 23 June. At the same time the deferment of five major industrial projects costing $3 bn has been announced and the price subsidy system for oil products has been abolished.

In reflection of the current poor state of sentiment, a $100 mn syndicated loan for the Development Bank of the Philippines (DBP) now in the market has attracted a very limited reponse. At best the final result looks likely to be a club deal with few banks involved. The position overall looks to be one of increasing strain. A debt crisis before the end of the year cannot be ruled out, and if the Philippines get through 1983 the situation next year is likely still to be critical. The short-tem outlook may be clearer on the return to Washington of an IMF Mission which is currently conducting a mid-year review of the standby agreement in Manila.

As at end-March 1983, ECGD had an estimated £217.5 mn at risk under Section 1 and £7.4 mn under Section 2. At end-December 1982 UK-registered banks' consolidated external claims in the Philippines totalled $1,777 mn; claims by British-owned banks totalled $1,609 mn of which $1,162 mn was unguaranteed.

SOUTH KOREA

Total indebtedness at end-March 1983 was $37.5 bn of which $14.0 bn was short-term.

Satisfactory progress with adjustment continues to be made. In the first quarter of 1983 real GNP was 9.3% higher than in the corresponding period of the previous year and strong growth is expected to be sustained through 1983. Consumer prices rose by 4.3% in the 12 months to April, an improvement on the end-December 1982 figure of 4.5%. After a disappointing performance in the first quarter - when they were 0.9% lower than in the first quarter of 1982 - exports picked up in April and, for the first four months of 1983 the current account deficit of $0.7 bn was on course for meeting the projected outturn for the whole year.

Korea is seeking an SDR576 mn IMF standby - to be discussed in the Board on 8 July. Real growth of 7.5% is envisaged for both 1983 and 1984, and the standby programme aims at reducing the fiscal deficit to 4% of GNP in 1983 (from 4.6% in 1982), keeping inflation below 5% in both 1983 and 1984, and bringing the current account deficit down from $2.5 bn in 1982 to $2.3 bn this year and $2 bn in 1984. The authorities have set a target of moving into current account surplus in 1987 - in recent years surpluses have been recorded only in 1965 and 1977. Performance criteria limit the increase in external indebtedness to $4.2 bn in 1983 (+11%) - when the debt service ratio will be 19.5% - and freeze short-term debt at its end-1982 level. The authorities are committed to a reduction in short-term debt during 1984.

In the meantime, market confidence in Korea appears to be holding up satisfactorily. Korea's second large syndicated loan of the year, a $300 mn eight-year loan for the Exim Bank was a two-part deal with one portion priced at 3/4% and 7/8% over LIBOR for the two four year tranches and the other at 1/4% over US prime. Although the terms were harder than for the Korea Exchange Bank loan earlier in the year, this hardening was not out of line with the recent trend for the region, and the loan appears to have been well received.

As at end-March 1983, ECGD had an estimated £209.1 mn at risk under Section 1, and £503.4 mn under Section 2. At end-December 1982 UK-registered banks' consolidated external claims in South Korea totalled $3,060 mn; claims by British-owned banks totalled $2,596 mn, of which $1,995 mn was unguaranteed.

INDEBTEDNESS AND BRITISH EXPOSURE (end December 1982)

$ billion

	Total external debt	British banks unguaranteed claims	ECGD amounts at risk
Latin America			
Argentina	39	2.3	0.4
Brazil	83	4.4	2.5
Chile	18	1.1	0.06
Ecuador	6	0.5	0.1
Mexico	83	5.2	1.8
Peru	12	0.4	0.2
Uruguay	4	0.3	0.01
Venezuela	34	2.4	0.08
Eastern Europe (convertible Currency)			
East Germany	15	0.8	0.2
Hungary	7	0.5	0.07
Poland	27	0.5	1.3
Romania	10	0.4	0.6
Yugoslavia	18	0.9	1.3
Far East			
Indonesia	26/	0.6	1.5/
Philippines	25	1.2	0.3/
South Korea	38/	2.0	1.0/

Because of differences in definition the ECGD Exposure figures in the final column are not directly comparable with the figures in the other two columns.

/ At end March 1983

* Because of Hong Kong's position as on offshore centre the available figures for external indebtedness and banking exposure to Hong Kong are not comparable to those for other countries shown above and do not provide a meaningful indication of the territory's debt exposure.

Elon Por
Indebtedness
Pt 2

JUL 1989

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SECRET

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THE DEPUTY GOVERNOR

(2)

BANK OF ENGLAND
LONDON
EC2R 8AH

C. AW.

Prime Minister

12 July 1983

The Governor is now having second thoughts about X. No decision required tonight; the Governor and Chancellor will put the matter to you tomorrow.

MCS 12/7

M C Scholar Esq
Private Secretary to
the Prime Minister
Prime Minister's Office
No 10 Downing Street
London
SW1

Dear Michael,

BIS LOAN TO BRAZIL

I am writing to confirm what I heard from the Governor speaking from Basle this morning and passed on to you by telephone.

Leutwiler's uncompromising remarks, on the need for the current \$400 million tranche of the BIS loan to be paid on its due date, appear to have been very effective. Larosière was subsequently on the 'phone to Delfim Netto who was fully-seized of the need to show some real movement and was going straight to the President to urge it. We also heard that Langoni, the central bank governor, had been stiffened.

Leutwiler then convened a meeting of the BIS Governors (representing the UK, France, Germany, Italy, the Netherlands and Sweden) with Larosière. After some discussion, the outcome of this meeting was as follows. It was proposed by Leutwiler and agreed unanimously by the Governors, subject, in some cases such as our own, to reference back to capitals, that if Larosière was able to say on Friday that he had received assurances that were satisfactory to him from President Figueredo, the BIS would issue the following statement:

> "In the light of the declaration by the President of Brazil, the Managing Director of the IMF has requested that the BIS and the central banks which participated in the credit to Brazil should postpone the maturity of the \$400 million tranche due on 15 July. This postponement should enable the IMF to complete its negotiations with the Brazilian authorities, against the background of the reforms announced by the President. The participating central banks have agreed to the Managing Director's request and, as a consequence, have taken over their respective shares. At the same time these central banks have asked the BIS to represent their interest in relation to their credits with Brazil."

You will note, of course, that this suggested statement contains no term on the postponement. It was agreed by all the central banks that this was now the right course because (a) they will only be making the postponement if the Brazilians have actually shown that they have responded to the leverage they have already exerted; and (b) they recognise that they cannot determine when the IMF negotiations will be complete though they must realistically be expected to take at least three weeks.

but they could backtrack later MCS

— so, go for 5 weeks, or 7 weeks, or....

It is also relevant that de Larosière asked the US Treasury whether if Brazil made a satisfactory declaration to him, they (the US Treasury) would be prepared to extend a loan to enable the Brazilians to pay off part or all of the $400 million tranche. He reported that the Treasury response was "not negative". The rationale behind this approach is that all concerned feel it would be in the general interest to preserve the credibility of the BIS as a provider of essentially short-term bridging finance which is unquestionably repaid when it becomes due. Our Governor was asked whether he could prevail on our Chancellor to telephone Regan to encourage him to provide (only, of course, if the satisfactory declaration was made) some finance. Larosière appeared to believe that Regan would be likely to be persuadable.

If no satisfactory declaration is forthcoming by 15 July it is agreed that there shall be no question of any further postponement of the BIS credit. It will be announced that the central banks have substituted themselves for the BIS, though asking the BIS to continue to represent their interest and on their behalf demand repayment. We shall then have a situation of technical default if the Brazilians are unable to make the payment.

X The Governor has asked me to say that he hopes that in the various circumstances outlined above, the Prime Minister will be content that he should join his colleagues in making the proposed statement.

I am copying this letter to John Kerr and Brian Fall.

Yours ever

Kit

C W McMahon

SUBJECT cc MASTER

cc FCO B of E

5

10 DOWNING STREET

From the Private Secretary

11 July 1983

BRAZIL

The Prime Minister held a meeting this morning to discuss the Chancellor's minute of 8 July, and the Bank's paper of 7 July on the current Brazilian situation. The Chancellor of the Exchequer, the Deputy Governor, Mr. Littler and Sir Alan Walters were present.

The Prime Minister said that it was a weakness of the Bank's paper that it neither indicated the likely position of the other creditor countries, in particular the Germans, Swiss and Dutch, at today's BIS meeting, nor did it specify the length of the rollover it proposed of the BIS facility. Her inclination was to join the Germans, Swiss and Dutch if they were against any further rollover. But she suspected that the matter would not be clear-cut, and that we should therefore argue for a two-week, final, rollover.

Mr.Littler reported that in a discussion with some of his opposite numbers, together with the IMF Managing Director, in Paris on Friday, M. de Larosiere had taken a firm line, suggesting that the critical policy decisions in Brazil would be taken by 15 July when the President would be departing for medical treatment. If they were not taken, that would be end of the road, and there could be no question of watering down the Fund's conditions for future drawings. There had been general agreement at the Paris meeting that this was the right line to take. The Deputy Governor said that the Bank of England's information from the commercial banks suggested that the Brazilians were much further away from making the necessary policy changes than this account indicated. But the IMF were nearer the action, and we must back de Larosiere's judgement.

The Prime Minister said that it was her impression that the creditor countries had not handled the Brazilian situation well. No-one had warned Brazil what would happen if they went into default. It was necessary to work out urgently detailed contingency plans, which she wished to see as soon as possible. If there was a risk that our stance in the Basle

/discussions

discussions would cause the Brazilians to refuse permission for our aircraft to land in Brazil on route for the Falklands if the refuelling operation failed, we should lower our profile accordingly. We should be guided in the Basle discussions by the view of M. de Larosiere; if, on his advice, we were prepared to agree a further roll over of the BIS facility, we should make it clear that this was a final roll over, for a very limited term: the precise date of the final repayment to be agreed with M. de Larosiere.

I am sending a copy of this letter to Brian Fall (Foreign and Commonwealth Office) and John Bartlett (Bank of England).

M. C. SCHOLAR

John Kerr, Esq.,
HM Treasury.

CONFIDENTIAL

GRS 1050
CONFIDENTIAL
FROM ROME 110645Z JUL 83
TO PRIORITY FCO
TELNO 328 OF 11 JUL 83

PS TO PM 10 DOWNING ST.

INFOR ROUTINE WASHINGTON MOSCOW AND UK DEL NATO

SAVING TO MODUK BONN BRUSSELS COPENHAGEN THE HAGUE AND PARIS:
HOLY SEE (ACTIONED ROME.

ITALY/INF

SUMMARY

1. INF WAS NOT AN ISSUE IN THE ITALIAN ELECTION CAMPAIGN. THE BUDESTAG DEBATE ON SECURITY POLICY ATTRACTED LITTLE ATTENTION HERE, AND COMMENTATORS DREW NO IMPLICATIONS FOR ITALY FROM KOHL'S TALKS IN MOSCOW (MYTELNO 329). THE PARTIES ARE NOW PREOCCUPIED WITH NEGOTIATIONS TO FORM A NEW GOVERNMENT, WHICH ARE LIKELY TO CONTINUE INTO AUGUST. THERE IS STILL NO REASON TO THINK THAT ITALY WILL NOT STAND BY HER COMMITMENT TO INSTAL GLCM AT THE END OF THIS YEAR, ALTHOUGH THERE WILL BE FRESH OBSTACLES TO OVERCOME IN THE AUTUMN.

PARTY ATTITUDES

13. THE PCI ARE MAINTAINING THEIR LOW-KEY OPPOSTION TO BASING AT COMISO, AND THE DC AND MINOR LAY PARTIES (REPUBLICANS, SOCIAL DEMOCRATS AND LIBERALS) CONTINUE TO ACCEPT THE NEED TO GO AHEAD AS PLANNED. SO THE PSI ARE STILL THE PARTY WHOSE ATTITUDE WILL BE CRUCIAL IN THE COMING MONTHS. DURING THE CAMPAIGN MORE THAN ONE OF THEIR SPOKESMEN GAVE THE NEED TO TAKE DIFFICULT DECISIONS OVER BASING AT COMISO AS ONE OF THE JUSTIFICATIONS FOR CALLIN EARLY ELECTIONS. THE REPLIES OF CRAXI TO QUESTIONS ON INF WERE ROBUST, AND THE LESS ORTHODOX VIEWS OF SOME ON THE LEFT OF THE PARTY (LIKE VITTORELLI) WERE KEPT OUT OF SIGHT . ALL THIS HAD BEEN ENCOURAGING.

4. ON THE OTHER HAND, THE MINISTER AT THE US EMBASSY HAS TOLD ME IN CONFIDENCE (PLEASE PROTECT) THAT THE PSI SENT A MESSAGE TO THEM ABOUT INF ON 28 JUNE, THE DAY AFTER THE ELECTIONS. IT CAME IN THE FORM OF A TELEPHONE CALL FROM ACQUAVIVA, THE HEAD OF CRAXI'S OFFICE, WHO DOES NOT NORMALLY DEAL WITH DEFENCE OR FOREIGN POLICY ISSUES. HE ASKED ABOUT THE POSSIBILITY OF DELAYING THE TIMETABLE FOR THE ARRIVAL OF CRUISE MISSILES AT COMISO. MY US COLLEAGUE INSTRUCTED THAT A FIRM REPLY BE SENT THAT ANY SUCH SUGGESTION WOULD BE VIGOROUSLY OPPOSED BY THE UNITED STATES. ON HEARING THIS ACQUAVIVA BACKTRACTED, SAYING THAT IT HAD ONLY BEEN AN IDEA.

CONFIDENTIAL

/5. WE

5. WE HAVE NO EVIDENCE THAT THE PSI ARE GIVING SEROUS THOUGHT TO THE POSSIBILITY OF CHANGING THEIR LINE ON INF. THEY ARE HOWEVER IN REGULAR CONTACT WITH THE SPD, AND CRAXI IS AWARE OF HIS VIRTUAL ISOLATION AMONG EUROPEAN SOCIALISTS ON THIS ISSUE. MUCH WILL DEPEND ON WHETHER THE PSI IS PART OF THE NEXT GOVERNMENT, AND IF SO, ON THE MINISTRIES WHICH THEY ARE ALLOCATED: THERE ARE STRONG RUMOURS THAT THEY WISH TO RELINQUISH DEFENCE. A FRESH INF DEBATE IN PLARLIAMENT THIS AUTUMN, WHICH IS NOT IN THEORY NECESSARY BUT MAY BE HARD TO AVOID NOW THAT ONE IS PLANNED IN THE BUDESTAG, WOULD INCREASE THE PRESSURE ON CRAXI. NEVERTHELESS, HIS POSITION IN THE PARTY IS STRONGER THAN IN DECEMBER 1979 WHEN THE ORIGINAL DECISION WAS TAKEN, AND A VOLTE FACE BY THE PSI NOW WOULD EXPOSE THEM TO FIERCE

CRITICISM FROM ALL OTHER PARTIES IN GOVERNMENT.

6. A MEMBER OF CHANCERY SPOKE TO ACQUAVIVA ABOUT INF ON 5 JULY, WITHOUT MENTIONING THE US APPROACH. HE ADMITTED THAT A DEBATE WAS LIKELY, AT THE INSTIGATION OF THE PCI OR EXTREME LEFT (DP), BUT DENIED THAT THE PSI WOULD MAKE TROUBLE.

PUBLIC OPINION

7. POPULAR OPPOSITION TO BASING AT COMISO IS STILL SPORADIC, AND THE PCI HAVE MADE NO RECENT EFFORT TO EXPLOIT IT. THERE HAVE BEEN NO FURTHER PEACE MARCHES, BUT THE PERMANENT CAMP OF DEMONSTRATORS AT COMISO MAY RECEIVE SOME FRESH RECRUITS IN THE SUMMER INFLUX OF TOURISTS AND STUDENTS. THE CHURCH HERE IS KEEPING A LOW PROFILE ON THE INF AT THE MOMENT.

MFA VIEWS

8. MFA OFFICIALS REMAIN OPTIMISTIC. THE NATO DEPARTMENT TOLD US ON 5 JULY THAT PREPARATIONS FOR THE ARRIVAL OF GLCM WERE GOING AHEAD ON SCHEDULE, AND THAT OVER 300 US PERSONNEL WERE ALREADY AT COMISO. THERE WERE NO SIGND OF THE SICILIANS THEMSELVES MOUNTING ANY SERIOUS OPPOSITION TO THE PLANNED DPELOYMENT.. UNLESS THE PSI WENT INTO OUTRIGHT OPPOSITION IN PARLIAMENT, WHICH WAS VERY UNLIKELY, HE DID NOT BELIEVE THAT THE SOCIALIST WOULD CREATE DIFFICULTIES. IF THE PCI WENT THROUGH THE MOTIONS OF DEMANDING A PARLIAMENTARY DEBATE, THE BEST TIME FOR THE GOVERNMENT TO HOLD IT MIGHT BE THE FIRST HALF OF NOVEMBER: MINISTERS COULD THEN USE ANY POSITIVE RESULTS FROM THE OCTOBER NPG MEETING, AND THE OPPOSITION COULD NOT EXPLOIT THE BUDESTAG DEBATE. IT WAS UNFORTUNATE THAT KOHL HAD NOT CONSULTED OTHER BASING COUNTRIES BEFORE GIVEING HIS UNDERTAKING TO STOP THE STATIONING OF MISSILES AND THEIR PARTS UNTIL 15 NOVEMBER (YRTELNO 338 TO BONN): BUT NO-ONE WOULD DEMAND THAT ITALY FOLOW SUIT.

/9. THE

9. THE MFA HAVE SUBMITTED TO FANFANI'S OFFICE A DRAFT REPLY TO ANDROPOV'S LETTER (MOSCOW TELNO 712NOTALL). SINCE ANDROPOV MADE NO IMPORTANT NEW POINTS, THE REPLY WAS A REPETITION OF STANDARD ALLIANCE ARGUMENTS. ON BRITISH AND FRENCH SYSTEMS IT ARGUED FORCEFULLY THAT THE WESTS' POSITION WAS SERIOUS AND THAT THE USSR COULD NOT HOPE TO DEVIDE WESTERN EURIPEAN NATIONS INTO DIFFERENT CATEGORIES AS REGARDS SECURITY. ALL WERE THREATENED BY SOVIET MISSILES, AND THERFORE NEEDED THE PROTECTION WHICH ONLY US MISSILES, INCLUDING CRUISE, COULD SUPPLY. ITALY COULD NOT THEREFORE ACCEPT ANY SUBCEILING IN THE INF NEGOTIATIONS TO TAKE ACCOUNT OF BRITISH AND FRENCH SYSTEMS, WHICH WERE DIFFERENT IN THEIR NATURE AND THEIR PURPOSE. THE MFA ARE NOT SURE WHETHER FANFANI WILL AGREE TO REPLY IN THESE TERMS: HE MIGHT SEND A SIMPLE ACKNOWLEDGMENT, OR EVEN IGNOR THE LETTER ON THE GROUNDS THAT AS CARETAKER PRIME MINISTER HE SHOULD NOT COMMIT HIS SUCCESSOR . BUT IF THERE WERE A SUBSTANTIVE REPLY, IT WOULD BE CIRCULATED TO NATO ALLIES.

10. THE SITUATION IS THUS REASONABLY SATISFACTORY FOR THE PRESENT. IF THE NEGOTIATIONS FOR ANOTHER FIVE-PARTY COALITION SUCCEED, STILL THE MOST LIKELY OUTCOME, I SEE NO REASON TO FORESEE A CHANGE IN THE ITALIAN POSITION. THE EPISODE IN PARAGRAPH 4 MAY BE EXPLAINED BY THE INTEREST BEING TAKEN AT THE TIME, BY SOME WITHIN THE PSI, IN A DIFFERENT POLITICAL ALIGNMENT INVOLVING A DEGREE OF COMMUNIST SUPPORT (OUTSIDE THE GOVERNMENT) FOR A COALITION. BUT CRAXI HAS FIRMLY TURNED DOWN THIS IDEA, SUGGESTED BY FORMICA, SHOULD RENEWAL OF THE FIVE PARTY COALITION FAIL, WE SHALL NEED TO KEEP A CLOSE EYE ON THE SITUATION BUT IT WOULD BE A MISTAKE TO SHOW ANY SIGN OF ANXIETY NOW.

11. FCO PLEASE PASS SAVING ADDRESSEES

BRIDGES

LIMITED

DEF D	PS	ADDITIONAL DISTRIBUTION START
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ACDD	PS/PUS	
NEWS D	SIR J BULLARD	
EESD	MR WRIGHT	
NAD	MR CARTLEDGE	
WED	MR JAMES	

B 4

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

BRAZIL

I have seen the report on the current Brazilian situation sent to you by the Bank of England on 7 July. I shall be letting you have a further monitoring report on the wider international debt situation early next week: the section on Brazil will take account of discussions in Paris and in Basle this weekend, and any other developments. But the following are my immediate reactions to the Bank's paper.

2. First, our number one priority must be to maintain the maximum pressure on Brazil to implement the IMF's adjustment programme. Some progress has been made on the external side - the latest trade figures are encouraging - but we still need evidence that the Brazilian Government are prepared to undertake the action necessary to control public expenditure, and - the most vital element of the programme - to break the wage indexation system which prevents the necessary adjustment process from taking place. As the Bank's note points out, the Brazilians last month took some measures to reduce spending and tighten credit: but they need to do more.Unless they show willing to implement effectively the critical parts of the IMF programme, we shall have to consider withdrawing our support - to do otherwise would risk wrecking the overall strategy for dealing with international debt problems.

3. Secondly, however, it would be right, at least in the very short term, to continue to support Larosiere,which means awaiting his judgement on how best to increase the pressure on the Brazilians. A Fund mission is in Brazil now, and the Managing Director will be best placed,in the light of its reports, to assess the prospects for getting the Fund programme back on the rails. Unless, therefore,

Larosiere takes the view in the discussions over the weekend prior to the BIS meeting that the Fund programme is beyond recovery, I agree with the Bank's assessment that we should be prepared to go along with the BIS in agreeing to a further very short postponement of the repayment of the instalment at present due on 15 July. Insistence on repayment on 15 July would not in my view achieve any practical benefits. The Brazilians would not repay (and the substitution agreement would transfer the rights and obligations from the BIS to the central banks). And the action by the BIS would almost certainly be interpreted by the international community as a declaration of default by Brazil: the consequences could take matters out of Larosiere's hands. On the other hand, a further short extension of the BIS facility will provide a little time for him to step up pressure on the Brazilians, and make a final judgement on whether the Fund programme can be put back in place. The end of this month should in my view be the limit. I have asked the Governor to do all he can to ensure that this pressure is reinforced by the terms under which the BIS agree to this final postponement.

4. I have asked officials to step up work on a contingency plan for action if the negotiations break down.

5. I am copying this minute to the Foreign and Commonwealth Secretary, to the Governor of the Bank of England, and to Sir Robert Armstrong.

John Kerr

p.p.

N L

8 July 1983

[Approved by the Chancellor]

10 DOWNING STREET (1)

Prime Minister

Brazil: paper by the Bank

(1) Alan /flag A argues that we should not roll forward the BIS facility on Monday; or that, if we do, we should do so for 2 weeks only.

(2) The Chancellor /flag B thinks we should roll forward, but for 2 weeks only and never again.

(3) Agree a 2 week final postponement

MCS 8/7

When creditors are weak, debtors will get into worse trouble

MT

SECRET

A 3

MR. SCHOLAR

BRAZIL

It is no surprise to see the Bank recommending that we agree to a Brazilian request for a further postponement of the BIS bridging loan. Essentially they want to put that decision in the hands of de Larosiere.

But for how long are we to roll over the BIS credit? The Bank is silent on this point. It is such an important issue that it cannot be a mere oversight. There must be a reason for the omission. Will this also be recommended by de Larosiere and agreed by us? As a very minimum requirement we ought to specify only another two weeks.

IMF Ineptitude

The Brazilian financing operation over the past nine months can inspire little confidence. The Bank says that the Brazilians have been ill-advised by the US banks with respect to the Interbank lines. But the IMF should have picked up the fragility of such promises; they are really no more than a confidence-booster in order to get everyone to join in. The IMF and central banks cannot slough off their responsibility onto the US banks. Everyone knows the US banks are critically interested in preserving their balance sheets, even at the expense of the rest of the world's taxpayers.

The IMF also now admit that (p.5) they did not take into account the seasonal pattern of exports. Why ever not? Every schoolboy knows that agriculture is a seasonal business.

The ineptitude of the financing plan is even more marked when it is recalled that American interest rates fell in mid-1982 and have stayed on that plateau in the first half of 1983. I suspect that the financial calculations assume that interest rates will either fall further or remain at the present low level. This is, I believe, a rash assumption. I expect US interest rates to rise.

The Next Act

I suspect that the IMF is bound to ask for the BIS roll over. The IMF is dominated by US banks. The banks in particular want to preserve the fictions in their balance sheets and the possibility of a bail-out by the US government. The US Adminstration, in turn, want to avoid the odium of such a bail-out as long as possible.

/The Brazilians know this

SECRET

The Brazilians know this. The widespread belief in Brazilia is that they will get the IMF's approval. I suspect the IMF will climb down, at least part of the way, on its definition of public sector deficit (the difference in definition is an astonishing 6-8% of GDP!) and on their part the Brazilians will make suitably impressive promises about de-indexation of wages. Some of these are already on offer. [But this is all my conjecture; I have no inside knowledge.]

The Bank omitted to say anything about the views of the member countries on the Board of the BIS. Leutwiler told me that Germany, Switzerland and Holland were firmly against a postponement of repayment of the bridging loan. If we joined that group then there would be four against the postponement. If all the other four countries (France, Italy, Belgium and Sweden) voted for postponement, the Board would be hung. It is normal procedure for the Chairman (Leutwiler) to have the casting vote. Thus our vote could be a critical one.

Conclusion

The Brazilian Government has successfully strung out its credit lines with cynical promises and little performance. The credibility of the creditors is at an all-time low. The integrity of interbank markets has already been jeopardised and now the bridging loan is being converted into merely another line of credit. We have paid too much already in financial blackmail. It is time to stop the charade. We should vote against postponement.

AW

ALAN WALTERS
8 July 1983

GRS 700

CONFIDENTIAL

A.S.C. 11/7.

CONFIDENTIAL
FM BRASILIA 081630Z JUL 83
TO PRIORITY FCO
TELEGRAM NUMBER 246 OF 8 JULY
INFO PRIORITY DTI, BANK OF ENGLAND, ECGD, CARACAS, UKDELIMF/IBRD
INFO SAVING RIO, SAO PAULO, MEXICO CITY

BRAZIL/IMF

1. THE SECOND PHASE OF NEGOTIATIONS BETWEEN BRAZILIAN ECONOMIC MINISTERS AND THE IMF TEAM BEGAN YESTERDAY IN BRASILIA WITH THE RETURN OF WIESNER AND STRUCKMEYER. TALKS WILL CONTINUE TODAY. DESPITE CONTINUING PROBLEMS THERE ARE INDICATIONS THAT A NEW AGREEMENT MAY BE REACHED SOON, PERHAPS NEXT WEEK, INVOLVING A FURTHER LETTER OF INTENT TO THE IMF CONTAINING REVISED TARGETS.

2. AS REPORTED IN MY TELNO 240, GALVEAS HAS BEEN OPTIMISTIC IN PUBLIC ABOUT AN EARLY AGREEMENT. BUT THE TASK OF AGREEING ON WAYS OF MEASURING THE PUBLIC SECTOR DEFICIT AND EVALUATION OF THE BRAZILIAN ECONOMIC PACKAGE HAS TAKEN CONSIDERABLE TIME AND IS STILL NOT CONCLUDED. DESPITE REFLECTION OF OPTIMISTIC OFFICIAL BRIEFING IN THE BRAZILIAN PRESS, IT IS NOT YET CLEAR WHETHER LAROSIERE HAS GIVEN HIS TEAM THE GREEN LIGHT TO ALLOW A REASONABLY GENEROUS REWORKING OF THE BRAZILIAN INFLATION, INTERNAL CREDIT, AND PUBLIC SECTOR TARGETS AND AGREEMENT ON REVISION OF THE INDEXED WAGE LAW SYSTEM. BRAZIL NEEDS THE IMF AGREEMENT BADLY TO PAY BACK THE OVERDUE BIS LOAN AND TO DO SOMETHING ABOUT THE GROWING PAYMENTS ARREARS. IT SHOULD ALSO HELP BRAZIL NEGOTIATE ADDITIONAL FINANCE FOR 1983. NOT ALL THE CARDS ARE IN THE IMF'S HAND: A SENIOR BUT ANONYMOUS BRAZILIAN MINISTER WAS QUOTED IN YESTERDAY'S PRESS AS SAYING ''OUR POWER IS IN THE SIZE OF OUR DEBT''. BRAZIL'S RECORD TRADE SURPLUS IN JUNE OF US DOLLARS 834 MILLION (REPORTED IN MY TELNO 238) WILL ALSO STRENGTHEN HER HAND.

3. THE BRAZILIAN GOVERNMENT HAS THIS WEEK SIMULTANEOUSLY FIELDED A VISITING TEAM OF BANKING ECONOMISTS, AND IS EFFECTIVELY BEGINNING A NEW RENEGOTIATION OF ITS FOREIGN DEBT. GALVEAS HAS ADMITTED TO NEEDING FURTHER LOANS OF AT LEAST US DOLLARS 3.5 BILLION IN 1983. MANY COMMERCIAL BANKERS EXPECT THIS FIGURE TO BE HIGHER. (CHAPMAN OF LLOYDS BANK SAID HE WOULD NOT EXPECT BANKS TO BE WILLING TO PROVIDE AS MUCH AS US DOLLARS 3.5 BILLION). BUT THE FRAGILITY OF BANKING CONFIDENCE WAS CLEARLY DEMONSTRATED BY YESTERDAY'S WAVE OF RUMOURS THAT BRAZIL HAD DECLARED A MORATORIUM. REPORTEDLY THE GOLD PRICE AS A CONSEQUENCE ROSE 25 DOLLARS. THESE RUMOURS WERE FORCIBLY DENIED BY GALVEAS AS ''ABSURD NONSENSE''. HE SAID THAT A MORATORIUM WAS OUT OF THE QUESTION, EXPRESSED CONFIDENCE IN THE NEW BANKERS' COORDINATING COMMITTEE, AND REFERRED TO THE ''SATISFACTORY PROGRESS'' OF THE TALKS WITH THE IMF MISSION.

/4.

4. THE HEAD OF THE BANCO CENTRAL'S FOREIGN REGISTRATION AND SUPERVISION DEPARTMENT TOLD US YESTERDAY THAT AS SOON AS DISCUSSIONS WERE CONCLUDED WITH THE IMF, BRAZIL WOULD GIVE THE GOVERNOR OF THE BANK OF ENGLAND (AND THE HEADS OF OTHER MAJOR CENTRAL BANKS) A FULL BRIEF ON THE PROJECTED SECOND PHASE OF THE BRAZILIAN FINANCING PLAN. THIS WILL COVER NOT ONLY FINANCING REQUIRED FOR 1983 AND 1984 BUT ALSO LAY DOWN THE BASIS FOR 1985.

5. THE IMF PRESSURES ON BRAZIL TO ADOPT A COHERENT AUSTERITY POLICY WERE REFLECTED IN THE RECENT DOMESTIC ECONOMIC PACKAGE WHICH TOOK 3 WEEKS TO PREPARE AND ISSUE. AS I HAVE REPORTED, THE MEASURES INVOLVED AN END TO WHEAT AND PETROL SUBSIDIES, CUTS IN PUBLIC ENTERPRISE BUDGETS, AND A LIMITED DEGREE OF DISINDEXATION OF THE ECONOMY'S MAIN PRICES. THE DOMESTIC ECONOMIC SITUATION IS NOW MUCH WORSE THAN IT WAS IN DECEMBER 1982: INFLATION IS RUNNING AT 130% P.A., (IN JUNE ALONE IT WAS 12.3%) INTEREST RATES ARE STILL HIGH, AND RECESSION IS WORSENING, BRINGING MORE BANKRUPTCIES AND INCREASED UNEMPLOYMENT. THE PREOCCUPATION WITH THE FOREIGN DEBT HAS LED TO DISTORTIONS AND A TIGHTER SQUEEZE IN THE INTERNAL ECONOMY, WHICH HAS CAUSED ANGUISH TO SAO PAULO INDUSTRIALISTS AND SPARKED OFF A WAVE OF SERIOUS STRIKES AT THE MAIN PETROBRAS REFINERY NEAR CAMPINAS IN SAO PAULO STATE AND AMONG METALLURGICAL WORKERS.

6. I HAVE ASKED TO SEE GALVEAS BEFORE HE LEAVES FOR VENEZUELA ON SUNDAY BUT I RATHER DOUBT WHETHER HE WILL FIND TIME, GIVEN THE IMMENSE PRESSURES ON HIM AND HIS COLLEAGUES IN THE FINANCIAL TEAM. HE WILL TAKE WITH HIM TO CARACAS A LARGE DELEGATION TO DISCUSS EXPANDED BARTER TRADE ON THE LINES OF THE RECENT BRAZIL/MEXICO AGREEMENT: AND HE MAY WELL EXCHANGE VIEWS WITH HIS VENEZEALAN COLLEAGUE ON RESPECTIVE DEBT STRATEGIES.

FCO PLEASE PASS SAVING TO MEXICO CITY

HARDING

[REPEATED AS REQUESTED]

MONETARY
SAMD

THIS TELEGRAM
WAS NOT
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2.

~~C.A.W.~~

Return to MCS when copied.

TELEPHONE
01-601 4444

BANK OF ENGLAND
LONDON EC2R 8AH

7 July 1983

Michael Scholar Esq
10 Downing Street
London
SW1

Prime Minister

You asked for a paper on Brazil by Anthony Loehnis.

FERS 8/7

A very weak paper - especially after the talk we had about the Cooke committee at the Richardson dinner.

Dear Michael

BRAZIL

I enclose a report on the current Brazilian situation as requested in your letter of 1 July. This has been discussed with Treasury officials who are in broad agreement with it.

The Chancellor will be letting you have another in the series of regular monitoring reports on the wider debt situation early next week. This will provide an opportunity to update the Brazilian situation in the light of any developments in Brazil itself or arising from discussions at the meetings in Paris and Basle either side of the weekend.

I am sending a copy of this letter and its enclosure to John Kerr (HM Treasury).

Yours sincerely

John Bartlett

John Bartlett
Private Secretary to the Governor

① What ARE the views of Germany Switzerland & Holland? If against, then I think we should join them. But I suspect they will wobble. In that case we should only agree to a 2 week FINAL postponement.

SECRET

BRAZIL

Background

1 Since 1967 Brazil has recorded very substantial GDP growth and a strong increase in exports. The latter, combined with Brazil's enormous natural wealth and reputation for able economic management, encouraged a steady flow of lending by international banks. Brazil's external borrowing was generally put to good use insofar as it was directed largely to productive investment (although some of the investments are now considered to have been too large in scale); and with borrowing controlled by the authorities the resulting debt structure was considered good insofar as there was no bunching of maturities.

2 There were, however, major weaknesses in Brazil's position. Since the second oil shock of 1979, oil imports accounted for some 50% of total imports; inflation was, and is, endemic and its symptoms were dealt with by a complex system of indexation; and the size of its external borrowing needs by 1982 had become so large that any interruption to the inflow of foreign resources was bound to have a rapid and disastrous effect on the country's balance of payments. In August 1982, Mexico's declaration of a 90-day moratorium quickly led to a drying up of Brazil's external sources of funds, when only $11 bn of the $16 bn of gross bank borrowing planned for 1982 had been secured.

Financial Assistance

3 In response to the liquidity crisis which then quickly emerged, governments, banks and the IMF responded with a variety of short and longer-term facilities. The first to respond was the US Treasury, with resources drawn from the Exchange Stabilisation Fund and swaps from the Fed totalling $1.53 bn. On 23 December Brazil obtained a $1.2 bn bridging facility from the BIS (later supplemented by a further $250 mn backed by SAMA). Proposals put by Brazil to commercial banks on 20 December with the full support of the IMF's Managing Director were for a four project package: (1) an 8-year jumbo loan of $4.4 bn (the first $2.5 bn tranche of which would repay a $2.2 bn bridging loan extended by the banks earlier in the month), (2) the rescheduling over 8 years of 1983 maturities of

debt due to banks totalling $4.7 bn, and the re-establishment at former higher levels of (3) trade related credit lines and (4) inter-bank lines. Agreements covering projects (1) and (2) were signed on 25 February and at the same time the commercial banks were morally committed to achieving the targets set for projects (3) and (4).

4 Meanwhile parallel negotiations were taking place with the IMF and on 28 February a three-year Extended Financing Facility for SDR 4,239 mn was approved by the IMF Board. The programme supported by the EFF required the reduction of the public sector financing requirement from 16.9% of GDP in 1982 to 8.8% in 1983 and aimed to increase the trade surplus from $0.8 bn in 1982 to $6 bn this year, implying a halving of the current account deficit to $7 bn and no change in net international reserves after a $8.9 bn fall last year. The IMF also approved a Compensatory Financing Facility for SDR 499 mn in December and a further CFF for SDR 466 mn in February.

5 At this point the outlook looked reasonably promising, particularly as on 21 February, shortly before the EFF was approved Brazil devalued its currency by 23% (and undertook to continue its programme of "mini-devaluations") and introduced additional export taxes. Nevertheless, over the following three months it became increasingly clear that Brazil was still suffering acute cash flow difficulties on its external payments, partly because the Brazilian authorities had under-estimated their financing needs for 1983, partly because the commercial banks failed to provide the total amount of finance that had been envisaged as necessary under the original four-project financing, and partly because the improved trade figures had not been reflected at that stage of the year in the actual cash flow figures.

6 The Brazilian authorities had probably been ill-advised by the US banks who helped them devise the four-part financing package, in particular with regard to project (4) which required over 450 banks around the world to re-establish interbank lines at the higher of the 30 June 1982 or 31 December 1982 levels - an unrealistic proposition. It was one thing to seek to hold interbank lending at the level it had reached when emergency action had to be taken (this had effectively been done in the case of

Mexico): it was quite another thing to ask banks to reconstitute earlier levels of interbank lending which they knew would effectively be illiquid medium-term funding.

7 By the end of February the original target of $10 bn for interbank lending had been reduced to $7.5 bn (justified in part because the commitments under project (3) proved higher than had been expected) but the current level is only about $6.0 bn. At the time the Fund agreement was signed at the end of February the Managing Director was given a moral undertaking by the banks that the "missing" $1.5 bn of bank finance would be found in one way or another. Despite the expenditure of a great deal of time and energy by Galveas (Minister of Finance) and Langoni (President of the Central Bank), it has proved impossible to raise the interbank total much above $6 bn, and until recently there has been a persistent tendency to haemorrhage.

Breakdown of IMF Programme

8 In the last week of May the IMF's Managing Director revealed that Brazil had exceeded nearly all its ceilings under the programme and would not be eligible to make its scheduled drawing under the EFF at the end of May. This had other serious consequences. IMF drawings at the end of May, August and November had been earmarked to repay the balance of the BIS bridging facility: the May repayment to the BIS has been postponed, originally to 30 June and now to 15 July. In addition, only $2.5 bn out of project (1) money had been drawn down immediately, the three remaining tranches (approx $633 mn each) to be disbursed in tandem with the IMF resources as and when these were due: the second tranche is effectively frozen until a further Fund drawing can be made. Meanwhile, payment arrears continue to mount.

i.e. out of $4.4b

9 The main areas in which the Fund were not satisfied by Brazil's performance were in the substantial overruns in public spending which boosted the public sector borrowing requirement and led to the agreed monetary parameters being exceeded. There is some disagreement

between the Brazilian authorities and the IMF Staff about the intepretation of the statistics, the Brazilians maintaining that, according to their methodology, they have passed the tests. Nevertheless, with a view to meeting the Fund's requirements to put the EFF programme back on course, two packages of measures were introduced in the course of June. These included reducing subsidies on agricultural and export credits, increasing commercial banks' reserve requirements, increasing both the scope and collection of taxes and cutting the budgets of state enterprises. So far, however, the Brazilian authorities have shown reluctance to take sufficiently robust measures in the field of de-indexation of wages and pensions which the Managing Director sees as an essential prerequisite for a successful programme to reduce inflation, and where earlier undertakings have not been fulfilled. At the end of June the heads of the Fund negotiating team were recalled to Washington as a sign of displeasure (although they were due to return to Brazil earlier this week).

10 The problem of implementing the necessary additional measures is basically a political one. The economic team consisting of Delfim Netto,(the Planning Minister and economic overlord), Galveas and Langoni appear to be lobbying the President to take the necessary action, but other advisers are thought to be warning him of the possibly damaging social consequences of further austerity measures and some may even be advocating a suspension sine die on all debt payments. Delfim Netto has recently (28 June) reiterated in the Chamber of Deputies his opposition to any such suspension. The situation is further complicated by President Figueiredo's imminent departure for treatment for a weak heart in the USA. This will put Vice-President Aureliano Chaves in charge, who is reputed not to be on good terms with Delfim.

The Way Forward

11 The viability of the rescue package for Brazil as originally envisaged has now been overtaken by events. The problem has been that although the banks and the IMF have aimed at restoring Brazil's financial and economic viability in the long run,

immediate short-term difficulties have remained. For instance, although Brazil's hopes of a $6 bn trade surplus appear achievable (the surplus in January-June being $2.95 bn), the IMF programme was perhaps not sufficiently geared to the fact that export earnings are seasonal and tend to accumulate in the second half of the year. In addition, although the first three projects in the banks' package have been a relative success, as discussed in paragraph 6 there has been a major shortfall on project 4 (the restoration of interbank credit lines). With hindsight it may be that the Brazilians should have sought a larger injection of medium-term money under Project 1.

12 The question, then, is whether a rescue package of some kind can be re-established, or whether the consequences have to be faced of a breakdown either deliberately provoked by the Brazilians or arising from a failure to reach agreement on the reinstatement of the Fund programme which is the sine qua non for the restoration of, or increase in, the flow of bank finance.

The Fund Programme

13 The main areas of disagreement between the IMF and Brazil concern wage indexation and the control of public expenditure. The Fund mission will be reporting later this month whether it judges the measures that have already been taken, or which the Brazilians agree to take, go far enough. Recent telegrams from the Embassy in Brasilia suggest that the Government is ready to make some moves by eliminating price increases arising from adjustment measures already taken from the cost of living index and to permit a degree of wage bargaining rather than strict indexation. Nevertheless, as the Managing Director reported during his visit to London last week, there are worrying signs of a lack of political will to grasp the nettle with sufficient vigour and speed. Even if they do it may be that the Fund will not be able to satisfy itself that the necessary measures have been taken until well into August and the Fund programme cannot be reinstated without Board approval which would have to be sought thereafter.

14 Assuming a satisfactory outcome to the Fund negotiations, the chances of making arrangements for the restitution of bank finance may have improved. The banks have recently formed an

Advisory Group under the chairmanship of Rhodes, the Citibank man who masterminded the banks' side of the Mexican operation. The attempt to flog further life into project 4 has been abandoned and the banks are talking about raising further medium-term money: \$3 bn for the rest of this year (including making good the shortfall under the original financing plan) and \$4 bn for next. In addition it is envisaged that banking debt maturities falling due in 1984 will also have to be rescheduled. The banks are also pressing for further official participation in this second phase of Brazil's rescue and would like to see the rescheduling of maturities owed to official creditors through the Paris Club.

15 The most immediate point for decision relates to the repayment of the \$400 mn due on the BIS bridging loan on 15 July which will be discussed in Basle next Monday, 12 July. The Brazilians are almost certain to request a postponement. The BIS could agree voluntarily to this or else treat the Brazilians as in default and therefore require the substitution agreement to come into effect, whereby the underwriting central banks will be severally substituted for the BIS in respect of the bulk of its rights and obligations under the loan agreement. The loan would then be overdue to the central banks concerned, rather than to the BIS, and those central banks would collectively have to pay the \$389 mn due to the BIS. (The Bank of England's share would be \$17.5 mn; any ultimate loss on this would be covered by HM Treasury's indemnity to the Bank.)

16 Though the implementation of the substitution agreement would not per se greatly affect the underlying reality of the Brazilian situation, the fact that it was action by the BIS which effectively forced the Brazilians into a default would surely have a damaging effect on confidence generally, as indicative of a minimalist approach by the BIS to its role in the overcoming of the international debt problem. It would also increase the risk of dissensions, once the 17 participating central banks became actual creditors of Brazil along with the BIS, about the appropriate way thereafter to handle the problem.

17 The decision will be one for the BIS Board to take (France, Germany, Italy, Belgium, the Netherlands, Switzerland, Sweden and

the UK are represented). They will no doubt be influenced by the views of the Managing Director of the IMF who will be in Basle at the time. He may argue that to let the substitution agreement take effect rather than rollover for a further period would be helpful in bringing the Brazilians to an agreement. On the other hand he may feel that chances of reaching agreement would be jeopardised if the BIS were to withdraw from the bridging loan when negotiations between the Fund and Brazil were still in progress. In either event, care will need to be taken as to how the BIS's decision is publicly presented. There is a danger that a further rephasing of the bridging loan will be interpreted as weakness, but this need not be so, so long as there is seen to be a reasonable prospect that the IMF drawings which are the other end of the bridge will be restored. There could be an equal danger to the confidence of both debtor countries and of creditor banks if the BIS is seen to withdraw.

18 The whole Brazilian problem is to be discussed by the G5 Deputies who are meeting in Paris on 8 and 9 July and also by the Governors of the G10 countries and Switzerland in Basle. De Larosiere will also be in Paris and Basle at the same time. This will give an opportunity to take stock of the position with our partners. In the light of this we will need to consider whether there are any additional means of putting pressure on the Brazilians to push them towards compliance with the IMF's requirements.

19 HMT and the Bank are studying the sequence of events that would follow the deliberate cessation of payments by Brazil and the actions we might have to take. The consequences of a cessation of payments by Brazil alone would be serious enough, in terms of the potential damage to banks and the reduction in trade. They would be dangerously multiplied if Brazil's example led to imitation. In order to minimise the temptation to other countries which have accepted and lived up to IMF programmes a strong, internationally agreed response, would be needed.

20 The Cooke Committee of Bank Supervisors met in Basle last week and has very much in mind the prudential consequences for banks following from a unilateral cessation of payments. That committee is not, however, the appropriate forum for discussion of possible sanctions that might be taken against a debtor that took such a step, which would require political decisions and lie mainly outside the field of banking supervision.

Conclusion

21 The cause of international confidence and the chances of achieving realistic Fund adjustment programmes with other indebted countries will not be enhanced if the Brazilians are seen to get away with failing to live up to the Fund's criteria. Our main interest therefore lies in supporting the Managing Director in his attempts to achieve a satisfactory agreement between the Fund and the Brazilian authorities which would get the Fund programme back on track, allow IMF drawings (and the linked drawings on the banks' medium-term loan) to be resumed and open the way to the completion of a revised refinancing package with the banks.

They have already failed.

22 In these circumstances, but subject to the IMF Managing Director's most up-to-date assessment of the situation, we believe the BIS should be prepared to agree to a Brazilian request for a further postponement of repayment of the instalment due on 15 July. To insist in vain on repayment might well precipitate a breakdown in Brazil's negotiations with the IMF. There is admittedly a risk that Brazil is seeking to defer necessary decisions regarding her domestic economy, but we believe the IMF should be given further time, if necessary, to determine whether this is the case. At the same time, we should press ahead with contingency plans for concerted international action in the event that the Brazilians deliberately espouse the moratorium route, or such a route becomes inevitable because a satisfactory agreement with the Fund proves impossible to achieve.

6 July 1983

GRS 260
UNCLASSIFIED
FM BRASILIA 061625Z JUL 83
TO PRIORITY FCO
TELEGRAM NUMBER 240 OF 6 JULY
INFO PRIORITY UKDEL IMF/IBRD WASHINGTON, ROUTINE DTI (OT5), ECGD
INFO SAVING RIO DE JANEIRO, SAO PAULO

BRAZIL: NEW JUMBO LOAN

1. TODAY'S BRAZILIAN PRESS REPORTS THE CONFIRMATION GIVEN AT A PRESS CONFERENCE YESTERDAY BY FINANCE MINISTER GALVEAS THAT BRAZIL WOULD SHORTLY BE SEEKING A NEW JUMBO LOAN OF AT THE MOST US DOLLARS 3.5 BILLION. NEGOTIATIONS WILL BEGIN AS SOON AS THE NEW ADVISORY COMMITTEE'S ECONOMIC TEAM, WHICH HAS BEEN IN BRAZIL, HAVE PRODUCED THEIR REPORT. THE OUTCOME OF THE NEGOTIATIONS WILL DEPEND ON THE RESULT OF THE FINAL AGREEMENT BETWEEN BRAZIL AND THE IMF.

2. GALVEAS STRESSED THAT THE FIGURE OF US DOLLARS 3.5 BILLION WAS STILL ONLY AN ESTIMATE AND WAS SUBJECT TO ANY FUTURE CHANGES IN THE BALANCE OF PAYMENTS COMPONENTS. THE ADDITIONAL BORROWING REQUIREMENT HAD BEEN ARRIVED AT BY REDUCING THE ESTIMATES FOR DIRECT INVESTMENT AND SUPPLIER CREDITS AND INCREASING THE ESTIMATES FOR INTEREST PAYMENTS AND LEASING. IT ALSO TAKES INTO ACCOUNT THE DROP IN COMMITMENTS TO PROJECT 4 (INTERBANK LINES OF CREDIT) AND THE POSSIBILITY OF INCREASING BRAZIL'S FOREIGN RESERVES.

3. GALVEAS DENIED THAT BRAZIL WAS NEGOTIATING A 600 MILLION DOLLAR LOAN WITH THE US TREASURY TO TIDE BRAZIL OVER WHILE THE NEW JUMBO WAS BEING NEGOTIATED. HE DENIED TOO THAT SUCH A LOAN COULD BE USED TO REPAY 400 MILLION OWING TO THE BIS. THE BIS HAVE AGREED TO POSTPONE REPAYMENT UNTIL 15 JULY AND GALVEAS ADMITTED THAT THIS EXTENSION WOULD BE INSUFFICIENT. BRAZIL WOULD BE ABLE TO PAY BIS ONLY WHEN THE IMF LIBERATED THE SECOND TRANCHE OF STANDBY CREDIT OF 411 MILLION US DOLLARS: INDEED, THE CONCEPT OF AUTOMATIC POSTPONEMENT UNTIL THE IMF LIBERATED ITS FUNDS STILL PREVAILED.

HARDING

MONETARY
S AM D

THIS TELEGRAM
WAS NOT
ADVANCED

GRS 270
UNCLASSIFIED
FM BRASILIA 061515Z JUL 83
TO ROUTINE FCO
TELEGRAM NUMBER 238 OF 6 JULY
AND TO ROUTINE DTI, BANK OF ENGLAND, ECGD, UKDEL IMF/IBRD
WASHINGTON
INFO SAVING RIO, SAO PAULO, MEXICO CITY

BRAZIL: MONTHLY TRADE SURPLUS

1. FINANCE MINISTER ERNANE GALVEAS ANNOUNCED YESTERDAY THAT THE BRAZILIAN VISIBLE TRADE SURPLUS FOR JUNE WAS US DOLLARS 834 MILLION. FOR THE FIRST TIME IN THE LAST 17 MONTHS (SINCE DECEMBER 1981) BRAZILIAN EXPORTS HAVE SURPASSED DOLLARS 2 BILLION IN ONE MONTH. EXPORTS AT DOLLARS 2.2 BILLION AND IMPORTS AT DOLLARS 1.7 BILLION WERE 18% UP AND 28% DOWN RESPECTIVELY ON JUNE 1982 FIGURES.

2. THIS SURPLUS IS A MONTHLY RECORD IN BRAZIL'S FOREIGN TRADE BALANCE, AND THE ACCUMULATED 6-MONTH SURPLUS OF DOLLARS 2.955 MILLION (DOLLARS 10.4 BILLION IN EXPORTS, DOLLARS 7.45 BILLION IN IMPORTS, THE LATTER 23% DOWN ON 1982) WILL IN GALVEAS'S VIEW MAKE IT POSSIBLE FOR THE COUNTRY TO EXCEED THE INTERNATIONAL MONETARY FUND GOAL OF A DOLLARS 6 BILLION TRADE BALANCE SURPLUS AT THE END OF 1983. TO MEET THE DOLLARS 6 BILLION FIGURE, MONTHLY SURPLUSES UNTIL THE END OF THE YEAR MUST NOW AVERAGE APPROXIMATELY DOLLARS 510 MILLION. GALVEAS BELIEVES THIS WILL BE POSSIBLE, BECAUSE THERE IS ''GREATER MOVEMENT IN INTERNATIONAL COMMERCIAL TRANSACTIONS''.

3. GALVEAS SAID HE EXPECTED NEGOTIATIONS WITH THE IMF TO BE CONCLUDED THIS WEEK, OR AT THE LATEST NEXT WEEK. HE THOUGHT BRAZIL'S NEGOTIATING POSITION STRENGTHENED BY THIS NEWS. THE THREE MAIN MEMBERS OF THE IMF MISSION TO BRAZIL ARE EXPECTED TO RETURN FROM WASHINGTON TODAY. GALVEAS SAID BRAZIL SHOULD RECEIVE THE SECOND PART OF THE IMF LOAN BEFORE THE END OF AUGUST.

4. GALVEAS ALSO SAID THAT THE INFLATION RATE FOR THE MONTH OF JUNE WOULD BE 12.1 PERCENT, ITSELF ALSO A RECORD FIGURE SINCE MARCH 1964.

FCO PLEASE PASS SAVING TO MEXICO CITY.

HARDING

(REPEATED AS REQUESTED)

MONETARY
SAMD

THIS TELEGRAM
WAS NOT
ADVANCED

primary commodities – not coffee

not a price matter

So creaming off for publ revenue

rate of tax lower than devaluation

bc A.W. DA

10 DOWNING STREET

From the Private Secretary

1 July 1983

Brazil

The Prime Minister had a word, at the Reception for Lord Richardson on Tuesday, with a number of people about the financial position of Brazil. The Prime Minister understands that there is likely soon to be pressure from the Americans to renew the bridging BIS loan, or to provide some additional facilities for Brazil; and that there is likely to be firm opposition from the Swiss, the Germans and the Dutch. The Prime Minister would be grateful for a report on the position of Brazil, and our likely stance in the matter. She would, in particular, like information on whether Brazil's compliance or non-compliance with IMF conditionality is likely to be a clear cut matter, and whether there is a risk that the Brazilians will defer the need for domestic decisions to put their economy right by proliferating and extending a series of allegedly short term loans and facilities.

I am sending a copy of this letter to John Kerr (HM Treasury).

M. C. SCHOLAR

John Bartlett, Esq.,
Bank of England.

PA

10 DOWNING STREET

MCS 5/7

Alan,

I don't know if you've seen the attached (Record of disc. between Chanc + IMF Managing Director)

(1) The Chancellor & de la R both

look very tough on Brazil

(2) de la R doesn't ask for more

money.

MCS 30/6

1/7

Michael

de L. has to look tough, as a prelude to his new demand for more money, and to give the IMF general credibility in monetarist circles. He is looking for more money – $8 Bn this was confirmed by Leutwiler. AW

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Prime Minister ① HMT

Mr de la Rosière didn't mention any of this at his meeting with the Chancellor (see record attached) MCS 29/6

PRIME MINISTER

IMF

Demonstrating the principle that rescheduling begets more rescheduling, the IMF is very likely to be asking for a considerable increase in its funding (over and above the 48½% increase in quotas and the three-fold increase in the GAB) during the next two weeks or so. Jacques de Larosiere is now making his rounds. The issue of new funds is likely to be discussed at the Paris meeting of the "deputies" on 8 July. The 48½% quota increase of last January has yet to be ratified and come into operation. But it now seems likely that the pressures of the American banks will ensure that Congress does ratify it, although with several attached clauses which would inhibit lending to countries, mostly Communist, which incur the ire of Congress. We do not know how this issue will be resolved, but I suspect that it is likely that some form of words will be found which is acceptable to the IMF and to Congress. The GAB, however, constitutes an increase from 6.4 billion SDRs to 17 billion SDRs. This is already agreed and does not need ratification.

The preliminary discussions of the new additional funding suggest that West Germany, Britain and Japan should be asked to contribute more than 1 billion SDRs each. Similarly, small countries such as Switzerland and the Netherlands should be asked to contribute between 250 million and 400 million. France, which has pursued such disastrous policies, will only be asked for a minimum sum of, say, 100-200 million SDRs. It is unlikely that the IMF will dare to approach the United States yet again; Congress, and perhaps even the Administration, would not put up with yet another draft of what is widely seen as a subsidy to American and international banks.

There is also another very important change involved in the new IMF proposals. As you know, the IMF has been concerned with short term finance for balance of payments adjustments. Now it is proposed that the IMF engage in intermediate financing, probably for about a seven year period. This is a substantial change of function. The IMF will need much greater funds if the money is to be tied up for long periods, and it marks a significant departure from the original concept of the function of the Fund. In fact the Fund will become a multinational aid agency - like the World Bank, the Asian Development Bank, the Inter-American Development Bank, etc.

CONFIDENTIAL

/In my view

In my view this would be wrong. But in any case we should think very hard before we tie up any more funds in multilateral aid agencies. We should not allow this metamorphosis without considerable thought for what it implies.

In my view, an extension of IMF assistance would:

a. demonstrate there are rewards to profligacy and unsound policies (viz France with her low contribution and perhaps even future borrowings, not to mention Brazil, Argentina, etc with their subsidised IMF credits);

b. designed to save the equity holders of American and various other international bank corporations, who have committed grave errors and wish the taxpayer to bail them out;

c. extend politically directed funding: the IMF staff have become more overtly politicised, thus ensuring that larger fractions of international capital flows are directed by political rather than commercial motives;

d. enhance the power of an international bureaucracy and increases the likelihood of a determined take-over by "global negotiations";

e. increase the strain on world capital markets at a time when the United States deficit is putting an unprecedented burden on financial flows;

f. raise the rewards for blackmail, such as we see now in the case of Brazil.

The penultimate point (e) is particularly relevant to the argument that the IMF should be allowed to borrow in international capital markets. I do not know whether de Larosiere will press this point. But if he does, I think we should oppose it since, although marginally better than a quota increase, it will provide the same strain on the system and, in effect, the same order of magnitude of the subsidy for profligacy.

I believe it is likely that the Foreign Secretary and perhaps even the Chancellor may find good arguments for supporting this additional increase in IMF resources. The pressure to be a good international financial statesman is considerable. It will be argued that it is in the UK's interests to make these substantial contributions, but I have yet to see that argument demonstrated. I can only see it doing most harm.

ALAN WALTERS
29 June 1983

CONFIDENTIAL

RECORD OF A DISCUSSION BETWEEN THE CHANCELLOR AND THE IMF MANAGING DIRECTOR, AT NUMBER 11 AT NOON ON 28 JUNE

M. de Larosiere expressed concern about the overall world economic situation. The two key problems were the US deficit, keeping interest rates high, and the financial situation of many developing countries, who badly needed interest rate reductions, and the sustained recovery in world markets which would permit improved export performance. There was no sign of the Americans taking action to forestall deficits of $200 billion a year, which would absorb more than 80% of net US domestic savings. US monetary policy was likely to tighten, bringing higher interest rates. And while the US recovery was now fairly rapid, interest rate increases could again put it in jeopardy. And if world recovery were to falter, the world financial system would be threatened, for a number of countries would find it very difficult to keep to agreed debt servicing and repayment programmes.

2. M de Larosiere said that, among the three countries which had caused most concern over the last year, the performance of Mexico and the Argentine was now rather better than the IMF had expected. The situation in respect of Brazil was however very different. Brazil had breached a number of key performance targets, and the IMF had accordingly been obliged to stop payments. A negotiation on the measures which Brazil would have to take in order to have the IMF programme reactivated had so far brought no agreement. The Brazilian Government seemed to lack determination and political will: the President was being advised from certain quarters to dig in against essential measures, and in particular against changes in the pay and pensions indexation arrangements. There was a risk that he might feel tempted to move to an outright default on external debt obligations. The IMF had asked that the White House should warn the Brazilian President, in minatory terms, that he was playing with fire. But what was quite certain was that if Brazil did not meet the agreed performance criteria, no IMF money would be forthcoming.

/3.

3. M. de Larosiere added that of course some in Brasilia might see attractions in a Polish solution, under which, while receiving no new IMF finance, Brasilia might enjoy a de facto moratorium on outstanding debt. It must be made plain in advance, and proved if the eventuality arose that this would be a very much more costly route for Brazil to go down. The risk of the contagion spreading made it essential that Brazil should realise, and that it should if necessary be demonstrated, that default would be sharply punished, with no new trade credits from any source, and, if necessary, the seizure of assets abroad.

4. The Chancellor entirely agreed that it was essential to maintain the principle, and demonstrate in practice, that the IMF was not a soft touch. Some in Brazil might think that the world financial community could not afford to see them go under: it must be made plain that this was an illusion. He agreed with M. de Larosiere that discreet planning among the principal IMF members might now be in order, and that this might conveniently take place at the meetings of G5 and G10 Deputies in the first week of July.

5. Turning again to Argentina, M. de Larosiere said that the problem of discrimination against UK non-banking concerns remained, and that the IMF had again stressed to the Argentine authorities that all such restrictions must be lifted by the end of July if the IMF drawing then due were to go ahead. The Argentine authorities argued that a political gesture, in the form of some relaxation of the exclusion zone, would be required from the United Kingdom before they could remove the restrictions in question: but they had been told in reply only that continuing discrimination would mean no further IMF finance.

6. The Chancellor said that he was glad to hear that the IMF were continuing to take this line, which was clearly right. It was a question of principle, and of law. M. de Larosiere said that he did not think that the problem would be quickly solved. The Argentine authorities were likely to seek a waiver from the Fund, but he had told the Argentine central bank governor that he would get little support on the IMF Board for such a waiver, and none from the Fund

/itself. The

itself. The legal issue was perfectly clear, and the Board was rightly very hostile to discrimination of the kind which the Argentine was practicing.

7. M. de Larosiere added that the Mexican programme was going very well. The Mexican authorities, by contrast with the Brazilians, had grasped the nettle, and had got their Budget back on track, with massive public expenditure reductions and tax increases. Following the devaluation, there had been a huge increase in exports, and the balance of payments position was now better than envisaged when the programme was negotiated, even though the expected future oil price had fallen.

8. The Chancellor said that it was important to try to reduce the risk of further future crises such as those which had affected Mexico, the Argentine and Brazil. He recalled earlier efforts to secure closer supervision and co-ordination of commercial lending: had they produced any results? M. de Larosiere said that there had been some progress. It was important too that the Fund should give clearer and earlier warning about worsening country debt situations. Governments too should envisage earlier warnings to their commercial banks. And the co-ordination of Fund and commercial bank lending policies should be further improved. The most pressing problem was however to encourage banks to avoid unco-ordinated and over-rapid withdrawals from problem areas.

JOK.

J O KERR

29 June 1983

PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Middleton
Sir T Burns
Mr Littler
Mr Lavelle
Mr Carey
Mr Ridley
Mr Bottrill
Mr Peretz

Mr Coles No 10
PS/Secretary of State, FCO
PS/Governor, Bank of England
Mr Wicks, UKDEL IMF/IBRD, Washington

CONFIDENTIAL CONFIDENTIAL

DESKBY 270900Z

FM UKDEL IMF/IBRD WASHINGTON 242100Z JUN 83

TO IMMEDIATE FCO

TELEGRAM NUMBER 233 OF 24 JUNE

MES.
1) Mr. Scholar
2) Prime Minister

MT AR 27/6.

MY TELNO 229 OF JUNE 16

IMF: ARGENTINA--FINANCIAL RESTRICTIONS

1. THE MANAGING DIRECTOR REPORTED TO ME HIS MEETING TODAY WITH DEL SOLAR (GOVERNOR OF THE ARGENTINIAN CENTRAL BANK).

2. BEFORE TELLING ME ABOUT THE DETAILS OF HIS CONVERSATION, THE MD SAID THAT ARGENTINA LOOKED AS IF IT WOULD MEET ALL THE IMF PROGRAMME TARGETS AND CRITERIA, EXCEPT THE REMOVAL OF THE PAYMENTS RESTRICTIONS. THE MD SAID THAT DEL SOLAR HAD TOLD HIM ABOUT HIS RECENT CONVERSATION IN BASLE WITH THE GOVERNOR OF THE BANK OF ENGLAND, ABOUT THE NEW LAW, WHICH GAVE THE ARGENTINIAN EXECUTIVE BRANCH POWER TO ACT TO REMOVE THE RESTRICTIONS. DEL SOLAR SAID THAT HIS AUTHORITIES HAD REMOVED ALL OBSTACLES PREVENTING UK BANKS MAKING REMITTANCES BUT WERE NOT IN A POSITION TO DO THIS FOR NON-BANKING COMPANIES. INDEED, THE ARGENTINIANS HAD HOPED THAT THE REMOVAL OF THE BANKING RESTRICTIONS WOULD HAVE LED THE UK TO MAKE SOME GESTURE ON THE EXCLUSION ZONE. ACCORDING TO DEL SOLAR, THE ARGENTINIANS WOULD NOT BE ABLE, FOR POLITICAL REASONS, TO REMOVE THE RESTRICTIONS ON NON-BANKING COMPANIES BY THE END OF JULY IF THERE HAD NOT BEEN PROGRESS ON THE EXCLUSION ZONE.

3. THE MD TOLD ME THAT HE HAD REPLIED TO DEL SOLAR THAT THE ARGENTINE COMMITMENT WAS TO REMOVE ALL, NOT PART, OF THE OUTSTANDING RESTICTIONS. IF DISCRIMINATION STILL REMAINED, THE FUND MANAGEMENT COULD NOT INDICATE TO THE BOARD THAT ALL THE IMF CONDITIONS HAD BEEN FULFILLED. THE MD ASKED DEL SOLAR TO INFORM HIS POLITICAL AUTHORITIES THAT THE FUND MANAGEMENT, AND PROBABLY THE BOARD, QUOTE COULD NOT LOOK WITH A BENEVOLENT EYE UNQUOTE ON THE REMAINING RESTRICTIONS. THE ARGENTINE POLITICAL AUTHORITIES SHOULD BE AWARE OF THE GREAT DIFFICULTIES TO WHICH THEY WERE EXPOSING THEMSELVES. IF THEY DID NOTHING, THEY WOULD NOT BE ELIGIBLE TO DRAW FURTHER MONEY. DEL SOLAR REPLIED TO THE MD THAT THE ARGENTINIANS WOULD THEN ASK FOR A WAIVER OF THE CONDITION. THE MD REPLIED THAT THE BOARD, IN HIS VIEW, WOULD NOT FAVOUR THIS AND THAT HE, LAROSIERE, COULD NOT GIVE SUCH A REQUEST ACTIVE SUPPORT.

4. THE MD SAID THAT BESIDES TALKING TO MCNAMAR (DEPUTY SECRETARY, US TREASURY), DEL SOLAR WOULD BE CONTACTING OTHER CERTAIN (UNNAMED) EXECUTIVE DIRECTORS IN THE FUND. YOU MAY THEREFORE WISH ME TO TALK TO MY OTHER COLLEAGUES, BESIDES THOSE REFERRED TO IN MY TELNO 232 OF JUN 23 TO ENSURE THAT THEY ARE AWARE OF THE TRUE POSITION. GRATEFUL FOR INSTRUCTIONS.

15.

5. ERB (IMF UNITED STATES ED) TOLD ME THAT IN HIS CONVERSATION WITH MCNAMAR, DEL SOLAR LINKED REMOVAL OF THE REMAINING RESTRICTIONS WITH THE OPENING UP OF FISHING RIGHTS AROUND THE FALKLANDS. MCNAMAR HAD TOLD DE SOLAR THAT THE US SUPPORTED THE UK POSITION. DEL SOLAR HAD REPLIED: QUOTE DON'T BRING THE SYSTEM DOWN UNQUOTE.

6 FINALLY, YOU WILL WISH TO KNOW THAT TVEDT (REPRESENTING THE NORDIC CONSTITUENCY) INFORMED ME THAT HIS AUTHORITIES HAVE ALREADY TOLD HIM TO SUPPORT THE UK POSITION.

WICKS

MONETARY
FID
ERD
MR GIFFARD
MR URE

COPIES TO:-
MR LITTLER } TREASURY
MR LAVELLE }
MR LOEHNIS B/ENGLAND

CONFIDENTIAL

Prime Minister

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

6/6

6 June 1983

M C Scholar Esq
10 Downing Street
LONDON SW1

Dear Michael,

BRAZIL

I wrote to you on 26 May with PM with our latest assessment of the international financial scene which included a report on the deterioration in Brazil's financial situation.

I can now confirm that, as expected, the IMF withheld the drawing by Brazil scheduled for 31 May pending new negotiations with the Brazilian authorities. As a direct consequence, and also as expected, the Central Bank of Brazil sought the postponement of the $400m BIS repayment due on the same date, and the BIS agreed to postpone it for one month.

The Treasury indemnity (which is valid until the end of August) remains in force, covering the Bank of England's commitment to the BIS facility. The amount at stake now stands at $47m, having been reduced from the original $110m by previous repayments. But there is now no question of the indemnity being called before the postponed repayment date of 30 June, and in practice, if IMF funds were still not available, the BIS might then consider a further postponement

I am sending copies of this letter to Tim Allen (Bank of England), Brian Fall (FCO) and John Rhodes (DOT).

Yours ever,

J O Kerr

J O KERR

E6 JUN 1983

Indebtedness Pt 7

3.61

CONFIDENTIAL

2

cc AW

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

23 May 1983

Michael Scholar Esq.
11 Downing Street
LONDON
SW1

Prime Minister

JC

23/5

MS

Dear Michael,

ARGENTINA: IMF AND COMMERCIAL BANK LOANS

In your letter of 17 May you asked when the medium term commercial bank loan to Argentina was likely to be signed.

The Bank of England's present assessment, based on recent information from LBI, is that signature of the loan is several weeks away. There is still significant disagreement between the banks and Argentina about the text of the loan documents, and several outstanding issues of substance remain to be settled before the loan is signed.

The Bank of England are keeping in close touch with LBI and will report immediately if there should be indications that the banks are close to signature.

Copies of this letter go to Brian Fall (FCO) and Tim Allen (Bank of England).

Yours ever.

John Kerr.

J O KERR
Principal Private Secretary

23 MAY 1983

CONFIDENTIAL

cc Sir Anthony Parsons
Mr. Coles

Econ. Pol.

MR. SCHOLAR

INTERNATIONAL FINANCIAL SCENE: BRAZIL

The letter from John Kerr does not specify what I believe is the most important cause of Brazil's deteriorating financial situation.

As you know, Brazil is the worst offender in using short term inter-bank deposits to finance its continuing financial deficit. Banks in a number of countries have refused to renew interbank credit lines. There was about $7½ billion outstanding last year and now this has gone down to less than $5½ billion. The defection of several small banks in the United States is important. Similarly, the complaint of Leutweiler that the Central Banks should not lean on commercial banks to keep renewing these interbank credit lines when they are being used for the "wrong" purposes. I understand that the Swiss commercial banks have withdrawn their support almost entirely. And I am told that many German banks are also failing to renew.

Everything seems set for a new call on finance from governments. It is likely that the interbank lines will collapse more or less completely. If this happens, then there will be a financial gap in the rescue package of several billion dollars, and perhaps even as much as four or five billion. I agree with John Kerr's assessment of the timing. It is likely to break just before the Williamsburg Summit.

AW

ALAN WALTERS
17 May 1983

CONFIDENTIAL

CONFIDENTIAL

cc 7?0
B of E

10 DOWNING STREET

From the Private Secretary 17 May 1983

ARGENTINIAN IMF AND COMMERCIAL BANK LOANS

Thank you for your letter of 16 May, and for the attached paper on the Argentinian loans and arms sales.

I showed this to the Prime Minister. She has enquired when it is envisaged that the medium-term loan will be signed. I should be grateful if you would let me know urgently if there is any prospect of the loan being signed in the near future.

I am sending a copy of this letter to Brian Fall (Foreign and Commonwealth Office) and Tim Allen (Bank of England).

M. C. SCHOLAR

John Kerr, Esq.,
HM Treasury.

CONFIDENTIAL

Minuted MES 17/5

We must try to stop the syndicate or the medium term loan

MT

PRIME MINISTER

Argentina, IMF and Commercial Bank Loans

The promised paper from the Treasury, FCO and Bank has now arrived and is attached.

It is a disappointing paper, in that it nowhere tells us what would happen if we asked the banks to freeze their share of the undrawn $300m in the bridging loan (paragraph 4a) and withdraw from the medium term loan, which is still unsigned; nor does it explain how we would present publicly ~~the~~ such a change of policy. (The Opposition would say that nothing new has happened since it was always likely that these loans would be used, or were being used, for arms purchase purposes). Nor does the paper ask whether our objective is to stop Argentina buying arms, or simply to disassociate ourselves from arms purchases which would be going ahead anyway.

The two practical issues are:-

i) Can we do anything about the May drawing under the IMF facility? I think not. The Fund have given Argentina until the July drawing to remove their discrimination against UK companies, and so, provided that Argentina meets the Fund's normal criteria, the May drawing will take place.

ii) Evidence of Russian arms sales to Argentina? We are promised a paper by the Americans on this, and should clearly wait for this before reaching any conclusions. John Coles and I think that you should have a better paper than the attached. Agree that the Cabinet Office should be asked to produce an OD paper on the whole issue, for consideration immediately after the Election?

Yes MT

MCS

16 May 1983

CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

16 May 1983

Michael Scholar Esq
10 Downing Street

Dear Michael,

ARGENTINA: IMF AND COMMERCIAL BANK LOANS

We spoke a week ago about the paper on financial relations with Argentina, and future policy options, which was in preparation in the Treasury. I now attach the final version, agreed with the FCO and the Bank, of this paper. It has been seen by the Chancellor.

Copies of this letter go to Brian Fall at the FCO and Tim Allen at the Bank.

Yours ever,

John Kerr.

J O KERR

ARGENTINA : IMF AND COMMERCIAL BANK LOANS

This note reviews the current state of play, and the options for UK policy, on the IMF and international commercial bank loans to Argentina.

Indebtedness

2. Argentina's total indebtedness at end-1982 was estimated at $39 billion, including $2.7 billion in arrears.

3. At end 1982, ECGD had an estimated £260 million at risk. Consolidated unguaranteed claims on Argentina by UK-registered banks at the same date were $3.1 billion; and by British-owned banks $2.3 billion.

Credit facilities

4. There are four main elements:-

a. A bridging loan of $1.1 billion from international banks was signed in December 1982, of which UK banks' share is $111 million. $800 million net of this loan has so far been disbursed.

b. An IMF standby facility of SDR1.5 billion was agreed in January 1983. Disbursement is in five quarterly instalments over a period of 15 months, subject to fulfilment of quarterly performance criteria (covering balance of payments deficit, public sector borrowing, domestic credit expansion and public sector net external borrowing), paying off all external arrears by end-June, and removal of disciminatory exchange restrictions against the UK by end-July at the latest. SDR 300 million has been drawn so far, and a further SDR 300 million can be drawn later this month provided the Fund are satisfied with Argentina's first quarter performance (as seems likely).

c. A medium term loan of $1.5 billion (UK banks' share $159 million) is still under negotiation with international banks, and signature, which has been several times postponed, is now unlikely before June. Argentina's need for external finance may now be rather less acute, reflecting her fairly strong trade performance.

d. A $500 million BIS facility (not involving the Bank of England) was agreed in January, but this is unlikely to be drawn before the May expiry date because of technical problems concerning gold negative pledge clauses.

Rescheduling proposals

5. Talks on rescheduling of $5.5 billion of public sector debt maturities due to the banks in 1983 are aiming at agreement by end-June. Refinancing of short-term private sector debt and foreign currency swops is still under negotiation. There is no sign at present of any request for a rescheduling of officially guaranteed debts in the Paris Club.

Policy considerations

6. Two kinds of difficulties arise on the position the Government has taken so far on the IMF support package and the commercial bank loans:-

a. The continuing general hostility, in Parliament, the media and from the public at large, to the UK apparently helping to bail out Argentina, in the wake of the Falklands War and reports of continued Argentine arms purchases. These problems would be exacerbated should recent indications that Argentina may be considering the purchase of arms from the Soviet Union gain general currency. Although the source of arms would not affect the financial case for UK participation in the support operation, it would add a new and troublesome dimension of political difficulty. It may in practice be very difficult to establish whether reports of possible Russian arms sales have any substance or can safely be discounted.

b. The remaining discriminatory financial restrictions affecting UK banks and other companies under Argentine Law 22591. The Argentine authorities have been told by Larosiere that removal of these restrictions is a condition for further drawings on the standby facility beyond July. British banks involved in the medium term loan are also pressing for removal of these restrictions before confirming their participation. The attached note by the Bank of England describes the nature and impact of these restrictions, and their bearing on the IMF and commercial bank facilities.

Scope for Government action

IMF Standby

7. Various scenarios can be envisaged.

8. If Argentina fails to satisfy the Managing Director that the discriminatory restrictions have been lifted, then the programme should lapse without further Executive Board discussion. In this event, it is almost certain that the commercial banks will not be prepared to proceed with their medium term loan and the question of British banks' participation will then no longer arise.

9. If the Managing Director is satisfied, the IMF programme is likely to be brought to the Board for review in July or August, and we would at that point have to decide whether we agreed with his view. This question would be partly a legal judgement, but would depend also on whether the banks and other UK companies concerned are satisfied with the position. It appears rather unlikely that there would be a difference of view between us and the Managing Director, given the very firm position he has taken on this issue. Assuming no breach in the performance criteria of the standby agreement we would have no grounds for causing difficulties during the Board review.

10. Assuming that the problem of discrimination is resolved to the Fund's and our own satisfaction, the possibility remains that Argentina might have to seek a waiver of its undertakings to the Fund because of a breach of the performance criteria. If this were to happen at a time when rumours of Soviet arms sales to Argentina were widespread, this would raise the question of whether the UK should support a request for a waiver.

11. If a situation did arise in which the UK decided to oppose within the Executive Board continuation of the standby programme for Argentina, the issue would be decided on a simple, majority vote. Our own voting share on the Board is 8%.

Medium term loan by commercial banks

12. The Government has no legal power to interfere with the decisions of the 30 or so British commercial banks, led by Lloyds Bank International, which are involved in the medium term loan. But it could adopt various public postures towards British participation, ranging from (at the positive end) active endorsement of the banks' position, through studied neutrality to (at the negative end) clearly dissociating itself from a decision to proceed.

13. As noted above, the key issue for the banks is likely to be whether discrimination has in fact been satisfactorily removed. But, even if this requirement is met, the Government nevertheless might wish to distance itself from involvement by Lloyds and others in the medium term bank loan if worries remained on Soviet arms.

The possibility of default

14. If the IMF programme or the commercial bank loan did collapse without intervention by the UK Government or banks, the possibility would of course arise of an Argentine default, perhaps an explicit repudiation of all her external debt. Our response would need to be concerted with other creditor countries, but the risk that other major debtor countries in South America might quickly follow suit though it could not be excluded entirely seems less than a few months ago. If, on the other hand, circumstances arose in which action by the UK alone might have the effect of blocking the loans, we clearly would need to assess carefully in the light of circumstances at the time the possible consequences, including the risk of financial counter-measures aimed against us and the effect of repudiation on British banks.

15. On the latter point, at the end of 1982 twelve British banks had exposure to Argentina of almost £1,600 million, equivalent to about 10% of their capital and reserves. In addition 19 consortium banks in London (predominantly foreign owned, but incorporated in the UK and supervised by the Bank of England) had a total exposure to Argentina of £430 million (about 40% of capital and reserves). The exposures of the great majority of the banks are small both in absolute amounts and in relation to the size of the bank.

16. In the event of a repudiation by Argentina it seems likely that banks would have to write off their Argentine exposure right away. In the first instance the cost of doing so would have to be borne by the current year's profit. If, after write-offs, the banks made a loss for the year this would have to be absorbed out of reserves, share capital and loan capital. Assuming that banks' profits run at much the same level as last year, it appears that five of the eight largest British banks would probably still show a profit, although in some cases at less than half last year's level. The remaining three would make losses, which could easily be absorbed out of their reserves, although not without damage to confidence in them. The most seriously affected would be the consortium banks. It is possible that one might become insolvent as a result of writing off its Argentine exposure; at least six others would suffer serious depletion of their reserves, although probably not to the extent of depositors losing money. The Bank have received "comfort letters" from the shareholders in all of the consortium banks in which they undertake to provide support if necessary; although it is not easy to judge in advance how far the shareholders' own ability to provide support would be impaired by an Argentine repudiation.

17. By comparison, of the four US banks with the largest exposure to Argentina it appears that one would make a loss, which could be absorbed out of reserves, two would roughly break even, and one would see its profit halved.

Conclusion

18. There is no immediate need for action and decisions are unlikely to be required until July. Lloyds are well aware of the pressure we have put on the IMF and that the IMF has given strong support to the UK position; they and other UK banks are therefore unlikely to commit themselves to the $1.5 billion loan if discrimination has not been lifted by Argentina. On the other hand we see no grounds at this stage for raising afresh with the banks the hypothetical question of Russian arms sales to Argentina; they are aware of the sensitivity of this issue and no doubt, if rumours of such sales began to develop, would approach the Bank for guidance. In that event a rapid reassessment would be needed in which developments in other Latin American debt situations, and of the international debt outlook more generally, would have to be taken into account.

ANNEX

FINANCIAL DISCRIMINATION AGAINST THE UK : LAW 22591

On 19 May 1982 the Argentine National Executive power approved Law 22591 which states that -

> "The non-disposability is decreed of all assets within the territory of the Argentine Republic ... which are the property of the United Kingdom ... the British Crown, British subjects not resident permanently in the Argentine Republic ... and any company ... directly or indirectly controlled thereby (Article 1)".

2. Under Article 4 this Law also provides for the appointment of overseers or co-administrators to the companies mentioned in Article 1; and a Supervisory Committee (committee of vigilance) was created (Article 5) to ensure these restrictions were enforced.

3. Despite the mutual lifting of financial sanctions on 18 September 1982, Law 22591 remains in force. Its main practical effect is to prevent British companies from remitting profits and dividends to the UK. Non-British companies may make such remittances through purchases of dollar-denominated public bonds (BONEX) from the Central Bank at the official rate of exchange, the bonds then being held to maturity (5 years or, more usually, sold overseas. British companies may purchase BONEX but may not dispose of them).

4. We have carried out regular checks this year with a number of UK companies which have operating companies in Argentina and their position has remained substantially unchanged during that period, ie Law 22591 continues to be administered in a restrictive way. In broad terms the position of UK companies is as follows:-

(i) 6 have made no profits and therefore have not purchased BONEX.

(ii) 3 have not attempted to purchase BONEX, despite having profits, mainly because they wish to keep a low profile.

(iii) 4 have purchased BONEX but have been refused permission to market them.

(iv) 2 have BONEX but have not asked permission to dispose of them.

In recent weeks, however, there have been instances of UK companies in Argentina being authorised to remit royalties and service payments to the UK - a very slight easing of the Argentine position.

5. Given the cessation of hostilities the IMF now view the implementation of Law 22591 as an act of discrimination by one member country against a fellow member. The Fund's Managing Director has so far taken a robust line on this issue and has stated that the payment restrictions have to be removed by Argentina as a condition of making further drawings under the existing standby arrangement after 31 July 1983. Nevertheless the Chancellor took the opportunity of a meeting with him in the margins of the Development Committee meeting in Washington on 28/29 April to underline the importance attached by the UK to the ending of discrimination.

6. The Argentine Government is now apparently considering a revised law to change the entire Law 22591 but the content of this remains unknown to us. The financial authorities are clearly aware of the need to remove discriminatory restrictions but have not so far been able to persuade the military junta that action must be taken. Failure to act would deprive Argentina of the following drawings on the IMF standby agreement:-

SDR 300 mn on or after 20 August 1983
SDR 300 mn on or after 20 November 1983
SDR 300 mn on or after 20 February 1984

Furthermore, the medium-term $1.5 bn loan from commercial banks would almost certainly not proceed. UK banks are unlikely to participate without the removal of financial sanctions and other banks would in all probability insist on Argentina being in good standing with the Fund.

Economic Policy - [illegible]

CONFIDENTIAL

cc AW 2

Prime Minister

MCS 17/5

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Please see now Alan Walters's note (attached) MCS 17/5

Michael Scholar, Esq
Private Secretary
No 10 Downing Street
LONDON SW1

16 May 1983

Dear Michael,

INTERNATIONAL FINANCIAL SCENE: BRAZIL

I wrote to you on 6 May with the latest in our series of assessments of the international debt scene. Despite substantial continuing problems, the overall prospect appeared a little more encouraging.

Since then, however, the financial situation in Brazil seems to have taken a turn for the worse. Notwithstanding encouraging trade figures for March and April (the surplus in the latter month being estimated at over $600 million) the build-up of arrears continues inexorably, and there have been reports of one major Brazilian bank having to have special overnight assistance in New York to meet its day-to-day obligations. More seriously, it is becoming clear from a number of sources that Brazilian delays in producing the run of statistics required by the IMF mean in reality that they are currently in breach of a number of their performance criteria under their arrangement with the Fund. This could put in jeopardy their next drawing from the Fund on 1 June, and that in turn puts a question-mark over the disbursement of their next instalment under the bank's "new money" project, the timing of which depends on continuing eligibility from Brazil to draw from the IMF.

I have heard of this, too, through banking contacts. MCS 17/5

For the moment we must await events on the IMF front (we understand that the Brazilians are due to talk to de Larosiere early this week, no doubt with a view to amending some of the criteria), but the Chancellor thought it right that you should know at once of this potentially awkward development.

We shall be making a further general assessment of the international debt scene with the Bank of England early next week and will let you have an updated appraisal of the position in Brazil and the other major problem countries in the light of that, and before Williamsburg.

/I am copying this

CONFIDENTIAL

I am copying this letter to Tim Allen (Bank of England), Brian Fall (FCO) and John Rhodes (Department of Trade).

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

Econ BL Pt 2
Indebtedness

11 [illegible] 1983

CONFIDENTIAL

(2)

Prime Minister

To note.

The paper on Argentina options is promised by the end of the week.

MCS 10/5

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

6 May 1983

Michael Scholar Esq
10 Downing Street
LONDON SW1

Dear Michael,

INTERNATIONAL FINANCIAL SCENE

The Chancellor has asked me to send you a further assessment by the Bank of England of the international financial scene, which the Treasury have discussed with the Bank and with other departments. Attached to this is an updated table showing British banks' and ECGD exposure to the major countries in Latin America, Eastern Europe and the Far East.

Since the last report fears of a further sharp fall in the oil price and of a rise in US interest rates have, at least for the moment, abated. The report was in fact prepared just before last week's meetings in Washington, on which the Chancellor has reported to the Prime Minister separately, but the message from Washington of increasing confidence over recovery, tempered with caution and emphasis on the need for continuous monitoring of problem countries on a case by case basis, reinforces the slightly more optimistic tone of this latest assessment.

The Chancellor has asked me to draw attention to the following particular points which arise from our consideration of the assessment.

(a) Barclays Bank last week received a triple AAA rating for a substantial bond issue in the New York market. This reflects the widespread confidence in British banks. Few US banks receive this top rating for credit-worthiness today.

(b) Mexico appears to be keeping to its IMF programme and Brazil believes the $6 billion trade surplus programmed for this year is attainable, although a cash flow gap of around $1.5 billion may emerge by July/August. Although there are still formidable risks ahead, if Mexico and Brazil continue successfully to adjust the chances are that, with suitable application, other Latin American countries will follow.

(c) Mexico may not, however, be able to meet the $1.5 billion of principal repayments of officially guaranteed private sector credits due in 1983 and is apparently seeking some form of rescheduling of these debts. This would afford Mexico relief but at the same time cost ECGD around £80-90 million in claims payments. ECGD are pressing for any rescheduling proposals to be discussed on a multilateral basis and are proposing that the additional $150 million export credit cover offered earlier in the year should now be limited to public sector risks.

(d) International banks, led by Lloyds Bank International, are insisting that Argentina end its discriminatory regulations before finally agreeing a $1.5 billion loan. The banks are also seeking assurances that Argentina will comply with their IMF targets. Although these may just be met under the first review, on current trends the June targets may be breached. We shall continue to monitor the position particularly closely, and a paper on policy options is in preparation.

(e) Pressure is mounting to resume negotiations on the re-scheduling of Poland's officially guaranteed debts. The Paris Club is to discuss this month the possibility of initiating exploratory discussions with the Poles with a view to subsequent official rescheduling negotiation. The entrenched United States position is, of course, the main obstacle.

(f) We think it prudent to keep a watch on the main debtors in the Far East, Indonesia, Philippines and South Korea. There are no signs of difficulty at present, and they continue to be able to raise new money on reasonable terms, but the amounts involved if any serious problems should arise are potentially very substantial.

(g) In the United States the Senate Banking Committee is still seeking to attach provisions to restrict US banks' overseas lending activities to the legislation to give effect to the IMF quota increase. But it looks increasingly as if Congress will be satisfied with a package of minor and flexible measures that has been proposed by the three US Federal banking regulatory agencies (the FED, FDIC and the Comptroller of the Currency).

I am sending copies to Tim Allen (Bank of England), Brian Fall (FCO) and John Rhodes (DOT).

Yours ever,

John Kerr.

J O KERR

INTERNATIONAL FINANCIAL SCENE

1 Main recent developments

The last report was written shortly before the OPEC agreement on the oil price. Signs since then that the agreement will hold have given the international market some reassurance. In particular, the risk of a further sharp fall in income of producers like Mexico, Nigeria and Indonesia has abated and with it the risk of a knock-on impact on confidence which could also have threatened oil importers like Brazil and South Korea; these countries will, of course, get some benefit immediately from the oil price fall and indirectly (and more slowly) from the resulting general increase in world activity. Meanwhile, fears that the US Fed might tighten monetary policy, and so put upward pressure on interest rates, have abated; in fact US rates, after an end quarter rise, are now slightly below their level in mid-March, and recent figures both for money supply and for the CPI have been reassuring. Nevertheless, these favourable developments are unlikely to obviate the need for additional finance this year for big debtors like Brazil and Mexico. A guide to how well they fare may be whether laggards (mostly Continental European banks) are successfully persuaded to contribute their full share of certain parts of the Brazilian debt package following meetings in London of the Brazilian Liaison Group (see below).

The countries in deficit which have so far avoided serious debt difficulties by being able to increase borrowing in the international capital markets have mostly had to concede somewhat higher margins and shorter maturities. Borrowers like Nigeria (who have reluctantly approached the IMF) and the Philippines have had to work harder in the negotiations: there is nothing left of the "borrowers' market" conditions for the developing countries typical up to a year ago, except possibly for Malaysia and Taiwan.

The Latin American packages have held together and the negotiation of others (Peru and Uruguay) continues in a reasonably orderly way, although the daily financing needs of most of them are being managed only on a hand-to-mouth basis. The Yugoslav package looks as though it is about to be put in place.

Latin America

Despite signature of the projects for new money and rescheduling nearly two months ago, a meeting of the Liaison Group of banks for Brazil in London on 18-19 April was informed that there are still acute short-term liquidity problems, with little or no progress having been made on the full restoration of short-term trade credits and money market facilities, each of which is some $1.5 bn short of target. As an adverse cash flow is in any case expected in coming months - even assuming healthy monthly trade surpluses in line with the record performance achieved in March - renewed efforts are being made to make good the two shortfalls. However, the outcome is very much in the balance and, with Fund reserve targets at stake, further bridging finance may need to be sought from either the banks or official institutions sooner rather than later. In addition, a request for further new medium-term finance later in the year remains probable.

Discussions on the Mexican proposals to reschedule public sector debt to banks are still at an early stage and the moratorium which expired on 23 March has had to be extended to 15 August. A major development has been the announcement of a scheme to reschedule private sector financial and commercial debts, which has provoked a mixed reaction among creditors. For their part, export credit agencies are both concerned and confused over the treatment of official credits to the private sector. Clarification is being sought from the Mexicans by the Paris Club, although some form of rescheduling of such debt appears inevitable. Despite these difficulties governments are anxious to avoid jeopardising their contributions to the rescue package by coming off export cover. On a more positive note, the IMF is reportedly satisfied that the economic programme is on course despite the loss in export revenue following the recent cut in oil prices. Mexico, however, remains vulnerable and the international banking community appears resigned to the likelihood that the country will need additional new loans later in the year.

Argentina is still moving only slowly towards agreement on its medium-term loan and rescheduling needs. Remaining obstacles include the need to eliminate interest arrears and assurances that the Argentines will comply with their IMF targets. These may just be met under the first review but the Fund staff are concerned that, on current trends, the subsequent June targets may be breached. The IMF will try to get the programme back on course but the Argentines are expected to argue that the original criteria were unrealistic. A further problem lies in Argentina's continued failure to remove discriminatory financial measures against UK companies; the Fund requires their elimination by end-July.

Elsewhere in Latin America, talks with the advisory groups of banks and the IMF are generally progressing slowly, although there is growing recognition of the urgent need to finalise packages for smaller countries in advance of possible second-round approaches by Brazil and Mexico. The Chilean package is perhaps the most difficult, following suspension of the standby arrangement in March. A "shadow" programme is being worked out to allow the resumption of Fund drawings by September at the latest. Meanwhile bridging finance is being sought, with commercial banks seeking official contributions from the BIS and US authorities. As far as we are aware, deadlines set by the IMF Managing Director for the receipt of commitments to participate in the rescue packages for Peru and Uruguay have not been met; in the case of Peru this may reflect no more than technical difficulties, while for Uruguay sufficient support from banks was eventually provided to enable an IMF two-year standby facility to be approved on 22 April. The Venezuelans have shown belated signs of getting to grips with the country's debt problems. In late March a moratorium on public sector principal payments was announced to allow negotiations to take place on the rescheduling of the country's short-term debt - without the threat of further damaging default actions. There has as yet been no suggestion that new money will be required. The authorities have nevertheless confirmed that an approach for unconditional assistance from the IMF will be made, and the banks may well require the assurance of IMF involvement. Ultimately further loans combined with an IMF programme may well be needed.

3 Eastern Europe

Progress towards a restructuring package for Yugoslavia continues, albeit slowly. HMG are making available £78 mn (some of which has already been disbursed) as their contribution to what the IMF, at least, see as the first of a series of annual financial packages. The commercial banks have reached agreement in principle on terms to refinance 1983 maturities and the provision of new money, and the BIS have offered a $500 mn short-term facility. The Poles held a preliminary meeting with the banks in March and sought a moratorium on debt repayments until at least 1990, whilst official creditors have agreed to discuss their next move at the Paris Club meeting in May. Romania achieved an unexpectedly large adjustment in its current account and the current round of rescheduling discussions should be the last, though there are more serious doubts about the medium term. Other Eastern European countries (GDR and Hungary) continue to struggle along, successfully adjusting their current account of the balance of payments by clamping down on imports. Nevertheless the improvement in their external position may not be sustainable, and in any case remains insufficient to meet all debt servicing obligations for 1983; as long as Western creditors are unwilling to increase commitments the situation remains precarious.

4 Far East

There are no immediate debt problems, but the difficulties in other areas have turned attention on the larger borrowers in a region which has hitherto been highly favoured by lenders. The Philippines, whose external position has been deteriorating for several years, and which has a sizeable short-term debt, looks the most vulnerable to an erosion of external confidence. Adjustment and economic management generally has been much stronger in South Korea but the very high level of short-term debt poses potential dangers here too. The reduction in the oil price has hit Indonesia severely and, if the oil price were to slide or world recovery were to fail, the current deficit could become unsustainable over the next year or two.

CONFIDENTIAL

INDEBTEDNESS AND BRITISH EXPOSURE (end December 1982)

$ billion

	Total external debt	British banks unguaranteed claims	ECGD amounts at risk*
Latin America			
Argentina	39	2.3	0.4
Brazil	81	4.4	2.5
Chile	18	1.1	0.05
Ecuador	6	0.5	0.1
Mexico	83	5.2	1.8
Peru	12	0.4	0.2
Uruguay	4	0.3	0.01
Venezuela	33	2.4	0.08
Eastern Europe (convertible currency)			
East Germany	15	0.8	0.2
Hungary	7	0.5	0.08
Poland	25	0.5	1.3
Romania	10	0.4	0.6
Yugoslavia	20	0.9	1.3
Far East			
Indonesia	20≁	0.6	1.7
Philippines	19	1.2	0.4
South Korea	37	2.0	1.1

Because of differences in definition the ECGD exposure figures in the final column are not directly comparable with the figures in the other two columns.

≁ At end March 1983; excludes short-term debt
* most recent estimates

CF/PA [ANNEX

[to John Kerr's letter to me of 6 May on "International Financial Scene" not shown to PM.]

MCS 10/5

This Annex contains country notes as follows:

LATIN AMERICA	Argentina, Brazil, Chile, Ecuador, Mexico, Peru, Uruguay and Venezuela
EASTERN EUROPE	East Germany (GDR), Hungary, Poland, Romania and Yugoslavia
FAR EAST	Indonesia, Philippines and South Korea

Notes (i) Each note begins with an estimate of the country's total external debt. The source for the estimates varies and might have come from the IMF, official sources within the country (Ministry of Finance, Central Bank etc) or reports from elsewhere (Embassies, press etc). In each case the figures quoted are the ones judged to be the most accurate and up-to-date.

(ii) Each note ends with a statement showing ECGD's position and the exposure of UK banks to the country concerned.

LATIN AMERICA

ARGENTINA

Total indebtedness at end-1982 was officially estimated at $39 bn including $2.7 bn in arrears.

Signature of the $1.5 bn medium-term loan (UK share of $159 mn) originally targetted for 31 March has been postponed and is now unlikely before some time in May. The advisory group of banks have approved the revised version of the draft loan agreement but have not yet passed it on to the Argentine Government. Before signing the loan, the banks are seeking a clarification of the (apparently xenophobic) Argentine bankruptcy law and a confirmation that the Argentines are complying with their IMF targets. The banks are also pressing for the remaining financial restrictions embodied in Law 22591 to be discontinued.

The Argentines are seeking an advance payment of their third and final drawing of $300 mn under the bridge loan but the banks are unlikely to consider this without getting certification from the IMF that Argentina is on target with its Fund programme. A further issue standing in the way of an early drawing is the fact that repayment of interest arrears is still not up to date although this problem is being tackled by the Argentine government who plan to bring all interest payments to date by June 1983. Repayment of public sector interest arrears corresponding to February ($280 mn) is two thirds complete and the Argentines are expected to start paying off March arrears in the last week of April.

Talks on the rescheduling of $5.5 bn of public sector debt maturities overdue on 1.12.82 and falling due from that date to 31.12.83 are aimed for agreement by end-June. The terms are likely to involve a six-year repayment schedule with a three-year period of grace. The refinancing of the short-term private sector debt covered by Central Bank exchange guarantees and $1.4 bn in foreign currency swaps is still under negotiation.

An IMF mission arrived in Argentina on 18 April to review Argentina's performance under the fifteen month standby arrangement worth SDR 1.5 bn which was approved on 24 January. According to our banking sources it seems probable that the Argentines will just fulfill the performance criteria for March but the Fund staff are understood to be unhappy about present trends which make the June targets look very vulnerable. The IMF will try to get the programme back on course but the Argentines are expected to argue that the original criteria were unrealistic. As well as fulfilling normal performance criteria, drawings under the programme after end-July are subject to the removal of continuing discriminatory financial restrictions against UK interests embodied in Law 22591. In the current political climate the Junta feel unable to tackle this problem without receiving impossible UK concessions (eliminating the exclusion zone around the Falkland Islands was mentioned to the Governor). Finance Minister Wehbe has offered to make payments of remittances to the British banks in the US but while this demonstrates the good intentions of the financial authorities it is not regarded as satisfactory or sufficient as it does nothing to eliminate the application of discriminatory measures against British companies.

A four month $500 mn BIS facility was agreed in January but despite the Argentines' apparent need for foreign exchange this is unlikely to be drawn before it expires in May because of gold negative pledge clauses in earlier loans which have not been waived.

Despite the uncertain political climate on account of the forthcoming elections in October, the likelihood of a trade surplus of some $3 1/2 bn in 1983 leaves room for some optimism.

At end-1982 ECGD had an estimated £116.5 mn at risk under Section 1 and £143.5 mn under Section 2. Argentina remains off cover.

At end-December 1982, UK-registered banks' consolidated external claims on Argentina totalled $3.3 bn of which $3.1 bn was unguaranteed; claims by British-owned banks totalled $2.6 bn of which $2.3 bn was unguaranteed.

BRAZIL

Total indebtedness at end-1982 was estimated by the IMF at $81.3 bn. Nearly two months have elapsed since major components of the rescue package were finalised - the signing of Projects (i) [new money loan of $4.4 bn] and (ii) [the rescheduling of 1983 banking maturities] together with IMF drawings totalling SDR 0.84 bn including the first tranche under the three-year SDR 4.24 bn EFF - but major difficulties persist. Most notably, Brazil is still faced with acute short-term liquidity problems which have led to arrears of some $600 mn building up, despite a record trade surplus of $514 mn in March and the expectation of a further surplus of $650 mn in April (though even so the targeted $6 bn trade surplus for the year will still be difficult to achieve). Furthermore, banks agreed to a deferment of half the repayment ($1.1 bn) of the bridging loan from 10 March to between June and December. However, despite the goodwill shown by banks towards the Brazilian package as a whole, continuing difficulties over Projects (iii) [short-term trade credits] and (iv) [money market facilities] are threatening the Brazilian financing strategy with the real danger that a further call on banks for medium-term finance this year may now be necessary.

Recent meetings between the commercial banks and the Brazilians have, however, focused instead on renewed efforts to firm up the $1.5 bn or so on each of the two projects which is said to be needed by Central Bank President Langoni. Project (iii) is thought to be a problem at the Brazilian end in matching exporters with pre-financing credits together with the declining level of imports whilst on Project (iv), continued reluctance from Spanish, Swiss, German and Arab banks to restore interbank lines is evident. If renewed commitments are not obtained, other alternatives such as a speeding up of Project (i) disbursements or further recourse to official organisations will need to be considered. [The $1.2 bn BIS facility (of which UK share $110 mn) is due to be repaid by end-August.] Continuing shortfalls on these two projects may also jeopardise Brazil's ability to meet Fund targets on international reserves - a performance criterion which will need to be met before a further tranche of EFF resources is made available after 1 June.

At end-1982, ECGD had an estimated £348.1 mn at risk under Section 1 and £858.6 mn under Section 2. Brazil remains on cover.

At end-1982, UK-registered banks' consolidated external claims on Brazil totalled $7.9 bn, of which $7.0 bn was unguaranteed; claims by British banks at that date amounted to $5.2 bn, of which $4.4 bn was unguaranteed.

CHILE

Total indebtedness at end-1982 was $18 bn (two-thirds private sector). Less than three weeks after IMF approval of an SDR 500 mn two-year standby, a precipitous decline in international reserves, resulting from speculation against the peso and the withdrawal of short-term credit lines by foreign banks, forced the Chileans to seek a renegotiation of commercial bank debt on 28 January. The following proposals were put to an Advisory Group (including Midland) of creditor banks:

(i) 90-day standstill with effect from 31 January, on all medium and long-term public and private (financial) sector capital repayments. Interest to remain current;

(ii) rolling over of short-term debt to maintain end-1982 levels ($4.2 bn);

(iii) rescheduling, over 8 years including 5 years' grace of 1983/84 maturities on medium and long-term public and private (financial) sector debt ($3.5 bn);

(iv) $0.9 bn new money;

(v) refinancing of 1983/84 maturities on debt owed by two liquidated banks on more favourable terms than (iii) above.

Subsequently the Advisory Group persuaded the Chileans to include private corporate sector debt in the moratorium; such debt is being negotiated bilaterally with individual creditors, but progress has been hampered by the government's reluctance to provide liquidity support for private corporate debtors. At the beginning of March, however, eight industrial companies which were close to collapse were given a 45-day reprieve in their overdue payments by local and foreign creditor banks and, following pressure from foreign bankers, the state-owned Banco del Estado extended a bridging loan of a reported pesos 2.66 bn (some $35 mn) until 15 April to six of these companies. Only recently have the authorities shown a willingness to assume more formal responsibility for private sector debt, with the announcement on 13 April of a scheme to refinance, over 10 years, some $7 bn in debts owed by the corporate sector to domestic commercial banks. The scheme forms part of a major economic package introduced on 22 March after consultations with the Fund who have temporarily suspended the standby arrangement in the knowledge that the original credit ceilings and reserve targets up to June would be breached. The package - which also includes the doubling of import duties, higher taxes on petrol, a more flexible exchange rate policy and the closing of the parallel market - is intended to lay the foundations for a resumption of Fund drawings, although it is not entirely clear when this will occur. The IMF are currently working with the Chileans on a "shadow" programme to enable them to get a "technical" waiver on the June targets. Continued IMF support is essential to the success of the financial support package.

So far only tentative agreement on the terms of the rescheduling has been reached. Meanwhile the authorities have revised their original request for new money in 1983 and are now seeking around $1.3 bn. At the same time, the prospective delay in disbursements of this money because of the time required to get the Fund programme back on course has prompted the Chileans to seek some $500 mn in bridging finance up to at least June in order to keep them in line with reserves targets. Commercial banks are seeking Fed/US Treasury and BIS contributions to the bridge, which, according to their plan, might be drawn in monthly portions provided the IMF could say the Chileans were in compliance with their "shadow" programme.

At end-1982, ECGD had an estimated £24.4 mn at risk under Section 1 and £13.4 mn under Section 2. Chile remains on cover.

At end-1982, UK-registered banks' consolidated external claims on Chile totalled $1.8 bn, of which $1.7 bn was unguaranteed; claims by British-owned banks totalled $1.2 bn, of which $1.1 bn was unguaranteed.

ECUADOR

Total indebtedness at end-1982 was $6.3 bn ($4.7 bn public sector). Reflecting a severe cutback in foreign credit at a time of reduced earnings from oil (60% of export earnings) and high international interest rates, reserves were more than halved last year to $320 mn and have fallen further since. The central bank is now delaying remitting foreign exchange to importers and is late in making interest payments.

The authorities have had a series of meetings with a Steering Committee of banks (chaired by LBI) to discuss the rescheduling over seven years with two years' grace of $1.2 bn of public sector banking debt maturing between 1.11.82 and 31.12.83. They had unilaterally suspended repayments of principal of such debt with effect from 1 November. Preliminary agreement was reached in January, but the package (which is likely to include $300-400 mn in new money) is subject to agreement being reached over a $175 mn IMF standby. Negotiations with the IMF have been prolonged but it is now hoped that approval will be given by the end of April. The authorities will face a difficult task in implementing the programme given their lack of a congressional majority and the recurrent protest within the country at austerity measures already taken, including a 21% devaluation of the sucre and sharp increases in the price of milk and fuel (announced on 19 March).

At the beginning of March the government announced that it would assume responsibility for $1.26 bn of private sector debt falling due this year to prevent many private companies from defaulting - provided that creditors are prepared to refinance the debt over six years. However a Steering Committee for private sector debt is to be appointed within the existing Committee in order to explore the possibility of treating public and private debt on an equal basis by drawing the latter into the general rescheduling package.

At end-1982, ECGD had an estimated £39.1 mn at risk under Section 1 and £28 mn under Section 2. Ecuador remains on (very restricted) cover.

At end-1982, UK-registered banks consolidated external claims on Ecuador totalled $0.8 bn, of which $0.7 bn was unguaranteed; claims by British-owned banks totalled $0.6 bn, of which $0.5 bn was unguaranteed.

MEXICO

Total indebtedness at end-1982 was an estimated $83 bn. The $5 bn medium term new money loan, from 526 banks to help close the 1983 financing gap was finalised on 15 March. The first tranche of $1.7 bn was drawn down on 23 March, although the Advisory Group of banks (which includes LBI) had already advanced their $440 mn portion of this on 25 February as a bridging loan. As of 8 February, 9 governments (including the UK with a share of $150 mn) had committed some $2.2 bn in new direct/guaranteed lines of credit compared with the $2 bn originally requested by de Larosiere; more recent reports indicate that a total of $3 bn may be sought by the Mexicans. Under the $925 mn BIS bridging facility (UK participation of $140 mn) agreed last August, the last $30 mn of the third (and final) tranche was drawn on 23 February. The parallel US facility (for a similar amount) is also fully drawn. Both facilities terminate on 23 August.

Difficulties in finalising the $5 bn loan have until recently prevented discussion of the proposals, submitted in December, to reschedule public sector debt to banks (excluding i.a. officially insured export credits). Consequently, the moratorium which expired on 23 March has been extended to 15 August. Mexico has a fair chance of completing rescheduling discussions by this date - a condition attached to the third drawdown of new money.

So far as public sector supplier debt (as we understand) and private sector financial and commercial debts are concerned, the authorities unveiled a scheme on 5 April which applies to all such debts contracted before 20 December 1982 that are rescheduled bilaterally over a minimum of six years. The scheme enables companies to discharge the equivalent of their debt in pesos under four repayment options, for which companies must apply between 25 April and 25 October. Since the scheme is much more advantageous than the separate supplier debt scheme announced on 28 February, debtors will presumably wish to change schemes in considerable numbers. Under the latter scheme Mexican public and private sector companies may, between 3 March and 15 July, establish interest bearing dollar-denominated deposits at the controlled rate of exchange for the amount of debt owed. The arrangement is effectively a refinancing operation, with creditors only able to draw on the accounts over a period of two years or more from an as yet unspecified date, but most probably August 1983.

Reaction to the schemes has been mixed. International banks appear to have accepted the 5 April arrangement, albeit reluctantly. At least it opens the way for meeting the requirements of the $5 bn loan documentation which makes the second ($1.1 bn due 15 May) and subsequent drawdowns conditional on implementation of a satisfactory private sector debt repayment scheme. On the other hand their is concern and confusion among export credit agencies over the treatment of officially guaranteed/disbursed private sector credits. Following discussions on 11-13 April, Paris Club members (including ECGD) have agreed jointly to telex the Mexicans seeking clarification on the subject by 24 May and to emphasise their understanding until now that Mexico would not request a rescheduling of official credits. However in the (likely) event of a rescheduling, the Mexicans will be encouraged to agree terms on a multilateral basis, although not necessarily under the Paris Club label given concern to avoid drawing in public sector debt. Despite these difficulties, governments are keen not to jeopardise the $2 bn official credit package by coming off cover. Meanwhile, these uncertainties are likely to hamper the supply of essential raw materials and intermediate goods needed by Mexico's export sector.

On the more positive side, an IMF mission, which visited Mexico in March in connection with the first quarterly review of the EFF package approved in December, is reportedly satisfied that the programme is on course despite the estimated $1- 1 1/2 bn loss in export revenue following the cut in oil prices. This view is not shared by key figures in the international banking community who expect that Mexico will need additional new loans later in the year.

At end-1982, ECGD had an estimated £655.3 mn at risk under Section 1 and £470.4 mn under Section 2. Mexico remains on cover for short-term business under Section 1 and all business under Section 2.

At end-December 1982, UK-registered banks' consolidated external claims on Mexico totalled $8.3 bn, of which $7.4 bn was unguaranteed; claims by British-owned banks totalled $5.9 bn, of which $5.2 bn was unguaranteed.

PERU

Total indebtedness at end-1982 was an estimated $11.5 bn. Under an SDR 650 mn 3-year EFF programme approved in June 1982 Peru successfully observed the technical performance criteria up to the first review later in the year, but had difficulty in curbing the public sector and current account deficits in line with objectives - 4% of GDP in 1982 (6.6% outturn) and 6% (7%) respectively. In February this year, after consulting the Fund, the authorities announced austerity measures aimed at reducing the public sector and current account deficits further to 3.8% and 4.5% of GDP respectively in 1983. However, in the present climate for lending to Latin America, these measures came too late and there was a sharp reduction in short-term credit lines from foreign banks in the first two months of the year. Peru's vulnerability to such a move had been heightened by a near-doubling (to $2.2 bn) last year in short-term debt reflecting a steep increase in non-trade related borrowing by the non-financial public sector which were not covered by IMF ceilings. For 1983, the IMF have redefined external financing to include all maturities of debt.

In mid-February the authorities made an abortive approach to the BIS for a $400 mn 180-day facility. Subsequently, Peru requested a facility for a similar amount from the US Treasury but, as far as is known, only received a $120 mn swap through the Exchange Stabilisation Fund. In early March, Peru clarified its 1983 external financing needs at meetings with creditor banks in New York, London and Tokyo, and have sought:

(a) The roll-over of $2 bn in short-term debt - (i) $500 mn public sector trade credits due 7 March-31 May 1983 to be renewed for at least 90 days to allow the authorities to arrange committed lines with individual lenders; (ii) $1.2 bn public sector working capital debt due 7 March 1983-6 March 1984 to be rolled over for 360 days from maturity; and (iii) $300 mn private bank debt due 7 March 1983-6 March 1984 also to be rolled over.

(b) Two 8-year credits (including 3 years' grace) totalling $880 mn - (i) $430 mn to refinance medium-term amortisation payments due to banks in 1983 (officially guaranteed export credits are not affected); and (ii) $450 mn in new money.

All interest payments will continue to be made. The IMF stipulated that commitments to participate in the financing had to be received by 15 April if de Larosiere was to approve disbursement of SDR 250 mn for the second year of the EFF at a Board meeting on 9 May. However, an Advisory Group of 10 banks (including National Westminster), which is co-ordinating responses, has not yet received replies for onward transmission to the IMF because the 265 creditor banks involved are encountering delays in calculating their contributions based on exposure at end-1982. With the Peruvians apparently experiencing considerable difficulties in assembling the necessary data on claims, banks are doing their own estimates.

At end-1982, ECGD had an estimated £39.6 mn at risk under Section 1 and £45.2 mn under Section 2. Peru remains on cover.

At end-December 1982, UK-registered banks' consolidated external claims on Peru totalled $0.8 bn, of which $0.7 bn was unguaranteed; claims by British-owned banks totalled $0.5 bn, of which $0.4 bn was unguaranteed.

URUGUAY

Total indebtedness at end-1982 was an estimated $4 bn of which $2.7 bn was public and publicly guaranteed.

Prompted by a widening financing gap in 1983, following the sharp deterioration in Uruguay's economic position in 1981/82 (highlighted by deepening recession, a rapidly increasing public sector deficit, private sector capital outflows and recourse to short-term borrowing as traditional medium and long-term credit sources dried up) Uruguay's central bank President, Puppo, asked commercial bank creditors, in early March, for a 90-day moratorium on repayment of principal amounts due to allow time for negotiations on rescheduling and new money.

An advisory committee of leading creditor banks (LBI, Bank of America, MHT, Nova Scotia, Bank of Tokyo and Credit Suisse under the chairmanship of Citibank) agreed on 30 March to proposals for rescheduling 90% of $786 mn public sector debt falling due in 1983/84. Uruguay's creditor banks (some 75 in total) are also being asked to grant a new medium-term credit of about $240 mn. One loan agreement is to cover both the rescheduled maturities and the new money which will have a 6-year maturity, including 2 years' grace. To ease the effect of the short grace period repayments are not equal but weighted towards 1988/89. Interest will be paid at a margin of 2 1/4% over LIBOR or 2 1/8% over US prime with front end and commitment fees of 1 3/8% and 1/2%, respectively. The banks are to sign commitment letters to keep trade credit at present levels (total reportedly $120 mn) for the next 12 months and there is apparently an understanding on interbank lines. Disbursement of the new credit will be linked to an SDR 378 mn two-year standby approved by the IMF Board on 22 April. The Managing Director of the IMF had earlier telexed creditor banks requesting their written assurances by 18 April that they would participate in the above arrangements, to enable him to be in a position to present the standby programme to the Executive Board.

Discussions with the World Bank on a Structural Adjustment Loan for $40 mn are proceeding but this will not be available before end-1983 or early 1984.

At end-1982 ECGD had an estimated £6.5 mn at risk under Section 1 and £0.7 mn under Section 2.

At end-December 1982, UK-registered banks' consolidated external claims on Uruguay totalled $0.4 bn, of which $0.3 bn was unguaranteed; claims by British-owned banks totalled $0.3 bn, nearly all of which was unguaranteed.

VENEZUELA

Total indebtedness at end-1982 was an estimated $33 bn ($27 bn public sector). On 22 March Venezuela announced a moratorium on public sector principal payments until 1 July 1983 to allow negotiations to take place on the rescheduling of the country's short-term debt - without the threat of further damaging default actions by foreign banks. An Advisory Committee of banks (chaired by Chase and including LBI) was formed to conduct the negotiations. Finance Minister Sosa subsequently appointed a team to liaise with the bankers. "Official" debt (guaranteed by ECGD etc) and publicly-issued fixed and floating rate bonds of the public sector are not included in the moratorium; and short-term trade-related debt will be paid provided that existing levels of finance are maintained. Inter-bank lines are also not included in the suspension. Interest will be kept current: Sosa has offered to pay either 1 1/4% over LIBOR or 1 1/8% over Prime on deferred short-term debt or the interest rate stipulated in the various loan agreements (the latter will apply to suspended medium-term debt). Although medium and long-term repayments have been included in the moratorium, Sosa is still only expected to present rescheduling proposals on short-term debt ($6.6 bn state agencies plus $3.5 bn state banks). It is still the authorities' intention to repay medium-term debt this year. As regards terms, press speculation suggests that a seven-year refinancing at 2% over LIBOR may prove acceptable to the banks (cf 1 5/8% over LIBOR for a seven-year term proposed last October under the original refinancing programme). Meetings with banks in New York and Tokyo were held in mid-April and Sosa is expected to visit Frankfurt in May.

Private sector debt is not covered under the moratorium and will not be included in the formal rescheduling proposals. Eligibility for the preferential rate of Bs4.29/$1 has now been extended to principal and interest payments on all private sector debt incurred up to 18 February. Foreign-owned companies are no longer excluded from the preferential arrangements and various restrictive clauses on types of eligible private debt have been removed. Although there is now no longer a direct requirement to extend maturities to four years, the release of preferential rate funds will be in three equal annual payments beginning in 1984. The government has reserved considerable flexibility for the operation of the system which will be dependent on the underlying reserves position.

There has as yet been no suggestion that new money will be required. However, Sosa confirmed this week that the authorities would shortly make a formal approach to the IMF for use of facilities. Around $1.2 bn is available to Venezuela through encashment of SDR's/drawings on its reserve tranche, but further loans combined with an IMF programme may be needed to satisfy the bankers. Sosa indicated that additional loans may be sought "later in the year" depending on income trends. An IMF mission has just completed its annual Article IV consultations two months' early. It is believed to have recommended a devaluation of the preferential rate to Bs6/$1 and ultimate unification of the exchange rate. The mission was dismayed by the quality of economic leadership in Venezuela and felt that the government was not facing the fundamental question of living within its reduced oil income. The 1983 Budget has only been cut by 3.1% and may prove to be based on optimistic assumptions. Current projections allow no margin for any further fall in revenues.

At end-1982, ECGD had an estimated £50.6 mn at risk under Section 1 and £6.9 mn under Section 2. Venezuela remains on cover.

At end-1982, UK-registered banks' consolidated external claims on Venezuela totalled $3.1 bn, of which $3.0 bn was unguaranteed; claims by British-owned banks totalled $2.5 bn, of which $2.4 bn was unguaranteed.

EASTERN EUROPE

EAST GERMANY - GDR

Total convertible currency indebtedness (perhaps as much as $15 bn at the end of 1981) is now probably declining, owing largely to a drawing down of reserves and drastic import cuts which cannot be sustained for long. Gross debts to BIS area banks (excluding banks in West Germany) had declined from over $10 bn at the end of 1981 to $8.5 bn by the end of September 1982. Existing undrawn credit facilities, though considerable, have fallen sharply and, because of its inability to raise substantial new medium and long-term credit from Western banks over the past year, the GDR has been forced to run down its balances with Western banks and confine its borrowing to the short term. Debt repayments probably exceeded $5 bn in 1982 and are unlikely to fall much below that in 1983 and 1984. GDR importing organisations in general have been obliged by the government to seek longer credit terms; ECGD is still on limited cover but has introduced tighter market limits. Serious debt servicing problems and even rescheduling are still possible.

At end-December 1982 UK-registered banks' consolidated external claims on East Germany totalled $1.5 bn (of which $1.4 bn unguaranteed). Claims by British-owned banks totalled $0.9 bn (of which $0.8 bn unguaranteed).

HUNGARY

Although Hungary is meeting the Fund's performance criteria under the one year standby the country's external accounts remain weak and threatened by weakness of banking confidence. Despite the availability of IMF drawings and the eventual success in raising a $200 mn club loan from the international capital market in April, Hungary's liquidity position continues tight. Hungary may have suffered substantial outflows of short-term deposits earlier this year when in January reserves fell by $400 mn to $785 mn. There are also indications that exports are lower than planned; consequently the surplus on the convertible currency current account may fall short of the $600 mn target. In order to avoid placing further undue strain on Hungary's liquidity position when the $300 mn BIS facility fell due for repayment on 26 April the BIS is considering extending a further $100 mn credit line to run from the April maturity date to 30 June, when an IMF drawing of SDR 83.1 mn becomes available. Although the convertible currency current account is forecast to improve in the second half of the year maturities of medium and long-term debt will also rise substantially during that period. Hungary's liquidity position is likely therefore to remain precarious throughout this year; the country's reserves could not sustain further substantial withdrawals of short-term funds and a failure to raise more medium-term credits from the international capital markets may still result in payments difficulties later this year or in 1984, though the planned $500 mn increase in reserves during 1983 may provide a safety valve. There is unlikely to be any net increase in 1983 in Hungary's debt from its end-1982 level of $7.5 bn. ECGD commitments are modest and under tight control.

At end-December 1982 UK-registered banks' consolidated external claims on Hungary totalled $0.8 bn, largely unguaranteed. Claims by British-owned banks stood at $0.5 bn.

POLAND

Total convertible currency indebtedness is about $25 bn. Bank and official creditors both negotiated rescheduling agreements in respect of debts due in 1981. Following the declaration of martial law in December 1981 virtually none of the $10 bn convertible currency obligations falling due in 1982 has been paid. On 3 November the banks signed a rescheduling agreement covering 95 per cent of the $2.4 bn repayments of principal due in 1982. Under the agreement half the interest due in 1982 is being lent back in the form of new three-year credits. Western official creditors agreed after the imposition of martial law not to resume talks on official rescheduling for the time being and did not attempt to negotiate a rescheduling agreement for 1982. In practice, the effect of this refusal has been to give Poland a pretext to stop all payments to governments, thereby gaining 100 per cent de facto relief on both principal and interest, including amounts for which a rescheduling agreement was concluded in 1981.

The resumption of negotiations with Poland on rescheduling official debt was raised at the recent Paris Club meeting; it was agreed that the task force should reconvene to examine available data with a view to holding a full meeting of official creditors in Paris in mid-May. The commercial bank task force held preliminary negotiations in Warsaw on 21-22 March. Whilst Poland agreed to honour 1981 and 1982 commitments they pressed for a moratorium on 1983 principal and interest at least until 1990 and preferably 1992. Thereafter they sought an eight to twelve year repayment at concessional rather than market interest rates. There has been no bank response to the Polish proposals. ECGD is off cover.

At end-December 1982 UK-registered banks' consolidated external claims on Poland totalled $1.7 bn of which $0.8 bn was unguaranteed. Claims by British-owned banks totalled $1.4 bn, of which $0.5 bn was unguaranteed.

ROMANIA

At end-1982 convertible currency debt totalled $9.8 bn. Bilateral agreements covering 1982 payments have now been signed with all Paris Club governments except West Germany. Negotiations on the 1983 banking agreement, which provides for 30% of this year's maturities to be repaid in the second half of 1983, 10% in 1984 and the balance over six and a half years with four year's grace, are likely to be concluded shortly. However, a Paris Club meeting to open negotiations on 1983 reschedulings, originally scheduled for 14-15 April, was postponed because of arrears under the 1982 agreement. The meeting is now to take place on 18-19 May on the condition that all arrears are settled by 6 May. ECGD is off cover.

At end-December 1982 UK-registered banks' consolidated external claims on Romania totalled $0.9 bn of which $0.6 bn was unguaranteed. Claims by British-owned banks totalled $0.6 bn, of which $0.4 bn was unguaranteed.

YUGOSLAVIA

Total indebtedness is about $20 bn. Notwithstanding an IMF upper-tranche programme, Yugoslavia failed to come to grips with increasingly severe payments imbalances in the late 1970s. These resulted from high growth and from investment financed by heavy foreign borrowing for projects which often would not yield convertible-currency earnings to service the debt. With reserves now largely exhausted, an international package involving both governments and banks has been devised under IMF auspices to provide Yugoslavia with new credit whilst restructuring existing debts.

Funds totalling $0.5 bn net should be available from the IMF and IBRD. A memorandum of understanding signed in Berne in January by representatives of 15 creditor countries envisages that governmental funds amounting to about $1.4 bn will be made available in medium-term credits, mostly in the form of export credits. The first instalment (£19 mn) of the £38 mn HMG loan has been disbursed and negotiations have begun on the £40 mn loan guaranteed by ECGD to refinance payments due to UK exporters. In addition ECGD will remain on cover for short-term business.

On 25 March the commercial banks' International Co-ordinating Committee reached agreement in principle on the terms of a package incorporating the refinancing of $1.4 bn medium-term debt and $2 bn short-term credits maturing in 1983 and the provision of $0.6 bn new money. The banks have asked governments to refinance officially supported debt in 1983 on no less favourable terms; at a creditors' meeting in Zurich on 16 April governments agreed to provide details of the Berne package to the banks. Satisfactory progress towards signature of the commercial bank package is a condition of the IMF for release of the May drawing although in Zurich the Fund indicated that they were content for final signature to be delayed until end-June.

The BIS have offered a $0.5 bn facility; backed partly by central banks (release of $0.2 bn of this, which is backed by gold, is conditional on the removal of certain outstanding problems concerning title to the gold). The Bank of England's share is $25 mn; the second instalment of the financial loan to be made available by HMG in August will take out the Bank.

At end-December 1982 UK-registered banks' consolidated external claims on Yugoslavia totalled $1.7 bn of which $1.3 bn was unguaranteed. Claims by British owned banks totalled $1.2 bn, of which $0.9 bn was unguaranteed.

FAR EAST

INDONESIA

Total medium- and long-term indebtedness is estimated at $20 bn at end-March 1983. Short-term exposure of BIS banks (the only available source for this category of debt) was $3.2 bn at end-June 1982.

With oil and LNG accounting for around 80% of export receipts, and other primary products for the bulk of the remainder, Indonesia has been badly affected by the world recession. The current account has swung from a surplus of $2.1 bn in 1980-81 to an estimated deficit of $7.3 bn in 1982-83 (ending 31 March) and over the past 12 months alone reserves have fallen by $4.9 bn to $6.4 bn (including $3 bn with the state commercial banks).

It is estimated that the reduction in the oil price, with consequential effects on LNG export prices, will cost Indonesia a net $2 bn of foreign exchange earnings in 1983-84. On 30 March, the rupiah was devalued by 27½% against the dollar and further measures of monetary and fiscal retrenchment are expected. The most significant result of the devaluation will be in restoring fiscal revenue of which 70% is derived from oil. There is some scope for import reduction but the direct benefit to exports from the devaluation is likely to be only modest. Following the devaluation, the authorities have forecast a current deficit of only $6 bn for 1983-84 but this looks optimistic, unless there is a very severe cut back on high-import content government development spending, and it might be more realistic to expect an outturn of, say, $7 bn.

The debt service ratio for 1982-83 is estimated to have been around 22% and is unlikely to be significantly higher in 1983-84. Indonesia has already obtained some $1.5 bn from the market this year. After expected inflows of development aid, direct investment etc, it seems probable that a financing gap of some $3-4 bn will still need to be covered. The Indonesians are in discussion with the Fund about a CFF purchase but their eligibility in respect of an oil export shortfall has yet to be established. A standby, however, could bring in $1.2 bn.

Indonesia has a good standing in the market, based on a reputation for sound economic management, good performance and a prudent strategy in the past of diversifying borrowings. This year the Indonesians should be able to cover their financing needs by a combination of further borrowing, probably including the IMF, and use of reserves but they must expect to encounter increasing resistance from lenders if they attempt to step up their calls on the markets very substantially.

Before the oil price cut the IMF were projecting current account deficits for Indonesia of between \$4.8 bn and \$3.3 bn up to 1987-88 on the assumption of an unchanged nominal oil price through 1984-85, increasing thereafter in line with world inflation. In the light of the latest developments, Indonesia's prospects of avoiding debt problems after this year will depend critically on world recovery and the future trend in the oil price.

As at end-February 1983, ECGD had an estimated £230.6 mn at risk under Section 1 and £333.0 mn under Section 2. At end-December 1982 UK-registered banks' consolidated external claims in Indonesia totalled \$1,159 mn; claims by British-owned banks totalled \$1,014 mn of which \$598 mn was unguaranteed.

PHILIPPINES

Total indebtedness at end-1982 was estimated at $19 bn. The external position of the Philippines has been deteriorating for some years. The country's dependence on imported oil, high interest rates and the world recession have all contributed, but the overall economic strategy - notably the commitment to a number of large industrial projects - and policy weaknesses have played their part. In 1982, the visible trade and the current account deficits, which have increased in each year since 1977, reached $2.8 bn and $3.4 bn (8½% of GNP) respectively and there was an overall payments deficit of $1.1 bn. Medium- and long-term debt increased by 17% and reserves fell by $0.2 bn to $2.5 bn (3.7 months' imports).

An SDR315 mn IMF standby and an SDR189 mn CFF purchase were approved in February. The standby programme provides for a reduction in the fiscal deficit - an area of major weakness - to 2.4% of GNP (1982 4.2%) and a cut in the current deficit to $2.5 bn, the improvement coming mainly from exports and increased invisible receipts (primarily remittances from the Middle East where the authorities are offering incentives to bring into the system a greater proportion of workers' earnings). Net long-term capital inflow of $1.9 bn is expected, of which some $0.7 bn is to be accounted for by commercial borrowing; a syndicated loan to the central bank has already raised $0.3 bn. The projected overall deficit of $0.6 bn, will largely be financed by IMF assistance. Besides ceilings on new medium- and long-term borrowing, the programme incorporates an undertaking not to permit any net increase in trade related short-term debt and to monitor closely other short-term debt. The precise total of the short-term debt is not clear - BIS banking figures probably include some double-counting but the IMF estimate is around $6 bn.

The IMF report that performance criteria were being met up to March and a mission will visit Manila in June. The oil price reduction will save an estimated $300 mn on the oil bill this year, and further restraints have been placed this month on foreign exchange expenditure and borrowing by state enterprises. IMF projections of only gradual improvement in the external position over the next few years, however, with the balance of payments not returning to overall surplus until 1985, and the debt service ratio - estimated at 24.8% for this year - still only just below 25% in 1987 are indications of continuing strain.

The Philippines now feature regularly in discussion of likely candidates for rescheduling. There is no evidence yet of banks reducing credit lines, but the talk is that most major banks are at or close to their limits for the Philippines and reluctant to increase exposure further. World recovery would ease the situation, but if a debt crisis is to be avoided confidence will have to be maintained, and policies of restraint followed for some time ahead.

As at end-February 1983, ECGD had an estimated £203.5 mn at risk under Section 1 and £8.9 mn under Section 2. At end-December 1982 UK-registered banks' consolidated external claims in the Philippines totalled $1,777 mn; claims by British-owned banks totalled $1,609 mn of which $1,162 mn was unguaranteed.

SOUTH KOREA

Total indebtedness at end-1982 was estimated at $37.2 bn.

The second oil shock in 1979 was imposed on an economy already strained by rapid and unbalanced growth, and the current account deficit rose to $5.3 bn in 1980. Firm policies of domestic restraint, flexible management of the exchange rate and weak commodity prices combined to bring down the deficit to $2.5 bn last year. Heavy borrowing over this period of adjustment, however, more than doubled the external debt between 1978 and end-1982.

For 1983, the official forecast is for a further reduction in the current deficit to $2 bn. In January/March the deficit, at $1.0 bn (January/March 1982 -$0.3 bn), was sharply up on the corresponding period of last year, but there will be an estimated net gain to the current account from the reduction in the oil price of some $0.6 bn ($0.8 bn saving on the oil bill, less $0.2 bn loss of earnings from Middle East construction projects). The total projected financing requirement for this year is $6.3 bn, of which $1.4 bn is to come from new bank borrowing; a syndicated loan to the Korea Exchange Bank has already raised $0.5 bn, though on somewhat harder terms than previous Korean borrowing.

Reserves were $6 bn at end-March (three months' imports), and the debt service ratio for this year is 19%. Korea has made a relatively successful adjustment and is still, generally, well regarded in the markets, but attention has recently focused on her position as the fourth largest ldc borrower after Brazil, Mexico and Argentina and on her large stake in construction business in the Middle East, and the high level of her short-term debt - $14.1 bn at end-1982, 38% of the total - makes her vulnerable to changes in confidence. During recent discussions in Seoul the IMF Staff were pushing the Koreans for a current surplus within two to three years. The Koreans have now approached the IMF with a view to a standby. It is understood that they have in mind a modest amount, more, at this stage, as a seal of Fund approval of their policies than because they need the funds.

As at end-February 1983, ECGD had an estimated £235.9 mn at risk under Section 1, and £345.2 mn under Section 2. At end-December 1982 UK-registered banks' consolidated external claims in South Korea totalled \$3,060 mn; claims by British-owned banks totalled \$2,596 mn, of which \$1,995 mn was unguaranteed.

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p.a.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

29 April 1983

Michael Power Esq.
Private Secretary
Overseas Development Administration
LONDON

Dear Power,

In view of Mr. Raison's visit to Washington next week you may wish to show him the attached copy of the Chancellor's speech to The Development Committee on 28 April. The strictly IBRD/IDA issues are covered in the third section; but the treatment of the IMF issues (the second section), and World Economic Prospects (first and last sections), also created some interest.

Copies of this letter and the speech go to Michael Scholar (No. 10), John Holmes (FCO), John Rhodes (DoT) and Richard Hatfield (Cabinet Office).

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

UK FILE COPY

SIR GEOFFREY HOWE'S STATEMENT TO
THE DEV. CTTEE ON APRIL 28, 1983

AS DELIVERED

DEVELOPMENT COMMITTEE: SPEAKING NOTES

WORLD ECONOMIC SITUATION

The world economic situation has been particularly difficult for us all since the second oil price shock in 1979. At least part of the problems we have had to face derive from lax policies in the past. It was widely thought that governments could borrow and spend their way out of recession. In practice, of course, this belief served only to postpone necessary adjustments and actually contributed to the severity of the problems of the world economy.

It has been, and still is, important to learn from these past mistakes. Although the transition to lower inflation has been, and still remains, difficult, considerable successes from the policies most of us have pursued are now apparent.

Certainly the difficulties have affected us all. The recession in the industrial countries has pushed unemployment to tragically high levels. And in

/the non-oil

the non-oil developing countries, who enjoyed growth at an average of 5 per cent growth a year in the years before 1979, output actually fell last year.

Every member of this Committee can recite the several causes of our present difficulties, which are at the same time symptoms of the underlying problem. Excessive debt commitments; depressed export earnings; high real interest rates; higher energy costs; a sharp--and inevitable--contraction in net bank lending; and equally inevitably, I am afraid, a slowdown in aid flows as donor countries sought to correct their own fiscal imbalances, for those fiscal imbalances have been, and in many cases still are, one cause of our problems--most of all high interest rates.

Even in the face of these difficulties, many developing countries have achieved considerable adjustment. Indeed many have adjusted better than some industrial countries. We should not fail to applaud this progress--even though we emphasise that the adjustment process must continue, if

/recovery is

recovery is to be on a sustainable basis.

IMF ISSUES

Let me say a word at this point, Mr Chairman, in my capacity as your counterpart, the Chairman of the IMF Interim Committee.

Clearly the Fund retains a vital responsibility for the process of adjustment, and particularly for the short-term debt problems which are still afflicting some developing countries - and not only developing countries, I am afraid - with special severity.

I believe the international financial community can take some credit for the speed and potential effectiveness of what has already been done. Last autumn, the IMF and many governments including my own were able rapidly to put in place appropriate rescue schemes for debtor countries that were able and willing to undertake the adjustments of their own economies which, in conjunction with the IMF, they agreed to be necessary. But as a result the need

/for increased

for increased IMF resources--repeatedly urged by the Committee--as well as by others deeply concerned with problems of developing countries, UNCTAD, and the Brandt Commission--became more obvious, and more urgent. I believe that the agreements which were reached, ahead of schedule, in January and February this year were an effective response. As you know, the resources available through the General Arrangements to Borrow are to be increased, and made more widely available; and IMF quotas are to be increased by nearly 50%. The effect of those changes--and we must go on explaining and emphasising this fact--will be to double the resources in practice available to the IMF, some two years earlier than had been planned. No mean achievement, and I pay tribute to my Interim Committee colleagues who helped secure it.

It is important, of course, that the quota and GAB increases should be ratified promptly. Even so, there could be a need for the IMF to restore its liquidity later this year by borrowing. If

/sums available

from official sources do not match expectations and requirements, then we shall need to consider--very carefully--borrowing from commercial markets.

I should like to pay tribute to the energy and imagination with which the Managing Director and Staff of the IMF have met the demands recently made for their help. They have moved with commendable speed to establish and develop contact with commercial banks, as well as governments, central banks, the BIS and the World Bank, to seek cooperative action in maintaining flows of funds on a sufficient scale to give time for the adjustment programmes in which they are also deeply involved to take effect.

I believe we have shown that the international community can effectively tackle these major debt problems, given the essential contribution which debtor countries themselves must make. This does not mean that we can afford to relax our vigilance. But I do not at present see scope for, and I confess that I am in any case distrustful of, any "blanket solution" to current debt problems. Proposals of this kind usually envisage major institutional developments which would take years to implement, or substituting Government decisions and public funds for market judgment and finance. The hubris of statesmen - more accurately perhaps of those who seek, generally in vain, to earn that title - who are confident that they can outguess the markets rarely goes unpunished.

One further IMF question is relevant to the work of this Committee. We agreed in February that consideration should again be given to the idea of a further SDR allocation. This is not the time or the forum in which to offer conclusions on that question. It will be discussed in the IMF Executive Board and Interim Committee later this year. For the present, I record only that I believe our discussion needs to be based on a thorough analysis of the likely demand for, and supply of, reserve assets over the next few years, going well beyond simple comparisons of reserve assets with growth of imports. It should consider such questions as:

- the impact of partially floating exchange rates on demand for reserves;
- the prospective scale and duration of payments imbalances which may need to be financed;
- the effect on reserve holdings, and needs, resulting from likely changes in the balance of payments positions of different groups of countries;

/- and realistic

- and realistic assumptions about continued flows of commercial lending.

I am sure that we can look to the IMF staff to undertake this kind of analysis during the coming weeks.

WORLD BANK AND IDA

I turn now to the issues which are directly the concern of this Committee - those that affect the Bank and IDA.

It is worth noting at the outset that, while the most obviously severe debt problems have often been those of relatively advanced developing countries previously able to attract commercial capital on a large scale, we must not forget that virtually all developing countries have been hit by the recession, and that the plight of the poorest has been particularly severe. Although, or perhaps because, their problems do not always hit the world's headlines, they deserve this Committee's particular consideration.

/For countries at

For countries at many different stages of development, the World Bank continues to play a vital role. The United Kingdom has supported the special action programme to help speed up disbursements of existing IBRD loans, and to remove some of the present restrictions on structural lending. There have been calls for the removal of the present 10% ceiling on the Bank's non project lending. I understand this is not in fact seen as an undue constraint in the immediate future. Even so, I believe that in due time the Executive Board should consider whether there should be some relaxation in this ceiling.

The Board will also need to consider the Bank's proposals for a modest increase in its five year lending programme. It is my view that a selective capital increase based on the relative increases agreed in the IMF quota review would provide a basis for a modest expansion in lending. And I hope that the IBRD Management will soon bring forward detailed proposals. In the meantime, I am sure that the Bank is right to make the most of opportunities for co-financing with private

/institutions, and I

institutions, and I welcome the recent introduction of new instruments for this purpose.

It is equally important that the major donor countries should maintain their support for IDA at reasonable levels. That is why I welcome the US Administration's intention to continue to seek Congressional approval for the supplementary IDA 6 appropriation this year. Clearly they are making strenuous efforts to secure this - and we must all hope that they succeed. Any further delay in IDA 6 appropriations would have very serious consequences for the future of IDA and for the countries which depend upon it. Similarly, we must strive for an early agreement on a reasonable total for the 7th replenishment, distributed on an equitable basis among the donor countries. I hope that it will be possible to make real progress on this before the next meeting of the Committee. Of course we will only succeed in doing so, if all participants are prepared to discuss a realistic IDA 7 total. The United Kingdom has demonstrated in the past the importance which we attach to IDA: and it is undiminished. But, as a true friend

/of IDA, I do

of IDA, I do warn that this Committee would do it a disservice if we were to raise expectations about IDA 7 which we are subsequently unable to deliver.

WORLD ECONOMIC PROSPECTS

Against this background, what are the prospects for a recovery of economic activity, world-wide?

There are many voices calling for measures that would, in the comfortable phrase, "stimulate activity" - at almost any cost. It is perhaps particularly tempting - and understandably so - to make

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such a call on behalf of those developing countries, which do not themselves have the capacity to generate the recovery of their economies, and look instead to renewed growth of activity in industrial countries, and so the world as a whole.

But we must be careful not to attempt to solve this year's problems - or indeed last year's - at the expense of the future, and careful too not to disregard the lessons of even the recent past. All too often we have seen governments, afflicted by a fall in economic activity, attempt artificially to stimulate demand, enjoy the fruits for a brief period, but then plunge again into higher levels of inflation and further weakness of activity.

The industrial countries, and so the world, would not benefit from short-lived

/boosts

boosts to expenditure or consumption, unmatched by output: history - not least the history of my own country - shows that this leads only to renewed inflation, which is the enemy of employment. Nor is there any foundation for the idea, occasionally advanced these days, that countries which have been relatively successful in reducing their rates of inflation could help others by expanding their domestic demand in a co-ordinated way: that course too would simply generate more inflation, and so would help no-one, least of all the developing countries. The modest successes that have so far been achieved have been won by policies of sustained well-judged restraint. The policies that have brought us to the verge of recovery need to be further sustained, and not reversed. The opposite argument is remarkably perverse.

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The recovery we all need must be one that can and will be sustained - something more than a flash in the pan. And that means that it cannot and must not be inflationary. I therefore welcome the consensus which developed among certain industrial countries at the Summit meeting in Versailles last year, and has strengthened since, that our countries should concentrate on securing sustainable, non-inflationary growth for the future. I note in passing that convergence on such policies is also the most important part of the recipe for greater exchange rate stability, which would benefit developed and developing countries alike.

I believe that important progress has been made.

First, a growing number of countries have been tackling budget deficit problems effectively. The determination to gain and

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keep control of structural budget deficits is widespread and strong. It is far from easy to translate determination into achievement. But that is what must be done. It is not words but deeds that influence markets and market expectations about inflation and interest rates.

Secondly, where progress has been and is being made in this way, control of monetary growth has been possible. Largely as a result, inflation has fallen steeply among the major countries, so that it now averages about 5%, the lowest rate for a decade.

Thirdly, nominal interest rates have fallen significantly in the United States, the United Kingdom and elsewhere, affording some immediate relief to developing country borrowers on international markets.

/Fourthly,

Fourthly, oil prices have fallen by some 15%, moderating the high earnings of oil-producing countries, but offering on balance a favourable impact on both world inflation and world output.

As a result of all this, the signs of recovery are now there for all to see. They are particularly evident in those countries which have had the greatest success in bringing down rates of inflation and interest rates. So long as favourable prospects for inflation can be maintained, there is now a good prospect of real growth recovering in 1983, and strengthening as the year proceeds and into 1984.

Recovery on the scale likely to be achieved will be modest and gradual. But what matters most is that we now have within our grasp a recovery which could be durable and could gather strength without

/precipitating

precipitating renewed inflation. The one thing that could damage that prospect would be an abandonment or reversal of the very policies of fiscal and monetary restraint that have made it possible.

The consensus on strategy is there. Over the coming weeks and months we must try to develop it and reinforce it over the medium-term. It must be our objective to bring about a mutually reinforcing performance, to go on achieving convergence with lower inflation. That is the road to higher real incomes and wealth; and to lower interest rates, and hence stockbuilding, investment and output. If we can go on making progress inthis way, we shall provide an economic environment for world activity in which the problems of debt, of growing protectionism, and of weak markets for developing countries will be eased, and overcome. I believe we must; and I very much hope we shall.

3 MAY 1983

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Prime Minister 2

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

26 April 1983

Michael Scholar Esq.
10 Downing Street
LONDON
SW1

Dear Michael,

ARGENTINA

The Chancellor had a word with the Prime Minister last week about financial relations with Argentina, and has asked me to let you know that he proposes to raise this matter with Larosiere in Washington later this week. He has discussed it with the Governor, who is of course in touch with Lloyds Bank, and who will similarly be raising it with Macnamar (US Treasury), who has recently returned from a visit to Argentina.

The Argentine agreement with the IMF in January was on the clear understanding that the elimination of discriminatory financial restrictions (notably those preventing the remittance of profits and dividends by UK companies) would be a pre-condition for concluding the mid-term review which is due in May, and for continued access to the Fund facility thereafter. All the evidence suggests that discrimination is continuing. The situation is posing acute difficulties for Lloyds, and no doubt for other British firms as well.

The understanding about removal of discrimination is basic Fund doctrine. Larosiere has made it clear to the Argentine Alternate Director to the IMF that if the restrictions have not been eliminated before then, there will be no May review. This is helpful as far as it goes, but the Chancellor believes it right to remind Larosiere of the importance which we attach to resolution of this problem, and to tell him that, since discrimination is continuing, we assume that there can be no question of any further Argentine drawing on the IMF facility, or any moves in that direction, and that we would vote against continuation of the Fund programme while discrimination persists. The Governor will be speaking to Macnamar in a similar sense.

The Chancellor also has very much in mind the question of reports of possible Argentine purchases of Soviet arms. He recognises that if these reports were to be confirmed, our posture on financial relations would need to be re-assessed. The practical steps that might then prove necessary are under consideration.

I am copying this letter to John Holmes (FCO) and to Tim Allen at the Bank.

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

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Mexico and Central America Department

DS No. 14/83

Prime Minister

A.J.C. 14/7.

MEXICO : WHAT WENT WRONG?

(Her Majesty's Ambassador at Mexico City to the Secretary of State for Foreign and Commonwealth Affairs)

SUMMARY

1. Three years ago Mexico was booming. Foreign banks competed fiercely to lend to a country with huge oil reserves, a large and growing industrial base and political stability. By 1982 the country was effectively bankrupt. The collapse of confidence and of the currency which occurred in 1976 was repeated, only more severely. (Paragraphs 1 – 2).

2. External factors played a part: high interest rates in the United States, the fall in price of oil and other export commodities, and the drying up of external credit. But it was the Government's policies which made the economy vulnerable. President Lopez Portillo wanted to be popular with all and did not take difficult but necessary decisions. (Paragraphs 3 – 4).

3. The Government's failure lay in four critical areas: it believed that the development of Mexico's massive oil resources had eliminated the balance of payments as a constraint on growth, and it failed to react in time to the down-turn in the market (paragraphs 5 – 6); in the cause of currency stability it allowed the peso to become greatly over-valued (paragraphs 7 – 8); in the cause of social justice it allowed an explosive growth in the cost of subsidies, and of the public sector deficit, while corruption reached unprecedented proportions (paragraphs 9 –10); above all it tried to tackle inflation by increasing production and jobs, long after the signs of overheating had become apparent (paragraphs 11 – 12).

4. Although a prominent member of the previous Administration, President de la Madrid has condemned past errors and seems genuinely bent on a new course which with IMF support would rid the economy of the deep ills which still afflict it. It remains to be seen if he has the political qualities to carry his good intentions into effect. (Paragraph 13).

Mexico City

18 April 1983

Sir,

1. Three years ago the Mexican economy was booming. Foreign banks were competing fiercely to provide loans and credits with ever more favourable spreads. Among all the countries of the world in need of capital, Mexico combined three characteristics which made it seem a uniquely desirable and secure borrower: huge oil reserves; a substantial and rapidly growing industrial base with a large and growing domestic market; and a tradition of political stability. In my despatch of

13 July 1982 I chronicled President Lopez Portillo's rake's progress towards massive foreign debt and huge public sector deficit. Now Mexico is effectively bankrupt, the economy is showing negative growth, and inflation has trebled. What went wrong?

2. In recent years the Mexican economy has shown a cyclical progression. The 1976 crisis was a comparatively mild pre-run of the present crisis. Then also government overspending led to a collapse of confidence and the currency, capital flight, and an appeal for rescue to the IMF. With this example before its eyes, the government might have been expected to avoid the same mistakes. In fact it failed to do so, and when disaster fell in 1982, disclaimed all responsibility.

3. Of course there were external factors which the Government could not have predicted: high interest rates in the United States, the fall in the price of oil and other export commodities (which are estimated to have cost Mexico US $10 billion in lost earnings in 1981), and the drying up of external credit. But it was the Government's policies which made the economy so vulnerable to external factors, and which proved so hard to change when the crisis broke. In October 1982 President-elect Miguel de la Madrid spoke unfamiliar truth when he said that Mexico's difficulties were due to excessive growth and decapitalisation brought about by internal as well as external factors.

4. Perhaps the key was the character of President Lopez Portillo. A man of charm who liked to be popular with all, he hoped to transform Mexican society without offending anyone. In his first year of office he was given contradictory advice by his Ministers of Finance and Planning. The first, Lic. Moctezuma Cid, was an orthodox classical economist who favoured cautious growth, control of inflation, flexible exchange rates, free movement of capital, less protection. The second, Lic. Carlos Tello, was a nationalist and dirigist in his views, and advocated high growth, fixed exchange rates, exchange controls, more protection and higher taxes. Each policy was consistent within itself, but the two could not be combined. President Lopez Portillo eventually dismissed both Ministers. He took the more popular options from both packages and rejected the difficult ones. For 3½ years the increase in oil revenues helped to obscure his Administration's failures in four critical areas: growing dependence on oil revenues, over-valuation of the currency, distortions caused by subsidies and corruption, and over all inflation.

5. On oil revenues, the Government knew, and Ministers seldom tired of saying, especially in the period before 1980, that Mexico must avoid becoming dependent on overseas revenue from this source. There was constant talk of the need for limits and ceilings for both production and exports. The queue of foreign governments pleading for more Mexican oil grew longer. At this time the unspoken but confident assumption was that if the balance of payments unexpectedly took a turn for the worse, the problem could always be overcome by turning on the oil tap. Many foreign bankers shared this assumption. Between 1979 and 1980 growing oil revenues caused improvement in many of the indicators commonly used to give warnings of balance of payments difficulties. Debt service payments fell from US $10.3 to US $7.7 billion; exports as a proportion of the official foreign debt grew from 28% to 43%; the debt service ratio fell from 67% to 33%; and the external public debt as a percentage of GDP declined from 22.1% to 18.5%.

6. When in the summer of 1981 the oil market suddenly turned soft, there were divided views within the government of how to react. The head of Pemex at the time, a self-made millionaire, favoured an aggressive marketing policy: he wanted to lower prices by whatever amount was needed to maintain the necessary volume of exports to achieve the desired revenues. But his colleagues in the government condemned this policy as disloyal to OPEC and unnecessarily submissive to pressures from the industrialised countries. He was overruled and disgraced. The President lent his prestige to the view that the market weakness would be short-lived, that Mexico should not damage its Third World credentials by under-cutting OPEC producers, and that the country's high credit

rating would enable it to increase borrowing to offset the short-fall in export income. The outcome was the worst of both worlds for Mexico. Pemex lost clients, and forfeited export revenue in trying to maintain high prices against the market. Within two months it was forced to reduce prices after all. From then on the self-imposed ceilings on production and exports became embarrassingly difficult to achieve. The shortfall was made up by foreign borrowing, much of it short term. As the general terms of trade for Mexico worsened, oil constituted an ever increasing proportion of export revenues. Earlier talk about the importance of avoiding the mistakes of Iran and Venezuela seemed ironically prophetic as the country slid deeper into oil dependence.

7. The next factor was overvaluation of the Mexican peso. The forced devaluation of 1976, after a long period of currency stability, had been a traumatic event for the Mexicans, who were used to assessing the value of things in dollars rather than in their own currency. President Lopez Portillo wanted to heal the wound. In theory the peso floated after 1976, but apart from a 10% drop in one day in 1977, it was in practice fixed. Ministers argued that control was necessary to restore internal and external confidence. Any devaluation would, they argued, increase the burden of servicing Mexico's foreign debt without in practice giving much help to exporters, as the booming internal market left little surplus capacity for exports. But the adverse impact on non-oil exports and tourism became more and more apparent. Given the degree of dependence of the Mexican on the US economy and the difference in inflation rates between the two countries, it was obvious that the fixed rate could not last much longer.

8. In late 1980 the Government at last changed course, and began a controlled downward movement of the peso. But as the rate of devaluation was less than the inflation differential, the peso continued to become more rather than less over-valued. The Government feared that speeding up the rate of devaluation would make people believe that a headlong slide was imminent and thereby precipitate a flight of capital. Again the outcome was that Mexico got the worst of both worlds. It exhausted its reserves in a prolonged but vain attempt to prop up the currency, giving plenty of time for small savers as well as speculators to move their capital out of the country, only to have the currency collapse at a most inopportune and damaging moment. President Lopez Portillo's famous phrase, the source of endless merriment, was that he would fight like a dog to defend the peso. He now lives in a house on what is known to all as the Cerro del Perro, the Hill of the Dog.

9. From 1976 onwards subsidies were an integral part of the Government's management of the economy. It is easy to see why. Mexico is a country with great inequality in the distribution of resources. Despite 60 years of government by a revolutionary party supposedly representing workers and peasants, contrasts of wealth and poverty are still enormous. Although the poor are used to their poverty, and have a tradition of stoic fatalism, the oil boom inevitably generated rising expectations. Every few weeks in the first years of the Lopez Portillo administration, there was fresh news of oil discoveries in Mexico, of rising prices in the international market, and of soaring export revenues. Everyone hoped to benefit from this sudden turn in the country's fortunes: but only some did. The private sector of industry mostly flourished. Officialdom, at federal, state and local level, benefitted more than was healthy: corruption, which is endemic in Mexico, reached unprecedented proportions as businessmen became used to giving, and officials to receiving, ever more lavish gifts for favours received or expected. But the peasants scraping a living from semi-barren land the slum-dwellers with no fixed employment benefitted scarcely at all.

10. In such circumstances the price of social stability was a system of subsidies designed to give the poor a share in the benefits of the new wealth and limit the worst effects of inflation through control of the prices of basic goods and services. The cost of this policy grew explosively during President Lopez Portillo's administration, reaching 15% of GDP in 1982: this was perhaps the main contributing factor to the growth of the public sector deficit which that year reached about 16% of

GDP. Naturally the Government took fright, but its eventual efforts to cut the cost made a bad situation worse: such efforts usually consisted of holding down the price paid to producers rather than raising the price to consumers. In this way certain vital economic activities, in particular agriculture, became unprofitable. The country's sugar refining industry was ruined. Dairy farms were abandoned. The pharmaceutical industry got into deep difficulties. Companies were forced to raise prices on other products to reduce losses on those that were controlled. The Government found itself obliged to import sugar, milk, eggs and other essential products at vast cost in cash and foreign exchange. It also held down the price of petrol, which was unchanged from 1974 to 1981. With the cheapest petrol in the world, Mexico became one of the most wasteful countries in terms of energy consumption.

11. Lastly I come to inflation. An influential group of Ministers in the Lopez Portillo Administration believed that in Mexico's case inflation reflected an imbalance between supply and demand, and that it could only be reduced by increasing supply, not by restraining demand. Such Ministers did not accept, even in 1981, that the economy had become over-heated. In this they received support from economists at Cambridge University where some had studied and with whom they had maintained contact. A Cambridge study in late 1981 concluded that "the planned rate of growth is not too high relative to the country's productive capacity and consequently it is not generating inflation".

12. Not all Ministers took this view. Lic de la Madrid, then Minister of Planning and a typical representative of the conservative financial establishment, was expressing concern as early as 1979 at the size of the budget deficit and at the inflationary impact of maintaining a growth rate of 8% at a time of world recession. But in the critical discussions in the cabinet the expansionists usually won the argument. President Lopez Portillo wanted to go down in history as the man who created 5 million jobs to match the relentless growth in the population (still running at over 2½% a year). He could not resist the arguments of those who said that the only alternative to his policies would bring recession and unemployment. In the end he had both, with inflation of about 100%.

13. President de la Madrid is well aware of the mistakes which led to Mexico's present plight. Although he was a prominent member of the Lopez Portillo Administration (a fact which he will not be allowed to forget), his inaugural speech on 1 December 1982 was in effect an indictment of the errors and follies of the previous six years. His own policies are designed to set the country on a new course, and with IMF support to rid the economy of the deep ills which still afflict it. As I have already reported, there is no doubt of his good intentions. But he has yet to show whether he has the political qualities and strength to carry them into effect.

14. I am sending copies of this despatch to HM Representatives at Washington, Brasilia, Caracas, Bogota, UKRep Brussels and UKDel IMF/IBRD, and to HM Treasury, the Department of Trade, Export Credits Guarantee Department and the Bank of England.

I am, Sir

Yours faithfully

Crispin Tickell

cc Mr. Coles
Mr. Middleton 14/4.

PRIME MINISTER

COMMENTS ON SIR JEREMY MORSE'S LECTURE
AS REPORTED IN THE TIMES OF 13 APRIL

Morse's suggestions are:

1. "There should be a bigger role for official international agencies such as the IMF and World Bank in channelling international capital flows with commerical banks playing a smaller role."

Answer

Since 1960, total international liquidity created by the IMF has increased from £800m SDRs to £50.4 bn in November 1982. Relative to world exports, the international liquidity of the IMF has expanded since 1960 by 4½ times. This expansion of international liquidity has fuelled the world inflation. Countries hit by unfavourable real disturbances could finance temporary deficits by borrowing in international capital markets at a proper opportunity cost. Instead they have tended to increase the world money supply by borrowing at concessionary rates from the IMF.

There is ample evidence that IMF credit availability encourages rescheduling. In fact 14 member countries out of a total of, on average, 114 IMF members accounted more than 80% of the years for which debt was rescheduled. Clearly debt rescheduling is not due to accidental processes. Rescheduling begets further rescheduling for the same debtors. Additional IMF funds would simply encourage yet more rescheduling and fuel more inflation.

This fact, of course, also discredits the argument that IMF conditionality induces countries to "put their house in order". The evidence suggests that it gives rise only to a very temporary adjustment; then the persistent rescheduling countries get back to their old habits and the fund of subsidised lending.

/2. The World Bank

2. "The World Bank should provide guarantees and political risk insurance for some poorer countries."

Answer
This is a distinct possibility that's worth exploring. It is, however, very difficult to define political risks as we all know. I suspect that further investigation would show that it is implausible but it is worth thinking further along these lines.

3. "Further move towards fixed exchange rates."

Answer
I think he chooses exactly the wrong option which is some kind of intervention on EMS lines, to smooth out the little bumps and introduce big ones. I believe our arguments against joining the EMS apply mutatis mutandis to any other system of crawling pegs or semi-fixed exchange rates.

4. "Special drawing rights should be extended to take the place of currency reserves."

Answer
If this is the case then there should be a proper private market in SDRs. In particular it should be possible for non-Government agencies to hold SDRs and to trade in them. His objective is to "bring greater control and management to international liquidity and prevent inflation recurring". But holding reserves in SDRs will certainly not prevent inflation recurring. Indeed, while reserves have been, partially at least, in the form of SDRs, we had the biggest peace-time inflation for centuries.

5. "The IMF, OECD, BIS and World Bank should cooperate more closely."

Answer
I think this is not objectionable, but he does see this as a preparation for forming a new institution to act as a world monetary authority. This would bring "discipline at the core

/of the system"

of the system". There I am distinctly nervous because it suggests an international regulation of world lending and international capital markets.

6. Finally, Morse stressed that his proposals did not mean trying to recreate the Bretton Woods system. But he is very keen on promoting the elements of Bretton Woods that still exist, and wishes to "bring in the Socialist countries as members of the monetary institutions".

Conclusion

I find Morse's arguments, when they are clear, to be often wrong and misplaced. Much of the report, however, is vague and insubstantial. I hope to have a copy of his speech early tomorrow morning and I will report if there is any substantial difference between my conclusions here and those I reach after reviewing his every word.

[Peter Middleton attended the lecture – he confirms my note.]

AW

ALAN WALTERS
13 April 1983

SUBJECT

cc OPS
Master

T. JO NMKS

10 DOWNING STREET

THE PRIME MINISTER

30 March 1983

PRIME MINISTER'S
PERSONAL MESSAGE
SERIAL No. T43/83

Dear Rob.

I was interested to read your address to the European Management Forum Symposium at Davos which you kindly sent me on 4 March.

In my letter of 1 December, I described my own approach to the issues which you have rightly identified for public debate.

I would like to add one general comment to what I said then. I think you may understate the progress that the international community has made.

There are signs that the inflationary habits of the 1970s are being broken. Interest rates have come down. This will, most of us believe, provide room for greater real growth of activity. And lower oil prices should reinforce the prospect of economic recovery.

The Interim Committee meeting in Washington in February also made solid progress. The GAB and Quota decisions were judged by the Managing Director to have effectively doubled IMF resources in terms of usable currencies. The decision

/to implement

to implement those increases quickly directly responds to one concern you expressed at Davos. The new initiatives taken by the IMF to encourage commercial banks to play a continuing part in the adjustment programmes of debtor countries is relevant to another. Of course more needs to be done, and this is perhaps particularly true in the trade field, where the current problems are, I agree, inseparable from payments issues. But we have taken some real steps forward, and I think they go beyond what you have called "band aid" solutions!

Warm regards

Yours sincerely

Margaret Thatcher

The Right Honourable R.D. Muldoon, C.H., M.P.

Econ Pol

Indebtedness

Pt 2

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Prime Minister

The summary of this report is at Flag A.

Agree, if colleagues do not dissent, to publication?

MCS 30/3

SECRETARY OF STATE FOR TRADE

ECONOMISTS' REPORT ON SUPPORT FOR CAPITAL GOODS FOR EXPORT

Since my minute of 13 December, with which I forwarded to the Prime Minister the agreed interdepartmental economists' report, we have had some useful exchanges on the arguments for and against export credit subsidies. In parallel, our officials have cooperated in working out new operating guidelines for ECGD, which I have now sent to the Prime Minister with my minute of 28 March. – with MCS?

2. These guidelines reflect a good deal of the thinking, and some of the specific suggestions, in the economists' report. The issue is an important one, and the existence of the report is already widely-known from slanted press reports. I believe that discussion between Government and industry would benefit from full exposure of the arguments. It can only be a matter of time before we are required to make the report available, eg to a Select Committee or to the committee of enquiry which you are proposing to set up into ECGD's future status. I think that we would do better to take the initiative, and publish it now. I hope you agree.

3. I do not envisage our giving the report any special publicity. It would be sufficient to lay a copy in the

/House of Commons

House of Commons Library and announce that fact in a written PQ. Obviously the announcement would need to make clear that the report was simply a background paper; we could also add such a disclaimer to all published copies.

5. I also think that it would be best not to publish paragraph 31 of the report, which is the only part of the report which contains policy recommendations. Without this paragraph the paper is a background to policy rather than advice to Ministers. Since it contains some calculations relating to particular projects, you may feel that it would also be right to remove Annex 1, or at least such information in it as would enable specific projects to be identified. I would welcome your advice on that.

4. Copies of this minute go to the Prime Minister, Patrick Jenkin, Francis Pym, and Sir Robert Armstrong.

G.H.
29 March 1983

Trade, Non-Tariff Barriers, Pt 3

RESTRICTED

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

28 March 1983

A J Coles Esq
10 Downing Street
LONDON SW1

Type letter pl.

A.J.C. 28/3.

Dear John.

MR MULDOON AGAIN

With your letter of 14 March you enclosed a further letter Mr Muldoon had sent to the Prime Minister about the case for a new Bretton Woods Conference.

Mr Muldoon enclosed this time a copy of his address to the European Management Forum Symposium at Davos. His covering letter suggests that recent pronouncements by Donald Regan, George Shultz and Helmut Schmidt indicate sympathy with the Muldoon approach.

... A summary of the Davos speech is attached. It is essentially the same as the speech Mr Muldoon gave at Suva last autumn and sent to the Prime Minister. We know from Peter Marshall that the Prime Minister last time sent a long reply - perhaps based on the draft I sent you on 29 November - and that it was greatly appreciated. But a shorter, rather cooler reply, drawing attention to the progress being made by the international community, may be appropriate this time, given that the ideas Mr Muldoon advances have hardly changed.

Part 1

... A draft on those lines is attached.

Yours ever,

John Kerr.

J O KERR

RESTRICTED

DAVOS SYMPOSIUM: ADDRESS BY MR MULDOON

General

Need for new Bretton Woods Conference to develop a co-ordinated set of policies to govern international trade and payments. Financial dislocation and protectionism feed on each other.

Historic background

Collapse of Bretton Woods system compounded by first oil shock. Subsequent high inflation and interest rates, unemployment, volatile exchange rates. Ad hoc international response. Recycling masked inadequate adjustment. Growth of debt burden.

Payments: current indications of strain

14 reschedulings sought in 1981: 40 countries 'in trouble' in 1982. In some cases debt service exceeds total exports. Over exposure of private banks. Attempts by banks to cut back aggravates problem.

Payments: solutions

Closer liaison between commercial banks and IMF.
Doubling of IMF quotas implemented quickly.
Long term bond issue, guaranteed by international agency, to relieve position of chronic debtors.
Easier Fund conditionality.
Symmetrical Fund Surveillance.
New decision making Council.
Substitution Account.
Increased aid flows.
SDR Aid Link.

Trade: current problems

GATT founded to deal with tariffs: but
Growth of NTBs ('600 different types').
50% of trade 'managed'.
Exchange fluctuations make nonsense of tariffs.
Trade restrictions abort past investment.

Trade: solutions

Major countries now emphasising need for 'co-ordinated expansionary policies'.
New opportunity needed for developing countries to trade their way out of difficulty.
This essential also for economic welfare of industrial countries (one third of whose manufacture exports go to developing countries).

Conclusions

Need for broad-based reappraisal. Summits can agree on analysis but are deficient on action. Operations of post war institutions have unravelled tight connections between trade and payments: must be put together again.

DRAFT LETTER FROM THE PRIME MINISTER

TO: THE RT HON R D MULDOON CH

I was interested to read your address to the European Management Forum Symposium at Davos which you kindly sent me on 14 March.

In my letter of 1 December, I described my own approach to the issues which you have rightly identified for public debate.

I would like to add one general comment to what I said then. I think you may understate the progress that the international community has made.

There are signs that the inflationary habits of the 1970s are being broken. Interest rates have come down. This will, most of us believe, provide room for greater real growth of activity. And lower oil prices should reinforce the prospect of economic recovery.

The Interim Committee meeting in Washington in February also made solid progress. The GAB and Quota decisions were judged by the Managing Director to have effectively doubled IMF resources in terms of usable currencies. The decision to implement those increases quickly directly responds to one concern you expressed at Davos. The new initiatives taken by the IMF to encourage commercial banks to play a continuing part in the adjustment programmes of debtor countries is relevant to another.
Of course more needs to be done, and this is perhaps particularly true in the trade field, where the current problems are, I agree, inseparable from payments issues. But we have taken some real steps forward, and I think they go beyond what you have called "band aid" solutions!

AR 25/3.

Econ Pol Indebtedness

Pt 2

Econ Pol
Debts

VCC AW 2

Prime Minister

MCS 25/3

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Michael Scholar, Esq
No 10 Downing Street
Whitehall
LONDON SW1

23 March 1983

Dear Michael,

INTERNATIONAL FINANCIAL SCENE

The Chancellor has asked me to send you the enclosed further assessment by the Bank of England of the international financial scene. Attached to it is a table showing the total indebtedness of the countries concerned in Latin America and Eastern Europe, and the exposure of British banks and ECGD to these countries. As you suggested in your letter of 1 February, I am not including detailed annexes on particular countries.

As you will see, the Bank's note was prepared before the recent OPEC agreement on oil prices and production quotas. If the price remains near its new level the fall could prove helpful to oil importing countries while not sufficient seriously to undermine the situation for those of the main problem countries that are oil exporters.

The Chancellor has asked me to draw your attention to the following points which arise from the attached assessment:-

a. On the two largest debtors - Mexico and Brazil - the speedy preparation of the large and complex financial assistance packages has been impressive and encouraging. But it would be premature to conclude that we are yet out of the wood on these countries. There is a real possibility that one or both could require further funding later this year.

b. There are emerging problems in a number of other South American countries - Venezuela, Chile, Ecuador, Uruguay and Peru - which individually are not large debtors but in aggregate involve debts of the order of Brazil or Mexico. One

/disturbing feature

disturbing feature is that all but one of those countries are oil producers. In the case of Venezuela, there is a danger of defaults arising from the administrative incompetence of the authorities there. However, it is encouraging that in most of these countries the IMF is continuing to give a positive lead to the commercial banks, which have had to bear the brunt of the rescue packages, by making support conditional on the banks providing a specified level of new money. This should help counter the defensive behaviour of the banks referred to in paragraph 4 of the report.

c. The banks' experiences in Latin America and Eastern Europe could have implications for their attitude to countries in South East Asia like Indonesia and South Korea. We propose to examine this in our next report.

d. The continuing stalemate on the rescheduling of Poland's officially guaranteed debts is most unsatisfactory. While the Americans are said to be reviewing their policy towards Poland, there are no signs yet of a change in their position on rescheduling. But there is now agreement within the EC on a more positive line, and this will be followed up when the matter is discussed again in Paris next month.

e. We shall be keeping a careful eye on the progress of proposals that have been put before the US Congress to place new restrictions on international lending by US banks. We understand that these proposals are not at present supported by the Administration, and that, as currently drafted, their imposition would be at the discretion of the Fed.

Two of the remits from the February Interim Committee to the Fund's Executive Board (access limits, SDR allocations) could have a bearing on some of these issues.

Copies of this letter, and the report, go to Brian Fall (FCO) and John Rhodes (DOT), and Tim Allen (Bank of England).

Yours ever

John Kerr

J O KERR

INTERNATIONAL FINANCIAL SCENE

1. Main developments since January

Developments since the end of January incorporate a mixture of good and bad, but on balance progress has been made. On the positive side, signatures have been put to medium-term loans for Mexico ($5 bn) and Brazil ($4.4 bn) and to a rescheduling agreement for the latter. Increased resources have been agreed for the IMF which has continued to take a firm lead in rescue operations for other countries in difficulty. Further official assistance has been provided recently by the US Treasury (to Brazil and Peru) and the Commodity Credit Corporation (to Mexico).

On the other side, Brazil is still experiencing liquidity problems and the number of problem countries encountering difficulties has increased as a result of the drying-up of credit facilities in the international market. Discussions with banking advisory groups about rescheduling 1983 maturities and the provision of new money have been set in train for Chile, Uruguay and Peru, while Venezuela's seeming paralysis of will gives increasing concern. Looking ahead, and notwithstanding some encouraging indicators in the United States, prospects of only a gradual world economic recovery on the one hand and uncertainties in the oil market on the other (which could also affect smaller banks in the United States) suggest that the existing financial arrangements put in place for Brazil and Mexico (to take the two largest problem countries) may require some reinforcement.

2. Latin America

The Brazilian projects for new money and rescheduling have been signed with the banks and the first drawings have been made on the loan and also under the IMF agreement, which came into effect on 28 February. Full restoration of short-term banking facilities has not been achieved, however, and Brazil continues to suffer acute liquidity difficulties and is incurring arrears on payments due. Poor trade performance in January and February and concern about the exchange rate forced a major devaluation last month whose effects have yet to feed through. The US Treasury have accordingly given additional short-term assistance, the banks have deferred half ($1.1 bn) of the repayment of their bridging loan and Brazil is asking the BIS for further short-term help. Even if these immediate liquidity problems can be managed, the months ahead are likely to be difficult and a Brazilian request for further finance later in the year seems probable. A major step forward for Mexico was the signing of the medium-term loan on 3 March. Creditors are now absorbing Mexico's complicated proposals for rescheduling maturities due up to end-1984. Though the package for Mexico is the most firmly bedded-down of those that are in train, the adjustment effort required will be harder to achieve if the OPEC market price should fall further.

Like Brazil, Mexico could well need more assistance before the end of 1983. Argentina is moving slowly towards agreement on its medium-term loan and rescheduling needs. Successful outcome there depends mainly on the political will of those in power, although there are also some administrative and technical problems still to be overcome. Elsewhere in Latin America, the number of countries in difficulties is increasing as a result of the drying up of credit. Chile, Ecuador, Uruguay and Peru are in various stages of talks with advisory groups of banks and the IMF. The arrangements for Peru, the most recent, have got off to a good start with a sensible, diplomatic presentation of the country's proposals to creditor banks carrying the backing of the IMF and other international financial organisations. By contrast, Venezuela gives increasing cause for concern as the authorities fail to get to grips with a fast-deteriorating debt servicing problem brought about largely by administrative incompetence. There is the danger that creditor banks will lose patience and be unresponsive to requests to assist with Venezuela's needs. This country presents the greatest danger of falling into widespread default.

3. Eastern Europe

Progress towards a restructuring package for Yugoslavia continues; the elements provided by governments and international institutions are now largely agreed, and the banks made further progress at a meeting in London last week. It may, however, be necessary to extend the temporary moratorium on debt repayments which expires on 31 March. The Poles have been procrastinating over discussions with bank creditors following changes in their negotiating team which may reflect a changing stance towards their debt. When they meet the banks (now planned for 21 March) they are likely to press for even greater relief over a much longer time-scale than in previous agreements. The GDR and Hungary are managing with a struggle to meet their commitments, but eventual reschedulings cannot be excluded. On the other hand, Romania has reached agreement in principle with a Steering Group of banks for rescheduling its 1983 maturities (it can afford slightly more repayments than in 1982) and has made overtures to the Paris Club for parallel relief.

4. Changing attitudes of banks and borrowers

In the aftermath of the major rescue packages, the international banks seem to be bracing themselves for a succession of much smaller, but similarly structured, packages for the countries mentioned in 2. This is leading to defensive behaviour by the banks and counter-defensive behaviour by the borrowers. It is preventing a return to a more normal relationship between the lending banks and the sovereign borrowers or the overseas agencies of the banks from these countries. This is a less favourable outcome than we had originally hoped, reflecting the doubts about the longer-term adequacy of the packages for Brazil and Mexico, but also the sheer time and effort needed to complete the negotiations. The defensive behaviour by the banks consists mainly of seeking to cut their exposure to countries likely to face a debt crisis soon, and a growing reluctance to commit new loans to so far creditworthy countries like Colombia, Indonesia and South Korea; the result is a rise in the margin needed to obtain full subscriptions to new Euro-market credits. The counter-defence of some borrowers, such as Chile and Uruguay, has been to freeze repayment of short-term debts ad interim. This seems to be a cat-and-mouse game as the Mexican and Brazilian precedents show that the exposure of each bank at some benchmark date is used to calculate "fair shares" of rescue packages. Naturally, the banks seek to reduce their level in advance of that, which can lead first to the threat of a liquidity crisis for the borrower and then to a refusal to allow any further outflows until new agreements can be reached.

5. Conclusions

The resilience of the international financial system has been further tested since January. A mechanism has evolved, particularly for Latin America debtor countries, with the IMF taking a strong lead in forging interdependence between its own facilities and programmes and the provision of assistance by the commercial banks. For their part, albeit with the change in attitude noted in paragraph 4 above, the commercial banks have shown themselves able to respond within days to the call to form suitable advisory groups for new countries joining the rescue queue. With support from central banks and governments implied if not always necessarily openly voiced, greater confidence in the system on the part of the banks has probably been felt.

Looking ahead in 1983, the international financial system is likely to have to face up to further challenges: the possibility of a continued increase in the number of countries needing help; conceivably, the spread of the problem (eg to Asia) whether because of the withdrawal of short-term funds or more fundamental economic causes; the risk that Argentina, Brazil or Mexico may not meet the targets set in IMF programmes or, by contrast, in the case of Yugoslavia, that the programme may not be adequate to deal with the problems faced by the country; and the growing likelihood that, for different reasons, Brazil and Mexico at least will return for more money.

The climate of uncertainty is increased by legislative proposals currently before the US Congress to apply limits to and/or restrictions on the price charged for international lending by American banks. Though the sponsors of this legislation are well aware of the acute problems of many debtor countries and their effect on the international financial system, there is always some risk that Congress as a whole will be less sensitive. It may therefore be that restrictions of this type could make it more difficult for the authorities and the banks together to manage the slowdown in lending to the developing countries in an orderly way - which has so far been one of the main aims of the rescue packages.

Whilst, therefore, a pragmatic response in the last eight months has so far successfully coped with three of the largest debtors in the Western world, it cannot be asserted with certainty that the worst is now behind the system and that the formula that has so far stood the test will continue to work smoothly for the increasing number of countries that are indenting for assistance, even though each on its own is less heavily indebted in absolute terms, and notwithstanding the successful outcome of last month's Interim Committee meeting.

Bank of England

March 1983

INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt	British banks unguaranteed claims	ECGD amounts at risk*
Latin America			
Argentina	39	2.4	0.4
Brazil	81	3.7	1.8
Chile	18	1.0	0.06
Ecuador	6	0.5	0.1
Mexico	83	5.3	1.7
Peru	12	0.4	0.1
Uruguay	4	0.3	0.01
Venezuela	30	2.3	0.09
Eastern Europe			
East Germany	16	0.9	0.2
Hungary	7	0.5	0.06
Poland	25	0.5	1.3
Romania	11	0.4	0.6
Yugoslavia	20	0.9	1.2

* Because of differences in definition the ECGD exposure figures in the final column are not directly comparable with the figures in the other two columns.

Jre VC

10 DOWNING STREET

From the Private Secretary 14 March 1983

International Financial Situation

With your letter of 29 November, you enclosed a draft letter for the Prime Minister to send to Mr. Muldoon in response to his letter of 22 October.

I now enclose a copy of a further letter which Mr. Muldoon has sent to the Prime Minister (and which he has also copied to the Chancellor of the Exchequer). I should be grateful if you could let me have a draft reply for signature by the Prime Minister in due course.

LBF 1

A.J.C

John Kerr, Esq.,
H.M. Treasury.

SUBJECT

CF - pps

cc Master Ops

PRIME MINISTER'S
PERSONAL MESSAGE
SERIAL No. T25C/83

Prime Minister
Wellington
New Zealand

4 March 1983

R12

The Right Hon. Margaret Thatcher MP
Prime Minister
10 Downing Street
London SW1
ENGLAND

Dear Margaret,

Since our correspondence late last year concerning my proposals for a comprehensive examination of the trade and payments system, there has been a good deal of public debate on the question. A growing number of voices, and not just within the developing world, are now making very similar proposals. We have already seen the United States Secretary of the Treasury, Mr Regan, suggest that there was a need to lay the groundwork for an international meeting on trade and payments - only to withdraw it quickly when, as I see it, it became apparent he was rather too far in front of the consensus in the United States. I have been gratified that George Schultz seems to recognise that the improvement of the world economy is of overriding importance to US foreign policy objectives. Helmut Schmidt's recent essay in the Economist covers very similar ground to my proposals.

While remedial steps are taken to deal with immediate problems - the recent decisions on Fund quotas and the General Arrangement on Borrowing come into that category - this debate on the longer term issue of how we might build on the existing trade and payments institutions will continue. I expect it to figure very prominently in the forthcoming calendar of international economic meetings.

As part of that process of debate I am circulating to selected political leaders copies of my latest address on the subject. This was the address I gave in January to the European Management Forum symposium held each year in Davos, Switzerland. A copy is attached, for your information.

...2.

I am taking the liberty of sending a copy to your colleague, Sir Geoffrey Howe, who, as Chairman of the Interim Committee, will play a key role in these matters.

With kind regards

Yours sincerely

Address by

Right Hon. R. D. Muldoon, C. H.

Prime Minister of New Zealand

to

European Management Forum

Davos, Switzerland, 27 January 1983

The Right Hon. Robert David Muldoon was born in Auckland, New Zealand, on 25 September 1921. He entered Parliament in 1960 and was Minister of Finance from 1967 to 1973. He has been Prime Minister and Minister of Finance since 1976.

As Minister of Finance, Mr Muldoon is a Governor of the Asian Development Bank (1969–1972 and 1976 on) and Governor for New Zealand of the International Monetary Fund (1967–72 and since 1976). He was chairman of the joint boards of governors of the I.M.F. and the World Bank for the 12 months ended October 1979. He was also chairman of the 1982 OECD Council of Ministers.

Address to European Management Forum

Davos, Switzerland, 27 January 1983

When I accepted an invitation to address this symposium, the first thought that occurred to me was that my audience would be composed overwhelmingly of practical people. People who rise to the most senior positions in government, business and the major international economic institutions tend to develop a keen sense of the possible.

I was also conscious of the fact that some 50 years ago Keynes had observed that practical men believe themselves to be exempt from any guiding ideas or intellectual influences.

Here is the conundrum. The proposition I wish to put before you practical people is very much an idea. It is an idea I have developed over a period of several years but crystallised into a set of proposals over the last six months or so. Put in its simplest terms the proposition is this: the gravity of the problems we now face requires us, as a world community, to sit down, as we did at Bretton Woods in 1944, and develop a co-ordinated set of policies to govern international trade and payments for the rest of this decade and beyond. We have a clear choice: we can either begin to search now for comprehensive solutions to the problems caused by the collapse of the Bretton Woods system or wait for the situation to deteriorate further when we would be forced to do so but in much less propitious circumstances.

I am taking the unusual step of presenting my conclusion before I present my analysis. I am doing this because my experience from various Commonwealth meetings has been that few people have queried the analysis, but there is a tendency to misinterpret the conclusion. One group of countries, and within the Commonwealth context they would form the large majority, enthusiastically support the proposals—in part, I suspect, because they see them contributing to their objectives in the North-South dialogue. The other group of countries, which has fought hard to keep international financial issues off the agenda for Global Negotiations, is inclined to see any critique of the existing framework for international trade and payments as dangerous in itself. No matter that the problems are so great as to threaten to overwhelm that system. Better the devil you know would be a reasonable summation of their attitudes.

The reaction to recent comments of Donald Regan on these same issues is a case in point. You will recall that the US Treasury Secretary on 6 December reached the conclusion that there was an urgent need to go beyond the ad hoc approaches of recent years and to start thinking about a concerted approach to the interconnected problems of protectionism, disinflation and debt. He referred to the need to lay the groundwork for some type of international meeting to examine these issues whereas I have used the shorthand of 'another Bretton Woods', simply to fix the scale of the task in people's minds. Yet within a matter of days of Mr Regan's comments, the usual levelling out process had begun. Mr Regan, we were informed, was voicing his personal views. Mr Regan was not, we were assured, calling for another Bretton Woods. Mr Regan was not briefed to say this, and so on. You will of course appreciate that it always causes the utmost surprise and consternation to advisers when a Minister demonstrates he is capable of forming an independent conclusion.

What I hope you will conclude from my analysis is that in calling for changes to international financing arrangements I am not attacking the International Monetary Fund and its sister bodies. I am urging that their role be strengthened. In calling for increased aid flows I am not undermining the pre-eminent importance of sound domestic economic management. I am suggesting that there are a number of serious deficiencies in the way in which we are currently trying to patch over the twin problems of growing financial disorder and growing protectionism. I believe that if we do not find some means of tackling these issues, the economic, political and indeed strategic consequences for the West will be most serious.

It will be a matter for historians to trace the background to our current difficulties. For practical purposes we could say they began with the collapse of the Bretton Woods system in the early 1970s and were compounded by the first oil shock. For some ten years since then we have faced such things as high and differential rates of inflation, massive unemployment, excessive interest rates,

financial crises and volatile movements in exchange rates that cannot be fully explained by differences in relative costs or trading performance.

The international community has responded in a fitful and ad hoc fashion, but always with supreme, although unjustified optimism for the future. The total situation has in fact continued to deteriorate. In 1972 I was present at an inaugural meeting of the Committee of Twenty which was set up to devise new rules to put in place of the rules for international monetary co-operation that were agreed at Bretton Woods. I was then, also, an optimist. The Committee of Twenty lasted for rather less than two years at which time the first of the oil shocks hit.

The response of the Committee of Twenty was to change its name. It then became known as the Interim Committee. Since then the Interim Committee has been largely concerned with short-term policy matters affecting the IMF. I am not belittling the progress made in establishing new financing facilities but merely questioning whether this was commensurate with the scale and nature of the long term financial problems emerging in the marketplace.

In the marketplace the immediate problem was to recycle funds to the deficit countries. In some respects, the recycling process was extremely successful. Certainly it achieved its main objective of avoiding default. Until very recently, few countries found it difficult to raise from the private capital markets the vast sums required.

In too many cases, however, the very ease of raising funds has masked the adjustment process. The money was lent by the private banks with very little thought or with excessive optimism as to the capacity of the countries to pay it back. Quantity, not quality, was the hallmark of those financial operations over the last 8–10 years.

As far back as 1976 at the annual meetings of the IMF and World Bank, I was arguing that the problems of the deficit countries were growing problems that would inevitably worsen and ultimately threaten the stability of the world economy. What has been overlooked has been that each year's deficits have been added on to the accumulated deficits of all the previous years. From 1973 to 1981 the longterm debt of less developed countries grew at an annual average rate of 20 percent. The net result, of course, has been that the debt service ratios of these countries has deteriorated year by year to the point where for many of them the position is unmanageable.

Where do we stand now? The aggregate picture is disturbing enough in itself. However, the aggregated statistics do not tell the whole story. Some countries have done well, but others are much worse than the average. In 1981, fourteen sovereign countries sought reschedulings of their external debt, in spite of the implications of their longterm reputations as borrowers. By 1982, some forty countries were in trouble and a considerable number of countries were facing the ludricous position whereby total debt service payments—that is, interest payments plus all debt falling due in that year—exceeded their entire earnings from the export of goods and services. The better-placed deficit countries with reasonable debt service ratios—such as New Zealand—may well benefit from this because they will tend to look more attractive to lenders. Where, however, does this leave the countries in real difficulties, and those who have lent them vast sums of money?

From all this, we can deduce one salient fact: these countries are facing longterm structural balance of payments difficulties quite different from the cyclical difficulties envisaged by the founders of the International Monetary Fund. Some of them will trade their way out of this only in the very long term, if ever. All of them will require medium to longterm financing arrangements.

This is something which the existing structure of capital flows is not well equipped to handle. Consider its components: private capital flows, official capital flows at market or near market rates, and aid flows.

The private banking system as a whole is seriously over-exposed. The nine biggest banks in the United States have lent the equivalent of 40 percent of their capital and reserves to one country alone—namely Mexico. The tendency, of course, is now for the smaller banks to seek to get their money out as loans fall due, leaving major banks to handle the burden. We have the danger of a new kind of bank run—a run of smaller banks on their larger brethren. Large banks in the United States, Canada, Europe and Japan are on the back of a tiger from which it is proving somewhat difficult to dismount.

To the extent that attempts to dismount are made, it will tend to aggravate the difficulties of the deficit countries. The drift to shorter maturities is well-documented. This makes debt management problems doubly difficult and of course leads to increased front-end costs of borrowing. International lending, especially to developing countries, has slowed down. Private banks have a key role to play now and in the future. What must change, I believe, is the framework within which their commercial operations are conducted. Left to their own devices, the sum of their individual commercial decisions has created considerable problems for the private banks, their central banks and the governments involved. In a recent survey of this problem, Anthony Solomon, President of

the Federal Reserve Bank of New York concluded:

> "The starting point must be close collaboration among the governments and central banks of the major industrial countries. For debt burdened countries it means the willingness to work with the international institutions, especially the IMF. There also needs to be responsible interchange between private sector lenders and the authorities of borrowing countries."

I believe that there must be closer liaison between private sector banks and the Fund, with of course the approval of the borrower. Turning to official flows, or more particularly the rules and policies of the IMF, the first and obvious point to be made is the inadequacy of the resources available to the Fund in terms of the scale of the problem. Obviously, the news that the Group of 10 countries have agreed to support a proposal for a significant increase in quotas is welcome. I would expect that the Interim Committee will decide to increase quotas around 50 percent. Clearly this will help, as will the decision to extend the facilities of the General Arrangement to Borrow to countries other than the Group of 10. However, this is well short of the doubling of quotas many countries were calling for and which I believe was appropriate. Furthermore it will take some time even for this inadequate increase to be approved, country by country, and thus for it to operate. Another possible approach which will shock some purists is to segregate some current indebtedness of the chronically indebted countries and convert it into a special form of long term debt, guaranteed by the international community, bearing fixed interest payable regularly, denominated in marketable instruments. This would relieve those countries of the burden of refinancing short and medium term debt as well as the pressure of the risk of fluctuating interest rates. It would give the lenders a better security than they have at present, and help the private sector banking system to raise further funds for international lending with confidence. The second point to be made is that the Fund's approach to conditionality must be eased. These two observations are intimately related. Because of the revolving nature of the Fund, the conditions attached to its lending operations cannot be eased unless the Fund is given greater resources.

In advocating easier conditionality I am using one of those dangerous international codewords that invites misinterpretation. I am not urging international economic profligacy on a grand scale. Far from it. What I am suggesting is that the traditional pattern of Fund conditionality—that is, rapid adjustment to balance of payments health—is inconsistent with the nature of the structural balance of payments problems facing many countries. It is imperative that deficit countries be encouraged to develop longterm adjustment programmes designed to trade their way out of difficulties to the extent they can. They require that. The international economy requires that. The Fund's policies, conceived in the 1940s to deal with cyclical deficits, are not geared to do that.

Indeed after many years of attending Fund meetings, I have come to the conclusion that there is a profound lack of realism marking the debate over conditionality. Those who have argued for maintaining a tough conditionality have undoubtedly carried the day. What has been the result? Effective and tight discipline? Rapid adjustment and return to balance of payments equilibrium?

Quite the reverse. Countries do not turn to the Fund until it is almost too late. Instead they have turned to private sources of lending which have minimal standards of conditionality in the IMF sense.

I would argue, therefore, that the Fund's approach to conditionality has had the perverse effect of encouraging less adjustment overall than would have occurred had the Fund applied a more flexible and sympathetic approach to conditionality. I am interested in the effective results of policy stances—not the ideological rigour which accompanies them.

Ultimately there are grave political risks in all this. I had a letter recently from an old colleague of mine, a Prime Minister of a Commonwealth country, who said that if he had been silly enough to accept the short-term adjustment programme suggested to him by the IMF, he would have faced the prospect of riots in the streets and peasant farmers producing food only for their own use. If you object to anecdotal evidence of this nature, consider the case of Turkey. This was a country which adopted a stringent adjustment programme which led to the downfall of the government, followed later by the downfall of the new government followed by a takeover by the army. In another country army rule might not be so benign. I was astonished recently to see the Turkish experience held up to a U.S. Senate Committee as a success story. We have long recognised the linkage between economic liberalism and political liberalism. If we cannot devise a longer-term framework for adjustment that provides a credible policy response for democratic governments, we may well find that some countries will move inexorably away from democratic traditions. Severe austerity programmes and relatively open government are uneasy bedfellows.

It is a fallacy to suggest that for every country it is possible to make adjustments which would bring its external current account into balance and at the same time provide a standard of living which would be acceptable to people who are governed in a democratic tradition.

Another inadequacy I see on the institutional side is the absence of any effective provision for symmetrical surveillance. That is, countries in surplus must be encouraged to adjust in the same way that deficit countries are expected to adjust. There is implicit recognition in the Fund's articles of agreement on this but there is no mechanism in place to achieve the desired result. The concept itself is based on a fundamental accounting fact that for every dollar one country has in surplus another country has one dollar in deficit.

With sovereign governments, we are unlikely to ever agree on automatic balance of payment adjustment guidelines. I do see the need, however, for a body with much greater authority than currently exists to oversee this issue. It may be necessary, therefore, to consider setting up some sort of council, based in the Fund, with decision-making powers, as opposed to the Interim Committee which is an advisory body only. Such a council—which on occasions I have referred to as an economic equivalent of the United Nations Security Council—is in fact explicitly provided for in the 1976 second amendment of the Articles of Agreement of the International Monetary Fund. This provision has never been given the serious consideration it merits.

We must also find some means of introducing greater stability into the process whereby international liquidity is created. At various times during the past decade, the rapid and variable growth of international liquidity, principally in the form of externally held US dollars and other currencies, has given rise to proposals to operate a substitution account. This would provide a mechanism to enable countries to exchange their holdings of foreign exchange for SDRs. The objectives of this would be to moderate one major source of instability in the international financial markets and to make the international economy less sensitive to changes in the domestic economic policies of the major countries.

I am not suggesting there are not difficulties in this proposal—just as there are with achieving an effective system of symmetrical surveillance. However, they are typical of the key issues that sooner or later we must examine in the context of the international trade and payments system as a whole.

Turning finally to aid flows, one can say simply that the volume of development assistance has remained stable at about $25 billion in nominal terms for several years, implying a substantial real decline. It is easy to label aid flows as wasteful or unproductive. Properly managed, they can contribute to the development process. New Zealand's own aid programme which is so very small in absolute terms, but which is most effective in the context of the tiny island states in the South Pacific, is one reason why I cannot accept the prevailing modern view on aid.

Looking at the position of the very poorest countries which will be quite unable to maintain absolute minimum standards without increased aid flows is another reason. We have to accept that democratic parliaments in present circumstances are not going to vote substantially increased amounts for either bilateral aid or multilateral aid. Given this disenchantment with aid, we are going to have to look at global mechanisms, such as the proposal to link Special Drawing Rights to international aid. We are going to have to look at measures which in effect tax the world community. One result will be an easing of the political tension in respect of aid proposals in the donor countries. If we are going to increase international liquidity by issuing SDRs, why not issue them as aid, rather than giving the wealthy countries that do not need them the lion's share. This then is how I read the present position relating to the payments side of the trade and payments equation as it has developed since the collapse of key elements of the Bretton Woods system. What about the trade side?

I do not wish to spend a lot of time discussing the evils of protectionism. At meetings such as this, protectionism represents a soft target. We can all deplore it because we all know that protectionism is something done by others, not ourselves.

What I would like to do is to analyse the *linkage* between protectionism and the critical financial issues I have just described, because it has a direct bearing on my central conclusion: namely that we need a second Bretton Woods type conference to examine the international trade-payments system as a whole.

To set the scene, let me quote the concluding comments of the annual GATT Study of International Trade published late last year:

> "The gradual but continuing accumulation of restrictions on international trade of course poses a threat to the multilateral trading system . . . . but the more immediate danger may be that it will trigger a severe disturbance in the already troubled international financial system. This danger was demonstrated in the decade of the Great Depression."

Financial dislocation and protectionism feed on each other. Take, for example, the impact of erratic changes in exchange rates on trade policy. I read recently the comments of the respected liberal international economist who observed that if Adam Smith were alive today and observed the recent exchange rate fluctuations he would have been a protectionist. The fact is that wild fluctuations in exchange rates bring about unpredictable and sometimes temporary shifts in comparative advantage. They make a nonsense of any residual protection system that relies upon tariff protection at the frontier. The magnitude of the swings quite outweighs the economic significance of the generally low tariff rates now prevailing as a result of the successes of the Kennedy and Dillon negotiating rounds in the GATT. I believe that this is part of the reason for the growing propensity of countries to resort to non-tariff barriers.

There are now over 600 different types of non-tariff barriers ranging from the so-called 'voluntary' restraint agreements through to local content requirements, variable import levies and so forth. The fact is that international trade is becoming less and less governed by the principles and rules formulated by the original negotiations of the GATT. One estimate I have seen is that by 1980 almost 50 percent of trade by all market economies was 'managed' trade—that is, trade which is not, for a variety of reasons, governed by the conventional forces of the arms-length free market.

The linkage between protectionism and financial dislocation goes deeper than this however. Ultimately, loans have to be serviced from export earnings. If trading opportunities are cut back, financing becomes a riskier business. As is suggested by the increasing talk of devices such as selective safeguards, protectionism is a particularly acute problem for those countries which have shown a marked competitive edge in certain sectors. When protectionism cramps the opportunities for investment in competitive export-oriented projects, it undermines the stability of the investment itself.

All the orthodox advice each country receives from its own advisers, from practical men of business and international experts, is that it must export more and, import less to deal with its financial difficulties. Simple arithmetic, however, shows the short-sightedness of this. The result of each individual country following this article of faith is a reduction in world trade and growth. That is exactly what is happening today. We may, however, be seeing the early signs of a shift in the international community's thinking on this. The OECD consensus for example is now clearly that the risks of inducing a further retrenchment of the world economy exceed the risks of a renewal of inflation. As was apparent from the Group of 10 meeting in Paris, the major countries are now more and more emphasising the need for co-ordinated expansionary policies. In my view, these need not reverse the gains made in reducing inflation.

It remains to be seen whether this will lead to a rethinking of the role of developing countries. In 1980, nearly one quarter of the exports of the industrial countries went to developing countries in terms of manufactured exports the proportion is about one third. The economic welfare of industrial countries thus depends increasingly on the developing countries being given the opportunity to trade their way out of difficulty.

If the developing countries have to tighten their belts, not only do their standards of living fall, but the exports, and thus the production, and thus the standards of living of the wealthier countries also fall. Additionally, those of their citizens who have invested in external loans may lose their money.

We have just concluded the GATT Ministerial meeting—the first for many years. Each country has walked away from that meeting applying a different set of adjectives to the same outcome. These descriptions range from 'realistic', 'preserving the basis for future discussions', to 'a failure'. I am awarding no prizes for attempts to match countries to these descriptions. It is all too familiar, I am afraid.

Call it what you will, it is manifestly clear that the post-war political mandate of the GATT is all but exhausted. That mandate was, primarily, to reduce tariffs on industrial goods. It has accomplished that with great success. In respect of agricultural products it has been a monumental failure. But the GATT is stymied by the fact that the key contracting parties are not prepared to use the framework of the General Agreement to deal with the trade problems of the eighties and nineties, let alone to explore the relationship between payments and trade. As with the International Monetary Fund, the GATT is operating with the remnants of a constitution designed for the problems of the 1940s. Both institutions need constitutions geared to the problems of the 1980s and beyond.

This brings me to the conclusion which I set out for your consideration at the start of my address. I believe that we need a broad-based reappraisal of the trade and payments system to establish a dynamic and liberal framework for international

economic relations for the remaining decade and a half of this century. This will be a formidable task, but the first requirement is political recognition of the need for such an appraisal.

The current international forums seem to me unlikely to produce the broad-based appraisal required. The North-South dialogue is not framed for an effective consideration. The problems of slow growth, protectionism, financial dislocation and debt are so closely connected that no institution can of itself forge the consensus necessary. The summit meetings of the wealthy countries may agree on an analysis, but agreement on action trips over the fact that one or more of them are always facing an election in the immediate future.

There are no easy answers and hard adjustments to economic reality will be required. My contention is that it is likely to prove easier for governments to face these adjustments if they can say to their peoples that other countries are moving in concert—that the decision has been agreed by the world community. This is an extension of a simple enough proposition in the trade field: namely, that multilateral trade liberalisation is politically feasible where unilateral trade liberalisation is generally not. Individual reforms are more manageable, more readily accepted as logical and necessary if they seem as part of a new strategy, covering the broad spectrum of trade and payments issues. The operations of the post-war institutions have tended to unravel the tight connections between trade and payments. The theme of my arguments is that the purpose of the next international review must be to put them together again.

The significance of Bretton Woods is that, because we were sufficiently scared, it created opportunities to break the political logjam on the policies that had caused so much harm to international co-operation in the 1930s. Some four decades later, I believe we are facing a comparable political logjam on the trade and payments front. After Bretton Woods each country had to ask itself: this is what the world community had decided. Now are we in or are we out? At the end of the day, the vast majority of mixed economies decided there was only one answer to that question. Unless we begin the first political steps towards a comprehensive examination of the present world trade and payments system, we shall simply have to accept whatever the existing framwork for international economic relations deals out to each of us. In that event, I must be totally pessimistic about the future of international economic co-operation and, indeed, the future of the world economy itself.

What I suggest is a conference, not of a day or two, but for as long as it takes to reach a consensus, many weeks perhaps. There will be many more sovereign states than at Bretton Woods, but no consensus will be reached unless the powerful countries concur.

All this will take time. The amount of time that today's band aid solutions can buy us is limited. The basic illness remains and will continue to worsen.

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SIR WALTER SALOMON

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3rd March, 1983

Dear Prime Minister,

As you are aware, I have been greatly concerned for some time about the inability of the powers that be to deal with the international financial crisis, and I refer in particular to the crisis of the international banking community. I therefore decided to write an article which I am going to present at the Annual General Meeting of my bank which takes place next month. I sent the article to Professor Hayek to read and he has written back to me and I quote : "it seems to be simple commonsense which I imagined everybody would understand, but hardly anyone does".

Subsequently Hermut Schmidt made a long and, in my opinion, very incoherent suggestion on how to deal with the international economic situation.

As the German Election is taking place this week Axel Springer thought it would be very constructive if he could publish my article in Die Welt, and I let him do so. I enclose a copy of the article which is in German and I also enclose the English translation.

Before giving the article to Die Welt I was in touch with the Features Editor of The Times because I would have preferred to have seen the article published in this country, but he would not accept my conditions, namely, that the article could not be cut, although I did say it could be divided into two parts.

I hope you will find my ideas which I set out in the article constructive; at least they are a new approach and should, I think, be seriously considered.

With kindest regards.

Yours ever

Walter H. Salomon

The Rt. Hon. Mrs. Margaret Thatcher, MP

Econ Pol

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TO CONTENT BEFORE TIME OF DELIVERY

Speech by The Rt Hon. J. Enoch Powell, MP, to the Marlow Conservative Supper Club at the Liston Hall, Marlow, Bucks, at 8 p.m. Friday 18th February 1983

When a thing sounds like nonsense, it generally is. I am not claiming that for an axiom or for a law of nature to which there are no exceptions. I simply say that it is a good rule of thumb, which will commonly see you through and enable you to avoid being 'taken for a ride' or at least to know that you are being 'taken for a ride' if you cannot avoid it.

When people hear that Britain is lending money to the Argentine to help it replace the armaments it lost in its unprovoked act of aggression, they say: "But what an absurd thing to do!" They are right. The obvious is true: it is an absurd thing to do. The voice of common sense, even if it sounds remarkably like Dennis Skinner asking the Government the same question three times a week, is not mistaken. It is a nonsense that Britain is lending money to the Argentine. But there is always an explanation for a nonsense, though there is rarely a good reason.

Nonsense is like an iceberg: the piece which appears above the surface and which people notice is nearly always a small part of a vaster and more comprehensive nonsense, of which they were unaware and which had been going on for a long time with impunity. The absurdity of Britain lending money to the Argentine is only part of the absurdity of the International Monetary Fund. At once, when this is pointed out, the temperature drops. Had we not been led to suppose that the International Monetary Fund is a good thing? Did it not provide us with endless instruction and amusement at the expense of socialist Chancellors of the Exchequer like Mr Callaghan or Mr Healey? Are the initials I.M.F. not pronounced by ministers and others - nay, by the Prime Minister herself - in tones that are charged with triumph as well as with veneration?

Fear not. These are the very hallmarks which all large and durable nonsenses exhibit - and for a simple reason. It is how they manage to survive and to flourish so vigorously and so long. An international environment is their ideal climate; for whereas one is liable to be more critical of beliefs and practices which appear to be local or peculiar, nothing is so daunting or thought-stopping as general approval on all sides throughout the world. It is the hoary old con. trick of St Augustine all over again: securus iudicat orbis, "what everybody thinks has got to be right". Alas, that may or may not do for combating theological heresy; but when the nations gather in conclave and agree upon something, that is always a clear warning to look out for trouble.

It recently came to pass that a number of countries, such as Mexico and the Argentine, including (like those) some which are possessed of great natural resources, were not able to pay - or at any rate discovered that they had no intention of paying - their debts or the interest upon their debts. This condition is sometimes misleadingly described as their being 'bankrupt', but the word is a misnomer. There never was the slightest possibility of their creditors putting the bailiffs in. The days of the Chinese Customs and of the Khedive Ismail the Magnificent are long since over: creditor nations and their citizens no longer take the debtor nations by the throat, crying "Pay me that thou owest" (Matthew 18.28). So what did the I.M.F., what did the assembled finance ministers of the major countries do? They said, "Quick, we must lend them some more money".

This is plain silly. There is no better security for the new loans than for the old ones. There is no prospect of clawing back from any of these countries the goods and services which they turn out to have had from us for nothing. All that is over the dam. But why throw more money away? "Oh", say the ministers, "but look at the damage to the system of international credit if they default". There is no damage to international credit, because there is no such thing as international credit. There is your credit and my credit - both, I trust, sound - and there is arguably Britain's credit and America's credit; but the debtor countries in question don't have any credit, they have lost it, it is gone.

"Ah yes", reply the finance ministers, "but look at the danger to trade. Those countries will not buy our goods if they can't pay for them". So the argument apparently is that we should pay for our own goods and give them away to these miscreants for nix. Don't imagine that the debtor countries would export without importing: they could only do that if, like Britain at the moment, they ran a deficit on capital account, i.e. paid their debts off, which is exactly the thing they are unwilling or unable to do. Come to think of it, it is the paying of debts, not reneging on them, which could be represented as a threat to international trade.

There was a delicious sentence in a reply which the Prime Minister gave last week - to Dennis Skinner, as it happened - and which I would like to share with you: "If Argentina defaulted", she said, "and her past debts were wiped out, having a present balance of payments" - that presumably meant a supplus on current account- "she would have far more liquid cash to buy armaments under those circumstances than if she paid her former debts". If, however, as the Prime Minister had just said, the loans were arranged "to enable Argentina to pay her previous debts", she would still have "the liquid cash". The only way for the creditors to get a hold on that "liquid cash" is direct administration à la Ismail or the Chinese Customs; and I doubt if even Mrs Thatcher can achieve that.

Apart from paying countries to pay their old debts, the I.M.F. has yet another purpose in life, no less foredoomed to futility. It is to lend countries foreign money to exchange for their own currency and thus force the latter's exchange rate up or prevent it from falling. If there is one thing more certain in this world than any other, it is that the relative value of the units of different currencies will never cease to fluctuate. Every economic change anywhere in the world, every variation in the economic policies of independent nations, is bound to be reflected in the changing relative value of their currencies. Nothing can prevent this. It can only be tempoparily concealed or delayed. If a country strikes oil or gold, if its government goes in for financing expenditure by inflation or for stopping financing expendituure by inflation, the relative value of that currency is going to rise or fall as the case may be.

Now, this is anathema to the philosophy of the I.M.F. The I.M.F. dislikes changes which it cannot itself predict or organise. It therefore acquires and lends huge sums of money to be laid out on the hopeless project of maintaining what are called stable rates of exchange - an activity not merely futile but actually harmful in so far as it delays or prevents that adjustment to changing realities which is automatically evoked by all movements of prices and rates. It is a solemn thought that the IMF thus imposes on the peoples of the member states a misapplication and waste of their own efforts and savings in the name of an object as undesirable as it is unattainable.

That reference to the people is timely. We are familiar with the effects which national governments have upon the weal and woe of those whom they govern. But when those national governments conspiretogether to create international bodies with appropriate initials and acronyms, it escapes notice that these bodies too draw their lifeblood from the same source. The component governments like to treat these organisations they have created as independent, autonomous and self-existing entities whose authority must be acknowledged and whose writ must be obeyed. Thus they hope to escape, and often do escape, from their own responsibility to their respective citizens.

If individual governments or private banks and firms were seen making loans to other countries for purposes as foolish or futile as those of the I.M.F., they would not long avoid detection and censure and would be obliged to stand over the consequences, political or commercial, of what they had been doing.

Nonsense is still nonsense when an international body is used to perpetrate it. The plain man's first perception, that Britain is lending money to the Argentine and that to do so is absurd, was right all the time. We, the people of this country, are entitled to say no, because it is our decision and our money.

Econ Pol

10 DOWNING STREET

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Prime Minister

You ~~with~~ should be aware of the very precarious position of the big Brazilian banks, noted at X attached. I had already heard about this from a City source: in effect the Brazilian banks have an unscheduled and unauthorized overdraft every night, mainly with US banks in New York. This could collapse anytime.

MCS 18/2

Confidential.

FROM: J.G.LITTLER
DATE: 17 February, 1983

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Sir Douglas Wass
Mr. Burns
Mr. Middleton
Mr. Unwin
Mr. Carey (o/r)
Mr. Lavelle
Mr. Hall

Ja. ✓

INTERNATIONAL DEBT PROBLEMS, PARTICULARLY BRAZIL

I think you were aware of difficulties over Brazil which came up while we were in Washington last week, and which took the Governor of the Bank of England away from our meetings for most of Thursday afternoon and Friday morning.

2. Along with the IMF programme and credit, the rescue operation for Brazil comprised four elements:

- $4.4 billion of new commercial bank money;
- agreed rescheduling of 1983 maturities;
- agreed extensions of official trade credit;
- arrangements to restore exposure of commercial banks in the inter-bank market, in favour of Brazil, to the higher of the levels of June and December last year (subsequently amended to restoring just over 80% of the June 1982 level).

x

3. Under the first three headings, there is no problem. Indeed the trade credit element has actually been over-subscribed. But there has been difficulty from the outset over the fourth element. The latest position seems to be that something approaching $½ billion as a minimum is still "missing". This is because various banks in different parts of the world have not met their part of the rebuilding of credit implied. Apparently the British banks have done all that was required of them. The situation is being held - literally from day to day with overnight money, by a group of United States banks which have set up a safety net operation for this purpose. The trouble is that their patience is wearing a little thin. There was considerable risk last night of the arrangement collapsing, but one or two extra contributions flowed in from Japanese and French

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sources, which may have encouraged an extension.

4. Unfortunately, we are in the position in which, at any time, the safety net banks in the United States may decide they have had enough, in which case payments will not be met. This will reopen what we thought to have been a settled package. The effect is bound to disconcert the markets, and probably to spill over on to the finely-balanced positions of two other countries:

- Venezuela: this has all the appearance of a mismanaged liquidity problem, rather than a deeper debt burden, but the short-term liabilities of Venezuela are very high indeed, and the willingness of commercial banks to keep on renewing them is not helped by the apparent insouciance of Dr. Sosa, the Finance Minister, who foolishly gave in London last night a public threat of future exchange controls!

- Chile: where the amounts involved are altogether smaller, but sentiment has been adversely affected by the change of Finance Minister in the middle of difficult negotiations.

5. I will keep in touch as well as possible, and pass on further news. Meanwhile, Mr. Kerr might like to let Mr. Scholar at No.10 know that these difficulties are around, rather than have No.10 taken by surprise by some unhappy headline news.

– in the FT today (Saturday)

(J. G. LITTLER)

Econ Pol

ADR 14/2.

1. Mr. Coles - to see

2. Confidential Filing - pl. file

10 DOWNING STREET

MR. BUTLER

Attached is a short note of the meeting I had with Miguel Schweitzer on Wednesday, 9 February, as you suggested.

A.A.W
11 February 1983

NOTE OF A MEETING WITH MIGUEL SCHWEITZER, MINISTER OF FOREIGN AFFAIRS (DESIGNATE), AND ROLF LUDERS (MINISTER OF FINANCE) AND CARLOS CACERES (GOVERNOR OF THE CENTRAL BANK, CHILE)

During a meeting on Wednesday, 9 February, I made it clear that I was not speaking on behalf of the British Government, but only in a personal capacity. Mr. Luders discussed the basis for the re-financing of Chilean debt. The Government wished to have a 90 day moritorium on the repayment principle of outstanding debt. They were proposing a refinancing package where the Government guaranteed long and medium term debt by the banks as well as the debt already guaranteed by Government. They did not propose to introduce a government guarantee for the debt of private corporations.

Secondly, they wanted to negotiate a roll over of short term credit both trade and non trade, and a new credit of $900 million.

They were forecasting in 1983 a balance of trade surplus of $900 million which would give rise to a deficit on the current balance of payments of $1.6 billion.

A consortium of banks led by Manufacturers Hanover Trust and Midland Bank were to be the negotiating party with which the Chilean Governments would discuss the refinancing during the 90 day standstill. Luders said that they had been fairly favourably received both in Tokyo and so far in New York and London. He had yet to visit Germany to complete his discussions.

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ALAN WALTERS
11 February 1983

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FM UKDEL IMF/IBRD WASHINGTON 042319Z FEB 83

TO IMMEDIATE F C O

TELEGRAM NUMBER 76 OF 4 FEBRUARY

AND TO UKREP BRUSSELS

MY TELNO 70.

IMF INTERIM COMMITTEE: CHAIRMAN'S SPEAKING NOTES

1. LITTLER MENTIONED TO ME BY TELEPHONE TODAY SOME SUGGESTED AMENDMENTS TO VAN HOUTVEN'S DRAFT. I HAVE HAD A WORD WITH VAN HOUTVEN ABOUT THESE.

2. ON THE SENTENCE ABOUT THE ROLE OF THE FUND IN RELATION TO COMMERCIAL BANKS, HE AGREES GENERALLY WITH LITTLER'S REDRAFT, BUT WOULD SUBSTITUTE THE WORD QUOTE COOPERATION UNQUOTE FOR QUOTE CONTACT AND EXCHANGE OF INFORMATION UNQUOTE.

3. ON THE SENTENCE ABOUT SAUDI ARABIA AND THE GAB, HE AGREES THAT QUOTE FURTHER CONTRIBUTIONS IN ASSOCIATION WITH THE GAB UNQUOTE WOULD BE MORE SUITABLE THAN QUOTE FURTHER ENLARGEMENT OF THE GAB UNQUOTE.

4. ON A POINT OF DETAIL, YOU MAY LIKE TO NOTE THAT IN PARA 2, FIRST SENTENCE, QUOTE ASSOCIATES UNQUOTE SHOULD BE SUBSTITUTED FOR QUOTE ALTERNATES UNQUOTE.

5. FCO PLEASE ADVANCE TO LITTLER AND BOTTRIL (TREASURY) GILCHRIST (BANK).

UKREP BRUSSELS PLEASE PASS TO CHANCELLOR'S PARTY ATTENDING THE ECOFIN MEETING.

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FM WASHINGTON 042255Z FEB 83

TO IMMEDIATE FCO

TELEGRAM NUMBER 298 OF 4 FEBRUARY

AND TO IMMEDIATE UKREP BRUSSELS

IMF INTERIM COMMITTEE

1 I CALLED ON SECRETARY REGAN THIS AFTERNOON AND DELIVERED THE PERSONAL MESSAGE FROM THE CHANCELLOR OF THE EXCHEQUER WHICH WAS SENT HERE BY TELEX ON WEDNESDAY AND CONFIRMED BY TELEPHONE BY THE TREASURY YESTERDAY MORNING.

2. REGAN WAS GRATEFUL FOR THIS MESSAGE AND SAID THAT HE AGREED WITH PARAGRAPHS 1-3. HE WAS HAPPY TO HAVE THE CHANCELLOR'S VIEWS ON PARAGRAPH 4 (IMPORTANCE OF ADEQUATE INCREASE IN QUOTAS, AND MEETING WITH CONGRESSIONAL LEADERS). HE WAS GRATEFUL FOR THE REMARKS IN PARAGRAPH 5 ABOUT THE BUDGET PROPOSALS RECENTLY ANNOUNCED BY THE ADMINISTRATION. HE SAID THAT HE WOULD LET THE CHANCELLOR KNOW ON PARAGRAPH 6 WHICH SUGGESTED THAT HE, THE CHANCELLOR AND THE MANAGING DIRECTOR MIGHT MEET PRESIDENT REAGAN AFTER THE INTERIM COMMITTEE. THE SAME THOUGHT HAD OCCURRED TO REGAN INDEPENDENTLY, BUT IT WOULD OBVIOUSLY DEPEND ON THE PRESIDENT'S SCHEDULE, ESPECIALLY AS IT WOULD BE A FRIDAY AFTERNOON.

3. REGAN ADDED THAT HE WAS GLAD ARRANGEMENTS HAD BEEN MADE FOR HIM TO MEET THE CHANCELLOR BEFORE THE INTERIM COMMITTEE. HE WAS HOPING THAT THIS WOULD BE A ONE-ON-ONE MEETING, AT WHICH HE COULD MENTION SOME OF THE IDEAS HE INTENDED TO BRING UP AT THE G5 DINNER. IN ADDITION TO EXCHANGING VIEWS ON THE IMF QUOTAS AND THE GAB, HE WANTED TO DISCUSS THE CURRENT OIL CRISIS, AND HOW WE WOULD PERFORM IF THE POSITION GOT MORE DIFFICULT. IF THE PRICE WAS TO FALL FURTHER, HE HOPED THAT THIS WOULD NOT HAPPEN PRECIPITOUSLY, BUT THE MARKET MIGHT NOT SEE IT THAT WAY. HE WAS INTERESTED AT THE WAY IN WHICH, FOR EXAMPLE, THE RUSSIANS AND THE EGYPTIANS HAD DROPPED THEIR PRICES SO QUICKLY. POLITICAL LEADERS WOULD BE LOOKING TO FINANCE MINISTERS FOR SOLUTIONS, AND HE WOULD RATHER HAVE A GAME PLAN THAN IMPROVISE.

4. ON THE PROSPECTS FOR THE BUDGET, REGAN OBSERVED THAT THE ECONOMIC PROJECTIONS WHICH HAD BEEN DEVISED TO AVOID ANY CRITICISM OF OVER-OPTIMISM HAD, IN HIS VIEW, ERRED ON THE SIDE OF OVER-PESSIMISM. FELDSTEIN WAS ALREADY INCLINING TO TAKE A SIGNIFICANTLY LESS PESSIMISTIC VIEW, IN WHICH CASE THE PROJECTED DEFICIT MIGHT BE CONSIDERABLY LOWER.

5. ON THE LUNCH WITH CONGRESSIONAL LEADERS, HE MENTIONED THAT THIS WAS PART OF A LARGER CAMPAIGN, ESSENTIALLY TO GET THEM TO RECOGNISE THAT THERE WAS A DIFFERENCE BETWEEN THE IMF, AND BODIES LIKE IDA AND AID.

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6. AS REQUESTED IN TELECON LITTLER/ANSON, WE HAVE SEPARATELY ASKED THE U S TREASURY FOR SOME NOTES ABOUT THE KIND OF POINTS WHICH THE CONGRESSIONAL LEADERS HAVE ALREADY RAISED IN PREVIOUS DISCUSSIONS WITH THE U S TREASURY. THESE WILL BE AVAILABLE WHEN THE CHANCELLOR ARRIVES. THE KEY POINTS, APART FROM THE ONE MENTIONED BY REGAN ARE: ANTIPATHY TO THE BANKS (WHY SHOULD WE BAIL THEM OUT?): GENERAL ANTIPATHY TO LDC'S: AND OBJECTIONS TO GIVING MONEY EITHER TO INTERNATIONAL INSTITUTIONS OR TO LDC'S WHEN THERE ARE PRESSING NEEDS AT HOME.

7. FCO PLEASE ADVANCE TO BOTTRILL (TREASURY), WHO MAY WISH TO PUT IN HAND BRIEFING FOR THE CHANCELLOR ON THE ENERGY MATTERS IN PARAGRAPH 3 ABOVE IF THIS IS NOT ALREADY COVERED BY EXISTING BRIEFING MATERIAL. UKREP BRUSSELS PLEASE PASS TO CHANCELLOR AND LITTLER, ATTENDING THE ECOFIN MEETING.

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TO PRIORITY FCO

TELEGRAM NUMBER 75 OF 4 FEBRUARY

IMF: INTERIM COMMITTEE

1. FOLLOWING IS THE LATEST VERSION OF THE PROGRAMME FOR THE CHANCELLOR'S VISIT FOR THE INTERIM COMMITTEE, FEBRUARY 8-11.

TUESDAY, FEBRUARY 8

16.15 MR LITTLER, MR LAVELLE, MR HALL AND MR GILCHRIST ARRIVE DULLES AIRPORT ON BA 277

20.00 CHANCELLOR, MR BURNS AND MR KERR ARRIVE NATIONAL AIRPORT ON PAN AM 887

WEDNESDAY, FEBRUARY 9

? 07.15 CHANCELLOR'S APPEARANCE ON ABC TV QUOTE GOOD MORNING AMERICA UNQOUTE, 1717 DE SALLES STREET NW

08.45 REGISTRATION FOR PARTICIPANTS, IMF ENTRANCE HALL

09.00 MR LEO VAN HOUTVEN (IMF SECRETARY) TO CALL ON CHANCELLOR IN HIS IMF OFFICE (ROOM 12-300H, TEL.NO. 477 8184)

09.15 MANAGING DIRECTOR TO CALL ON CHANCELLOR (ROOM 12-300H)

? CHANCELLOR TO BRIEF UK PRESS

11.50 GOVERNOR AND MR LOEHNIS ARRIVE NATIONAL AIRPORT (SHUTTLE FROM NEW YORK)

12.00 MR SHANG MING, CHINESE MEMBER OF INTERIM COMMITTEE, ACCOMPANIED BY MR ZHANG (IMF EXECUTIVE DIRECTOR), MME. HE (DEPUTY DIRECTOR, DEPARTMENT OF INTERNATIONAL ORGANISATIONS AND CONFERENCES) AND MR ZHANG (INTERPRETER)

12.30 SECRETARY REGAN TO CALL ON THE CHANCELLOR IN ROOM 12-300H

13.00 CHANCELLOR TO LUNCH WITH SECRETARY REGAN TO MEET SENATORS AND CONGRESSMEN (IMF 2ND FLOOR, MD'S DINING ROOM). MANAGING DIRECTOR AND MEXICAN AND BRAZILIAN FINANCE MINISTERS WILL BE PRESENT.

? 15.00 MR B T CHIDZERO, ZIMBABWEAN MEMBER OF THE INTERIM COMMITTEE (MINISTER OF FINANCE) TO CALL ON CHANCELLOR (ROOM 12-300H)

? 16.00 DR MANMOHAN SINGH, INDIAN MEMBER OF INTERIM COMMITTEE (CENTRAL BANK GOVERNOR) TO CALL ON CHANCELLOR (ROOM 12-300H)

17.00 G5 MEETING AT BLAIR HOUSE

18.30 G5 TO MEET WITH MANAGING DIRECTOR AT BLAIR HOUSE FOR DRINKS

19.00 G5 WORKING DINNER AT BLAIR HOUSE

? 19.30 OR 21.30 G10 DEPUTIES MEETING (IF NECESSARY) IN IMF BOARD ROOM, 12TH FLOOR

THURSDAY, FEBRUARY 10

08.30 G10 MINISTERS MEETING, IMF BOARD ROOM, 12TH FLOOR

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10.00 INTERIM COMMITTEE MEETING, EUGENE BLACK AUDITORIUM, WORLD BANK 'C' BUILDING, 11TH FLOOR (ENTRANCE THROUGH E BUILDING-- ACROSS FROM IMF)

13.00 CHANCELLOR'S LUNCH FOR INTERIM COMMITTEE MEMBERS (MANAGING DIRECTOR'S DINING ROOM, 2ND FLOOR)

15.00 INTERIM COMMITTEE RESUMES

20.00 CHANCELLOR'S WORKING DINNER FOR INTERIM COMMITTEE MEMBERS AT THE F STREET CLUB, 1925 F STREET NW (TEL: 331 0020)

FRIDAY, FEBRUARY 11

10.00 INTERIM COMMITTEE

AFTER CONCLUSION OF MEETING: CHAIRMAN'S PRESS CONFERENCE WITH MANAGING DIRECTOR

13.00 G7 DEPUTIES MEETING

20.45 CHANCELLOR, AND MESSRS. BURNS, LITTLER, KERR, LAVELLE, HALL, AND MR LOEHNIS, DEPART DULLES ON BA 276.

2. FCO PLEASE ADVANCE TO P/S CHANCELLOR, LITTLER, LAVELLE (TREASURY), P/S GOVERNOR, LOEHNIS AND GILCHRIST (BANK OF ENGLAND), T BURNS (TREASURY)

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FM UKDEL IMF/IBRD WASHINGTON 042359Z FEB 83

TO PRIORITY F C O

TELEGRAM NUMBER 77 OF 4 FEBRUARY

INFO NAIROBI

IMF: KENYA - BALANCE OF PAYMENTS SUPPORT

1. JIMENEZ (AFRICAN DEPARTMENT) EXPAINED TO US TODAY THE OUTCOME OF THE DONORS' MEETING ON 25 JANUARY. HE ALSO ASKED WHETHER THE UK WOULD CONSIDER, AS A MATTER OF URGENCY, BRINGING FORWARD THE DISBURSEMENT OF ITS ADDITIONAL BALANCE OF PAYMENTS SUPPORT FOR KENYA PLEDGED AT THE MEETING. (SEE PARA 5 BELOW).

2. HE SAID THAT AS A RESULT OF HIS INTENSIVE BILATERAL DISCUSSIONS WITH DELEGATIONS AT THE MEETING HE HAD IDENTIFIED A TOTAL OF SOME SDR 86 MILLION AS NEW BALANCE OF PAYMENTS SUPPORT PROMISED FOR 1983. BUT MUCH OF THIS WOULD BE COMMODITY ASSISTANCE AND A PROPORTION WOULD HAVE TO BE DISCOUNTED IN RECKONING ACTUAL AVAILABILITY THIS YEAR. HIS BEST GUESS WAS THAT KENYA COULD REALISTICALLY COUNT ON AN EXTRA SDR 67 MILLION TOWARDS MEETING AN ESTIMATED FINANCING GAP OF SDR 91 MILLION.

3. TWO HELPFUL FACTORS HAD HOWEVER EMERGED. THE US GOVERNMENT HAD RELEASED A LARGE DISBURSEMENT OF BALANCE OF PAYMENTS SUPPORT IN DECEMBER. AND IT NOW LOOKED AS THOUGH IMPORTS HAD BEEN CONTROLLED MORE TIGHTLY IN 1982 Q4 THAN EXPECTED. DECEMBER HAD, THEREFORE, SEEN AN UNEXPECTED ACCUMULATION OF RESERVES. THIS PROVIDED AN UNFORESEEN AVENUE FOR MEETING THE REMAINING GAP, A PART OF WHICH HAD BEEN PREDICTED ON THE NEED TO BUILD UP RESERVES THIS YEAR. HE DID NOT THINK THAT THE UNEXPECTED IMPORT CUTS WERE LIKELY TO BE UNWOUND IN THE SHORT-TERM.

4. THE FINANCING GAP HAD, THEREFORE, BEEN MORE OR LESS CLOSED IN A STATISTICAL SENSE BUT THERE WAS A MAJOR TIMING PROBLEM REGARDING CASH FLOW. HE EXPECTED THAT MOST OF THE ADDITIONAL ASSISTANCE WOULD BECOME AVAILABLE ONLY IN THE LATER PART OF THE YEAR. HE UNDERSTOOD THAT LITTLE OF THE UK MONEY WOULD BE AVAILABLE BEFORE 1 APRIL. AND THE US GOVERNMENT HAD PROGRAMMED ALL ITS ADDITIONAL MONEY FOR THE FOURTH QUARTER OF 1983. AS THINGS STOOD, KENYA'S CASH POSITION WOULD BE EXTREMELY TIGHT IN THE FIRST QUARTER AND THE AUTHORITIES WOULD BE HARD PUT TO MEET THE CREDIT CEILINGS UNDER THE PROGRAMME.

5. JIMENEZ SAID THAT HE HAD ASKED THE AMERICANS, THROUGH THEIR AMBASSADOR IN NAIROBI, WHETHER DOLLARS 10 MILLION OF THE US SUPPORT COULD BE MADE AVAILABLE BEFORE END-JUNE. HE ALSO PUT IT TO US THAT THE UK SHOULD CONSIDER SWITCHING PERHAPS ONE-HALF OF ITS EXTRA CONTRIBUTION INTO THE PRE-JULY PERIOD. WE TOOK NOTE OF HIS REQUEST AND SAID THAT WE WOULD ENQUIRE WHAT, IF ANYTHING, COULD BE DONE. GRATEFUL IF YOU WOULD CONSIDER JIMENEZ'S REQUEST AND LET US KNOW AS SOON AS POSSIBLE WHAT ANSWER WE SHOULD GIVE.

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6. JIMENEZ ALSO TOLD US THAT THE KENYAN AUTHORITIES HAD ASKED FUND MANAGEMENT IF THE SIZE OF FUND ASSISTANCE UNDER THE PROPOSED STANDBY PROGRAMME COULD BE INCREASED. THEY THOUGHT THE SCALE OF GROSS DRAWINGS WAS SMALLER THAN HAD BEEN ALLOWED TO OTHER COUNTRIES IN SIMILAR CIRCUMSTANCES AND THIS WAS EVEN MORE TRUE OF NET DRAWINGS, GIVEN KENYA'S HEAVY SCHEDULED FUND REPURCHASES.

7. WE HAVE BEEN APPROACHED SEPARATELY BY SANGARE (EXECUTIVE DIRECTOR RESPONSIBLE FOR KENYA) WHO LAST THURSDAY ASKED THE MANAGING DIRECTOR TO GIVE FAVOURABLE CONSIDERATION TO KENYA'S LATEST REQUEST. HE SAID THAT HE HOPED THAT IT WOULD BE POSSIBLE FOR US TO PUT IN A WORD WITH MANAGEMENT ON BEHALF OF THE KENYANS. EVEN IF THINGS TURNED OUT WELL, THEIR EXTERNAL FINANCIAL POSITION THIS YEAR WOULD BE EXTREMELY TIGHT AND EVEN A SMALL ADDITIONAL DISBURSEMENT FROM THE FUND AT AN EARLY STAGE WOULD HELP ENORMOUSLY.

COMMENT:

8. MANAGEMENT IS PRESENTLY CONSIDERING HOW TO PROCEED IN THE KENYAN CASE AND WHETHER THE EXTERNAL FINANCING POSITION IS YET SUFFICIENTLY SECURE TO GO TO THE BOARD. IF WE ARE TO INFLUENCE THEIR THINKING EARLY ACTION WOULD OBVIOUSLY BE NECESSARY - PERHAPS AN APPROACH TO DALE (DEPUTY MANAGING DIRECTOR), GIVEN THAT LAROSIERE'S MIND WILL BE FULLY TAKEN UP WITH THE INTERIM COMMITTEE NEXT WEEK. BEFORE TALKING TO DALE IT WOULD BE HELPFUL TO HAVE YOUR REACTION TO JIMENEZ'S REQUEST. ON THE SIZE OF FUND ASSISTANCE, WE FEEL THAT IF WOULD BE REASONABLE TO SUGGEST A MODEST ACCELERATION IN THE PHASING OF DRAWINGS WITHOUT DEPARTING TOO FAR FROM MANAGEMENT'S WISH TO MAINTAIN LEEWAY FOR A FOLLOW-UP PROGRAMME.

9. FCO PLEASE ADVANCE TO LYNCH (ODA), APPLEYARD (ERD), ATKINSON (HMT) AND GILCHRIST (BANK OF ENGLAND).

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DESKBY 070900Z FEB 83

FM BRASILIA 04:1840Z FEB 83

TO IMMEDIATE FCO

TELEGRAM NUMBER 031 OF 4 FEBRUARY

SAVING INFO PARIS, BONN, BRUSSELS

YOUR TELNO 41: IMF INTERIM COMMITTEE, WASHINGTON, 10/11 FEBRUARY

1. I CALLED TODAY ON FINANCE MINISTER GALVEAS TO EXPLAIN THE CHANCELLOR'S REASONS FOR BRINGING FORWARD THE MEETING OF THE INTERIM COMMITTEE AND THE IMPORTANCE HE ATTACHES TO ITS SUCCESS. I HANDED OVER A SPEAKING NOTE BASED ON POINTS I - X IN PARAGRAPH 2 OF YTUR, AND TOOK HIM THROUGH THEM ORALLY.

2. GALVEAS RESPONDED VERY WELL. HIS COMMENTS ON POINTS OF DETAIL WERE AS FOLLOWS.

3. ON POINT IV (GAB EXTENDED AGREEMENT), HE SAID THAT BRAZIL WOULD ADVOCATE STRONGLY THAT APPLICATIONS SHOULD BE PROCESSED THROUGH THE IMF.

4. WITH REGARD TO POINT VIII (SIZE OF THE FUND), BRAZIL WAS FIRMLY IN FAVOUR OF A 100 PER CENT INCREASE IN THE QUOTA.

THE REASONS FOR THIS WERE:

(A) THE NEED TO REINFORCE THE POSITION OF THE IMF BY INCREASING LIQUIDITY IN ORDER TO DEAL WITH BALANCE OF PAYMENTS PROBLEMS:

(B) THE DECLINE IN THE RATIO OF THE EXISTING TOTAL QUOTA TO GLOBAL INTERNATIONAL IMPORTS.

THIS WAS THE POSITION OF ALL G77 DEVELOPING COUNTRIES.

5. WITH REGARD TO IX (DISTRIBUTION OF QUOTAS), BRAZIL WOULD FAVOUR 100 PER CENT EQUIPROPORTIONALITY, THOUGH MORE FOR REASONS OF REGIONAL SOLIDARITY THAN BECAUSE THIS HAD GREAT PRACTICAL SIGNIFICANCE FOR BRAZIL.

6. HE WENT ON TO EXPLAIN A POINT OF EVIDENT SIGNIFICANCE FOR BRAZIL AND WHICH HE WILL CLEARLY PUSH HARD AT THE WASHINGTON MEETING, NAMELY, THE CREATION OF A NEW ISSUE OF SDRS IN THE FORM OF AN ADDITIONAL US DOLLARS 4 BILLION FOR THE PERIOD 1982-84. HIS RATIONALE WAS THAT:

(A) ACCESS TO WORLD LIQUIDITY WAS NOT EVENLY DISTRIBUTED:

(B) THE CREATION OF 4 BILLION WAS A MODEST AMOUNT AND WOULD NOT BE INFLATIONARY, PARTLY BECAUSE THE INDUSTRIALISED NATIONS WOULD NOT NEED TO DRAW ON THEIR SDR ALLOCATION AND PARTLY BECAUSE COUNTRIES LIKE BRAZIL WHICH MIGHT DRAW THESE NEW SDRS WOULD USE THEM TO RE-BUILD THEIR RESERVES. AS A RESULT, DEMAND PRESSURE FOR FUNDS ON THE INTERNATIONAL FINANCIAL MARKETS WOULD BE REDUCED.

HE STATED THAT THE CREATION OF ADDITIONAL SDRS WOULD HAVE THE SUPPORT OF ALL DEVELOPING COUNTRIES, INCLUDING THE ARABS.

7. HE MADE THE FURTHER POINT THAT, UNLESS THE EXISTING RULES WERE CHANGED, COUNTRIES WOULD HAVE TO PAY FOR 25 PER CENT OF ANY INCREASE IN EXISTING QUOTAS WITH SDRS. ABOUT 90 COUNTRIES USING THE IMF AT THE MOMENT HAD NO SDRS LEFT.

8. HE WELL TOOK POINT X, NAMELY THE NEED FOR RAPID FORWARD MOVEMENT FROM THE START OF THE MEETING AND THE CONSEQUENT NEED FOR FLEXIBILITY. HE WOULD BE AMONG THE SMALL GROUP OF DEVELOPING COUNTRY REPRESENTATIVES WHO WOULD HAVE A PRIOR MEETING WITH TREASURY SECRETARY REGAN AND HE SET STORE BY THIS AND ALSO THE INITIAL LUNCHEON ON DAY ONE.

COMMENT

9. I THINK THAT THE CHANCELLOR CAN COUNT ON STRONG SUPPORT FROM GALVEAS, WHO SEES THE SUCCESS OF THIS MEETING AS CRUCIAL TO THE FUTURE HEALTH OF THE INTERNATIONAL FINANCIAL SYSTEM.

FCO PSE PASS SAVING TO PARIS, BONN, BRUSSELS

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TO IMMEDIATE FCO
TELEGRAM NUMBER 95 OF 4 FEBRUARY 1983
INFO ROUTINE UKDEL IMF/IBRD WASHINGTON

YOUR TELNO 41 TO JEDDA: IMF INTERIM COMMITTEE:
WASHINGTON, 10 - 11 FEBRUARY

1. SINCE THE CHANCELLOR HIMSELF PUT THE POINTS IN TUR TO DELORS AT THEIR BILATERAL MEETING ONLY TWO WEEKS AGO, I INSTRUCTED FINANCIAL COUNSELLOR TO ACT WITH DE ROSEN, CHEF DE BUREAU FOR IMF AFFAIRS AT THE TRESOR, AND TO REINFORCE THIS BY SPEAKING TO A MEMBER OF DELORS' CABINET. GARSIDE LEFT A PIECE OF PAPER SETTING OUT THE POINTS IN TUR, STRESSING THAT THEY REPRESENTED THE CHANCELLOR'S OWN THINKING AND SAID THAT IF DELORS WISHED CLARIF - ICATION ON ANY POINT, I WOULD BE AT HIS DISPOSAL.

2. DE ROSEN SAID THAT THE FRENCH POSITION ON THE QUOTA REVIEW HAD NOT UNDERGONE ANY BASIC CHANGE SINCE DELORS WROTE TO THE CHANCELLOR BEFORE THE JANUARY G10 MEETING. THE FRENCH CONTINUE TO SEEK AN INCREASE IN THE SIZE OF THE FUND IN THE UPPER PART OF THE RANGE OF INCREASES PROPOSED AND ARE STILL SYMPATHETIC TO LDC ARGUMENTS IN FAVOUR OF A HIGH DEGREE OF EQUIPROPORTIONALITY.

3. FOLLOWING TRADITIONAL PRACTICE, THERE WILL BE A MEETING OF FRANC ZONE MINISTERS OF FINANCE IN PARIS ON 8 FEBRUARY AND DE ROSEN UNDERTOOK TO CONTACT US AFTER THAT IF AS A RESULT HE HAD ANYTHHING URGENT AND IMPORTANT TO TELL US.

FCO PLEASE ADVANCE TO:
APPLEYARD - ERD.
BOTTRILL - HM TREASURY.

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FM SANTIAGO 021600Z FEB 83

TO IMMEDIATE F C O

TELEGRAM NUMBER 104 OF 2 FEBRUARY

AND TO IMMEDIATE BANK OF ENGLAND (CRAWFORD), DOT (OWEN), TREASURY (DENNISON), ECGD (BREACH CPD)

OUR TELEGRAM NUMBER 76

CHILE : DEBT RESCHEDULING

1 FROM RECENT CONVERSATIONS WHICH AMY HAS HAD WITH THE MINISTER OF FINANCE, LUDERS, THE PRESIDENT OF THE CENTRAL BANK, CACERES, AND REPRESENTATIVES OF SOME OF THE 12 BANKS INVOLVED IN THE RECENT NEW YORK RESCHEDULING TALKS, THE FOLLOWING PICTURE EMERGES. THE CHILEAN GOVERNMENT HAS PROPOSED THAT ALL CHILEAN PUBLIC AND PRIVATE EXTERNAL DEBT MATURING WITHIN THE NEXT 90 DAYS SHOULD BE ROLLED OVER FOR A FURTHER 90 DAYS WITH IMMEDIATE EFFECT. AS FAR AS WE KNOW, ALL 12 BANKS ARE NOW DOING THIS AUTOMATICALLY FOR ''WORKING CAPITAL'' LOANS AND HAVE RECOMMENDED THAT OTHERS SHOULD FOLLOW THEIR EXAMPLE,. WE HEAR THAT SOME US REGIONAL BANKS ARE STILL UNHAPPY, BUT WILL PROBABLY FOLLOW THE PACK. AS REGARDS TRADE-RELATED LOANS, THE TREND APPEARS TO BE TO MAINTAIN OR SLIGHTLY REDUCE BANKS' CURRENT LEVELS OF EXPOSURE.

2. AT NEW YORK, LUDERS AND CACERES ALSO PROPOSED THAT CHILE'S 1983 AMORTIZATIONS (US DOLLARS 1.33 BN) SHOULD BE ALLOWED A FIVE-YEAR GRACE PERIOD AND REPAYED IN THE THREE YEARS THEREAFTER (IN 1988-91). FOR THE 1984 AMORTIZATIONS (US DOLLARS 1.06 BN), A FOUR OR FIVE YEAR GRACE PERIOD IS SOUGHT WITH A FOUR OR THREE YEAR REPAYMENT PERIOD THEREAFTER. WE DO NOT KNOW BANKERS' REACTIONS TO THESE PROPOSALS BUT THE CHILEAN PRESS REPORTS TODAY THAT THE FINANCIAL TIMES HAS CLAIMED THAT LONDON BANKERS REGARD THESE PERIODS AS EXCESSIVE.

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3. LUDERS HAS ALSO ANNOUNCED THAT CHILE WILL BE LOOKING FOR A FRESH LOAN OF US DOLLARS 913 M FROM THE FOREIGN BANKS IN 1983 (WITH 3/4 YEAR GRACE PERIOD AND 7 YEARS IN TOTAL TO PAY).

4. WE GATHER THAT THE PRINCIPAL STUMBLING BLOCK AT NEW YORK WAS THE QUESTION OF FOREIGN BANKS' DIRECT LENDING TO CHILEAN PRIVATE SECTOR COMPANIES, AND THAT BANK OF AMERICA WALKED OUT OF THE MEETING ACCUSING THE CHILEAN GOVERNMENT OF SHIRKING ITS RESPONSIBILITIES IN THIS AREA . WE BELIEVE THAT THIS ASPECT IS ALSO OF PARTICULAR RELEVANCE FOR US SINCE A SIGNIFICANT PROPORTION OF BRITISH BANKS' EXPOSURE TAKES THE FORM OF DIRECT LOANS TO THE PRIVATE SECTOR.

5. LUDERS AND CACERES WILL BE VISITING NEW YORK (AND POSSIBLY JAPAN) FOR FURTHER DISCUSSIONS AROUND 7-14 FEBRUARY AND WILL BE IN EUROPE AROUND 21-26 FEBRUARY TO TALK TO PRIVATE BANKERS.

6. GRATEFUL FOR IMMEDIATE ADVICE FROM THE BANK OF ENGLAND ON TOTAL BRITISH LOAN EXPOSURE TO CHILEAN BANKS AND CHILEAN PUBLIC AND PRIVATE COMPANIES (SEPARATE FIGURES IF POSSIBLE) SMI COLON AND GUIDANCE AS TO THE ATTITUDE WE SHOULD ADOPT IN FUTURE CONTACTS WITH THE CHILEAN AUTHORITIES. I EXPECT TO SEE BOTH LUDERS AND CACERES ON 7 FEBRUARY.

HICKMAN

FINANCIAL
SAMD

COPIES TO
MR CRAWFORD B/ENGLAND
MR DENNISON TREASURY
MR OWEN DOT
MR BREACH CPD ECGD

ECON POL Sup
bc. Mr. Walters
+ report (copied already below)

10 DOWNING STREET

From the Private Secretary 1 February 1983

Thank you very much for your letter of 31 January, with which you enclosed a further report prepared by the Bank of England on the international banking system.

The Prime Minister read this with great interest. She would indeed like to continue to receive reports of this kind. So far as the format of the reports is concerned, I doubt whether it is necessary to include detailed annexes which were appended to the report. No doubt this material is readily available if the Prime Minister wished to have the detailed information; so that it would be best to keep the size of the report down in this way.

I am sending copies of this letter to Brian Fall (Foreign and Commonwealth Office) and Tim Allen (Bank of England).

M. C. SCHOLAR

John Kerr, Esq.,
HM Treasury.

CONFIDENTIAL

→ c AW

Prime Minister

I assume you would like to go on receiving these reports?

MCS 31/1

Yes please

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Michael Scholar, Esq
10 Downing Street
LONDON SW1

31 January 1983

Dear Michael,

I enclose a further report prepared by the Bank of England on the international banking situation, together with annexes discussing individual countries in more detail. You will realise that this continues to be a fast-moving scene, and that the notes on particular countries are liable to become out of date very quickly.

The Treasury and Bank of England are in close touch continuously on these subjects, and review the position more comprehensively every few weeks with FCO officials and others closely interested.

Perhaps you would let me know if you would like to continue to receive reports of this kind, and whether the form of the attached material is about right.

Copies of this letter, and the report, go to Brian Fall at the FCO and Tim Allen at the Bank.

Yours ever,

John Kerr.

J O KERR

CONFIDENTIAL

CONFIDENTIAL 27.1.83

INTERNATIONAL BANKING SITUATION

Since November the main preoccupation of the markets has shifted from Mexico to Brazil, which has been forced by its acute cash shortage to follow a rather similar path. The Brazilians, by protesting too much that their situation was under better control than the Mexican one and by mishandling their relations with the commercial bankers, initially created some confusion. Following strong pressure from the Bank, they have, however, now put the organisation in place for a fairly speedy conclusion to negotiations with the banks, and the response to their package of financing measures has been encouraging. Larosière has swung firmly behind the Brazilians' request and on Monday 24 January adopted the same tactics towards the banks as he did for Mexico, telling them that he would only recommend the Brazilians adjustment programme to the IMF Executive Board if he had confirmation from the banks that they had fully committed themselves to the financing package. The negotiations on most parts of the package for Argentina have been concluded except for final details of rescheduling of 1983 maturities.

The Venezuelans and the Chileans both have payments difficulties, but the root causes are rather different from the rest. Venezuela has a history of incompetent administration of its international financing, recently compounded by some loss of confidence in the domestic banks. It has sensibly decided to shift from a policy of reliance on short-term debt to funding with longer maturities but has handled the implementation poorly. Its once ample reserves are being dissipated in the process and now the prospects for the oil price threaten to worsen the situation. Chile's domestic difficulties have led to a crisis in their domestic banks; a number of these are either being liquidated or taken over by the government in a way which initially seemed to treat foreign creditors rather badly. Most of Chile's foreign debt has been contracted by private borrowers which makes it harder to find a collective solution.

There is some concern lest the domestic crisis spills over and infects their relations with foreign creditors.

In Eastern Europe, negotiations are in progress on restructuring 1983 maturities of Poland and Romania, although in the case of Poland, this is restricted to commercial bank debt until the conditions for the resumption of talks on official debt are met. Meanwhile, Poland enjoys de facto a 100% moratorium on official debt. The Yugoslav situation is more untidy, with Yugoslavia reluctantly accepting the need to restructure its debt within a package (including new money), largely put together at the instigation of the IMF and the US authorities and involving international institutions, governments and commercial banks. Details for the countries mentioned are given in the attached table and the country notes; there are also notes on East Germany and Hungary, which could also run into financing difficulties.

Confidence within the international markets is improving despite some unhelpful new developments, like the Chilean difficulties. The ability of the system to deal with shocks of this kind, demonstrated by the experience of the last half year, seems, for the time being at least, to have removed the fear of a widespread collapse of the system and to encourage confidence that major debt problems can be dealt with. Swift action by the authorities in providing inter-government or BIS/central bank assistance to Brazil in conjunction with firm handling by Larosière of the IMF relationship, both with the borrowers and the private lenders, has shown that official response to Mexico earlier on was not a flash in the pan but a demonstration by the authorities not to allow panic to cause or spread instability. A symptom of the restored resilience of the market against this background is the way it took in its stride this week the announcement that a US bank (Seafirst Corporation of Seattle) with large loan losses in the energy sector and considerable exposure to Latin America, had been given a $1.5 bn credit to strengthen it by a consortium of major US banks; this news last summer would have rung alarm bells throughout the international and US domestic banking markets.

Nevertheless, there is still some tension which will last until the agreements on the financing packages for the problem countries have been signed, probably within the next couple of months. Whether that tension lessens very much thereafter must depend on a number of other factors. The direction of the oil price in the wake of the disarray in OPEC is now hanging over some of the heavily indebted countries. If there is a substantial and rapid decline it will threaten the revenue of Mexico, Venezuela and some other countries like Nigeria and Indonesia which could be vulnerable. It could also have an adverse impact on energy-related borrowers in Canada and the US with the risk of a knock-on effect on some of their domestic banks.

Other debtor countries dependent on imported energy like Brazil will benefit from the improvement in their balance of payments and that prospect ought in principle to improve their creditworthiness. As well as this direct benefit, they could also be helped by any resulting general stimulus to the world economy which could reinforce the recovery expected later this year. However, there is a danger that the impact on Mexico and the other heavily indebted oil producers will lead to a more generalised deterioration in the financing climate. The banking community in the past has not always differentiated adequately between sovereign borrowers and if this were repeated then other Latin American countries would also find themselves under the same cloud.

In conclusion, the crisis has so far been successfully contained and we now have to nurse the recovery to cautious confidence. There are still risks. The appetite of the banks for international lending is expected in any event to be reduced. The outcome will be improved by signs of recovery in the major economies and any other indicators that the adjustment programmes agreed with the IMF can and will stick. Agreement in the forthcoming Interim Committee meeting on a substantial increase in Fund quotas will also do much to restore nerves.

INTERNATIONAL FINANCIAL SUPPORT PACKAGES

A: LATIN AMERICA

	MEXICO	BRAZIL	ARGENTINA	VENEZUELA	CHILE
Estimated debt outstanding (end-1982)	$83 bn	$81 bn	$39 bn	$28 bn	$18 bn
Payments arrears	Moratorium on public sector principal payments (from August 1982) during negotiation of restructuring	Moratorium on public & private sector principal payments (from January 1983) during negotiation of restructuring	-	-	-
	$1.3 bn principal and interest on private debt	-	$2.5 bn principal and interest on public and private debt	$84 mn which authorities have undertaken to pay off	-
Rescheduling negotiations	$19.5 bn public sector maturities reportedly falling due 23.8.82-31.12.84 (requested)	$4.0 bn public & private sector maturities falling due in 1983 (requested)	$5.5 bn public sector maturities overdue on 1.12.82 and falling due from then to 31.12.83 (requested)	$5.9 bn public sector short-term debt being refinanced — not strictly "rescheduled" (in progress)	$2.8 bn private commercial bank maturities falling due in 1983 and 1984 (request imminent)
Terms					
: LIBOR + (%)	+ 1 7/8	+ 2 1/8 - 2 1/2	+ 2 1/8	1-1 5/8	N/A
: Prime + (%)	+ 1 3/4	+ 1 7/8 - 2 1/4	+ 2	1 1/4 - 1 1/2	N/A
: fee (%)	1	1 1/2	1 1/8	?	N/A
: grace period (years)	4	2 1/2	3	0 - 2 1/2	N/A
: maturity (years)	8	8	7	2 - 7	3-5?
New money from banks	Target $5 bn for 1983 o/w over $4.7 bn committed by 24.1.83	Target $4.4 for 1983 o/w $4.1 bn committed by 24.1.83	Target $1.5 bn for 1983	-	not yet known
		$2 bn bridging loan apparently obtained	$1.1 bn bridging loan signed 31.12.82 ($600 mn drawn by 10.1.83)		
Official assistance				-	-
: BIS	$925 mn (almost fully drawn)	$1.2 bn (fully drawn)	$0.5 bn agreed		
o/w UK	($140 mn)	($110 mn)	(NIL)		
	$925 mn parallel US facility	$250 mn parallel SAMA facility			
: Governments	$2 bn requested	$1.5 bn (US Treasury)	-		
o/w UK	($150 mn)				
: IMF	SDR 3.4 bn (EFF) SDR 0.2 bn (1st credit tranche) (both approved December 1982)	SDR 4.2 bn (EFF) SDR 0.2 bn (1st credit tranche) (approval of both end-Feb?) SDR 0.5 bn (CFF) (approved Dec 1982)	SDR 1.5 bn (standby) SDR 0.5 bn (CFF) (both approved January 1983)		SDR 0.5 bn (standby) SDR 0.3 bn (CFF) both approved January 1983)

B: EASTERN EUROPE

	ROMANIA	YUGOSLAVIA
Estimated debt outstanding (end-1982)	$11 bn	$20 bn
Payments arrears	Principal payments temporarily suspended (from January 1983) during negotiation of restructuring	90-day deferral of principal payments falling due to 31.3.83 (from 18 January 1983) during negotiation of restructuring
	-	-
Rescheduling negotiations	$2 bn in 1981 arrears and 1982 maturities (signed) $1.1 bn of 1983 maturities (requested)	$1 bn medium/long-term debt maturities in 1983 rolled over (proposed) $2 bn short-term maturities rolled over for 18-24 months (proposed)
Terms		
: LIBOR + (%) : Prime + (%) : fee (%) : grace period (years) : maturity (years)	N/A	N/A
New money from banks	-	$1 bn proposed
Official assistance		
: BIS o/w Bank of England		$0.5 bn requested ($30 mn?)
: Governments o/w UK		$1.3 bn £78 mn
: IMF	SDR 1.1 bn (standby) approved June 1981 o/w SDR 450 mn drawn; SDR 368 mn to be available in 1983; balance in 1984 H1	SDR 1.7 bn (standby) approved o/w SDR 554 mn in 1983 (last year)

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EASTERN EUROPE

East Germany - GDR

1 Total convertible currency indebtedness has been as high as perhaps $16 bn but is probably now declining, at some considerable cost in terms of economic disruption. Existing undrawn credit facilities are sizeable but have nevertheless fallen quite sharply. GDR is unable to raise substantial new credits from Western banks. Figures recently released by the BIS show that gross debts to BIS banks (excluding banks in West Germany) have declined from over $10 bn at the end of December 1981 to $8 1/2 bn at the end of September 1982. The decline has been achieved partly by running down reserves and partly by savage cutbacks in imports, which cannot be sustained indefinitely. Payments delays and approaches to suppliers for longer than normal credit terms have become more frequent. We understand, in confidence, that an approach for assistance in raising a DM financing credit equivalent to some $1.5 bn was made to the West German government. The French have been requested to accept some deferment of repayment obligations. Serious debt servicing problems (and perhaps rescheduling) are still possible. ECGD has introduced tighter market limits but is still on cover.

Hungary

2 Total convertible currency indebtedness was $7.4 bn at the end of June 1982 having fallen from $8.7 bn at the end of December 1981. Hungary has been helped over short-term liquidity problems this year by several tranches of bridging finance from the BIS in which the Bank of England participated (without official guarantees). The amount outstanding at any one time has varied but is currently $300 mn of which the Bank share is 6.7 per cent. In response to a deteriorating convertible currency balance of payments position, and under the aegis of the IMF, the Hungarians introduced a number of measures, including devaluations and increases in consumer prices, and have also raised interest rates. The convertible currency current account, in consequence, is now in rough balance. On

8 December the IMF Board approved an economic adjustment programme providing $0.6 bn over 13 months. However, Hungary still faces a substantial debt burden over the next few years and will need further IMF programmes until debt is reduced to more manageable levels. The country will remain highly vulnerable to the weakness of banking confidence in Eastern Europe until large enough current account surpluses are achieved to repay some maturing debt and rebuild reserves. ECGD commitments are modest and under tight control.

Poland

3 Total convertible currency indebtedness is about $25 bn. Bank and official creditors both negotiated rescheduling agreements in respect of debts due in 1981. Following the declaration of martial law in December 1981 virtually none of the $10 bn convertible currency obligations falling due in 1982 has been paid. On 3 November this year the banks signed a rescheduling agreement covering 95 per cent of the $2.4 bn repayments of principal due in 1982. Under the agreement half the interest due in 1982 is to be lent back in the form of new three-year credits. Western official creditors agreed after the imposition of martial law not to resume talks on official rescheduling for the time being and did not attempt to negotiate a rescheduling agreement for 1982. In practice, the effect of this refusal has been to allow Poland to stop all payments, thereby gaining 100 per cent de facto relief on both principal and interest. We (and many other Western creditors, but excluding the US and France) would like to have a rescheduling agreement in place, so as to receive payment of at least some of the debt. The Poles are expected to begin negotiating the rescheduling of 1983 commercial bank maturities in early February. To some extent Polish insolvency has been discounted by the banks, many of which have written off a proportion of their loans, but total default would still impose a burden. ECGD is off cover.

Romania

4 Total convertible currency debt is about $11 bn. In July the Paris Club agreed the general terms of a rescheduling of 80% of

debts due in 1982. Bilateral agreements have now been signed with most creditor countries (including the UK). The separate negotiations on the rescheduling of bank debts were completed in December and the Romanians have now approached the Paris Club and commercial banks to propose rescheduling 75% of 1983 maturities. Governments have already agreed in principle to consider this provided that access to IMF resources remains open and banks are also likely to reach an agreement before too long. A substantial adjustment in the Romanian economy, and continuing access to IMF funds, should eliminate the need for reschedulings in subsequent years. ECGD is off cover.

Yugoslavia

5 Total indebtedness is about $20 bn. Notwithstanding an IMF upper tranche programme, Yugoslavia failed to come to grips with increasingly severe payments imbalances resulting from high growth and investment rates in the late 1970s. With reserves largely exhausted, an international package is being devised under IMF auspices to provide Yugoslavia with new credit whilst restructuring existing debt. To cope with the Yugoslav insistence that they will not reschedule, other euphemisms are being employed. Imports have been cut drastically and other recent economic measures include devaluations and increases in prices and interest rates. The IMF has now reached agreement on a tight programme, for the third year of the current standby agreement. This is the key to the proposed financial package which includes a $500 mn bridging facility by the BIS (backed partly by gold and partly by central banks) and some $1.3 bn in government credits as well as further IMF and IBRD monies. HMG's contribution to the government credits will be in the order of $125 mn (part of which is likely to serve initially as collateral for the Bank of England participation - expected to be around $30 mn - in the BIS bridging operation). The commercial banks are being requested to roll-over some $3 bn of maturities this year and to provide a further $1 bn in new money. Yugoslavia has, at their suggestion, sought a 90-day deferral of maturities to give more time for discussions. The indications are that a financial package is feasible, though its adequacy will depend on the success of the IMF programme . ECGD has a substantial exposure to Yugoslavia, but is now virtually off cover except for short-term business.

LATIN AMERICA

1 Argentina

Total indebtedness at end-1982 was an estimated $39 bn. Financial sanctions between the UK and Argentina were lifted jointly in September. Following subsequent negotiations, Argentina reached agreement in early November with the four main UK clearing banks on the settlement of debt arrears built up while the sanctions were in force. Other UK banks also subsequently began to receive payments from the Argentines. We understand that these arrears have been more or less settled. This paved the way for the signing of a $1.1 bn banks' bridge loan on 31 December and enabled discussions to continue on a further $1.5 bn medium-term loan (which bankers expect to be finalised by end-February) and on the rescheduling of $5.5 bn of public sector debt maturities overdue on 1.12.82 and falling due from that date to 31.12.83. Official support has come from the IMF in the form of a 15-month Standby Arrangement worth SDR 1.5 bn and a CFF for SDR 520 mn. These were approved at an Executive Board meeting on 24 January. As well as fulfilling normal performance criteria, drawings under the programme after end-July are subject to the removal of existing discriminatory restrictions (which in effect means the remaining restrictions against UK interests). A $500 mn BIS facility has been arranged but does not involve UK participation. Despite the rapid international response to Argentina's financial difficulties, there are widespread fears that the unstable domestic political situation will conspire to make the IMF programme unworkable and thus jeopardise further bank loan disbursements which are conditional on continued access to Fund resources.

2 Brazil

Total indebtedness at end-1982 was an estimated $81 bn. Following difficulties, particularly in October, in obtaining medium-term finance in the wake of the Mexican crisis, the authorities turned to official bodies, international organisations and banks for emergency loans to see them through the remainder of 1982.

Official support has included credits of $1.5 bn from the US Treasury; $1.2 bn (UK participation of $110 mn) from the BIS, supplemented by a parallel facility of $250 mn from the Saudi Arabian Monetary Agency (SAMA); and an SDR 500 mn CFF from the IMF. A request for an SDR 4.2 bn 3-year EFF should be approved by the IMF Executive Board by end-February. International banks, which had provided bridging finance totalling $2 bn, were approached on 20 December for a four-project package consisting of: (1) $4.4 bn in new money (for the whole of 1983); (2) the rescheduling of 1983 maturities (both public and private sector) to an amount put by the Brazilians at $4.0 bn; and the restoration of (3) trade-related credit lines and (4) interbank facilities to the higher of their exposure to Brazil at 30. 6.82 or 31.12.82. Whilst projects 1 and 2 have received a good response from banks (commitments respectively of $4¼ bn and, according to the Brazilians, $4.3 bn), the restoration of credit lines has been more difficult. There are also fears that the Brazilian forecast of a trade surplus of $6 bn is over-optimistic and as a result banks could well be approached for further financing later in the year.

3 Chile

Total indebtedness at end-1982 was an estimated $18 bn (two-thirds private sector). The economy is deep in recession (real GDP fell by 13% last year). Reserves have fallen sharply from $3.3 bn at end-1981 to $1.9 bn at the end of last year, largely as a result of the difficult conditions in the euromarkets and speculation against the peso. A two-year IMF Standby (SDR 500 mn) and a CFF (SDR 297 mn) were approved by the IMF Board on 10 January. However confidence in the country is low as a result of Chile's domestic financial crisis which came to a head on 13 January when the authorities announced the liquidation of two banks and a finance house and the "intervention" of a further five banks. After initial doubts as to their intentions the Chilean authorities have indicated that they would deal responsibly with the foreign liabilities of these institutions ($3.8 bn) - possibly in the context of the renegotiation of commercial banking debt which is currently being sought. This is likely to affect some $2.8 bn in maturities falling due this year and next. The question of new money from banks is also likely to be raised and initial meetings were being held in the week ending 28 January. With debt service amounting to $3.6 bn on medium and long-term public and private sector debt, and with an additional $4 bn in short-term debt to be rolled over, agreement with the bankers will need to be reached if Chile is to avert a wider rescheduling.

4 Mexico

Total indebtedness at end-1982 was an estimated $83 bn. Concerted international co-operation in helping to resolve the country's external financial difficulties and early indications of the willingness of the new administration, which took office on 1 December 1982, to adopt sound economic adjustment measures facilitated IMF approval of a 3-year EFF and a first credit tranche drawing, totalling SDR 3.6 bn, on 23 December. With the aim of closing Mexico's financing gap in 1983, the IMF's Managing Director had earlier asked commercial banks to lend $5 bn in new money (over $4.7 bn had been committed by late January) and had also requested a total of $2 bn (over $1.8 bn committed) in official export credits from various governments (including the UK). Under the $925 mn BIS bridging facility (UK participation of $140 mn), which had been linked, inter alia, to progress on an IMF arrangement, all but $70 mn of the third (and final) tranche had been drawn by 20 January. Following an agreed extension for four months to 23 March 1982 of an original 90-day moratorium on public sector capital repayments due to banks, the authorities submitted formal rescheduling proposals to the Advisory Group of banks in early December. Under the proposals, principal payments on public sector debt outstanding at 23 August 1982 and falling due between then and end-1984 would be rescheduled over up to 8 years. Plans to reschedule private sector debt are expected to be announced shortly. Looking to the future, major uncertainties over the Mexican's ability to adhere to the IMF's tough programme targets are reinforced by the likelihood of a further reduction in the price of oil, which accounts for some 75% of the country's exports. Any serious under-performance in relation to the IMF programme would risk unwinding the current international financial rescue operation.

5 Venezuela

Total indebtedness at end-1982 was an estimated $28 bn. With oil accounting for 95% of exports and 60% of fiscal income the weakness in the oil market led to severe strains in Treasury finances last year. Together with the country's difficulties in the euromarkets this has led to sustained speculative pressure on the Bolivar and a sharp fall in reserves. Confidence in the country has also been badly shaken by the collapse of the Banco de los Trabajadores (the Trade Unions' bank) which was brought under the control of the government in late November. Venezuela is currently attempting to refinance \$2.4 bn of short-term debt maturing by end-March and intends to refinance a further \$3.5 bn by the end of this year (out of a total of \$8.7 bn). The programme started quite successfully in October but has run into difficulties following a series of late payments by some state agencies, in particular the development agency CVF (which has been declared in default). In view of the danger that the refinancing programme could collapse as a result the authorities have said they will ensure that the \$84 mn of CVF arrears will be settled. International reserves totalled around \$11 bn at end-1982, but foreign exchange reserves in the hands of the Central Bank were only some \$2.5 bn - leaving Venezuela insufficiently liquid to sustain heavy repayments as a result of refinancing shortfalls or to cope with further capital outflows without, for example, gold sales.

Commonwealth Information

NEWS RELEASE

24 January 1983

83/7

STUDY ON THE INTERNATIONAL FINANCIAL AND TRADING SYSTEM

The Commonwealth Secretary-General, Mr Shridath Ramphal, today announced the setting up of a Steering Group of nine eminent Commonwealth experts to guide the Secretariat in a study of the international trade and payments system, including the role of the international economic institutions.

The group, with Professor Gerald Helleiner of the University of Toronto as its chairman, will have its first meeting in London this week (27 - 29 January).

The Secretariat was asked to undertake the study by Commonwealth Finance Ministers at their meeting in London in August 1982.

At that time, Ministers expressed concern over the state of the world economy and the increasing strains in the international financial system. To avoid further deterioration and to institute a process of sustained recovery, they felt there was need for reform of the whole framework of international economic cooperation.

In pursuit of this reform and to forestall what he termed 'the emerging economic crisis', the Prime Minister of New Zealand, Mr Robert Muldoon, called for a new Bretton Woods type international conference. While his analysis and proposals received widespread support, the meeting felt that a prior need was a comprehensive examination of the international financial and trading system. They agreed, therefore, to a Nigerian proposal that the Commonwealth Secretariat should undertake a major study of the international trade and payments system, including the role of international institutions like the International Monetary Fund and the World Bank.

COMMONWEALTH SECRETARIAT
Marlborough House
London SW1Y 5HX
01-839 3411

Subsequently, Commonwealth Heads of Government of the Asia/Pacific Region, at their meeting in Fiji in October 1982, welcomed the initiative and called for the examination to be comprehensive. More recently, there have been signs of still wider support for a review of the international financial and trading system, possibly including a conference - on the line of Bretton Woods.

The Steering Group has been appointed to bring to bear on the study professional competence and relevant experience of the highest level available in the Commonwealth. Besides Professor Helleiner, the Group includes Professor Conrad Blyth, Dr William Demas, Ambassador Kenneth Dadzie, Professor Stuart Harris, Dr Lal Jayawardena, Sir Jeremy Morse Mr I G Patel and Mr Harry Osha. Brief biographical notes on the members of the Group are attached.

Members will serve in their personal capacities and not as as representatives of their governments or institutions. In view of the importance of the study to the whole international community, the Steering Group is expected to consult a cross-section of leading personalities, both within and outside the Commonwealth.

The first meeting of the group will be held on 27 - 29 January 1983 in Marlborough House, London; further meetings will be arranged to allow the study to be completed in advance of the next Finance Ministers Meeting in September 1983.

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MEMBERS OF THE STEERING GROUP

Professor Gerald K Helleiner (Chairman)	Professor of Economics, University of Toronto; Vice Chairman, North-South Institute, Ottawa
Professor Conrad Blyth	Professor of Economics and Head of Economics Department, University of Auckland; formerly Senior Economist, Social Policy Division, OECD.
H E Mr Kenneth Dadzie	High Commissioner of Ghana to the United Kingdom; formerly Director-General for Development and International Economic Cooperation, United Nations.
Mr William Demas	President, Caribbean Development Bank, Barbados; Chairman, UN Committee for Development Planning; formerly Secretary-General, Commonwealth Caribbean Regional Secretariat.
Professor Stuart Harris	Director, Centre for Resources and Environmental Studies, Australian National University, Canberra.
H E Dr Lal Jayawardena	Ambassador Extraordinary, Ministry of External Affairs, Colombo; formerly Ambassador of Sri Lanka to Belgium, the Netherlands and Luxembourg and to the European Communities, and Secretary to the Treasury and to the Ministry of Finance, Sri Lanka.
Sir Jeremy Morse	Chairman, Llyods Bank Limited; Chairman, Committee of London Clearing Banks; formerly Chairman of the Deputies of the Committee of the Board of Governors of the IMF on Reform of the International Monetary System and Related Issues (the Committee of Twenty).
Mr Harry M Osha	Executive Chairman, Milestone Investment Services Limited; formerly Managing Director, Nigerian Industrial Development Bank Limited and Deputy Permanent Secretary, Federal Ministry of Finance, Nigeria.
Mr I G Patel	Director, Indian Institute of Management, University of Ahmedabad, India; formerly Governor of the Reserve Bank of India, Deputy Administrator UNDP, and Secretary to the Ministry of Finance, India.

Prime Minister

2

Mts 17/1

17 January 1983
ALAN WALTERS

Econ. Pol.

PRIME MINISTER

CHILE

MT

The problem of lack of confidence in the currency has resulted in a disintegration of the financial system in Chile. A flight of capital and the resulting strain on liquidity has resulted in three major banks being liquidated. And in the case of the five major banks in Chile, covering about 65% of the banking system, the government has appointed a man who they call a manager. They will remain in business under government direction. The government has not guranteed the debts of these banks. But it has said it will meet their liquidity needs.

In particular, the government takes the view that liquidated banks may default on their foreign debt. This, it is said, will teach the lenders a lesson to be more discriminating in their lending practices. One would think that it is a bit late in the day to do that.

The government are putting some pressure on private creditors to establish rescheduling of debts with creditors. This again is a complete reversal of policy since, when I was there, there was a policy of "no rescheduling". I expressed by scepticism about such a policy, but it was reversed even quicker than I thought ~~it would~~.

These reversals and confusions of policy will undoubtedly lead to another great capital outflow. I suspect that the authorities will be unable to hold the peso at the "crawling peg" rate of about 73 pesos to the dollar. The result will be dreadful turmoil and confusion in the foreign exchange markets.

I am very worried about the effects of Chile on the international financial system. It is a small country and it does not have the priority that Mexico, Brazil and Argentina enjoy in the international banking system. I suspect it hardly figures in Paul Volckers's "drip feeding" arrangements. It could just spark off a major crisis. I do not know the distribution of their creditors, although they are clearly for the most part American banks. I have tried to check with my contacts in the United States, but they seem to know very little about the risks involved. While it is mainly

/the Fed's

the Fed's responsibility to bail out American banks, I am not entirely certain that they are apprised of the dangers.

17 January 1983

ALAN WALTERS

RESTRICTED

GRS 245

RESTRICTED [CULL]

FM BRASILIA 31:1700Z DEC 82

TO IMMEDIATE FCO

TELEGRAM NUMBER 487 OF 31 DECEMBER

REPEATED INFO BANK OF ENGLAND, UKDEL IBRD WASHINGTON

SAVING INFO RIO DE JANEIRO, SAO PAUL, BONN, PARIS

MY TELNO 486 BRAZIL: FOREIGN DEBT

1. ACCORDING TO REPORTS IN TODAY'S BRAZILIAN PRESS, SERRANO, DIRECTOR OF THE BANCO CENTRAL'S FOREIGN SECTOR, STATED YESTERDAY THAT IF THE INTERNATIONAL BANKS DID NOT ACCEPT BRAZIL'S PROPOSALS FOR RESCHEDULING THE LOANS FALLING DUE IN JANUARY AND FEBRUARY 1983 BY 1 MARCH 1983 THE COUNTRY WOULD HAVE NO ALTERNATIVE BUT TO DECLARE ITSELF INSOLVENT. SERRANO ADDED, HOWEVER, THAT THE BANCO CENTRAL WAS NOT YET WORKING ON THIS HYPOTHESIS.

2. UNTIL YESTERDAY LESS THAN HALF OF THE 648 INTERNATIONAL BANKS ASKED HAD GIVEN A POSITIVE REPONSE TO THE PROPOSALS MADE IN NEW YORK. NO BANK HAD SAID NO.

3. NOW THAT TIME HAS VERY NEARLY RUN OUT BEFORE THE FIRST 1983 AMORTISATIONS ARE DUE TO BE PAID, BRAZIL, AND THE LARGE BANKS WHICH ARE SUPPORTING HER, ARE FACED WITH THE PRACTICAL PROBLEM OF WHAT TO DO WHILE THEY WAIT FOR MEDIUM AND SMALL BANKS TO REPLY. PRESS OPINION IS THAT THEY WILL ASSUME SILENCE IS CONSENT AND GO AHEAD WITH THE OPERATIONAL PLAN TELEXED TO ALL THE BANKS.

FCO PSE PASS SAVING TO BONN AND PARIS

HARDING

[REPEATED AS REQUESTED]

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FM MEXICO CITY 241800Z DEC 82
TO ROUTINE FCO
TELEGRAM NUMBER 1084 OF 24 DECEMBER
INFO TREASURY, DOT, ECGD, BANK OF ENGLAND, UKDEL IMF/IBRD, WASHINGTON

MEETING WITH MEXICAN MINISTER OF COMMERCE.

1. ON 21 DECEMBER THE COMMUNITY AMBASSADORS ENTERTAINED HECTOR HERNANDEZ, THE NEW MEXICAN MINISTER OF COMMERCE, TO LUNCH, AND HAD A GENERAL DISCUSSION WITH HIM ABOUT THE CURRENT PROBLEMS OF THE MEXICAN ECONOMY.
2. HERNANDEZ EMPHASISED THE DEGREE TO WHICH THE MEXICAN ECONOMY WAS INTERTWINED WITH THAT OF THE UNITED STATES. THIS MEANT THAT MEXICO SUFFERED MORE THAN MOST COUNTRIES FROM THE MEASURES WHICH THE US ADMINISTRATION HAD TO TAKE TO MAINTAIN THE ROLE OF THE DOLLAR AS THE WORLD'S PRINCIPAL RESERVE CURRENCY. AT PRESENT MEXICO SUFFERED NOT ONLY FROM A SEVERE SHORTAGE OF DOLLARS BUT ALSO FROM AN UNEXPECTED OUTFLOW OF PESOS TO THE UNITED STATES. THIS HAD BEEN ONE OF THE RESULTS OF THE PREVIOUS EXCHANGE CONTROL SYSTEM. INDEED THE EFFECT OF THIS HAD BEEN TO PROVIDE ONLY SOME 20% OF THE IMPORTS NEEDED TO KEEP THE MEXICAN ECONOMY TURNING. HE HOPED THAT THE NEW SYSTEM WOULD GRADUALLY PUT THINGS RIGHT.
3. HERNANDEZ EMPHASISED THAT UNDER THE NEW EXCHANGE SYSTEM THERE WOULD BE NO GOVERNMENT SIBSIDY. DOLLARS EARNED BY EXPORTS AND DOLLARS USED FOR IMPORTS WOULD BOTH BE AT THE CONTROLLED RATE, WITH A NEGLIGIBLE DIFFERENCE BETWEEN BUYING AND SELLING RATES. THUS THE RISK OF THE AMERICANS IMPOSING COUNTERVAILING DUTIES HAD BEEN REMOVED. THE GOVERNMENT WOULD BE OBLIGED TO MAINTAIN ITS SEVERE RESTRICTIONS ON IMPORTS. IT COULD NOT AFFORD TO DO OTHERWISE. BUT IMPORTS OF AROUND US DOLLARS 15 BILLION WOULD STILL BE NECESSARY IN 1983. HE MENTIONED THAT SOME US DOLLARS 11 BILLION WOULD BE AVAILABLE FOR USE AT THE CONTROLLED RATE, AND SOME US DOLLARS 3 BILLION AT THE FREE MARKET RATE. HE FEARED THAT THERE WOULD BE A NEGATIVE GROWTH IN GNP IN 1983 BUT WAS SURE THAT THE ECONOMY WOULD RECOVER SOON AFTER.
4. THERE WAS A BRIEF DISCUSSION ABOUT THE POSSIBILITY OF EVENTUAL MEMBERSHIP OF GATT. HERNANDEZ SAID THAT IMMEDIATE ACCESSION WOULD INVOLVE MORE BANKRUPTCIES AND MORE UNEMPLOYMENT IN KEY SECTORS. IN THE LONGER TERM THE GOVERNMENT WOULD ATTEMPT TO REDUCE PROTECTION AND MAKE IT MORE SELECTIVE. HE IMPLIED THAT GATT MEMBERSHIP WAS A DISTINCT POSSIBILITY IN THE FUTURE.

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5. HERNANDEZ SAID THAT THE EUROPEAN COUNTRIES HAD GREATLY IMPROVED THEIR SHARE OF THE MEXICAN MARKET IN THE LAST FEW YEARS, AND HAD GENERALLY DONE PRETTY WELL OUT OF MEXICO. HE WELCOMED THE DEGREE OF DIVERSIFICATION WHICH THIS INVOLVED AND THE CORRESPONDING REDUCTION IN MEXICAN DEPENDENCE ON THE UNITED STATES. BUT IF THE EUROPEANS WISHED TO RETAIN THEIR MARKET SHARE AND SEE THEIR INVESTMENTS PROSPER, THEN THEY HAD TO COME TO THE HELP OF MEXICO IN HER HOUR OF NEED. I POINTED OUT THAT THE EUROPEAN RESPONSE TO MEXICO'S FINANCIAL DIFFICULTIES HAD BEEN EXEMPLARY. HERNANDEZ AGREED, AND PAID PARTICULAR TRIBUTE TO THE ROLE OF THE BANK OF ENGLAND AND THE BRITISH COMMERCIAL BANKS. THE HELP ALREADY GIVEN BY THE EUROPEANS IN AND OUT OF THE FINANCIAL PACKAGES WHICH HAD BEEN PUT TOGETHER WOULD NOT BE FORGOTTEN.

6. HERNANDEZ CONTINUED THAT THE EUROPEANS WOULD NEVERTHELESS HAVE TO THINK HARD ABOUT HOW THEY COULD MAINTAIN THEIR TRADE WITH MEXICO AT A TIME WHEN MEXICO WAS SUFFERING AN ACUTE SHORTAGE OF FOREIGN CURRENCY. PERHAPS UNORTHADOX TRADING METHODS WOULD BE REQUIRED. BY THIS HE DID NOT MEAN TO SAY THAT THE GOVERNMENT WAS CONTEMPLATING USING THE TRADING METHODS OF COMMUNIST COUNTRIES, BUT WE SHOULD LOOK AGAIN AT SYSTEMS OF COMPENSATORY TRADE, AND TRY TO GIVE MORE GENEROUS EXPORT CREDITS. I ASKED IF HE WOULD LIKE TO EXPAND FURTHER ON THIS POINT, BUT HE SAID HE WOULD PREFER TO REFLECT AND DISCUSS IT WITH US ON A FUTURE OCCASION.

7. MY DUTCH COLLEAGUE CHALLENGED HIM ON CURRENT USE OF THE PHRASE THAT THE STATE WAS THE RECTOR OF THE ECONOMY. WHAT DID THIS MEAN? HERNANDEZ SAID THAT EVERY COUNTRY HAD ITS OWN POLITICAL RHETORIC. MORE IMPORTANT FOR US WAS THE PRESIDENT'S PROPOSAL THAT THE CONCEPT OF THE MIXED ECONOMY SHOULD BE WRITTEN INTO THE MEXICAN CONSTITUTION.

8. WHEN ASKED ABOUT THE GOVERNMENT'S ATTITUDE TO FOREIGN INVESTMENT, HERNANDEZ SAID THAT THE GOVERNMENT NATURALLY WISHED TO ENCOURAGE IT, AND HAD ALREADY MADE SIGNALS TO THAT EFFECT. IT WOULD BE EXTREMELY DIFFICULT TO MODIFY THE EXISTING LAW. THIS WOULD ONLY STIR UP A POLITICAL HORNET'S NEST. BUT WAYS AND MEANS COULD BE FOUND TO INTERPRET THE LAW IN A FLEXIBLE WAY. THE GOVERNMENT WAS FULLY CONSCIOUS OF WHAT FOREIGN INVESTMENT COULD DO TO GENERATE JOBS AND INCREASE MEXICAN EXPORTS. THIS WOULD OF COURSE TAKE TIME, AND COULD ONLY FOLLOW RESTORATION OF CONFIDENCE. HERE HE EMPHASISED THE PRIORITY THE GOVERNMENT WOULD GIVE TO HELP SMALL ENTERPRISES PAY COMMERCIAL DEBTS CONTRACTED BEFORE 20 DECEMBER. WHEN IT WAS POINTED OUT THAT ONE OF THE WAYS OF GETTING ROUND THE FOREIGN INVESTMENT LAW HAD BEEN TO ENCOURAGE THE PRIVATE BANKS, NOW NATIONALISED, TO TAKE UP EQUITY IN JOINT ENTERPRISES, HERNANDEZ INDICATED THAT THE GOVERNMENT WOULD SOON BE REORGANISING THE NATIONALISED BANKS AND ALLOWING A PROPORTION OF THEIR EQUITY TO BE HELD BY THE PRIVATE SECTOR.

/9.

9. HERNANDEZ MADE IT CLEAR THAT HE DID NOT FAVOUR THE IDEA OF CURRENCY REFORM. NOTHING THE MEXICANS COULD DO BY CHANGING THE NAME OF THEIR MONEY COULD AFFECT THE REALITIES OF MEXICAN INVOLVEMENT WITH THE UNITED STATES AND THE US DOLLAR.

10 HERNANDEZ SAID THAT THE GOVERNMENT'S POLICIES WERE BOTH ORTHODOX IN ECONOMIC TERMS AND TOUGH IN POLITICAL TERMS. HERE HE EXPRESSED HIS ADMIRATION FOR MRS THATCHER AND WHAT SHE HAD BEEN ABLE TO DO FOR THE BRITISH ECONOMY. BUT WHAT WAS POSSIBLE IN AN INDUSTRIAL COUNTRY WAS NOT NECESSARILY POSSIBLE IN MEXICO. MEXICANS WERE UN-DISCIPLINED. MANY SUFFERED FROM DIRE POVERTY. A RIOT ELSEWHERE MIGHT LEAD TO THE BURNING OF A BUILDING OR TWO: BUT IN MEXICO ONCE VIOLENCE GOT OUT OF HAND IT WOULD BE DIFFICULT TO CONTROL. THE GOVERNMENT WAS DETERMINED TO DO WHAT IT BELIEVED WAS RIGHT. BUT IT NEEDED THE HELP, SYMPATHY AND UNDERSTANDING OF ITS FRIENDS.

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TO IMMEDIATE FCO
TELEGRAM NUMBER 299 OF 23 DECEMBER 1982
INFO MEXICO CITY

IMF: MEXICO--EXTENDED ARRANGEMENT AND FIRST CREDIT TRANCHE (EBS/82/208 SUPPLEMENTS 1, 2 AND 3)

1. THE EXECUTIVE BOARD TODAY DISCUSSED MEXICO'S REQUEST FOR A 3-YEAR EXTENDED ARRANGEMENT WITH THE FUND AND A FIRST CREDIT TRANCHE DRAWING. AFTER A LENGTHY DISCUSSION IN WHICH 19 DIRECTORS INTERVENED, THE REQUESTS WERE APPROVED. ALL DIRECTORS EXPRESSED EITHER WARM SUPPORT OR FAIRLY STRONG IF QUALIFIED SUPPORT. ALL FELT THAT THE PROGRAMME FOR THE FIRST YEAR OF THE ARRANGEMENT WAS A STRONG ONE, AND CONTAINED TOUGH MEASURES. THERE WAS GENERAL AGREEMENT THAT NO FEASIBLE ALTERNATIVE TO A VERY VIGOROUS PROGRAMME WAS POSSIBLE. IT WOULD BE VITALLY IMPORTANT BOTH FOR MEXICO AND FOR THE FUND THAT THE PROGRAMME SHOULD SUCCEED. ALL CONGRATULATED THE MANAGING DIRECTOR ON HIS HANDLING OF THE CASE, ALTHOUGH A NUMBER OF DIRECTORS SUGGESTED THAT THE PROCEDURES OUGHT TO BE REVIEWED IN A CALMER ATMOSPHERE WHEN THE DUST HAD SETTLED. THERE WAS GANERAL AGGEMENT THAT THE BANK'S RESPONSE TO THE MANAGING DIRECTOR'S INITIATIVE ON THE FINANCING PACKAGE FOR MEXICO (SEE PARAS 4 AND 5 BELOW) WAS ADEQUATE IN THE CIRCUMSTANCES.

2. THE MAIN POINTS FROM THE MD'S SUMMING UP WERE AS FOLLOWS. THE MAGNITUDE OF ECONOMIC IMBALANCES LEFT NO CHOICE OTHER THAN DRASTIC ADJUSTMENT. THE OBJECTIVE OF THE PROGRAMME WAS NOT AUSTERITY BUT RESTORATION OF BALANCE. FISCAL ADJUSTMENT WAS THE KEY ELEMENT AND IT WOULD BE IMPORTANT TO MONITOR PERFORMANCE HERE CLOSELY IN ORDER TO REASSURE THE FINANCIAL COMMUNITY THAT THE PROGRAMME WAS EFFECTIVE. SOME DIRECTORS HAD FELT THAT MONETARY POLICY HAD BEEN DEALT WITH IN RATHER TOO GENERAL A WAY AND WERE CONCERNED AT THE LEVEL OF CENTRAL BANK CREDIT TO GOVERNMENT. IT WAS ALSO FELT THAT INTEREST RATES WERE STILL PERHAPS OVERCONTROLLED. SEVERAL DIRECTORS THOUGHT THAT THE PAPERS HAD BEEN VAGUE ON WAGE RESTRAINT, AND HE HAD BEEN GLAD TO HAVE ASSURANCES FROM SENIOR (VENEZUELA, REPRESENTING MEXICO) THAT WAGE SETTLEMENTS WERE ON A MODERATING TREND. ALL DIRECTORS HAD STRESSED THE NEED FOR FLEXIBILITY IN SETTING THE CONTROLLED EXCHANGE RATE. ELIMINATION OF EXTERNAL ARREARS WOULD BE ESSENTIAL FOR THE RESTORATION OF CONFIDENCE. FULL AND CAREFUL MONITORING OF PROGRESS WOULD BE ESSENTIAL. THE STAFF SHOULD NOT WAIT FOR THE MAY REVIEW TO ESTABLISH WHETHER SLIPPAGES WERE OCCURING. A NUMBER OF DIRECTORS FELT THE NEED FOR MORE THOUOUGH DELINEATION OF THE MEDIUM STRATEGY AND SEVERAL WOULD HAVE PREFERRED A SERIES OF STAND-BY ARRANGEMENTS RATHER THAN THE EFF APPROACH.

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3. THE MD NOTED THAT THE MEXICAN CRISIS HIGHLIGHTED THE IMPORTANCE OF ACTIVE FUND SURVEILLANCE. RECALLING THE LONG DELAY BEFORE THE LAST ARTICLE IV CONSULTATION, HE WOULD SEE TO IT THAT THE PERIODICITY OF ARTICLE IV CONSULTATIONS WAS RESPECTED AT ALL COSTS, BUT THE FUND HAD NOT BEEN INACTIVE OVER MEXICO DURING THAT PERIOD. A STRONG AND CLEAR WARNING HAD BEEN GIVEN TO THE MEXICAN AUTHORITIES IN NOVEMBER 1981 IN WHICH IT HAD BEEN FIRMLY POINTED OUT THAT A MAJOR REORIENTATION OF PUBLIC SECTOR POLICIES WAS NEEDED. WHAT HAD BEEN INADEQUATE WAS THE AUTHORITIES' RESPONSE TO THESE COUNSELS. PERHAPS, WITH HINDSIGHT, THESE MEMORANDA SHOULD HAVE BEEN PUT TO THE BOARD. HE WOULD DO THIS MORE FORCEFULLY IN FUTURE.

FINANCIAL SUPPORT

4. AT THE BEGINNING OF THE MEETING THE MD RECALLED THAT THERE WAS A FINANCING GAP OF DOLLARS 7 BILLION FOR 1983, NOT COVERED BY FUND DRAWINGS OR BY REGULAR CAPITAL INFLOWS OR RESCHEDULING. HE REPORTED THAT HE HAD RECEIVED WRITTEN ASSURANCES FROM GOVERNMENTS FOR SUPPLEMENTARY CREDITS OF DOLLARS 2 BILLION ON TOP OF THOSE ALREADY IN THE PIPELINE. HE THANKED THE UNITED STATES TREASURY FOR THEIR EFFORTS IN GATHERING TOGETHER THIS PART OF THE PACKAGE. (WE HAVE LEARNED FROM CONTACTS IN THE US DIRECTOR'S OFFICE THAT THE MD CHOSE HIS WORDS ADVISEDLY. IN FACT, THE WRITTEN ASSURANCES WERE PROVIDED BY THE US GOVERNMENT WHICH UNDERTOOD THAT THE ADDITIONAL DOLLARS 2 BILLION WOULD BE PROVIDED, WITHOUT SPECIFYING A BREAKDOWN OF COUNTRY SHARES. THIS AGREES WITH SPRINKEL'S CABLE TO FINANCE MINISTRIES OF DECEMBER 22, WHICH WE HAVE JUST SEEN.)

5. THE MD ALSO REPORTED THAT HE HAD RECEIVED, THROUGH CITIBANK, REPLIES FROM COMMERCIAL BANKS UNDERTAKING TO INCREASE THEIR NET EXPOSURE TO MEXICO BY AN AMOUNT OF DOLLARS 4,320 MILLION, WHICH WAS DOLLARS 680 MILLION SHORT OF THE DOLLARS 5 BILLION HE HAD ASKED FOR. HE HAD PUT THE CRITICAL MASS FOR NEW BANKING EXPOSURE AT DOLLARS 4.5 BILLION AND WAS THUS DOLLARS 180 MILLION SHORT OF HIS IMMEDIATE TARGET. HE THEN LISTED THE FOLLOWING COUNTRIES WHERE THE BANKS' RESPONSES HAD FALLEN SHORT OF QUOTA:-

	QUOTA	SHORTFALL	(DOLLARS MILLION)
JAPAN	918	92	
SPAIN	121	121	
GERMANY	265	47	
ITALY	130	122	
BELGIUM	76	30	
SWITZERLAND	222	94	
ARAB BANKS	107	57	
USA	1911	235	

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/ OTHER

OTHER COUNTRIES' BANKS HAD FULFILLED THEIR QUOTA. THERE HAD BEEN OVER-CONTRIBUTION FROM BANKS IN THE UNITED KINGDOM, CANADA, AND THE NETHERLANDS. HE INVITED EXECUTIVE DIRECTORS RESPONSIBLE FOR SHORTFALL COUNTRIES TO DO WHAT THEY COULD IN THE COURSE OF THE DAY TO HASTEN RESPONSES. DURING THE MEETING, SENIOR ANNOUNCED THAT A TELEX WAS ON ITS WAY FROM THE SPANISH AUTHORITIES PROMISING DOLLARS 93 MILLION AND DE GROOT SAID THAT THE BELGIAN BANKS HAD FULLY MET THEIR CONTRIBUTION BUT HAD BEEN ERRONEOUSLY REPORTED BY CITIBANK. THE MD APPEALED TO EXECUTIVE DIRECTORS FOR COUNTRIES WITH OUTSTANDING SHORTFALLS TO SEE WHAT THEY COULD DO TO PRODUCE A RESPONSE BY DECEMBER 27.

6. A FULL REPORT OF THE DISCUSSION FOLLOWS SAVING.

7. FCO PLEASE ADVANCE TO RICHARD BROWN (BANK OF ENGLAND)

ANSON

ADVANCED AS REQUESTED

MONETARY
ERD
MCAD
NAD

COPIES TO:

MR RICHARD BROWN
BANK OF ENGLAND

(PA)

See note attached page (ii)

Monday 20 December 1982

(Answered by the Prime Minister on Monday 20 December 1982)

UNSTARRED NO. (W) Mr Vivian Bendall: To ask the Prime Minister, if she will introduce legislation to prevent any British bank from lending money to Argentina if it appears to Her Majesty's Government that the money may be used for, or diverted to, arms purchases; and if she will make a statement.

~~We have no present plans to take powers...~~

We ~~do not intend~~ are not proposing ~~at present~~ in present circumstances to take powers to reintroduce financial restrictions between the United Kingdom and Argentina.

The International Monetary Fund has been negotiating with Argentina an economic programme to accompany access to drawings on the Fund's facilities. In parallel, with the support of the IMF, negotiations have been taking place on two ~~temporary~~ loans to be provided by a group of international banks, including British banks.

One of these is a bridging loan; the other is a medium-term loan which is conditional on approval of an IMF standby agreement.

These loans are not intended for arms purchase, but

~~They~~ are, ~~rather,~~ to help Argentina to continue paying its debts, many of which are to residents of this country. We support the IMF in its efforts to maintain the stability of the international financial system.

Surely these loans are bridging loans until and only until the IMF facility can be drawn. MT

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Econ Pol
Lloyds Pt. ...

BoE

10 DOWNING STREET

From the Private Secretary

17 December 1982

Dear John,

LLOYDS BANK INTERNATIONAL AND ARGENTINA

The Prime Minister was grateful for the Chancellor's minute of 16 December about Lloyds Bank's participation in a financing package for Argentina.

If this matter had arisen at Prime Minister's Questions yesterday or on Tuesday, the Prime Minister had it in mind to say that the Government supports the IMF, both generally and in its operations in Argentina, and that it would be absurd to support the IMF on the one hand, and on the other to undermine them by requesting Lloyds to withdraw from the financing package, which was being arranged under the auspices of the IMF, and as a measure designed to lead to an IMF facility.

The Prime Minister was not content with the draft Answer to Mr. Vivian Bendall's Question which was attached to the Chancellor's minute. I attach a revised draft, on which I would be grateful for your comments by 4.15 pm this afternoon. Meanwhile, the Prime Minister has agreed that if you or the Bank of England need to say something today, it could be to the effect that Lloyds are, for their own commercial reasons, participating in this package, that this is all being done with the approval of the IMF, and that it is not the Government's policy to interfere; and that the Bank have said this to Lloyds, in the course of discussions on these matters with them.

I am sending copies of this letter to Brian Fall (Foreign and Commonwealth Office), Tim Allen (Bank of England) and Richard Hatfield (Cabinet Office).

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
HM Treasury

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BoE

MR VIVIAN BENDALL (C) ILFORD NORTH: To ask the Prime Minister if she will introduce legislation to prevent any British bank from lending money to Argentina, if it appears to HMG that the money may be used for, or diverted to arms purchases and if she will make a statement.

DRAFT ANSWER

We do not intend to take powers to reintroduce financial restrictions between the UK and Argentina.

The International Monetary Fund has been negotiating with Argentina an economic programme to accompany access to drawings on the Fund's facilities. In parallel, with the support of the IMF, negotiations have been taking place on two loans to be provided by a group of international banks, including British banks. These loans ~~will not be used~~ are not for arms purchases. ~~nor can they be diverted to finance arms purchases:~~ They are, rather, to help Argentina to continue paying its debts, many of which are to residents of this country. We support the IMF in its efforts to maintain the stability of the international financial system.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

LLOYDS BANK INTERNATIONAL AND ARGENTINA

Our respective offices have been in touch about this matter over the past few days, following the adverse weekend press comment about Lloyds' participation in a financing package for Argentina in parallel with IMF support. Vivian Bendall's written PQ to you on Monday means that we now need to define the Government's position.

..... 2. I attach a note by the Bank of England which sets out the present state of play on the IMF financing package for Argentina, and discusses the possible implications of the withdrawal of British banking involvement in it.

3. There can be no doubt that Lloyds' own stake in South America is such that it is very much in their own interests to go ahead. Equally, it is important, in terms of the UK's wider economic interests in working through the IMF to preserve the stability of the international financial system, that the package should be put together. As the Bank of England note points out, if the British banks (who would take a share of around 10 per cent) were to drop out, this could put the success of the whole operation at risk, which could in turn prejudice the other delicately poised rescue operations for Mexico and Brazil. The process of normalising financial relations with Argentina, which was launched by our decision to lift sanctions in September, would be stopped in its tracks, and the outlook for our financial and commercial interests in Argentina would be bleak. The aim of the operation is of course to ensure that Argentina does not dishonour its financial commitments, many of which are owed to UK residents, including some guaranteed by ECGD.

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4. That said, however, I fully recognise the very sensitive political and domestic issues which arise here. Our own difficulties are compounded by unfortunate statements to the press by Sir Jeremy Morse that Lloyds would be prepared to pull out, if that were our wish. In spite of this, I think we would be ill-advised to depart from the traditional position that lending decisions must be for the banks' own commercial judgement, with which it is not our policy to interfere. If we were to imply that we had any wish, let alone right, to influence these commercial decisions, we would be embarking on a very slippery slope, with an immediate intensification of the pressure on us from the Americans and others to "deliver" more UK bank lending in other parts of South American and Yugoslavia.

5. Had it not been for the PQ, I would have seen no need to intervene, unless Lloyds had pressed us for a Government view. As it is, we have now to answer ~~to~~ the Bendall PQ, and to take into account the concern which Lloyds have forcibly expressed to the Bank of England that they may have to withdraw from the loan operation unless the Government make it clear that the participation of British banks is not in conflict with Government policy. For the reasons set out above I believe this would be unfortunate, and I recommend that you should reply as in the attached draft.

6. I am copying this minute to the Foreign and Commonwealth Secretary and the Governor of the Bank of England.

G. Allen.

[approved by the Chancellor]

G.H.

16 December 1982

PARTICIPATION BY BRITISH BANKS IN LOANS TO ARGENTINA

1 The decision to remove financial restrictions between the UK and Argentina was influenced by awareness (i) that the UK had more to lose than Argentina by their continuation; and (ii) that their continuation stood in the way of any attempt to resolve Argentina's debt crisis, which, together with that being experienced by other Latin American countries, posed a serious threat to the international financial system. The purpose of the removal of the restrictions was to return banking and financial relationships so far as possible to the status quo ante the commencement of hostilities.

2 Over the past few months the IMF has been working to put together a rescue package for Argentina, in parallel with those they are arranging for Mexico and Brazil. The main elements of all these packages are a strongly conditional IMF programme to accompany access to drawings on Fund facilities, a bridging loan to cope with immediate liquidity difficulties and a commitment by banks to the provision of additional medium-term finance. In the case of Argentina, the programme has been agreed with the Fund, which will provide a 15-month standby facility for SDR 1.5 bn, while a group of banks are in the final stages of finalising arrangements and commitments for a $1.1 bn bridging loan and a $1.5 bn medium-term loan.

3 In view of the normalisation of banking and financial relationships which has been in process since the reciprocal lifting of financial sanctions, it was understandable that Lloyds Bank International, one of the major foreign banks operating in Argentina, should have been asked to join the group of international banks arranging these loans. HMT and the Prime Minister's office were informed of this, and of the possibility that other British banks might consider it commercially appropriate to participate in the loans, in a letter dated 19 November sent by Loehnis to Scholar.

4 If Lloyds were now to withdraw from their co-ordinating role, and they and other British banks were to withhold support from the loans at this late stage, there is a very real possibility that the success of the whole Argentinian package might be put at risk. This would have a major effect on confidence generally and would at very least complicate the task of bringing the Mexican and Brazilian operations to a successful conclusion. The co-operation of the international banks in these operations depends crucially on their being convinced that the burden is being shared reasonably fairly. Considerable pressure has been exerted by foreign banks on the Argentinians to make good arrears owing to British banks as a condition of their willingness to contemplate the present banking operations. They would find the non-participation of British banks now very hard to understand; and it is unlikely that they would be willing to step up their own commitments in order to fill in the gap left by the British withdrawal (British banks' participation, based on their proportionate exposure, would amount to some 10%-11% of the whole).

5 There must also be a very strong possibility that a British withdrawal would lead to reprisals being taken against them in Argentina, which could extend to British firms operating in Argentina more generally.

6 Lloyds have made it clear, in their response to the public reaction to the handling of the matter in last week's Mail on Sunday that they would not wish to proceed if this was contrary to HMG's wishes. Other British banks would no doubt take their cue from a decision by Lloyds to withdraw.

7 Public concern that British banks should not lend money to Argentina that might be used to purchase military supplies that could be used against the Falkland Islands in the future is wholly understandable. It should be said, however, that arms purchases are normally financed under bilateral credit arrangements between the purchasing and selling countries with benefit of relevant export credit guarantees. There is no reason to believe that this was not the case with recent Argentinian arms purchases, or that the normal pattern will be departed from in the future.

MR VIVIAN BENDALL (C) ILFORD NORTH: To ask the Prime Minister if she will introduce legislation to prevent any British bank from lending money to Argentina, if it appears to HMG that the money may be used for, or diverted to arms purchases and if she will make a statement.

DRAFT ANSWER

The Government has no plans to reintroduce financial restrictions between the UK and Argentina. The Government's decision to remove the restrictions in September was influenced by awareness that their continuation stood in the way of any attempt to resolve Argentina's debt crisis, which, together with similar difficulties being experienced by other countries, posed a serious threat to the international financial system.

Since that time the IMF has been negotiating with Argentina a strongly conditional economic programme to accompany access to drawings on the Fund's facilities. In parallel and with the full knowledge and support of the Managing Director of the IMF negotiations have been taking place on two loans to be provided by a group of international banks, including British banks. Their purpose is to help Argentina to contiue paying its debts, many of which are owed to residents of this country. It is HMG's policy to support the IMF in its endeavours to maintain the stability of the international financial system.

PRIME MINISTER

LLOYDS BANK AND ARGENTINA

Please see the Chancellor's minute (attached).

The Treasury and the Bank, it seems to me, are making a great meal of this. I do not think the suggested written answer will do at all.

I ~~will have a~~ go tomorrow at a revised draft answer. But there is an urgent point, on which I would be grateful for your decision.

If the question had come up at Questions today or on Tuesday the line was going to be that we support the IMF, both generally and in its operations in Argentina, and it would be absurd to support the IMF on the one hand and on the other hand to undermine them by requesting Lloyds to withdraw from this loan which was being arranged under the auspices of the IMF, and as a measure designed to lead to an IMF facility.

The Bank of England need to say something tomorrow if Lloyds come under a lot of pressure to quit the loan. Can the Bank say that Lloyds are, for their own commercial reasons, in the loan, that this is all being done with the approval of the IMF, and that it is not the Government's policy to interfere; and that the Bank have said this Lloyds, in the course of discussions with them?

Yes
No

J. S. Colling

mt

pp. MICHAEL SCHOLAR
16 December 1982

Look forward to revised reply

10 DOWNING STREET

AB

We
~~The Government has~~ does not intend to ~~introduce legislation~~ take powers to reintroduce financial restrictions between the UK and Argentina.

The International Monetary Fund has been negotiating with Argentina (an economic programme to accompany access to drawings on the Fund's facilities. In parallel, with the support of the IMF, negotiations have been taking place on two loans to be provided by a group of international banks, including British banks. ~~Their purpose is not~~ These loans will not be used for arms purchases ~~but~~ nor can they be diverted to finance arms purchases: they are, rather, to help Argentina to

10 DOWNING STREET

continue paying its debts, many of which are to residents of this country. [~~It is the government's policy to~~ We support the IMF in its efforts to maintain the stability of the international financial system.]

JR

10 DOWNING STREET

From the Private Secretary

14 December 1982

Dear Chris,

BANKING ACT 1979: EXEMPTION FROM DEPOSIT PROTECTION FUND: APPLICATION FROM THE BANCO LA NACION ARGENTINA

Thank you for your further letter, dated 10 December, about the application from the Banco de la Nacion Argentina for their exemption from contributing to the Deposit Protection Fund.

I have shown this to the Prime Minister, who agrees that the Treasury may accept this application, and grant the exemption sought.

I am sending copies of this letter to Brian Fall (FCO) and Tim Allen (Bank of England)

Yours sincerely,

Michael Scholar

C.D. Harrison, Esq.,
HM Treasury.

Original on Trade: Non Tariff Barriers Pt 2

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

MT

PRIME MINISTER

EXPORT CREDIT SUBSIDIES AND RISKS

In my minute of 19 October I proposed that we should seek to control export credit subsidies and to limit the risks of ECGD credit insurance. You agreed and asked that my officials, together with those of other departments concerned, should work these proposals up into operational guidelines. This work is proceeding and we shall be sending the results to you when they are ready.

2. Patrick Jenkin, Arthur Cockfield, and I agreed that there should be, in parallel with the exercise on operational guidelines, a critical examination of the economic implications of export subsidies and guaranteed credit. A group of economists in the Treasury, the Department of Industry and Trade, and the ODA have prepared the attached report on the general subject of supporting capital goods exports. You might like to look at the summary and conclusions which are in paragraphs 30 and 31.

3. The report considers both the explicit support through the provision of subsidised export credit and ATP and the potential costs of default. We had a wide-ranging discussion of these costs at your seminar on the international banking situation on 1 September and there is no sign that the risks of default have diminished since then.

4. The report shows that expenditure on fixed rate credit, ECGD insurance and tied ATP expenditure has been concentrated on a fairly small percentage of total exports. Fixed interest support varies.

It has involved substantial public expenditure in the past and could do so again. On individual contracts, especially those involving ATP, subsidies have been very large.

5. Such support involves direct costs of two kinds. There is a transfer of UK resources abroad when subsidies effectively reduce the price of exports to foreign purchasers, as they often do. And taxation and/or Government borrowing are higher, thus adversely affecting the profitability and prospects for other companies, because the subsidies have to be financed.

6. At a more strategic level, the UK gains from the preservation of an open multilateral trading system. Competitive export subsidisation is liable to be self-defeating, leading to losses all round. Hence we have an interest in the maintenance of the Consensus and its use in restraining export subsidies internationally on both fixed rate and mixed credits.

7. I agree with tbe broad thrust of the report. It provides a useful background to thework on the operational guidelines, and to the parallel work on criteria for support of overseas projects on which I understand officials will shortly be reporting back to E Committee. It will help us decide in cases of specific export projects whether the circumstances are sufficiently exceptional to justify support on the scale that has been provided in the past. If anything, it suggests that we should be even more sceptical of export credit subsidies than I was in my minute of 19 October.

8. I am sending copies of this minute to Patrick Jenkin and Arthur Cockfield.

G.H.

13 December 1982

FROM: I C R BYATT
3 December 1982

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CHANCELLOR OF THE EXCHEQUER
SECRETARY OF STATE FOR INDUSTRY   Copies to each
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Mr Burns
Sir Kenneth Couzens

Sir P Carey, D/Industry
Mr M D M Franklin, D/Trade
Sir W Ryrie, ODA

<u>Members of the Working Group</u>

Dr J M Healey, D/Trade
Mr J R Shepherd, D/Industry
Mr P J Goate, D/Trade
Mr R S Porter, ODA
Mr B R Ireton, ODA
Mr P N Sedgwick, Treasury
Mr S Matthews, Treasury

SUPPORT FOR CAPITAL GOODS EXPORTS

I was asked to convene a working group of economists in the Treasury and the Departments of Industry and Trade to assess the economic implications of support for exports of capital goods. I attach our report. The summary and conclusions are in paragraphs 30 to 31.

2. The report shows that expenditure on fixed rate credit, ECGD insurance and tied ATP expenditure has been concentrated on a fairly small percentage of total exports. Fixed interest support varies. It has involved substantial public expenditure in the past and could so so again. On individual contracts, especially those involving ATP, subsidies have been large.

3. Such support involves direct costs of two kinds. Subsidies which effectively reduce the price of exports to foreign purchasers involve a transfer of UK resources abroad. Subsidies have to be financed by taxation, so adversely affecting the profitability and prospects for other companies.

4. Despite these general arguments, subsidies can be advantageous in specific cases. We have examined the arguments advanced for such subsidies in the UK context. There is something in them. We argue, however, that they point to an approach that seeks to confine subsidies to cases in which they can have beneficial industrial results or where they - or the possibility of their use - could deter other countries from using subsidies. One implication of such an approach to subsidies is that the UK should not automatically "match" the subsidies offered by competitors.

/5. At a

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5. At a more strategic level, the UK gains from the preservation of an open multilateral trading system. Competitive export subsidisation is liable to be self-defeating, leading to losses all round. Hence we have an interest in the maintenance of the Consensus and its use in restraining export subsidies internationally on both fixed rate and mixed credits. Lower interest rates have reduced the scale of subsidy through fixed rate credit. It would not be in our interest to have it replaced by other subsidies. Furthermore, the creditworthiness of borrowers has declined - and may decline further. Premium income of export credit insurance should rise sufficiently to cover these risks, and to avoid the development of a new form of subsidy.

6. We conclude therefore that export subsidies are generally not cost-effective and that there is an economic case for limiting ATP and restraining fixed rate credits. We have indicated some ways in which this might be done.

I R Byatt

for I C R BYATT

THE COSTS AND RISKS OF SUPPORT FOR CAPITAL GOODS EXPORTS

1. In contrast to practice with most other forms of exports, there has in recent years been direct encouragement of capital goods exports through measures such as the provision of fixed rate export credits and funds from the Aid and Trade Provision (ATP) of the Aid programme. This note provides a brief assessment of the economic implications of this support, the principal beneficiaries from it, and the extent to which the costs can be justified on economic grounds.

The cost of subsidies

2. The subsidies and guarantees provided on officially supported fixed rate export credits and ATP are a somewhat disguised form of support compared with the provision of straight export or production subsidies, but their costs are no less real. The costs to public expenditure can arise in three main ways:

(a) the cost of the interest subsidy is the difference between the fixed rate of interest on export credits and market rates;

(b) the costs of default by credit receiving countries where this has not been adequately provided for by insurance premia; and

(c) the cost of ATP, which is normally grant aid provided to an overseas country and expressly tied to a particular contract.

3. The cost of the interest subsidies (a) varies from year to year mainly as a result of movements of market interest rates on outstanding credits, but also due to changes in the fixed rate charged on new business. Minimum levels for these fixed rates have been agreed under the "Consensus" agreement, which operates under OECD auspices, in an attempt to limit competition between some credit-giving countries. The Consensus minima for fixed rates change infrequently, but as a result of growing levels of subsidy due to higher world interest rates, a substantial increase was eventually agreed in November 1981. A further increase for some markets was

subsequently agreed in July 1982. Table 1 shows market and fixed rates of interest and the size of the resulting interest support costs in recent years.

4. The bulk of current expenditure reflects subsidies on credits provided at the low fixed rates that prevailed prior to the recent changes to the Consensus. Thus unless market interest rates fall quite a bit further there will be a continuing call on public expenditure. The terms of past credits are by definition fixed and it is hence possible to affect the total subsidy bill only through the terms granted on new credits. Market interest rates have come down substantially in 1982, but new fixed rate export credits to developing countries still involve a subsidy of the order of 8 per cent of the value of the UK exports supported, even if there are no special terms (see annex 1 for more details of these calculations). Furthermore, we cannot be sure that over the 10-20 year life of a credit, market interest rates will not rise again. The future course of American interest rates is, for instance, not within the UK's control and just below a half of outstanding credits are denominated in dollars. The problem of interest subsidies cannot therefore be regarded as having "disappeared".

5. ECGD is under instruction, taking one year with another, to run its insurance business at no net cost to public funds. It does this by rejecting unduly hazardous risks and by charging premia at a level judged sufficient to fund net losses on claims paid and operating costs. In recent years, however, the flow of new premium income has not been sufficient to cover losses and these have had to be met from cumulated reserves (see diagram 1) although not all these losses are attributable to business on fixed rate credits. In relation to premium income of around £235 million in 1981-82 the negative net cash flow figures averaging about £50 million a year over the past three years and a prospective negative net cash flow of the order of £280 million in 1982-83 are clearly large and cannot be sustained for long without substantially reducing if not eliminating cumulated cash reserves (which stood at about £480 million at the end of 1981-82). At the moment the perceived risk of default at some stage in the life of a medium or long-term credit is probably rather higher than it was in the case of a large

TABLE 1: AMOUNTS AND COSTS OF FIXED RATE EXPORT CREDITS IN THE UK

	Cost of interest subsidies	ATP Expenditure	Average consensus minimum interest rates on new credit over 5 years		Average market interest rates		Fixed rate credit outstanding at end year (current prices)		
	£m (current prices)	£m (current prices)	(a) To developing countries (category III)	(b) To rich countries (category I)	(i) 3 month £ interbank[1]	(ii) 6 month Eurodollar[1]	£	Foreign currency (£ equivalent)	Total
1977-78	116	0	7.5	8.0	8.1	7.9	4280	30	4310
1978-79	220	12	7.5	8.0	11.9	10.9	4670	240	4910
1979-80	357	30	7.5	8.0	16.0	14.7	4630	850	5480
1980-81	461	29	7.7[2]	8.5[3]	16.5	15.8	4320	1770	6090
1981-82	587	53	8.5[4]	9.5[5]	15.2	17.3	4430	(2840)[6]	(7270)[6]
November 1982	na	na	10.0[7]	12.4[7]	10.3	11.0	na	na	na

Notes:
1. includes margin received by banks.
2. fixed rate raised from 7½% in 7¾% in July 1980.
3. fixed rate raised from 8% to 8¾% in July 1980.
4. fixed rate raised from 7¾% to 10% in November 1981.
5. fixed rate raised from 8¾% to 11¼% in November 1981.
6. figure for 31 December 1981 in case of foreign currency loans.
7. consensus rates since July 1982.

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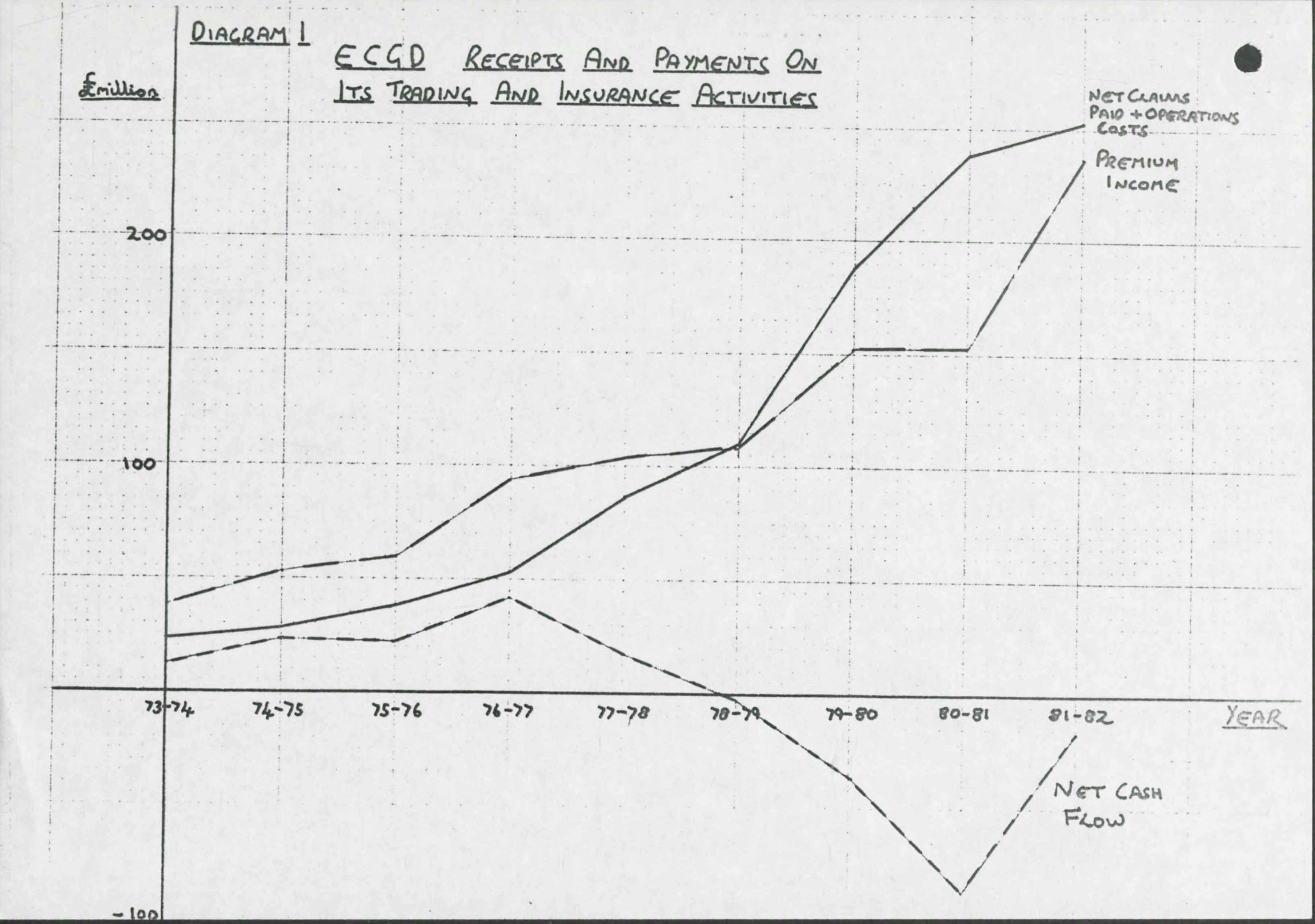
DIAGRAM I
ECGD RECEIPTS AND PAYMENTS ON ITS TRADING AND INSURANCE ACTIVITIES
£million
200
100
-100
73-74
74-75
75-76
76-77
77-78
78-79
79-80
80-81
81-82
YEAR
NET CLAIMS PAID + OPERATIONS COSTS
PREMIUM INCOME
NET CASH FLOW

number of developing countries. Losses on insurance may thus become a relatively larger part of the budgetary costs of supporting capital goods exports.

6. Funds from the ATP are mixed with fixed rate export credits to provide a higher rate of subsidy to the foreign importer in order to win certain contracts for UK firms. "Mixed" credits thus involve two types of public expenditure costs : interest subsidies and a charge on the Aid Programme. It is sometimes argued that ATP does not involve additional public expenditure as it simply represents a change in the distribution of a given programme. This can be true only in the very short run as the size of the total aid budget is a matter for ministerial decision and there is little reason for thinking that there is less discretion for adjusting the size of this than other programmes. Even in the short run, where the size of the Aid Programme is fixed, increased expenditure on ATP has a cost in terms of the reduced political and developmental benefits that can generally be expected to be derived from using aid funds in this way rather than in the regular bilateral aid programme, though the extent of these lost benefits is difficult to quantify.

Who benefits from the subsidies

7. Under present arrangements, fixed rate export credits are extended by UK banks, who are reimbursed by the Exchequer for the difference between the fixed rate of interest they receive from the overseas customer and the agreed market rate which they have been promised (which for sterling credits is taken to be 3 month interbank rate plus a margin of 7/8 to 1 per cent according to the life of the credit). Although this subsidy goes to the banks that undertake the lending, they obviously have to pay a market rate of interest on the deposits they raise to carry out this lending and the subsidy is only compensating them for this. It is not necessary to compensate the banks directly for the risk premium that they would normally charge on much of this lending as they have the ECGD guarantee.

8. The benefit of the subsidy is divided between the overseas purchaser (who gets cheap credit) and the UK exporter (who is able to make a larger profit than would otherwise have been the case). The precise division depends on particular market conditions, but it is reasonable to assume that in most cases a good part of the benefit goes to the foreign importer. Thus although interest subsidies on export credits do not take the form of a straight export subsidy, they have substantially similar effects. Indeed, it is possible to express the interest subsidy which is spread over the whole life of a credit in the same terms as a straight subsidy by use of a discounted cash flow approach to calculate its present value. As a proportion of the value of exports the present value of the subsidy has been estimated at more than 50 per cent in some ATP cases when market interest rates were of the order of 15 per cent - see the table in annex I. As noted in paragraph 4, the fall in market interest rates has reduced the rate of subsidy, although it is still of the order of 30-40 per cent in ATP cases.

<u>The characteristics of export credit subsidies and ATP as policy instruments</u>

9. The exports supported by fixed rate export credits and ATP have accounted for about 5 per cent of total UK exports and about 8 per cent of manufactured exports (ie about 1½ per cent of GDP, or just over 1 per cent when account is taken of their import content). The support thus helps only a small proportion of exports. The main qualifying condition for this support, however, is simply that the exports in question customarily attract credit terms of 2 years or more and that they go to non-EEC countries. Fixed rate export credits are generally available automatically if this condition is met and ECGD cover is available in the market concerned. There is, however, some scope for discretion in that a higher subsidy rate can be achieved in some cases by adjusting the terms of the fixed rate credit or by mixing it with funds from the ATP.

10. Some limits are placed on this discretion by the "Consensus" agreement on minimum interest rates on fixed rate credits. The same minimum interest rates, however, apply whatever the currency of denomination of the credit (apart from special arrangements for currencies where market interest rates are below the minimum of the matrix, eg the yen). This means that the Consensus does not in

practice set a uniform maximum subsidy rate, since market interest rates on different currencies vary widely, as do expectations of changes in their exchange rates. The OECD and EC also operate various notification procedures to regulate the use of mixed credits, but like the rules governing fixed rate export credits they do not actually place any maximum limits on the subsidy rates. The Consensus and the levels of market interest rates in relation to the minimum fixed rates thus impose some constraints on the use of subsidies for capital goods exports, but do not preclude their use as instruments of industrial and commercial policy if countries so wish.

Responding to the subsidies of other countries

11. It is often argued that the provision of subsidies on UK capital goods exports is justified because other countries do so. This does not, however, in itself establish an economic case for the UK adopting a similar policy even though the UK goods may be held to be basically competitive. There is obviously a cost involved in copying the practices of others because subsidies paid on capital goods exports have to be paid for by higher taxes on the rest of the economy. Indeed, as a large part of the subsidy provided by fixed rate export credits and ATP is likely to go to the foreign importer, they tend to reduce the real incomes of UK residents as a whole. Automatically matching the subsidies of others can thus be a very costly policy.

12. The scale of these costs will depend on whether the subsidies of others are likely to be a permanent feature of international trade. Where subsidised foreign competition is the rule rather than the exception, it will probably be necessary to support not just current exports but future ones as well. The costs to the British economy of doing this would be substantial and in these circumstances may well be in the UK's interests to treat the subsidies of others as a datum and specialise in the production of goods that do not need such support.

13. The position is, however, complicated by the fact that the level of subsidies provided by others varies over time, particularly in the case of fixed rate credits, as market interest rates fluctuate, but fixed rates are adjusted only infrequently. There may, in particular, be a respectable case for an intermittent subsidy to

British capital goods exports where there are large fluctuations in market interest rates - and therefore the subsidy implied by the availability of fixed rate export credit - in all countries. These fluctuations could cause excessive swings in UK competitiveness if the UK did not allow the differential between its fixed and market rates to move broadly in line with the corresponding differential in other countries. In such circumstances, though, all credit giving countries should see their common interest in securing early changes to the Consensus minimum rates.

14. The objections to responding to the subsidies of others therefore apply with less force where there is a reasonable expectation that the need for subsidies is only temporary. This might be the case if retaliation by the UK can influence competitors' behaviour and induce them to eliminate or at least to restrict provision of subsidies. Correspondingly retaliation will be counter-productive if it serves only to escalate the level of subsidy. In economic terms therefore matching is not justified for its own sake, but only because of any contribution it can make to the eventual elimination of subsidies. In the absence of such a contribution the case for subsidy has to be made out on specific industrial or other domestic policy grounds and on the usual economic criterion that the benefits outweigh the costs.

Arguments for supporting capital goods industries

15. The thrust of the government's economic policy has been to rely on the operation of market forces to secure the most efficient use of resources. This is not to say that markets are always perfect or that there is never a case for government intervention. The question is how strong are the arguments in the case of capital goods exports. The capital goods industries do not all have distinct characteristics differentiating them from other industries in such a way as to justify public support through export subsidies. Capital goods exports, though, and particularly large project business, frequently, but not invariably, tend to be characterised by large and intermittent orders, a substantial degree of sub-contracting, significant bidding costs, the importance of reputation and goodwill in

winning orders and having a significant part of their total business in developing countries. These characteristics, however, are not unique to capital goods exports.

16. It is perhaps worth distinguishing between government intervention in the form of the provision of insurance services and in the form of subsidies. Many of the arguments about the scale and riskiness of capital goods exports point to a need for insurance facilities rather than subsidies. Through its greater ability to pool risks and the fact that it is ultimately underwritten by the Exchequer, an agency like ECGD may be able to insure risks (particularly in the case of medium and long term business) at lower net costs to the customers than a private enterprise. There are thus strong arguments for government intervention in the form of self-financing insurance facilities for exports and in this paper therefore we focus on the arguments for subsidies. In particular the paper examines the arguments that they support industrial policy and that they create employment.

(a) Industrial arguments

17. A case can be made on various grounds for public subsidies to help industry. There may, for instance, be certain types of risks that are not covered by ECGD insurance, but which it is difficult for individual firms to cope with by themselves. Winning orders for capital goods exports often involves heavy bidding costs in relation to contract size. Projects may also be risky because they involve new technology or because they are extremely large in relation to the size of the firm undertaking them. In these circumstances British companies which take the "lead" in bidding may tend to be cautious, especially in their pricing. There could be a case for some public subsidy here. The government should, though, in general look for an appropriate market response in the form either of risk finance or diversification of the firm concerned.

18. The development of new technologies often involves a "learning curve" with costs per unit falling as experience of production is built up. Orders won through export subsidies may help this experience to be acquired, though if the benefits from doing this accrue only to the firm winning the order the provision of a public subsidy is not necessarily justified. Not all capital

goods exports, however, have this characteristic (the technology of ships, for instance, is fairly well established) and where they do, the appropriate level of subsidy will vary from case to case. This argument does not, therefore, provide a satisfactory justification for general support such as the basic interest subsidy on fixed rate credits, and the subsidy rate on more selective devices like ATP is probably rather more than can be justified on these grounds alone.

19. Where costs and benefits occur which are not reflected in the price mechanism some public subsidy may be justified. When a lead company wins a contract it generates orders for other sub-contracting firms and may stimulate "follow-on" business for other firms. The benefit to sub-contractors should be reflected in the allowance the lead firm makes for the costs of their work in formulating its bid, so no subsidy is justified on this account. Prospective "follow on" orders may, however, justify some support. Although there have been clear cases of such follow on orders, there is little or no systematic evidence that substantial unsupported follow-on orders do result from contracts won with the use of aid or large export credit subsidies or that they are greater than for non-capital goods exports. There may in fact be a danger that subsidising capital goods exports may make it more difficult to sell follow on orders on commercial terms, as competitors may retaliate and importers may be encouraged to expect subsidies. The arguments about gaining a marketing advantage and securing follow on orders do not therefore provide a satisfactory justification for export credit subsidies and only limited justification for ATP.

20. Industrial policy also has to respond to the changing pattern of international comparative advantage (due to such factors as the development of the newly industrialising countries, the rise in oil prices, the development of North Sea oil production and so on). Such changes are likely sooner or later to compel changes in the structure of British industry. It is extremely difficult, however, to say which British industries should be encouraged to grow and which should contract. It is correspondingly difficult to decide how to use export credit subsidies and ATP to encourage such structural adjustment. Export credit subsidies help increase demand

for capital goods and may thus facilitate investment, technogolical innovation etc in the industries that supply them. The subsidies may therefore indirectly promote structural adjustment. They may, however, also delay adjustment by supporting industries in which the UK no longer has a comparative advantage (eg shipbuilding).

21. In some cases moderating the pace of decline in industries which may be uncompetitive in the long run, could ease the process of redeploying resources which may be painful and costly. Similarly support which alleviates the effects of economic changes (eg in exchange rates or interest rates) may be justified if it does not distort or delay adjustment toward the industrial structure consistent with trend changes in market forces. It is often difficult in practice, though, to distinguish fluctuations and trends and there is a danger that in seeking to alleviate the effects of the former, policy may end up resisting necessary adjustment to trend changes in competitiveness etc. at a considerable net cost in terms of a higher tax burden on the rest of the economy which has to bear the cost of financing these subsidies.

22. At best ATP and fixed rate export credits are thus somewhat crude instruments for intervention in support of industrial policy objectives. They do not cover sectors to which the industrial arguments for subsidy apply with equal force and they do not allow much freedom to select cases by reference to the relevance of these arguments. Insofar as they can be used to support the "right" industries they do so indirectly by subsidising their exports and are not conditional on any investment or restructuring being undertaken by the firms in question. They do not act directly on many of the problems which make the development of new industries so difficult (eg the costs and risks of new technology, the development of a skilled labour force etc) or which make the decline of old industries so painful (eg poor labour mobility).

(b) Employment arguments

23. Pressures for protectionist measures (such as ATP and subsidised export credit) and other measures to help industry naturally tend to increase in periods of recession, when many industries are facing contraction rather than growth in an expanding

economy. It is thus sometimes argued that support for capital goo exports can be justified on employment grounds. It is desirable, however, to distinguish (a) whether to assist industry and employment by policy measures that have implications for public finances, and if so by how much, and (b) whether official support for capital goods exports is an efficient way to use a given total of fiscal aid to industry. Of course (a) and (b) are not wholly independent, but it is not the purpose of this note to answer (a). The overall stance of macroeconomic policy is thus taken as given. Although we estimate the effects of policy measures as if they are providing a stimulus to aggregate demand, this is simply because it helps the presentation of comparisons.

24. An attempt has been made to estimate the costs per job-year of export credit subsidies and ATP and the results are set out in table 2. The results depend on how quickly the resources that would be unemployed in the absence of these measures are reabsorbed into employment through the normal operation of market forces. The estimates set out below illustrate the implications of three assumptions; namely that resources are fully re-employed after 3, 5 and 10 years. The other key assumptions for these cost per job calculations are the rate of subsidy and the extent to which the employment produced by these fiscal measures is additional or would have occurred in any case. Supported employment is assumed to last the life of the project and after this the level of employment is lower than if the project had not been undertaken until all those who had been employed on it are again re-employed.

25. In the case of ATP we assume that all exports are additional, although this will not necessarily be the case where the UK initiaties a mixed credit offer or where the exports the ATP supports crowd out other exports that could have been covered within ECGD's credit limit for the market in question. To the extent that all the exports are not additional the cost per job figures for ATP will be underestimates. In the case of export credit subsidies UK exports of capital goods have been assumed to be substantially more responsive to the provision of subsidies than any available statistical studies of UK exports suggest is the case. To the extent that UK exports are less responsive to the provision of subsidies, the estimates of cost per job year shown below will be underestimates. Finally, it is worth emphasising that the margin of error around these estimates are inevitably wide.

TABLE 2 DIRECT COSTS PER JOB YEAR OF EXPORT CREDIT SUBSIDIES AND ATP

	Export credit subsidies	1982 prices Mixed credit: ATP plus fixed rate credit
1. Re-employment over 10 years	£50,000	£33,000
2. Re-employment over 5 years	£130,000	£87,000
3. Re-employment over 3 years	£200,000	£132,000

26. Cost per person off the unemployment register is likely to be higher than cost per job since some jobs will go to people who were not previously registered as unemployed. If unemployment is reduced there are likely to be some offsetting savings in benefit payments and additional personal tax receipts, but the figures in the table are many times larger than any feasible figure for the annual gains to the Exchequer on this account.

27. There can be no doubt, on the evidence of this table, that export credit subsidies are an extremely expensive way of reducing unemployment. A comparison may be made with the cost of special employment measures (SEMs). Estimates of the gross cost per person off the register of the current set of SEMs using DE/MSC estimates of their effectiveness range from about £3000 in the case of YOP to about £7000 in the case of the Young Workers Scheme. However, some of these measures are concerned more with redistributing the burden of unemployment than with an attempt to generate an increase in the level of employment. The SEMs which can most appropriately be compared with the above figures seem to be either the Community Enterprise Programme (CEP), or measures like the previous government's Temporary Employment Subsidy (TES) or Professor Layard's proposed incremental employment subsidy. The CEP currently has a gross cost per person off the register of about £5000 a year.

28. Any assessment of the cost of employment subsidies depends on what are inevitably uncertain estimates of their effectiveness in generating net additions to national employment. Academic estimates of the effects of the TES suggest that it had a gross cost of approaching £4000 per person off the unemployment register (at 1982 prices). Professor Layard suggests that the subsidy he has proposed would have a gross cost of some £7000 per person off the unemployment register. With more pessimistic assumptions it would be possible to double that figure, but even so the cost is well below the lowest figure in table 2. Moreover, the government have, of course, decided not to introduce a scheme on the lines of that proposed by Professor Layard.

29. The fact that the public expenditure cost of interest subsidies on export credits is comparatively low in the early part of the life of an export credit may, however, mean that the short run effects of a change in the rate of subsidy relative to other countries may be comparatively strong. Treasury analysis suggests that the demand stimulus provided by most fiscal measures is completely crowded out after about three to four years under a regime of monetary targets - see for instance the Treasury model simulations prepared for the NEDC meeting in April. (This is the case for increases in ATP which add to public expenditure, as well as for measures such as increased nationalised industry investment or a reduction in the National Insurance Surcharge). As the public expenditure costs of increased export credit subsidies fall mostly after the actual exports are delivered, the crowding out process is likely to take longer, but it will not be postponed indefinitely. Indeed future real incomes are likely to be reduced as higher taxes have to be paid to finance the continuing payments of interest subsidies. The comparatively favourable short run effects of export credit subsidies are thus likely to be more than balanced by their longer run costs.

SUMMARY OF CONCLUSIONS AND POLICY IMPLICATIONS

30. The balance of the arguments discussed in this assessment of the economic effects of support for capital goods exports suggests the following conclusions.

(a) There are no a priori reasons for discriminating in favour of the capital goods sector by providing a general subsidy on its exports. Nevertheless, the scale of the support provided through the interest subsidy on fixed rate export credits has been very large in recent years. The fall in market interest rates and the rise in the Consensus minimum fixed rates have now reduced the level of subsidy, but they have not eliminated it, and circumstances could change at some time in the future to raise the level of subsidy once more.

(b) The fact that other countries may support their capital goods exports through subsidised export credits and mixed credits is not an economic argument for automatically doing likewise, even if UK firms would be competitive in the absence of the foreigners' subsidies. Subsidising UK exports always has a cost, especially as part of the subsidy is likely to benefit the foreign importer, and the rest of industry will directly or indirectly bear this cost through higher taxation. The justification for "matching" the subsides of others thus depends on whether the industrial and commercial benefits outweigh these costs or whether "matching" - or the threat of it - gives the UK any negotiating advantage.

(c) There is little systematic evidence that capital goods export business won with the help of subsidies generates significant follow on orders or other marketing advantages. Such benefits may occur in some cases, but are not obviously greater than for many other types of unsupported UK export business.

(d) The government's economic policy is to rely principally on the operation of market forces to secure the most efficient use of resources. Markets do not, however, always work perfectly and there can be a case for supporting particular industries or firms. Industrial arguments do not, though, provide a satisfactory justification for general support of the capital goods industries such as that provided by fixed rate export credit subsidies. There are arguments for supporting particular industries to help them develop new technology or to assist them over a period of "convalescence" while they improve their international competitiveness. There may also be instances in which export orders convey benefits to other UK firms and industries. It is, however, difficult to determine to which industries and firms these arguments genuinely apply and to target export subsidies to help them. Insofar as export credits and ATP can be used to support the "right" industries they do so indirectly by helping them to win export orders and are not conditional on any investment or restructuring being undertaken by the firms in question. Because this support is not specifically designed to meet particular industrial objectives this greatly reduces its cost effectiveness.

(e) Estimates in this paper suggest that export credit subsidies and ATP are likely to be an extremely expensive way to reduce unemployment. Export credit subsidies can appear attractive because the production of exports occurs fairly quickly but the interest subsidy is spread over a period of years - the "benefit now pay later" argument. The continuing burden of paying interest subsidies long after the exports concerned have been delivered means, however, that over a credit's whole life there is likely to be a net reduction in the UK's real national disposable income.

31. This analysis suggests the UK should seek to control and target the scale of support given to the capital goods industries in order to improve its industrial and commercial cost-effectiveness. In particular we offer the following policy conclusions.

(1) There should be no subsidy as a result of the operation of ECGD's insurance services. ECGD should continue therefore to pursue the objective of running its trading and insurance business taking one year with another at no net cost to public funds. In view of the deterioration in the creditworthiness of many customers and the fact that in many cases this is likely to be more than a temporary phenomenon, this could well mean charging higher premia for business in some markets, commensurate with the increased risks. It will in addition mean a stricter policy to refuse unacceptable risks. The UK does not gain by the production of exports for which the customer does not pay.

(2) The Consensus is an important instrument to restrain self-defeating competition through the use of export subsidies. In the present climate of world recession the Agreement could be subject to considerable pressure in spite of the beneficial effect of lower market interest rates. It is therefore important to maintain the Consensus in order to deter an outbreak of "beggar my neighbour" export subsidies. The UK, however, should do more than this and it should support a closer alignment of Consensus rates with market rates of interest. This could imply a closer alliance of UK policies with those of the Americans and Germans, and some opposition to French views.

(3) The UK should scrupulously avoid actions, especially in the field of ATP, which undermine its credibility as an upholder of the Consensus. Thus to the extent that an ATP is retained it should as far as possible be confined to "matching" the terms of

others. There should be no presumption, however, that the UK should automatically "match" - only when the likely economic benefits warrant it. The rates of subsidy provided through mixed credits which use ATP funds are, however, high and probably rather higher than the economic benefits usually warrant. It is therefore necessary to set limits on both the rate of subsidy provided on specific contracts which use ATP funds and the total amount of funds available in the ATP budget. We note that the Working Group on Criteria for the Selection of Overseas Projects is developing the idea of "thresholds" for rates of subsidy. For any projects with rates of subsidy above the "threshold" it would be necessary to show exceptional benefits.

(4) The fall in interest rates during 1982 has virtually eliminated the subsidies on many new sterling credits, though there is still a subsidy on new sterling export credits to developing countries. It would not be in the UK's economic interest to offset this development by making up the subsidy through other means (eg ATP, longer repayment terms, or insurance premia which are below what the market would require).

(5) The UK should consider also how to restrict interest subsidies should market interest rates rise again. The best way to achieve this aim would be through changes in the Consensus minima for fixed rates to prevent them getting too far out of line with market rates. In the absence of such multilateral agreement there are a number of ways the UK could take action on its own; of which the following are some possibilities:

- The establishment of a maximum differential between the rate of interest paid by the importer on export credits and the market rate of interest : this would require the adjustment of the rate paid by the importer in order to keep within this maximum differential if market interest rates rise by more than a certain amount. A related idea would be to have a fixed differential (which would never be above the agreed maximum) between the market interest rate and that paid by the importer through the provision of floating rate credits. Another way to achieve a maximum differential between the importer's and the market rate of interest in circumstances in which the importer attaches considerable weight to the interest costs being known and fixed would be to finance exports through guaranteed fixed interest rate bonds. If long term market interest rates rose the existence of a maximum differential between market rates and those paid by the importer would inevitably imply the payment of higher interest on new bonds by importers;

- the avoidance of all special terms on fixed rate credits (eg cover for local costs, capitalisation of pre-commissioning interest etc);

- a rise in the minimum level of fixed interest rates on export credit for particular markets or particular types of exports where demand is less sensitive to credit terms or the industrial case for support is weak;

- the encouragement of financing in low interest rate currencies when sterling market interest rates have risen relative to the Consensus minima for fixed rate lending, but when market rates for other currencies have not done so.

CALCULATION OF SUBSIDY RATES AND SOME EXAMPLES
OF SPECIFIC EXPORT CONTRACTS

The attached table gives details of recent bids by UK companies for major overseas contracts involving very high subsidy levels. It shows the impact of the various forms of government support on the total level of subsidy incorporated in each bid, expressed as a percentage of the value of the UK element of the contract.

2. Subsidies made available under the Industry Act, the Science and Technology Act and the Aid and Trade Provision (ATP) are normally on grant terms. But the largest form of export subsidy - expenditure on interest support by ECGD - involves a stream of payments to the banks over the period of the export credits to meet the difference between the fixed rate of interest paid by the borrower and the "agreed" return to the banks, which is a margin of about 1 per cent over short term money rates. These expected future payments can be discounted back to give an estimate of subsidy costs in net present value terms. Market long term interest rates are used as a proxy or indication of the "agreed" rate over the period of the export credit in order to calculate the size of the subsidy and as the discount rate in order to convert it into a present value sum.

3. The level of subsidy rises substantially if there are modifications to the basic fixed rate export credit facility. To take a specific example, assuming a fixed rate loan of 10 per cent and a market rate of 12 per cent, an export credit with a 15 per cent downpayment, a four year draw down and an eight year repayment period results in a subsidy level of 8½ per cent. This subsidy level increases:-

(a) to 10 per cent if credit is provided for local costs equal to 15 per cent of UK content;

(b) to 12 per cent if in addition the repayment period is extended to fifteen years and

(c) to 14 per cent if in addition the interest accruing during the draw down period is capitalised.

4. An example shown in the attached table of the high levels of subsidy which can result solely from use of ECGD's interest support programme is the Hong Kong Island Line railways contract (43 per cent). The Indonesian hydro-electric power project (52 per cent) and the Zimbabwe railway contract (56 per cent) show the effects of combining ECGD and ATP subsidies. In the bid for the Mexican Sicartsa I contract, which the UK won, ECGD and ATP subsidies were combined with a subsidy under the Science and Technology Act, giving a total subsidy level of nearly 65 per cent.

5. All these subsidy figures take no account of possible additional Exchequer costs, through payment of claims by ECGD, which could result from defaults on credits.

CASES INVOLVING EXCEPTIONALLY HIGH SUBSIDY ELEMENTS

Date	Country	Project	Value of Exports	ECGD Terms	Local Costs	ATP	Other Assistance	Subsidy	Companies' estimates of jobs created or preserved	Comments
1977	Poland	24 Ships	$142.3m	7¼% over 7 years for 70% ($100m) of loan.	£9.55m	-	B.S. guarantee for Eurobond borrowing of $65m. Intervention Fund Subsidy of £28m.	33.6%	-	
1981	India	Coastal Steel Plant	£780m	85% of UK goods at 7¼% over 10 years with 5 years' grace.	£50m (RTA)	-	£125m ODA grant and special Industry Act support of up to £20m. agreed.	54.3%	50,000 man years	Proposed offer of buy back agreement. Contract lost.
1981	India	1) Thermal Power station and 2) Associated coal mine	1) over £368m 2) £134m.	1) 7¼% for balance of UK content over 10 years	-	£65m plus £75m RTA	-	73%	40,000 man years	HMG side agreement to increase bilateral aid and Ministerial decision to waive pro rata provisions in IDA agreement. Terms of 2) still under discussion.
1981	Kenya	System X	£13.7m	85% of UK content at 10% over 8 years	-	£6.85m	-	ATP 44.5% ECGD 9.9% 54.4%		
1981-2	Mexico	Sicartsa I	£232.5m	85% of UK content plus 15% locals and EC element at 7¼% over 15 years.		£34.9m.	£5m grant under Science and Technology Act	ATP 22.1% ECGD 40.3% PPDS 2.2% 64.6%	25,000 man years	Contract Won.
1981-2	Mexico	Sicartsa II	£68m	85% of UK content and eligible EC (German) costs and local costs: 7¼% over 3 years' grace	£41m. (financed in DM up to 15% of UK and eligible £ (element)	-	Authority given to use ECGD S.3 matching facility.	39.8% excluding S3 assistance 44½% with 7% interest on UK element.	-	Contract lost.
1981	Hong Kong	Rail cars for Island line and for Kowloon-canton railway	£55m) £60m) £17.5m	8½% over 8½ years with capitalisation of interest. Cash contract: no ECGD cover	none	-	- - PPDS £3.507m	) 43%) -	N/A	The PPDS assistance for the cash contract enabled Metro Cammell to quote a lower price

Date	Country	Project	Value of UK Exports	ECGD Terms	Local Costs	ATP	Other Assistance	Subsidy	Companies' estimates of jobs created or preserved	Comments
1981	Hong Kong	Castle Peak 'B' Power Station	£755m	8¼% interest over 12 years from date of commissioning of Units 1+2 and then Units 3 and 4.	HK$ 1.4bn	-	CEC at half (ie. 1%) premium rate at cost of £0.8m. S.7 assistance for consultancy services - £20m.	42%	34,000 man years.	-
1981	Zimbabwe	Railway Electrification Phase 1.	£27.46m	115% of UK element and local costs (15% of UK/third country costs) over 10 years at 7½%.		£8.239m	-	56% ECGD 23% ATP 33%	1,000 man years	Possible follow-on contract but again on ATP supported terms
1981	Indonesia	Hydro Electric power projects at Mrica and Maung	c.£50 m.	7¼% over 10 years plus local costs of up to 15% of UK content		£12.075m	-	52% ATP 25% ECGD 27%	N/A	Still under negotiation

Restricted.

(PA)

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

13 December 1982

Michael Scholar, Esq.,
No.10

Dear Michael,

LOANS FOR ARGENTINA

The final paragraph of Anthony's Loehnis' letter of 19 November to you described a proposed $1.1 billion bridging loan to Argentina by commercial banks. You should I think be aware, with a view to Questions tomorrow, that the Speaker this morning disallowed a PNQ by Mr. Dalyell to the Chancellor, asking for "a statement on the proposal of British banks to make a loan of over $1 billion to Argentina". The attached text, which was given to the Speaker before he reached his decision, might be worthy of inclusion in your papers for tomorrow.

Yours ever,

J.O. Kerr

J.O. KERR

Nearly a dozen banks from various Western countries are currently negotiating with Argentina about the terms of a $1.1 billion bridging loan. The only British bank involved is Lloyds Bank International (LBI). LBI would hope to persuade other UK banks to participate subsequently, and the total UK participation is likely to be about 10 per cent. The loan would be for repayment in March 1984. The negotiations are taking place with the full knowledge and support of the Managing Director of the IMF. The loan would in effect be bridging to an eventual IMF facility. LBI, and any other British banks which may decide to participate, do not need any consent from the Bank of England or the Treasury to do so.

Econ Pol: Industrial Subsidies Part 2

Trade

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Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

PRIME MINISTER

EXPORT CREDIT SUBSIDIES AND RISKS

In my minute of 19 October I proposed that we should seek to control export credit subsidies and to limit the risks of ECGD credit insurance. You agreed and asked that my officials, together with those of other departments concerned, should work these proposals up into operational guidelines. This work is proceeding and we shall be sending the results to you when they are ready.

2. Patrick Jenkin, Arthur Cockfield, and I agreed that there should be, in parallel with the exercise on operational guidelines, a critical examination of the economic implications of export subsidies and guaranteed credit. A group of economists in the Treasury, the Department of Industry and Trade, and the ODA have prepared the attached report on the general subject of supporting capital goods exports. You might like to look at the summary and conclusions which are in paragraphs 30 and 31.

3. The report considers both the explicit support through the provision of subsidised export credit and ATP and the potential costs of default. We had a wide-ranging discussion of these costs at your seminar on the international banking situation on 1 September and there is no sign that the risks of default have diminished since then.

4. The report shows that expenditure on fixed rate credit, ECGD insurance and tied ATP expenditure has been concentrated on a fairly small percentage of total exports. Fixed interest support varies.

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It has involved substantial public expenditure in the past and could do so again. On individual contracts, especially those involving ATP, subsidies have been very large.

5. Such support involves direct costs of two kinds. There is a transfer of UK resources abroad when subsidies effectively reduce the price of exports to foreign purchasers, as they often do. And taxation and/or Government borrowing are higher, thus adversely affecting the profitability and prospects for other companies, because the subsidies have to be financed.

6. At a more strategic level, the UK gains from the preservation of an open multilateral trading system. Competitive export subsidisation is liable to be self-defeating, leading to losses all round. Hence we have an interest in the maintenance of the Consensus and its use in restraining export subsidies internationally on both fixed rate and mixed credits.

7. I agree with tbe broad thrust of the report. It provides a useful background to thework on the operational guidelines, and to the parallel work on criteria for support of overseas projects on which I understand officials will shortly be reporting back to E Committee. It will help us decide in cases of specific export projects whether the circumstances are sufficiently exceptional to justify support on the scale that has been provided in the past. If anything, it suggests that we should be even more sceptical of export credit subsidies than I was in my minute of 19 October.

8. I am sending copies of this minute to Patrick Jenkin and Arthur Cockfield.

G.H.

13 December 1982

FROM: I C R BYATT
3 December 1982

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CHANCELLOR OF THE EXCHEQUER
SECRETARY OF STATE FOR INDUSTRY Copies to each
SECRETARY OF STATE FOR TRADE

c Chief Secretary
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Sir P Carey, D/Industry
Mr M D M Franklin, D/Trade
Sir W Ryrie, ODA

Members of the Working Group

Dr J M Healey, D/Trade
Mr J R Shepherd, D/Industry
Mr P J Goate, D/Trade
Mr R S Porter, ODA
Mr B R Ireton, ODA
Mr P N Sedgwick, Treasury
Mr S Matthews, Treasury

SUPPORT FOR CAPITAL GOODS EXPORTS

I was asked to convene a working group of economists in the Treasury and the Departments of Industry and Trade to assess the economic implications of support for exports of capital goods. I attach our report. The summary and conclusions are in paragraphs 30 to 31.

2. The report shows that expenditure on fixed rate credit, ECGD insurance and tied ATP expenditure has been concentrated on a fairly small percentage of total exports. Fixed interest support varies. It has involved substantial public expenditure in the past and could so so again. On individual contracts, especially those involving ATP, subsidies have been large.

3. Such support involves direct costs of two kinds. Subsidies which effectively reduce the price of exports to foreign purchasers involve a transfer of UK resources abroad. Subsidies have to be financed by taxation, so adversely affecting the profitability and prospects for other companies.

4. Despite these general arguments, subsidies can be advantageous in specific cases. We have examined the arguments advanced for such subsidies in the UK context. There is something in them. We argue, however, that they point to an approach that seeks to confine subsidies to cases in which they can have beneficial industrial results or where they - or the possibility of their use - could deter other countries from using subsidies. One implication of such an approach to subsidies is that the UK should not automatically "match" the subsidies offered by competitors.

/5. At a

5. At a more strategic level, the UK gains from the preservation of an open multilateral trading system. Competitive export subsidisation is liable to be self-defeating, leading to losses all round. Hence we have an interest in the maintenance of the Consensus and its use in restraining export subsidies internationally on both fixed rate and mixed credits. Lower interest rates have reduced the scale of subsidy through fixed rate credit. It would not be in our interest to have it replaced by other subsidies. Furthermore, the creditworthiness of borrowers has declined - and may decline further. Premium income of export credit insurance should rise sufficiently to cover these risks, and to avoid the development of a new form of subsidy.

6. We conclude therefore that export subsidies are generally not cost-effective and that there is an economic case for limiting ATP and restraining fixed rate credits. We have indicated some ways in which this might be done.

I R Byatt

I C R BYATT

THE COSTS AND RISKS OF SUPPORT FOR CAPITAL GOODS EXPORTS

1. In contrast to practice with most other forms of exports, there has in recent years been direct encouragement of capital goods exports through measures such as the provision of fixed rate export credits and funds from the Aid and Trade Provision (ATP) of the Aid programme. This note provides a brief assessment of the economic implications of this support, the principal beneficiaries from it, and the extent to which the costs can be justified on economic grounds.

The cost of subsidies

2. The subsidies and guarantees provided on officially supported fixed rate export credits and ATP are a somewhat disguised form of support compared with the provision of straight export or production subsidies, but their costs are no less real. The costs to public expenditure can arise in three main ways:

(a) the cost of the interest subsidy is the difference between the fixed rate of interest on export credits and market rates;

(b) the costs of default by credit receiving countries where this has not been adequately provided for by insurance premia; and

(c) the cost of ATP, which is normally grant aid provided to an overseas country and expressly tied to a particular contract.

3. The cost of the interest subsidies (a) varies from year to year mainly as a result of movements of market interest rates on outstanding credits, but also due to changes in the fixed rate charged on new business. Minimum levels for these fixed rates have been agreed under the "Consensus" agreement, which operates under OECD auspices, in an attempt to limit competition between some credit-giving countries. The Consensus minima for fixed rates change infrequently, but as a result of growing levels of subsidy due to higher world interest rates, a substantial increase was eventually agreed in November 1981. A further increase for some markets was

subsequently agreed in July 1982. Table 1 shows market and fixed rates of interest and the size of the resulting interest support costs in recent years.

4. The bulk of current expenditure reflects subsidies on credits provided at the low fixed rates that prevailed prior to the recent changes to the Consensus. Thus unless market interest rates fall quite a bit further there will be a continuing call on public expenditure. The terms of past credits are by definition fixed and it is hence possible to affect the total subsidy bill only through the terms granted on new credits. Market interest rates have come down substantially in 1982, but new fixed rate export credits to developing countries still involve a subsidy of the order of 8 per cent of the value of the UK exports supported, even if there are no special terms (see annex 1 for more details of these calculations). Furthermore, we cannot be sure that over the 10-20 year life of a credit, market interest rates will not rise again. The future course of American interest rates is, for instance, not within the UK's control and just below a half of outstanding credits are denominated in dollars. The problem of interest subsidies cannot therefore be regarded as having "disappeared".

5. ECGD is under instruction, taking one year with another, to run its insurance business at no net cost to public funds. It does this by rejecting unduly hazardous risks and by charging premia at a level judged sufficient to fund net losses on claims paid and operating costs. In recent years, however, the flow of new premium income has not been sufficient to cover losses and these have had to be met from cumulated reserves (see diagram 1) although not all these losses are attributable to business on fixed rate credits. In relation to premium income of around £235 million in 1981-82 the negative net cash flow figures averaging about £50 million a year over the past three years and a prospective negative net cash flow of the order of £280 million in 1982-83 are clearly large and cannot be sustained for long without substantially reducing if not eliminating cumulated cash reserves (which stood at about £480 million at the end of 1981-82). At the moment the perceived risk of default at some stage in the life of a medium or long-term credit is probably rather higher than it was in the case of a large

TABLE 1: AMOUNTS AND COSTS OF FIXED RATE EXPORT CREDITS IN THE UK

	Cost of interest subsidies	ATP Expenditure	Average consensus minimum interest rates on new credit over 5 years		Average market interest rates		Fixed rate credit outstanding at end year (current prices)		
	£m (current prices)	£m (current prices)	(a) To developing countries (category III)	(b) To rich countries (category I)	(i) 3 month £ interbank[1]	(ii) 6 month Eurodollar[1]	£	Foreign currency (£ equivalent)	Total
1977-78	116	0	7.5	8.0	8.1	7.9	4280	30	4310
1978-79	220	12	7.5	8.0	11.9	10.9	4670	240	4910
1979-80	357	30	7.5	8.0	16.0	14.7	4630	850	5480
1980-81	461	29	7.7[2]	8.5[3]	16.5	15.8	4320	1770	6090
1981-82	587	53	8.5[4]	9.5[5]	15.2	17.3	4430	(2840)[6]	(7270)[6]
November 1982	na	na	10.0[7]	12.4[7]	10.3	11.0	na	na	na

Notes:
1. includes margin received by banks.
2. fixed rate raised from 7½% in 7¾% in July 1980.
3. fixed rate raised from 8% to 8¾% in July 1980.
4. fixed rate raised from 7¾% to 10% in November 1981.
5. fixed rate raised from 8¾% to 11¼% in November 1981.
6. figure for 31 December 1981 in case of foreign currency loans.
7. consensus rates since July 1982.

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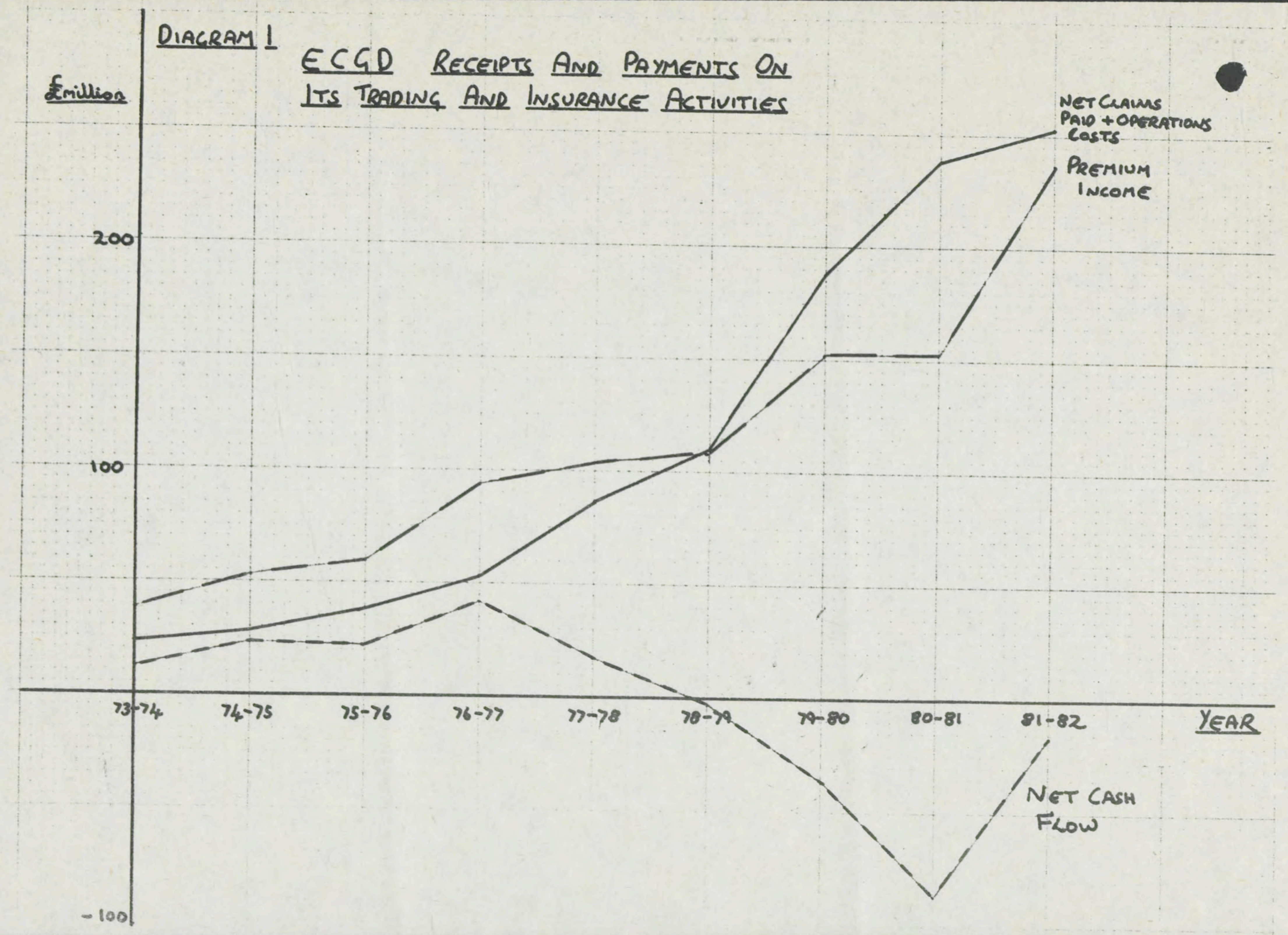

DIAGRAM 1
ECGD RECEIPTS AND PAYMENTS ON ITS TRADING AND INSURANCE ACTIVITIES
£million
200
100
-100
73-74
74-75
75-76
76-77
77-78
78-79
79-80
80-81
81-82
YEAR
NET CLAIMS PAID + OPERATIONS COSTS
PREMIUM INCOME
NET CASH FLOW

number of developing countries. Losses on insurance may thus become a relatively larger part of the budgetary costs of supporting capital goods exports.

6. Funds from the ATP are mixed with fixed rate export credits to provide a higher rate of subsidy to the foreign importer in order to win certain contracts for UK firms. "Mixed" credits thus involve two types of public expenditure costs : interest subsidies and a charge on the Aid Programme. It is sometimes argued that ATP does not involve additional public expenditure as it simply represents a change in the distribution of a given programme. This can be true only in the very short run as the size of the total aid budget is a matter for ministerial decision and there is little reason for thinking that there is less discretion for adjusting the size of this than other programmes. Even in the short run, where the size of the Aid Programme is fixed, increased expenditure on ATP has a cost in terms of the reduced political and developmental benefits that can generally be expected to be derived from using aid funds in this way rather than in the regular bilateral aid programme, though the extent of these lost benefits is difficult to quantify.

Who benefits from the subsidies

7. Under present arrangements, fixed rate export credits are extended by UK banks, who are reimbursed by the Exchequer for the difference between the fixed rate of interest they receive from the overseas customer and the agreed market rate which they have been promised (which for sterling credits is taken to be 3 month interbank rate plus a margin of 7/8 to 1 per cent according to the life of the credit). Although this subsidy goes to the banks that undertake the lending, they obviously have to pay a market rate of interest on the deposits they raise to carry out this lending and the subsidy is only compensating them for this. It is not necessary to compensate the banks directly for the risk premium that they would normally charge on much of this lending as they have the ECGD guarantee.

8. The benefit of the subsidy is divided between the overseas purchaser (who gets cheap credit) and the UK exporter (who is able to make a larger profit than would otherwise have been the case). The precise division depends on particular market conditions, but it is reasonable to assume that in most cases a good part of the benefit goes to the foreign importer. Thus although interest subsidies on export credits do not take the form of a straight export subsidy, they have substantially similar effects. Indeed, it is possible to express the interest subsidy which is spread over the whole life of a credit in the same terms as a straight subsidy by use of a discounted cash flow approach to calculate its present value. As a proportion of the value of exports the present value of the subsidy has been estimated at more than 50 per cent in some ATP cases when market interest rates were of the order of 15 per cent - see the table in annex I. As noted in paragraph 4, the fall in market interest rates has reduced the rate of subsidy, although it is still of the order of 30-40 per cent in ATP cases.

The characteristics of export credit subsidies and ATP as policy instruments

9. The exports supported by fixed rate export credits and ATP have accounted for about 5 per cent of total UK exports and about 8 per cent of manufactured exports (ie about 1½ per cent of GDP, or just over 1 per cent when account is taken of their import content). The support thus helps only a small proportion of exports. The main qualifying condition for this support, however, is simply that the exports in question customarily attract credit terms of 2 years or more and that they go to non-EEC countries. Fixed rate export credits are generally available automatically if this condition is met and ECGD cover is available in the market concerned. There is, however, some scope for discretion in that a higher subsidy rate can be achieved in some cases by adjusting the terms of the fixed rate credit or by mixing it with funds from the ATP.

10. Some limits are placed on this discretion by the "Consensus" agreement on minimum interest rates on fixed rate credits. The same minimum interest rates, however, apply whatever the currency of denomination of the credit (apart from special arrangements for currencies where market interest rates are below the minimum of the matrix, eg the yen). This means that the Consensus does not in

practice set a uniform maximum subsidy rate, since market interest rates on different currencies vary widely, as do expectations of changes in their exchange rates. The OECD and EC also operate various notification procedures to regulate the use of mixed credits, but like the rules governing fixed rate export credits they do not actually place any maximum limits on the subsidy rates. The Consensus and the levels of market interest rates in relation to the minimum fixed rates thus impose some constraints on the use of subsidies for capital goods exports, but do not preclude their use as instruments of industrial and commercial policy if countries so wish.

Responding to the subsidies of other countries

11. It is often argued that the provision of subsidies on UK capital goods exports is justified because other countries do so. This does not, however, in itself establish an economic case for the UK adopting a similar policy even though the UK goods may be held to be basically competitive. There is obviously a cost involved in copying the practices of others because subsidies paid on capital goods exports have to be paid for by higher taxes on the rest of the economy. Indeed, as a large part of the subsidy provided by fixed rate export credits and ATP is likely to go to the foreign importer, they tend to reduce the real incomes of UK residents as a whole. Automatically matching the subsidies of others can thus be a very costly policy.

12. The scale of these costs will depend on whether the subsidies of others are likely to be a permanent feature of international trade. Where subsidised foreign competition is the rule rather than the exception, it will probably be necessary to support not just current exports but future ones as well. The costs to the British economy of doing this would be substantial and in these circumstances may well be in the UK's interests to treat the subsidies of others as a datum and specialise in the production of goods that do not need such support.

13. The position is, however, complicated by the fact that the level of subsidies provided by others varies over time, particularly in the case of fixed rate credits, as market interest rates fluctuate, but fixed rates are adjusted only infrequently. There may, in particular, be a respectable case for an intermittent subsidy to

British capital goods exports where there are large fluctuations in market interest rates - and therefore the subsidy implied by the availability of fixed rate export credit - in all countries. These fluctuations could cause excessive swings in UK competitiveness if the UK did not allow the differential between its fixed and market rates to move broadly in line with the corresponding differential in other countries. In such circumstances, though, all credit giving countries should see their common interest in securing early changes to the Consensus minimum rates.

14. The objections to responding to the subsidies of others therefore apply with less force where there is a reasonable expectation that the need for subsidies is only temporary. This might be the case if retaliation by the UK can influence competitors' behaviour and induce them to eliminate or at least to restrict provision of subsidies. Correspondingly retaliation will be counter-productive if it serves only to escalate the level of subsidy. In economic terms therefore matching is not justified for its own sake, but only because of any contribution it can make to the eventual elimination of subsidies. In the absence of such a contribution the case for subsidy has to be made out on specific industrial or other domestic policy grounds and on the usual economic criterion that the benefits outweigh the costs.

Arguments for supporting capital goods industries

15. The thrust of the government's economic policy has been to rely on the operation of market forces to secure the most efficient use of resources. This is not to say that markets are always perfect or that there is never a case for government intervention. The question is how strong are the arguments in the case of capital goods exports. The capital goods industries do not all have distinct characteristics differentiating them from other industries in such a way as to justify public support through export subsidies. Capital goods exports, though, and particularly large project business, frequently, but not invariably, tend to be characterised by large and intermittent orders, a substantial degree of sub-contracting, significant bidding costs, the importance of reputation and goodwill in

winning orders and having a significant part of their total business in developing countries. These characteristics, however, are not unique to capital goods exports.

16. It is perhaps worth distinguishing between government intervention in the form of the provision of insurance services and in the form of subsidies. Many of the arguments about the scale and riskiness of capital goods exports point to a need for insurance facilities rather than subsidies. Through its greater ability to pool risks and the fact that it is ultimately underwritten by the Exchequer, an agency like ECGD may be able to insure risks (particularly in the case of medium and long term business) at lower net costs to the customers than a private enterprise. There are thus strong arguments for government intervention in the form of self-financing insurance facilities for exports and in this paper therefore we focus on the arguments for subsidies. In particular the paper examines the arguments that they support industrial policy and that they create employment.

(a) <u>Industrial arguments</u>

17. A case can be made on various grounds for public subsidies to help industry. There may, for instance, be certain types of risks that are not covered by ECGD insurance, but which it is difficult for individual firms to cope with by themselves. Winning orders for capital goods exports often involves heavy bidding costs in relation to contract size. Projects may also be risky because they involve new technology or because they are extremely large in relation to the size of the firm undertaking them. In these circumstances British companies which take the "lead" in bidding may tend to be cautious, especially in their pricing. There could be a case for some public subsidy here. The government should, though, in general look for an appropriate market response in the form either of risk finance or diversification of the firm concerned.

18. The development of new technologies often involves a "learning curve" with costs per unit falling as experience of production is built up. Orders won through export subsidies may help this experience to be acquired, though if the benefits from doing this accrue only to the firm winning the order the provision of a public subsidy is not necessarily justified. Not all capital

goods exports, however, have this characteristic (the technology of ships, for instance, is fairly well established) and where they do, the appropriate level of subsidy will vary from case to case. This argument does not, therefore, provide a satisfactory justification for general support such as the basic interest subsidy on fixed rate credits, and the subsidy rate on more selective devices like ATP is probably rather more than can be justified on these grounds alone.

19. Where costs and benefits occur which are not reflected in the price mechanism some public subsidy may be justified. When a lead company wins a contract it generates orders for other sub-contracting firms and may stimulate "follow-on" business for other firms. The benefit to sub-contractors should be reflected in the allowance the lead firm makes for the costs of their work in formulating its bid, so no subsidy is justified on this account. Prospective "follow on" orders may, however, justify some support. Although there have been clear cases of such follow on orders, there is little or no systematic evidence that substantial unsupported follow-on orders do result from contracts won with the use of aid or large export credit subsidies or that they are greater than for non-capital goods exports. There may in fact be a danger that subsidising capital goods exports may make it more difficult to sell follow on orders on commercial terms, as competitors may retaliate and importers may be encouraged to expect subsidies. The arguments about gaining a marketing advantage and securing follow on orders do not therefore provide a satisfactory justification for export credit subsidies and only limited justification for ATP.

20. Industrial policy also has to respond to the changing pattern of international comparative advantage (due to such factors as the development of the newly industrialising countries, the rise in oil prices, the development of North Sea oil production and so on). Such changes are likely sooner or later to compel changes in the structure of British industry. It is extremely difficult, however, to say which British industries should be encouraged to grow and which should contract. It is correspondingly difficult to decide how to use export credit subsidies and ATP to encourage such structural adjustment. Export credit subsidies help increase demand

for capital goods and may thus facilitate investment, technogolical innovation etc in the industries that supply them. The subsidies may therefore indirectly promote structural adjustment. They may, however, also delay adjustment by supporting industries in which the UK no longer has a comparative advantage (eg shipbuilding).

21. In some cases moderating the pace of decline in industries which may be uncompetitive in the long run, could ease the process of redeploying resources which may be painful and costly. Similarly support which alleviates the effects of economic changes (eg in exchange rates or interest rates) may be justified if it does not distort or delay adjustment toward the industrial structure consistent with trend changes in market forces. It is often difficult in practice, though, to distinguish fluctuations and trends and there is a danger that in seeking to alleviate the effects of the former, policy may end up resisting necessary adjustment to trend changes in competitiveness etc. at a considerable net cost in terms of a higher tax burden on the rest of the economy which has to bear the cost of financing these subsidies.

22. At best ATP and fixed rate export credits are thus somewhat crude instruments for intervention in support of industrial policy objectives. They do not cover sectors to which the industrial arguments for subsidy apply with equal force and they do not allow much freedom to select cases by reference to the relevance of these arguments. Insofar as they can be used to support the "right" industries they do so indirectly by subsidising their exports and are not conditional on any investment or restructuring being undertaken by the firms in question. They do not act directly on many of the problems which make the development of new industries so difficult (eg the costs and risks of new technology, the development of a skilled labour force etc) or which make the decline of old industries so painful (eg poor labour mobility).

(b) <u>Employment arguments</u>

23. Pressures for protectionist measures (such as ATP and subsidised export credit) and other measures to help industry naturally tend to increase in periods of recession, when many industries are facing contraction rather than growth in an expanding

economy. It is thus sometimes argued that support for capital goods exports can be justified on employment grounds. It is desirable, however, to distinguish (a) whether to assist industry and employment by policy measures that have implications for public finances, and if so by how much, and (b) whether official support for capital goods exports is an efficient way to use a given total of fiscal aid to industry. Of course (a) and (b) are not wholly independent, but it is not the purpose of this note to answer (a). The overall stance of macroeconomic policy is thus taken as given. Although we estimate the effects of policy measures as if they are providing a stimulus to aggregate demand, this is simply because it helps the presentation of comparisons.

24. An attempt has been made to estimate the costs per job-year of export credit subsidies and ATP and the results are set out in table 2. The results depend on how quickly the resources that would be unemployed in the absence of these measures are reabsorbed into employment through the normal operation of market forces. The estimates set out below illustrate the implications of three assumptions; namely that resources are fully re-employed after 3, 5 and 10 years. The other key assumptions for these cost per job calculations are the rate of subsidy and the extent to which the employment produced by these fiscal measures is additional or would have occurred in any case. Supported employment is assumed to last the life of the project and after this the level of employment is lower than if the project had not been undertaken until all those who had been employed on it are again re-employed.

25. In the case of ATP we assume that all exports are additional, although this will not necessarily be the case where the UK initiaties a mixed credit offer or where the exports the ATP supports crowd out other exports that could have been covered within ECGD's credit limit for the market in question. To the extent that all the exports are not additional the cost per job figures for ATP will be underestimates. In the case of export credit subsidies UK exports of capital goods have been assumed to be substantially more responsive to the provision of subsidies than any available statistical studies of UK exports suggest is the case. To the extent that UK exports are less responsive to the provision of subsidies, the estimates of cost per job year shown below will be underestimates. Finally, it is worth emphasising that the margin of error around these estimates are inevitably wide.

TABLE 2 DIRECT COSTS PER JOB YEAR OF EXPORT CREDIT SUBSIDIES AND ATP

		1982 prices
	Export credit subsidies	Mixed credit: ATP plus fixed rate credit
1. Re-employment over 10 years	£50,000	£33,000
2. Re-employment over 5 years	£130,000	£87,000
3. Re-employment over 3 years	£200,000	£132,000

26. Cost per person off the unemployment register is likely to be higher than cost per job since some jobs will go to people who were not previously registered as unemployed. If unemployment is reduced there are likely to be some offsetting savings in benefit payments and additional personal tax receipts, but the figures in the table are many times larger than any feasible figure for the annual gains to the Exchequer on this account.

27. There can be no doubt, on the evidence of this table, that export credit subsidies are an extremely expensive way of reducing unemployment. A comparison may be made with the cost of special employment measures (SEMs). Estimates of the gross cost per person off the register of the current set of SEMs using DE/MSC estimates of their effectiveness range from about £3000 in the case of YOP to about £7000 in the case of the Young Workers Scheme. However, some of these measures are concerned more with redistributing the burden of unemployment than with an attempt to generate an increase in the level of employment. The SEMs which can most appropriately be compared with the above figures seem to be either the Community Enterprise Programme (CEP), or measures like the previous government's Temporary Employment Subsidy (TES) or Professor Layard's proposed incremental employment subsidy. The CEP currently has a gross cost per person off the register of about £5000 a year.

28. Any assessment of the cost of employment subsidies depends on what are inevitably uncertain estimates of their effectiveness in generating net additions to national employment. Academic estimates of the effects of the TES suggest that it had a gross cost of approaching £4000 per person off the unemployment register (at 1982 prices). Professor Layard suggests that the subsidy he has proposed would have a gross cost of some £7000 per person off the unemployment register. With more pessimistic assumptions it would be possible to double that figure, but even so the cost is well below the lowest figure in table 2. Moreover, the government have, of course, decided not to introduce a scheme on the lines of that proposed by Professor Layard.

29. The fact that the public expenditure cost of interest subsidies on export credits is comparatively low in the early part of the life of an export credit may, however, mean that the short run effects of a change in the rate of subsidy relative to other countries may be comparatively strong. Treasury analysis suggests that the demand stimulus provided by most fiscal measures is completely crowded out after about three to four years under a regime of monetary targets - see for instance the Treasury model simulations prepared for the NEDC meeting in April. (This is the case for increases in ATP which add to public expenditure, as well as for measures such as increased nationalised industry investment or a reduction in the National Insurance Surcharge). As the public expenditure costs of increased export credit subsidies fall mostly after the actual exports are delivered, the crowding out process is likely to take longer, but it will not be postponed indefinitely. Indeed future real incomes are likely to be reduced as higher taxes have to be paid to finance the continuing payments of interest subsidies. The comparatively favourable short run effects of export credit subsidies are thus likely to be more than balanced by their longer run costs.

A

SUMMARY OF CONCLUSIONS AND POLICY IMPLICATIONS

30. The balance of the arguments discussed in this assessment of the economic effects of support for capital goods exports suggests the following conclusions.

(a) There are no a priori reasons for discriminating in favour of the capital goods sector by providing a general subsidy on its exports. Nevertheless, the scale of the support provided through the interest subsidy on fixed rate export credits has been very large in recent years. The fall in market interest rates and the rise in the Consensus minimum fixed rates have now reduced the level of subsidy, but they have not eliminated it, and circumstances could change at some time in the future to raise the level of subsidy once more.

(b) The fact that other countries may support their capital goods exports through subsidised export credits and mixed credits is not an economic argument for automatically doing likewise, even if UK firms would be competitive in the absence of the foreigners' subsidies. Subsidising UK exports always has a cost, especially as part of the subsidy is likely to benefit the foreign importer, and the rest of industry will directly or indirectly bear this cost through higher taxation. The justification for "matching" the subsides of others thus depends on whether the industrial and commercial benefits outweigh these costs or whether "matching" - or the threat of it - gives the UK any negotiating advantage.

(c) There is little systematic evidence that capital goods export business won with the help of subsidies generates significant follow on orders or other marketing advantages. Such benefits may occur in some cases, but are not obviously greater than for many other types of unsupported UK export business.

(d) The government's economic policy is to rely principally on the operation of market forces to secure the most efficient use of resources. Markets do not, however, always work perfectly and there can be a case for supporting particular industries or firms. Industrial arguments do not, though, provide a satisfactory justification for general support of the capital goods industries such as that provided by fixed rate export credit subsidies. There are arguments for supporting particular industries to help them develop new technology or to assist them over a period of "convalescence" while they improve their international competitiveness. There may also be instances in which export orders convey benefits to other UK firms and industries. It is, however, difficult to determine to which industries and firms these arguments genuinely apply and to target export subsidies to help them. Insofar as export credits and ATP can be used to support the "right" industries they do so indirectly by helping them to win export orders and are not conditional on any investment or restructuring being undertaken by the firms in question. Because this support is not specifically designed to meet particular industrial objectives this greatly reduces its cost effectiveness.

(e) Estimates in this paper suggest that export credit subsidies and ATP are likely to be an extremely expensive way to reduce unemployment. Export credit subsidies can appear attractive because the production of exports occurs fairly quickly but the interest subsidy is spread over a period of years - the "benefit now pay later" argument. The continuing burden of paying interest subsidies long after the exports concerned have been delivered means, however, that over a credit's whole life there is likely to be a net reduction in the UK's real national disposable income.

(Not for publication)

31. This analysis suggests the UK should seek to control and target the scale of support given to the capital goods industries in order to improve its industrial and commercial cost-effectiveness. In particular we offer the following policy conclusions.

(1) There should be no subsidy as a result of the operation of ECGD's insurance services. ECGD should continue therefore to pursue the objective of running its trading and insurance business taking one year with another at no net cost to public funds. In view of the deterioration in the creditworthiness of many customers and the fact that in many cases this is likely to be more than a temporary phenomenon, this could well mean charging higher premia for business in some markets, commensurate with the increased risks. It will in addition mean a stricter policy to refuse unacceptable risks. The UK does not gain by the production of exports for which the customer does not pay.

(2) The Consensus is an important instrument to restrain self-defeating competition through the use of export subsidies. In the present climate of world recession the Agreement could be subject to considerable pressure in spite of the beneficial effect of lower market interest rates. It is therefore important to maintain the Consensus in order to deter an outbreak of "beggar my neighbour" export subsidies. The UK, however, should do more than this and it should support a closer alignment of Consensus rates with market rates of interest. This could imply a closer alliance of UK policies with those of the Americans and Germans, and some opposition to French views.

(3) The UK should scrupulously avoid actions, especially in the field of ATP, which undermine its credibility as an upholder of the Consensus. Thus to the extent that an ATP is retained it should as far as possible be confined to "matching" the terms of

others. There should be no presumption, however, that the UK should automatically "match" - only when the likely economic benefits warrant it. The rates of subsidy provided through mixed credits which use ATP funds are, however, high and probably rather higher than the economic benefits usually warrant. It is therefore necessary to set limits on both the rate of subsidy provided on specific contracts which use ATP funds and the total amount of funds available in the ATP budget. We note that the Working Group on Criteria for the Selection of Overseas Projects is developing the idea of "thresholds" for rates of subsidy. For any projects with rates of subsidy above the "threshold" it would be necessary to show exceptional benefits.

(4) The fall in interest rates during 1982 has virtually eliminated the subsidies on many new sterling credits, though there is still a subsidy on new sterling export credits to developing countries. It would not be in the UK's economic interest to offset this development by making up the subsidy through other means (eg ATP, longer repayment terms, or insurance premia which are below what the market would require).

(5) The UK should consider also how to restrict interest subsidies should market interest rates rise again. The best way to achieve this aim would be through changes in the Consensus minima for fixed rates to prevent them getting too far out of line with market rates. In the absence of such multilateral agreement there are a number of ways the UK could take action on its own; of which the following are some possibilities:

- The establishment of a maximum differential between the rate of interest paid by the importer on export credits and the market rate of interest : this would require the adjustment of the rate paid by the importer in order to keep within this maximum differential if market interest rates rise by more than a certain amount. A related idea would be to have a fixed differential (which would never be above the agreed maximum) between the market interest rate and that paid by the importer through the provision of floating rate credits. Another way to achieve a maximum differential between the importer's and the market rate of interest in circumstances in which the importer attaches considerable weight to the interest costs being known and fixed would be to finance exports through guaranteed fixed interest rate bonds. If long term market interest rates rose the existence of a maximum differential between market rates and those paid by the importer would inevitably imply the payment of higher interest on new bonds by importers;

- the avoidance of all special terms on fixed rate credits (eg cover for local costs, capitalisation of pre-commissioning interest etc);

- a rise in the minimum level of fixed interest rates on export credit for particular markets or particular types of exports where demand is less sensitive to credit terms or the industrial case for support is weak;

- the encouragement of financing in low interest rate currencies when sterling market interest rates have risen relative to the Consensus minima for fixed rate lending, but when market rates for other currencies have not done so.

CALCULATION OF SUBSIDY RATES AND SOME EXAMPLES OF SPECIFIC EXPORT CONTRACTS

The attached table gives details of recent bids by UK companies for major overseas contracts involving very high subsidy levels. It shows the impact of the various forms of government support on the total level of subsidy incorporated in each bid, expressed as a percentage of the value of the UK element of the contract.

2. Subsidies made available under the Industry Act, the Science and Technology Act and the Aid and Trade Provision (ATP) are normally on grant terms. But the largest form of export subsidy - expenditure on interest support by ECGD - involves a stream of payments to the banks over the period of the export credits to meet the difference between the fixed rate of interest paid by the borrower and the "agreed" return to the banks, which is a margin of about 1 per cent over short term money rates. These expected future payments can be discounted back to give an estimate of subsidy costs in net present value terms. Market long term interest rates are used as a proxy or indication of the "agreed" rate over the period of the export credit in order to calculate the size of the subsidy and as the discount rate in order to convert it into a present value sum.

3. The level of subsidy rises substantially if there are modifications to the basic fixed rate export credit facility. To take a specific example, assuming a fixed rate loan of 10 per cent and a market rate of 12 per cent, an export credit with a 15 per cent downpayment, a four year draw down and an eight year repayment period results in a subsidy level of 8½ per cent. This subsidy level increases:-

(a) to 10 per cent if credit is provided for local costs equal to 15 per cent of UK content;

(b) to 12 per cent if in addition the repayment period is extended to fifteen years and

(c) to 14 per cent if in addition the interest accruing during the draw down period is capitalised.

4. An example shown in the attached table of the high levels of subsidy which can result solely from use of ECGD's interest support programme is the Hong Kong Island Line railways contract (43 per cent). The Indonesian hydro-electric power project (52 per cent) and the Zimbabwe railway contract (56 per cent) show the effects of combining ECGD and ATP subsidies. In the bid for the Mexican Sicartsa I contract, which the UK won, ECGD and ATP subsidies were combined with a subsidy under the Science and Technology Act, giving a total subsidy level of nearly 65 per cent.

5. All these subsidy figures take no account of possible additional Exchequer costs, through payment of claims by ECGD, which could result from defaults on credits.

CASES INVOLVING EXCEPTIONALLY HIGH SUBSIDY ELEMENTS

Date	Country	Project	Value of Exports	ECGD Terms	Local Costs	ATP	Other Assistance	Subsidy	Companies' estimates of jobs created or preserved	Comments
1977	Poland	24 Ships	$142.3m	7¼% over 7 years for 70% ($100m) of loan.	£9.55m	-	B.S. guarantee for Eurobond borrowing of $65m. Intervention Fund Subsidy of £28m.	33.6%	-	
1981	India	Coastal Steel Plant	£780m	85% of UK goods at 7¼% over 10 years with 5 years' grace.	£50m (RTA)	-	£125m ODA grant and special Industry Act support of up to £20m. agreed.	54.3%	50,000 man years	Proposed offer of buy back agreement. Contract lost.
1981	India	1) Thermal Power station and 2) Associated coal mine	1) over £368m 2) £134m.	1) 7¼% for balance of UK content over 10 years	-	£65m plus £75m RTA	-	73%	40,000 man years	HMG side agreement to increase bilateral aid and Ministerial decision to waive pro rata provisions in IDA agreement. Terms of 2) still under discussion.
1981	Kenya	System X	£13.7m	85% of UK content at 10% over 8 years	-	£6.85m	-	ATP 44.5% ECGD 9.9% 54.4%		
1981-2	Mexico	Sicartsa I	£232.5m	85% of UK content plus 15% locals and EC element at 7¼% over 15 years.		£34.9m.	£5m grant under Science and Technology Act	ATP 22.1% ECGD 40.3% PPDS 2.2% 64.6%	25,000 man years	Contract Won.
1981-2	Mexico	Sicartsa II	£68m	85% of UK content and eligible EC (German) costs and local costs: 7¼% over 3 years' grace	£41m. (financed in DM up to 15% of UK and eligible £ (element)	-	Authority given to use ECGD S.3 matching facility.	39.8% excluding S3 assistance 44½% with 7% interest on UK element.	-	Contract lost.
1981	Hong Kong	Rail cars for Island line and for Kowloon-canton railway	£55m) £60m) £17.5m	8½% over 8½ years with capitalisation of interest. Cash contract: no ECGD cover	none	-	- - PPDS £3,507m	) 43%) -	N/A	The PPDS assistance for the cash contract enabled Metro Cammell to quote a lower price

Date	Country	Project	Value of UK Exports	ECGD Terms	Local Costs	ATP	Other Assistance	Subsidy	Companies' estimates of jobs created or preserved	Comments
1981	Hong Kong	Castle Peak 'B' Power Station	£755m	8¼% interest over 12 years from date of commissioning of Units 1+2 and then Units 3 and 4.	HK$ 1.4bn	-	CEC at half (ie. 1%) premium rate at cost of £0.8m. S.7 assistance for consultancy services - £20m.	42%	34,000 man years.	-
1981	Zimbabwe	Railway Electrification Phase 1.	£27.46m	11% of UK element and local costs (15% of UK/third country costs) over 10 years at 7¾%.		£8.239m	-	56% ECGD 23% ATP 33%	1,000 man years	Possible follow-on contract but again on ATP supported terms
1981	Indonesia	Hydro Electric power projects at Mrica and Maung	c.£50 m.	7¾% over 10 years plus local costs of up to 15% of UK content		£12.075m	-	52% ATP 25% ECGD 27%	N/A	Still under negotiation

10 DOWNING STREET

1

Prime Minister

We were discussing this.

If we do exempt this Bank we may be criticised for recognizing its head office (or the Argentine state) as a suitable guarantor. To that we would have to reply that, as financial relations with Argentina normalise, yes we do think them suitable.

If we do not exempt them, the Fund would have to pay up on a default.

Agree to exemption - I find it

PTO

hard to see on what grounds we could refuse the application for exemption.

MCS 13/12

Agree to exemption

[illegible]

1

Prime Minister

Do you now agree that the BNA should be exempted from the obligation to contribute to the Deposit Protection Fund?

MCS 10/12

ECONOMIC SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

M C Scholar Esq
10 Downing Street
LONDON
SW1

How far could it be used as a precedent for other subsidiaries in London who [illegible] international debt problems we would [illegible] concern?

10 December 1982

Dear Michael,

BANKING ACT 1979: EXEMPTION FROM DEPOSIT PROTECTION FUND: APPLICATION FROM THE BANCO LA NACION ARGENTINA

Thank you for your letter of 3 December about the BNA's application for exemption from the Deposit Protection Fund.

As its name suggests, the Banco de la Nacion Argentina (BNA), is a state-owned organisation which is charged inter alia with holding the foreign currency funds of national organisations, public authorities, and nationalised industries in Argentina, and carrying out banking operations abroad for them. The London branch deals with the financing of foreign trade, mainly for Argentine state-owned organisations, but also some private sector bodies and bodies from other Latin American states; it holds the personal accounts of Argentine diplomats in this country and Europe and of some Argentine nationals; and it undertakes a modest amount of business in the market, for example on syndicated loans.

As a branch (not a subsidiary) the BNA in London is an integral part of its parent in Argentina. If the BNA in London could not meet its obligations, and the Head Office was unable or unwilling to support the London branch, the state guarantee would be called. If this guarantee was not met, the operations of the BNA world-wide would be put into question. The failure of the BNA could provoke a general default by Argentina. The Treasury believes that Argentina is likely to go to considerable lengths to avoid the very serious consequences of a default, and so would back the BNA's obligations. If Argentina became temporarily unable to meet her own obligations, an agreement with creditors could of course mean that depositors in the BNA had to wait for their money, but as these depositors are very largely Argentine enterprises and Argentine citizens, the impact would fall for the most part on Argentina. In this context it is noting ?

Perhaps worth nothing that if we do not exempt the BNA the Deposit Protection Fund would be responsible for making good the losses of depositors in the London branch of the BNA, should the Argentine Government fail to meet the guarantee. This would mean that the British clearing banks would pay the lion's share of the compensation payments, which are limited by statute to 75% of the first £10,000 lost by each depositor.

I am copying this letter to Brian Fall (Foreign and Commonwealth Office) and Tim Allen (Bank of England).

yours sincerely,

Chris

C D HARRISON
Private Secretary

Econ Pol : Indebtedness Pt 2

Econ Pol

CONFIDENTIAL

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FM PARIS 071943Z DEC 82

TO PRIORITYITY FCO

TELEGRAM NUMBER 1175 OF 7 DECEMBER 1982

INFO PRIORITY JEDDA, WASHINGTON, UKREP BRUSSELS, UKDEL IMF/IBRD WASHINGTON

SAUDI ARABIAN LOAN TO FRANCE

1. TWO FRENCH NEWSPAPERS HAVE TODAY (7 DECEMBER) PUBLISHED REPORTS THAT SAUDI ARABIA HAS AGREED TO LEND FRANCE OVER TWO BILLION US DOLLARS, BY MEANS OF A DEPOSIT IN A PARIS BANK. THE FIRST REPORT APPEARED IN QUOTIDIEN DE PARIS, WHICH A RATHER SENSATIONALIST RIGHT-WING DAILY, BUT THE SECOND APPEARED IN AN ARTICLE IN LE MONDE SIGNED BY PAUL FABRA, A HIGHLY RESPECTED ECONOMIC CORRESPONDENT. NO SOURCES ARE GIVEN BUT CONSIDERABLE CIRCUMSTANTIAL EVIDENCE IS PRESENTED. THE TRESOR HAS MET JOURNALISTS' QUESTIONS TODAY WITH QUOTE NO COMMENT UNQUOTE.

2. IF THE REPORTS PROVE WELL FOUNDED AS INDEED THEY MAY, THIS NEWS WOULD SUGGEST A BELIEF IN GOVERNMENT THAT THE US 4 BILLLION DOLLARS CREDIT CONTRACTED IN OCTOBER WILL PROVE INSUFFICIENT TO MEET THE PRESSURE ON THE FRANC WHICH CAN BE EXPECTED TO CONTINUE OVER THE COMING MONTHS. WE HAVE IT ON GOOD AUTHORITY THAT OVER HALF THE 4 BILLION DOLLARS HAS BEEN DRAWN DOWN SINCE THE CREDIT WAS SIGNED IN LATE OCTOBER, AND THE GOVERNMENT IS APPARENTLY DETERMINED TO AVOID ANOTHER REALIGNMENT OF THE FRANC WITHIN THE EMS (OR AN EXIT FROM ITS EXCHANGE RATE SYSTEM) BEFORE THE MUNICIPAL ELECTIONS IN MARCH.

FRETWELL

MONETARY D

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THIS TELEGRAM
WAS NOT
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TELEGRAM NUMBER 1035 OF 07 DECEMBER
INFO TREASURY,DOT,3CGD,BANK OF ENGLAND,UKDEL IMF/WORLD BANK
WASHINGTON.

MY TEL NO 1021: NEW MEXICAN GOVERNMENT MEASURES.

SUMMARY.

1. THE NEW MEXICAN ADMINISTRATION HAS TAKEN FURTHER STEPS TO DEMONSTRATE ITS DETERMINATION TO PROVIDE THE BASIS FOR RENEWED CONFIDENCE IN THE MEXICAN ECONOMY.

NEW MINISTERIAL RESPONSIBILITIES.
2. AMENDMENTS HAVE BEEN MADE TO THE CONSTITUTION CHANGING THE RESPONSIBILITIES OF VARIOUS CABINET POSTS. FRANCISCO ROJAS ASSUMES A NEW POSITION IN THE CABINET AS CONTROLLER-GENERAL RESPONSIBLE FOR VETTING AND CONTROLLING PUBLIC SECTOR EXPENDITURE. RESPONSIBILITY FOR PROMOTING PRIVATE SECTOR INDUSTRIAL DEVELOPMENT PASSES TO THE MINISTER OF TRADE - NOW CALLED MINISTER OF TRADE AND INDUSTRY-, THE PREVIOUS INDUSTRY MINISTER BECOMING THE MINISTER OF ENERGY, MINING AND PUBLIC SECTOR INDUSTRIES.

NEW ECONOMIC STRATEGY.
3. IN THE MOST DIRECT CRITICISM YET OF THE PREVIOUS GOVERNMENT'S POLICIES, PLANNING MINISTER SALINAS DE GORTARI SAID IN A SPEECH ON 6 DECEMBER THAT IF MEXICO HAD CONTINUED ON ITS PREVIOUS COURSE THIS WOULD HAVE LED TO MORE INFLATION, LASTING DAMAGE TO THE COUNTRY'S PRODUCTIVE CAPACITY, MASS UNEMPLOYMENT AND SEVERE STRAINS TO THE FABRIC OF SOCIETY. THE NEW GOVERNMENT WAS NOT JUST TRYING TO OVERCOME THE IMMEDIATE FINANCIAL CRISIS, BUT TO BRING ABOUT LONG-TERM IMPROVEMENTS IN THE EFFICIENCY OF INDUSTRY AND AGRICULTURE.

INTEREST RATES.
4. INTEREST RATES HAVE BEEN RAISED, IN MOST CASES BY THREE PERCENTAGE POINTS, TO 44% FOR THREE MONTHS DEPOSITS AND 50% FOR 12 MONTH DEPOSITS. BUT INTEREST RATES ARE STILL WELL BELOW THE CURRENT RATE OF INFLATION.

SUBSIDIES.
5. THE PROGRESSIVE REDUCTION OF SUBSIDIES CONTINUES. STEEP RISES IN PUBLIC TRANSPORT FARES ARE REPORTED TO BE IMMINENT.

NEW FOREIGN LOAN.
6. MUCH PUBLICITY HAS BEEN GIVEN TO A NEW US DOLLAR 50 MILLION FIVE YEAR LOAN FROM THE BANK OF AMERICA TO THE PRIVATE SECTORV

/ MINING

MINING COMPANY GRUPO INDUSTRIAL PENOLES. THIS IS SAID TO BE THE FIRST FOREIGN CREDIT TO THE PRIVATE SECTOR SINCE 1 SEPTEMBER. SENIOR REPRESENTATIVES OF THE BANK OF AMERICA HAVE BEEN QUOTED AS SAYING THAT IT DEMONSTRATES THEIR CONFIDENCE IN THE NEW MEXICAN ADMINISTRATION.

CENSORSHIP.

7. IN THE LAST DAYS OF THE LOPEZ PORTILLO ADMINISTRATION A NEW LAW WAS PUSHED THROUGH CONGRESS OSTENSIBLY DESIGNED TO SUPPRESS PORNOGRAPHY. THE LAW IS EXPRESSED IN EXTREMELY SWEEPING TERMS, PROHIBITING PUBLICATIONS, FILMS ETC WHICH ARE CONTRARY TO GOOD BEHAVIOUR OR MORALITY, WHICH COULD DISCOURAGE A FAVOURABLE ATTITUDE TOWARDS WORK AND STUDY, WHICH COULD ENCOURAGE CONTEMPT FOR THE MEXICAN PEOPLE, ITS CHARACTERISTICS, CUSTOMS, HISTORY AND TRADITIONS, WHICH GO AGAINST INTERNATIONAL SOLIDARITY, PROMOTE SUPERSTITION OR IGNORANCE OR WHICH USE INCORRECT LANGUAGE, AMONG OTHER THINGS. THE LAW HAS PROVOKED A GROWING CHORUS OF RIDICULE AND INDIGNATION FROM WRITERS AND JOURNALISTS OF ALL POLITICAL PERSUASIONS. IT IS WIDELY SEEN AS THE FIRST DEMONSTRATION OF THE PURITANICAL ZEAL OF THE WIFE OF PRESIDENT DE LA MADRID. ALTHOUGH SOME OF THE PROVISIONS SEEM VIRTUALLY UNENFORCEABLE, IT IS FEARED THAT IT COULD PROVIDE A LEGAL BASIS FOR BANNING NOT ONLY MATERIAL CONSIDERED IMMORAL BUT ALSO PUBLICATIONS WHICH ARE POLITICALLY CONTROVERSIAL OR DISRESPECTFUL. THERE HAVE BEEN SOME OTHER SIGNS THAT THE NEW GOVERNMENT MAY ADOPT A LESS LIBERAL ATTITUDE TOWARDS THE PRESS, TELEVISION AND CINEMA THAN DID ITS PREDECESSOR.

CHANGE OF ELECTION DATE.

8. ANOTHER CONSTITUTIONAL AMENDMENT HAS BEEN INTRODUCED TO CHANGE THE DATE OF THE NEXT PRESIDENTIAL ELECTIONS FROM JULY 1988 TO SEPTEMBER 1988. THIS IS DESIGNED TO REDUCE THE FIVE MONTH LAME-DUCK PERIOD BETWEEN THE SIX-YEARLY PRESIDENTIAL ELECTIONS AND THE ASSUMPTION OF OFFICE BY THE PRESIDENT-ELECT, WHICH DE LA MADRID HIMSELF CLEARLY FOUND EXCESSIVE.

TICKELL

FCO/WHITEHALL
MCAD

THIS TELEGRAM
WAS NOT
ADVANCED

fla K6

Econ Pol

10 DOWNING STREET

From the Private Secretary

3 December 1982

BANKING ACT 1979: EXEMPTION FROM DEPOSIT PROTECTION FUND: APPLICATION FROM THE BANCO DE LA NACION ARGENTINA

Thank you for your letter of 30 November in which you sought agreement to the inclusion of the Banco de la Nacion Argentina in the list of foreign banks to be exempted from the obligation to contribute to the Deposit Protection Fund.

I showed your letter to the Prime Minister. She has asked on what grounds it is thought the Argentine Government would be in a position to honour their guarantee to sterling deposits with the Banco de la Nacion Argentina.

I am copying this letter to Brian Fall (Foreign and Commonwealth Office) and Tim Allen (Bank of England).

M. C. SCHOLAR

C. D. Harrison, Esq.,
Office of the Economic Secretary,
H.M. Treasury.

SUBJECT

File

cc FCO
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ops

10 DOWNING STREET

THE PRIME MINISTER

1 December, 1982

PRIME MINISTER'S
PERSONAL MESSAGE
SERIAL No. T 229A/82

Dear Rob.

I have now had a chance to read carefully the copy of your speech at Suva, which you sent to me on 18 November; and to look also at your article for the journal of the Royal Commonwealth Society. Both the analysis and the proposals you made were interesting and thought-provoking.

I found myself in agreement with nearly all your analysis. I agree with you that it was a sad day when the exchange rate part of the Bretton Woods system finally collapsed under the strains of American inflation, and when the oil price increase destroyed all hope of an early return to stable exchange rates. I am sure you are right to say that growing protectionism and the international debt situation should be looked at together as threats to the international trade and payments system of the free world; and that protectionism has taken many new forms not originally recognised in the GATT. I see the force of your argument about agricultural protectionism, and the damage it inflicts on third countries. You know we have done our best for New Zealand in that area.

I agree that there has been over-lending to some of the newly industrialising countries in the 1970s - and to Eastern Europe - and that time will be needed to put the situation right. And of course you are right to say that cutting back subsidies and budget deficits in these countries can be particularly painful, though we have to remember that bank lending helped some of the newly industrialising countries to maintain or achieve very high growth rates in the 1970s in spite of the enormous oil price increases.

/ You say in your

PM

You say in your article that you have no simple solution for the problems which beset us but you do have a number of lines of attack. In the complex world in which we now live - vastly more complex in its power balance and in its financial and economic structure than the world of 1946 - that must be the right approach, always provided that one does not lose sight of certain basic lessons on which I am sure we would both agree: that the free market economic system has performed infinitely better than the bureaucratic Marxist command economy; that the free system has successfully accommodated great changes in economic strength among nations; and that inflation and monopoly have been the main forces damaging its performance and its ability to provide sustained growth and jobs.

On lines of advance, I agree that we must provide substantial new resources for the IMF. Indeed I hope we can find ways of accelerating the process of doing so and demonstrating that the international community can reach speedy and constructive agreements. There is certainly something to be said for trying to encourage countries in trouble to turn sooner rather than later to the Fund. But I think we should do them (and ourselves) a disservice if we went too far to suggest that due conditionality could be avoided.

I agree too that we must by a whole series of steps reduce the risk of banking failures and rebuild confidence. I like your point about "symmetrical surveillance" of surplus as well as deficit countries, though I am not sure how you would apply it to OPEC surplus countries. But I would myself want to be careful about really long-term lending by the IMF, with conditionality extending over equally long periods and tending in practice to become nominal. The IMF may have to do more, but I don't think it can or should take over a large part of what has been done by the international banks and by private investment.

I was interested in what you say about a new Bretton Woods conference. Geoffrey Howe told me how you developed the argument at Lancaster House and in Toronto. I look forward to seeing the results of the review of the international financial system that is now being undertaken by the Commonwealth Secretariat.

/ Of course you

Of course you are right about the need for political will and about the irrelevance of some existing machinery like the "global negotiations". But would your conference go beyond the questions of protectionism and alleviations for LDCs described in your proposals? To many people, including myself, "Bretton Woods" means the post-war currency system which ended in 1973. Currency fluctuations can cause acute trade problems and greatly affect LDCs. I would much like to see a way out of currency instability, but I don't see that happening without a durably lower level of inflation and interest rates in major countries and the avoidance of shocks like the oil price increases.

I have replied at length: forgive me. As you can see, I found your speech and article of great interest.

Yours sincerely

Raymond

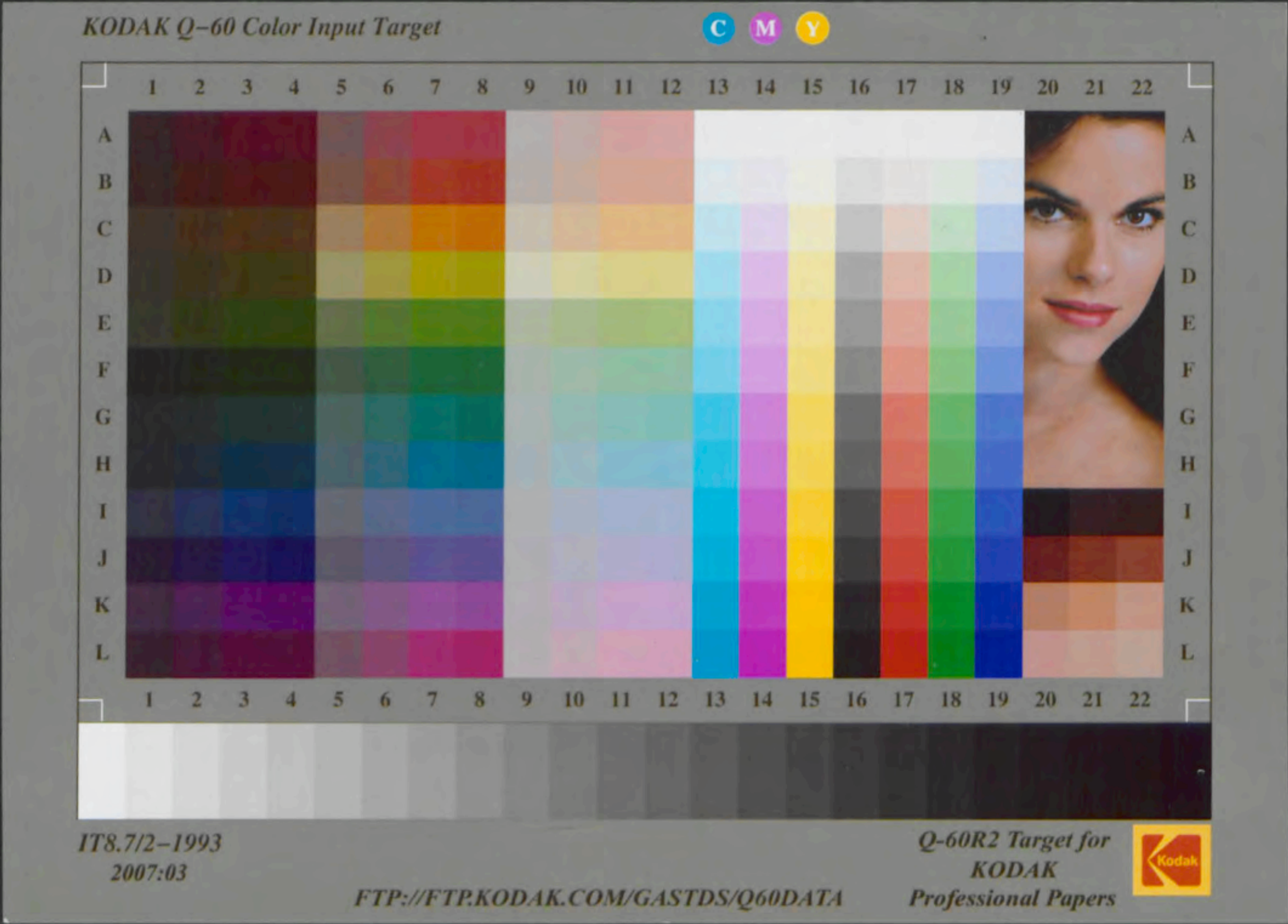
The Right Honourable Robert Muldoon, CH, MP.

PART 1 ends:-

HMT to MCS 30.11.82

PART 2 begins:-

PM to PM of New Zealand, T229A/82 1.12.82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