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PREM 19/1201

PART 4

MT

CONFIDENTIAL FILING

Indebtedness of Various Countries and it's effect on the Western Banking System

ECONOMIC POLICY

Pt 1: AUGUST 1982

Pt 4: MARCH 1984

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
5.3.84		16.7.84					
~~9.3.84~~		~~24.7.84~~					
~~12/3/84.~~		~~31.7.84~~					
16.3.84		~~3.8.84~~					
~~22.3.84~~		~~10.8.84~~					
~~28.3.84~~		~~5.9.84~~					
~~2.4.84~~		~~13.9.84~~					
~~5.4.84~~		~~14.9.84~~					
~~11.4.84~~		~~19.9.84~~					
~~21.5.84~~		~~21.9.84~~					
~~30.5.84~~		~~25.9.84~~					
~~1.6.84~~		~~14.11.84~~					
~~4.6.84~~		~~26.11.84~~					
~~7.6.84~~		~~29.11.84~~					
~~13.12.6.84~~		~~3.12.84~~					
~~15.6.84~~		~~24.12.84~~					
~~18.6.84~~		31.12.84					
~~22/6/84.~~		PART ENDS					
~~28.6.84~~							
~~2/7/84~~							

PREM 19/1201

PART 4 ends:-

DB to HMT 31.12.84

PART 5 begins:-

Ch/EX to PM 22.1.85

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10 DOWNING STREET

From the Private Secretary

31 December 1984

The Prime Minister has seen and noted your letter of 27 December to Andrew Turnbull about the international financial scene.

David Barclay

Miss Margaret O'Mara,
HM Treasury.

2

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

27 December 1984

Andrew Turnbull Esq
10 Downing Street

Prime Minister

AT 28/12

Dear Andrew,

INTERNATIONAL FINANCIAL SCENE

I enclose the latest assessment of developments on the international financial scene which has been discussed in the Treasury's International Debt Group.

2. Of the individual countries discussed, the various elements in the Argentine package are moving forward fast. The prospects for putting together the commercial banks' contribution, agreed by the Advisory Committee, seem quite good. Assuming that the critical mass of banking contributions is reached by then, we expect the IMF Board to approve Argentina's application for a Standby Arrangement and her CFF request on 28 December. Negotiations on the rescheduling of officially guaranteed debt would then follow in the Paris Club in January.

3. There have also been recent developments in relation to Yugoslavia and Poland. After some hesitation, the Yugoslavs have decided to seek a one year Standby Arrangement from the Fund running from April 1985 when the present Standby expires. This will allow official creditors to go ahead with the rescheduling of 1985 maturities agreed in principle in Geneva last month. But the Yugoslavs continue to press both bank and official creditors for a multi-year rescheduling agreement. Official creditors are sceptical about this in the absence of continuing IMF conditionality.

4. On Poland, significant progress was made at the last Paris Club meeting in November when agreement on the terms of a generous rescheduling agreement covering the period from 1982 to 1984 was reached. However, the expected meeting to initial this has been cancelled by the Poles, who are apparently unable to resolve difficulties they have created by seeking to link the rescheduling agreement with new Western credits.

5. I am copying this letter to Len Appleyard (FCO), Callum McCarthy (DTI) and John Bartlett (Bank of England).

Yours sincerely,

Margaret O'Mara

MISS M O'MARA

Attachment to HMT ... 27.12.84
International Financial Scene.

CONFIDENTIAL

INTERNATIONAL FINANCIAL SCENE

The past few weeks have seen some encouraging developments, notably a further fall in US interest rates and the agreement reached between Argentina and its bank working committee. But the fall in interest rates is unlikely to go much further and has been associated with a slowing down of growth in the US. The forthcoming Presidential election in Brazil adds a further major element of uncertainty.

In the USA, CD rates fell during November from 9.9% to 9% - the lowest since the first half of 1983 - and the Federal Reserve cut its discount rate from 9% to 8.5%, reversing the rise in April this year. However, renewed concern about the growth of the money supply may well mean that the fall in interest rates has, at least for the time being, come to an end. At the same time, growth in the US economy has slowed down. Real GNP in the third quarter rose by only 1/2%, compared with 2% in each of the previous two quarters, and leading indicators do not suggest that growth at previous rates is likely to be resumed in the near future; nor is growth elsewhere in the industrial world likely to make up the difference. On the face of it, therefore, debtor countries should find it more difficult to go on improving their trade performance (given that they must resume some import growth). However, the US trade deficit itself shows no sign of shrinking - rather the reverse - and debtor countries may still, therefore, be able to achieve an acceptable trade balance. A number of debtors should also be assisted by signs of an upturn in some commodity prices and by continuing weak oil prices - although some major debtors, notably Mexico, Venezuela and Nigeria, would be adversely affected by a significant and sustained fall in oil prices.

The developing countries as a group are likely to continue to press for special attention for their particular needs. The Latin Americans will maintain their advocacy of a Summit on Latin American debt; the Indians, with NAM support, will again call for an international conference on the reform of the world monetary and financial system and the Africans will ask for assistance on both debt and development to help them deal with the economic crisis in Africa. The urgency with which these groups present their case will depend on the performance of the international economy: falling growth rates and rising interest rates will greatly exacerbate their difficulties. But whatever the economic outturn during the first quarter of 1985, the eyes of the developing countries will be firmly fixed on the meetings of the interim and Development Committees of the IMF and IBRD in Washington on 17-19 April. From these meetings they hope - but do not necessarily expect - to receive some sort of positive response from the industrialised countries to what they regard as their not unreasonable requests for help. But despite the essentially technical nature of those meetings, the developing countries will doubtless try to score political points (whether inside or outside the conference room), not least with the aim of influencing the conclusions of the Bonn Economic Summit 3 weeks later.

At the beginning of December, Argentina reached agreement in principle with its bank working committee on a package which includes the rescheduling of $17 bn of public and private sector maturities up to the end of 1985 and $4.2 bn of new money (details are given below) in 1984 and 1985. Terms are less favourable than for Mexico, but the package is expected to be difficult to sell, not least because the new money element implies an increase of nearly 17% in exposure to Argentina.

Elsewhere in Latin America, a number of debtor countries have shown satisfactory economic performance, while making little progress in negotiating further packages. Brazil's performance in the third quarter permitted a drawdown under its EFF, which in turn released the final tranche of new money for this year. But negotiations for a MYRA are being delayed by uncertainties among banks ahead of the Presidential election in January. Progress on negotiating Venezuela's MYRA has also been slow, and the "roadshows" have been postponed to early 1985. Chile's third quarter performance was satisfactory, but negotiations on a rescheduling and new money package for 1985 have not yet begun.

In Eastern Europe, considerable progress was made at the end-November meeting with the Poles, but they cancelled a subsequent meeting planned for 18 December, at which it had been hoped to initial an agreement to reschedule arrears of principal and interest arising from 1982 to 1984. This appears to reflect a continuing desire for Western support for resumed membership of the IMF and for substantial new credits. Although the USA has subsequently lifted its ban on IMF re-entry, creditors continue to oppose any linkage between new credits and rescheduling. Yugoslavia, which rejected an offer of a serial MYRA by the banks, continues to seek a block rescheduling. Official creditors remain opposed at present to any form of MYRA and will only consider rescheduling 1985 maturities if an IMF Standby is arranged for 1985.

In the Philippines, the position has improved considerably: several austerity measures recommended by the IMF are already in place, the Fund has agreed a Standby arrangement, and the authorities are now finalising arrangements with official and commercial creditors both for rescheduling and for new money to meet the 1985 financing gap. On the other hand, South Korea has had to come to the markets to finance a higher than expected current account deficit this year, and prospects for the external position next year are not too favourable.

The proposed arrangements for Citicorp to insure itself against prolonged delays in receiving interest payments from debtor nations have attracted the disapproval of the New York State Insurance Commissioner. It is not clear whether any contract in fact exists, but in any case it is becoming increasingly apparent that these arrangements cannot be seen as a precedent for other banks.

Banks continue to show an interest in swapping (as opposed to selling) doubtful debt; but for legal and accounting reasons, it seems that this type of business has - so far at least - been on a modest scale.

More detail about the position in major debtor countries is given below.

(i) Latin America

The major development since the last report has been the agreement in principle reached during the weekend of 1-2 December between Argentina and the commercial bank Working Committee. The speed with which agreement was reached surprised some bankers, coming only three weeks after the US banking regulators had categorised certain loans to Argentina as "substandard". The main elements of the agreement are (a) the rescheduling of $17 bn of public and private sector maturities falling due between 1982 and 1985; and (b) $4.2 bn in new money for 1984 and 1985, of which $3.7 bn is in the form of a medium-term loan, and the balance a four-year trade credit. Overall, the terms are more generous to Argentina than those set in the agreements of 1983. Under the proposed deal, the Argentines are committed to repay the $750 mn outstanding from the 1982 $1.1 bn bridging loan in the first quarter of 1985, and to eliminate all interest arrears by the second quarter (including a down-payment of $750 mn before end-1984). The Working Committee's figures show a net transfer of financial resources to the banks of

#5

around $6.5 bn in the period to end-1985; but even so, it is clear that the package will be difficult to sell. In particular, smaller US and European banks could prove very reluctant to participate, given that the new money element of the package entails an overall increase in bank exposure to Argentina of nearly 17% over the base level chosen. "Roadshows" have now begun (the one for UK and some European banks was held in Zurich on 13 December), and a good deal of "arm-twisting" is likely to be required: some of the larger banks (including LBI) have already indicated that they will not take up any shortfall created by non-participation by smaller and medium-sized banks.

As regards the rest of the Argentine package, the official sector is being asked for a substantial contribution, including a rescheduling in the Paris Club of 85% of principal and interest (about $1.8 bn) falling due in 1984/85, and of around $1 bn in new export credits; and a $0.5 bn bridging loan from the US Stabilisation Fund to cover the first tranche of Argentina's Standby, together with a drawing of SDR 275 mn under the CFF. The bridging loan is subject, inter alia, to the IMF Managing Director agreeing to put the 15-month SDR 1,419 mn Standby to the Board, which he wishes to do before end-December while 1984 access limits still apply. In turn, th MD will put the Standby request (plus the CFF application) to the Board only when a "critical mass" (not yet defined) of commercial bank commitments to the package has been secured. The Board, which is due to consider Argentina's request on 28 December, provided the above conditions are met, will take account of recent mildly encouraging developments in Argentine economic management, including a tightening of monetary and fiscal policy and depreciation of the peso in real terms.

In Brazil, a $371 mn drawdown under the EFF took place at the end of November, following satisfactory performance in the third quarter. This facilitated release of the final $875 mn tranche of the $6.5 bn 1984 new money package. Consequently, attention has turned to the next stage of the EFF and Phase III of the debt rescue package. An IMF team is currently negotiating with the Brazilian authorities, who

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have agreed on a tighter target for fiscal policy for 1985; other targets (for the final quarter of this year and the first quarter of 1985) have still to be decided. Brazil's performance on external account has been exceptional, but the failure of demand management policies to slow down inflation gives cause for much concern. However, an attack on the country's complex indexation laws is politically difficult ahead of the indirect Presidential elections, scheduled for mid-January. For similar reasons, the banks are concerned about the implications of granting Brazil a MYRA: many fear that Tancredo Neves (who is likely to defeat Paulo Maluf, the pro-government candidate, in the Presidential elections) will wish to renegotiate an "inherited" MYRA, even though he has made assurances to the contrary. Thus, it is possible that, in their meeting on 17 December, the Advisory Group will steer the Brazilians towards an interim rescheduling agreement covering 1985 maturities. The Brazilians are unlikely to ask for new money in 1985. An approach is likely to be made to the Paris Club later this month on a further round of rescheduling.

With more than 50 individual loan agreements involved, the Mexican MYRA is not expected to be signed until February. Meanwhile, the external account continues to perform strongly, and a substantial increase in reserves (of around \$5 bn) is forecast for this year.

Elsewhere in Latin America, slow progress has been made on the MYRA which was agreed in principle between Venezuela and its Advisory Committee on 21 September. The agreement was a major factor in the decision last month by US-banking regulators to lift the "substandard" classification from US bank loans to Venezuela. However, resolution of the private sector debt problem - a condition of the MYRA - has not been achieved, and Venezuela has therefore postponed its "road-shows" from early November to January/February 1985. Meanwhile, Venezuela's Advisory Committee agreed on 1 November to a seventh 90-day moratorium on payments of principal on public sector debt. In Chile, satisfactory performance in the third quarter prompted the IMF Board to approve a drawdown of the final tranche under the Standby, which was released on 14 December. In turn, this should trigger release of the final tranche of the 1984 new money.

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However, some recent measures suggest that the Chileans may be wavering a little in their commitment to the adjustment effort in the face of popular discontent and economic difficulties which stem from external developments beyond their control (notably the historically low price of copper on international markets). However, the banks will insist on progress towards a follow-on Standby before considering Chile's request for a rescheduling (possibly multi-year) and $800 mn of new money in 1985.

Peru's Standby has effectively lapsed, with the fiscal deficit running at over 10.1% of GDP, compared with an IMF-agreed target of 4.1%. The impasse with the banks, IMF and Paris Club, described in the last report, might not be broken until April, when the Peruvians will elect a new President and Congress. In Ecuador, the new Febres Cordero Administration is edging towards a new Fund programme, and has reached agreement in principle with the steering committee of banks on a MYRA covering maturities falling due in 1985-89, on $350 mn of new money, and on a new trade facility for $700 mn. Colombia is still attempting to avoid a Fund programme and is trying to attract new money from the banks on the strength of its own economic adjustment programme. Piecemeal rescheduling of private sector debt is continuing.

(ii) The Far East

In the Philippines, rescheduling and new money proposals have been offered to commercial and official creditors: to date, commercial bank acceptance of the proposals has reached 92%. At the same time, the authorities have accepted the IMF's conditions for a Standby, as well as increasing administered prices and further liberalising exchange control.

Elsewhere in the Far East, South Korea has come to the markets for around $375 mn, in order to cover a higher than expected current account deficit for this year. If the external position deteriorates further, Korea's favourable credit standing could be adversely affected, which would be a particular cause for concern given the country's large amount of short-term debt (some $12 bn). In

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contrast, Indonesia's external position continues to improve, and the current account deficit for fiscal 1984/85 is likely to be below $4 bn (compared with the governments's target of $4.7 bn), even though oil production was reduced temporarily following the OPEC agreement.

(iii) Eastern Europe

Official creditors reached provisional agreement with Poland in late November on the financial terms of a rescheduling covering some $11 bn falling due in 1982 to 1984. The terms provide for 100% relief on principal, interest and arrears of interest, now to be repaid between 1990 and 1995. In addition, 50% of the moratorium interest falling due in 1985 will be rescheduled over the following four years. The agreement was due to be initialled on 18 December, provided that the Poles paid 30% of the arrears under the 1981 agreement and abandoned some political rhetoric in the draft text. This last point appears to have caused difficulties in Warsaw for the Polish negotiators, and they cancelled the meeting. The US has subsequently lifted its ban on IMF entry, but official creditors continue to oppose any linkage between new credits and rescheduling.

On 26 November, official creditors received a Yugoslav request for a multi-year rescheduling agreement covering debt maturities in 1985-88 without a further IMF programme. They indicated their willingness to consider rescheduling 1985 maturities, but only if a Standby agreement was in place and, while recognising the need for relief in later years, did not commit themselves to its form, although they underlined the need for IMF conditionality in any such operation. The next move now lies with the Yugoslavs: no date has been set for a further meeting, and a moratorium on 1985 debt maturities seems inevitable. The Yugoslavs have rejected a commercial bank proposal for a four-year serial MYRA (including privileged credits) and are insisting on a block rescheduling. A further meeting is scheduled to be held in London on 8 January: meanwhile, a 3-month moratorium has been agreed.

Elsewhere in Eastern Europe, a $150 mn six-year credit for the GDR has been heavily oversubscribed and increased to $400 mn; and a $250 mn six-year credit for Hungary was raised to $300 mn. The Hungarians have formally applied to the IMF for a follow-on programme to replace the Standby which expires in January. The new programme is designed to put an IMF seal of approval on their reform programme, rather than to provide resources, and the Hungarians have intimated that they do not intend to make any drawings. However, the surplus on the convertible-currency current account remains modest in relation to forthcoming debt maturities, and both the GDR and Hungary continue to be vulnerable should banking sentiment change.

Romania has survived 1984 without recourse to further rescheduling, but may be unable to meet the peak of $1.5 bn debt maturing in 1985 without some accommodation from creditors. However, recent steps - including a 30% revaluation of the exchange rate - have reversed the measures taken at the IMF's request, and imply that the Romanians do not expect to seek Fund assistance.

(iv) Southern Europe

Contrary to earlier expectations, it is now possible that Portugal will meet the official target of reducing year-on-year inflation to 23% by the end of 1984, while the current account deficit is expected to decline to $0.8 bn (well below the Standby target of $1.25 bn). But rumours persist of political pressures for a more expansionary stance than the Finance Minister feels to be prudent, and prospects for the current account next year seem less favourable.

In Greece, the 1985 Budget aims to do no more than hold the deficit at the same proportion of GDP (10.2%) as this year. The current account deficit of the balance of payments is expected to be much the same this year as last, at around $2 bn.

In Turkey, the current account deficit for the first eight months of this year, at $1.4 bn, was little changed on the same period in 1983 and already exceeds the target for the year as a whole. This disappointing performance comes at a time when maturities from earlier reschedulings are beginning to fall due, and the total financing requirement in 1985 is likely to be in excess of $7 bn. The country is no longer eligible for IBRD Structural Adjustment Loans, and there are reports that it may not seek an IMF programme next year. There is a danger that a further round of rescheduling will be needed.

(v) Other

Nigeria has made no progress in negotiations with the IMF on a possible three-year EFF (SDR 2.4 bn if annual access is set at 95% of quota). The first tranche of the promissory notes rescheduling uninsured trade arrears was issued on 9 November: the authorities have indicated that most of the remainder will be issued by the year-end, and interest payments are to be made from 5 January 1985. Official credit agencies remain insistent that restructuring of insured trade arrears should be negotiated within a multilateral framework and be conditional on agreement being reached with the IMF. As an interim measure, the Nigerians have confirmed that they will pay an amount equivalent to interest calculable from 1 January 1984 at a rate of 1% over LIBOR on those insured arrears registered by Chase Manhattan and reconciled with importers' submissions to the Central Bank.

The Israeli government has reached agreement with trade unions and employers on a three-month wage and price freeze. Although the trade deficit in 1984 was largely offset by the prepayment of US aid, the domestic situation remains very disturbing, and only a few stabilisation measures have been implemented.

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INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt	British-owned banks' exposure [1]	ECGD amounts at risk [2]
	End-Dec 1983	End-June 1984	End-Sept 1984
Latin America			
Argentina	46	2.6	0.2
Brazil	92	6.6	1.7
Chile	19	1.3	0.1
Colombia	11	0.7	0.2
Ecuador	7	0.6	0.1
Mexico	91	6.4	1.3
Peru	13	0.4	0.1
Venezuela	35	2.3	-
Eastern Europe (convertible currency)			
East Germany	12-13	0.6	0.1
Hungary	8	0.5	0.1
Poland	24*	0.5	0.7
Romania	9	0.3	0.4
Yugoslavia	19	1.0	1.1
Southern Europe			
Portugal	14	1.3	0.3
Greece	12	1.5	0.4
Spain	38	2.8	0.1
Far East			
Indonesia	33	0.9	1.4
Philippines	25	1.3	0.2
South Korea	40	2.7	0.8
Other			
Morocco	12	0.1	0.2
Nigeria	20	1.2	2.9
Israel	29	0.6	0.1

[1] This column now shows exposure defined as consolidated external claims, adjusted for certain inward and outward risk transfers in respect of guaranteed loans, plus any net claims on local residents in local currency.

[2] Excluding claims paid (net of recoveries). Because of differences in definition, these estimates are not directly comparable with the figures in other columns.

*Excluding interest arrears of some $3 bn.

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10 DOWNING STREET

From the Private Secretary 24 December 1984

Following the Chancellor's minute of 7 December about the Paris Club negotiations, the Prime Minister has now seen the Minister for Trade's subsequent minute of 14 December. She has agreed to Mr Channon's suggestion that it should be put to the Argentines that in the context of the Paris Club meeting and without recourse to form bilateral negotiations the two sides should agree to remove all remaining economic and trade restrictions against each other.

I am copying this letter to Peter Ricketts (Foreign and Commonwealth Office) and Steve Nicklen (Mr Channon's office, Department of Trade and Industry).

(Timothy Flesher)

David Peretz Esq
HM Treasury

CONFIDENTIAL

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10 DOWNING STREET

From the Private Secretary

14 December, 1984.

Argentina: Application to Paris Club

The Prime Minister and the Chancellor discussed his minute of 7 December at their meeting today. It was agreed that HMG should take no part in the provision of new officially guaranteed trade credit, but should take part in the Paris Club negotiations for rescheduling existing official credit.

The Prime Minister has noted that the UK banks will be contributing to the package of new lending, and will be taking part in the rescheduling of existing bank lending. It was agreed that, if questioned, Ministers should say that this was a commercial decision for the banks themselves for which approval had been neither sought nor given.

I am sending copies of this letter to Len Appleyard (Foreign and Commonwealth Office) and Callum McCarthy (Department of Trade and Industry).

Andrew Turnbull

D.C.L. Peretz, Esq.,
HM Treasury.

CONFIDENTIAL

cc NO

Prime Minister (1)

Agree X be tried, though it would not, I think, be the first time?

AT 17/12

Yes

JU596

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PRIME MINISTER

ARGENTINA: APPLICATION TO PARIS CLUB

I have seen Nigel Lawson's minute to you of 7 December proposing that we should participate directly in the Paris Club negotiations on rescheduling the Argentine debt. I believe there are good reasons for being there - we might lose out if we were not - and I support the proposal.

X 2 By agreeing to reschedule our part of the debt we should in effect be helping the Argentine economy, and doing so publicly. This leads me to wonder if it might not be a good opportunity to put it to the Argentines that in the context of the Paris Club meeting, and without recourse to formal bilateral negotiations, the two sides should agree to remove all remaining economic and trade restrictions against each other. The proposal could justifiably be presented as in the long term interests of the Argentine economy; and it would avoid the linkage with discussions on sovereignty.

3 The Argentines might not agree; but we should lose nothing by trying.

4 I am copying this to Nigel Lawson and Geoffrey Howe.

P.C.

P C

14 December 1984

Department of Trade & Industry

13 December 1984

SECRET

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MR TURNBULL

A CONTINGENCY PLAN FOR A BANKING CRISIS

1. The Treasury Paper "Possible Support Operations..." deals mainly with defaults by a third world borrower with respect to the debt it owes to western banks. The emphasis is on how very little we know either about bank balance sheets or the financial consequences of the erosion of confidence.

2. Similarly, the paper is alarming in revealing the fragility of the degree of international cooperation and agreement (paras 27-36). I am particularly concerned that:

> "Treasury officials agree that it seems best to rely on the pressure of a crisis to bring about... agreement" [on which Central Bank is responsible for which subsidy] (para 36).

In a crisis it may be too late.

3. The "Breakdown in the US" is dealt with in a summary way in two paras in Annex C. But this can now be extended and updated in the light of Continental Illinois, Penn Square, Drysdale etc. I think this Annex should also be extended to cover the contingency in a major domestic breakdown - say two MCBs at one time - in the light of FDIC commitments and assets, the likely litigation, and the general operation of the Fed's defence mechanism. In particular the report should examine the apparent effect of the FDIC announcement of the extended guarantee to large depositors in accelerating instead of containing the run on Continental.

Money Centre Banks

It is essential that we reassess the power and plausibility of the new explicit guaranties and the likely problem of challenge of their lack of constitutional status.

AW

ALAN WALTERS

SECRET

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CONFIDENTIAL

cc ~~JR~~

For CHEX
Bilateral,
Friday

Foreign and Commonwealth Office

London SW1A 2AH

12 December, 1984

AT - with you?
CDP 12/12

Dear Charles,

Argentine: Application to Paris Club

— with CDP

In his minute of 7 December, the Chancellor of the Exchequer proposed that, subject to the views of the Prime Minister, the UK should participate in Paris Club negotiation with Argentina in the normal way.

The Foreign Secretary agrees with the Chancellor that such an approach is the best means of protecting effectively our own financial interests and considers that it would be consistent both with our policy towards Argentina and with our desire to discourage the politicisation of international financial institutions.

I am sending copies of this letter to David Peretz (HM Treasury) and Callum McCarthy (DTI).

Yours ever,

Peter Ricketts

(P F Ricketts)
Private Secretary

C D Powell Esq
10 Downing Street

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12 DEC 1984

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(2)

PRIME MINISTER

ARGENTINA

The proposals for dealing with Argentina's debts are in five parts:

(i) An IMF programme under which a standby of SDR 1.4 bn was agreed on 25 September.

(ii) New money from the banks. The Advisory Committee* has reached agreement on the provision of $4.2 billion of which 40 per cent will be used to meet future interest payments to the banks. UK banks are likely to provide about 10 per cent of this.

* ie the negotiating group. Endorsement of all the lending banks is now being sought.

(iii) Rescheduling old bank loans. About $16.5 billion of loans due in 1982-85 will be rescheduled, including that to British banks.

(iv) New official money. The IMF are seeking about $1 billion. The UK are not contributing .

(v) Rescheduling $2.2 billion of official debts at the Paris Club, of which $125 million is owed to HMG.

The Chancellor recommends that the UK Government should take part in the Paris Club negotiations.

Agree for discussion at Thursday's bilateral?

Yes mb

AT

Reluctantly agree - mt

10 December 1984

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cc JR

PRIME MINISTER

ARGENTINA: APPLICATION TO PARIS CLUB

You had a report last month (letter of 12 November on the International Finance Scene) on the latest state of play in the negotiations between Argentina and the International Monetary Fund on a new standby agreement. The same letter mentioned the need to consider shortly the question of UK participation in a Paris Club rescheduling of existing official and officially guaranteed debts. This is, of course, a quite separate issue from our decision not to contribute to meeting Argentina's 1985 financing needs through new trade credits.

2. The Argentines submitted a formal request to reschedule some \$2.0 billion of officially guaranteed debt in June. The UK share of this would be \$125 million (roughly 6 per cent). The precondition for such a rescheduling is of course a Fund programme.

3. Latest indications are that the commercial banks will agree to the package worked out with their Advisory Committee, ie rescheduling plus some \$4.2 billion of new money in support of an IMF programme. The Managing Director of the Fund appears to have been given reasonable assurances of the availability of new officially guaranteed trade credit. The Argentina programme could therefore go to the Fund Board for approval at the end of this month. Assuming it is endorsed by the Board, discussion of rescheduling in the Paris Club is likely to take place at the meeting on 14-18 January.

4. For their part the Argentines seem to have dropped their earlier suggestion that the Swiss should represent us. But whatever their view, I believe that the UK should participate directly in the Paris Club rescheduling in the usual way. This would be consistent with our general line that all creditors have the right to participate in the Paris Club negotiations if they so wish, regardless of political differences. It is also the best means of effectively protecting our own considerable financial interests.

5. If successful, the Paris Club negotiations would lead to a multilateral rescheduling agreement, implemented by separate bilateral agreements between the debtor and individual creditor countries. UK agreements are usually published in the Treaty series. I understand that there are no legal obstacles to concluding such an agreement with Argentina. The agreement would be purely financial in nature and would carry no wider political implications. It would however be necessary for UK officials to meet Argentine officials directly, to negotiate the terms of the bilateral agreements, but there are now several precedents for this and it would be consistent with our attempts to return to more normal relations.

6. Subject to your views, therefore, I propose that the UK should participate in these Paris Club and subsequent negotiations in the normal way.

7. I am sending copies of this letter to Geoffrey Howe and Norman Tebbit.

N.L.

N.L.
7 December 1984

Econ Pol Pt 4

Indebtedness

COVERING SECRET

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

5 December 1984

Andrew Turnbull Esq
10 Downing Street
LONDON
SW1

Dear Andrew

CONTINGENCY PLANNING FOR BANKING PROBLEMS CAUSED BY EVENTS OVERSEAS

I understand that the Chancellor mentioned to the Prime Minister last week a Treasury paper that had been produced on this subject about a year ago, and undertook to show a copy to the Prime Minister.

... I attach a copy of the fairly full paper produced in the Treasury in November 1983. Although, as you will see, it takes for the sake of example support operations required in the case of a major debtor country's ceasing to service its debts, the analysis in practice would also cover a situation where problems were caused by the failure of one or more US banks.

Yours ever,
David

D L C PERETZ
Principal Private Secretary

POSSIBLE SUPPORT OPERATIONS FOR BANKS BY UK AUTHORITIES IF A MAJOR DEBTOR COUNTRY CEASED TO SERVICE ITS DEBTS

I Introduction

The purpose of this paper* is to consider, so far as this can sensibly be done in advance of a crisis, what effects and decisions the UK Authorities would face if a major debtor country ceased to service its debts to banks. Brazil is used as a topical illustrative case, but the paper would in general be valid for other countries. The uncertainties are far too great for it to be realistic to attempt a detailed contingency plan. These uncertainties - about the development of a crisis and the reactions of depositors and the authorities in different countries - pervade the whole paper. But subject to these the paper aims to cover the following ground:

(a) the likely nature of the difficulties for banks in London caused by a crisis in which one or perhaps two major debtor countries ceased to service their debts to banks. This would not necessarily cause serious problems in the UK, especially if the UK authorities acted quickly to supply liquidity to their banks. But it could do so, probably in the form of a withdrawal of dollar bank deposits. Withdrawals would arise from loss of confidence in the quality of some banks' assets and hence in banks' ability to repay deposits. This scenario envisages liquidity problems but not a crisis of default by several major countries together in which the value of some British banks' assets could be reduced so far that they were worth less than their liabilities. Nevertheless, the scenario envisages a reduction in the profitability and the capital base of certain major banks as a result of the reduced value of their assets which could leave continuing problems even after a liquidity crisis of this kind had been handled successfully; (Sections II and VII).

(b) the broad decisions which would face the UK authorities about whether, when and how to act either by making statements designed to restore confidence or by providing liquidity support. These decisions would be difficult but would have to be taken quickly and almost certainly on the basis of inadequate information. Decisions would probably also be needed on intervention in the foreign exchange market and on the supply of UK Government debt; (Section III).

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* The paper reflects a major contribution from Bank representatives dealing with the Banking Department, overseas, banking supervision and home finance. But it has not been formally agreed with the Bank.

2. The paper assumes that despite the arguments for avoiding or minimising the extent and cost of support by the authorities acting as a lender of last resort in a crisis, the case for taking such action in certain circumstances is accepted in principle.* The difficult judgement is when those circumstances exist.

3. The immediate purpose of any domestic operations to provide liquidity would be to prevent a bank with assets worth more than its liabilities from becoming insolvent in the sense of being unable to meet its liabilities on the due date. But the underlying intention would be to protect economic activity (at levels compatible with adequate performance on inflation) from the damage which a breakdown in the financial system would or could cause. The purpose of support would not be to protect banks' shareholders, management or employees, or even their depositors. The extent to which the banks should bear the full losses arising from a crisis which called for a support operation is again something that can only be judged in an actual situation; however, a major aim must be to minimise any cost falling on the taxpayer.

II Future and Possible Effects of a Crisis

4. The effect of a crisis on UK domestic institutions will depend in the first instance on the form Brazil's failure to pay takes, the speed with which it develops and its presentation. The decision to stop payments could be explicit and sudden. But the most likely contingency may be a gradual slide in which it becomes clear - with no formal repudiation of debts (and indeed perhaps repeated assurances about resuming debt servicing as soon as possible) - that there is no prospect of repayment in the foreseeable future. Annex A describes more fully how a crisis might develop.

5. A cessation of debt service payments would affect the confidence of depositors because of fears about the effect on the value of some banks' assets. We cannot predict

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* In other words it is assumed that of the two doctrines expressed in the following quotations Bagehot, who believed in providing support on "onerous terms", prevails.

> "...... the most mischievous doctrine ever broached in the monetary or banking history of this country, viz. that it is the proper function of the Bank of England to keep money available at all times to satisfy the demands of bankers who have rendered their own assets unavailable". (Hankey, 1866)
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> "Theory suggests, and experience proves, that in a panic the holders of the ultimate Bank reserve (whether one bank or many) should lend to all that bring good securities, quickly, freely and readily. By that policy they allay a panic; by every other policy they intensify it". (Bagehot, 1873)
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> These quotations are lifted from a paper by Lipton and Griffiths-Jones on "International Lenders of Last Report.

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which banks or class of banks will suffer first or worst from loss of confidence and withdrawal of deposits; nor the extent to which switching of deposits between different banks (or banking centres), accompanied and helped by "tiering" of interest rates, will prevent serious liquidity problems arising for the banking system as a whole in the UK (or the main centres taken together). But for the purpose of this paper we assume that a Brazilian debt crisis leads among other things to a very large withdrawal of dollar deposits from banks in London, including but not confined to some of the big 4 clearing banks. Total foreign currency liabilities of British banks in London alone are over $100 billion.

6. Although the exposure of British banks to Brazil is very large, even a complete and final default by Brazil would leave the banks' assets well above the value of their liabilities.

7. The total exposure of British banks to Brazil had risen to $5.8 billion or about £3.8 billion at the end of June. This figure excludes risks transferred to ECGD and also loans to American banks heavily exposed to Brazil. If the two clearing banks worst affected had to provide fully against their Brazilian assets at the end of the current accounting year, as a result of a default, they would lose all their profits and up to one third of their capital base. In practice whether full provision would be appropriate would depend on the nature of Brazil's inability to repay. The full figures would first emerge when the banks made their annual report to shareholders, unless an earlier announcement was made.

8. The difficulties would of course be worse in degree if another Latin American country ceased to make debt service payments. The total exposure of British banks to Argentina is $2.5 billion or £1.6 billion. Eighteen British banks have exposure either to Brazil or Argentina, of which 14 have exposure to both. Three of these had a combined exposure at the end of June 1983 exceeding 50 per cent of their capital base. Of these two are major (big four) clearing banks. None of them should become insolvent as a result - their assets would still be worth more than their liabilities - provided these two countries alone cease to service their debts.

9. That could change if Mexico and Venezuela, where British banks' exposure is of the same order as in Brazil and Argentina respectively, <u>also</u> ceased payments. But this paper does <u>not</u> cover that scenario. It is concerned with the liquidity problems that could arise if one or two major countries stopped paying. These problems would arise from loss of confidence as much as from banks' objective balance sheet position, even though the exposure of British banks as well as of other countries' banks is large in absolute terms.

10. So long as the banks losing deposits can replace them eg by paying higher interest rates to the banks gaining deposits, who will thus profit from the rising interest rate differential, there is no need for support by the authorities (except on preemptive "stitch in time" grounds - see paragraph 22 below). But once the market ceases to redistribute deposits between banks in this way, the authorities will need to consider acting. The potential liquidity shortage of individual banks would build up over time and could reach large figures. The Bank has calculated, on certain rather extreme assumptions, that two clearing banks could need liquidity assistance of up to $1 billion in foreign currency alone by the end of the first month after Brazil had ceased payments, even after realising as far as possible their foreign currency assets and using up their sterling liquid assets, at a time when other UK-based banks would certainly face unusual liquidity pressures.

III Main Decisions Facing Authorities

International Co-operation

11. It will be in the UK's interests to press for the maximum amount of agreement between national authorities on the responsibility for arranging and providing liquidity support. The UK authorities must avoid taking on an unfair share of support. The exposure of UK owned banks to Brazil is third in volume after USA and Japan; but the London market's exposure is second only to that of New York. This is discussed on Section IV.

Statements and other 'Pre-emptive' Action

12. Liquidity problems inevitably pose difficult choices for the authorities. These decisions, which are bound to be based on judgement and incomplete knowledge, may need to be taken fast. On the one hand it is not necessary for the authorities to respond immediately to the first rumours affecting confidence, tiering of interest rates or difficulties of individual institutions not important for the system. Such tremors have occurred in the past and been overcome without official action. On the other, since confidence is at issue, there is a case for early preemptive action by the authorities - either statements which may need to contain a blank cheque element to be effective but may cost nothing if they succeed; or perhaps providing 'early' liquidity help to an individual bank.

Intervention in Currency Market and Supplying More Debt

13. Apart from decisions on international negotiations, statements, and liquidity support for individual banks, the authorities may well face decisions on whether to intervene in the foreign exchange market and/or whether to supply additional domestic debt instruments.

14. It is uncertain in which direction any pressure on sterling might be working. It would be downward if banks in London had to purchase dollars to meet withdrawals of dollar deposits. Even if US banks were perceived to be at greater risk than UK banks depositors could shift into US Government debt. But it is also possible that sterling would benefit from movement of international funds out of dollars. The decision on whether and how to intervene to support sterling or to offset a rise in the value of sterling would have to be taken at the time as would possible decisions on interest rates. The scope for the UK Authorities acting alone to intervene is limited first by the size of the immediately liquid dollar reserves (around $4 billion) and second by the size of funds that could be borrowed abroad at short notice.

15. Additional demand for government debt might arise from switches out of bank deposits by depositors or by banks out of interbank loans or from an inflow into sterling. If so the authorities might wish to supply more gilts or Treasury bills in order to prevent interest rates from being bid down to an undesirable level.

16. To the extent that the authorities intervened to support sterling or supplied more debt, the scale of the money market shortage and hence of the Bank's normal operations to supply cash would be increased. But this would not in itself involve a major policy decision on support operations. These points are amplified in Annex B.

Providing Liquidity Support

17. There would be a preliminary stage during which the Bank would be monitoring London markets closely to get the information on which to base a judgement about the seriousness of the situation caused by the cessation of debt service payments. It would also be in close touch with central banks elsewhere especially in the USA. It would in particular be looking at a range of evidence including:

(i) unusual withdrawals of dollar or other deposits;

(ii) exchange rate movements;

(iii) interest rate tiering between different classes of banks, different banking centres, and between bank assets and UK or US government debt;

(iv) bank share prices.

Some tiering can be survived without any special official action. Annex D describes what happened in 1982 when no special liquidity support was provided.

18. During this period the Bank and the Treasury would be in close touch on how the situation was developing. A new phase would start if a decision were taken to embark on providing liquidity support to individual institutions, as distinct from the Bank's normal provision of cash to the money market through the discount houses. This decision would involve consultation between the Governor and the Chancellor.

19. Liquidity support to individual banks, which would be given in sterling, can be provided through the purchase of assets, lending or guarantees of loans made by third parties. These techniques and the terms which should fully reflect the risk so far as this was compatible with the purpose of liquidity support are discussed in some detail in Section VI. The knowledge that such sterling support was available would help confidence, but in certain circumstances the availability of additional dollar swap lines with the Fed might also need to be made known.

20. The next main issue is which institutions should and should not receive support once the case for some action has been accepted. The aim of preventing economic activity from being damaged by a breakdown of the banking system implies that support should be given to those banks whose survival is both at risk and vital for the system as a whole, but not to others, (though this would involve some inequity since not all those banks peripheral to the system would have been managed with less than average prudence.) We and the Bank have found it difficult to get beyond this level of general presumption in advance of an actual crisis, but the Bank have provided a description of their approach in paragraphs 21-26 below. This is helpful though it necessarily leaves many questions open including the treatment of branches or subsidiaries of foreign banks for which we hope the parent central bank would accept responsibility (see Section IV). The Bank's approach does not rule out assistance to banks not themselves essential to the system on grounds of specific knock on effects or confidence effects. But it does not seem realistic to settle general policy on this in advance of a specific crisis.

The Bank's Approach

21. Given the central importance of the clearing banks to the economy as a whole, as well as to the banking system, it must be presumed that it would always be necessary to arrange support for any of them which got into difficulties.

22. Beyond this group it is difficult to identify any bank whose survival would be so obviously important. It would be necessary to consider in each case the nature of the particular crisis and therefore what the reaction to it should be. This means that it is vital

not to rule in advance that any particular bank would always, or could never, be support-worthy. It may be that offering limited support early on in a crisis to an otherwise unlikely candidate would prevent the need for larger-scale assistance to a wider group of banks, more important to the system, at a later stage. (This was an important reason for support to the secondary banks in 1974-75.) Thus while there would be no presumption that any particular categories of banks would be supported it must be recognised that in the heat of a crisis the Bank would want to offer assistance in the most effective way even if this were to a candidate not obviously identifiable in advance.

23. It would, for example, be necessary to take account of the particular structure of an individual bank's balance sheet in deciding whether it should be a candidate for support. The liabilities of some banks are concentrated heavily in the form of interbank deposits, including deposits with clearing banks and important accepting houses; if the borrowing bank should as a result of the liquidity difficulties fail to meet these deposits as they fell due, the liquidity pressures could be transferred to its counterparties. The Bank does not have detailed information on all depositing counterparties with any given bank nor, if it did, would it necessarily be able to judge immediately how vulnerable they themselves might be.

24. On the assets side, likewise, without detailed knowledge of all of the borrowing customers of any given institution, the repercussions of a closure arising from liquidity difficulties is impossible to forecast; but it could be damaging to particular sectors or to particular customers in sensitive areas of the economy.

25. Another uncertainty concerns the amount of time available in which to decide upon action. The subsidiary of a foreign bank located here might be unable to ascertain that it would receive the necessary support from its parent because of such accidental factors as public holidays, the availability of senior officials, or the time needed to arrive at an agreed distribution of support in the case of multiple parentage. In such cases, the Bank's knowledge of the circumstances and its informal contacts with the responsible monetary authorities might lead it to the view that it was sensible and prudent to give support against a presumption of transfer of responsibility in due course.

26. Above all the Bank would have to take account of the effect on confidence of the failure, through liquidity difficulties, of even a small bank. The circumstances in which we envisage such an incident could very well be an important turning point in market sentiment and confidence, affecting the banking system as a whole. If the banking community should at such a juncture observe the Bank declining to assist a given institution the shock to confidence could, in some cases, be severe and seriously aggravate the situation. This is not

to say that the Bank would always intervene to provide support whatever the nature of the institution in trouble. That again would depend on its place in the market, the complexion of its customers on both sides of the balance sheet, the amount of publicity which might attend the failure, etc. There are, no doubt, institutions where the balance of judgement would point to allowing them to fail; otherwise London would become the depository for the bulk of the bad or doubtful international assets in the banking system. But until a particular case arises it is impossible to anticipate where the balance would lie.

IV International Co-Operation

27. The September paper assumed that there would be agreement on parallel action to support banks at least by the US and UK authorities and preferably by other countries as well. We have explored with the Bank what such co-operation might amount to in terms of action as well as of possible statements. The Bank have asked that the information in paragraphs 28-31 below should not be passed on by the Chancellor to the Finance Ministers of other countries. The reason for this is that some other central banks, which have not passed similar information on to their governments, might react badly if they learnt that British Ministers had been given it. The risk is that this would harden attitudes and so make it more difficult to agree on action in an actual crisis.

29. The earlier paper quoted the 1974 statement on euro-markets by G10 Governors that:

> "...... it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means were available for that purpose and will be used if and when necessary."

29. During 1982 the Bank initiated discussions in Basle aimed at reaching agreement on:

(a) a new reassuring statement that could be used if the international debt situation required it; and

(b) a broad division of responsibility between central banks which would enable them, if necessary, to honour the collective assurance given by the G10 Governors in 1974.

30. It proved impossible to agree on (a). Indeed the Bank doubts whether it would have been possible last year to agree even on the 1974 text if it had not already existed.

31. On (b) some progress was made in agreeing which central banks should be primarily concerned with banks' foreign establishments and should "take the initiative in making the arrangements" for dealing with their liquidity problems, as follows:

Type of Bank	Central Bank Responsible
Branch	Parent
Subsidiary	Parent and host jointly
Joint Venture	Host

The responsibility for "initiating" these arrangements for subsidiaries was thus not clear cut and no decisions were taken about the sharing out among central banks of responsibility for providing liquidity support as opposed to initiating the arrangements. However, the UK authorities would clearly have responsibility for the consortium banks which would be hard hit in the scenario described in this paper.

32. Joint responsibility for initiating arrangements for subsidiaries reflects conflicting arguments. As subsidiaries are legally distinct entities incorporated in the host countries, the legal argument points to the host central bank being responsible. The practical argument points in most situations to the parent central bank since most large banks operating an international network treat wholly owned and even majority owned subsidiaries in much the same way as branches.

33. Turning from responsibility for initiating arrangements to the actual provision of liquidity, we have agreed in principle with the Bank that in an actual crisis our aim should be to agree with the US and as many other countries as possible that parent central banks should be responsible in general for providing subsidiaries as well as branches with liquidity. (In practice the host central bank might act as agent and unless the nature of the crisis pointed clearly, as in the case of difficulties for Crocker in California in the aftermath of an earthquake, to a particular situation there would be some tricky individual cases eg with Grindlays in London as well as Crocker in the USA.) This division of responsibility would be in the UK interest since the liabilities of subsidiaries and branches of UK banks operating in the US is about half of the equivalent figure for branches and subsidiaries of US banks in the UK (about $130 billion). Equivalent figures for other G10 countries are not available but in general the UK is more significant as a host than as a parent.

34. There are doubts about the willingness of other central banks to adopt a distribution of responsibilities for support on the lines suggested in paragraphs 32 and 33 above, and not even the US could at this point be counted upon to agree to them. However in a real crisis the US authorities* might be prepared to accept them and with the possible support of Canada and the Netherlands the Bank might be able to achieve an agreement on these lines

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* This paper is based on the assumption that this is correct. If it were not, the results would be serious as Annex C explains.

at a Basle meeting of the G10 Governors. But on past form a number of major countries are likely to prove difficult. These include Germany, France, and Italy. The pattern of Japanese business in London, mainly through branches, is very skewed in favour of this principle - their dollar liabilities in London are over $130 billion, while the British banks' yen liabilities in Tokyo must be negligible by comparison. There is a fair chance that the Japanese would follow the US-UK lead.

35. However, for self-protection we cannot rule out assisting non-British banks. Non-G10 banks have nearly $50 billion of liabilities in London; they are a mix of subsidiaries and branches and are a very heterogeneous group. It would be impossible to predict with any certainty which authorities would support their own and which would not. In aggregate, however, these banks clearly have enough weight to cause considerable damage. There might be a case, if the system seemed otherwise at risk, for making an exception to the home country principle. Before reaching that conclusion, we would seek to insulate the vital organs of the market from them - perhaps by attaching a condition to liquidity support that it could only be used to meet obligations to banks whose home central banks were co-operating in an international effort. Indeed, that intention might be an effective weapon of suasion.

36. The position therefore is that there is no clear cut internationally agreed plan for implementing the 1974 assurance: silence then and since then about what would actually be done is not attributable only to a wish to avoid moral hazard for the banks. We have discussed with the Bank the possibility of seeking to fill this gap. They are, however, certain that any attempt to do so in Basle in advance of a crisis would fail. The reasons for this include legal inhibitions (Germany), the political need to defend in public any agreement reached before a crisis arises (US), and the wish to keep one's hands as free as possible. The Bank consider that the same would be true if discussions were opened at Ministerial level. Failure accompanied by leaks about failure would be the worst of all worlds. Treasury officials agree that it seems best to rely on the pressures of crisis to bring about the sort of agreement described in paragraph 32 above. At that point the Chancellor and other G5 Ministers could exert pressure for a workable plan of action to be agreed.

V Statements

37. We have concluded that there is no point in embarking on a contingency drafting exercise. But Annex ~~D~~ G usefully brings together a range of past statements that have been made. These include:

(a) the full communique issued by G10 Governors in 1974;

(b) a reference back to this in a speech by the Deputy Governor in 1982;

(c) a statement by the Canadian central bank Governor about the availability of lender of last resort facilities for banks in difficulties;

(d) a similar statement about an individual Canadian bank;

(e) a press report of a Bank of England statement about National Westminster in 1974;

(f) a statement by National Westminster itself on the same occasion.

38. If a crisis arose, statements might also be made by the IMF and perhaps by governments. Timing is clearly a vital factor for statements designed to maintain confidence. It would be risky to make one before confidence is in question. Equally statements should not be delayed until confidence has been destroyed.

39. Any statement implying a commitment to provide support by the authorities in the UK, which would be subject to parallel action by other major countries, would be cleared with Ministers.

40. Of course it is possible to get through a crisis without a statement. Apart from their comment on rumours about National Westminster in Annex ~~D~~ G, the Bank made no general statement during the domestic secondary banking crisis. It was, of course, known at a very early stage that the lifeboat had been formed.

VI <u>Operational Aspects of providing Liquidity Support</u>

41. <u>(a)</u> <u>Techniques</u>. The main forms of support for individual banks open to the Bank would be:

(i) purchase of assets;

(ii) secured lending;

(iii) unsecured lending;

(iv) guarantees by the Banking Department of loans from third parties.

••• 42. Annex E gives details about the capacity of the Banking Department and Issue Department. The Issue Department has no powers to borrow currency or to give guarantees. Moreover since its assets back the note issue and its profits are paid into the National Loans Fund, it is preferable that it should not hold risky assets. In general the Bank would use the Banking Department when this was not ruled out either by the sheer size of the operation or by the risk in relation to the Banking Department's balance sheet - its free reserves are about £180 million - and profitability.

43. The terms for these operations should be as 'commercial' as is compatible with their object - in line with Bagehot's support for "onerous terms". There would thus in general be a presumption in favour of exhausting the scope for giving support by purchasing sound assets and by secured lending before embarking on unsecured lending or guarantees. In practice, however, the scope for using the less risky techniques may not be large for two reasons. First, the banks in liquidity difficulties may have sold off all their sound assets before the issue of support by the Authorities arises.

44. Second, to the extent that assets are still available for sale the safest assets to purchase would be claims on or guaranteed by the public sector (Treasury Bills, gilts, local authority debt, and export credit paper guaranteed by ECGD). On these grounds there would be a case in support operations with individual banks for buying these assets before even the best claims on the private sector such as eligible bills. On the other hand to insist on this in all cases might leave the supported bank with an inadequate balance sheet and a choice would have to be made at the time. (For the purposes of the Bank's normal money market operations so far as these could be distinguished it would clearly in the interest of confidence to continue the normal practice of dealing mainly in eligible bills.)

45. In the statistics the Banking Department is deemed to be in the private sector and therefore its transactions are not relevant to public expenditure or the PSBR. The Issue Department is considered part of the public sector but its expenditure on the purchase of eligible bills does not count as public expenditure nor add to the borrowing requirement. This is because these operations - or any dealings in short-term instruments which are close substitutes for money market transactions - are regarded as essential short-term provision of funds as part of the normal central banking. Nor do these operations increase monetary growth as they displace one asset by another in the banking system's total balance sheet: they do not increase the size of that balance sheet. But of course increased purchases of central government debt by the non-bank private sector which may be the originating cause of the shortage would <u>reduce</u> monetary growth. Support operations by the Issue Department would only be defined as public expenditure and increase the PSBR if they involved long-term commitments rather than money market operations - eg taking the form of long-term loans or the acquisition of capital. These criteria will apply whether money market operations take the form of general assistance to the market via the discount houses or direct support for individual banks.

46. (b) Distribution of risk and reward between the Exchequer and the Bank. If an asset acquired by the Issue Department turns out to be worth less than it cost, the Exchequer bears it directly in the form of reduced Issue Department profits. This should not, however, occur unless the Department has begun to acquire assets of an unusual kind (see paragraph 51 below).

47. If the same thing happens to an asset acquired by the Banking Department, the Bank bears it unless there is a Treasury guarantee or indemnity. The same goes for loans by the Banking Department.

48. If the Bank asks for a guarantee of repayment or an indemnity against any loss on a Banking Department loan and the Treasury agrees to provide one, decisions would be needed on the allocation of risk and reward. The Treasury would want a slice of any profit if it was bearing part of the risk.

49. (c) Powers and Parliament. Any guarantees or indemnities by the Treasury to the Bank of England would be given not under a statutory power but under the Crown's common law power; this procedure is permissible since there is no legislation which precludes it. There are, however, standard procedures for non-statutory guarantees, including the laying of minutes before Parliament.

50. If there were any question of loans by a Government Department to individual banks, which is unlikely on the scenario considered here, the conditions for drawing on the Contingencies Fund would have to be satisfied; these are set out in Annex F.

51. The Accounting Officer for the National Loans Fund must be consulted if any unusual use of the Issue Department's resources is ~~likely~~ contemplated. This would include consultation between the Bank and the Accounting Officer before the Issue Department were used in a way that might be regarded by Parliament as an alternative to public expenditure.

52. The scale and destination of the flow of funds in a crisis are uncertain. But one possibility is that a surplus might build up in the National Loans Fund. This could happen if the authorities decided either to supply extra Government debt or to intervene in support of sterling in the foreign exchange market on a very large scale. The Treasury Solicitor's Department has confirmed that in those circumstances the Treasury has the power to borrow and to deposit the NLF surplus with the Banking Department. The Banking Department could then use the surplus to provide liquidity support under Section 12 of the National Loans Act 1968 as amended by Section 152(i) of the Finance Act 1982, so long as

the Treasury considered this "expedient for the purpose of promoting sound monetary conditions". However since the power conferred by this wide wording would in practice be being used in a scenario very different from the one originally described to the House - sales of debt designed to control the growth of monetary aggregates - there would be a strong case on grounds of Parliamentary propriety for informing the House if the powers are used in this way, preferably before they are so used, unless a Parliamentary statement would be incompatible with the purpose of the operation - preserving or restoring confidence.

VII Problems Remaining after a Liquidity Crisis

53. The loss or diminution of assets would remain a problem even after a liquidity/confidence crisis had been successfully handled. Doubts about the affected banks would have to be resolved and the supervisors would wish to ensure that this was done. The route would depend on the nature of the crisis and the way in which each bank had been affected. A bank which had suffered a loss of deposits, but without significant erosion of its net worth, would be in a different position from one which had suffered serious capital losses. In the first case the bank would need to restore its liquidity and re-establish its reputation. The workings of the markets and the concern of the supervisors might mean that some reduction in new lending for a period might be part of this process.

54. In the second case, however, it would be necessary to prepare a plan for a phased return to normal supervisory ratios over a longer period. The timescale would depend on the extent of its losses and the availability of support. It would be unhelpful to force a rapid return to normal ratios if this means cutting back the bank's existing good business or precipitate sales of assets at below book value as this would reduce the bank's ability to generate new capital resources. Mergers, sales of investments and participations and giving up less remunerative activities are all possibilities that would need to be considered. During the period of convalescence the Bank of England as supervisory authority would need to be flexible whilst laying down for each bank clear ultimate objectives.

HF Group
HM Treasury
4 November 1983

LIST OF ANNEXES

ANNEX A

BRAZIL: DOMESTIC SUPPORT OPERATIONS

SCENARIO

The analysis which follows is necessarily speculative; there are many possible scenarios, and the order of events cannot be predicted with any confidence.

Background

2. That said, the background in very broad terms could look something like the following:

(i) Brazil fails to meet due dates by growing delays and creditors/international institutions etc. are unable to gloss this over; this leads to gradual recognition that a state of default effectively exists as "excessive" arrears build up (eg arrears which trigger prudential or accounting responses and are perceived as threatening banks' asset positions). At the other extreme, though less likely, Brazil might simply repudiate her debts.

(ii) Other Latin American countries, notably Argentina, might follow suit.

(iii) Serious damage results to banks' asset side. The precise extent of damage may only emerge later, eg when annual accounts are published and the scale of provisions becomes evident. If it were great enough the solvency of some banks could be called into question. But there will be an growing impact in terms of loss of confidence as depositors and other members of the financial community take a view, probably on very uncertain information, of the impact on banks known or believed to be most exposed to these risks. This loss of confidence could be sharp if it were triggered by an unexpected event such as an assassination, coup or natural disaster. It could lead to substantial and unpredictable disturbances on banks' liabilities side, which would be influenced by factors such as the response of different national authorities and shifts in the relative confidence placed in different banks, different financial centres, and different currencies. The disturbances could lead to a local or to a more widespread liquidity crisis. Solvency difficulties could follow later for some banks when assets had to be reclassified formally - even if the liquidity storm had been weathered.

(iv) In these circumstances one cannot predict in which directions funds would flow, whether there would be marked exchange rate effects, whether UK banks would be net beneficiaries of a flight into quality, to what extent the interbank market would continue to recycle liquidity, to what extent funds could escape from the banking system, or to what extent the authorities in different countries could intervene to restore the flow of liquidity to where it was needed. If, for example, funds went into notes and coin, the authorities could hardly direct holders to put them back. There is a question in extremis whether dollar clearing in New York would seize up if confidence in key US banks broke down.

(v) The scope for responses by Governments and Central Banks is considered in part III of the main paper. The paragraphs which follow set out the possible anatomy of the liquidity crisis in more specific terms, both in the international (ie mainly US dollars) and in the domestic context (both dollars and sterling) to the extent that they can be separated. Events would not necessary follow in the order suggested. Official responses would have to be made on the best available information about the position which the crisis had reached. The situation would be bound to be fluid and uncertain, and could accelerate out of control at any time. On the other hand, there are points where the authorities could reverse the chain of events - eg if the USA made it plain that whatever happened the 10/15 largest US banks would not be allowed to fail.

<u>Detailed consequences: international scene</u>

3. In more detail, we could expect most if not all of the following developments:

(i) Once confidence starts to erode Brazilian banks in international centres (mainly New York) could lose interbank deposits and be forced to close. Same could happen if another country defaulted to its banks.

(ii) Other Latin American banks in international centres could suffer acute confidence difficulties by contagion.

(iii) Major US banks with large exposures would face tiering in the markets and would have to resort to the Fed. discount window to obtain cash. Their branches outside the USA could suffer similar tiering.

(iv) Precautionary moves by banks generally could make the markets less efficient as a channel of liquidity. All banks would take defensive steps to protect liquidity.

(v) Tiering could spread to non-US banks with large exposures to Brazil (some UK banks) or particularly dependent on the interbank market for funds (Italian, perhaps Japanese).

(vi) Possible segmentation of international market if markets perceive different liquidity prospect between centres.

(vii) "Safe" banks offered huge deposits as there are only very limited opportunities for cash to "leak" from international wholesale market.

(viii) Non-bank depositors attempt to shift out of bank deposits into safer assets - government securities, other financial institutions etc. causing relative yields to shift sharply.

(ix) Possible exchange market pressures as depositors seek to move to "safer" currencies, and banks seek to retain the balance between their foreign currency assets and liabilities.

(x) In practice some of these developments could not be reconciled; the international money market could seize up; international and perhaps some national payments transactions (ie in the ordinary ~~cause~~ course of non-banks' business) could not be made.

Details: domestic scene

4. The major parallel developments on the domestic scene are:

(xi) If the flight into quality is against the UK, UK banks, including clearers, experience difficulty in obtaining new interbank funds to finance non-renewal of bid deposits in foreign currency with fixed maturity dates. Limited stocks of short-term currency assets held for normal market conditions become inadequate to meet non-renewals.

(xii) UK banks face exceptional sterling withdrawals which their stock of liquid assets cannot finance - as with (xi), though liabilities structure is very different - most sterling liabilities are withdrawable at or very near sight but are historically very stable.

(xiii) Points (v), and (viii) and perhaps (vii) and in the worst case (x) apply within the UK domestic system and on the national level as well as on the international plane.

ANNEX B

SUPPORT OPERATIONS AND MONEY MARKET FLOWS

Faced with a run on its liabilities a bank needs to dispose of its assets rapidly, or replace its liabilities to the public with borrowing from other banks. If overall portfolio preferences are unchanged (depositors still wish to hold their funds with banks but allocated differently between them) then the banking system may be able to reallocate the funds to keep the threatened banks liquid. But the system could begin to fragment with strong banks reluctant to increase their claims on weak banks. These pressures could first affect dollar deposits. It could be that even with no move out of dollar deposits as a whole, UK banks could lose dollar deposits to overseas banks. But these changes in dollar holdings would not lead to overall sterling shortages unless the Authorities intervened to provide dollars to UK banks.

2. If there were an overall change in depositors' sterling portfolio preferences and they wished to hold their assets as liabilities of the public sector rather than the banks, then the Authorities would perceive an increase in the demand for public sector debt. The Authorities would then need to decide rapidly whether to intervene with extra supplies of public debt (to keep prices more stable) or to limit their supply to a more normal level and allow prices to adjust. If they intervened and supplied more debt there would be an increase in the size of money market shortages. The shortages would have to be relieved as the short-term money flows between the public and private sectors have to balance and if no explicit assistance were provided the ultimate balancing mechanism would be a reduction in bankers' deposits at the Bank of England.

3. An analogous situation could arise _if_ the events also gave rise to downward pressure on sterling in the foreign exchange markets, for example if sterling depositors sought to move their deposits into dollars or to acquire US government debt; or if banks had to convert sterling liquid assets into dollars to meet withdrawals of dollar deposits. If the Authorities decided to intervene they would be running down foreign claims in the reserves and the payment for these claims would increase the size of money market shortages to be relieved. If the Authorities did not intervene then the flows into and out of sterling would balance but possibly at a much lower exchange rate. It might well be that, in the circumstances, other countries would also be intervening in the foreign exchange market on a larger than normal scale. The scope for the UK Authorities acting alone to intervene is limited first by the size of the immediately liquid dollar reserves - at present not more than around $4 billion - and second by the size of funds that could be borrowed abroad at short notice. It might be possible in a crisis to negotiate an increase in swap lines with the Fed. At present these

stand at $3 billion. The Bank believe that an attempt to increase the swap network now would not be successful, but that it would be successful in an emergency.

4. It is possible, of course, that the pressures on sterling could be in the other direction with sterling actually benefitting from international movements of funds. In these circumstances the Authorities could intervene to sell sterling to stop the exchange rate rising. This could happen at the same time as the Authorities were selling more domestic claims on the UK Government. In these circumstances the foreign exchange transactions would be offsetting the money market flows caused by Government debt sales.

5. The prime agent for assistance to relieve money market shortages is the Issue Department of the Bank of England. The total size of its balance sheet is determined by its liability, the note issue. Increased acquisition of assets from the banking system to relieve money market shortages needs to displace another asset already held by the Issue Department - its ways and means advances with the NLF. These currently stand at approximately £1½ billion. If and when these had been reduced to zero, any surplus in the NLF ~~would start~~ accumulated ~~a surplus~~ under the terms of the 1982 Finance Act ~~which~~ would be deposited with the Banking Department, to enable the Department to carry on purchasing assets from banks.

6. In some circumstances depositors might set such store on security that the Authorities would also notice an increase in demand for their non-interest bearing liabilities. There could be an increase in demand for notes (though rapidly meeting the physical constraint of our limited stocks). This would constitute a negative money market influence as they would need to be paid for by the banks, but as the notes determine the size of the Issue Department's balance sheet there would be a corresponding increase in the capacity of the Issue Department to relieve shortages. The other component of the wide monetary base could also increase if banks increased the desired level of their balances at the Bank of England, which would increase the capacity of the Banking Department to purchase bills and hence would also not involve the NLF going into surplus.

N.B.
The point about the alteration is that the Bank/Treasury could actively acquire assets of any kind to displace Ways & means held by Issue Department – when these are [illegible] – only to the extent that there is a surplus can the Banking Department take over. Thereafter on any day when the Exchequer/NLF is "in deficit" the NLF surplus will reduce. After the surplus is reduced to nil further deficits involve the availability of W&M in Issue Dept. The position is thus rather different since [illegible] the W&M are exhausted, the initiative to purchase assets only exists so far as there is a daily surplus.

ANNEX C

BREAKDOWN IN THE US

It is widely believed, probably correctly, that the Fed would step into rescue any very large US bank. Most of those with the largest exposures to Brazil are in this category. However this cannot be taken entirely for granted and a situation is not impossible in which the US authorities were unable or unwilling to participate in international action to provide emergency liquidity. The American domestic political climate is at present very unsympathetic towards the banks and any actions requiring congressional support could be frustrated by opposition. More likely the sheer size of the problem could be beyond the resources immediately available to the Fed if several major banks were ailing at the same time. In such a crisis there could also be a breakdown of the US dollar clearing system, which is managed by the large New York banks most likely to be affected, and through which all international and domestic US dollar transactions are cleared. US banks are particularly concerned over the problem of "daylight overdrafts" ie the exposure arising from the despatching of payments early in the day before the receipts needed to meet them arrive. Fear that some banks were insufficiently liquid to meet their own obligations could paralyse the system, including dollar transactions between banks and central banks in other centres.

2. It is also possible that the Fed could refuse access in the US to its discount facilities, if the intention were to use them to meet a dollar liquidity shortage in another country. It is unlikely, but not impossible, that a liquidity crisis would start elsewhere, but, if it did, normal market mechanisms could lead to such an intention. Non-US banks without a US dollar base of their own typically have lines of credit arranged with branches of US banks either in their own centres or in New York. If these were honoured in a crisis, the US branches could finance such drawings by using their non-overdraft facilities with their head offices. If this led to a liquidity shortage in New York, the first recourse of US banks would normally be to the discount window of the Fed, but such access is at the discretion of the Fed, not automatic.

ANNEX D

TIERING IN THE INTERBANK MARKET

There is always an element of price discrimination in the interbank market but the discrimination against the less than prime banks is generally modest with normally no more than 1/8 or 1/4 percentage point separating the best from the worst rate. It may however be greater when the market is unsettled and this is when the market tends to talk of "tiering".

2. Tiering in this sense occurred in the summer and autumn of 1982. By July 1982 it was reported that it had become quite pronounced and that a span of ½ per cent had developed between the best and the worst rates. At that time the prime US banks were able to fund themselves the most cheaply, as is usual. Thereafter, using the rates paid by the US banks as a base, the following tiers could be identified:-

1/16% premium	-	UK clearers and prime continental banks (excluding French and Italian banks).
1/8% premium	-	French and Japanese banks.
3/16% premium	-	smaller banks (including UK merchant banks).
1/4% premium	-	Latin American and other banks from developing countries.
1/2% premium	-	East European banks

3. In addition to this general "stretching" of the tiering structure, at various times individual banks or groups of banks (notably American, Canadian, German and Italian), many of them normally accepted as prime names, found themselves having to pay more than usual for funds because the market associated them closely with country debt problems and/or the events surrounding Dome Petroleum, AEG, Drysdale, Penn Square and Ambrosiano. By September, when the debt problems of Mexico had become fully apparent, it was being reported that US banks were no longer unquestioned prime names in the interbank market and that the UK clearers and Japanese banks were able to raise funds more cheaply than many of them. Continental Illinois and Canadian Imperial Bank of Commerce may have faced discrimination against them of as much as 1 per cent. Such rates may, however, have been quoted as signals of unwillingness to deal and it does not follow that business was actually transacted at those rates.

4. There is a limit to the amount of tiering which is likely to occur in the market because of the reactions of both <u>borrowing</u> and of <u>lending</u> banks. Borrowing banks will strongly resist

tiering against them because if their cost of funds gets seriously out of line with that of the market as a whole they could find that they can no longer make an adequate return on their syndicated lending. Borrowing banks fear that by making a concession on price they will simply confirm the lending bank's view of their creditworthiness (and desperation for funds) and encourage lenders to demand higher and higher premia in future. Their reaction is therefore not to borrow from counterparties at rates which are "over the odds" but to delay their funding, if possible, or to seek alternative sources of funds (borrowing on standbys from parents for example). Equally, on the side of the lending banks, a point is reached in their perception of counterparties in the market at which they are not prepared to assume the credit risk even at higher than normal rates. Their reaction is rather to withdraw deposits, cut lines etc. The outcome of lines being cut is, of course, the reduction in interbank activity which has been detectable over the last year.

5. In addition to the market effects described, there has been unusual pricing of interbank loans to Mexican and Brazilian branches outside those countries. Some banks have sought to take advantage by asking as much as 3 per cent or 4 per cent over market rates, but we believe that the branches have refused. They are typically paying 1 per cent above for 6 months money, a little less for shorter maturities. The deposits are however part of the agreement by the international banking community to maintain their exposure and their pricing is to an extent artificial.

6. From October 1982 onwards market sentiment began to improve and is now considerably stronger than that prevailing last autumn. This is due to a number of factors, including the market's inherent ability to adjust, reasonably successful handling of debt problems, and the emergency of generally easier market conditions as interest rates have both declined and become more stable. A selective enquiry carried out by the Bank in August this year revealed that no systematic tiering in price seemed to be taking place (though the French banks were said to be paying over their normal position in the market from time to time) and that the span of rates appeared to have returned to a more normal range of 1/4 per cent. There were, however, indications of lines to banks from developing countries and small banks being cut.

7. Another aspect of the uncertainties prevalent in the international banking markets last year was a shift in investor preference away from commercial bank instruments into US government paper. As a result, starting in May 1982, at around the time of the Drysdale affair, an unusually large differential opened up between US Treasury Bill rates and US commercial bank CD rates. After peaking in September 1982 (see attached table) the differential has narrowed considerably this year.

3 MONTH TREASURY BILL/CD AND CP DIFFERENTIAL (%)

	Treasury bills	CDs	Differential	CPs	Differential
7 May (average)	12.48	14.06	1.58	14.00	1.52
14 May (average)	12.32	13.74	1.42	13.56	1.24
Monday 17 May	12.27	13.75	1.48	13.44	1.17
Tuesday 18 May ƒ	12.21	14.00	1.79	13.56	1.35
Wednesday 19 May	11.87	13.85	1.98	13.56	1.69
Thursday 20 May	11.37	13.35	1.98	13.31	1.94
Friday 21 May	11.70	13.55	1.85	13.31	1.61
28 May (average)	11.49	13.35	1.86	13.11	1.62
4 June (average)	12.01	13.76	1.75	13.34	1.33
11 June (average)	12.02	13.77	1.75	13.49	1.47
Monday 14 June	12.32	14.15	1.83	13.94	1.62
Tuesday 15 June	12.25	14.20	1.95	14.19	1.94
Wednesday 16 June	12.30	14.30	2.00	14.19	1.89
Thursday 17 June ≠	12.61	15.00	2.39	14.56	1.95
Friday 18 June	12.69	15.05	2.36	14.56	1.87
25 June (average)	12.77	15.11	2.34	14.59	1.82
2 July (average)	12.68	15.11	2.43	14.69	2.01
9 July (average)	12.12	14.44	2.32	14.22	2.10
16 July (average)	11.65	13.88	2.23	13.34	1.69
23 July (average)	10.57	12.41	1.84	11.89	1.32
30 July (average)	10.34	11.96	1.62	11.71	1.37
6 August (average)	9.70	11.64	1.94	11.21	1.51
Monday 9 August	9.70	11.80	2.10	11.44	1.74
Tuesday 10 August	9.99	11.75	1.76	11.44	1.45
Wednesday 11 August	9.87	11.75	1.88	11.19	1.32
Thursday 12 August ø	9.19	11.55	2.36	11.06	1.87
Friday 13 August	8.84	10.80	1.96	10.56	1.72
Monday 16 August	8.53	10.30	1.77	9.94	1.41
Tuesday 17 August*	8.03	9.70	1.67	9.56	1.53
Wednesday 18 August	7.97	9.70	1.73	9.06	1.09
Thursday 19 August	6.90	9.80	2.90	9.31	2.41
Friday 20 August	7.20	9.55	2.35	9.31	2.11
Monday 23 August	7.45	9.55	2.10	9.31	1.86
Tuesday 24 August	7.52	9.60	2.08	9.06	1.54
Wednesday 25 August	7.32	9.65	2.33	9.19	1.87
Thursday 26 August	6.95	9.85	2.90	9.44	2.49
Friday 27 August	7.94	10.35	2.41	9.69	1.75
Monday 30 August	8.04	10.25	2.21	9.69	1.65
Tuesday 31 August	8.40	10.40	2.00	9.56	1.16
Wednesday 1 September	8.37	10.60	2.23	10.31	1.94
Thursday 2 September	8.29	10.65	2.36	10.31	2.02
Friday 3 September	8.37	10.60	2.23	10.31	1.94
Tuesday 7 September	8.37	10.45	2.08	10.19	1.82
Wednesday 8 September	8.16	10.55	2.39	10.19	2.03
Thursday 9 September	8.20	10.65	2.45	10.31	2.11
Friday 10 September	8.32	10.85	2.53	10.44	2.12
Monday 13 September	7.97	11.00	3.03	10.56	2.59
Tuesday 14 September	7.72	10.80	3.08	10.56	2.84
Wednesday 15 September	7.95	11.05	3.10	10.56	2.61
Thursday 16 September	7.95	10.95	3.00	10.69	2.74
Friday 17 September	8.08	10.95	2.87	10.56	2.48

ƒ Drysdale affair

≠ Sudden change in outlook for interest rates after a poorly received Treasury auction led to increased fears of bankruptcies

ø Collapse of Lombard Wall

* Henry Kaufman's statement about interest rate prospects.

ANNEX E

CAPACITY OF BANK TO PROVIDE SUPPORT

I POWERS

	Banking Department	Issue Department
Power to borrowing sterling	Yes	No
Power to lend sterling (see Notes 1 and 2 below)		
(a) Secured	Yes	Yes
(b) Unsecured	Yes	Yes
Power to hold sterling assets	Yes	Yes
Power to borrow currency	Yes	No
Power to lend currency	Yes	Yes
Power to hold currency assets	Yes	Yes (last used 1932)
Power to guarantee		
(a) Sterling	Yes	No
(b) Currency	Yes	No
Contraints on size of operation	Prudential considerations - Size of Department's own balance sheet	Operational requirements of Issue Department - Size of Note Issue
Could Treasury guarantee?	Yes	HMT automatically liable to make good any depreciation at quarterly revaluation of assets
Other Comments		Size of note issue may expand if demand for notes increases in extreme crises

Note 1

Banks which have issued laon stocks have generally written in to those agreements provisions which would make the stocks repayable immediately if other creditors were offered better security. This could in practice to prevent the Bank from taking security against support loans, whether in sterling or currency.

Note 2

Anybody who knowingly lends to an insolvent institution risks being ruled by the courts to have assumed responsibility for all that institutions liabilities. In practice, however, it is unlikely that a support loan made in good faith would be taken as evidence of intent to keep the borrower in business for fraudulent ends and of course the implication of providing assistance is that the question of default to other creditors will not arise.

SECRET

II METHODS OF SUPPORT

Method		Role of Bank	Amount Now Available To 4 Major Clearers (Highly Speculative)	Comment
(a)	Recall of funds lent to discount and gilts market	Waive undertakings given by banks	Up to £3 billion	
(b)	Purchase of assets			
(i)	commercial bills	Purchase by Banking, then Issue Departments	Up to £2 billion	The value of commercial bills may be less certain
(ii)	Treasury and local authority bills	Purchase by Banking, then Issue Departments		
(iii)	gilts	Purchase by Banking, then Issue Departments	Over £3 billion	Risk that purchase and resale agreements could be construed as loans against security
(iv)	CDs of other banks	Purchase by Banking, then Issue Departments	Up to £2 billion	Asset, might be of dubious value
(v)	loans to local authority	Purchase by Banking, then Issue Departments	£1 billion	Unwieldy formalitites necessary
(vi)	ECGD + DTI shipbuilding guaranteed assets	Banking, then Issue Departments	£4 billion	Up to 30 per cent can be refinanced in times of liquidity difficulty under present arrangements
(vii)	Loans and advances to non-bank private sector, excluding loans to persons and overdrafts	Purchase by Banking, then Issue Departments	£24 billion	Possible major administrative difficulties uncertain value profound long term consequences

NB - CONSTRAINTS ON USE OF BOTH DEPARTMENTS MEAN THAT FIGURES CANNOT BE CUMULATIVE

SECRET

SECRET

Method	Role of Bank	Amount Now Available To 4 Major Clearers (Highly Speculative)	Comment
(c) Bank guarantees	Bank Banking Department, possibly supported by Treasury guarantee,	£+ Prudential constraint	
(d) Direct Treasury guarantees to ultimate borrowers			
(e) Treasury loans/grants/equity purchase			Initial recourse to Contingencies Fund. Thereafter legislation needed. Extreme option.

SECRET

ANNEX F

CONDITIONS FOR THE USE OF THE CONTINGENCIES FUND

The Treasury Solicitor has advised that the Contingencies Fund could be used to enable the Treasury to make loans to individual banks providing the conditions for drawing on the Fund are satisfied. Payments would ultimately be made from a Treasury vote and would be accounted for by a Treasury Accounting Officer.

2. The main considerations which would need to be borne in mind are the following:-

(a) the advances must be in respect of urgent services in anticipation of the provision made or to be made by Parliament for those services becoming available (Section 3(1) of the Miscellaneous Financial Provisions Act 1946);

(b) the Treasury must be satisfied that it is not precluded from providing the money either by the absence of statutory powers (see (c) below) or by the implications to be drawn from any relevant statutory provision. For example, if the law already provided powers to make payments for a certain purpose, but these powers did not extend to a related purpose, the inference might be that Parliament had precluded payment for that related purpose. However, the Treasury Solicitor has not identified any such inhibitions in the circumstances we have been looking at;

(c) the general rule is that "the use of the Contingencies Fund to finance expenditure which requires specific legislation in order to meet accepted constitutional propriety is to be condemned" (the 1932 concordat between the PAC and the Treasury);

(d) advances from the Fund should not be made unless it is reasonable to assume that the provision in terms of legislation to authorise the use of public funds for this purpose will be made by Parliament so that the Fund will thus be repaid (this requires inter alia an informed assessment of the outcome of the vote);

(e) in principle, advances from the Fund should be deferred until the legislation has had a second reading. Exceptionally, if it is impossible to postpone the payments until the necessary money has been voted, the Fund may be used to meet urgent expenditure in anticipation of legislation which the Government has the firm intention of introducing at the first available opportunity; and

(f) use of the Fund should be preceded by a statement to Parliament either separately or during the Second Reading Debate on the legislation.

ANNEX G

G10 GOVERNORS' COMMUNIQUÉ ISSUED SEPTEMBER 1974 (PC)

At their regular meeting in Basle on 9th September, the Central Bank Governors from the countries of the Group of Ten and Switzerland discussed the working of the international banking system. They took stock of the existing mechanisms for supervision and regulation and noted recent improvements made in these fields in a number of major countries.

They agreed to intensify the exchange of information between Central banks on the activities of banks operating in international markets and, where appropriate, to tighten further the regulations governing foreign exchange positions.

The Governors also had an exchange of views on the problem of the lender of last resort in the Euromarkets. They recognized that, it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary.

(b)

More sharply aware of the risks involved in their exposure to particular countries in difficulties, there could be a problem if they began more generally to withdraw from, or at least to run down their involvement in, individual countries or groups of countries, without a fully balanced assessment of those countries' positions. We have seen similar behaviour in respect of involvement in lending to companies, both domestically and internationally. Excessive prudence can be as dangerous in some circumstances as excessive exuberance in others.

Perhaps it would be useful at this point to recall the line which we at the Bank have taken on the whole subject of country lending—and I think it has been a broadly consistent line ever since the problem leapt into prominence in 1974.

First, we have always wanted to see the maximum possible contribution from the official international institutions—and especially the IMF. This has been because we believe that funds from these institutions with their associated conditionality are likely to carry the best prospects of facilitating appropriate adjustment. At the same time it has always been clear that the magnitude of the financing task has been such that official funds could not play more than a minor role. The major part has had to come from the banking system. That being so, we have concentrated on trying to ensure that international bank lending was prudently and appropriately carried out. We have encouraged the provision and distribution of as much information as possible. We have, with other central banks, worked to develop a collaborative approach to supervision of international lending. And we have encouraged banks not to react abruptly or short-sightedly to changes either in a borrowing country itself or in other countries with superficial similarities.

You will recall that the Governor addressed this question in a speech he gave in Bonn in December.[1] He noted that, as with domestic bankers in their dealings with companies, international bankers face a dilemma when a country begins to experience debt difficulties. Prudent banking practice may suggest that exposure should be reduced, by the refusal of requests for new credit and the termination of existing lines or deposits as they mature; on the other hand, action of this sort, if precipitate or taken simultaneously by a number of the country's creditors, may well hasten and exacerbate the very difficulties from which the banks are trying to escape. Action by a single bank taken in its own narrow interests can easily prove detrimental not only to its own longer-term interest, but also to the interests of the wider banking community. In such circumstances there can be no guiding rule, but each case must be judged on its individual merits.

A more widespread difficulty might arise if problems deriving from a particular rescheduling caused banks to react defensively towards other indebted countries, precipitating difficulties for them. Banks must consider carefully whether the difficulties faced by a country are transient or whether they reflect fundamental maladjustment or mismanagement. A solution may, in some cases, lie in a widening of spreads with a consequent increase in the return on capital, so as to encourage further lending. But any banks which do withdraw support at an inappropriate moment, even if in one particular instance they manage to protect their immediate interest at the cost of precipitating difficulties for others, could find that damage done to their standing in the market might not serve them well in the longer term.

I do not underestimate the difficulties there are in making the appropriate differentiation between borrowers. Obviously there will be occasions when some common external factor, economic or political, influences a range of countries. Nevertheless, more often than not, there will be differences in the impact such factors have or in the reaction to them; and it is of great importance that such differences be properly assessed and appropriately responded to, in the longer-term interests of the banks, the borrowers and the wider world community.

The question is sometimes raised whether central banks are adequately prepared to deal with failures if, despite all efforts to guard against them, they arise. Recently the Group of Thirty risk study group has noted commercial bank concerns in this area. Traditionally, at times of uncertainty, confidence has been restored by resolute action by the relevant central bank. If problems were to arise from international lending, co-ordination between a number of authorities would be required, simply by virtue of the international nature of markets: responsibility would need to be shared amongst them. This need is fully acknowledged by the central banks of the major industrial countries. Indeed, as long ago as September 1974 the Governors of the Group of Ten central banks stated publicly in the wake of the Herstatt affair that they were satisfied that means were available for the provision of temporary liquidity to the euromarkets and would be used if and when necessary.

That statement still stands. As was also said in 1974, however, it would not be practicable or advisable to lay down in advance detailed rules and procedures for the provision of such liquidity. In particular, if such provision were to be in any sense automatic or if the factors or criteria which determined it were precisely specified, there would be a danger that the disciplines of the market would be overriden—if the arrangements looked too restrictive—or undermined, if they looked too lax.

Financial sanctions on Argentina

After these rather general remarks, I would now like to turn to one particular question on which I am sure you will expect me to say something.

(1) See the March *Bulletin*, page [illegible]

(C)

Miss Carney: You have mentioned that the Bank of Canada's responsibility relates to the liquidity of the chartered banks. What role would the Bank of Canada play if a chartered bank became illiquid; if a chartered bank, say, ran into trouble because of a failure of a large corporate client?

Mr. Bouey: There are two aspects to that I think I should mention. One is that in terms of short-term problems, if a bank finds difficulty in meeting its reserve requirements, for some particular reason, then we will lend the money pretty well automatically, at least up to some limits. And that is a temporary thing having to do with the way in which their clearing swings moved against them—unexpected swings arising out of certificates of deposits that were not rolled over, or something like that. We do that fairly frequently; not all the time, but fairly frequently.

The situation you are really talking about I think is where a bank gets into a more serious liquidity problem, really because some lack of confidence develops and people are reluctant to renew their deposits or place as many deposits in the bank as one would like to see. In that case, the Bank of Canada will certainly stand behind the bank and we will lend against its assets. We can only make secured loans.

Miss Carney: Okay. Is there any limit to that? Say one of the large corporate chartered banks in Canada ran into really serious problems, because some of them are over-extended in relation to one or more companies, how far would you support them? Would you bail out the chartered bank? Is that within your power?

Mr. Bouey: This is a very hypothetical question. I do not believe any bank is in that situation. But if a bank, and I am not going to refer to any particular kind of bank, was suffering liquidity problems for some reason of lack of confidence, the bank will go as far as necessary. That is not bailing them out; that is just lending money against sound assets. ?

Extract from Minutes of the House of Commons Standing Committee on Finance, Trade and Economic Affairs.

(d)

BANK OF CANADA | BANQUE DU CANADA

press statement | communiqué

FOR IMMEDIATE RELEASE

January 26, 1983

CANADIAN COMMERCIAL BANK

OTTAWA, January 26, 1983. In response to a number of enquiries concerning the Canadian Commercial Bank which arose following the annual meeting of that bank in Edmonton yesterday, Gerald K. Bouey, Governor of the Bank of Canada, stated that the Canadian Commercial Bank is a solvent and profitable bank and if it requires any liquidity support, the Bank of Canada will provide it.

(f)

National Westminster Bank Limited

41 Lothbury, London, E.C.2

PRESS RELEASE

In view of the fall in the price of National Westminster Bank shares during this week and particularly on Friday, we have felt it necessary to make a statement concerning certain rumours of which we are aware and which have absolutely no foundation.

In the first place, there have been rumours surrounding the allegations made by Signor Sindona in his submission to the Milan Tribunal, and I now state that, after a detailed investigation, International Westminster Bank is satisfied that the alleged letter of 30th November 1972 is false and supporting documents have been submitted through our legal representatives to the Milan authorities.

Furthermore, we would reiterate our earlier statement that the Bank has no outstanding liabilities or losses in relation to the Sindona Group of banks or from foreign exchange operations undertaken by any of its units throughout the world.

A further rumour current this week relates to the suggestion that we have received a substantial amount of support from the Bank of England on the grounds, apparently, that we feel unable to make a Rights Issue. This rumour has been categorically denied by the Bank of England and is again wholly false. Indeed, we have had no discussions whatever concerning the possibility - or otherwise - of our making a Rights Issue.

National Westminster Bank much regret that our shareholders, depositors and staff should have to be faced with suggestions currently appearing in the Press and elsewhere which are, as I have stated earlier, totally without foundation.

J. F. Prideaux

30th November, 1974.

Sir John F. Prideaux, O.B.E.

Chairman

(e)

EVENING STANDARD 29.11.74

Bank of England denies Natwest rescue move

THE BANK OF ENGLAND this afternoon firmly denied a rumour that had swept round the City that the National Westminster Bank had sought or been offered substantial support by the Bank.

"Absolute nonsense," said a spokesman.

Natwest's shares had been clobbered by the rumour, dropping 6p to 88p at one time—12p below their par value. Earlier this year they were more than 300p. Other Bank shares fell in the atmosphere of uncertainty surrounding the commitments to the "fringe" banks and the wobbling property world.

Elsewhere business was down to the merest trickle and market minds had plenty of time to exercise a rather-rueful sense of humour.

Although Mr Harold Wilson is not the City's best friend he could take credit for supplying the ammunition for today's fun.

So dealers spent their time contemplating the "weevils nibbling away at the pound in their pockets." They also posted such notices on their price boards as "please don't feed the weevils" while others, according to an Exchange Telegraph reporter, clasped their hands to ears, mouth and eyes and proclaimed "Hear no weevil, speak no weevil and see no weevil."

GRS 2000

UNCLASSIFIED

(FM BERNE 041300Z)

FM BISBA

TO IMMEDIATE FCO

TELNO 814 OF 3 DECEMBER 1984

Prime Minister
See para 8.
CDP.

INFO PRIORITY MOD (SIC A3A), CBFFI BANK OF ENGLAND ASUNCION BRASILIA CARACAS MEXICO CITY MONTEVIDEO SANTIAGO UKMIS NEW YORK WASHINGTON PORT STANLEY

PRESS SUMMARY (1, 2AND 3 DEC)

1. SUMMARY

HEADLINES OVER THE LAST THREE DAYS ARE SHARED BETWEEN THE FOREIGN DEBT AGREEMENT WITH INTERNATIONAL CREDITOR BANKS, INCREASES IN FUEL AND TRANSPORT TARIFFS, THE BEAGLE SETTLEMENT AND EVENTS IN EL SALVADOR AND CHILE.

1. FOREIGN DEBT

ON MONDAY ALL DAILIES FRONT-PAGED THE GOVERNMENT'S ANNOUNCEMENT THAT A DEBT AGREEMENT WITH FOREIGN PRIVATE BANKS HAS BEEN REACHED. THIS INCLUDES 4.2 BILLION DOLLARS TO REFINANCE THE DEBT FALLING DUE BETWEEN 1982 AND 1985, 1 BILLION DOLLARS FROM OFFICIAL CREDIT AGENCIES (THE US TREASURY OR THE EXIMBANK AND POSSIBLY ALSO THE CENTRAL BANKS OF GERMANY, JAPAN AND FRANCE) AND 270 MILLION DOLLARS FINANCED BY THE IMF ON TOP OF A REQUESTED STAND-BY LOAN. THE ECONOMY MINISTRY STATEMENT STRESSES THE RELATIVELY FAVOURABLE INTEREST RATES AND THE THREE YEAR GRACE PERIOD GRANTED FOR THE NEW LOANS. ''LA NACION'' ATTEMPTS A PRELIMINARY ASSESSMENT OF THE DEAL AND ARRIVES AT GENERALLY POSITIVE CONCLUSIONS WHILE RECOGNISING THAT THE CONDITIONS ARE UNDERSTANDABLY LESS ATTRACTIVE THAN THOSE ACHIEVED BY MEXICO. (BA HERALD MONDAY PAGE 1, CLARIN MONDAY P 15 AND NACION MONDAY P 1 AND 13).

3. DOMESTIC ECONOMY

PETROL AND TRANSPORT PRICES HAVE BEEN RAISED BY 25 AND 16.5 PER CENT RESPECTIVELY. INTERNATIONAL POSTAL AND TELECOMMUNICATIONS TARIFFS WERE ALSO INCREASED. THE CENTRAL BANK WILL MAINTAIN THROUGH DECEMBER THE PRESENT INTEREST RATES OF 17 PER CENT FOR DEPOSITS AND 19 PER CENT FOR LOANS. IN THE LIGHT OF PRESENT INFLATION LEVELS AND SALARY GUIDELINES, THESE MEASURES ARE JUDGED TO BE RECESSIONARY AND DESIGNED TO MEET IMF CRITERIA. (CLARIN SATURDAY P 10 TO 12, NACION SUNDAY SECTION 3 P 2).

SUNDAY

SUNDAY'S ''CLARIN'' (P 22-23) NOTES A 10 PER CENT FALL IN REAL TERMS IN NOVEMBER TAX REVENUES COMPARED WITH THOSE FOR THE PREVIOUS MONTH. IN OCTOBER THE TREASURY DEFICIT WAS ALMOST 19 PER CENT ABOVE THE SEPTEMBER FIGURE. ACCORDING TO SUNDAY'S ''BUENOS AIRES HERALD'' (P 17) THE 1985 BUDGETARY PROVISIONS FOR THE YACYRETA HYDROELECTRIC PROJECT WILL BE SEVERELY REDUCED AS PART OF THE EFFORT TO CUT PUBLIC SPENDING.

SPEAKING IN CONCORDIA ON SATURDAY, PRESIDENT ALFONSIN REITERATED HIS ELECTORAL COMMITMENT TO RAISE REAL SALARY LEVELS BY 6 TO 8 PER CENT AT THE END OF THIS YEAR. (NACION SUNDAY P 22).

OFFICIAL INDEC STATISTICS INDICATE THAT INDUSTRIAL ACTIVITY INCREASED DURING THE THIRD QUARTER BY 1.9 PER CENT AS COMPARED TO THE SAME PERIOD IN 1983, WITH EMPLOYMENT UP BY 4.2 PER CENT. HOWEVER A SURVEY BY THE ARGENTINE BUSINESS UNIVERSITY (UADE) SUGGESTS THAT ACTIVITY IN MANUFACTURING INDUSTRY HAS NOW BEGUN TO DECLINE AGAIN. THE LEFT-WING PERONIST DAILY ''LA VOZ'' SEES GLOOMY ECONOMIC PROSPECTS FOR THE NEXT FEW MONTHS. (BA HERALD SUNDAY P 2, NACION SECTION 3 P 5, LA VOZ MONDAY P 2 AND 16).
ECONOMY MINISTER GRINSPUN ANNOUNCED THAT THE GOVERNMENT IS PLANNING A LAW ON TECHNOLOGY TRANSFER WHICH WOULD RESTRICT THE DRAIN OF FOREIGN CURRENCY FROM ARGENTINA. 486 MILLION DOLLARS IN ROYALTIES WERE REMITTED ABROAD LAST YEAR. MHE AUTHORITIES ALSO AIM TO ENSURE THROUGH NEW BILATERAL AGREEMENTS A GREATER SHARE FOR ARGENTINE SHIPS IN THE COUNTRY'S INTERNATIONAL TRADE . (CLARIN SATURDAY P 13 AND AMBITO FINANCIERO MONDAY P 6).

4. BEAGLE SETTLEMENT

ALL PAPERS HIGHLIGHT THE POPE'S ADDRESS ON FRIDAY TO THE ARGENTINE AND CHILEAN DELEGATIONS IN THE VATICAN, WHERE HE EMPHASISED HIS QUOTE PROFOUND SATISFACTION UNQUOTE AT THE RECENTLY SIGNED BEAGLE SETTLEMENT. ON SATURDAY HE EXPRESSED TO A GROUP OF VISITING ARGENTINE BISHOPS HIS QUOTE DESIRE TO RETURN TO YOUR COUNTRY ONE DAY UNQUOTE, BUT HE IS NOT EXPECTED TO ATTEND THE CEREMONY FOR THE EXCHANGE OF THE INSTRUMENTS OF TREATY RATIFICATION. (CLARIN SATURDAY P 2-3, SUNDAY P 2-3, NACION SATURDAY P 1 AND SUNDAY P 6, BA HERALD SATURDAY P 1 AND SUNDAY P 17).

CHILEAN AIR FORCE COMMANDER FERNANDO MATTHEI'S DECLARED FULL SUPPORT FOR THE AGREEMENT IS RECORDED ON MONDAY. (CLARIN P 10 AND NACION P 5). ''LA VOZ'' CARRIES A SIGNED ARTICLE BY CARLOS SUAREZ ATTACKING THE ACCORD AS A SURRENDER AND ALLEGING THAT ITS SPEEDY CONCLUSION IS SOUGHT BY QUOTE THE INTERNATIONAL OIL MONOPOLIES AND THE BRITISH OCCUPIER OF OUR MALVINAS ISLANDS UNQUOTE. (MONDAY P 8).

IN ''LA PRENSA'' , MANFRED SCTONFELD WRITES IN SIMILAR TERMS AND URGES THAT ARGENTINA SHOULD NOT LOWER HER GUARD IN RELATION TO THE FALKLANDS. (COPY AND TRANSLATION BY BAG TO FCO).

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5. ANTARCTICA

MUCH SPACE IS GIVEN TO NEWS THAT CHILE WILL HENCEFORTH USE THE FORMER BRITISH SCIENTIFIC BASE AT ADELAIDE. EXPLANATIONS BY THE CHILEAN AMBASSADOR IN BUENOS AIRES, THAT THE MOVE HAS NO POLITICAL CONNOTATIONS AND THAT THE TRANSFER TOOK PLACE SIX MONTHS AGO ARE WIDELY ACKNOWLEDGED. HOWEVER, AN MFA STATEMENT PUBLISHED BY ALL PAPERS IMPLICITLY RE-AFFIRMS ARGENTINA'S SOVEREIGNTYOVER PART OF ANTARCTICA, RECALLS THAT ARGENTINA, CHILE AND THE UK HAVE OVERLAPPING CLAIMS AND THAT ARGENTINA AND CHILE RECOGNIZE EACH OTHER'S SOVEREIGNTY OUTSIDE THESE CONFLICTING ZONES. ''CLARIN'' INSISTS THAT THE UK IS QUOTE TRYING TO MAINTAIN COLONIES IN THE SOUTH ATLANTIC ISLANDS UNQUOTE IN ORDER TO BUTTRESS HER SOVEREIGNTY ARGUMENTS. (CLARIN SATURDAY P 2 AND 4, TIEMPO ARGENTINO SATURDAY P 10 , PRENSA SUNDAY P 2).

6. FALKLANDS

PROMINENCE IS AGAIN GIVEN TO DECLARATIONS IN LONDON BY VISITING ARGENTINE PROTESTANT CLERGYMENT CALLING FOR NEGOTIATIONS TO FACILITATE THE RETURN OF THE FALKLANDS TO ARGENTINA .(NACION SUNDAY P 3, PRENSA SUNDAY P 2).

SUNDAY'S ''NACION'' (P 3) CARRIES AN ARTICLE REVIEWING THE POLEMIC ON THE SINKING OF THE BELGRANO. ACCUSATIONS LEVELLED AT HMG BY OPPOSITION MPS ARE FACTUALLY LISTED AND THE GOVERNMENT IS SAID TO HAVE SOMETHING TO HIDE. THE IDENTIFICATION OF THE HMS CONQUEROR OFFICER WHOSE DIARY ON THE BELGRANO INCIDENT WAS RECENTLY PUBLISHED BY THE ''OBSERVER'' IS ALSO RECORDED. (NACION MONDAY P 2, TIEMPO MONDAY P 6).

AN ANSA DESPATCH ON FOREIGN MINISTER CAPUTO'S FALKLANDS-RELATED STATEMENTS IN ALGIERS IS RELAYED BY SEVERAL PAPERS. THIS HIGHLIGHT HIS COMMENT THAT QUOTE THE INTRANSIGENCE OF GREAT BRITAIN IN THE FACE OF ARGENTINE RIGHTS TO SOVEREIGNTY OVER THE MALVINAS PLACES US IN A DIFFICULT POSITION AND PREVENTS A PEACEFUL SOLUTION TO THE CONFLICT UNQUOTE. (CLARIN MONDAY P 2 AND TIEMPO P 5).

A STUDY IDENTIFIES THE FALKLANDS QUOTE EXCLUSION ZONE UNQUOTE AS ONE OF THE CAUSES OF THE CRISIS IN THE ARGENTINE FISHING INDUSTRY . IT CLOSES RICH FISHING GROUNDS TO ARGENTINE TRAWLERS, WHILE LEAVING FOREIGN FLEETS TO OPERATE FREELY AND SUBSEQUENTLY TAKE-OVER ARGENTINA'S TRADITIONAL MARKETS THROUGH DUMPING TACTICS. THE GOVERNMENT IS ALLEGEDLY EXAMINING INTER ALIA THE POSSIBLITY OF DIPLOMATIC TALKS WITH COUNTRIES FISHING OFF THE ISLANDS AND STEPS TO SECURE ACCESS FOR ARGENTINE VESSELS TO THE AREA. (NACION SUNDAY SECTION 3 PAGE 1AND 4. COPY AND TRANSLATION BY BAG TO FCO).

/ON

ON FRIDAY, ALFONSIN RECEIVED PLAYERS FROM THE ''INDEPENDIENTE'' FOOTBALL CLUB WHO WILL PLAY LIVERPOOL IN TOKYO ON 9 DECEMBER. HE TOLD THEM TO PLAY HARD AND WIN BUT TO REFRAIN FROM VIOLENCE AND NOT TO THINK OF TAKING REVENGE FOR THE FALKLANDS DISPUTE. (BA HERALD SATURDAY P 4 AND DIARIO POPULAR P 15).

A READER'S LETTER IN TODAY'S ''BUENOS AIRES HERALD'' (P 5) SHARPLY CRITICISES THE ANGLO-ARGENTINE COMMUNITY'S PASSIVE ATTITUDE TOWARDS THE SYSTEMATIC DENIGRATION OF ITS CONTRIBUTION TO THE NATION. THE AUTHOR CALLS FOR A RESUMPTION OF CULTURAL TIES AS A FIRST STEP TOWARDS THE RESTORATION OF PEACEFUL BILATERAL RELATIONS.

7. INTERNAL POLITICS

THERE ARE RUMOURS OF IMMINENT CABINET CHANGES PLACING PERONIST PRESIDENTIAL ADVISOR ANGEL FEDERICO ROBLEDO IN THE MINISTRY OF DEFENCE, RAUL BORRAS IN THE MINISTRY OF INTERIOR, ANTONIO TROCCOLI IN THE MINISTRY OF ECONOMY, BERNARDO GRINSPUN IN THE CENTRAL BANK AND ENRIQUE GARCIA VAZQUEZ AS ARGENTINE REPRESENTATIVE TO INTERNATIONAL ECONOMIC ORGANIZATIONS. RADICAL SENATOR ADOLFO GASS HAS CONFIRMED THAT A RESHUFFLE WILL BE ANNOUNCED BY ALFONSIN ON 10 DECEMBER. (CLARIN SATURDAY P 6 AND BA HERALD MONDAY P 7).

PERONIST PARTY FIRST VICE-PRESIDENT LORENZO MIGUEL HAS BEEN ELECTED SECRETARY GENERAL OF THE FEDERAL CAPITAL BRANCH OF THE METAL WORKERS' UNION (UOM) ALTHOUGH HIS OPPONENTS HAVE REQUESTED THE COURTS TO ANNUL THE POLL RESULTS. (CLARIN SATURDAY P 7, BA HERALD MONDAY P 7).

THE SUPREME COUNCIL OF THE ARMED FORCES, WHOSE ELEVEN MEMBERS PRESENTED THEIR RESIGNATIONS ON 14 NOVEMBER, REPUTEDLY WILL BE RE-CONSTITUTED THIS WEEK. (CLARIN MONDAY P 2).

8. ARMED FORCES

BUDGETARY RESTRICTIONS NEXT YEAR ARE EXPECTED TO REQUIRE A REDUCTION IN THE NUMBER OF CONSCRIPTS TAKEN BY THE ARMY, A CUT-BACK IN THE NUMBER OF SAILING DAYS ALLOWED FOR NAVY VESSELS, ABOUT WHICH NAVY CHIEF OF STAFF RAMON AROSA HAS ALREADY COMPLAINED, AND A REDUCTION IN FLYING HOURS FOR AIR FORCE PILOTS FROM 300 TO 60 P.A. IS ALSO LIKELY. FUNDS ALLOCATED TO THE ARMED FORCES WILL APPARENTLY AMOUNT TO APPROXIMATELY 2 BILLION DOLLARS OR 2.3 PER CENT OF GDP COMPARED WITH 6 PER CENT IN 1983. (NACION SATURDAY P 4).

DETAILS OF MILITARY UNITS TO BE DISBANDED ARE PROVIDED BY ''TIEMPO ARGENTINO'' (SATURDAY P 3) AND ''LA NACION'' (MONDAY P 5).

FOLLOWING THE SIGNING OF THE BEAGLE SETTLEMENT , THE ARMY WILL NOW BEGIN TO EXTEND THE QUOTE ATLANTIC ROAD UNQUOTE IN TIERRA DEL FUEGO EASTWARDS FROM RIO MOAT. (TIEMPO SUNDAY P 6).

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9. FOREIGN RELATIONS

WIDE COVERAGE IS GIVEN TO CAPUTO'S THREE DAY VISIT TO ALGERIA WHICH PRODUCED A SERIES OF TRADE AGREEMENTS. (CLARIN SATURDAY P 3, MONDAY P 2).

THE MINISTER HAS DENIED THAT ALFONSIN WILL STAND AS CANDIDATE FOR THE PRESIDENCY OF THE NON-ALIGNED MOVEMENT. (CLARIN MONDAY P 2).

ALFONSIN IS EXPECTED TO VISIT NEW DELHI AT THE INVITATION OF PRIME MINISTER RAJIV GANDHI IN JANUARY FOR DISCUSSIONS WITH OTHER HEADS OF STATE ON DISARMAMENT. (NACION MONDAY P 2).

SHARKEY
UNQUOTE

POWELL-JONES

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

29 November 1984

Charles Powell Esq
10 Downing Street
LONDON
SW1

CDP o/v
CDP 4/xii

Dear Charles

YUGOSLAVIA: RESCHEDULING

Following our discussion earlier this week about the record of the Prime Minister's meeting with Mr Dizdarevic on 7 November, you might like to see paragraph 6 of the attached record by Peter Mountfield of his meeting in Geneva on 26 November.

I am also sending a copy to Len Appleyard.

Yours ever
David

D L C PERETZ
Principal Private Secretary

BGMAGE

RESTRICTED

10 DOWNING STREET

From the Private Secretary

28 November 1984

TAXATION AND PROVISIONS

The Prime Minister has seen your letter to me of 26 November. She has noted that the banks do not favour an extension of tax relief to any part of their general provisions. She has noted, however, that the banks are examining with Inland Revenue the possibility of considering the banks' taxation computations in stages.

I am copying this letter to John Bartlett (Governor of the Bank of England's office).

(Andrew Turnbull)

David Peretz, Esq.,
HM Treasury

RESTRICTED

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pps tonight pl

From: P MOUNTFIELD
Date: 27 November 1984

MR LITTLER

cc
Mr Unwin
Mr Lavelle
Mrs Case or
Mr Edelshain
Mr Towers
PS/CHANCELLOR 12/12

YUGOSLAV DEBT: GENEVA MEETING, 26 NOVEMBER

Yesterday's meeting passed off very smoothly. There were clear signals (though no positive confirmation) that Yugoslavia has now decided to sign an SBA with the Fund for 1985. On the strength of that, the Paris Group can reschedule official debt.

2. Minister Klemencic continued to press for a MYRA. He said he knew (from bilateral discussions in capitals) that a block rescheduling was out; but that a serial rescheduling was possible, provided there were adequate linkage with a Fund programme. He also understood that something stronger than the Mexican provisions would be required. He therefore proposed a new gimmick. There would be strengthened Article IV consultation, based on a single performance criterion: probably the trade account or the current account. This would be derived from the Yugoslav's own medium term recovery plan. If performance fell below this criterion, then Yugoslavia would itself wish to seek a further SBA. This would be the creditors' guarantee of good behaviour. In a brief question session, I tried to probe this, but got no further elucidations. I think he means that the conditionality which the Fund would impose, upon a reapplication of this kind, would be enough to ensure that the creditors' money was safe. On this basis, he hoped to get a serial rescheduling deal each successive stage

of which would be contingent on continued observance of the single performance criterion. I doubt if this would be good enough: and in any case, the other creditors were not prepared to contemplate any form of serial rescheduling.

3. We ended up with a "Chairman's summing up" which was released to the press at the end of the meeting. I attach the text. The two key sentences are in paragraph 3. This notes that "a partial consolidation of Yugoslavia's external debt may still be necessary for several years" - ie, we are not doing a limited one-off 1985 operation. We go on to express willingness "to remain involved in this process". But we then say that the debt consolidation group will meet "to work out the initial stage of the debt restructuring". Over lunch, the German and American delegates joined me in emphasising that this meant 1985 only. And as you will see, this is contingent on an agreement with the IMF.

4. The next move will be a report back to the Federal Assembly, afterwhich the Yugoslav Government hopes to announce its decision on a SBA. The "Debt Consolidation Group" (ie the Paris Club under another name) will meet, either just before Christmas, in the course of regularly scheduled meeting, or in January.

5. Behind the scenes, I discussed with the Americans their draft text for such a meeting. I have sent the draft to Mr Edelshain. The key points are:

a. It is firmly set in the context of a multi-year recovery plan;
b. The operational bits relate to 1985 only, and are contingent on an agreement with the Fund;
c. It contains a goodwill clause, under which the creditors would agree to reschedule 1986 and 1987

maturities (though not 1988 as requested) provided the present programme is implemented, and that Yugoslavia "continues to have an arrangement with the IMF after 1985" - the precise definition of that arrangement is in square brackets and remains to be negotiated.

6. During the meeting the American representative told me that the Yugoslavs assured her the UK supported a MYRA. This may reflect the possible misunderstanding with the Prime Minister during the Dezdarivic visit. After lunch, with the draft communique safely agreed - and at the request of the Swiss chairman - I took Klemencic aside and told him frmly that there was no chance of a MYRA. He should not ask in Paris for more than the creditors could accept. I made it clear that the UK was solid with the others on the point. I shall follow this with their representative in London.

PM

P MOUNTFIELD

Geneva, November 26, 1984

Final version
1620.

Chairman's Summing Up

1. Representatives of Austria, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Italy, Japan, Kuwait, the Netherlands, Norway, Sweden, Switzerland, the United Kingdom, and the United States met with representatives of Yugoslavia in Geneva on November 26, 1984 under the chairmanship of State Secretary E. Brunner of Switzerland. The Yugoslav delegation was led by Mr. Vlado Klemencic, Member of the Federal Executive Council and Federal Secretary for Finance. Representatives of the International Monetary Fund, the World Bank and the Commission of the European Communities also attended the meeting.

2. Cooperating governments noted positively the results achieved by the Yugoslav Government in implementing their adjustment measures in the framework of their ongoing stabilization program, ~~which has been supported by stand-by arrangements with the International Monetary Fund.~~ In particular, they noted that the improvement in the current account of the balance of payments in 1983, and thus far in 1984, seems to have been achieved on a more sustainable basis than that in the preceding period, which had concentrated on a shakeout of imports. The trimming of imports was made sustainable in part by a more efficient use of resources made possible by a reduction of personal consumption, public expenditures and non-productive investment. They welcomed the

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positive prospects for 1985 and beyond, signaled by the increase in the export market shares in the convertible currency area and underpinned by basic adjustments in the internal economy, particularly in the areas of pricing of commodities, money and foreign exchange. Participants emphasized the need for stability and continuity of current policy trends and policy implementation in the coming years. Continued cooperation and association with the International Monetary Fund was seen as a necessary ingredient in the medium-term strategy of the authorities.

3. Despite the positiveresults achieved in recent years, participants noted that, in the effort of achieving full normalization of external liquidity flows, a partial consolidation of Yugoslavia's external debt may still be necessary for several years. They expressed willingness to remain involved in this process within the context of the Yugoslav medium-term program supported by the IMF. They stood ready to convene the "debt consolidation Group" to work out the initial stage of the debt restructuring which will come into effect when a satisfactory arrangement has been reached between Yugoslavia and the International Monetary Fund.

4. Cooperating governments noted the progress made in and welcomed the current efforts to reach a multi-year arrangement between commercial banks and Yugoslavia. Participants further welcomed the preparedness of the World Bank and other multilateral organizations to continue to strengthen the flow of voluntary financing into Yugoslavia through co-financing arrangements. They noted with

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satisfaction the re-emergence of voluntary credit flows to Yugoslavia and the efforts--partly through the new Law on Foreign Investment--made by the Yugoslav authorities to attract foreign non-debt capital.

5. They thanked the Swiss authorities for providing the Chair to these meetings and for their hospitality to the Group.

29 NOV 1984

7.10 International Debt file

RESTRICTED

Prime Minister
To note outcome. AT 26/11

CC/NO.

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

26 November 1984

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew

TAXATION AND PROVISIONS

The Prime Minister may recall that, in June, the Governor suggested to her and the Chancellor a possible method of encouraging the banks to increase the level of their provisioning against bad and doubtful sovereign debt. He floated the idea of perhaps giving a measure of tax relief to banks' general provisions against sovereign debt owed by a "basket" of countries ("basket provisions"). At present, relief is confined to specific provisions against "bad debts proved to be such, and doubtful debts to the extent that they are respectively estimated to be bad".

Officials from the Treasury, Inland Revenue and Bank of England have looked into this. This letter reports their conclusions, with which the Chancellor and Governor concur.

The Bank of England have sought the views of the clearing banks as to whether additional tax relief on their provisions would be likely to result in increased provisioning overall. The banks took the view that they would not welcome an extension of tax relief to any part of their general provisions. They gave two reasons: first, under the Bank of England's supervisory arrangements, provisions against which tax relief has been granted are not allowed to count as part of the banks' capital base for prudential purposes; and secondly, the banks think it undesirable that provisioning policy should be influenced by considerations of tax planning, which, in the banks' view, might be implied if changes were made to the tax regime applied to provisions.

One suggestion has arisen from these discussions which the Inland Revenue are examining with the banks. This is the possibility that the Revenue might agree to consider the banks' taxation computations in stages, so that they could be given greater certainty at an earlier stage, as to whether or not they would obtain tax relief on their specific provisions. It would mean, however, that the banks themselves would have to supply some information earlier than at present. They do not file their full taxation computations until some 18 months after the end of their financial year, so that they do not know for some considerable time whether or not tax relief will be granted on provisions.

We will, of course, continue to keep under review the level of banks' provisions against bad and doubtful sovereign debt, and watch carefully for any problems which might arise.

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

Yours ever
David

D L C PERETZ
Principal Private Secretary

International Debt file

DRAFT/AAW/mee/11/19/84

Currency Boards

Currency boards (CBs) once ubiquitous in the colonial regimes of Africa, Asia and the Caribbean, now survive only in such small countries as Singapore, Brunei and Hongkong. The main characteristic of the currency board system is that the board stands ready to exchange domestic currency for the foreign reserve currency at a specified and fixed rate. To perform this function the board is required to hold realizable financial assets in the reserve currency at least equal to the value of the domestic currency outstanding. Hence in the CB system there can be no fiduciary issue. The backing to the currency must be at least 100 percent. Although in principle it is the currency board that is required to convert on demand all offers of domestic or reserve currency, in practice, where there is a banking system, however elementary, it is the banks which have carried out most of the exchange business. The buying and selling rates for both currencies have a sufficient spread so that the costs of exchange are covered. This convertibility of currencies in the CB system does not extend to bank deposits or any other financial assets. If a person has a bank deposit and wishes to use the CB to convert it to foreign currency then the deposit must be first converted into domestic currency and then presented to the CB.

These disciplines of convertibility and the avoidance of deficit financing were characteristic of much of 19th century Britain and France. The principle of the Currency Board was enshrined in the provisions of the

(British) Bank Charter Act of 1844. The Issue Department of the Bank of England was to act like a CB. It is not surprising that the principles were considered proper for the newly acquired colonies. At first the settlers or officials used the notes and coin of the imperial power as a normal extension of imperial trade. The metropolitan currency and coin, since it was widely accepted and considered "as good as gold," served as a stable means of exchange and as a store of value in those largely inflation-free days of colonial occupation.

There were disadvantages of circulating the metropolitan currency, for example, sterling notes and gold sovereigns, in the colonies. First, there was a high risk of destruction or loss. Second, real resources were locked into the circulating media and produced no rate of return. Any loss of currency notes would be to the benefit of the issuer (e.g., the Bank of England) and the colony would correspondingly lose the real value of the notes. The institution of a CB enable the colony to avoid such loss. The Bank of England note could be stored in the CB's vaults and local currency issued to the same value. Thus the accidental loss of a domestic note would not diminish the net assets of the colony. In addition, the CB would find it efficient to replace worn notes from its stock without having its assets tied up in sending battered Bank of England notes back to London for reissue.

In practice the CB did not need to hold all its reserves in Bank of England notes. It could buy interest bearing financial assets of suitable liquidity. Provided these assets could be converted at sufficiently short notice without significant loss into bank notes (or provided the CB could borrow notes on such security), the principles of convertibility, 100 percent reserves and no fiduciary issue were satisfied. This more sophisticated CB system could be used to earn at least some of the profits of seignorage for the benefit of the colony. Most colonies developed a CB system although a few countries continued to circulate some foreign notes and coins as parallel currencies. The non-colonial countries of Liberia and Panama however have used the United States dollar as a circulating medium. In the case of Liberia it was argued that there were doubts whether the people would have confidence in a CB supervised by the government of Liberia. In particular, there were fears - alas not groundless - that the monetary system would be used improperly to finance government spending.

As colonies became independent states in the 1950's and 1960's they generally eschewed the CB system and formed Central Banks to manage their currencies, ostensibly for "development" purposes. Some countries, such as Singapore, continued to operate a sophisticated CB system. And Hongkong, after experimenting with an unpegged currency from 1972, returned to a CB system based on the United States dollar in October 1983.

The financial experience of countries which departed from CB systems has not been auspicious. Increasing inflation, generated largely by deficit financing through Central Bank credit and note issue, has been characteristic of most of the two or three decades since independence. The objective of promoting growth and development has not been generally achieved; indeed in

Africa the experience and the forecast is one of degeneration. And it is difficult to avoid the conclusion that the financial instability, brought in train by the the abrogation of the CB system has played a considerable role in this process. Nevertheless, it is unlikely that, whatever the arguments in favor of the CB system, there will ever be a resuscitation of what is wrongly regarded as a manipulative monetary mechanism of colonialism or neo-imperialism.

The claims for a CB system are many, some clearly dubious. One main claim is that the CB system provides an annual increment of the money supply which is simply the mirror image of the surplus on the current balance of payments. If there were no banks, or if the banks acted only as depositories or "cloakrooms" for currency, and if there were no imports or exports of capital in the form of foreign currency, then this assertion would be correct. The only way in which the residents could acquire foreign currency, and so swap for domestic currency, would be through net earnings from trade. When there is a surplus on the current account the money supply grows by that amount, and when a deficit appears the money stock contracts by the value of the deficit. This one-to-one relationship was thought to provide an automatic system which ensured that monetary behaviour always moved to eliminate a deficit or a surplus.

With notes and coin as the sole form of money and with no capital imports of foreign currency this one-to-one model was clearly valid. However with the additional elements of bank deposits and credit the issue becomes much less clear cut. A proportional relation still holds even with a fully developed system of bank deposits acting as money and bank credit, provided first that there are no foreign capital movements, second that the banks maintain domestic currency in their reserves as a constant fraction of their deposit liabilities, and third that the public hold a constant ratio of domestic currency to bank deposits. All these fixed ratios would ensure that the M_1 definition of the money supply (currency + coin + checking accounts) would expand proportionally, but not one-to-one with the current balance.

If there are capital flows other than those required to settle the net bills of the trade account, then the proportionality disappears. A flow of capital, such as a colonial branch bank borrowing from its parent, will entail the acquisition of a foreign financial asset (as well as the corresponding liability). The branch bank, if required to hold reserves in domestic currency, will exchange its foreign financial asset (or strictly currency) at the CB and acquire domestic currency reserves. So, keeping the reserve fraction constant, it will extend loans and expand deposits thus increasing the deposit component of the money supply. The limit to such borrowing and domestic credit creation is set by the demand for credit in the colony, which in turn depends on the marginal profitability of credit in the colony relative to the interest rate. (This rate will normally be at a slight premium over the metropolitan interest rate). In practice the limit to such borrowings will be set by judgements of bankers and businessmen of the capacity and willingness of domestic borrowers to pay the servicing charges.

There is one set of circumstances which would insulate the monetary system from external capital flows. This would be the case where the importation of capital is effected only to supply the foreign exchange component of a domestic investment which would otherwise not occur. The insulation is complete if the investment generates profits in foreign exchange which just offsets the servicing charges. These conditions of foreign capital flows were probably a fair approximation to reality for the period covered by the CB era. But with the dominance of western commercial bank lending to Third World governments, they are hardly characteristic of modern capital flows. Capital flows do normally affect monetary conditions.

The proportionality proposition is also upset by changes in the reserve-deposit ratios and by any changes in the fraction of the money stock which the public desires to hold in the form of currency. Prudential control of banks, often the responsibility of the Central Bank in the parent bank's country, usually takes the form of specifying <u>minimum</u> reserves which may be less than the prudential reserves held normally by banks. The branch banks may thus decide to extend credit and deposits, when conditions of confidence and credibility change, by running down their reserve to deposit ratio to somewhere near the specified minimum. The ability of branch banks generally to borrow from the head office in London gives considerable latitude to their liquidity requirements and virtually guarantees the solvency of the branch in the colony.

In the long-run much more important than the reserve deposit ratio are changes in the currency-deposit ratio of the public. The modern process of financial innovation economizes on cash. The use of the check rather than cash is the predominant financial trend in all countries. For any given quantity of currency and other bank reserves the choice of the public for a larger ratio of deposits to currency has provided the main impetus for an expansion of the money supply (M_1) in CB systems. The stability and confidence generated by the CB system undoubtedly much encouraged the use of deposits.

This phenomenon nullifies one of the main criticisms of the CB system, namely that it provides a stiltifying monetary constraint on development and inhibits growth in the colony. It is perhaps ironic that the countries that have retained their CB arrangements, Singapore and Hongkong, have been the highest growth economies in the oil importing Third World. Their money supply has expanded partly through current balance surpluses and capital imports, but mainly through the increased use of deposits associated with the financial stability of the CB system. Both Singapore and Hongkong inflated during the late 1960's and 1970's at roughly the same relatively low rates as the currencies on which they were based. Thus they avoided the excessive inflation which affected many Third World countries which had adopted more "advanced" systems of central bank finance.

Another important criticism was thought to be not only the preclusion of counter cyclical monetary and budgetary policy, but also the promotion of a pro-cyclical policy. Many CB colonies produced export crops which were sold in markets with widely fluctuating prices. No monetary manipulation, ~~however~~, can turn a one-commodity export economy into a nicely diversified recession-proof system. The collapse of commodity prices in a world recession generally gave rise to a large deficit on the current balance and so induced the CB to contract the money supply. The isomorphic case of a boom in export prices was thought to be less onerous, although it did transmit the increase in the price of exports into domestic inflation. However there was no reason, apart from extraneous regulations, why the authorities as well as firms and persons could not hold or transfer foreign assets as a precaution against such oscillations. In the case of the Hongkong CB, the freedom to hold assets in any form and any currency has been the sine qua non of the financial system. And, for many decades, the government of Hongkong has held a large portfolio of foreign financial assets which can be used to expand or contract the CB issue.

It might be thought that the CB system would exacerbate the liquidity shortages and even the solvency of the domestic banking system and so make it difficult to contain runs on banks and all the fear and instability that inevitably follows. Since most banking business was carried out by the branches of metropolitan banks, there was little fear of a run on a particular branch causing solvency problems, and liquidity shortages could be covered quickly by transfer. Moreover the knowledge that the resources of the parent banks lay behind the branch gave rise to a singular confidence and so nipped any incipient run in the bud. For the local banks, which had no such

Again this criticism was largely invalid.

recourse, the ebb and flow of confidence were much more serious (as in the United States in 1931-3 and Hongkong in 1983). Insofar as the CB system promotes international branch banking, so it promotes stability.

Although the CB system did not have all the virtues or faults which were attributed to it, it did have some singular advantages. To some extent it depoliticized the monetary system and insulated the public purse from plundering politicians. There was no resort to the printing press to reward political allies or ruin one's opponents. It gave a real credibility to the fixed exchange rate so that people willingly held both currency and deposits knowing that they would maintain their value. Similarly it precluded the possibility that the exchange rate would be used to attempt to solve political and social problems. These constraints, once thought to be vices, are now widely regarded as virtues. The evident failure of trying to promote growth or equality by inflationary finance may create a new respect for CB. The return of Hongkong in 1983 to a full CB system based on the US dollar was in response to political uncertainties as well as the realization that such financial stability was sorely needed. It would be rash however, to imagine that CB's are the wave of the future. One suspects that they may be used rather more frequently in small economies that are heavily dependent on large trading partners. Similarly they are likely to remain the basic system for the great trading centers such as Singapore and Hongkong where they have worked so well. Those exceptions apart, the CB is unlikely to be the vehicle for monetary and fiscal rectitude in the Third World.

CONFIDENTIAL

file X6

cc Mr Redwood

10 DOWNING STREET

From the Private Secretary

14 November 1984

INTERNATIONAL FINANCIAL SCENE

The Prime Minister has seen your letter to me of 12 November and the report by the Bank which was attached to it. She agrees with the Chancellor in rejecting an approach to international debt problems which identifies a "financing gap" which is to be filled by Government contributions. She agrees with him, also, in rejecting any contribution by the UK Government to such a gap in the case of Argentina.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office), Callum McCarthy (Department of Trade and Industry) and John Bartlett (Bank of England).

ANDREW TURNBULL

TRG

David Peretz, Esq.,
H.M. Treasury.

CONFIDENTIAL

2

13 November 1984

PRIME MINISTER (2) The analyses of the US deficit is especially worth noting

AT 13/11

INTERNATIONAL DEBT

The London Economic Summit backed the UK's view that there should be no grand scheme. It supported the softly-softly approach, trying to tempt countries and other borrowers back into the ways of solvency and prudence, easing the transition by encouraging more equity and rescheduling of debt.

Since 1981, the markets have quietly and steadily been sorting out the problems of the 25 major country borrowers. Pressures upon these countries has reduced their current account deficit from $79 billion to $31 billion[1], and the trend is still downwards.

Improvement in their balance of payments is crucial. Over the last 2 years, imports have fallen relative to the foreign currency reserves there to pay for them, and exports now bear a slightly better relationship to the costs of meeting the interest charges on their international borrowings.

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1 All figures come from Simon & Coates' useful Economics Compendium

The necessary rescheduling of debt has gone on apace. The total short-term debt of the 25 countries has fallen from $140 billion in 1982 to $91 billion in 1984. Their long-term debt has been rising steadily: $300 billion in 1979; $436 billion in 1982; and $549 billion by 1984.

The figures do not show that we are yet out of the wood. The system remains fragile and accident-prone. A false step at any point by one of the major borrowers or, more importantly, by the major lenders, could disrupt the whole structure. But we should draw modest encouragement from the quiet processes of the marketplace that are rescheduling the debts, and from the improvement in the countries' trade performance.

<u>The US</u>

Meanwhile, the new large international borrower, the US, is still proceeding on its spendthrift course. A Federal deficit of $180 billion per annum means that simply paying the interest on the growing stock of debt guarantees a further major increase in the total debt outstanding. **The Congressional Budget Office is forecasting net interest on US Government debt rising from $134 billion in 1985 to well over $200 billion by 1989.** The impact of compound arithmetic is remorseless. A drop in foreign confidence would be reflected in a lower dollar and higher interest rates - a combination which would start to correct the balance of payments deficit at the expense of reduced activity.

<u>What is wrong with Sir James Goldsmith's view of the US deficit in the Observer of 4 November</u>? (Figures from N M Rothschild/OECD; not checked with official sources)

Sir James Goldsmith said: "If you compare (the US Budget deficit) with that of European countries, it is - in net OECD terms - $110 billion and not $175 billion . . . Every decline of 1 per cent in interest rates saves $12-$15 billion in the financing of the deficit. I expect a 3-4 per cent decline in interest rates. The deficit is the red herring of the experts".

His lower deficit must result from deducting the surplus of state and local government budgets. Yet the financial surplus of the US state of local governments is only $40 billion per annum, and not the $65 billion the quotation suggests.

He should then add back the off-budget outlays in the US which are currently running at around $15 billion, ie a deficit of $150 billion, not $175 billion or $110 billion.

He ignores the distinction between cyclical and structural budget deficits. The US budget deficit is a problem because it is so large at a point in the economic cycle when it ought to be small.

The effect of a 1% decline in US interest rates on the deficit is not as stated. Because of the maturity structure of the US federal debt, the effect would take time to build up, rising from, say, \$7 billion in Year 1 to \$18 billion by Year 6.

If rates do fall, it will probably be because the US economy is slowing down. For each year the US growth falls one percentage point below the Treasury's target (of 4 per cent) an additional \$12 billion would be added to the US budget deficit, thereby offsetting the benefit of lower interest charges.

The OECD indicate that they will be anticipating a US current account deficit next year in the region of \$130 billion! This must begin to slow the US economic recovery. US manufacturing industry is already experiencing order shortfalls (through import penetration) and rising stock levels.

<u>Financing UK economic activity and Government borrowing</u>

Insurance companies and pension funds have stopped placing new investment overseas. Between 1979 and 1983, they invested £10 billion overseas. The first half of 1984 saw a small net disinvestment of £23 million. This important turn-round is likely to continue; more cash will be available for UK companies and the gilt market.

The prospect for next year, if public expenditure can be held to the targets, is for a relatively easy task on financing the deficit, compared with previous years. This reflects the growing cash surpluses in UK institutions; the growing disinclination to invest overseas; the attractive returns currently available on gilts and equities; and the satisfactory state of the corporate sector.

The message is clear for the UK. Companies have every opportunity to expand and to create jobs: they have an embarrassment of cash; the problem is encouraging them to use it in the right ways. And interest rates should fall as a requirement for net Government gilt sales of some £4 bn is quite modest, compared with previous years. A strong equity market, well underpinned by institutional cash, is ideal for a large denationalisation programme.

The recent rally in the pound against the dollar, coupled with the drop in interest rates and good levels of funding, illustrate the wisdom of benign neglect of the markets in the period of difficulty a few weeks ago. Further interest rate falls would be a welcome stimulus all round, and would be an added incentive in building a policy that creates more jobs. Long live the policy of no sterling target.

J Redwood

JOHN REDWOOD

10 DOWNING STREET

Prime Minister (2)

To note latest report on International Financial Scene.

Agree the strong line UK representatives have been taking: on

(i) "non-gapology" as a general approach

(ii) in refusing any HMG participation in closing the gap?

AT 13/11

Yes MT

O.10 8.17

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cc JR

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

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

12 November 1984

Dear Andrew

INTERNATIONAL FINANCIAL SCENE

I attach the latest report by the Bank on developments in the international financial scene,which has been discussed in the Treasury's international debt group.

Among the individual countries discussed, Argentina remains the main concern and two-thirds of the recent meeting of G5 Debt Deputies in Washington was spent in discussing it.

It was evident from those discussions that the Managing Director was prepared to go forward with a programme based on the Argentine Memorandum of Understanding provided that the "financing gap" for 1984 and 1985 of $5.34 billion, after taking account of flows from the Fund, Paris Club and bank rescheduling, could be bridged in full. The Fund had discussed this with the banks, whose position was that they would consider putting up $3.5 billion of new money at the most, subject to a firm commitment by governments to provide the rest. The Fund, therefore, with the US representatives's support, invited contributions in the form of additional trade credits in 1985 (ie a repetition of the Brazil exercise last year).

This provoked a very hostile reaction from other G5 represenatives who questioned both the assumptions behind the calculation of the gap and the Fund's whole approach which we had criticised last year in the case of Brazil. As a result of these criticisms, the Fund have amended their arithmetic, narrowing the "financing gap" to $820 million (rounded up, for safety, to $1 billion) but remain unrepentent in seeking trade credit contributions.

to be filled by Governments

The Chancellor's view is that we must reject this firmly as indeed our representative did at the Washington meeting. There can be no question of any official UK contribution, although we will

? need to consider whether there are any circumstances in which we would be willing to take part in a Paris Club rescheduling. Meanwhile, we shall continue to make clear our objections to the Fund's approach, which stand irrespective of the country involved. The French and German Governments seem likely to take a similar line.

We will report separately any substantive developments in advance of the next regular report which will be available shortly before Christmas.

I am copying this letter to Len Appleyard (FCO), Callum McCarthy (DTI), and John Bartlett (B/E).

Yours ever

David

DAVID PERETZ
Principal Private Secretary

A ASSESSMENT

The recent easing in US interest rates, after some months of stability, will certainly have come as a welcome development for debtor countries. CD rates dipped below 10% for the first time since the beginning of the year, and US rates in general are back down to the levels seen last Spring. Though the cause is probably lower than expected growth in the US economy - 2.7% (ar) in Q3 compared to an earlier estimate of 3.6% (ar) - which would tend to depress demand for debtor countries' products, a substantial part of the slowdown in the US seems to have been due to a further worsening in its net trade position, and imports into the US continued to grow strongly. The recent cuts in North Sea and Nigerian oil prices will, if they are sustained, be of benefit to a number of countries. (But insofar as the agreed OPEC production cuts can be achieved, the effect of the price cuts will be limited and possibly only temporary.) Oil exporting countries, such as Mexico and Nigeria itself, will obviously be adversely affected by the price cuts, but initial calculations suggest that the impact on Mexico, at least, may not be so great as to threaten its current strategy. On the other hand, the general weakness of commodity prices remains a negative factor for many countries.

Little has changed on the financial scene. The international banking figures for Q2 show that lending overall was a bit more buoyant - indicating that the problems with Continental Illinois had no significant impact on international lending. The flow of finance to developing countries rose from $1.2bn to $4.7bn* between Q1 and Q2, but it remained no more than a trickle, mostly consisting of unspontaneous lending to Latin American countries. Taken together these countries once again made net deposits of funds with the banking system (even excluding interest payments); gross deposits made increased from $3.6bn in Q1 to $7.2bn in Q2, leaving the net flow of funds from these countries little changed at $2.6bn ($2.4bn in Q1). One noticeable feature is that lending to Mexico ($2.2bn) exceeded (by $1.2bn) her drawdown of unspontaneous lending. At the moment, it is not yet clear what accounted for this increase, but it is unlikely to reflect a return to normal

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* Figures adjusted for exchange rate effects.

market borrowing: indeed, a possible cofinancing deal between commercial banks and the IADB has been postponed until the financial package has been finally agreed by the Mexicans and the banks, indicating that the return to normality will need careful handling if it is to be brought about successfully.

Negotiations between debtor countries and both the IMF and the commercial banks continue with varying degrees of progress. On September 25th Argentina reached initial agreement on the terms of an IMF programme, but there is widespread scepticism both about the adequacy of the programme itself and the ability, if not the determination, of the authorities to carry it out. Nevertheless, the agreement has paved the way for discussions with the banks about a rescheduling and new money package, although the banks are also looking for greater participation by Governments. Argentina's payment of most interest due up to the beginning of May this year probably helped persuade US regulators meeting on 2 November not to downgrade the status of all US banks' loans to Argentina, but some loans were classified as sub-standard. The Philippines has also mananged to reach initial agreement with the IMF and, subsequently, the commercial banks. Banks will be asked to provide new loans of \$925mn and to maintain trade lines and reschedule non-trade maturities; this \$925mn, however, falls considerably short of the \$1.65bn originally sought by the Filipinos. In part, the shortfall is to be made up by an increase in the funds to be sought from official creditors, but it is not clear that firm commitments for these additional funds have yet been secured. Brazil has submitted a further Letter of Intent (its sixth). The opening of the next round of negotiations with the banks has been postponed until mid-November, but later meetings will be required to allow the banks to hear a report on the views of an IMF mission which is shortly due to visit the country. No progress has been made in the negotiations between the IMF and Nigeria. Most exporters with uninsured trade arrears appear to have accepted the rescheduling offer put to them by the Nigerians, but the promissory notes rescheduling these arrears are now expected to issue after the year-end, rather than October as originally planned. Export credit agencies meanwhile remain insistent that a multilateral agreement on rescheduling insured trade arrears is conditional on agreement being reached with the IMF; as an interim measure the Nigerians have agreed to pay an amount equivalent to interest on these arrears.

The multi-year rescheduling agreement proposed for Mexico (the banks have yet finally to agree) is setting a precedent for other countries. A similar arrangement has already been agreed in principle for Venezuela, and the advisory banks would be ready to consider a MYRA for Brazil if time before the elections permits (which is doubtful). Yugoslavia has pressed for multi-year rescheduling both from commercial bank and official creditors; the banks have not yet commited themselves, whilst official creditors are not proposing to negotiate any rescheduling until agreement has been reached with the IMF on a further programme.

Another innovation in the proposed Mexican arrangements is the option of currency diversification, under which non-US banks would be permitted, with the agreement of their authorities, to convert up to 50% of their Mexican exposure into local currency over a 42 month period. This innovation too is likely to set a precedent: thus, in Venezuela's case, it has also been proposed that perhaps 45-50% of dollar exposure, subject to a ceiling of $3bn for all eligible banks, should be convertible into non-dollar currencies.

Quite a stir was caused in September by the news that Citibank had insured itself against some losses on part of its problem country exposure. On closer examination, however, it was found that this insurance was extremely limited and, being related to Citibank's particular needs and objectives, was unlikely to be the forerunner of generalised attempts to spread the risks of bank lending to problem countries.

The regional co-ordination of debt strategies took a further step forward on 13/14 September, when Foreign and Finance Ministers of the eleven Latin American countries represented at Cartagena in June re-assembled in Mar del Plata (Argentina) to review developments over recent months and plan the way ahead. The meeting discussed a number of major specific proposals (mostly aimed at boosting the resources and operation of the IMF, IBRD and IADB), but made no mention of these in its final communique. Instead, the communique suggested that creditor countries had lost the sense of urgency needed to solve Latin America's debt problem, and re-affirmed unequivocally the group's determination to seek to politicise the debt problem and obtain more far-reaching co-operation and assistance from creditor Governments. This was reflected in an explicit decision to invite the industrialised countries to participate in a "direct political dialogue", ideally during the first half of next year. Demands to that end from the debtors - including the so-called "moderates", Mexico and Brazil - do not appear to have been satisfied by the subsequent decisions of the Interim and Development Committees to consider the debt crisis in greater depth at their April 1985 meetings. The Latin Americans have already made clear their frustration over the handling of debt problems on a purely technical plane, arguing that the regional debt crisis is sui generis and, as such, merits additional discussion outside existing technical institutional fora, preferably at a high-level inter-Governmental meeting.

The next full follow-up meeting to Mar del Plata is to be held in the Dominican Republic at an unspecified date during the first quarter of 1985. Meanwhile, the Latin Americans are likely to continue to review developments through informal contacts (Cartagena Foreign Ministers will be holding talks in Brasilia on 12-17 November), and are likely to define more closely what they would hope to achieve in any creditor/debtor summit - no doubt pressing their case, when the occasion arises, directly with individual creditor Governments.

B REGIONAL SUMMARIES

(i) Latin America

Argentina eventually reached agreement, on 25 September, with the IMF on the terms of a Memorandum of Understanding in support of its request for a 15 month Standby for SDR 1.4 bn. There is, however, widespread scepticism in the international financial community as to the adequacy of the Memorandum, which is vague and somewhat evasive in character, and as to the real political will/ability of the authorities to pursue sufficiently rigorous adjustment, in particular through wages and fiscal policies, to reduce inflation from a current year-on-year rate of almost 700% to an annual rate of 150% in the final quarter of 1985.

Nevertheless, the Fund agreement has improved relations between Argentina and its foreign bank creditors. At end September the banks agreed a formal 4-month rollover to 15 January of the $750 mn outstanding under the 1982 bridge loan in return for Argentine repayment to them of their $100 mn participation in the end-March emergency package and some progress on the question of arrears. More recently, on 24 October, Argentina spontaneously paid $58 mn to creditor banks in order to bring interest "substantially current" to 2 May. Its motive was to try to avoid an adverse classification of its US bank loans by keeping them under 180 days in arrears at 2 November, when US regulators met to review the standing of loans to problem countries. Argentina's action was successful insofar as there was no general downgrading of US banks' loans, as noted earlier. Meanwhile, on 16th October, negotiations began with the banks on a rescheduling and new money package. The Fund's MD has made his recommendation of the Standby programme to the Board conditional on a commitment by principal creditors to provide sufficient new money to cover Argentina's external financing requirement up to end-1985. Argentina is seeking to reschedule 1982-1985 maturities over 14 years from 1986, and to obtain $5.45 bn in new money for 1984/5, including reinstatement of the undrawn $1 bn from the 1983 $1.5 bn medium term loan. The Working Committee has already made clear that the identified new money requirement is unrealistic and has urged the Argentines to approach the IMF, IBRD, US and other governments for further assistance. The Paris Club has formally been asked to reschedule some $1.5 bn in 1983-85 maturities. Much depends on the response of governments to a new request for credit facilities, on top of the Paris Club rescheduling, which would help to reduce the proportion of the financing gap that would have to be provided by the banks.

Following discussions with the IMF staff, the Brazilians have submitted a sixth Letter of Intent, incorporating revised EFF performance criteria for the second half of 1984, scheduled for Fund Board approval on 9 November. Phase III negotiations with the banks will now start in mid-November, but further rounds of discussion will be necessary as the banks will wish to be informed of the outcome of the next Fund mission (not due in Brazil before 10 November) which will be looking at 1985 external financing requirements as well as 1984 Q3 performance criteria. In preliminary talks, the banks had wanted to limit initial agreement to 1985 financing needs only, delaying a multi-year agreement until the outcome of the January Presidential election was known. Following Brazilian insistence, however, the Advisory Committee chairmen have agreed to recommend consideration of a MYRA to the Committee, subject to four conditions: (i) that no new money is required in 1985 (ii) that Paris Club Governments participate in the package (iii) that the Presidential candidates undertake not to undermine any agreement while it is being canvassed in the market and (iv) that the Fund's MD and the Chairman of the FRB lend their support. However, with the delays in the negotiating timetable shortening the period before the election, it is increasingly expected that the outgoing Brazilian Administration will not in the event be able to meet the above conditions.

The Mexicans mounted a "roadshow" in October to gather support for the MYRA agreed with the Advisory Group of banks two months previously. There is no indication as yet of creditor banks' reactions.

Following closely on the heels of the Mexican deal, a multi-year rescheduling was agreed in principle between Venezuela and its Advisory Group on 21 September. The agreement, which is conditional on a satisfactory resolution of the private sector debt problem, covers $20.75 bn of public sector maturities falling due between 22 March 1983 and end-1988. Terms include a maturity of 12 1/2 years from end-1984 and interest at LIBOR + 1 1/8% throughout. A roadshow is scheduled for early November.

Elsewhere, Chile introduced a devaluation package on 17 September aimed at ensuring compliance with performance criteria for the final six months of the current standby programme. Subsequent domestic political pressure has, however, resulted in a dilution of the measures, and in the resignation of the cabinet at the beginning of November. It is not yet known if the economics ministers are to be changed. In a new round of debt rescheduling negotiations, expected to take place in November following the IMF's current quarterly performance review, but which may now be postponed because of the cabinet's resignation, the Advisory Group of banks is likely to press the Chileans to seek Paris Club relief in order to reduce the substantial new money requirement, of $0.8 - 1 bn, envisaged in 1985. In Ecuador, the new Febres Cordero Administration has introduced a number of exchange rate and other measures primarily aimed at improving the trade balance. Disappointingly, however, they are less comprehensive than originally expected. Negotiations with the IMF on a new Standby are continuing.

Peru breached second quarter IMF performance targets, and there are now serious doubts over the Government's political will in getting the Standby programme back on course. This will hold up signature of Peru's bilateral agreements with Paris Club creditors, and delay indefinitely the completion of the $2.5 bn commercial bank refinancing package. Meanwhile, arrears to all creditors are steadily mounting.

Although Colombia's reserve loss has slowed down recently, Government finances are in a parlous state, and it remains to be seen whether the substantial tightening of demand management policies urged by the IMF in recent Article IV consultations can be implemented outside a formal programme. Creditor banks are now seeking a broader strategy than the current piecemeal rescheduling of private sector debt.

(ii) Far East

The Philippines reached agreement with the IMF on a draft Letter of Intent for an 18-month Standby Arrangement for SDR 615mn.

Subsequently, the Advisory Committee of Banks approved a package including new money ($925mn) to be committed during the remainder of 1984 and 1985 and a rescheduling of debt maturing in the period between October 1983 (when the debt moratorium was first introduced) and the first quarter of 1986; the terms have not yet been put to the individual banks involved. The amount now being proposed for the banks is substantially less than the $1.6bn originally calculated on the basis that the private and the official sectors should contribute equally. It is not clear that commitments have been received from the official sector to make up this shortfall. Once a "critical mass" of new banking money has been promised, and if the IMF do obtain assurances on adequate official lending (they are now seeking $2.1bn), the Standby Arrangement will be discussed by the IMF Board. We understand that preliminary Paris Club talks may begin in December.

(iii) Eastern Europe

Little progress was made when Poland and its official creditors began substantive negotiations in Paris on 22 and 23 October on the rescheduling of debt due from 1982 on. The talks are likely to be resumed at end-November.

Negotiations between Yugoslavia and its creditors over 1985 maturities, and possibly those beyond, are at an early stage. The commercial banks' International Co-ordinating Committee met at end-September, but did not commit themselves on the Yugoslav request for a MYRA covering all maturities falling due between 1985 and 1988 including those relating to previously rescheduled debt and non-spontaneous new money. Meanwhile the official creditors also have been asked for a MYRA, but agreed in Paris on 24 October to reply that a meeting to reschedule debt (as opposed merely to review general economic prospects) be held only after Yugoslavia had reached agreement with the IMF on arrangements to follow the expiry of its current Standby.

Following another poor harvest, the USSR appears to be attaching high priority to the protection of its foreign exchange position, not least by an enforced improvement in its terms of trade with Eastern

Europe, where the recent improvement in external finances is rather superficial, having been effected largely by cuts in imports of capital goods. Exports from Eastern Europe have shown little dynamism in the face of sluggish markets and growing competition from the newly industrialised countries. In general, economic prospects for the region remain gloomy.

(iv) Southern Europe

Portugal's trade performance shows continuing improvement and indications are that the IMF Standby target of a current account deficit of $1.25 bn in 1984 should be comfortably met. For 1985, however, forthcoming Presidential elections, and the assumptions contained in a medium-term recovery plan now under consideration by the Government, point to some relaxation of policy; and little improvement is reportedly envisaged in the current deficit over the next three years. In the meantime, Electricidade de Portugal's recent mandate for a $50 mn credit was well received in the market and was doubled to $100 mn.

The Greek current account deficit in 1984 is likely to be around last year's level of $2 bn, although reserves have shown some improvement. Greek loans continue to be favourably received (although an initiative to lower borrowing margins has been unsuccessful), but Parliamentary elections due next year provide an unfavourable background to prospects of further progress with adjustment, and any deterioration in performance could have a significant impact on international banking sentiment.

There are indications that Turkey's current-account deficit this year will not be reduced to the $1.3bn forecast by the Fund, but may total $2bn (against $2.2bn in 1983 and an earlier target of $0.3bn for this year). The Government's failure to reduce this deficit significantly is likely to affect creditor sentiment adversely and augurs ill for the country's prospects of meeting substantial debt maturities over the medium-term without recourse to renewed rescheduling.

(v) Other

No progress has been made in Nigeria's negotiations with the IMF. The Nigerian President has stated that acceptance of the conditions on which IMF is insisting would be tantamount to political suicide. Most exporters with uninsured trade arrears have agreed to the Nigerian offer to reschedule the arrears in the form of six-year promissory notes and the notes are expected to issue after the year-end. Official credit agencies, on the other hand, have insisted on a multilateral restructuring of insured trade arrears, conditional on agreement being reached with the IMF; as an interim measure the Nigerians have agreed to pay an amount equivalent to interest on these arrears calculable from the beginning of 1984.

The Israeli Government of National Unity has announced a series of measures designed to protect the foreign exchange position and cut the budget deficit, but a number of these measures have yet to be implemented. Although the external position for 1984 has been largely stabilised by the pre-payment of US economic aid, there is growing concern about trends in the domestic economy (particularly the sharp acceleration in inflation - which reached 450% in the twelve months to end-September and is expected to rise further).

CONFIDENTIAL

INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt	British-owned banks' exposure [1]	ECGD amounts at risk[2]
	End-Dec 1983	End-June 1984	End-June 1984
Latin America			
Argentina	46	2.6	0.2
Brazil	92	6.6	1.9
Chile	20	1.3	0.1
Colombia	11	0.7	0.2
Ecuador	7	0.6	0.1
Mexico	91	6.2	1.4
Peru	13	0.4	0.1
Venezuela	35	2.3	-
Eastern Europe (convertible currency)			
GDR	12-13	0.6	0.2
Hungary	8	0.5	0.1
Poland	24	0.5	0.8
Romania	9	0.3	0.5
Yugoslavia	19	0.9	1.2
Southern Europe			
Portugal	14	1.3	0.3
Greece	12	1.5	0.4
Spain	38	2.8	0.1
Far East			
Indonesia	33	0.9	1.5
Philippines	25	1.3	0.3
South Korea	40	2.7	0.9
Other			
Morocco	12	0.1	0.3
Nigeria	20	1.2	3.3
Israel	29	0.6	0.2

[1] This column now shows exposure defined as consolidated external claims, adjusted for certain inward and outward risk transfers in respect of guaranteed loans, plus any net claims on local residents in local currency.

[2] Excluding claims paid (net of recoveries). Because of differences in definition, these estimates are not directly comparable with the figures in other columns.

DD UKDEL WASHINGTON 091730Z
GRS 530
CONFIDENTIAL
DESKBY 091730Z
FM FCO 091703Z NOV 84
TO IMMEDIATE UKDEL IMF/IBRD WASHINGTON
TELEGRAM NUMBER 284 OF 9 NOVEMBER 1984
INFO PRIORITY PARIS
SAVING BISBA

YOUR TELNO 231 OF 1 NOVEMBER: IMF ARGENTINA

1. PLEASE TELL THE MANAGING DIRECTOR THAT WE ARE NOT REPEAT NOT PREPARED TO CONTRIBUTE TO THE DOLLARS 1 BILLION PLUS OF NEW EXPORT CREDITS WHICH REPRESENT THE OFFICIAL ELEMENT IN THE ARGENTINE FINANCE PACKAGE. IN FACT CONTRIBUTIONS IN PROPORTION TO PAST AND PROSPECTIVE TRADE PATTERNS WOULD MAKE OUR SHARE NIL (IF BASED ON THE RECENT PAST) OR NEGLIGBLE (STERLING 25-30 MILLION?) IF BASED ON PROSPECTIVE TRADE. BUT WE ARE NOT PREPARED TO COMMIT ANYTHING IN ADVANCE.

2. THE TIMING AND CONDITIONS OF RESTORATION OF UK EXPORT CREDIT COVER DOES NOT YET ARISE. WE SHALL LOOK AT IT AGAIN AFTER THE RESCHEDULING OPERATION IS COMPLETE, PROVIDED ALL TRADE SANCTIONS HAVE THEN BEEN LIFTED. GIVEN THE PRESENT STATE OF ANGLO-ARGENTINE RELATIONS, YOU NEED NOT FEEL INHIBITED IN CONFIRMING OUR RELUCTANCE OPENLY IN THE BOARD OR ELSEWHERE.

3. FOR YOUR GUIDANCE WE REMAIN UNHAPPY WITH THEOWAY THE FUND CONTINUE TO RELY ON 'GAPOLOGY'. AS UNWIN SAID AT THE G5 DEBT DEPUTIES MEETING, THE FUND'S ASSUMPTIONS ABOUT THE TRADE ACCOUNT LOOK VERY SUSPECT AS DOES THE UNDERLYING ARITHMETIC. WE ARE CHECKING THE FIGURES TO SEE IF THEY SUPPORT THE MD'S CLAIM THAT THERE WILL BE EQUALITY OF MISERY BETWEEN BANKS AND GOVERNMENTS.

4. THERE IS NO CHANGE IN HMG'S ATTITUDE TO PARTICIPATION BY UK BANKS. IT IS ENTIRELY A MATTER FOR THEIR COMMERCIAL JUDGEMENT. BUT IF THEY GO AHEAD WITHOUT AN IMF PROGRAMME, WE SHALL FEEL FREE TO CRITICISE THEM PUBLICLY. WE DO NOT BELIEVE THAT THEY WILL DEMAND UK GOVERNMENT PARTICIPATION AS THE PRICE OF THEIR OWN CONTRIBUTION - PARTICULARLY WHEN THEY WILL BE NET BENEFICIARIES

FROM THE CURRENT PROPOSALS.

5. YOU REPORTED THE MANAGING DIRECTOR'S VIEW THAT IF THE OFFICIAL COMPONENT WAS NOT FORTHCOMING THERE WOULD BE NO FUND PROGRAMME. WE CONSIDER THAT THE AMERICANS, WHO BELIEVE THE PROGRAMME SHOULD NOT BE ALLOWED TO FAIL, WILL IN THE LAST RESORT FILL ANY GAP.

6. THE NEW TIMETABLE MAY MAKE IT IMPOSSIBLE TO RESCHEDULE IN THE PARIS CLUB IN THE WEEK OF 17 DECEMBER AS PLANNED. THE QUESTION OF UK PARTICIPATION IN THE PARIS CLUB DOES NOT NEED TO BE SETTLED IMMEDIATELY AND HAS YET TO BE CONSIDERED BY MINISTES.

7. FOR YOUR GUIDANCE, JURGENSEN HAS JUST TOLD US (PLEASE PROTECT) THAT THE US EMBASSY IN PARIS IS ASKING ABOUT THE SIZE OF ANY FRENCH CONTRIBUTION. HE SAYS HE HAS REFUSED TO GIVE A FIGURE. BUT FOLLOWING REFERENCE TO MINISTERS, THE FRENCH POSITION IS NOW 'A LITTLE MORE OPEN' THAN LAST WEEK. FRANCE IS PREPARED TO GIVE THE FUND, FOR ITS USE ONLY, AN INDICATIAN OF WHAT CREDIT MIGHT BE AVAILABLE FROM GOVERNMENT SOURCES AS A CONTRIBUTION TO THE 'CRITICAL MASS'. THIS IS, IN FACT, THE MECHANISM PROPOSED BY THE RECENT BRAU REPORT. JURGENSEN BELIEVES THAT FRG WILL ALSO REFUSE TO GIVE ANY FIGURE TO THE US, THOUGH PIESKE TOLD G5 DEPUTIES THAT FRG WOULD SOON RESUME LIMITED SHORT-TERM COVER. SO FAR, WE HAVE HAD NO APPROACH FROM THE US EMBASY IN LONDON.

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HD/ERD
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SIR R ARMSTRONG } CABINET OFFICE
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GRS 2000
RESTRICTED
DE SKBY 252000Z
FM UKDEL IMF/IBRD WASHINGTON 251628Z SEP 84
TO IMMEDIATE FCO
TELEGRAM NUMBER 206 OF 25 SEPTEMBER

FOLLOWING TELEGRAM NOW SENT TO YOU FOR ACTION AT REQUEST OF ORIGINATOR WAS SENT TO UKMIS NEW YORK TELNO 3 OF 23 SEPTEMBER.
BEGINS:
FM UKDEL IMF IBRD WASHINGTON 231941Z SEP 84
TO IMMEDIATE UKMIS NEW YORK
TELEGRAM NUMBER NOUMBER 003 OF 23 SEPTEMBER

FOR PRIVATE SECRETARY TO SECRETARY OF STATE

FOLLOWING IS TEXT OF CHANCELLOR OF EXCHEQUER'S STATEMENT TO THE DEVELOPMENT COMMITTEE ON SEPTEMBER 23.
FOR YOUR INFORMATION, THE TEXT HAS NOT (REPEAT NOT) BEEN MADE AVAILABLE TO OTHER PARTICIPANTS OR TO THE PRESS
BEGINS
1. MANY MINISTERS HERE OR THEIR COLLEAGUES TOOK PART IN OUR DISCUSSION IN YESTERDAY'S INTERIM COMMITTEE MEETING ABOUT WORLDV ECONOMY, OUR COMMUNIQUE RECORDED THE GREATLY IMPROVED PERFORMANCE AND OTULOOK WE SEE THIS YEAR, COMPARED WITH A YEAR AGO.

2. WE FOCUS TODAY ON THE PROBLEMS OF DEVELOPING COUNTRIES, I WELCOME THE WORLD DEVELOPMENT REPORT WHICH THE BAK STAFF HAVE PRESENTED TO US. THE EVIDENCE AND ACTUAL BENEFITS OF WORLD RECOVERY ARE NOT YET AS CLEARLY SEEN BY MANY DEVELOPING COUNTRIES AS BY INDUSTRIAL COUNTRIES. THIS MAY BE PARTLY A MATTER OF NATURAL DELAYS AS THE RECOVERY GENERATED FIRST IN THE UNDUSTRIAL COUNTRIES TAKES TIME

BE PARTLY A MATTER OF NATURAL DELAYS AS THE RECOVERY GENERATED FIRST IN THE UNDUSTRIAL COUNTRIES TAKES TIME TO SPREAD. IT IS PARTLY ALSO A REFLECTION OF DEEP-SEATED PROBLEMS IN MANY DEVELOPING COUNTRIES, AND OF THE SMALLER AND LESS VIGOUROUS ECONOMIC BASE ON WHICH THEY HAVE TO BUILD.

3. BUT THERE ARE SIGNS OF A BETTER CLIMATE. THE RAPID GROWTH OF WORLD TRADE- AN INCREASE OF AROUND 8 PER CENT THIS YEAR - HAS BEEN REFLECTED IN THE BALANCE OF PAYMENTS OF MANY DEVELOPING COUNTRIES. THEIR COLLECTIVE CURRENT ACCOUNT DEFICITS HAVE BEEN SHARPLY REDUCED. THJE HAVE BEEN PAINFUL CUTBACKS IN THEIR IMPORTS AND RATES OF GROWTH IN MANY CASES, BUT THERE ARE NOW PROSPECTS OF RESUMED GROWTH.

4. BEFORE TURNING TO THE IMMEDIATE ISSUES RAISED BY THE REPORT, IN PARTICULAR THE OPERATIOS OF THW WORLD BANK GROUP AND THE PROBLEMS OF AFRICA - LET ME SAY A LITTLE MORE ABOUT WHAT I HAVE REFERRED TO AS THE DEEP-SEATED PROBLEMS.

5. WE ARE FAMILIAR FROM MANY EARLIER MEETINGS AND COMMUNIQUES WITH QUESTIONS OF MORE OPEN MARKETS FOR TRADE, THE DEMANDS FOR, AND CONSTRAINTS ON, OFFICIAL AID AND HELP FROM MULTILATERAL INSTITUTIONS, AND THE NEED FOR PRIVATE INVESTMENT. INSIDE THE ECONOMIES OF DEVELOPING COUNTRIES THERE ARE COMPLEX PROBLEMS OF FINANCIAL AND ECONOMIC MANAGEMENT, OF THE PROPER ROLES OF PUBLIC AND PRIVATE SECTORS

IN UNDEVELOPED ECONOMIES, AND THE PURSUIT OF BALANCED DEVELOPMENT IN A COMPETITIVE WORLD.

6. AND DEVELOPING COUNTRIES HAVE TO TACKLE THESE PROBLEMS IN A WORLD ECONOMIC CLIMATE WHICH IS INEVITABLE DOMINATED BY THE PERFORMANCE OF MAJOR INDUSTRIAL COUNTRIES AND THE EFFECTS OF THE POLICIES OF THOSE COUNTRIES.

7. THERE IS PLAINLY NEED FOR A DIALOGUE ADDRESSED TO THESE DEEP-SEATED PROBLEMS - A DILAOGUE IN WHICH DEVELOPING AND DEVELOPED CUNTRIES CAN TOGETHER EXAMINE MEDIUM-TERM PROPECTS AND NEEDS IN A REALISTIC SPIRIT.

8. THIS WAS THE ESSENCE OF THE PROPOSAL OF THE LONDON SUMMIT THIS YEAR THAT FINACNE MINISTERS SHOULD CONSIDER THE SCOPE FOR INTENSIFIED DISCUSSION IN THIS DEVELOPMENT COMMITTEE OF INTERNATIONAL FINANCIAL ISSUES OF PARTICULAR CONCERN TO DEVELOPING COUNTRIES.

9. I SPENT TWO DAYS IN TORONTO LAST WEEK AT MEETINGS WITH MY FELLOW FINANCE MINISTERS OF THE COMMONWEALTH, WHICH INCLUDES MANY OF THE POOREST DEVELOPING COUNTRIES IN AFRICA, ASIA AND THE CARIBBEAN.

10. THOSE MEETINGS ALSO GAVE STRONG SUPPORT FOR WIDE-RANGING DISCUSSIONS BETWEEN DEVELOPED AND DEVELOPING COUNTRIES FOR WHICH THE DEVELOPMENT COMMITTEE COULD PROVIDE A FORUM.

11. YESTERDAY, RECOGNISING THAT SOME OF THE INTERESTS

11. YESTERDAY, RECOGNISING THAT SOME OF THE INTERESTS INVOLVED EHERE ARE APPROPRIATE TO THE INTERIM COMMITTEE, WE ENVISAGED PARALLEL MEETINGS OF THE INTERIM COMMITTEE AND THE DEVELOPMENT COMMITTEE AND THE DECISION WAS TAKEN TO HOLD AN INTERIM COMMITTEE MEETING FOR THIS PURPSOSE NEXT APRIL. I HOPE WE CAN DECIDE TODAY TO CARRY THE IDEA FORWARD WITH AN ARRANGEMENT FOR THIS COMMITTEE TO MEET AROUND THIS TIMMTO CONCENTRATE ON RELATED AREAS OF THE KIND I HAVE INDICATED.

12. LET ME SKETCH ONE OR TWO THOUGHTS I WOULD WANT TO FEED IN TO THESE DISCUSSIONS.

13. DEVELOPING COUNTRIES, INCLUDING THE MORE ADVANCED AMONG THEM, WHETHER DEBTORS OR NOT, WILL BE LOOKING FOR INFLOWS OF CAPITAL FOR A LONG TIME TO COME. THE CANNOT REALISTICALLY - NOR SHOULD THEY - RELY ON OFFICIAL AID OR LENDING FROM INTERNATIONAL INSTITUTIONS TO SATISFY ALL THEIR NEEDS.

14. JUST AS IN DEVELOPED COUNTRIES, AND IN SOME OF THE STRIKINGLY SUCCESSFUL DEVELOPING COUNTRIES OF ASIA, THEY NEED TO HELP FINANCE PRODUCTIVE INVESTMENT BY TAPPING PRIVATE CAPITAL IN ALL ITS FORMS. AND WHAT IS NEEDED IS LONG-TERM EQUITY INVESTMENT WHICH WILL AVOID THE ACUTE DEBT-SERVING PROBLEMS OF EXCESSIVE SHORT-TERM BANK FINANCE. WE NEED TO EXPLORE PRACTICAL WAYS AND MEANS.

15. ABOVE ALL, INVESTMENT REQUIRES CONFIDENCE. ONE OF THE TRAGEDIES IN MANY DEBTOR CUNTRIES - AND OTHER DEVELOPING COUNTRIES TOO - IS THAT THEY NOT ONLY HAVE DIFFICULTY IN ATTRACTING FOREIGN INVESTORS, BUT THEY HAVE LOST A HUGE VOLUME OF POTENTIAL INVESTMENT BY THE FLIGHT OF CAPITAL FROM THEIR OWN RESIDENTS.

16. I THEREFORE AGREEENTIRELY WITH THE IMPORTANCE THE WORLD DEVELOPMENT REPORT ATTACHES TO THE NEED FOR DEBTOR COUNTRIES TO ADOPT POLICIES THAT WILL RESTORE THE CONFIDENCE NOT MERELY OF THE OUTSIDE WORLD BUT OF THEIR WON PEOPLE. IN THIS CONTEXT IT IS IMPORTANT TO RECOGNISE THAT FOREIGN EXCHANGE CONTROLS ARE NOT - AND CANNOT BE - A SUBSTITUTE FOR RESTORING THAT CONFIDENCE. TO IMAGINE OTHERWISE IS AN ILLUSION.

WORLD BANK ISSUES

17. I TURN NOW TO THE IBRD AND ITS ASSOCIATED INSTITUTIONS. W WAS VERY PLEASED TO HAVE BEEN ABLE TO SUPPORT THE SELECTIVE CAPITAL INCREASE OF DLRS 8.4 BILLION, ALTHOUGH THIS MEANT ACCEPTING A REDUCTION IN THE UK'S SHARE AND RANKING, THUS ENABLING JAPAN TO TAKE SECOND PLACE AFTER THE US, CONSISTENT WITH HER ECONOMIC STRENGTH AND WORLDWIDE RESPONSIBILITIES.

18. THE LONDON SUMMIT ATTACHED QUOTE PARTICULAR IMPORTANCE TO ...STRENGTHENING THE ROLE OF IBRD IN FOSTERING DEVELOPMENT OVER THE MEDIUM AND LONG TERM UNQUOTE. MY GOVERNMENT SUPPORTS THIS WHOLEHEARTEDLY. I AM GLAD TO

DEVELOPMENT OVER THE MEDIUM AND LONG TERM UNQUOTE. MY GOVERNMENT SUPPORTS THIS WHOLEHEARTEDLY. I AM GLAD TO KNOW THAT THE BANK IS STUDYING ITS FUTURE ROLE AND WILL BE BRINGING PROPOSALS BEFORE US NEXT YEAR. I ASSUME THAT THESE WILL CINLUDE WAYS OF STRENGTHENING ITS CAPITAL BASE. THE UK IS READY TO JOIN IN CONSIDERATION OF A FUTRE GENERAL CAPITAL INCREASE, ALTHOUGH THERE WILL, OF COURSE, BE MANY QUESTIONS TO RESOLVE, SUCH AS THE ABSOLUTE SIZE OF THE INCREASE, THE PROPORTION THAT SHOULD BE PAID - IN AND SO ON.

19. THRE WILL BE OTHER IMPORTANT ISSUES TO CONSIDER ALSO. THESE INCLUDE THEBALANCE BETWEEN TRADITIONAL PROJECT LENDING, WHICH REPRESENTS THE CENTRAL PART OF THE BANK'S OPERATIONS, AND THE VARIETY OF MORE FLEXIBLE FORMS OF ASSISTANCE THAT HAVE DEVELOPED IN RECENT YEARS. IT IS OF CENTRAL IMPORTANCE, AND IN THE INTERESTS OF BORROWING MEMBERS, THAT THE BANK'S LENDING SHOULD SUPPORT SOUND POLICIES FOR ADJUSTMENT AND DEVELOPMENT.

20. BESIDES BEING A PROVIDER OF FUNDS, THE BANK IS A SETTER OF STANDARDS, AN INNOVATOR AN A COORDINATOR. I THEREFORE PARTICULARLY STRONGLY SUPPORT ITS IDEAS FOR INCREASED CO-FINANCING. A ALSO WARMLY WELCOME THE INTEREST THE BANK IS TAKING IN IDEAS FOR INVESTMENT INSURANCE. THE WHOLE QUESTION OF COOPERATION BETWEEN THE BANK AND THE FUNDS NEEDS TO BE EXAMINED AFRESH. COLLABORATION OF THIS KIND WILL HELP TO REASSSURE THE PRIVATE INVESTER ABOUT THE LONG-TERM HELATH OF DEVELOPING ECONOMIES, AND WILL ENCOURAGE A GREATER FLOW OF PRIVATE FUNDS.

21. HERE I WELCOME THE REPORT FROM THE INTERNATIONAL FINANCE CORPORATION. THE IFC IS A CATALYST IN THE PROCESS OF MOBILISING PRIVATE INVESTMENT. IT HAS A DISTINGUISHED RECORD IN PROMOTING DEVELOPMENT IN A WIDE RANGE OF COUNTRIES. IT IS NOW WELL- EQUIPPED TO DEVELOP ITS ROLE SIGNIFICANTLY. I HOPE TO SEE PROGRESS IN ITS ABILITY TO ATTRACT GREATER FLOWS, AND NEW KINS OF FLOWS, OF PRIVATE INVESTMENT.

22. I WISH WE COULD HAVE RECORDED EQUAL SUCCESS IN PROMOTING THE ACTIVITIES OF IDA. THE UK HAS BEEN A LEADING SUPPORTER OF IDA AND WE WOULD HAVE BEEN GLAD TO JOIN IN ON IDA 7 OF DLRS 12 BILLION, OR IN THE SUGGESTED SUPPLEMENTARY FUND. WE ATTACH IMPORTANCE TO THE REVIEW OF THE IDA 7 REPLENSHMENT WHICH IT IS AGREED SHOULD BE CONDUCTED NEXT YEAR.

AFRICA

23. I TURN NOW TO THE ACTUE PROBLEMS OF SUB-SAHARAN AFRICA ON WHICH IT IS RIGHT THAT WE SHOULD FOCUS OUR ATTENTION. HISTORY HAS GIVEN THE UK STRONG TIES WITH MANY OF THESE CUNTRIES AND I REITERATE OUR COMMITMENT TO HELPING TO SOLVE THE PROBLEMS OF THIS AGONISINGLY HARD-PRESSED REGION OF THE WORLD. THIS

OUR ATTENTION. HISTORY HAS GIVEN THE UK STRONG TIES
WITH MANY OF THESE CUNTRIES AND I REITERATE OUR
COMMITMENT TO HELPING TO SOLVE THE PROBLEMS OF THIS
AGONISINGLY HARD-PRESSED REGION OF THE WORLD. THIS IS REFLECTED IN THE SUBSTANTIAL AMOUNT OF OUR BILATERAL AID WHICH GOES TO SUB-SAHARAN COUNTRIES- AMOUNTING LAST YEAR TO SOME POUNDS STERLING 236 MILLION.

24. I WELCOME THE LATEST REPORT. IT IS A THOROUGH AND COMPREHENSIVE STUDY. IT IS SIGNIFICANT THAT THE ANALYSIS OF SUB-SAHRAN PROBLEMS IS NOW GENERALLY ACCCEPTED,. IT IS RIGHT TO EMPHASISE THE PROPER OPERATION, REHABILITATION, MAINTENANCE AND FULLER USE OF EXISTING ASSESTS. MANY AFRICAN GOVERNMENTS ARE NOW ACTING TO REFORM ECONOMIC POLICIES. AND I BELIEVE A GROWING NUMBER APPRECIATE THE BENEFITS TO BE GAINED FROM ACCEPTING AND ENCOURAGING INWARD PRIVATE INVESTMENT. BUT THERE IS A NEED FOR SUSTAINED EFFORT ON THE PART OF GOVERNMENTS. MNAY STILL HAVE TO ADDRESS FUNDAMENTAL ISSUES.

25. THE REPORT'S CRITICISM OF SOME OF THE PAST PRACTICES OF DONORS IS JUSTIFIED. MUCH OF OUR AID IS NOW IN A FORM DESIGNED TO IMPROVE THE YIELD OF PAST INVESTMENTS AND WE ARE CINCREASINGLY ALLOCATING AID IN SUPPORT OF STRUCTURAL ADJUSTMENT PROGRAMMES AGREED WITH THE FUND OR BANK. I BELIEVE THIS IS A PARTICULARLY USEFUL FORM OF AID, AND I URGE FELLOW DONORS TO EXAMINE AGAIN THEIR RESTRICTIONS ON NON-PROJECT AID AND AID FOR RECURRENT COSTS.

26. THE REPORT IS RIGHT TO STRESS THE BEFEFITS OF BETTER COORDINATION BEWTWEEN DONORS AND RECIPIENT GOVERNMENTS. WE AGREE THAT THE WORLD BANK SHOULD BE PREPARD TO PLAY A LARGER ROLE HERE, AS PROPOSED IN THE REPORT. BUT IT REQURES THE FULL COOPERATION OF AFRICAN GOVERNMENTS AND THE SUPPORT OF ALL DONORS. REAL GAINS COULD BE ACHIEVED THROUGH CONCERTED EFFORTS OF THIS KIND, SUPPORTING SOUND DEVELOPMENT POLICIES.

27. MR CHAIRMAN IT IS NOW TWO YEARS CINCE YOU TOOK OVER THE CHAIR OF THIS COMMITTEE. WE HAVE ALL ADMIRED THE FIRMNESS AND CONSISTENCY OF PURPOSE WITH WHICH YOU HAVE GUIDED THE ECONOMY OF PAKISTAN: AND YOU HAVE BROUGHT THE SAME QUALITIES OF FORMNESS AND CONSISTENCY, MIXED WITH COURTESY AND GOOD HUMOUR, TO THE TAKS OF GUIDING THE PROCEEDINGS OF THIS COMMITTEE.

ENDS

FCO PASS DESKBY 260800Z MRS DIGGLE TREASURY.

WICKS

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MR JEREMY THOMAS
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SIR R ARMSTRONG
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PS/CHANCELLOR
PERM. SECRETARY
SECOND PERM. SEC. O.F.
MR J B UNWIN
MR P MOUNTFIELD
MR R G LAVELLE
MRS P C DIGGLE DB 260800Z
OVERSEAS SECTION (7) } TREASURY

MR LOEHNIS
MR M J NALFOUR
MR GILCHRIST } BANK OF ENGLAND

PS/MINISTER OF TRADE
MR R WILLIAMS } DTI

UNCLASSIFIED
DESKBY 252000Z
FM UKDEL IMF/IBRD WASHINGTON 251626Z SEP
TO IMMEDIATE FCO
TELEGRAM NUMBER 205 OF 25 SEPTEMBER

IMMEDIATE
ADVANCE COPY

FOLLOWING TELEGRAM NOW SENT TO YOU FOR ACTION AT REQUEST OF ORIGINATOR WAS SENT TO UKMIS NEW YORK TELNO 2 OF 23 SEPTEMBER.
BEGINS:
FM UKDELIMF IBRD WASHINGTON 231940Z SEP 84

TO IMMEDIATE UKMIS NEW YORK
TELEGRAM NUMBER 002 OF 23 SEPTEMBER

MIPT
FOR PRIVATE SECRETARY TO SECRETARY OF STATE
FOLLOWING IS TEXT OF COMMUNIQUE ISSUED AFTER THE INTERIM COMMITTEE MEETING ON SEPTEMBER 22.
BEGINS
1. THE INTERIM COMMITTEE OF THE BOARD OF GOVERNORS OF THE INTERNATIONAL MONETARY FUND HELD ITS TWENTY-THIRD MEETING IN WASHINGTON DC ON SEPTEMBER 22 1984, UNDER THE CHAIRMANSHIP OF MR WILLI DE CLERQ, VICE-PRIME MINISTER AND MINISTER OF FINANCE AND FOREIGN TRADE OF BELGIUM. MR JACQUES DE LAROSIERE, MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND, PARTICIPATED IN THE MEETING. THE MEETING WAS ALSO ATTENDED BY OBSERVERS FROM A NUMBER OF INTERNATIONAL AND REGIONAL ORGANIZATIONS AND FROM SWITZERLAND.

2. IN THEIR DISCUSSION OF THE WORLD ECONOMIC OUTLOOK, MEMBERS OF THE COMMITTEE EXPRESSED SATISFACTION THAT ECONOMIC GROWTH IN THE INDUSTRIAL WORLD HAD BEEN PROCEEDING DURING 1984 AT A 5 PERCENT RATE- EVEN MORE RAPIDLY THAN EXPECTED. THEY NOTED THAT INVESTMENT HAD DISPLAYED PARTICULAR STRENGTH, AND THAT INFLATION HAD REMAINED UNDER CONTROL. CONCERN WAS VOICED, HOWEVER, THAT EUROPEAN COUNTRIES

RATE- EVEN MORE RAPIDLY THAN EXPECTED. THEY NOTED THAT INVESTMENT HAD DISPLAYED PARTICULAR STRENGTH, AND THAT INFLATION HAD REMAINED UNDER CONTROL. CONCERN WAS VOICED, HOWEVER, THAT EUROPEAN COUNTRIES HAD NOT YET PARTICIPATED FULLY IN THE RECOVERY AND THE UNEMPLOYMENT IN THESE COUNTRIES REMAINED AT VERY HIGH LEVELS. THE COMMITTEE EXPRESSED CONCERN THAT THE POSITION OF MANY DEVELOPING COUNTRIES REMAINED DIFFICULT. NONETHELESS, IN A NUMBER OF THE DEVELOPING COUNTRIES, THE FURTHER REDUCTION ON CURRENT ACCOUNT DEFICITS THAT WAS IN PROSPECT WAS VIEWED AS ENCOURAGING, ESPECIALLY AS IT STEMMED INCREASINGLY FROM EXPORT GROWTH, AND WAS BEING ACCOMPANED BY A RETURN TO POSITIVE GROWTH IN PER CAPITA INCOMES.

THE COMMITTEE AGREED THAT CONTINUED PURSUIT OF A MEDIUM-TERM STRATEGY WAS APPROPRIATE TO SUSTAIN RECOVERY. SUCH A STRATEGY WOULD INVOLVE, IN PARTICULAR, A DISINFLATIONARY MONETARY POLICY, FURTHER ACTION TO IMPROVE THE STRUCTURE OF GOVERNMENT BUDGETS AND REDUCE DEFICITS, PRIMARILY THROUGH REDUCED SPENDING, AND A DETERMINED ATTACK ON STRUCTURAL RIGIDITIES, INCLUDING PROTECTIONIST MEASURES, WHICH IMPEDE THE EFFICIENT FUNCTIONING OF MARKETS.

3. WHILE THE EXTERNAL DEBT PROBLEMS OF MANY DEVELOPING COUNTRIES REMAIN SERIOUS, THE COMMITTEE FELT THAT GOOD PROGRESS HAD BEEN MADE IN THE IMPLEMENTATION OF THE COORDINATED STRATEGY OF DEBTORS AND CREDITORS TO TACKLE THE PROBLEMS WITHIN THE FRAMEWORK OF ADJUSTMENT PROGRAMS -- A DEVELOPMENT THAT HAS BEEN FACILITATED BY THE RECOVERY IN WORLD TRADE. THE COMMITTEE STRESSED THAT A SATISFACTORY RESOLUTION OF DEBT PROBLEMS WOULD CONTINUE TO REQUIRE CLOSE COOPERATION AMONG ALL PARTIES CONCERNED. IN THIS CONNECTION, IT IS IMPORTANT THAT REASONABLE ECONOMIC GROWTH BE MAINTAINED IN INDUSTRIAL COUNTRIES, THAT REAL INTEREST RATES COME DOWN SUBSTANTIALLY FROM CURRENT LEVELS, AND THAT THE INDEBTED COUNTRIES THEMSELVES PURSUE DETERMINED ADJUSTMENT POLICIES. THE MAJOR INDUSTRIAL COUNTRIES HAVE A SPECIAL RESPONSIBILITY TO PURSUE POLICIES THAT RESULT IN NONINFLATIONARY GROWTH, AND PERMIT DEVELOPING COUNTRIES ADEQUATE ACCESS TO MARKETS. THERE IS ALSO A CONTINUING NEED FOR ADEQUATE FINANCING TO ENCOURAGE AND FACILITATE EFFECTIVE ADJUSTMENT. THE BORROWING COUNTRIES THEMSELVES HAVE TO MAKE THE FUNDAMENTAL CONTRIBUTION BY PERSEVERING WITH PROGRAMS OF ECONOMIC ADJUSTMENT THAT STRENGTHEN THEIR EXTERNAL POSITION, LAY THE BASIS FOR A MORE EFFECTIVE UTILIZATION OF RESOURCES, AND THEREBY RESTORE CREDITWORTHINESS AND PERMIT THE RESUMPTION OF GROWTH AT AN EARLY DATE. IN THIS CONNECTION, THE COMMITTEE WELCOMED THE INITATIVES TOWARD MULTIYEAR DEBT RESCHEDULING ARRANGEMENTS IN CASE OF EFFECTIVE ADJUSTMENT. THE COMMITTEE ALSO STRESSED THE IMPORTANCE OF A CONTINUING FUND ROLE IN THE IMPLEMENTATION OF THE COORDINATED STRATEGY OF EXTERNAL DEBT MANAGEMENT.

4. THE COMMITTEE EXPRESSED CONCERN OVER THE CONTINUED RESORT TO PROTECTIONIST MEASURES. IT NOTED THAT THE DRIFT TOWARDS PROTECTIONISM, IF UNCHECKED, WOULD UNDERMINE THE PROSPECTS FOR WORLD RECOVER
Y
AND WOULD IMPEDE THE SMOOTH FUNCTIONING OF THE INTERNATIONAL TRADING AND FINANCING SYSTEM. THE COMMITTEE, THEREFORE, WELCOMED THE COMMITMENTS TO OPEN TRADE POLICIES UNDERTAKEN AT THE LONDON SUMMIT OF MAJOR INDUSTRIAL COUNTRIES WHICH HAVE A LARGE WEIGHT IN WORLD TRADE, AND IN OTHER INTERNATIONAL FORA IN THE RECENT PAST. WHILE WELCOMING SOME RECENT ACTIONS IN SOME COUNTRIES TO RESIST

WHILE WELCOMING SOME RECENT ACTIONS IN SOME COUNTRIES TO RESIST PROTECTIONIST PRESSURES, IT CALLED ON ALL MEMBERS TO TRANSLATE GENERAL COMMITMENTS INTO CONCRETE ACTIONS TO PREVENT NEW, AND TO ROLL BACK EXISTING, PROTECTIONIST MEASURES.

THE COMMITTEE CALLED ATTENTION TO THE NEED FOR IMPROVED ACCESS TO FOREIGN MARKETS FOR THE EXPORTS OF DEVELOPING COUNTRIES AS AN IMPORTANT ELEMENT IN SUPPORTING THE ADJUSTMENT EFFORTS OF THESE COUNTRIES AND IN CONTRIBUTING TO A LONG-TERM SOLUTION OF THE DEBT PROBLEM. THE COMMITTEE ALSO EMPHASIZED THE IMPORTANCE OF INCREASED AND EFFECTIVE INTERNATIONAL SURVEILLANCE OF TRADE POLICIES. IN THIS REGARD, IT CONSIDERED THAT THE FUND SHOULD CONTINUE TO GIVE SPECIAL ATTENTION TO THE PROBLEM OF PROTECTIONISM IN THE CONTEXT OF ITS SURVEILLANCE FUNCTION, AND IN SUPPORT OF THE EFFORTS OF THE GATT AND OTHER INSTITUTIONS HAVING RESPONSIBILITIES IN THIS FIELD.

5. IT WAS AGREED THAT, AT ITS NEXT MEETING, THE INTERIM COMMITTEE WILL DISCUSS, IN A MEDIUM TERM FRAMEWORK AND IN THE CONTEXT OF THE GLOBAL FINANCIAL ENVERONMENT AND THE CURRENT APPROACHES TOWARD RESOLVING DEBT PROBLEMS CERTAIN ISSUES RELATING TO THE ADJUSTMENT EFFORTS AND BALANCE OF PAYMENTS PROSPECTS OF MEMBER COUNTRIES. THESE WILL INCLUDE EXTERNAL INDEBTEDNESS, INTERNATIONAL CAPITAL FLOWS, TRADE POLICIES, AND THE ROLE OF FUND SURVEILLANCE IN DEALING WITH THESE ISSUES. IN THIS CONNECTION, IT CALLED ON THE MANAGING DIRECTOR TO PREPARE, IN THE FRAMEWORK OF THE FUND'S COMPETENCE, BACKGROUND PAPERS FOR CONSIDERATION BY THE EXECUTIVE BOARD, AND TO REPORT TO THE NEXT MEETING OF THE COMMITEEE, IN ORDER TO PROVIDE A BASIS FOR ITS DISCUSSION OF THESE ISSUES.

6. THE COMMITTEE DISCUSSED THE QUESTION OF THE FUND'S POLICY ON ENLARGED ACCESS AND THE LIMITS ON ACCESSS TO THE FUND'S RESOURCES IN 1985. IT WAS RECALLED THAT THE FUND'S POLICY ON ENLARGED ACCESS IS A FACILITY OF A TEMPORARY CHARACTER AND THAT THIS POLICY AND THE ACCESS LIMITS UNDER IT, AS WELL AS THE ACCESS LIMITS UNDER THE FUNDS SPECIAL FACILITIES, WERE TO BE REVIEWED BEFORE THE END OF 1984.

THE COMMITTEE RECOGNISED THAT, IN SPITE OF THE IMPROVEMENT IN THE WORLD ECONOMIC SITUATION, MANY MEMBER COUNTRIES CONTINUED TO FACE DIFFICULT PAYMENTS PROBLEMS AND THAT SERIOUS UNCERTAINTIES REMAINED ABOUT THE PROSPECTS IN THE MEDIUM TERM. IN THESE CIRCUMSTANCES, THE COMMITTEE AGREED THAT THERE WAS A NEED FOR THE CONTINUATION OF THE ENLARGED ACCESSS POLICY AND IT REACHED THE FOLLOWING CONCLUSIONS ON THE ACCESS LIMITS FOR 1985:

A. ACCESS UNDER THE ENLARGED ACCESS POLICY IN 1985 SHOULD BE SUBJEC
T
TO ANNUAL LIMITS OF 95 OR 115 PERCENT OF QUOTA, THREE-YEAR LIMITS OF 280 OR 345 PERCENT OF QUOTA, AND CUMULATIVE LIMITS OF 408 OR 450 PERCENT OF QUOTA, DEPENDING ON THE SERIOUSNESS OF THE BALANCE OF PAYMENTS NEED AND THE STRENGTH OF THE ADJUSTMENT EFFORT. AS AT PRESENT, THE EXECUTIVE BOARD SHOULD RETAIN THE FLEXIBILITY TO APPROVE STAND-BY OR EXTENDED ARRANGEMENTS FOR AMOUNTS ABOVE THESE ACCESS LIMITS IN EXCEPTIONAL CIRCUMSTANCES.

B. THE PRESENT ACCESS LIMITS UNDER THE SPECIAL FACILITIES SHOULD BE RETAINED.

B. THE PRESENT ACCESS LIMITS UNDER THE SPECIAL FACILITIES SHOULD BE RETAINED.

C. AS AT PRESENT, ACCESS LIMITS SHOULD NOT BE REGARDED AS TARGETS. THESE LIMITS, AND THE ENLARGED ACCESS POLICY ITSELF, SHOULD BE REVIEWED BEFORE THE END OF 1985, AND YEARLY THEREAFTER, IN LIGHT OF ALL RELEVANT FACTORS, INCLUDING THE MAGNITUDE OF MEMBERS' PAYMENTS PROBLEMS AND DEVELOPMENTS IN THE FUND'S LIQUIDITY POSITION.

THE COMMITTEE REQUESTED THE EXECUTIVE BOARD TO COMPLETE, BEFORE THE END OF THIS YEAR, THE NECESSARY ACTION IN ORDER TO IMPLEMENT THE CONCLUSIONS REACHED BY THE COMMITTEE.

7. THE COMMITTEE CONSIDERED AGAIN THE QUESTION OF AN SDR ALLOCATION AGAINST THE BACKGROUND OF THE STATE OF INTERNATIONAL LIQUIDITY AND THE CONDITIONS OF THE WORLD ECONOMY. IN THIS CONNECTION, IT NOTED THE STATEMENT OF THE MANAGING DIRECTOR ON THE DISCUSSIONS ON THE SUBJECT IN THE EXECUTIVE BOARD.

MOST MEMBERS OF THE COMMITTEE EXPRESSED AGAIN THEIR FIRM VIEW THAT THERE WAS A LONG TERM GLOBAL NEED TO SUPPLEMENT EXISTING RESERVE ASSETS AND THAT AN ALLOCATION OF SDRS IN PRESENT CIRCUMSTANCES WOULD BE IN FULL CONFORMITY WITH THE REQUIREMENTS OF THE FUND'S ARTICLES, AND WOULD STRENGTHEN THE WORLD ECONOMY AND THE INTERNATIONAL MONETARY SYSTEM. SOME MEMBERS OF THE COMMITTEE, HOWEVER, CONTINUED TO FEEL THAT A GLOBAL LIQUIDITY SHORTAGE HAD NOT BEEN DEMONSTRATED. IN THEIR VIEW, THE PROBLEMS FACED BY SOME COUNTRIES WITH RESERVE INADEQUACIES SHOULD BE MET THROUGH ADJUSTMENT IN ECONOMIC POLICIES AND THE PROVISION OF CONDITIONAL FINANCING.

WHILE NO CONCLUSION WAS REACHED AT THIS MEETING, THE COMMITTEE RECOGNIZED THAT THE MATTER SHOULD BE KEPT UNDER CLOSE AND CONTINUING CONSIDERATION. THEREFORE, IT URGED THE EXECUTIVE BOARD TO CONTINUE ITS EXAMINATION OF THE ISSUES INVOLVED. THE MAJORITY OF THE MEMBERS OF THE COMMITTEE AGREED THAT EFFORTS SHOULD CONTINUE TOWARDS THE ACHIEVEMENT OF A BROAD CONSENSUS ON AN SDR ALLOCATION IN THE CURRENT BASIC PERIOD.

8. THE COMMITTEE AGREED TO HOLD ITS NEXT MEETING IN WASHINGTON DC IN APRIL 1985.

ENDS

FCO PLEASE PASS DESKBY 260800Z MRS DIGGLE TREASURY.

WICKS

NNNN

[redacted]

ADVANCE COPIES 99

PS (2)
PS/PUS
SIR C TICKELL
MR JEREMY THOMAS
...............(GEOG DUS)
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HD/ERD
HD/......(GEOG)
HD/ECONOMIC ADVISERS
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RESIDENT CLERK

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SIR R ARMSTRONG
MR BUCKLEY
MR B CARTLEDGE
} CABINET OFFICE

PS/CHANCELLOR
PERM. SECRETARY
SECOND PERM. SEC. O.F.
MR J B UNWIN
MR P MOUNTFIELD
MR R G LAVELLE
MRS P C DIGGLE DB 260800Z
OVERSEAS SECTION (7)
} TREASURY

MR LOEHNIS
MR M J NALFOUR
MR GILCHRIST
} BANK OF ENGLAND

PS/MINISTER OF TRADE
MR R WILLIAMS
} DTI

GRS 2400
RESTRICTED
DESKBY 252000Z
FM UKDEL IMF/IBRD WASHINGTON 251624Z SEP 84
TO IMMEDIATE FCO
TELEGRAM NUMBER 204 OF 25 SEPTEMBER

IMMEDIATE

ADVANCE COPY

FOLLOWING TELEGRAM SENT TO YOU FOR ACTION AT REQUEST OF ORIGINATOR.
WAS SENT TO UKMIS NEW YORK TELNO 1 OF 23 SEPT.
BEGINS:
FM UKDEL IMF/IBRD WASHINGTON 231939Z SEP 84
TO IMMEDIATE UKMIS NEW YORK
TELEGRAM NUMBER 001 OF 23 SEPTEMBER

FOR PRIVATE SECRETARY TO SECRETARY OF STATE
FOLLOWING IS TEXT OF CHANCELLOR OF EXCHEQUER'S STATEMENT TO THE INTERIM COMMITTEE ON SEPTEMBER 22. FOR YOUR INFORMATION, THE TEXT HAS NOT (REPEAT NOT) BEEN MADE AVAILABLE TO OTHER PARTICIPANTS OR TO THE PRESS.
BEGINS

1. MR CHAIRMAN, YOU ARE PRESIDING OVER OUR DISCUSSIONS TODAY IN THE KNOWLEDGE THAT THIS PARTICULAR SET OF RESPONSIBILITIES WILL SHORTLY COME TO AN END. WE WISH YOU WELL IN YOUR IMPORTANT NEW ROLE. MEANWHILE, WE WILL NEED, AND I KNOW WE WILL RECEIVE, THE BENEFIT OF YOUR GOOD SENSE AND EXPERIENCE TO GUIDE US TODAY AS IT HAS IN THE PAST.

THE WORLD RECOVERY

2. THE WORLD RECOVERY IS PROVING STRONGER THAN MANY EXPECTED A YEAR AGO WITH PARTICULARLY RAPID GROWTH IN THE UNITED STATES, AND A MORE GRADUAL UPTURN IN OTHER INDUSTRIAL COUNTRIES. THE RISE IN ACTIVITY IN THE INDUSTRIAL WORLD, COUPLED WITH THE ADJUSTMENT EFFORTS OF DEVELOPING COUNTRIES, HAS BROUGHT A SHARP REDUCTION IN THE CURRENT PAYMENTS DEFICITS OF MANY DEBTOR COUNTRIES. A PARTICULARLY WELCOME FEATURE OF THE PRESENT

PAYMENTS DEFICITS OF MANY DEBTOR COUNTRIES. A PARTICULARLY WELCOME FEATURE OF THE PRESENT SITUATION IS THAT WORLD TRADE SEEMS LIKELY TO RISE BY A HEALTHY 8 PER CENT THIS YEAR AFTER FOUR YEARS OF VIRTUAL STAGNATION.

3. THE UNDERLYING FACTORS BEHIND THE RECOVERY HAVE BEEN THE FIRM EFFORTS MANY OF US HAVE MADE TO REDUCE INFLATION, CURB BUDGET DEFICIT
S
AND TO REMOVE THE RIGIDITIES THAT AFFECT SO MANY OF THE ECONOMIES. WE MUST CONTINUE WITH THESE POLICIES, WITH RENEWED DETERMINATION.

4. IN THE UNITED KINGDOM, AS A RESULT OF THESE POLICIES, WE ARE NOW IN THE FOURTH YEAR OF ECONOMIC RECOVERY, WHILE INFLATION HAS REMAINED RELATIVELY LOW AT 5 PER CENT.

5. IN RECENT YEARS THE EMPHASIS OF POLICY IN MANY COUNTRIES, INCLUDING THE UK, HAS BEEN ON FINANCIAL STABILIATION. AND WE HAVE SEEN THE BENEFITS OF THAT STABILISATION. BUT WHILE MAINTAINING THIS IMPROVE MACRO POLICY WE MUST NOW PLACE MORE EMPHASIS ON MICRO-ECONOMIC AND STRUCTURAL PROBLEMS, WHICH ARE THE CAUSE OF THE CONTINUING HIGH LEVEL OF UNEMPLOYMENT WHICH SO MANY OF US FACE TODAY.

6. IMPROVED MICRO POLICIES INVOLVE DIFFICULT CHOICES -- JUST AS WITH IMPROVED MACRO POLICY.

THE UK IS DETERMINED TO CONTINUE TO OPERATE POLICY TOWARDS THE TWIN OBJECTIVES OF MICRO AND MACRO POLICY:

- A MACRO POLICY DESIGNED TO KEEP INFLATION LOW
- A MICRO POLICY DESIGNED TO IMPROVE PRODUCTIVE POTENTIAL AND ENSURE ADEQUATE EMPLOYMENT PROSPECTS IN THE FUTURE.

DIALOGUES

7. THE ISSUES RAISED BY RECOVERY HAVE REMINDED US ALL OVER AGAIN OF THE INTERDEPENDENCE OF THE FORTUNES OF DEVELOPING AND DEVELOPED COUNTRIES. WE SHARE AN INTEREST IN RE-EXAMING ASPECTS OF THE INTERNATIONAL MONETARY SYSTEM, THE ROLES OF MULTILATERAL INSTITUT-IONS, PROBLEMS OF FLOWS OF RESOURCES, OF INVESTMENT AND DEBT, AND OF TRADE AND PROTECTIONISM.

8. THE LONDON ECONOMIC SUMMIT IN JUNE OF THIS YEAR RESPONDED POSITIVELY TO MANY DEVELOPING COUNTRIES' UNDERSTANDABLE REQUEST FOR A DIALOGUE ON THESE MATTERS.

9. AS SECRETARY REGAN HAS REMINDED US, THE LONDON ECONOMIC SUMMIT DECLARATION OF THE HEADS OF GOVERNMENT OF THE 7 MAJOR INDUSTRIAL-ISED COUNTRIES EXPLICITLY ASKED THEIR FINANCE MINISTERS TO CONSIDER THE SCOPE FOR INTENSIFIED DISCUSSION OF INTERNATIONAL FINANCIAL ISSUES OF PARTICULAR CONCERN TO DEVELOPING COUNTRIES WITHIN THE DEVELOPMENT COMMITTEE OF THE BANK AND FUND. AT THE COMMONWEALTH FINANCE MINISTERS' MEETING IN TORONTO EARLIER THIS WEEK WE CONCLUDED THAT A SPEICAL MEETING OF THE DEVELOPMENT COMMITTEE SHOULD BE HELD NEXT SPRING FOR THIS PURPOSE.

10. I THEREFORE WELCOME SECRETARY REGAN'S RESPONSE TO THE LONDON SUMMIT INITIATIVE.

11. HE HAS PROPOSED AVARIANT OF THE ORIGINAL PROPOSAL, UNDER WHICH THERE SHOULD BE A SPECIAL DISCUSSION IN THE INTERIM COMMITTEE AS WELL AS IN THE DEVELOPMENT COMMITTEE. CLEARLY THE FUND WILL NEED

THERE SHOULD BE A SPECIAL DISCUSSION IN THE INTERIM COMMITTEE AS WELL AS IN THE DEVELOPMENT COMMITTEE. CLEARLY THE FUND WILL NEED TO BE DEEPLY INVOLVED, WHATEVER HAPPENS, SINCE MANY OF THE ISSUES TO BE DISCUSSED FALL WITHIN ITS COMPETENCE. AND CLEARLY THE PAPERS ON THESE ISSUES WILL NEED TO BE PREPARED BY THE FUND.

12. BUT THE PRECISE QUESTION OF WHETHER WE NEED A SPECIAL MEETING OF THE INTERIM COMMITTEE AS WELL AS THE DEVELOPMENT COMMITTEE, OR WHETHER WE SHOULD BEGIN WITH A MEETING OF THE DEVELOPMENT COMMITTEE, WHICH WOULD THEN BE ABLE TO REFER TO THE INTERIM COMMITTEE ANY PROPOSALS ON MATTERS WHICH CLEARLY FALL WITHIN THE COMPETENCE OF THE FUND, IS SOMETHING ON WHICH IT WOULD BE FOOLISH TO TAKE A DOGMATIC POSITION. LET US SEE WHICH PROPOSAL COMMANDS THE GREATEST DEGREE OF ACCEPTANCE. WHAT IS IMPORTANT IS THAT THE DIALOGUE TAKES PLACE, AND DOES SO FIRMLY WITHIN THE FRAMEWORK OF OUR EXISTING INTERNATIONAL FINANCIAL INSTITUTIONS.

13. I NOW TURN TO THE QUESTION OF SDRS.

14. I AM NOT PERSUADED OF THE CASE FOR AN ALLOCATION OF SDRS ON THE CRITERIA WE ARE REQUIRED TO APPLY TO THIS DECISION.

15. NOR AM I IMPRESSED BY ARGUMENTS THAT ARE SOMETIMES ADDUCED TO BOLSTER THE CASE WHICH RELY ON AN OUTDATED VIEW OF THE ROLE OF THE SDR IN THE SYSTEM.

16. MOREOVER, I DOUBT IF AN ALLOCATION WOULD HAVE A HELPFUL BEARING ON THE REAL PROBLEMS WE HAVE TO CONSIDER. IT COULD INSTEAD BE AN UNHELPFUL DISTRACTION.

17. LET ME EXPLAIN BRIEFLY WHY I REACH THESE CONCLUSIONS.

18. FIRST, THE QUESTION OF CRITERIA. IN AN EXCHANGE RATE SYSTEM WHERE THE MAJOR CURRENCIES FLOAT, THE REQUIREMENT FOR RESERVES IS LESS THAN IT USED TO BE. IT IS ALSO THE CASE -- AND THE DEBT PROBLEM ITSELF BEARS WITNESS TO THIS -- THAT OVER THE LAST DECADE POTENTIAL SOURCES OF LIQUIDITY FOR CREDITWORTHY BORROWERS HAVE INCREASED BEGIN SQUARE BRACKETS LAST WORD UNDERLINED END SQUARE BRACKETS. HOWEVER, EVEN WITHOUT REFERENCE TO THESE POINTS I SEE NO REASON TO BELIEVE THAT GLOBAL RESERVES ARE INADEQUATE. NON-GOLD RESERVES HAVE INCREASED BY 12 PER CENT SINCE THE END OF 1982. IN GLOBAL TERMS, PRESENT LEVELS RELATIVE TO IMPORTS ARE CLOSE TO THE AVERAGE OF THE 1970S. FINALLY, WE ARE ALSO REQUIRED TO TAKE A LONG-TERM VIEW. THE PROSPECT FOR THE PERIOD AHEAD IS THAT CENTRAL BANKS WILL HAVE THE OPPORTUNITY TO INCREASE THEIR HOLDINGS OF DOLLARS
.

19. SECOND, THE ROLE OF THE SDR. AN IMPORTANT ELEMENT OF THE ARGUMENT FOR AN ALLOCATION HAS THE FLAVOUR OF GIVING THE SDR THE BENEFIT OF THE DOUBT ON SOME GENERAL PHILOSOPHIC GROUNDS. BUT I THINK A FAIRER WAY OF LOOKING AT IT WOULD BE TO RECOGNISE THAT THE CIRCUMSTANCES WHICH LED US TO SEEK TO DEVELOP THE SDR NO LONGER EXIST. THE SYSTEM WE HAVE IS A MULTICURRENCY RESERVE SYSTEM. THAT IS ONE REASON WHY I WELCOME RECENT MOVES TO INTERNATIONALISE THE YEN.

20. THIRDLY, THE DISTRACTION POINT. AN ALLOCATION OF SDR WILL NOT SOLVE THE DEBT PROBLEM. IT WILL NOT SOLVE THE PROBLEM OF US INTEREST

SOLVE THE DEBT PROBLEM. IT WILL NOT SOLVE THE PROBLEM OF US INTEREST RATES. THERE ARE ISSUES HERE WHICH WE NEED TO TACKLE. IF DEBTOR COUNTRIES CAN RECOVER CREDITWORTHINESS, AND IF WE ARE SUCCESSFUL IN ENCOURAGING NEW KINDS OF CAPITAL FLOWS TO THEM, THIS WOULD DEAL WITH THE RESERVE AND OTHER PROBLEMS WITH WHICH THEY ARE FACED IN AN APPROPRIATE MANNER.

21. I NOW TURN TO THE QUESTION OF THE LEVEL OF ACCESS TO IMF RESOURCES. THIS IS THE MOST IMPORTANT OPERATIONAL DECISION WE HAVE TO CONSIDER TODAY.

22. IT IS TEMPTING SIMPLY TO KEEP THE EXISTING LIMITS. AND IN THE CASE OF THE CFF, GIVEN RECENT TRENDS IN COMMODITY PRICES, THIS DOES SEEM THE RIGHT CONCLUSION.

23. BUT AS TO ACCESS LIMITS PROPER, I BELIEVE THAT A MODEST CHANGE IS IN ORDER. IF WE WERE TO MAKE NO MOVEMENT AT ALL, WE WOULD BE FAILING TO RECOGNISE THAT WORLD ECONOMIC CONDITIONS HAVE IMPROVED. WE WOULD ALSO BE FAILING TO ACKNOWLEDGE THE AGREED TEMPORARY NATURE OF THE ENLARGED ACCESS FACILITY. CLEARLY, WE NEED TO KEEP ENLARGE ACCESS ARRANGEMENTS GOING FOR THE TIME BEING. BUT WE SHOULD ALSO BE TAKING THE FIRST STEP BACK TO A QUOTA-BASED FUND.

24. I DO BELIEVE, HOWEVER, THAT WE HAVE TO BE VERY CAUTIOUS ABOUT ANY REDUCTION IN THE CUMULATIVE LIMITS WE SET. IF WE SET THEM TOO LOW WE RULE OUT THE POSSIBILITY OF FOLLOW ON PROGRAMMES FOR COUNTRIES WHO REQUIRE ANOTHER YEAR OR TWO OF FUND SUPPORT.

25. THIS IS NOT TO SAY THAT I FAVOUR PROLONGED USE OF FUND RESOURCES. AS A GENERAL PRINCIPLE I BELIEVE THE OPPOSITE. WHAT I AM SPEAKING OF HERE, IN SUGGESTING MAINTENANCE OF GENEROUS CUMULATIVE LIMITS, IS HELPING THROUGH THE FINAL STAGE OF TOUCH BUT EFFECTIVE ADJUSTMENT PROGRAMES. I BELIEVE WE SHOULD ASK THE EXECUTIVE BOARD TO THINK ABOUT HOW BEST TO MAKE A CLEAR DISTINCTION BETWEEN THE TWO, AND I WELCOME THE MANAGING DIRECTOR'S STATEMENT THIS MORNING THAT HE INTENDS TO ADDRESS THIS ISSUE.

US BUDGET DEFICIT

26. I SPOKE EARLIER OF THE NEED FOR FURTHER ACTION IS THE RECOVERY IS TO BE SUSTAINED. THE MOST PRESSING ISSUE HERE IS THE HIGH LEVEL OF US AND CONSEQUENTLY WORLD INTEREST RATES. DURING THE PERIOD WHEN MONETARY GROWTH AND INFLATION WERE BEING REINED BACK FROM THE EXCESSES OF THE 1970S, SOME RISE IN INTEREST RATES WAS ALSO TO BE EXPECTED. BUT NOW THAT GREATER FINANCIAL STABILITY HAS BEEN ACHIEVED IN MOST MAJOR INDUSTRIAL COUNTRIES, WE MIGHT HAVE EXPECTED LOWER INTEREST RATES TO ENCOURAGE AND SUSTAIN THE REVIVAL OF INVESTMENT AND TIME ON WHICH GROWTH SO HEAVILY DEPENDS. THIS YEAR'S RISE IN INTEREST RATES, THEREFORE, IS PARTICULARLY UNHELPFUL.

27. A MAJOR FACTOR BEHIND THIS STATE OF AFFAIRS IS THE CONTINUING LARGE US BUDGET DEFICIT. THE RISE IN THE AMERICAN STRUCTURAL DEFICIT AT A TIME WHEN PRIVATE CREDIT DEMANDS ARE ALSO INCREASING HAS RAISED US DOMESTIC INTEREST RATES, PARTICULARLY REAL INTEREST RATES, AND RESULTED IN AN UNHEALTHY OVERVALUATION OF THE DOLLAR. BUT IS HAS ALSO TENDED TO INCREASE PRESSURE ON RATES IN THE REST OF THE WORLD, DESPITE THE EFFORTS OTHER GOVERNMENTS HAVE BEEN MAKING TO REDUCE THEIR OWN STRUCTURAL BUDGET DEFICITS.

BEEN MAKING TO REDUCE THEIR OWN STRUCTURAL BUDGET DEFICITS.

28. I FEAR THAT THE BLUNT TRUTH IS THAT A RISING US STRUCTURAL BUDGET DEFICIT, FINANCED IN LARGE PART BY DRAWING ON THE SAVINGS OF THE REST OF THIS WORLD, AND ACCOMPANIED BY MASSIVE CURRENT EXTERNAL DEFICITS, IS UNHEALTHY AND UNSUSTAINABLE.

29. THE 'DOWNPAYMENT' MEASURES THAT THE ADMINISTRATION HAVE PREPARED TO REDUCE THE DEFICIT ARE WELCOME BUT IT MUST BE IN THE INTEREST OF THE US ITSELF, OTHER INDUSTRIAL COUNTRIES, AND THE DEVELOPING WORLD THAT FURTHER ACTION IS TAKEN AS SOON AS FEASIBLE TO PUT THE DEFICIT ON A CONVINCING DECLINING PATH.

30. LET ME CONCLUDE THIS SECTION WITH TWO QUOTATIONS.

31. INCREASES IN OUR INTEREST RATES DIRECTLY ADD TO THE STRAIN ON THE EXTERNAL PAYMENTS OF HEAVILY INDEBTED DEVELOPING COUNTRIES, AND, OVER TIME, THE CAPITAL FLOWS AND TRADE IMBALANCE WILL NOT BE SUSTAINABLE, POSING THE RISK OF FURTHER FINANCIAL DISTURBANCES IN THE ABSENCE OF NEEDED POLICY ADJUSTMENT. ... WE CANNOT, IN MY JUDGEMENT, ESCAPE THE NEED FOR DECISIVE ACTION TO REDUCE OUR FEDERAL BUDGET DEFICIT.

32. MR PAUL VOLCKER, CHAIRMAN OF THE FEDERAL RESERVE BOARD, SPEAKING TO THE SENATE SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY IN JUNE OF THIS YEAR.

33. I AGREE WITH CHAIRMAN VOLCKER.

34. WITH RESPECT TO THE BUDGET DEFICITS, AS THINGS NOW STAND, DEFICITS NEXT YEAR WILL REMAIN IN THE SAME AREA AS CURRENTLY, AND UNACCEPTABLY LARGE THEREAFTER. THE IMPLICATIONS FOR FINANCIAL MARKETS AND THE ECONOMY BECOME MORE ADVERSE PRECISELY AS GROWTH IN THE PRIVATE SECTOR GENERATES MORE NEED FOR CREDIT AND CAPITAL. THAT OUTLOOK MUST BE CHANGED IN THE ONLY WAY IT CONSTRUCTIVELY CAN BE -- MOVING BEYOND THE WELCOME '' DOWN PAYMENT '' TO FURTHER SUBSTANTIVE ACTION ON THE BUDGET AS SOON AS FEASIBLE.

35. MR PAUL VOLCKER, SPEAKING TO THE SENATE SUBCOMMITTEE ON BANKING IN JULY OF THIS YEAR.

36. I AGREE WITH CHAIRMAN VOLCKER.

DEBT

37. I TURN NOW TO THE PROBLEM OF INTERNATIONAL DEBT.

38. THE CASE BY CASE APPROACH, WHICH WE HAVE ADOPTED -- AND RIGHTLY SO -- REPRESENTS A COHERENT STRATEGY. IT RESTS ON COMMON PRINCIPLES -- ABOVE ALL ON THE CENTRAL IMPORTANCE OF COUNTRIES TAKING MEASURES TO PUT THEIR FINANCES IN ORDER AND RESTORE THEIR CREDITWORTHINESS. BUT IT RECOGNISES THE INESCAPABLE FACT THAT EVERY DEBTOR COUNTRY IS INDIVIDUAL AND DIFFERENT. THEY ALL HAVE DIFFERENT RESOURCES AND ABILITIES, DIFFERENT KINDS OF SCALES OF DEBTS AND INTERNATIONAL FINANCIAL AND ECONOMIC DIFFICULTIES AND OPPORTUNITIES.

39. IT ALSO RECOGNISES THE NEED TO BUY TIME, IN THIS SITUATION TIME IS A VALUABLE COMMODITY, BORROWING COUNTRIES NEED TIME FOR

TIME IS A VALUABLE COMMODITY, BORROWING COUNTRIES NEED TIME FOR NEW POLICIES TO WORK: BANKS NEED TIME TO ADJUST THEIR BALANCE SHEETS. AS SO OFTEN IN INTERNATIONAL AFFAIRS, PATIENCE IS A PRIME VIRTUE. THE EVIDENCE OF THE LAST YEAR IS THAT IN MANY COUNTRIES NEW POLICIES CARRIED THROUGH WITH GREAT COURAGE ARE TAKING EFFECT, AND THAT WE ARE SLOWLY MAKING REAL PROGRESS. MEANWHILE WE ALL OWE AN INCALCULABLE DEBT OF GRATITUDE TO THE MANAGING DIRECTOR FOR THE KEY ROLE HE HAD PLAYED WITH SUCH DISTINCTION IN BRINGING THIS ABOUT.

40. BUT WE ALSO NEED TO USE THIS TIME WE HAVE BOUGHT TO DEVELOP NEW IDEAS ON HOW TO BRING GREATER STABILITY INTO THE FINANCIAL ENVIRONMENT OF DEBTOR COUNTRIES IN THE MEDIUM-TERM.

41. THE LONDON SUMMIT ALSO ADDRESSED THIS ISSUE. IT COMMENDED MULTI-YEAR RESCHEDULING IN APPROPRIATE CASES. IT ENCOURAGED CLOSER COOPERATION BETWEEN THE WORLD BANK AND THE FUND. IT COMMENDED THE ENCOURAGEMENT OF PRIVATE INVESTMENT, AND THE SEARCH FOR THE DEVELOPMENT OF OTHER LONG-TERM FORMS OF FINANCE TO SUPPLEMENT OR SUBSTITUTE FOR BANK LENDING.

42. ALL THESE APPROACHES NEED TO BE PURSUED WITH VIGOUR. BUT THE DEBT PROBLEM IS BOUND TO REMAIN A MATTER OF SERIOUS CONCERN SO LONG AS PRESENT LEVELS OF INTEREST RATES PERSIST.

CONCLUDING REMARKS

43. MR CHAIRMAN, I HAVE TOUCHED TODAY ON THE OPERATIONAL DECISIONS IMMEDIATELY BEFORE US. I HAVE SAID SOMETHING ABOUT WAYS IN WHICH I BELIEVE WE CAN MAKE MORE PROGRESS, OVER A RATHER LONGER TIME SCALE, IN AREAS OF PERSISTING CONCERN TO THE INTERNATIONAL COMMUNITY. WE WILL NOT SAY THE LAST WORK ON ANY OF THEM TODAY. BUT WE CAN CHART THE WAY FORWARD. AND WE CAN EXPLORE TOGETHER HOW TO BUILD UPON THOSE AND OTHER IDEAS IN THE TWO FURTHER MEETINGS WE HAVE IN VIEW IN COMING MONTHS.

ENDS

TEXT OF INTERIM COMMITTEE COMMUNIQUE MIFT.

FCO PASS DESKBY 260800Z MRS DIGGLE TREASURY.

WICKS

NNNN

GRS 4200

International Debt file

UNCLASSIFIED
DESKBY FCO 250800Z
FM UKDEL IMF/IBRD WASHINGTON 250330Z SEPTEMBER 84
TO IMMEDIATE FCO
TELEGRAM NUMBER 203 OF 24 SEP
AND TO IMMEDIATE UKMIS NEW YORK

PLEASE ADVANCE TO HM TREASURY (JOHN PAGE) AND ERD
FOLLOWING IS TEXT OF SPEECH TO BE DELIVERED BY CHANCELLOR OF EXCHEQUER AT IMF/IBRD ANNUAL MEETINGS AT 10.30 AM WASHINGTON TIME ON TUESDAY, SEPTEMBER 25.
FOR UKMIS NEW YORK ONLY: OUR TELNO 4 REFERS.

INTRODUCTION

I SHOULD LIKE AT THE OUTSET TO JOIN MY COLLEAGUES IN EXTENDING A VERY WARM WELCOME TO OUR TWO NEW MEMBERS -- SAINT CHRISTOPHER AND NEVIS, AND MOZAMBIQUE.

A YEAR AGO MOST OF US SAW THREE MAIN EXTERNAL THREATS TO OUR NATIONAL ECONOMIES: UNCERTAINTY OVER THE PROSPECTIVE WORLD ECONOMIC RECOVERY, HIGH INTEREST RATES, THE INTERNATIONAL DEBT DIFFICULTIES. I WOULD LIKE TODAY TO LOOK AT EACH IN TURN.

BEFORE DOING SO I WILL, AS LAST YEAR, SAY SOMETHING ABOUT THE EXPERIENCE OF MY OWN COUNTRY.

THE UK ECONOMY

DEVELOPMENTS IN THE UK OVER THE PAST YEAR HAVE BEEN MUCH AS I FORESAW WHEN I SPOKE AT THIS MEETING LAST YEAR. WE ARE NOW IN THE FOURTH SUCCESSIVE YEAR OF STEADY RECOVERY. AS EXPECTED, THE PATTERN OF THE RECOVERY HAS CHANGED. FIXED INVESTMENT AND EXPORTS HAVE BOTH GROWN RAPIDLY OVER THE PAST YEAR WHILE CONSUMER SPENDING HAS GROWN MORE SLOWLY. IN PARTICULAR, MANUFACTING INVESTMENT IN THE FIRST HALF OF 1984 WAS ABOUT 15 PER CENT UP IN REAL TERMS ON A YEAR AGO. AT THE SAME TIME THE INFLATION RATE HAS REMAINED BROADLY FLAT AT 5 PER CENT, A PATTERN WHICH HAS PERSISTED NOW FOR SOME 18 MONTHS.

FISCAL AND MONETARY POLICY HAVE DEVELOPED AS INTENDED. BOTH BROAD AND NARROW MEASURES OF MONEY ARE GROWING AT A RATE WELL WITHIN THEIR TARGET RANGES. AND WE ARE CONTINUING TO REDUCE THE BUDGET DEFICIT. LAST YEAR IT WAS OVER 3 PER CENT OF GDP. THIS YEAR WE BUDGETED FOR 2 AND A QUARTER PER CENT OF GDP AND PRESENT INDICATION SUGGEST THAT WE REMAIN BROADLY ON TARGET.

GROWTH LAST YEAR WAS 3 AND QUARTER PER CENT. THIS YEAR THE FALL IN COAL OUTPUT AS A RESULT OF THE CONTINUING MINERS STRIKE IS EQUIVALENT TO ALMOST 1 PER CENT OF GDP IN 1984, AND GROWTH THIS YEAR MAY THEREFORE BE CLOSER TO 2 PER CENT THAN THE 3 PER CENT PREVIOUSLY EXPECTED.

/BY

BY THE SAME TOKEN, GROWTH NEXT YEAR SHOULD BENEFIT BY ABOUT 1 PER CENT AS COAL OUTPUT RETURNS TO ITS NORMAL LEVEL. AS A RESULT, I WOULD EXPECT RECORDED GROWTH NEXT YEAR TO BE HIGHER THAN THIS YEAR.

WHILE NONE OF US CAN CLAIM ACTUALLY TO HAVE ABOLISHED THE BUSINESSCYCLE, THE POLICIES WHICH THE UK, IN COMMON WITH MANY OTHER INDUSTRIALISED COUNTRIES, HAS BEEN FOLLOWING FORM A SOUNDER BASIS FOR SUSTAINABLE GROWTH THAN WE HAVE KNOWN IN THE PAST.

SO FAR AS MY OWN COUNTRY IS CONCERNED, THAT IS BORNE OUT BY THE IMPORTANT DIFFERENCES BETWEEN THIS RECOVERY AND PREVIOUS RECOVERIES.

THERE HAS BEEN NO SIGNIFICANT STOCKBUILDING. THIS MEANS THERE IS MUCH LESS CHANCE OF A SHARP STOCKBUILDING CYCLE. THERE IS LITTLE THREAT FROM HIGHER INFLATION, WHICH SO OFTEN HAS BEEN AN IMPORTANT FACTOR IN CYCLICAL SLOWDOWN. IN ADDITION, THE DIFFERENT PHASING OF OUTPUT GROWTH IN THE US AND EUROPE MEANS THAT THE GROWTH OF WORLD TRADE SHOULD BE MORE EVEN. AND COMMODITY PRICES, INCLUDING OIL, ARE SHOWING WEAKNESS RATHER THAN THE RAPID GROWTH OF THE LAST TWO CYCLICAL UPSWINGS.

IN PREVIOUS CYCLES INFLATION HAS TENDED TO RISE AS SOON AS RECOVERY HAS BECOME WELL ESTABLISHED. AS A RESULT, MANY COMMENTATORS HAVE ARGUED THAT AN INFLATION UPTURN IN THE UK IS IMMINENT. WE TAKE A DIFFERENT VIEW. OUR ANALYSIS SUGGESTS THAT THE PRESSURES MAKING FOR HIGHER INFLATION ARE NOT STRONG. MONETARY GROWTH CONTINUES TO DECLINE, AND COMPETITIVE PRESSURES ARE LIKELY TO CONTINUE TO RESTRAIN PRICE INCREASES. THE UNDERLYING TREND OF INFLATION IS STILL DOWNWARD. THIS PERFORMANCE OF INFLATION DURING THE CURRENT RECOVERY HAS CONVINCINGLY REVERSED THE SECULAR UPWARD TREND OF THE LAST TWO DECADES.

THE ONE OUTSTANDING WORRY IS UNEMPLOYMENT, WHICH IS NOT ONLY FAR TOO HIGH BUT CONTINUES TO RISE.

NOT THAT NEW JOBS ARE NOT BEING CREATED. OVER THE YEAR TO LAST MARCH, THE NUMBER OF PEOPLE IN WORK IN THE UK HAS RISEN BY AROUND A QUARTER OF A MILLION--ABOUT DOUBLE THE RISE IN UNEMPLOYMENT OVER THE SAME PERIOD.

BUT WE OUGHT TO BE DOING BETTER THAN THIS. TO SOME EXTENT, OF COURSE, THE RISE IN UNEMPLOYMENT IS THE TEMPORARY CONSEQUENCE OF THE LONG OVERDUE SUCCESS OF BRITISH INDUSTRY IN MAKING ITSELF MORE COMPETITIVE BY CUTTING COSTS AND IMPROVING PRODUCTIVITY.

BUT THE HEART OF THE PROBLEM-- AND HERE THE CONTRAST WITH THE UNITED STATES IS PARTICULARLY STRIKING--HAS BEEN THE STEADY GROWTH IN REAL WAGES.

WE MUST NOT BE SEDUCED BY THE WONDERS OF HIGH-TECH INTO OVERLOOKING THE FACT THAT MANY OF THE JOBS OF THE FUTURE WILL BE IN LABOUR-INTENSIVE SERVICE INDUSTRIES WHICH ARE NOT SO MUCH LOW-TECH AS NO-TECH.

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I SEE LITTLE PROSPECT OF REVERSING THE TREND OF UNEMPLOYMENT UNLESS WE CAN DECISIVELY MODERATE THE GROWTH OF REAL WAGES. AS THE MANAGING DIRECTOR PUT IT IN A SPEECH TO THE ECONOMIC AND SOCIAL COUNCIL OF THE UNITED NATIONS LAST JULY:

QUOTE THERE ARE NOW CLEAR INDICATIONS THAT IN SOME OF THE MAJOR INDUSTRIAL COUNTRIES, ESPECIALLY IN EUROPE, THE PRESENT COST OF LABOUR MAY BE INCOMPATIBLE WITH THE ATTAINMENT OF HIGH EMPLOYMENT GOALS. UNQUOTE.

THIS MEANS THAT IT HAS BECOME MORE IMPORTANT THAN EVER TO REMOVE RIGIDITIES IN THE LABOUR MARKET AND PRODUCT MARKETS ALIKE.

IN RECENT YEARS THE EMPHASIS OF POLICY IN MANY COUNTRIES, INCLUDING THE UK, HAS BEEN ON FINANCIAL STABILISATION. AND WE HAVE SEEN THE BENEFITS OF THAT STABILISATION. BUT WHILE MAINTAINING THIS POLICY INTACT WE NEED TO PLACE MORE EMPHASIS ON SUPPLY SIDE POLICY IN THE TRUE SENSE OF THAT MUCH-ABUSED TERM: IN DEALING WITH THE STRUCTURAL PROBLEMS WHICH ARE THE CAUSE OF THE CONTINUING HIGH LEVEL OF UNEMPLOYMENT WHICH SO MANY OF US FACE TODAY.

THE WORLD ECONOMY

IN THE INDUSTRIALISED WORLD AS A WHOLE, RECOVERY HAS IN GENERAL BEEN STRONGER EVEN THAN THE HOPES, LET ALONE THE FEARS, OF A YEAR AGO. THE IMF STAFF'S LATEST FORECAST FOR GROWTH THIS YEAR SHOWS A FURTHER UPWARD REVISION. AND ALMOST ALL MAJOR FORECASTERS EXPECT REASONABLE RATES OF GROWTH TO CONTINUE NEXT YEAR, AND WITH A LESS UNEVEN DISTRIBUTION.

THE POSITION OF MANY DEVELOPING COUNTRIES, AND I WILL COME BACK TO THIS, HAS ALSO STRENGTHENED. THE CURRENT ACCOUNT DEFICIT OF THE NON-OIL DEVELOPING COUNTRIES THIS YEAR IS EXPECTED TO BE ONLY DOLLARS 45 BILLION, LESS THAN HALF ITS LEVEL IN 1981. THIS IMPROVEMENT HAS REFLECTED IN MANY CASES CUT-BACKS IN IMPORTS AND NATIONAL INCOME. WE RECOGNISED AT THE LONDON SUMMIT THE SOCIAL AND POLITICAL HARDSHIPS THIS INVOLVES. BUT SUCH ADJUSTMENT IS PAVING THE WAY FOR RENEWED AND SUSTAINABLE FUTURE GROWTH. THE PROCESS MUST CONTINUE, BUT WE SHOULD BE LOOKING NOW FOR EMPHASIS ON THE POSITIVE ASPECTS OF MAINTAINING AND FINANCING HEALTHY GROWTH.

TRADE AND CAPITAL FLOWS

IN THE TRADE FIELD THERE IS AGREEMENT TO BEGIN PRELIMINARY CONSULTATIONS ON A NEW ROUND OF MULTILATERAL TRADE NEGOTIATIONS. WITH RECOVERY BEING SUSTAINED I HOPE WE NEED NOT WAIT FOR THAT NEGOTIATION BEFORE TAKING ACTION TO ROLL BACK PROTECTIONIST BARRIERS: NOT JUST TARIFFS BUT SUBSIDIES AND OTHER DISTORTIONS.

WITH AN OVERVALUED DOLLAR CAUSING IMPORTS TO FLOOD INTO THE UNITED STATES, WITH HIGH AND RISING UNEMPLOYMENT IN EUROPE, AND WITH THE CONTINUING HARDSHIP FACED BY MUCH OF THE DEVELOPING WORLD, THE PRESSURES FOR PROTECTIONISM ARE VERY STRONG INDEED. IT IS ESSENTIAL THAT WE RESOLVE ALL THE MORE STRONGLY TO RESIST THEM. /NOTHING

NOTHING COULD BE MORE SELF-DEFEATING THAN A WORLDWIDE DRIFT TO PROTECTIONISM. AND FEW THINGS WOULD BE MORE DAMAGING TO OUR BURGEONING RECOVERY.

THE PAST YEAR HAS ALSO SEEN PROGRESS IN PROMOTING THE FREE FLOW OF CAPITAL BETWEEN COUNTRIES. I HAVE PARTICULARLY IN MIND THE STEPS ANNOUNCED BY THE JAPANESE GOVERNMENT TO PROMOTE THE INTERNATIONAL USE OF THE YEN. THIS INVOLVES A CONTINUING PROGRAMME OF SPECIFIC MEASURES, AND WE WILL FOLLOW DEVELOPMENTS HERE WITH CLOSE INTEREST.

IN SHORT, IN THE FIRST OF OUR THREE MAIN AREAS OF CONCERN, THE FUTURE COURSE OF WORLD ECONOMIC ACTIVITY, WE HAVE A DISTINCTLY IMPROVED CLIMATE, AND THE MEDIUM-TERM PROSPECTS FOR WIDELY-SHARED RECOVERY ARE BETTER THAN FOR MANY YEARS PAST.

INTEREST RATES.

INTEREST RATES ON THE OTHER HAND REMAIN A DOMINANT CONCERN FOR MOST OF US, AND I MUST LINK THIS WITH THE SITUATION IN THE US. THE US ACCOUNTS FOR ONE-FIFTH OF WORLD GNP AND SOME 15 PERCENT OF WORLD TRADE. SO US POLICIES CANNOT SIMPLY BE JUDGED BY DOMESTIC CRITERIA, EVEN IN ECONOMIC TERMS, QUITE APART FROM THE RESPONSIBILITES THAT ACCRUE TO THE UNITED STATES AS THE LEADER OF THE FREE WORLD.

ON THE DOMESTIC SIDE, THE US ACHIEVEMENT HAS BEEN REMARKABLE BY ANY POST-WAR STANDARDS. IN PARTICULAR THE CREATION OF OVER 6 MILLION NEW JOBS SINCE THE END OF 1982 OWES A GREAT DEAL TO THE FLEXIBILITY OF THE US LABOUR MARKET AND THE MODERATE INCREASES IN REAL LABOUR COSTS COMPARED WITH MOST OTHER LEADING INDUSTRIAL COUNTRIES IN RECENT YEARS.

SUCCESS IN THE CREATION OF NEW JOBS AND THE VIGOROUS GROWTH OF OUTPUT IN THE LAST TWO YEARS REFLECT THE ADMIRABLE STRENGTH AND RESILIENCE OF THE US ECONOMY. BUT THERE ARE OTHER FEATURES THAT REPRESENT A CAUSE FOR REAL CONCERN.

ALTHOUGH THE US BUDGET DEFICIT MAY BE LOWER AS A PROPORTION OF GDP THAN THAT OF SOME OTHER MAJOR INDUSTRIAL COUNTRIES, IT HAS GROWN VERY LARGE IN RELATION TO THE LEVEL OF NET DOMESTIC SAVINGS. AND ITS SHEER SIZE WEIGHS HEAVILY IN THE DEMAND FOR SAVINGS WORLDWIDE. AS THE RECOVERY STIMULATES A GROWING PARALLEL DEMAND FOR PRIVATE INVESTMENT, WITHOUT ANY MATCHING GROWTH OF DOMESTIC SAVINGS, WE SEE TWO EFFECTS. INTEREST RATES ARE HELD AT UNPRECEDENTE
D
LEVELS IN REAL TERMS, AND THE NEEDS OF THE US ECONOMY PRE-EMPT A LARGE SHARE OF THE SAVINGS OF THE REST OF THE WORLD. /THE

THE NEED TO ATTRACT INCREASING CAPITAL INFLOWS FROM THE REST OF THE WORLD TO FINANCE THE BUDGET DEFICIT HAS AS ITS INEVITABLE COUNTERPART - FOR THE EXTERNAL ACCOUNTS HAVE TO BALANCE - A CURRENT ACCOUNT TRADE AND PAYMENTS DEFICIT OF GETTING ON FOR DOLLARS 100 BILLION A YEAR, AND STILL RISING: WHILE THE UNPRECEDENTED RATE OF INTEREST ON THE WORLD'S LEADING RESERVE CURRENCY HAS INEVITABLY LED TO A SHARP RISE IN THE VALUE OF THE DOLLAR IN TERMS OF OTHER CURRENCIES.

I COME FROM A COUNTRY THAT HAS EXPERIENCE FROM THE PAST OF THE ADVANTAGES - AND ALSO OF THE RISKS AND THE RESPONSIBILITIES - OF OPERATING A RESERVE CURRENCY. THE ABILITY TO BORROW ABROAD IN ONE'S OWN CURRENCY GIVES OPPORTUNITY AND TIME WHICH WOULD NOT OTHERWISE BE AVAILBALE, TO SOME EXTENT AT THE EXPENSE OF THE REST OF THE WORLD. BUT WE ALSO HAVE EXPERIENCE OF THE CONSEQUENCES THAT OCCUR WHEN THIS SPECIAL PRIVILEGE IS ABUSED.

IMBALANCES, IN THE BUDGET AND IN THE TRADE AND CURRENT ACCOUNTS, OF THE SIZE WE ARE NOW SEEING IN THE UNITED STATES CAN CONTINUE FOR MUCH LONGER THAN THEY COULD IN ANY OTHER COUNTRY. BUT THEY CANNOT BE SUSTAINABLE FOREVER.

AND MEANWHILE, THE PROBLEM OF INTERNATIONAL DEBT, TO WHICH I WILL TURN IN A MOMENT, IS GREATLY EXACERBATED.

THE US AUTHORITIES HAVE THEMSELVES POINTED THE WAY AHEAD WITH THEIR IMPORTANT QUOTE DOWN PAYMENT UNQUOTE DECISION. TIMELY REINFORCEMENT OF THAT APPROACH WILL BE CRUCIAL IF THE PROCESS OF ADJUSTMENT IS NOT TO END IN TEARS.

PERHAPS, HERE IN WASHINGTON, IT WOULD BE APPROPRIATE FOR ME TO CONCLUDE THIS SECTION OF MY SPEECH WITH SOME WORDS OF THOMAS JEFFERSON:
QUOTE
I PLACE ECONOMY AMONG THE FIRST AND MOST IMPORTANT OF REPUBLICAN VIRTUES, AND PUBLIC DEBT AS THE GREATEST OF THE DANGERS TO BE FEARED. TO PRESERVE OUR INDEPENDENCE, WE MUST NOT LET OUR LEADERS LOAD US WITH PERPETUAL DEBT. UNQUOTE +

OPEN SQUARE BRACKETS +
LETTER WRITTEN IN 1816 BY JEFFERSON TO WILLIAM PLUMER QUOTED IN THE 1984 SHANN MEMORIAL LECTURE GIVEN BY JOHN STONE, SECRETARY OF THE AUSTRALIAN TREASURY. + CLOSE SQUARE BRACKETS

INTERNATIONAL DEBT

I TURN NOW TO THE QUESTION OF INTERNATIONAL DEBT. I SUGGESTED LAST YEAR SOME IDEAS GOING BEYOND THE IMMEDIATE STRATEGY ADOPTED BY THE INTERNATIONAL COMMUNITY BUILT AROUND PROGRAMMES OF ADJUSTMENT. SOME OF THOSE IDEAS WERE CARRIED A STAGE FURTHER AT THE RECENT LONDON SUMMIT. I SHOULD LIKE TO SAY A LITTLE MORE ABOUT THEM NOW.

BORROWING OF THE WRONG KIND

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I WILL NOT TODAY GO OVER ALL THE ORIGINS OF THE DEBT PROBLEM. BUT IMPORTANT ELEMENTS WERE: TOO MUCH BORROWING AND BORROWING OF THE WRONG KIND. BY BORROWING OF THE WRONG KIND I MEAN UNDUE RELIANCE ON BANK FINANCE.

IN RETROSPECT IT IS EASY TO SEE HOW THIS HAPPENED. FINANCING DIFFICULTIES WERE SUBSTANTIAL AND AROSE RELATIVELY SUDDENLY. THE PRIVATE BANKING SECTOR IS GENERALLY ABLE TO RESPOND MORE QUICKLY TO SUDDEN CHANGE. IT IS THEREFORE PERHAPS NOT SURPRISING THAT THE BANKS TOOK ON THE MAJOR ROLE IN THE RECYCLING PROCESS. INDEED, THE SUBSTANTIAL RECYCLING OF FUNDS THAT TOOK PLACE DURING THE SEVENTIES AND EIGHTIES WAS INTITIALLY HELPFUL IN AVOIDING SEVERE DEFLATION IN DEVELOPING COUNTRIES AND PROVIDING THEM WITH TIME TO ADJUST. BUT, WITH THE BENEFIT OF HINDSIGHT, IT IS CLEAR THAT OVERSHOOTING IS A CHARACTERISTIC NOT MERELY OF THE FOREIGN EXCHANGE MARKET. THE PATTERNS AND SCALES OF FINANCING THAT RESULTED AND THE LACK OF CONDITIONALITY ATTACHING TO MOST OF THE FLOWS, MADE THE DEBTOR COUNTRIES AND THE INTERNATIONAL FINANCIAL SYSTEM HIGHLY VULNERABLE TO THE CHANGES IN THE ECONOMIC ENVIRONMENT THAT HAVE OCCURRED SINCE THE END OF THE 1970S.

THE UNHAPPY LEGACY OF THAT PERIOD WHICH WE NOW FACE IS A BURDEN OF LIABILITIES OF DEBTOR COUNTRIES WHICH PRESENT CONSIDERABLE PROBLEMS IN TERMS OF THEIR RELATIVE SIZE, THEIR MATURITY PROFILES AND THE ACCOMPANYING VULNERABILITY TO INTEREST RATE FLUCTUATIONS: AND FOR BANKS POTENTIALLY DESTABILISING DOUBTS AS TO THE TRUE VALUE OF A PART OF THEIR ASSETS.

DEBTOR COUNTRIES

SOME DEBTOR COUNTRIES HAVE ACHIEVED CONSPICUOUS SUCCESS IN SOME ASPECTS OF ADJUSTMENT - THE TURN ROUND IN THE BALANCE OF TRADE OF BOTH MEXICO AND BRAZIL ARE NOTABLE EXAMPLES OF WHAT CAN BE ACHIEVED. IF INESCAPABLY AT THE COST OF CONSIDERABLE PAIN AND SACRIFICE. BUT EVEN THOSE COUNTRIES WHICH HAVE TACKLED ADJUSTMENT IN THE MOST DETERMINED FASHION STILL HAVE SOME WAY TO GO. SOME COUNTRIES ARE AS YET ONLY A LITTLE WAY ALONG THE ADJUSTMENT ROAD: AND SOME COUNTRIES HAVE NOT YET MADE A START.

THE NEED FOR FURTHER ADJUSTMENT IS EVIDENT. MANY COUNTRIES STILL HAVE TO CONTEND, IN VARYING DEGREES, WITH HIGH RATES OF INFLATION AND SUBSTANTIAL BUDGET DEFICITS BEYOND THE SCOPE OF FINANCING BY DOMESTIC SAVINGS. SOME ARE STILL CLINGING TO OVERVALUED EXCHANGE RATES, ON THE MISTAKEN GROUNDS THAT THIS WILL MODERATE INFLATION - THE REAL EFFECT IS TO DAMAGE INTERNATIONAL TRADE PERFORMANCE AND DEPRESS AND DISTORT DOMESTIC PRODUCTION. THESE ARE NOT STABLE CONDITIONS. THEY DO NOT MAKE FOR REAL GROWTH OF PROSPERITY.

THE ESSENTIAL POINT, ON A LONGER PERSPECTIVE, IS THAT BORROWING COUNTRIES WILL NEED TO PLACE MORE DEMPHASIS ON CHANGING THE STRUCTURE OF THEIR ECONOMIES TO REDUCE DISTORTIONS AND DISINCENTIVES. MORE CONSIDERATION NEEDS TO BE GIVEN TO WAYS IN WHICH THIS CAN BE ACHIEVED.

/CONTINUING

CONTINUING ADJUSTMENT IS NEEDED FOR BOTH INTERNAL AND EXTERNAL REASONS, IF THE FUTURE DEVELOPMENT OF THESE COUNTRIES IS TO BE PUT AGAIN ON A SOUND BASIS, AND IF THEY ARE TO RESTORE CONFIDENCE IN THEMSELVES AS WELL AS IN WORLD FINANCIAL MARKETS.

ONE OF THE TRAGEDIES IN MANY DEBTOR COUNTRIES - AND OTHER DEVELOPING COUNTRIES TOO - IS THAT THEY NOT ONLY HAVE DIFFICULTY IN ATTRACTING FOREIGN INVESTORS, BUT THEY HAVE LOST A HUGE VOLUME OF POTENTIAL INVESTMENT BY THE FLIGHT OF CAPITAL FROM THEIR OWN RESIDENTS.

DEBTOR COUNTRIES NEED TO ADOPT POLICIES THAT WILL RESTORE THE CONFIDENCE NOT MERELY OF THE OUTSIDE WORLD BUT ALSO - AND EQUALLY IMPORTANT - OF THEIR OWN PEOPLE. FOREIGN EXCHANGE CONTROLS ARE NOT - AND CANNOT BE - A SUBSTITUTE FOR RESTORING THAT CONFIDENCE. TO IMAGINE OTHERWISE IS AN ILLUSION.

PRIVATE FINANCIAL FLOWS

AS DEBT-SERVICING PROBLEMS EMERGED AMONG DEVELOPING COUNTRIES, BANKS THAT HAD LENT TO THEM FACED UNCERTAINTY ABOUT THE VALUE AND MATURITY OF A PROPORTION OF THEIR ASSETS. THEY HAVE RESPONDED TO THIS BY ESTABLISHING A HIGHER LEVEL OF PROVISIONS.

IT IS OF PRIME IMPORTANCE THAT THIS PROCESS CONTINUES: AND THAT BANKS BUILD UP AND MAINTAIN PROVISIONS TO ALLOW FOR THE PROBABILITY OF SOME LOSSES OF VALUE, EVEN WHERE THEY CANNOT WITH ANY CERTAINTY BE IDENTIFIED INDIVIDUALLY. THEY MUST ALSO CONTINUE THE PROCESS OF STRENGTHENING THEIR BALANCE-SHEETS IN OTHER WAYS, NOTABLY BY ADDING TO THEIR CAPITAL RESOURCES.

THERE ARE A NUMBER OF LESSONS FOR THE LONGER TERM. FOR THE INTERNATIONAL FINANCIAL SYSTEM AS A WHOLE IT CAN BE ARGUED THAT A BALANCE NEEDS TO BE MAINTAINED BETWEEN UNCONDITIONAL MARKET LENDING AT COMMERCIAL RATES AND CONCESSIONARY LENDING WHICH WILL, FOR THE MOST PART, BE CONDITIONAL. THE BANKING SYSTEM HAS UNDOUBTEDLY A ROLE TO PLAY BUT IT IS NOT APPROPRIATE FOR IT TO PLAY THE MAJOR ROLE THAT IT HAS IN RECENT YEARS IN FINANCING DEBTOR COUNTRIES' BALANCE OF PAYMENTS DEFICITS. AT THE LEVEL OF THE INDIVIDUAL BANK THE EVENTS OF RECENT YEARS PROVIDE AN ELOQUENT CASE FOR THE NEED TO MAINTAIN AN APPROPRIATELY DIVERSIFIED PORTFOLIO. BANKS AND THEIR SUPERVISORS ARE WELL SEIZED OF THIS ALTHOUGH IT WILL NOT BE QUICKLY ACHIEVED.

BANKS HAVE BEEN PREPARED TO PUT UP SUBSTANTIAL SUMS OF NEW MONEY IN QUOTE UNSPONTANEOUS UNQUOTE LENDING IN SUPPORT OF DEBTORS WHICH HAVE AGREED PROGRAMMES WITH THE IMF. THEY ARE SHOWING A WILLINGNESS TO ADAPT TO THE CHANGING NEEDS OF DEBTORS AT DIFFERENT STAGES OF ADJUSTMENT, AS WITNESS THE IMAGINATIVE AND LONGER-TERM PACKAGE RECENTLY NEGOTIATED FOR MEXICO. THIS CONSTRUCTIVE APPROACH WAS ADVOCATED FOR APPROPRIATE CASES AT THE LONDON SUMMIT. / BUT

BUT THE FACT REMAINS THAT IT IS NECESSARY, BOTH IN THE INTERESTS OF DEBTORS AND OF THE BANKS, THAT NON-BANK PRIVATE FLOWS SHOULD GRADUALLY BECOME MORE PROMINENT. THE LONDON SUMMIT ADDRESSED THIS ISSUE AND OUTLINED A STRATEGY TO CREATE A SOUNDER FINANCIAL FRAMEWORK FOR MEDIUM-TERM DEVELOPMENT IN THE PRESENT DEBTOR COUNTRIES. I HAVE MENTIONED MULTI-YEAR RESCHEDULING: LET ME RECALL NOW THREE OTHER IMPORTANT ELEMENTS.

FIRST, A STRONGER ROLE FOR THE WORLD BANK GROUP OF INSTITUTIONS, IN FOSTERING DEVELOPMENT OVER THE MEDIUM AND LONG-TERM, NOT LEAST AS A CATALYST FOR PRIVATE INVESTMENT.

SECOND, THE ENCOURAGEMENT OF PRIVATE INVESTMENT. I WELCOME THE EMPHASIS THE MANAGING DIRECTOR HAS GIVEN TO THE IMPORTANCE OF BORROWING COUNTRIES QUOTE TAKING STEPS TO DISMANTLE OR RELAX ADMINISTRATIVE OR OTHER OBSTACLES WHICH OFTEN APPLY TO INFLOWS OF DIRECT INVESTMENT UNQUOTE. THIS IS A MATTER TO WHICH I BELIEVE THE EXECUTIVE BOARD SHOULD ALWAYS PAY CLOSE ATTENTION BOTH IN ITS REGULAR SURVEILLANCE AND IN ITS EXAMINATION OF COUNTRY PROGRAMMES. AN IMPORTANT ADVANTAGE TO DEVELOPING COUNTRIES, ESPECIALLY DEBTORS, OF SEEKING PRIVATE DIRECT INVESTMENT IS THAT IT CAN SERVICE ITSELF AS, AND ONLY AS, IT CONTRIBUTES TO PROFITABLE OUTPUT. IN THIS CONTEXT, I HOPE WE SHALL BE ABLE TO BRING TO FRUITION A WORKABLE PLAN FOR THE INSURANCE OF PRIVATE OVERSEAS INVESTMENT.

THIRD, ENCOURAGING OTHER FORMS OF FIANCE THAT PROMISE TO BE MORE APPROPRIATE AND STABLE. FOR THE MOMENT, THE FINANCIAL POSITION OF MANY DEBTOR COUNTRIES REMAINS SO PRECARIOUS THAT THE PROVISION OF UNSPONTANEOUS BANK LENDING WILL HAVE TO CONTINUE TO PLAY A PART IN MEETING THEIR IMMEDIATE FINANCING NEEDS. BUT THE RECENT MEXICAN AGREEMENT SHOWS THAT A RETURN TO SPONTANEOUS LENDING IS A PRIZE WITHIN REACH. BEYOND THAT, DEBTOR COUNTRIES SHOULD BE GIVEN ENCOURAGEMENT TO FIND MEANS OF REDUCING THE RELATIVE BURDEN OF BANK DEBT BY OFFERING OPPORTUNITIES FOR MORE STABLE AND APPROPRIATE INVESTMENT -- THE KINDS OF INVESTMENT THEY WILL SURELY IN ANY CASE NEED TO FOSTER IN SUPPORT OF THEIR INTERNAL DEVELOPMENT FOR MANY YEARS TO COME.

BETTER AND HEALTHIER COMMERCIAL WAYS OF FINANCING THE FUTURE NEEDS OF DEVELOPING COUNTRIES COULD BE FOUND IN PRIVATE INVESTMENT, DIRECT AND PORTFOLIO, AND IN LONGER-TERM MARKETABLE INSTRUMENTS. I WOULD LIKE TO SEE BANKS POSITIVELY ENCOURAGING DEVELOPMENTS OF THESE KINDS. MANY OF THEM COULD DOUBTLESS FIND AN ACTIVE ROLE AS AGENTS IN PLACING FINANCIAL INSTRUMENTS THAT COMPLEMENTED, OR IN SOME CASES REDUCED, THE BANKS' OWN LENDING, TO THIS END DEVELOPING A MORE DIRECT RELATIONSHIP BETWEEN SOME OF THEIR PRESENT DEPOSITORS AND THE ULTIMATE BORROWERS.

/THE

THE DEVELOPMENT OF SUCH DIFFERENT FORMS OF FINANCING WILL TAKE TIME AND IS LIKELY TO RELATE TO NEW MONEY RATHER THAN THE DIRECT MARKETING OF EXISTING DEBT. BUT THE ACTION ALREADY BEING TAKEN, WITH ADJUSTMENT BOLSTERED BY RESCHEDULING, HAS BOUGHT TIME AND IS HELPING TO CREATE A SITUATION WHERE SOME DEBTORS AT LEAST MAY BEGIN TO CONTEMPLATE RETURNING TO THE BOND MARKET AND WHERE OUTSIDE INVESTORS MAY BE WILLING TO LOOK AGAIN AT PARTICIPATIONS IN LOCAL RESOURCES AND ASSETS. BANKS AND OTHER FINANCIAL INSTITUTIONS SHOULD BE ENCOURAGED TO DEVISE NEW INSTRUMENTS TO BRING STABLE CAPITAL TO COUNTRIES WHOSE UNDERLYING RESOURCES IN MANY CASES ARE SO ABUNDANT.

THE LESSON FOR GOVERNMENTS

THE KINDS OF FUTURE FINANCING FLOWS I AM ADVOCATING ARE FOR COMMERCIAL MARKETS TO DEVELOP. THEY ARE NEEDED TO MOBILIZE IN UP-TO-DATE WAYS THE KIND OF FINANCING WHICH HAS BEEN BASED ON PRIVATE RESOURCES IN THE PAST. GOVERNMENTS OF HOST COUNTRIES CAN DO MUCH BY CREATING CONFIDENCE AND A HOSPITABLE CLIMATE. INTERNATIONAL INSTITUTIONS CAN PLAY A VALUABLE ENCOURAGING ROLE, WHICH IS WHY I WARMLY WELCOME THE EFFORTS, FOR EXAMPLE, OF THE WORLD BANK TO PROMOTE JOINT VENTURES AND CO-FINANCING, AND THE IDEAS THE IFC HAS BEEN NURTURING FOR THE DEVELOPMENT OF UNIT AND INVESTMENT TRUST OUTLETS IN SOME DEVELOPING COUNTRIES.

GOVERNMENTS OF CREDITOR COUNTRIES CAN AND SHOULD OFFER ENCOURAGEMENT THEY ARE ALSO DIRECTLY INVOLVED WITH DEBTOR COUNTRIES, LARGELY THROUGH THEIR VARIOUS EXPORT CREDIT AGENCIES, AND ON A LARGE SCALE. THEY HAVE SHOWN READINESS, THROUGH THE PARIS CLUB, TO NEGOTIATE RESCHEDULING ARRANGEMENTS, AND WILL BE PREPARED TO EXTEND THIS APPROACH TO MULTI-YEAR AGREEMENTS WHERE APPROPRIATE, IN PARALLEL WITH NEGOTIATIONS BY COMMERCIAL BANKS. THE UK HAS TAKEN THE INITIATIVE IN PUSHING FORWARD CONSIDERATION OF THE TECHNICAL ISSUES THAT ARISE.

IN THE PAST THE UNITED KINGDOM IN COMMON WITH MANY OTHERS HAS NORMALLY SUSPENDED PROVISION OF OFFICIAL EXPORT COVER TO COUNTRIES WHICH HAVE RESCHEDULED DEBT. WE HAVE REVIEWED THIS POLICY AND SHOULD SHORTLY BE READY IN APPROPRIATE CASES TO MAINTAIN COVER OR RESUME IT AT AN EARLIER STAGE TO SUPPORT CREDIT FOR GOODS WHICH WOULD CONTRIBUTE TO THE ECONOMIC RECOVERY OF THE DEBTOR COUNTRY. IN THIS AREA WE SEE A CASE FOR SOME HARMONISATION OF APPROACH AMONGST INDUSTRIAL COUNTRIES GENERALLY AND I WELCOME THE DISCUSSIONS NOW TAKING PLACE TO THIS END.

BUT BY FAR THE MOST IMPORTANT CONTRIBUTION WHICH GOVERNMENTS OF THE MAJOR CREDITOR COUNTRIES CAN MAKE LIES IN THEIR OWN GENERAL ECONOMIC AND FINANCIAL POLICIES. THE BIGGEST SINGLE CONTRIBUTION SO FAR TOWARDS EASING THE DEBT PROBLEM HAS BEEN THE RECOVERY OF WORLD ECONOMIC ACTIVITY AND, ESPECIALLY DURING THE PAST YEAR, THE RESUMPTION OF MORE VIGOROUS GROWTH OF WORLD TRADE. THE BIGGEST SINGLE CONTRIBUTION WHICH COULD BE MADE OVER THE NEXT YEAR OR SO WOULD BE DEVELOPMENTS OF US POLICIES WHICH COULD LEAD TO LOWER DOLLAR AND WORLD INTEREST RATES.

/THE

THE CASE BY CASE APPROACH

IT IS TEMPTING, OF COURSE, TO SEEK NOW A RADICAL NEW APPROACH TO INTERNATIONAL DEBT. HOWEVER, I DO NOT BELIEVE THAT THAT IS THE WAY FORWARD. THERE IS NO SUCH RADICAL ALTERNATIVE WHICH CAN SATISFACTORILY RESOLVE WHAT IS CLEARLY A HIGHLY COMPLEX PROBLEM. RATHER WE HAVE TO PERSEVERE WITH THE PRESENT APPROACH, VARYING IT AS NECESSARY TO MEET THE PARTICULAR CIRCUMSTANCES AS THEY ARISE. I REMAIN FIRMLY OPPOSED TO THE QUOTE GLOBAL SOLUTIONS UNQUOTE TO THE DEBT PROBLEM WHICH ARE CANVASSED FROM TIME TO TIME. THESE INVARIABLY - IF NOT ALWAYS EXPLICITLY - INVOLVE NEW AND INFLATIONARY METHODS OF FINANCING, OR THE ASSUMPTION BY THE TAXPAYERS OF CREDITOR COUNTRIES OF THE OBLIGATIONS OF THE DEBTOR COUNTRIES OR THE RISKS OF THE BANKS.

THERE IS NO SENSIBLE ALTERNATIVE TO THE CASE-BY-CASE APPROACH WHICH WE HAVE BEEN PURSUING.

CONTRARY TO WHAT IS ALLEGED BY ITS CRITICS, IT REPRESENTS A COHERENT STRATEGY.

IT RESTS ON COMMON PRINCIPLES - ABOVE ALL ON THE CENTRAL IMPORTANCE OF COUNTRIES TAKING MEASURES TO PUT THEIR FINANCES IN ORDER AND RESTORE THEIR CREDITWORTHINESS. BUT IT RECOGNISES THE INESCAPABLE FACT THAT EVERY DEBTOR COUNTRY IS INDIVIDUAL AND DIFFERENT. THEY ALL HAVE DIFFERENT RESOURCES AND ABILITIES, DIFFERENT KINDS AND SCALES OF DEBTS AND INTERNATIONAL FINANCIAL AND ECONOMIC DIFFICULTIES AND OPPORTUNITIES.

AND THE CASE-BY-CASE APPROACH ALSO RECOGNISES THE NEED TO BUY TIME. BORROWING COUNTRIES NEED TIME FOR THE PROCESS OF ADJUSTMENT TO WORK. BANKS NEED TIME TO GET THEIR BALANCE SHEETS IN ORDER. THIS IS A SITUATION ON WHICH TIME - PROVIDED IT IS PUT TO GOOD USE - IS AN INVALUABLE COMMODITY.

THE LONDON INITIATIVE

AT OUR MEETINGS OVER THE PAST WEEKEND WE WERE ABLE WITHIN THE INTERIM COMMITTEE TO REACH SATISFACTORY OPERATIONAL DECISIONS WHICH WILL PROVIDE CONSTRUCTIVE GUIDANCE TO THE WORK OF THE EXECUTIVE BOARD OF THE FUND IN THE COMING MONTHS.

BUT THE MOST IMPORTANT OUTCOME OF OUR DELIBERATIONS IN THE INTERIM AND DEVELOPMENT COMMITTEES DERIVES FROM THE PROPOSAL CONTAINED IN THE ECONOMIC DECLARATION AT THE END OF THE LONDON SUMMIT LAST JUNE. IT WAS THEN AGREED, BY THE SEVEN NATIONS TAKING PART, THAT FINANCE MINISTERS SHOULD SET UP AN INTENSIVE DISCUSSION OF INTERNATIONAL FINANCIAL ISSUES OF PARTICULAR CONCERN TO DEVELOPING COUNTRIES WITHIN THE FRAMEWORK OF THE ESTABLISHED INTERNATIONAL FINANCIAL INSTITUTIONS.

/THIS

THIS INITIATIVE RECOGNISED THE CLOSE INTERDEPENDENCE OF DEVELOPING AND DEVELOPED COUNTRIES. IT REFLECTED THE INTEREST THEY SHARE IN A RE-EXAMINATION, IN A MEDIUM-TERM FRAMEWORK, OF ASPECTS OF THE INTERNATIONAL MONETARY SYSTEM, OF EXTERNAL INDEBTEDNESS, THE ROLES OF MULTILATERAL INSTITUTIONS, INTERNATIONAL CAPITAL FLOWS AND INVESTMENT, AND TRADE POLICIES AND PROTECTIONISM. THE CONCERNS EXPRESSED IN THE LONDON DECLARATION HAVE BEEN ECHOED IN OTHER INTERNATIONAL FORA INCLUDING THE RECENT MEETING OF COMMONWEALTH FINANCE MINISTERS IN TORONTO.

AS HOST COUNTRY AT THE LONDON SUMMIT, IT IS THEREFORE OF PARTICULAR SATISFACTION TO THE UNITED KINGDOM THAT AT THE MEETINGS THAT HAVE JUST BEEN CONCLUDED, THE INTERIM AND DEVELOPMENT COMMITTEES HAVE RESPONDED BY DECIDING TO SET TIME ASIDE NEXT SPRING FOR DISCUSSIONS COVERING THE BROAD AREAS I HAVE OUTLINED.

I AM SURE THAT THIS IS THE MOST CONSTRUCTIVE WAY OF MEETING THE VERY UNDERSTANDABLE REQUEST OF DEVELOPING COUNTRIES THROUGHOUT THE WORLD FOR A DIALOGUE WITH THE INDUSTRIALISED NATIONS.

CONCLUDING REMARKS

TWO YEARS AGO SAW THE START OF GLOBAL ECONOMIC RECOVERY. THIS YEAR WE CAN REASONABLY CLAIM THAT IT IS WELL ESTABLISHED. IN THE COMING YEAR THE TASK BEFORE US WILL BE TO SUSTAIN IT BY MAKING PROGRESS IN THE FOLLOWING AREAS:

WE NEED TO:

- PUT OUR OWN HOUSES IN ORDER BY SECURING STABLE MONETARY CONDITIONS AND REDUCED BUDGET DIFICITS:
- PRESS FORWARD WITH SUPPLY SIDE POLICIES TO IMPROVE PRODUCTIVE POTENTIAL AND EMPLOYMENT:
- RESIST THE FORCES OF PROTECTIONISM AND MOVE TOWARDS A NEW ROUND OF MULTILATERAL TRADE NEGOTATIONS:
- MAINTAIN THE MOMENTUM OF ECONOMIC ADJUSTMENT, WHERE IT IS STILL NEEDED:
- DEVELOP NEW WAYS OF FINANCING THE FUTURE NEEDS OF DEVELOPING COUNTRIES AND RELAX OBSTACLES TO FLOWS OF PRIVATE CAPITAL.

AND LET US IN ALL THESE ENDEAVOURS RECOGNISE THE RESPONSIBILITIES WHICH FLOW FROM THE INTERDEPENDENCE OF OUR ECONOMIES, AN INTERDEPENDENCE OF WHICH THE FUND AND THE BANK ARE SO VALUABLE AN INSTITUTIONAL EXPRESSION.

WICKS

MONETARY

ERD
NAD

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ADVANCE COPIES 37

FALKLAND ISLANDS GENERAL

PS
PS/LADY YOUNG
PS/MR RENTON
PS/MR RIFKIND
PS/PUS
MR DEREK THOMAS
MR J FREELAND
SIR W HARDING
MR GOODALL
MR O'NEILL
SIR C TICKELL
MR D C THOMAS
MR WESTON
MR BARRINGTON
HD/PUSD
HD/SAMD
HD/FID
HD/NEWS DEPT
HD/EED
HD/ECD (E)
HD/UND

PS/NO 10 DOWNING ST
PS/S OF S FOR DEFENCE
MR ~~RD~~ NH NICHOLLS, AUSD STAFF, MOD

PS/CHANCELLOR } TREASURY
MISS M E CUND }
MR LITTLER }

SIR R ARMSTRONG } CABINET OFFICE
MR ~~A D S GOODALL~~ Cartledge }
DIO }

MR POWER, SAD, ODA

MR A FORTNAM IAT/D. TRANSPORT

RESIDENT CLERK

(2)

IMMEDIATE

UNCLASSIFIED

(FM BERNE 251552)

FM BISBA

TO IMMEDIATE FCO

TELNO 635 OF 24 SEPTEMBER 1984

INFO PRIORITY MOD (SIC A3A), CBFFI BANK OF ENGLAND ASUNCION BRASILIA CARACAS MEXICO CITY MONTEVIDEO SANTIAGO UKMIS NEW YORK WASHINGTON PORT STANLEY

PRESS SUMMARY

1. PRESIDENT ALFONSIN'S NEW YORK VISIT AND THE IMF MEETING IN WASHINGTON TAKE MOST OF THE WEEKEND HEADLINES.

2. BEFORE HIS DEPARTURE, ALFONSIN DECLARED THAT QUOTE UNDER NO CIRCUMSTANCES SHOULD CREDITOR NATIONS BE SUBJECTED TO HEAVY, ABSURD BURDENS, WITH USURIOUS INTEREST RATES GOIMG TO PAY THEIR FOREIGN DEBTS, BECAUSE THIS ONLY LEADS TO SOCIAL CONFLICT, TENSION , AND THE SERIOUS PROBLEMS ENDQNGERING WORLD PEACE UNQUOTE.

3. MONDAY'S PAPERS ALL REPORT THAT IN HIS INTERVIEW WITH PRESIDENT REAGAN, ALFONSIN RECEIVED A POSITIVE REPLY TO HIS CALL FOR A POLITICAL DIALOGUE BETWEEN INDUSTRIALISED AND LATIN AMERICAN COUNTRIES ON THE REGION'S FOREIGN DEBT, ALTHOUGH US TREASURY SECRETARY DONALD REGAN IS CITED AS SAYING THAT THE IBRD AND IMF DEVELOPMENT COMMITTEE SHOULD NOT BE TURNED INTO A POLITICAL FORUM.

4. SPEAKING IN WASHINGTON ON SATURDAY, ECONOMY MINISTER BERNARDO GRINSPUN ECHOED ALFONSIN IN STRESSING THE THREAT TO DEMOCRACY IN DEVELOPING COUNTRIES POSED BY THE ECONOMIC CRISIS. HE DEMANDED A REDUCTION IN INTEREST RATES AND REPEATED A PROPOSAL THAT THE FOREIGN DEBT PROBLEM BE TREATED WITH A MORATORIUM ON BOTH INTEREST AND CAPITAL UNTIL A LONG-TERM SOLUTION COULD BE FOUND.

5. ON FRIDAY THE CENTRAL BANK DEVALUED THE PESO BY 3.19 PER CENT BRINGING THE TOTAL DEVALUATION OF THE OFFICIAL RATE TO 26.1 PER CENT SINCE THE BEGINNING OF THE MONTH. THE BANK'S PRESIDENT, ENRIQUE GARCIA VAZQUEZ, HAS INDICATED THAT A TIGHT MONETARY POLICY WILL BE APPLIED UNTIL THE END OF THE YEAR.

6. BEFORE LEAVING FOR NEW YORK, FOREIGN MINISTER DANTE CAPUTO

6. BEFORE LEAVING FOR NEW YORK, FOREIGN MINISTER DANTE CAPUTO ASSERTED THAT THE UK SHOULD BE WORRIED BY THE DEGREE OF SUPPORT FOR ARGENTINA AT THE UN OVER THE FALKLANDS ISSUE AND AGAIN REFERRED TO OUR QUOTE INTRANSIGENCE UNQUOTE WHICH WOULD ALLEGEDLY COST US POLITICAL CAPITAL IN THE INTERNATIONAL COMMUNITY. ALFONSIN WAS EXPECTED TO ADDRESS THE UN ON THE FALKLANDS TODAY, BUT HE AND CAPUTO BOTH RULED OUT BILATERAL TALKS WITH THE UK DURING THEIR PRESENT TRIP.

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7. ON MONDAY MOST PAPERS CARRIED AN EFE AGENCY STORY THAT WE ARE NERVOUS ABOUT A POSSIBLE CHANGE OF VOTE BY FRANCE, ITALY AND GREECE, AND THEY NOTE THE PUBLICATION BY THE OBSERVER OF A SUPPOSEDLY CONFIDENTIAL DOCUMENT ON THE FALKLANDS SENT BY THE BRITISH TO OTHER GOVERNMENTS.

8. WHILE POLITICIANS AND HUMAN RIGHTS GROUPS CRITICIZED THE REPORT FROM THE NATIONAL COMMISSION ON THE DISAPPEARANCE OF PERSONS (DCONADEP) FOR NOT LISTING THE NAMES OF THOSE GUILTY OF EXCESSES DURING THE DIRTY WAR, THE GOVERNMENT HAS ANNOUNCED THE CREATION OF A NEW INTERIOR MINISTRY UNDER-SECRETARIAT TO CONTINUE THE COMMISSION'S WORK.

9. THE SUPREME COURT HAS MEANWHILE REFUSED TO TRY A CASE INVOLVING FORMER PRESIDENT JORGE VIDELA AND OTHER HIGH-RANKING RETIRED OFFI- CERS AND HAS TRANSFERRED IT TO THE ARMED FORCES SUPRME COUNCIL. THE COUNCIL IS IN TURN EXPECTED TO INFORM THE FEDERAL CRIMINAL APPEALS COURT TOMORROW THAT IT IS STILL UNABLE TO REACH A VERDICT IN COURT MARTIALS OF FORMER MEMBERS OF THE MILITARY JUNTAS FOR HUMAN RIGHTS ABUSES, AND JUSTICE MINISTER CARLOS ALCONADA ARAMBURU HAS STATED THAT MANY CRIMES ARE LIKELY TO GO UNPUNISHED FOR LACK OF EVIDENCE.

10. DANIELLE MITTERRAND, WIFE OF THE FRENCH PRESIDENT, ARRIVED IN BUENOS AIRES ON AN OFFICIAL VISIT ON SATURDAY. INVITED BY SENORA ALFONSIN, SHE WILL MEET RELATIVES OF FRENCH CITIZENS WHO DISAPPEARED UNDER THE MILITARY REGIME.

11. THE ARMY APPARENTLY OWES ITS SUPPLIERS BETWEEN 1.2 AND 1.5 BILLION PESOS, AND ITS COST-CUTTING EFFORTS INCLUDE A REDUCTION IN THE QUANTITY OF FOOD PURCHASED FOR ITS CONSCRIPTS.

12. A REPORT BY THE BUENOS AIRES-BASED CENTRE FOR DEFENCE STUDIES AND RESEARCH (CIED) CLAIMS THAT ARGENTINA CANNOT SIGNIFICANTLY REDUCE HER ARMED FORCES UNLESS HER PRINCIPAL NEIGHBOURS, CHILE AND BRAZIL, AGREE TO DO THE SAME. IN LISTING THE MILITARY EQUIPMENT AVAILABLE TO THE THREE ARGENTINE SERVICES, THE ORGANIZATION CONTENDS THAT THE NAVY POSSESSES 20 EXOCET MISSILES.

13. ENERGY SECRETARY CONRADO STORANI HAS DEFENDED AN OIL EXPLORATION CONTRACT SIGNED BY YPF WITH SHELL AGAINST STRONG CRITICISM THAT IT IS DISADVANTAGEOUS TO ARGENTINA.

14. PERONIST DEPUTIES SEEM SET TO PROVOKE A POSTPONEMENT OF TODAY'S SCHEDULED DEBATE ON THE 1984 BUDGET, ALTHOUGH THERE ARE SIGS AMONG THEIR RANKS OF GROWING FACTIONALISM AND DISSATISFACTION WITH THE CURRENT PARTY LEADERSHIP.

JOY

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SAVINGRAM

BY BAG

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FROM UKDEL IMF/IBRD WASHINGTON

TO FCO SAVINGRAM NO 439 OF 23 SEPTEMBER 1984 AND SAVING (FOR INFO) UKDEL OECD,

UKMIS NEW YORK, UKMIS GENEVA, DELHI, MEXICO CITY

G24 MINISTERIAL MEETING

Following is Communique of the Ministerial Meeting of the Group of Twenty-Four held in Washington on 21 September 1984.

BEGINS

1. Ministers of the Group of Twenty-Four on International Monetary Affairs held their Thirtieth meeting in Washington, D.C., on September 21, 1984. Mr. Pranab Kumar Mukherjee, Minister of Finance, India, was in the Chair, with Mr. Bernardo Grinspun, Minister of Economy, Argentina, and Mr. A. Tesfaye Dinka, Minister of Finance, Ethiopia, as Vice-Chairmen. The meeting was attended by Mr. J. de Larosière, Managing Director, International Monetary Fund, Mr. A. W. Clausen, President, The World Bank, Mr. Munoz Ledo, New York Chairman, Group of 77, Mr. F. Fischer, Executive Secretary, Development Committee, Mr. Shuaib U. Yolak, Under-Secretary General, United Nations, Mr. S. Abrahamian, Chief, International Monetary Issues and Financial Markets Branch, UNCTAD, Mr. S. Dell, Project Director, UNDP/UNCTAD, Mr. Ali K. Hussain, OPEC, Mr. Y. S. Abdulai, Director-General, OPEC Fund, Mr. Hassan Al-Najafi, Governor, Central Bank of Iraq, and Mr. Hamad S. Al-Sayari, Acting Governor, Saudi Arabian Monetary Agency (SAMA). Mr. Wang Bingqian, State Counsellor and Minister of Finance of China attended as an invitee.

2. The meeting of Ministers was preceded, on September 19, by the Forty-First Meeting of Deputies of the Group of Twenty-Four, with Mr. R. N. Malhotra, India, as Chairman, and Mr. H. A. Alonso, Argentina, and Mr. Taddesse Gebre Kidan, Ethiopia, as Vice-Chairmen.

3. Ministers reviewed the world economic situation and noted that economic activity in industrial countries was expected to improve considerably in 1984 but pointed out that, while the growth rate was strong in North America and had picked up in Japan, it continued to be weak in Europe where unemployment still remained at very high levels. They viewed with concern that the prospect for 1985 was for a substantial slowing down in the pace of growth. They also expressed concern that despite continued moderation in inflation in the industrial world, interest rates continued to be excessively high and had risen further in 1984, that misalignment of exchange rates as between major currencies persisted, and that protectionism had continued to intensify.

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/4. Ministers

4. Ministers noted that, notwithstanding some improvement in prospects for growth in output and trade in 1984, the economic and financial conditions in many developing countries remained severely constrained, characterized as they were by low or negative growth rates, declining per capita incomes in many countries, cutbacks in investment, stringency in liquidity, continued constraints on imports, and heavy debt service burdens. The terms of trade of developing countries continued to be weak, and there has been a disturbing decline in commodity prices recently. These developments have had a particularly severe impact on Sub-Saharan Africa.

5. Ministers deplored that, despite improvement in economic activity in industrial countries, protectionist measures continued to intensify, reducing access for developing countries' exports and rendering adjustment in their external accounts all the more difficult. They pointed out that the ability of developing countries to service their debt depends crucially on the growth of their exports. They emphasized that the debt position of many countries continued to be serious and had been aggravated by high and rising interest rates. It is crucial to bring down interest rates, as persistence of the current high rates involves, in many cases, large reverse flows of resources to industrialized countries, with serious implications for the investment and growth prospects of developing countries. Further, resolution of the debt problem required imaginative solutions involving debt restructuring over the longer term on reasonable conditions consistent with the need for orderly adjustment and growth. In this connection, they urged that the recent exercises in multi-year restructuring of debt should be extended to other cases.

6. Ministers underscored the strong adjustment efforts made by many developing countries at great social cost, and emphasized that the effective resolution of their problems called for important changes in the policies of industrial countries. Ministers, therefore, urged that industrial countries take urgent action to make structural changes in industries where these do not have comparative advantage, eliminate protectionist measures, improve access of exports from developing countries, lower interest rates, improve the alignment of exchange rates, liberalize access to their capital markets and increase the flow of official development assistance. Industrial countries in Europe, especially those that have successfully moderated inflation, should shift the emphasis of their macroeconomic policies so as to promote and expand world recovery and bring down unemployment in their economies. Healthy recovery in the European economies would create more demand for imports from developing countries, especially from Africa and other exporters of primary commodities. They emphasized that, considering the large weight of the United States economy, lowering of the United States fiscal deficit and interest rates and adjustment of the U.S. dollar's exchange rate to more sustainable levels would have a beneficial impact on the world economy.

7. Ministers reiterated the need for special supportive measures for reviving the growth momentum in developing countries, especially through increased financing including, in particular, concessional flows to low-income countries, and stressed that resources of international financial institutions be further strengthened to enable them to play a more effective role in the adjustment and development process.

/8. Ministers

8. Ministers considered the question of access limits to Fund resources for 1985 and noted that the prospects for developing countries were marked by uncertainties, such as high interest rates, weak terms of trade, the seriously reduced access of several countries to commercial banks, and the hump in debt servicing in the second part of the 1980s. They pointed out that the reduction in the aggregate current account deficits of developing countries had been brought about mainly through severe compression of imports, which was not sustainable in the medium term, and that several members would need large Fund financing in support of their adjustment programs, which are structural in character and require a longer time-span. Adjustment must not be pushed beyond the limits of social and political tolerance.

9. Ministers pointed out that, among other reasons, the Enlarged Access Policy was necessitated by the inadequacy of quotas, which have remained insufficient even after the Eighth General Review, and urged that, until the size of quotas bears an appropriate relationship to world trade, it is imperative to maintain the policy of enlarged access without dilution.

10. Ministers, therefore, emphasized the need for continuing the Enlarged Access Policy in 1985 and beyond, and for maintaining, as a minimum, the current access limits under the policy.

11. Ministers stressed the need for maintaining, as a minimum, the present access limits under the Fund's special facilities. They pointed out that there was no warrant to link the review of access limits under the special facilities to those under the Enlarged Access Policy, and urged that the annual review of access under the special facilities should be discontinued.

12. Ministers urged a reversal of the increased conditionality being applied to the Compensatory Financing Facility, as conditionality had little relevance in the case of this Facility, which was designed to meet reversible export shortfalls beyond the control of the countries concerned. They also urged to make it a truly quick disbursing facility.

13. Ministers called for a study by the International Monetary Fund for establishing either a new facility in the Fund or for enlarging the Compensatory Financing Facility for alleviation of debt servicing burden arising out of increases in interest rates which are beyond the control of developing countries. They urged that this study be completed by the time of the next meeting of the Interim Committee.

14. Ministers regretted that Fund financing in 1984 in individual cases had been highly restrictive and could have discouraged some members from approaching the Fund for assistance. They urged liberalized financing, considering the continuing needs of several member countries and the improved liquidity of the Fund, so as to ensure that there is an appropriate balance between adjustment and financing.

15. Ministers urged that, as directed by the Interim Committee, in implementing its policies on access to its resources, the Fund should be particularly mindful of the very difficult circumstances of the small quota, low-income member countries; and avoid reducing its financing to such countries under a restrictive interpretation of its "catalytic" role. They urged that the conditionality relating to financing for these countries should take into account their special problems.

/16. In considering

16. In considering the question of an allocation of SDRs, Ministers noted that the international non-gold reserves had stagnated over the recent years and that there was need for their substantial supplementation in view of the expected growth of world trade in the coming years.

17. Ministers expressed concern over the acute stringency in the reserve position of a large number of developing countries which had severely constrained their import capacity and brought about increasing trade and payments restrictiveness with an adverse impact on investment and growth in these countries. They emphasized that a substantial allocation of SDRs would promote economic recovery and would not be inflationary, would ease the serious constraints in the payments position of developing countries, promote world trade, help reserve diversification, improve the balance between conditional and unconditional liquidity, reduce dependence on borrowed reserves, and generally support orderly adjustment.

18. Ministers reiterated their view that an annual allocation of no less than SDR 15 billion would be necessary in the Fourth Basic Period, and urged that as almost three out of the five years of the Fourth Basic Period had elapsed, annual allocations should continue beyond 1986.

19. Ministers emphasized that the unconditional use of SDR allocations must remain inviolate and rejected ideas suggesting conditional use of allocated SDRs as these contravene the letter and spirit of the Articles of Agreement of the Fund, imply a fundamental change in the character of the SDR, and would undermine the objective of making it the principal reserve asset.

20. Ministers deplored that in spite of a vast majority of Fund membership being in favor of an SDR allocation, no allocation has so far been made in the Fourth Basic Period, thereby making orderly adjustment more difficult and giving wrong signals to the international community regarding the commitment to make the SDR the principal reserve asset, and urged member countries which have not so far found it possible to agree to an allocation, to urgently reconsider their position. They urged the Interim Committee to develop a political consensus urgently for a substantial SDR allocation.

21. Ministers called for the establishment of a link between SDR allocations and development finance, a proposal which was all the more justified in the present context.

22. Ministers expressed grave concern at the serious decline in living standards in Sub-Saharan Africa, and deplored the prospective decline in net capital flows to the region from an annual average of about $11 billion in 1980-82 to $5 billion in 1985-87, which was inconsistent with the crisis confronting Africa. They commended the World Bank for its Report on a Joint Program of Action for Sub-Saharan Africa, and expressed the hope that it would constitute a basis for action by the international community in support of the region's development. They emphasized that the consensus which may develop on the Program of Action should be vigorously pursued and urgently and effectively implemented.

/23. Ministers

23. Ministers called upon the donor Governments and the multilateral institutions to maintain net annual capital flows during the next few years in real terms, at least at the level achieved during 1980-82, and for this purpose, urged multilateral institutions to devise appropriate mechanisms such as a special assistance facility. They urged bilateral donors to urgently implement the Trade and Development Board Resolution (165-S-IX). They further urged that all outstanding bilateral ODA loans to the least developed countries be converted into grants, a measure which will provide relief to most countries of this region.

24. Ministers urged that, to improve its effectiveness, bilateral assistance should be provided within the framework of recipient Governments' development programs and priorities. They further urged the IBRD to expand its lending to Sub-Saharan Africa and the IFC to accord high priority to the region in its developmental lending and investment activities.

25. Ministers expressed concern at the decline in commodity prices, which has seriously affected the external balances of primary producers and, in this context, called for urgent steps for stabilization and improvement of commodity prices, including early implementation of the Common Fund Agreement.

26. Ministers deplored the intensification of protectionist measures in most industrial countries which had harmed the multilateral trading system and slowed the growth of world trade. They believe that the achievement of an open trading system depends crucially on the industrial countries eliminating their protectionist barriers. Ministers emphasized that in promoting a liberalized multilateral trading system, the special and preferential treatment in favor of developing countries recognized by GATT should be maintained and effectively implemented, especially in relation to items of interest to developing countries, such as agriculture, textiles and manufactures.

27. Ministers underlined the importance of respecting the jurisdiction of GATT and UNCTAD in trade matters.

28. Ministers stressed that multilateral financing should not be linked to conditionality relating to trade matters, as that would accentuate the present asymmetry prevailing between developed and developing countries.

29. Ministers took note of the work being done by the World Bank regarding its future role and emphasized that its objective must continue to be one of commitment to development, growth and poverty alleviation, as enshrined in its Articles of Agreement. They urged that the Bank should quickly proceed to determine the financing needs of all developing countries, and take early steps to negotiate a General Capital Increase by FY 1986 so as to enable its lending operations to be expanded sufficiently to fully meet these needs, having regard to the Bank's enlarged coverage, the requirements of the energy sector, and structural adjustment lending.

/30. Ministers

30. Ministers urged that in its relations with highly indebted countries, the Bank should play a supportive role so that adjustment in these countries takes place in an environment of growth. They reiterated that a Task Force be established under the aegis of the Development Committee to study all aspects of the debt problem, including its relationship with the needs of development finance, and urged that the study be completed within a period of six months. This should not prejudice other initiatives on the part of debtor and creditor countries for alleviating the debt problem.

31. Ministers expressed concern at the undue emphasis on policy-based lending and the move to link the quantum of Bank assistance to increasing conditionality, and emphasized that coordination between the World Bank and the International Monetary Fund should be in keeping with their respective roles, and not become a means for exerting a concerted pressure on borrowing countries.

32. Ministers regretted the increasing tendency towards greater conditionality with regard to financing for development and adjustment and even in relation to flows of commercial bank credits and its further reinforcement through greater institutional coordination. Excessive emphasis on policy-based lending and conditionality would adversely affect the integrity and flexibility of national policies, and can interfere with the smooth flow of resources to the developing world. Ministers therefore urged that these trends be reversed through adoption of a more balanced approach.

33. Ministers noted the significant contribution made by IDA in the low-income developing countries through high net transfers, proven effective utilization of resources, alleviation of poverty, and provision of technical assistance, and urged that IDA as a multilateral institution should be strengthened.

34. Ministers expressed deep disappointment at the very inadequate IDA VII replenishment of $9 billion and at the lack of success so far in raising supplementary funds, and urged the Management of IDA to resume their efforts to expeditiously negotiate a supplementary fund of the order of $3 billion. They called upon the donor community to act generously, and not allow considerations of burden sharing to stand in the way of adequate funding of a program which is of such crucial concern to the low-income countries.

35. Ministers adopted a Revised Program of Action Towards Reform of the International Monetary and Financial System and called for its early implementation. In their view, there should be no delay in moving towards a thoroughgoing reform of the international monetary and financial system which would secure the objectives of sustained growth, exchange and monetary stability, and adequacy of resources for investment, particularly to meet the special needs of developing countries. Ministers called for the convening of an international monetary and financial conference as an important and essential step in this direction.

36. Ministers agreed to hold their next meeting at a place and on a date to be announced later.

ENDS

WICKS

MONETARY

ERD

(2)

21 September 1984

PRIME MINISTER

AT 21/9

The continuing surge of the dollar reflects the powerful financial pressures at work, channelling massive funds into the US to pay for the large balance of payments deficit on current account. US interest rates remain at penally high levels, with US prime of 13 per cent, compared with a latest US inflation figure of 2.9 per cent. US domestic borrowers are still shielded from the worst impact of this by the substantial tax breaks they enjoy. The run-up to the quarter end naturally increases world demand for dollars, as international borrowers have to buy the US currency to pay their interest charges.

The pattern is as it has been for more than a year. The US banks, short of capital and short of liquidity, are not increasing their debt exposure overseas. Capital exports from the US have effectively stopped. At the same time, the US banks have to bid for funds, and the high resulting interest rates are very attractive to depositors from around the world.

The latest Mexican rescheduling will contain an option for non-US banks to convert half their dollar loans into domestic currencies. Such conversions are another factor in reducing the world supply of dollars, while increasing the supply of other currencies through liquidation of dollar debt. The abolition of withholding tax on US treasuries for foreign buyers is a further inducement to channel money into the US: at the same time it makes Eurodollar investment less attractive. The debt crisis therefore imposes a perpetual vicious circle, stopping more American dollar lending and converting existing dollar debt into other currencies.

Banks are still under pressure. By 1983, capital represented some 3.73 per cent of the total asset base of the 34 largest US, Canadian, UK and Japanese banks, dominated by the US ones. In 1970, the ratio was more than 5 per cent. The renewed fears about the quality of lending, not only internationally but also domestically in the US (particularly to the energy sector) serves to accelerate dollar strength and the contraction of the credit base.

The latest US estimates show both growth and inflation falling. The second quarter real growth figure has been revised downwards to 7.1 per cent, and the "flash" estimate for the third quarter shows the real growth rate dropping off to an annual 3.6 per cent. Inflation has slackened off to 2.9 per cent from 3.3 per cent. (Our 5.0 per cent no longer looks satisfactory). AW

The falling trend of housing starts, the high level of real interest rates, the flash figure, and anecdotal evidence about the US economy, all point to a sharp slowing in the phenomenal growth rate the economy was recording 6 months to a year earlier.

The US remains locked into the battle of the two deficits. The substantial balance of payments deficit is still being added to by the growing strength of the dollar. It has been estimated that a 1 per cent real increase in the dollar leads to an additional $2 billion of trade deficit after a 2-year gap, assuming other factors are equal. The latest surge in the dollar will exacerbate the problem.

It still requires some combination of slower economic growth, lower US interest rates, a change of sentiment, and perhaps some resumption of additional dollar lending overseas, as part of the rescheduling and repackaging of international debt to bring the dollar down significantly.

The international debt problem

I checked with the Bank of England. They deny heaping praise on Sir Walter's scheme. AT

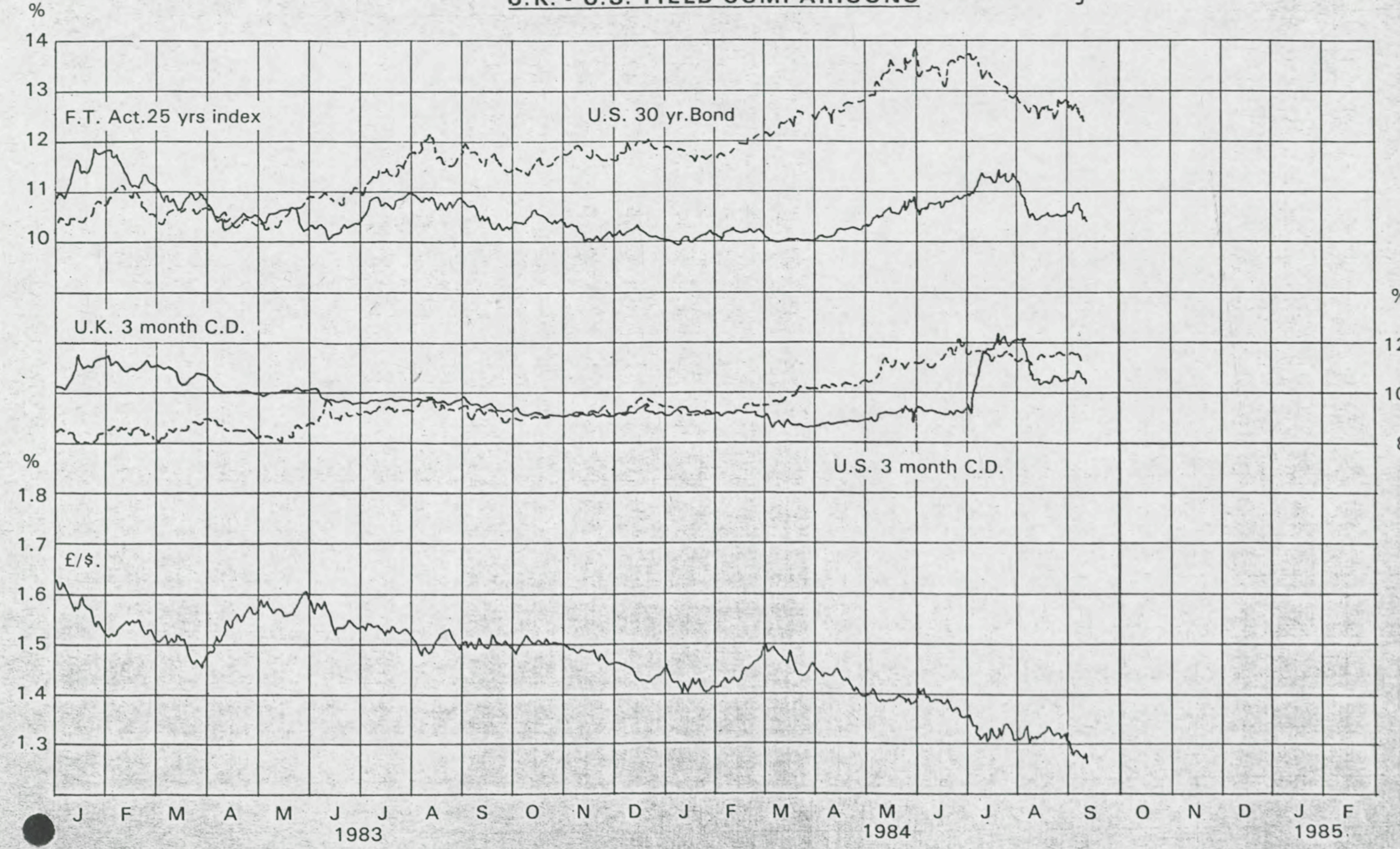
I telephoned Alan Walters and discussed the Salomon proposals with him. He responded as we had done, welcoming the movement towards a market in debt - as he always has - but expressing considerable scepticism about the international body designed to weed out the bad debt and judge the solvency of banks. Nonetheless, he readily agreed to give the pamphlet a favourable wind for publication, and to see if he could help Walter Salomon with Paul Volcker. His view was that the US economy is slowing down quite quickly now, and this might feed through to lower interest rates and a more stable dollar.

John Redwood

JOHN REDWOOD

High US rates
long & Short term.

U.K. - U.S. YIELD COMPARISONS



10 DOWNING STREET

From the Private Secretary

Prime Minister

Although there are elements in Sir Walter's scheme which are desirable - greater marketability of loans, more non debt financing - his scheme as a whole is subject to major defects as the Treasury and Policy Unit notes make clear.

Do we really want Western Governments to take over bad loans? or to make huge subsidies? Is the solution suitable for Mexico really suitable for Argentina?

AT
19/9

19 September 1984

PRIME MINISTER

Walter Salomon is right in his analysis of the origins of the problem, right in urging the transfer of real assets from those countries that owe money to the creditors and right to want a market in dud debt. More enthusiastic acceptance of the need for equity finance of new ventures in the Third World is an essential part of any recovery package, and more should be done to explore methods of achieving this. It may be best to confine this to new money rather than attempting to convert existing loans into equity.

A step-by-step approach to a market in bad debt would be preferable to his big bang solution. There are already precedents as some syndicated loans are switched from bank A to bank B, and there is a market in country risk debt, as with the Mexican bonds, which can give people some guidance on the true value of these assets. Under his scheme a bank could be obliged to give its bad loan to the International Realisation Company, it could then buy it back (paying expenses on the way) only to have to give it back again if the status of the loan deteriorated further!

Walter Salomon's plan would succeed in putting much of the cost of solving the present problem on Western taxpayers through the tax break mechanism he propounds. Much better as a relief to the Third World would be sound financial policies in the United States leading to lower US interest rates.

The dangers in his scheme are:

1. The existence of the International Realisation Company could precipitate a worse crisis than it is designed to alleviate. It could, for example, encourage more debtor nations to renege on their obligations or to seek a soft deal.

2. The Realisation Company could work at the expense of the shareholders of independent commercial banks and requires deliberately changing the basis of solvency calculations in a way which weakens the institutions. Whilst any solution to the problem should make the shareholders of commercial banks that have made bad loans bear the brunt of the adjustment, and not the taxpayers, this method could worsen the banks and shareholders' plight unnecessarily.

3. To avoid a future crisis, Walter Salomon effectively recommends the nationalisation of most international lending from here on. This is likely to get the Western countries into worse trouble, both because governments will be no better at assessing risk than the shareholders and managers of commercial banks have

been, and because the existence of a specific government pledge behind a given loan could make it even more tempting for a debtor nation to demand a renegotiation.

New equity finance for the Third World is vital, one-off renegotiations will sometimes be needed and some money can be routed via the IMF. But let's not put into being a supranational body with wide-ranging powers to interfere in the practices of commercial banks, with powers to subvene Western taxpayers' money to come to the support of the Third World on the grounds that world trade will then be expanded.

JOHN REDWOOD

6.23

cc NO

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

19 September 1984

Andrew Turnbull Esq
10 Downing Street
LONDON
SW1

Dear Andrew,

INTERNATIONAL DEBT

On 13 September you sent us a pamphlet containing a proposal for resolving international debt problems which Sir Walter Salomon had shown to the Prime Minister. I attach an appraisal of it, as you requested.

In your letter you refer to the proposal for special tax credits. We too are unclear as to precisely how the scheme would work. It appears that banks' corporation tax liability would be reduced to the extent that they abated interest rates payable by debtor nations. Whatever the details, it would amount to a massive subsidy to debtor countries.

You also asked about the accounting procedure for loans in the temporary stewardship of the Realisation Company. This does not appear to be of crucial importance to the general intention of the scheme. The procedure followed would depend on accounting practices in individual countries. It might make most sense for banks to ascribe to such loans the value of similar debt which had already been sold.

I am copying this to John Bartlett in the Governor's office.

Yours ever,

Judith

MISS J C SIMPSON
Private Secretary

SIR WALTER SALOMON'S PROPOSALS ON INTERNATIONAL DEBT

Summary of proposals

Sir Walter Salomon's proposals can be summarised as follows:

(i) the creation of an "International Realisation Company", supported by the Western central banks. This would take non-performing loans into temporary stewardship, market them on the banks' behalf, and pay them the proceeds. It could renegotiate loans with debtors, and "repackage" for sale loans made by different banks.

(ii) Developed country governments would grant tax credits to banks in respect of interest payments on loans to troubled debtor countries. The details are unclear. But the intention is that the benefit would pass on to debtors in the form of lower interest payments - ie the tax system should be used indirectly to give debtors a subsidy.

(iii) Developing countries should be more welcoming to foreign equity capital, and permit the sale of existing assets to foreigners. Future borrowings should be on a fully secured basis.

(iv) Banks whose balance sheets were badly hit by loan sales would have to be reconstructed. This might involve separating non-performing loans from performing loans, with the two parts of the bank being backed by separate shares (the 'A' and 'B' shares in the scheme which Sir Walter previously mentioned to the Prime Minister).

(v) Banking supervision in the UK should be carried out by an independent body of bankers, not by the Bank of England.

Analysis

2. Sir Walter Salomon's scheme is founded on the assumption that the international banking system is close to collapse ("the spectre of default is visible on all sides".) Neither we, nor any of the other Summit countries, nor the IMF share this view, though there are considerable downside risks in the current situation. In our view the current case-by-case strategy, despite many uncertainties, continues to be sustainable. So the premise on which the scheme is based is in our judgement misconceived.

3. Nor are we attracted by the idea of giving debtor countries a subsidy, which would mainly benefit middle-income developing countries. Even if we were, it is not obvious that the most efficient way of doing so would be through the tax system. In 1983 bank debt service payments by all developing countries were around $50 billion. So tax relief at the corporation tax rate in the lender countries concerned would cost up to perhaps $20 billion to $25 billion a year, including perhaps £2 billion a year in the UK. If this interest subsidy were payable only on problem loans, as Sir Walter proposes, this would encourage debtors to relax efforts to continue servicing loans properly, in order to qualify. Commercial discipline on the banks would also be weakened.

4. We agree, however, with Sir Walter on the importance of encouraging an increase in more stable forms of finance such as direct and equity investment, and are continuing to press developing countries to be more receptive to this.

5. We also see some attraction in greater marketability of bank debt, which the proposed realisation company is a way of achieving. In principle, marketability has the attractions of giving a market value to bank debt - which may be more appropriate than the full book value. Risk might be spread to non-bank investors. But so far, banks have not engaged in large-scale marketing of their debts, because of legal

restrictions in some countries, scarcity of potential purchasers, and reluctance by banks and debtors to see debts traded at prices substantially below book values.

6. It is difficult to see what would induce banks to give their problem loans to a realisation company. They would run the risk of receiving considerably less than the book value when loans were sold. Sir Walter says that, as an inducement for banks to join the scheme, regulatory authorities should disregard doubtful loans in calculations of capital ratios for solvency purposes. But this would mean a much tougher stance than currently exists in developed countries, and would in practice not be achieved over the timescale Sir Walter has in mind. An added difficulty could be that loans may generally not be sold without the authority of the borrower; who would not welcome the large discounts which could occur when a loan was sold, as this would indicate their credit standing and affect the cost of new money.

7. It is not clear how loans would be treated in the banks' accounts while under the stewardship of the realisation company. It might be necessary for the banks to ascribe to them the value of similar debt which had already been marketed, although this would depend on the accounting procedure in individual countries (in the UK it might be possible for the loan to keep its full value until actually sold).

8. As loans were sold, banks' financial positions could become very precarious, as Sir Walter admits. Much would depend on the speed with which the realisation company marketed the debt - rapid sales could lead to lower prices. In the meantime, pressures could build up for the realisation company to help service the debts in its stewardship - with taxpayers' money. And, since central banks, through the BIS, would be backing the company, they would come under strong pressure to rescue banks which were in difficulty as a result of loan sales.

9. Sir Walter proposes that non-performing loans be separated off from performing loans, and that banks raise new capital

to carry on business. But it is possible that banks' liabilities, used to fund problem loans sold by the realisation company, might exceed levels which could be covered by new capital issues - as in the case of Continental Illinois. If such liabilities were not met by other banks by means of measures such as the "safety-net" arrangement for Continental, which required central bank involvement, the financial system generally would face severe difficulties.

10. The Treasury does not share Sir Walter Salomon's doubts about the effectiveness of Bank of England supervision. Bank officials engaged on this specialist work are not generalist civil servants, but experienced central bankers of high international standing. Supervisors have statutory independence from political interference. We doubt that the transfer of supervision to a committee of practising bankers would improve supervisory standards; there would in any event be problems of conflict of interest and security of commercial information.

Conclusions

11. Sir Walter starts from an extreme view that the stability of the international financial system is not sustainable under present policies. He is right to advise greater non-bank investment in developing countries. But his proposal for tax credits on loan interest would mean massive government subsidies. His proposal for a realisation company, while based on a view of the desirability of marketability of debt which has some attractions in principle, would cause substantial difficulties in operation. While there remains scant evidence of any non-bank interest in taking on ldc debt, it is wiser to develop marketability step by step, in co-operation with the banks, rather than introducing a grandiose scheme involving a new institution. It would not be helpful to take supervisory functions away from the Bank of England.

Econ Pol: Indebtedness Pt 4

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TO IMMEDIATE FCO

TELNO 626 OF 19 SEPTEMBER 1984

INFO PRIORITY MOD (SIC A3A), CBFFI BANK OF ENGLAND ASUNCION BRASILIA CARACAS MEXICO CITY MONTEVIDEO SANTIAGO UKMIS NEW YORK WASHINGTON PORT STANLEY HOLY SEE

PRESS SUMMARY

1. TODAY'S TOP NEWS IS ECONOMY MINISTER GRINSPUN'S ANNOUNCEMENT YESTERDAY OF A 'TECHNICAL AGREEMENT ' WITH THE IMF WHICH HE HAS TAKEN WITH HIM TO WASHINGTON AND WHICH HE SAYS SHOULD ENABLE ARGENTINA TO SEEK A STANDBY CREDIT OF OVER 1.5 BILLION DOLLARS FROM THE FUND TO RUN FROM 1 OCTOBER FOR 15 MONTHS. GRINSPUN CARE' FULLY AVOIDED REFERRING TO A FULL AGREEMENT WITH THE FUND, INDIC- ATING THAT THERE WAS STPLL A LONG NEGOTIATION AHEAD.

2. FOLLOW-UP REPORTS ON THE MAR DEL PLATA CONFERENCE SUGGEST THAT MOST LATIN AMERICAN COUNTRIES ARE REACTING CAUTIOUSLY TO REPORTS OF US OFFICIAL OPPOSITION TO A CREDITOR/DEBTOR SUMMIT CONFERENCE.

3. AS THE AIRLINE AND BANK STRIKES CONTINUE, AGREEMENT HAS BEEN REACHED TO DEBATE THIS YEAR'S BUDGET ON 24 SEPTEMBER AND POSTPONE THE DATE FOR NORMAL CONSIDERATION OF THE 1985 BUDGET UNTIL

THE DATE FOR NORMAL CONSIDERATION OF THE 1985 BUDGET UNTIL NOVEMBER. SOCIAL CONTRACT DISCUSSIONS SEEM TO BE DRAGGING.

4. MOST PAPERS ARE PREPARING FOR THIS WEEK'S BIG NEWS EVENT: PUBLICATION TOMORROW OF THE SABATO COMMISSION REPORT ON THE DISAPPEARED WHICH IS EXPECTED TO NAME SOME 1,300 OFFICERS AND NCOS PRESUMABLY INVOLVED IN HUMAN RIGHTS VIOLATIONS. THERE ARE REPORTED TO HAVE BEEN BITER ARGUMENTS WITHIN THE COMMISSION OVER PUBLICATION OF NAMES. INCREASED TENSION IN THE ARMED FORCES IS FORECAST AS THE DATE APPROACHES.

5. INTERNAL CONTROVERSY CONTINUES WITHIN THE RADICAL PARTY WHOSE NATIONAL COMMITTEE MEETING HAS BEEN POSTPONED AGAIN.

6. TODAY'S F'TIEMPO ARGENTINO' SAYS A BAHIA BLANCA PAPER YESTERDAY REPORTED THAT QUOTE SERIOUS COMPLICATIONS ARISING IN THE HOLY SEE COULD PARALYSE THE (BEAGLE) NEGOTIATIONS COMPLETELY, LEADING TO SUSPENSION OF THE PLEBISCITE UNQUOTE. THE DIFFICULTIES ARE NOT SPECIFIED BUT RADICAL DEPUTY JOSE BIELICKI MAINTAINS THE PLEBISCITE WILL GO AHEAD.

7. SENATE DEFENCE COMMITTEE CHAIRMAN ANTONIO BERHONGARAY MAINTAINS, AFTER HIS CONVERSATION WITH BRITISH MP DONALD ANDERSON, THAT HE IS CONVINCED ARGENTINA WILL GET THE FALKLANDS BACK IN THE MEDIUM TERM. SEVERAL PAPERS CARRY REPORTS FROM THE UN OF SIR JOHN THOMSON'S PRESS BRIEFING UNDER THE HEADLINE 'GREAT BRITAIN TRIES TO AVOID DEBATE AT THE UN'. THE BRITISH REPRESENTATIVE IS REPORTED SAYING QUOTE DEBATES HERE TEND TO SHARPEN MATTERS AND CAUSE CONFRONTATIONS: THEY ARE NOT A NORMAL PRELUDE TO NEGOTIATIONS. I WOULD SAY THAT IF THE ARGENTINES DECIDED THEY DID NOT WANT A DEBATE THIS YEAR I SHOULD CONSIDER THIS ENCOURAGING UNQUOTE.

8. IGLESIAS ROUCO IN 'LA PRENSA' WRITING OF THE QUOTE TOADS UNQUOTE ALFONSIN AND THE RADICALS ARE HAVING TO SWALLOW (MEANING CLIMB-DOWN OVER TE IMF AND OTHER INTERNAL PROBLEMS) SUGGESTS THAT KISSINGER LEFT WITH FAR FROM OPTIMISTIC A VIEW OF THE TRUE POSITION OF ALFONSIN'S GOVERNMENT OVER THE FALKLANDS AND NEGOTIATIONS WITH BRITAIN, BELIEVING, ACCORDING TO ROUCO'S SOURCES, THAT THE ARGENTINE LEFT IS PUSHING THE GOVERNMENT IN THE SAME DIRECTION AS THOSE WHO ENCOURAGED GALTIERI, ANAYA AND LAMI DOZO TO REJECT HAIG, BELAUDE TERRY AND LONDON'S PEACE PROPOSALS AND CONTINUE THE WAR AGAINST THE BRITISH IN 1982 (COPY AND TRANSLATION BY BAG TO FCO)

JOY

POWELL-JONES

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TELNO 615 OF 14 SEPTEMBER 1984

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PRESS SUMMARY

1. ALL PAPERS HIGHLIGHT PRESIDENT ALFONSIN'S INAUGURAL ADDRESS TO REPRESENTATIVES OF THE CARTAGENA CONSENSUS STATES MEETING IN MAR DEL PLATA. HE CALLED FOR A DIALOGUE BETWEEN THE GOVERNMENT'S OF CREDITOR AND DEBTOR COUNTRIES TO SUPPLEMENT SEPARATE NEGOTIATIONS WITH THE BANKS, AND STRESSED THE NEED TO AVOID DISRUPTING THE INTERNATIONAL FINANCIAL SYSTEM. HE ADDED A WARNING ON THE SERIOUS IMPLICATIONS OF THE POLICIES PRACTISED BY QUOTE THE BIG CREDIT CENTRES UNQUOTE, BUT REJECTED THE IDEA OF A DEBTORS' CLUB. (TEXT AND TRANSLATION OF SPEECH BY BAG TO FCO). THE US TREASURY IS MEANWHILE WIDELY REPORTED TO OPPOSE A SPECIAL SUMMIT OF DEBTOR AND CREDITOR NATIONS.

2. ECONOMY MINISTER BERNARDO GRINSPUN HAS NOTIFIED THE INTERNATIONAL BANKS THAT ARGENTINA LACKS THE FUNDS TO REPAY THE 750 MILLION DOLLARS OF THE BRIDGING LOAN THAT FALL DUE TODAY. THE LOAN IS EXPECTED TO BE ROLLED OVER ON A DAILY BASIS UNTIL AN AGREEMENT IS REACHED. GRINSPUN ALSO DECLARED THAT QUOTE THE FIRST

THE LOAN IS EXPECTED TO BE ROLLED OVER ON A DAILY BASIS UNTIL AN AGREEMENT IS REACHED. GRINSPUN ALSO DECLARED THAT QUOTE THE FIRST STAGE OF THE FOREIGN DEBT RENEGOTIATION WITH THE IMF, THE CLUB OF PARIS AND CREDITOR BANKS WILL PROBABLY BE COMPLETED IN THREE OR FOUR WEEKS UNQUOTE.

3. HENRY KISSINGER YESTERDAY DISCUSSED THE FOREIGN DEBT PROBLEM WITH ALFONSIN AND STATED THAT ARGENTINA WAS QUOTE MAKING A TREMENDOUS EFFORT UNQUOTE IN FIGHTING INFLATION. THE PRESIDENT HAS ALLEGEDLY ACCEPTED KISSINGER'S INVITATION TO A DINNER AT HIS NEW YORK APARTMENT ON 26 SEPTEMBER WHERE TALKS WITH IMPORTANT US BANKERS WILL BE POSSIBLE.

4. KISSINGER'S PLANNED ADDRESS TO THE ARGENTINE INTERNATIONAL RELATIONS COUNCIL (CARI) HAD TO BE CANCELLED, SINCE HIS SECURITY COULD NOT BE GUARANTEED AS A RESULT OF THE PRESENCE OUTSIDE THE ORGANIZATION'S HEADQUARTERS OF DOZENS OF PROTESTING ''COMMUNISTS, PERONISTS AND ACTIVISTS'' . DEMONSTRATORS HAD INYULTED AND SPAT AT US AMBASSADOR FRANK ORTIZ AND THE PAPAL NUNCIO AS THEY ARRIVED FOR THE MEETING.

5. AN INTERIOR MINISTRY DOCUMENT CIRCULATED TO PARTICIPANTS IN THE SOCIAL CONTRACT TALKS ACKNOWLEDGES ERRORS IN THE GOVERNMENT'S MANAGEMENT OF THE ECONOMY. IT CONCEDES THAT QUOTE A TRUE REACTIVATION CANNOT BE BASED ON A SIMPLE INCREASE IN CONSUMPTION AND REAL WAGES UNQUOTE AND CALLS FOR EVERYONE TO ACCEPT QUOTE THE EVENTUAL DISTRIBUTION OF THE COSTS OF THE REQUISITE ADJUSTMENT UNQUOTE. TAXATION INBALANCES AND A MAJOR DECLINE IN INVESTMENT ARE ALSO ADMITTED.

6. BANK CLERKS INTEND TO RESUME STRIKE ACTION NEXT WEEK IN SUPPORT OF WAGE CLAIMS, BUT WILL NOT PROTEST ALFONSIN'S DECISION TO VETO CERTAIN ARTICLES OF THE RECENTLY PASSED BILL GIVING THEM JOB SECURITY.

7. IN MAR DEL PLATA FOREIGN MINISTER CAPUTO YESTERDAY MET PRIVATELY WITH HIS CHILEAN COUNTERPART TO DISCUSS THE BEAGLE DISPUTE. ON THE FALKLANDS ISSUE, SEVERAL PAPERS NOTE THAT DR DAVID OWEN HAS REQUESTED EXPLANATIONS FROM THE PRIME MINISTER CONCERNING REPORTS THAT HER PRESS SECRETARY HAD EXPRESSED A PREFERENCE FOR A RELATIVELY SEVERE JUDGE TO TRY THE CASE OF CLIVE PONTING.

8. FOLLOWING THE EXPLOSION AT THE ''ENGLISH TOWER'' ON WEDNESDAY NIGHT, A SECOND BOMB, REPORTED MADE WITH THREE KILOS OF TROTYL, WAS DISCOVERED INSIDE THE BUILDING AND WAS SAFELY REMOVED. THE HAND-BILLS FOUND CLOSE TO THE SITE ANNOUNCED THAT QUOTE THE CONTINENTAL AREA INVADED (BY THE BRITISH) COMPRISES SOME 5,000,000 HECTARES, WHICH IS THE EQUIVALENT OF MORE THAN TWICE THE PROVINCE OF TUCUMAN UNQUOTE AND THAT THE NAMES AND TELEPHONE NUMBERS OF THE ENTITIES WHICH OWNED THE

E LANDS WOULD BE MADE KNOWN IN FUTURE ''RAIDS''.

JOY
POWELL-JONES

PP MODUK (SIC A3A)

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Prime Minister (2)

Summarised in the Treasury cover note, though the table at the end is worth noting

AT 17/9

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

14 September 1984

Andrew Turnbull Esq
10 Downing Street
London SW1

Dear Andrew

INTERNATIONAL FINANCIAL SCENE

I attach the latest report by the Bank on developments on the international financial scene, which has been discussed in the Treasury's international debt group. Many of the issues discussed in the report will be raised in the forthcoming Toronto and Washington meetings.

Among the general issues it is worth noting the positive benefits of the multi-year rescheduling agreement reached in principle between the commercial banks and Mexico. Its successful completion, so soon after the London Summit's recommendation of this approach, is encouraging and should reduce the ability of the more extreme Latin American debtors to win over the moderates on arguments about lack of response by the industrialised countries.

On individual countries, Argentina remains the main problem. There has been some recent indications, eg from the Fund Managing Director, of greater optimism about the prospects for early agreement with the Fund; but previous history suggests it would be right to be very cautious indeed - not only about the prospects for such an agreement but also about the prospects of Argentina sticking to any agreement reached. Although the $750 billion bridging loan which falls due on 14 September will almost certainly be rolled over again, the commercial banks are currently taking a robust attitude towards Argentine demands and the next crunch point will come at the end of October when the US Regulators meet.

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They could decide to downgrade Argentina's credit rating requiring the banks to write-off some 10% of their outstanding loans. In advance of that we shall be taking a fresh look at our own contingency planning and concerting the plans with our US and other G5 colleagues.

Of the other countries Nigeria remains the most worrying. There is still no sign of the Fund agreement which must precede a multilateral agreement to reschedule her debts. In the meantime, the Nigerians are contemplating a unilateral offer to insured creditors extending to them the benefits of the agreement already reached with the uninsured. We shall be giving further thought to the handling of this in the light of discussions this week in the Paris Club.

I am copying this letter to Len Appleyard (FCO), Callum McCarthy (DTI) and John Bartlett (BOE).

Yours ever,
David

D L C PERETZ
Principal Private Secretary

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INTERNATIONAL FINANCIAL SCENE

Uncertainties about the course which Argentina will eventually follow continue to be a major concern for the markets. Meanwhile, a number of negotiations in train elsewhere - notably Mexico - appear to be making progress, while others remain deadlocked. Against this background, regional co-ordination of debt strategies is again under discussion in Mar del Plata (the follow-on to Cartagena).

The economic background to the debt problem remains mixed. On the one hand, unexpectedly strong growth in the major industrial economies over the past few quarters has helped to boost exports by developing countries; combined with enforced cutbacks in imports, this has significantly narrowed the trade deficits of these countries. On the other hand, dollar interest rates, which have changed little over the past few weeks, remain obstinately high and the exchange rate strong. At the same time, commodity prices, after strengthening during 1983, have weakened so far this year, particularly in the second quarter. Moreover, although the outlook in North America and Japan remains generally favourable, there is continued concern about the pace, and even perhaps the durability, of sustained recovery in Europe.

Figures of international bank lending in the second quarter - when the problems at Continental Illinois surfaced - are not yet available. In the previous three months, a rise in lending to non-oil developing countries was more than accounted for by the involuntary \$3 bn loan to Brazil. Over the same period, these countries increased their balances with banks abroad by a further \$4 bn, of which nearly half was by Latin American countries.

Negotiations between Mexico and the Advisory Group of banks on a multi-year rescheduling have now been completed. It would clearly be beneficial from many points of view if the Mexican package could be quickly put in place. The deal is predicated on new money requirements being met on a voluntary basis and, as such, can be regarded as a notable effort towards re-establishing normality for

Mexico - although it remains to be seen whether the projected amount of voluntary lending by banks (averaging $2 1/2 bn per annum between 1985-1990) will be forthcoming. It is likewise welcome that a mechanism for IMF monitoring has been devised, which takes account of Mexico's unwillingness to submit to further IMF conditionality after the current EFF expires at end-1985, and at the same time satisfies the banks' insistence on IMF monitoring "with teeth". As regards burden-sharing, it is a disappointment to British banks that most members of the Advisory Group were not in favour of an approach to the Paris Club, even though it was widely recognised that Mexico would set a precedent for subsequent multi-year rescheduling negotiations. But this perhaps serves to reinforce the validity of the case-by-case approach: there was no immediate and obvious need to restructure official trade credit in the Mexican case, although there certainly is such a need for other countries eg Brazil. In this context, the growing willingness of creditor governments to renew (limited) cover for certain countries in the event of a rescheduling, is particularly timely and welcome.

Meanwhile, the regional co-ordination of debt strategies takes a further step forward on 13/14 September, when Foreign and Finance Ministers of the eleven Latin American countries represented at Cartagena in June re-assemble in Mar del Plata (Argentina) to review developments over the last few months. When the agenda was discussed in August, it was agreed to invite major creditor countries to attend a summit on Latin American debt. This reflected a general view that creditors had not responded adequately to the "restraint and maturity" demonstrated at Cartagena. Following the August meeting, several Latin American countries have asked the Summit Seven and other OECD countries how they would react to a proposal for some kind of high level, political meeting with the Latin American debtors. We, together with our principal Summit partners, dislike the idea of a high-level political meeting because we think it could lead to public confrontation and damage the prospects for making practical progress in handling debt issues. Some of the Latin American countries evidently share this concern. We have therefore told the Latin Americans informally - having previously ascertained that our principal Summit partners generally agreed -

that we were sceptical of the value of such a meeting and thought the Mexican idea of using the IMF/IBRD Development Committee seemed more practical. The Mar del Plata meeting this week will be considering, in the light of these exchanges, how to carry forward the idea of a political dialogue with the creditors; and the question will no doubt be discussed during the IMF/IBRD annual meetings later this month.

As regards the specific Cartagena proposals for debt relief, a committee has been formed by the Latin Americans to study a system of compensatory credits to offset high international interest rates. The scheme, if agreed by Ministers, would be submitted to the IMF/IBRD Annual Meetings later this month.

Turning to some of the main problem countries, the Philippine authorities have now accepted virtually all of the IMF's proposals for a programme, but progress on a bank financing package is being delayed by wrangling over the Citibank Manila question. In Nigeria, talks with the Fund remain deadlocked, and the Nigerians are meanwhile endeavouring to by-pass official credit agencies and settle insured arrears directly with suppliers. On the other hand, banks have implemented a multi-annual rescheduling agreement for Poland, and the Poles have made a move to break the deadlock in official negotiations. Brazil, which is shortly to begin Phase III negotiations, has met all the IMF's performance criteria so far this year, but is faring much less well with its targets for inflation and the monetary aggregates. The picture in the smaller Latin American countries is mixed (see following section). But Argentina continues to be the most intractable problem: substantial differences remain with the IMF, and the time is rapidly approaching when the Argentines must decide whether to go it alone or accept Fund conditionality. Meanwhile, it remains very doubtful whether Argentina will meet its next repayment obligation on 14 September.

More detail about the position in major debtor countries is given below.

(i) Latin America

Argentina is still the major source of concern. Although recent discussions with the Fund staff have produced a broad measure of agreement on the overall policy objectives of a new Standby programme, there is still a wide gap between the two sides. This prompted creditor banks to refuse an Argentine request to roll over the end-June bridging loan of $125 mn when it fell due on 15 August, and repayment was accordingly made. The next major deadline for the banks is 14 September, when Argentina is due to repay the $750 mn outstanding from the 1982 bridging loan of $1.1 bn. But there is little prospect of the country being able or willing to repay this amount from its own resources, and the banks will almost certainly have to agree to a further roll-over. The precise terms will no doubt depend on the degree of progress which the Argentines have made in their talks with the IMF. The protracted negotiations with the IMF may well not continue much beyond the forthcoming IMF Annual Meeting: the size of Argentina's external financing requirement (officially forecast at $11 bn in 1984-85) and the continuing deterioration in the economy are putting pressure on the authorities to settle their differences with the Fund. Furthermore, the IMF has its own credibility to consider: it will be difficult for the Managing Director or his Deputy to go on being a party to statements that progress is being made if, in fact, two or more of the original stumbling-blocks remain in place. Perhaps around the end of this month, therefore, Argentina may have to decide whether to go it alone or accept the IMF's prescriptions: some indication of its thinking may emerge after Mar del Plata.

Against this background, Mexico has reached a timely agreement in principle with the Advisory Group of banks on a multi-year rescheduling of some $48 bn of public sector debt falling due between 1985 and 1990. The restructuring is effectively split into two tranches, with repayments extending up to 1998; implementation of the second tranche will depend on favourable Fund reports in 1987 (see below). The average spread is 1 1/8% over LIBOR or cost of funds: the prime rate option has been eliminated. No restructuring fees are to be charged.

The IMF will - subject to formal approval by the Board which has not yet been given - assess targets set by the Mexicans, and monitor progress, as part of the annual Article IV Consultations; and will also conduct mid-year reviews. The reports will be made available to the banks: if the Fund indicates dissatisfaction with Mexico's performance or targets, the banks may decide to call an event of default.

LBI and other British banks were strongly in favour of an approach to the Paris Club, but found little support from most other members of the Advisory Group, and the idea was eventually dropped.

The draft agreement contains a provision for non-US banks to switch a proportion of their dollar lending into local currency, subject to approval by the respective central banks.

Details of the draft package were finalised on 8 September and circulated to creditor banks early this week.

As attention begins to focus on Phase III of Brazil's debt rescue package, the authorities have indicated a desire to complete the new round of negotiations - including the question of a multi-year rescheduling - before next January's Presidential election. However, because of the political uncertainty surrounding the elections, the banks may seek an interim agreement to reschedule maturities only in 1985, while deferring discussion on a multi-year arrangement until the new Administration has been installed. An IMF team recently reached agreement with the authorities on performance targets for the second half of 1984, which should pave the way for signature of a sixth Letter of Intent later this month.

Elsewhere in Latin America, formal bank rescheduling negotiations with Venezuela began on 25 July, and reasonable progress has reportedly been made on the three basic issues of IMF monitoring, private sector debt, and interest arrears. Once these are resolved, negotiations will begin on terms: initial positions are some way apart - the Venezuelans have requested the rescheduling, over 15 years, of all public sector maturities between 1983 and 1992 - and the authorities appear optimistic in expecting to have reached agreement by the end of this month. Although Chile comfortably met all IMF performance targets at the end of June, the Fund consider that further measures of restraint will be required if the annual targets are to be met. The Advisory Group of banks meets later this month to discuss strategy for 1985 and beyond: the possibility of a multi-year rescheduling is likely to be considered.

Peru's Standby agreement seems certain to require renegotiation in a few months' time. While second quarter performance targets may have been only slightly exceeded, a much larger overshoot is expected in the third quarter. Meanwhile, final agreement on the $2.5 bn commercial bank refinancing package, covering maturities in 1984/85, has been further delayed. In Ecuador, the Febres Cordero Administration, which took office on 10 August, has already initiated talks with the IMF on a new Standby, with a view to obtaining a new money loan from banks before the end of the year. In early August, the banks signed an agreement to reschedule $348 mn of public sector debt falling due in 1984. Colombia's economic and financial position continues to deteriorate; and recent evidence that private sector debt is being rescheduled in a piecemeal fashion is likely to weaken confidence even further and make foreign banks less willing to undertake new lending.

(ii) The Far East

In the Philippines, the government has now accepted the Fund's proposals for a Standby programme almost in their entirety: the measures would be implemented largely as prior action in support of a SDR 615 mn eighteen-month Standby to end-1985. The Fund staff hope to put the proposals to the Board by end-October, but disagreement between banks on the Citibank Manila question might lead to serious delay in assembling the new money package.

Elsewhere in the Far East, Indonesia and South Korea continue to command relatively favourable spreads in the euromarkets.

(iii) Eastern Europe

In a move to break the deadlock in official negotiations, Poland has offered to meet Paris Club requirements in respect of non-consolidated 1981 debt and interest arrears; and attention is now turning to

Poland's application in 1981 for IMF membership, which had earlier been blocked by NATO sanctions. The governmental Task Force is due to meet in Paris on 14 September to discuss economic developments.

Meanwhile, the commercial bank multi-annual rescheduling agreement (for 1984 to 1987) signed in London in July has been implemented, even though the associated amount of new money was below the target threshold. The banks are expected to meet the Yugoslavs in October to discuss their 1985 financing requirements: a multi-annual rescheduling agreement is likely to be raised. A further waiver of performance criteria under the SDR 370 mn Standby was approved on 31 August. Elsewhere in the region, the GDR has obtained a DM 950 mn ($330 mn) loan from West German banks, on the same terms (1% over Libor) as the DM 1 bn credit raised in June 1983; and Romania has indicated that it will not seek a further IMF programme.

(iv) Southern Europe

Portugal's external balance is responding well to the IMF-supported recovery programme, and the current account deficit is expected to be within the Fund's target. But longer-term prospects are less favourable, with a debt service ratio of around 30% projected for the remainder of the decade, leaving little or no scope for relaxation of adjustment policies. The Greek current account deficit in 1984 is still forecast to be around $2 bn - much the same as last year. There is no indication of any further strengthening in the adjustment programme. Nevertheless, a $200 mn loan by the Public Power Corporation of Greece was favourably received, and the amount was increased in response to oversubscription. In Israel, attention continues to focus on resolving the political stalemate which followed the general election. Meanwhile, the interim government is unable to implement further measures to check the recent rapid decline in the economy.

(v) Africa

Nigeria has made no further progress in negotiations with the IMF on a three-year EFF. Meanwhile, trade credit agencies remain insistent that a multilateral restructuring of trade arrears must be conditional on agreement being reached with the IMF. This has prompted the Nigerians to plan the issue of promissory notes to individual companies on similar lines to those already agreed for companies with uninsured arrears, thus bypassing trade credit agencies. Morocco's rescheduling negotiations with commercial banks remain deadlocked, but the IMF have allowed two drawings under the Standby to be made by 30 November.

CONFIDENTIAL

INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt End-Dec 1983 (except where stated)	British-owned banks' exposure [1] End-Dec 1983	ECGD amounts at risk[2 End-June 1984
Latin America			
Argentina	46	2.5	0.2
Brazil	92	6.1	1.9
Chile	19	1.3	0.1
Colombia	12	0.7	0.2
Ecuador	7	0.6	0.1
Mexico	91	6.3	1.4
Peru	12	0.4	0.1
Venezuela	34	2.4	-
Eastern Europe (convertible currency)			
East Germany	13-14	0.7	0.2
Hungary	8	0.5	0.1
Poland	27	0.5	0.8
Romania	9	0.3	0.5
Yugoslavia	19	0.9	1.2
Southern Europe			
Portugal	14	1.4	0.3
Greece	12	1.6	0.4
Spain	40	2.8	0.1
Far East			
Indonesia	31	0.8	1.5
Philippines	25	1.4	0.3
South Korea	40	2.6	0.9
Other			
Morocco	12	0.1	0.3
Nigeria	20	1.3	3.3
Israel	29	0.6	0.2

[1] This column now shows exposure defined as consolidated external claims, adjusted for certain inward and outward risk transfers in respect of guaranteed loans, plus any net claims on local residents in local currency.

[2] Excluding claims paid (net of recoveries). Because of differences in definition, these estimates are not directly comparable with the figures in other columns.

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PS
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PS/MR WHITNEY
PS/MR RIFKIND
PS/PUS
MR DEREK THOMAS
SIR J FREELAND
SIR W HARDING
MR GOODALL
MR O'NEILL
SIR C TICKELL
MR D C THOMAS
MR WESTON
MR BARRINGTON
HD/PUSD
HD/SAMD
HD/FID
HD/NEWS DEPT
HD/EED
HD/ECD (E)
HD/UND

(2)

PS/NO 10 DOWNING ST
PS/S OF S FOR DEFENCE
MR ~~RD~~ NH NICHOLLS,AUSD STAFF,MOD

PS/CHANCELLOR } TREASURY
MISS M E CUND }
MR LITTLER }

SIR R ARMSTRONG } CABINET OFFICE
MR ~~A D S GOODALL~~ Cartledge }
DIO }

MR POWER,SAD,ODA

MR A FORTNAM IAT/D. TRANSPORT

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TO IMMEDIATE FCO

TELNO 610 OF 13 SEPTEMBER 1984

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IMMEDIATE

INFO PRIORITY MOD (SIC A3A), CBFFI BANK OF ENGLAND ASUNCION BRASILIA CARACAS MEXICO CITY MONTEVIDEO SANTIAGO UKMIS NEW YORK WASHINGTON PORT STANLEY

PRESS SUMMARY

1. IN A MIXED BAG OF HEADLINES RENEWED SPECULATION ABOUT THE IMMINENCE OF AN AGREEMENT WITH THE IMF FIGURES PROMINENTLY. ECONOMY MINISTRY SOURCES ARE CITED AS CLAIMING THAT DETAILS OF A 15 MONTHS PROGRAMME HAVE BEEN VIRTUALLY FINALIZED IN CONSULTATION WITH THE FUND, AND THAT TALKS ARE TAKING PLACE IN NEW YORK TO HAVE ARGENTINA'S INTERNATIONAL CREDITOR BANKS EXTEND THE DEADLINE ON THE 750 MILLION DOLLARS OF THE BRIDGING LOAN WHICH FALLS DUE TOMORROW.

2. HENRY KISSINGER, WHO IS CURRENTLY VISITING BUENOS AIRES, HAS REPORTEDLY DECLARED THAT QUOTE ARGENTINA SEEKS A CONFRONTATION BETWEEN DEBTOR AND CREDITOR NATIONS INSTEAD OF A CONSTRUCTIVE DIALOGUE UNQUOTE. ECONOMY MINISTER GRINSPUN HAS CONFIRMED TO JOURNALISTS THAT HE AND KISSINGER DIFFER IN THEIR VIEWS OF THE FOREIGN DEBT PROBLEM.

3. MOST PAPERS ALSO HIGHLIGHT THE MAR DEL PLATA MEETING OF THE CARTAGENA CONSENSUS COUNTRIES WHICH WILL BE INAUGURATED TODAY

3. MOST PAPERS ALSO HIGHLIGHT THE MAR DEL PLATA MEETING OF THE CARTAGENA CONSENSUS COUNTRIES WHICH WILL BE INAUGURATED TODAY BY PRESIDENT ALFONSIN. PRESS COMMENTATORS EXPECT THE CONFERENCE TO FORMULATE DEMANDS THAT THE IMF BE MORE FLEXIBLE IN ITS GUIDELINES FOR THE FISCAL DEFICITS, INTERNATIONAL RESERVES AND MONETARY TARGETS OF LATIN AMERICAN DEBTOR COUNTRIES.

4. THE PARALLEL DOLLAR RATE CONTINUED ITS CLIMB YESTERDAY, INCREASING BY 2.7 PER CENT AND BRINGING THE GAP BETWEEN THE BLACK MARKET AND OFFICIAL RATES TO 39.8 PER CENT .

5. THE PRICE OF CATTLE ON THE HOOF HAS RISEN BY 32 PER CENT DURING THE PAST FEW DAYS AND BY 50 PER CENT SO FAR THIS MONTH.

6. INTERIOR MINISTER ANTONIO TROCCOLI YESTERDAY CHAIRED A NEW ROUND OF SOCIAL CONTRACT TALKS WITH TRADE UNION AND BUSINESS REPRESENTATIVES. THE PRESIDENT OF THE ARGENTINE INDUSTRIAL UNION (UIA), ROBERTO FAVELEVIC, HAS CRITICIZED THE GOVERNMENT'S ECONOMIC POLICIES AS RECESSIVE BUT HAS INSISTED THAT EMPLOYERS WILL CONTINUE TO COOPERATE IN THE DISCUSSIONS. FIGURES RELEASED BY THE UIA INDICATE THAT 1984 INDUSTRIAL INVESTMENT IS LIKELY TO BE 50 PER CENT BELOW 1980 LEVELS.

7. WIDE COVERAGE IS GIVEN TO ALFONSIN'S DECISION TO VETO SEVERAL ARTICLES OF THE BANK AND INSURANCE CLERKS' JOB SECURITY BILL. BANK CLERKS MAY NOW INITIATE PROTEST ACTION.

8. ALFONSIN HAS DEFENDED THE DECISION TO OFFER SUPPLY FACILITIES AT PUERTO MADRYN TO US NAVY SHIPS PARTICIPATING IN UNITAS MANOEUVRES. HE STRESSED THAT QUOTE A COUNTRY WHICH HAS NOT BROKEN OFF RELATIONS WITH ANOTHER MUST ALLOW ITS SHIPS TO TAKE ON SUPPLIES UNQUOTE.

9. ARGENTINE ARMY OFFICERS INVOLVED IN JOINT MANOEUVRES WITH THE COUNTRY'S NAVY HAVE COMPLAINED ABOUT LACK OF HELICOPTER FUEL AND THE SHORTAGE OF INFRA-RED SIGHTS FOR NIGHT VISION. THERE IS ALLEGEDLY ALSO CONCERN ABOUT THE PROBLEMS OF KEEPING THE RANKS OF NON-COMMISSIONED OFFICERS UP TO STRENGTH.

10. A REMOTE-CONTROLLED PLASTIC EXPLOSIVE DEVICE LAST NIGHT DAMAGED THE ''ENGLISH TOWER'' IN CENTRAL BUENOS AIRES. HAND BILLS FOUND CLOSE TO THE SCENE AND BEARING THE TITLE ''DENUNCIATION'' ATTRIBUTED RESPONSIBILITY TO A GROUP CALLED QUOTE ARGENTINE MILITANT PATRIOTISM UNQUOTE. THE INCIDENT WAS DESCRIBED IN THE PAMPHLETS AS QUOTE A REPUDIATION OF THE HUMILIATING PRESENCE IN OUR COUNTRY OF ENGLISH PARLIAMENTARIANS ON AN APPARENT ''GOOD WILL'' MISSION UNQUOTE. THE MESSAGE ALSO PROMISED THAT QUOTE WE SHALL PERMANENTLY KEEP UP THREATS AND ACTS OF AGGRESSION AGAINST THE FORCES OF OCCUPATION ON OUR ISLANDS UNTIL THESE ARE FINALLY RECOVERED UNQUOTE.

11. ''LA NACION'' NOTES THAT GEORGE MEDLEY, DIRECTOR OF THE WORLD WILD LIFE FU ND, HAS CALLED FOR CONSERVATION MEASURES TO PROTECT FISH STOCKS IN THE WATERS AROUND THE FALKLANDS.

JOY

UNQUOTE

POWELL-JONES

NNNN

SENT/RECD AT 14125Z KR//DRH

Folder for reading on Thursday

AT 14/9

(2)

PRIME MINISTER

INTERNATIONAL BANKING CRISIS

Sir Walter Salomon says that before you went on holiday he sent you a paper of his on how to solve the international banking crisis. I do not remember seeing this though you may have received a copy directly. If not I now attach a copy.

Sir Walter has asked whether you would like to

i) Comment on his paper?

ii) See him prior to the International Banking Conference starting at the end of next week?

Before you can comment or discuss this with him I think you need an analysis from the Treasury/Bank of England.

Agreed MT

Briefly, the proposal seems to involve the establishment of an agency under the BIS which would take over non-performing debts from the banks. The agency would negotiate with the debtor countries a longer repayment schedule and a more favourable interest rate which would be made possible by financial assistance from the industrial country governments. The loans would be secured on assets in the debtor countries and when the loans had been put on a sound basis they would be sold by the agency to financial institutions and the proceeds realised would be returned to the lending bank. If this happened, the lending bank, if there was any shortfall, would have to write off the difference. Since governments would be making available finance to enable the debtors to service their debt through what Sir Walter calls tax credits (he does not explain what tax the credit is against) there is a possibility that the loans would be kept near their face value.

Subsidy

!

Sir Walter claims this is the first proposal from an experienced, practical banker though there is no substance whatsoever to this claim. The scheme incorporates many of the elements which appear in the other fifty or so schemes which have been identified. It is a comprehensive, rather than a case-by-case, solution which involves the creation of a new international agency. It requires financial support by governments, it involves the securing of loans on LDC assets and incorporates a market for debt.

In my view, it omits one important element in the debt problem. Most of the debt was attracted in dollars on variable rate interest terms. As a result of US fiscal policies, the debtor countries have suffered a double penalty. Not only are interest rates much higher than expected but the burden of the debts is much greater than expected. To repay a given quantity of dollars, the debtors have to export much greater quantities of goods. The beneficiaries of this are those who deposit dollars with the banks and have seen the value of their deposits rise dramatically in terms of other currencies. Following the rise in the oil price in 1973-74, the burden of debt of the oil importing countries was reduced by the weakness of the dollar and by world inflation; after 1979 the opposite has happened.

Agree we tell Sir Walter:

i) That you have asked for an analysis of the paper? Yes

ii) That you are not yet in a position to comment? I would rather wait for that before commenting. The analysis had not been done before as he had asked me to keep the previous paper strictly confidential

iii) That you will ~~not~~ be able to discuss this with him, ~~given your diary~~, before his Conference at the end of next week? I willing to see him

When we have comments we can decide whether you should see Sir Walter or write to him.

AT

13 September 1984

bile BM

10 DOWNING STREET

From the Private Secretary 13 September 1984

Dear David,

INTERNATIONAL DEBT

I wrote to you on 6 June about a proposal which Sir Walter Salomon had put to the Prime Minister for resolving the international banking crisis. He has now set out his proposals in more detail in the attached pamphlet. I would be grateful if you could commission an appraisal of this proposal. In particular I am puzzled by the proposal for special tax credits. It is not clear what tax these are credits against but the purpose seems to be for Western governments to provide some financial asssistance to the debtor countries to enable them to meet their debt service payments. Also I am unclear about the way a bank would account for a loan while it was temporarily with the Realisation Company being put onto a sound financial basis. Does the bank assume that the full value of the loan will be realised or does it assume that the whole loan should be written off, with anything that is realised being treated subsequently as a bonus?

BM As Sir Walter is pressing the Prime Minister for a reaction, I would be grateful if a note could reach me by Thursday of next week.

I am copying this letter to John Bartlett (Governor of the Bank of England's office).

Yours sincerely
Andrew

(Andrew Turnbull)

David Peretz, Esq.,
HM Treasury

EC

1. MR. TURNBULL

2. PRIME MINISTER

Before you went on holiday Walter Salomon sent you a paper on how to solve the International Banking Crisis. I attach a copy.

Sir Walter wonders whether you would like to:-

(i) comment on his paper.

(ii) see him prior to an International Banking Conference starting at the end of next week.

CR.

12 September, 1984

This paper is intended to provoke thought and discussion and suggest a constructive framework. It is not a blueprint and should not be regarded as such. However, if the basic ideas are accepted, the technical details can be worked out by a team of experts including, where necessary, international lawyers and accountants.

Sir Walter Salomon

The International Banking Crisis:

A new approach by Sir Walter Salomon

The Salomon Plan

THE AUTHOR

Sir Walter Salomon was for many years Chairman and is now President of Rea Brothers Plc, the private bankers. He comes from an old Hamburg banking family and having witnessed the havoc caused by the German inflation of 1923-24, escaped from Hitler to Britain in 1937.

He is life president of the Young Enterprise movement which he founded and a Freeman of the City of London. He was knighted in 1982 and has had conferred on him the Brazilian Order of the Cruzerio do Sul and the Officer's Cross of the Order of Merit: First Class (Federal German Republic). He has written on current affairs topics for many years and previous publications include 'One Man's View' (1973) and 'Fair Warning' (1983).

CONTENTS

SUMMARY

—Lenin predicted that capitalism 'would destroy itself through the disintegration of the monetary system'. We are now on the brink of such a collapse.

—It is said that 52 propositions have been put forward to solve the international banking crisis, but none by an experienced, practical banker.

—Papering over the cracks, as with the nationalisation of Continental Illinois Bank, is not the answer. This merely means that some banks are bailed out at the expense of others (some would say this amounts almost to a fraudulent preference) and that many of those responsible in the offices of the banking supervisory authorities keep their jobs. This is an example of the stupidity of tackling the effects of the crisis rather than the fundamental causes.

—The people who created the crisis cannot solve it—the blame lies with governments and politicians, central banks and commercial banks. The solution must be taken out of their hands.

—The problem cannot be dealt with nationally but must be handled on an *international* basis.

—Confidence can only be restored with a constructive approach—the proposals are not designed to undermine the present system but to save it, although in the process some well known banking names may disappear.

—Responsibility for the present crisis should not be taken by the less developed countries alone. In some instances loans were pressed on them for political reasons. In any case a number of these countries have already made Herculean efforts to avoid default.

—Whilst most less developed countries are insolvent in the sense that they run serious current account deficits, many of them are enormously rich in raw materials, mineral reserves, etc. These resources should be mobilised for the benefit of the countries concerned as proper risk collateral.

—A scheme in excess of the scale of the post-war Marshall Plan is required, although this time the benefits should not be squandered on social experiments but applied to regaining financial equilibrium.
—All non-performing loans should be transferred from the commercial banks into the temporary stewardship of an International Realisation Company. The trustee should be the Bank for International Settlements.
—There would be no advantage for any individual bank refusing to join the scheme, as the regulatory authorities would disregard any doubtful loans in calculations of capital ratios for solvency purposes.
—In order to relieve the desperate financial plight of the less developed countries, Western governments must enable interest rates on borrowing to be cut by abolishing tax on such receipts provided the entire benefit of the abatement is passed back to the borrowers. In these circumstances it may also be possible—and certainly desirable—to establish sinking funds.
—The Realisation Company would be empowered to reorganise and repackage non-performing loans with a view to realising them on behalf of the banks. This would be done either by selling them on an open market basis or by arranging for repayment or re-scheduling according to strictly traditional banking criteria.
—The Realisation Company would need to be given absolute immunity from any kind of litigation by the banks, their shareholders or other third parties so that it could act independently. In effect it would act like a liquidator of a private business.
—All new loans to less developed countries would have to be arranged on normal commercial terms with adequate security. Sovereign guarantees would not normally be sufficient collateral. Restrictions on foreigners taking charges on assets situated within national boundaries should be lifted.
—Banking supervision shall be taken out of the hands of those national central banks which lack independence from political interference and are bureaucratic in approach.
—If governments want commercial banks to give credits for political reasons they shall provide guarantees so that if they are not repaid the government concerned would be liable.

INTRODUCTION AND BACKGROUND

In 1971 in a speech given to the Institute of Bankers in London I said there had been certain developments in the eurodollar market where 'some of the good old banking principles had been sadly neglected . . . there is also growing concern that perhaps the condition of the borrowers is not always examined as closely as might be desirable . . . if there should be a serious disturbance, it might lead to most undesirable consequences in the international money market'. Then in 1976 I wrote: 'I can foresee the day, if it is not already here, when many of these (developing) countries will not be able either to service the loans or make repayments on the due date'.

I would also draw your attention to Lenin's chilling prediction that capitalism 'would destroy itself through the disintegration of the monetary system.' In May the eighth largest bank in the United States, the Continental Illinois, collapsed because its depositors lost confidence in its soundness. Two months later the American government itself was forced to take over Continental Illinois's bad loans in the most expensive bank rescue in American history. At the same time the world's major debtor countries in Latin America have been indicating that high US interest rates are making it impossible for them to service more than a tiny proportion of their loans.

These countries owe more than $40 bn to the top nine American banks, whose capital and reserves total only $31·5 bn; likewise British high street banks are owed a sum by these same debtors that also exceeds their capital and reserves. To put the matter bluntly, many large international banks are insolvent because they have lent on a vast scale to countries in Latin America and elsewhere which cannot repay their debts in any conceivable circumstances.

There can be no justification for empty discussion that undermines confidence because a credible plan designed to restore equilibrium is lacking. Naturally governments and central banks have said as little as possible about the matter because they h… been concerned to preserve faith in the existing system. But I am reminded of the atmosphere in 1938 and 1939 just before the last war. Everyone knew conflict was coming but somehow nobody seemed able to do anything to prevent it. I am informed that behind the scenes no less than fifty-two propositions have been put forward to solve the problem. However, to my knowledge not one of these fifty-two has been put forward by an experienced banker.

Meanwhile, Mexico, Brazil and some of the other countries involved have made heroic efforts to meet their obligations by blocking off all but the most essential imports, by forcing substantial cuts in real wages on their people and by acquiescing in increased unemployment although social security is rudimentary if it exists at all. But on the most optimistic forecasts these countries cannot expect to attain surpluses on their current accounts sufficient to meet their debt obligations even in their 'restructured' form. They have stated that high US interest rates are making it impossible for them to service more than a tiny proportion of their loans. Nor can political problems be ignored. Brazil and Argentina, for instance, are both attempting the tricky passage from military dictatorship to Western style democracy. They are thus simply incapable of imposing an IMF deflation on their people. Argentina has publicly discussed the advantages and disadvantages of default.

Many estimates have been made of the exposure of leading American and British banks to Latin American risks alone; the calculations have been based on the reasonably full information which the banks themselves disclose. The results invariably show that many banks have lent significantly more than an amount equivalent to their capital and reserves to Latin America. In May this year, for instance, the Federal Financial Institutions Examination Council in the United States showed that the nine largest American banks had loans totalling $40·4 bn outstanding to Mexico, Brazil, Venezuela and Argentina compared with a combined capital of $31·5 bn. In July, the London stockbroking firm of Panmure Gordon & Co. published tentative estimates for the British Big Four banks showing that as a group they had lent £12·8 bn to Latin America compared with total capital of £8·9 bn.

…n on favourable assumptions about the amounts of bad debt already 'written off' and the residual value of the great bulk that remains, nobody can doubt the conclusion that a number of important banks are effectively bust.

In 1975 I wrote an article which was published simultaneously in *The Times* in London and *Die Welt* in Germany called 'Bonds for the Arab Oil Funds' and in 1983 an article called 'Origin and Cure of the International Banking Crisis'. I have included both these articles as appendices to this discussion paper so that you can see that my proposals are not dependent upon *hindsight*.

Last year when I attended the Per Jacobsson Lecture at the IMF Meeting in Washington, there was a question and answer period at the end of the lecture. My question to the speaker, Mr H. Johannes Witteveen, was whether he agreed that some of the leading bankers had been acting irresponsibly, and furthermore, whether we had any guarantee that they would not do so in the future. After some thought, his reply was that this might be so with hindsight. I subsequently told him that in my opinion it showed a lack of foresight! Anyone in doubt about the views I have expressed in the past needs only to re-read my books 'One Man's View' and 'Fair Warning'.*

* 'One Man's View' and 'Fair Warning' are published by Churchill Press, 2 Lord North Street, London SW1, price £2·00 and £5·95 respectively.

THE EVENTS LEADING TO THE PRESENT CRISIS

I place the blame for what has gone wrong on governments, politicians, the central banks and the commercial banks. The politicians encouraged the notion from the time of the first oil shock onwards that commercial banks virtually had a duty to engage in what was known as 're-cycling'. In other words the unspendable surpluses of the oil exporting countries were to be taken in as deposits and on-lent to the countries that were most severely punished by the rise in oil prices, the rest of the third world. But in giving this encouragement politicians blithely ignored the risks to both sides of a bank's balance sheet. Put simply, the nature of the deposits was unsuitable for the type of borrowing facilities demanded by the third world countries. Finance ministers and officials of Western governments were often unduly influenced by the highly intelligent and persuasive ways in which representatives of developing countries always present their case. Aid was demanded by right and with no strings attached; requests for bank finance were couched in much the same terms. I dare say, too, that Western governments were tempted into promising developing countries extra loans at favourable terms in return for, say, votes at a forthcoming meeting of the United Nations.

I also blame the central banks for the present crisis. I have long regretted the nationalisation of the central banks of the Western world and their loss of independence. Central banks are one of the natural checks in the financial system; by weakening their authority we make it more difficult to prevent excesses developing. Where once they looked after the interest of the bankers, they have become subject to the whims of politicians. They can be forced to carry out a policy dictated to them by government with which they instinctively disagree. Central bankers no longer deserve the title; they have become government officials. Who can now doubt that Western central banks and other agencies charged with supervising commercial banks have failed to meet their responsibilities?

of progressive deterioration in bank balance sheets has taken place under their very eyes. The U.S. Comptroller of the Currency who first discerned weaknesses in Continental Illinois' position in 1981 is still at his post assisting with the biggest bail out in American banking history. While small banks often find central banks unduly obstructive, large banks have been allowed to carry on regardless.

It is instructive to look a little more deeply into the background of the nationalisation of Continental Illinois. This bank crashed primarily because it purchased a dud loan book from another bank, Penn Square Bank of Oklahoma. It is clear that normal banking criteria had not been applied and although the authorities were alerted to the problems of Penn Square in 1981 and its chief, energy lender was known to wear a Batman mask to the office and drink liquor out of his shoes, nothing was done until it was too late.

By 1982 Continental had plunged into substantial losses, despite which the Chairman maintained that he still believed his bank's lending techniques were 'basically correct' adding 'we have no intention of pulling in our horns.' The bank remained 'strong, financially sound and stable,' he claimed. Confidence, however, which is a bank's most precious possession, had been fatally damaged. Statements about pressing on regardless provided no reassurance.

Soon afterwards the bank sold its credit-card business to raise capital. Yet rumours that the bank was in severe difficulties began to circulate. Breaking with all precedent, the United States Comptroller of the Currency issued a statement.

It could hardly have been more definite, or reassuring. The Comptroller said that his agency was 'not aware of any significant change in the bank's operations as reflected in its published financial statement that would serve as a basis for these rumours.' And he added, for good measure, that the bank's financial ratios compared favourable with others. A few days later sixteen rival banks arranged a standby credit for Continental Illinois amounting to $4·5 bn.

All to no avail. Once confidence in a banking institution is fractured, it cannot be restored by statements representing no more than wishful thinking, whoever might issue them. Exactly seven days after the Comptroller had said his piece, the Ameri... authorities had to give the bank a further $2bn infusion of emergency finance. The new Chairman said: 'This positive step . . . provides us with the resources needed to do business and once and for all should and must stop the rumours.' Moreover, the Chairman of the Federal Deposit Insurance Corporation promised domestic and foreign depositors that 'they will not suffer loss.'

It made no difference. The bank could not prevent deposits draining away. So, finally, it was announced that the Federal Deposit Insurance Corporation would take control of the bank, appointing as it did so another set of top executives. The conclusion is that as confidence could never be re-established and the bank is a large one, it eventually had to be nationalised—and by a government to which such a move is particularly abhorrent.

Rather than attending to fundamental weaknesses in bank balance sheets, central banks have taken the lead in positively encouraging banks to make available further sums to the debtor countries as part and parcel of re-scheduling agreements. The only logic in lending more money to borrowers who have admitted that they cannot pay what they already owe is that it allows banks to pretend that they are still receiving interest on their loans. This spurious fact in turn enables the banks to persuade their auditors that these loans can still be classified as sound in their balance sheets. That central banks can play a leading role in such a charade is one of the more regrettable aspects of the crisis.

Finally the leading international banks themselves must carry a large responsibility for what has gone wrong. Re-cycling literally billions of dollars fitted in with the league-table mentality of many of them. They became obsessed with growth and with overtaking their rivals. The extent of their balance sheet footings was more important to them than what is prudent and what is not.

More to the point, the managers of these burgeoning commercial banks seemed to think that when lending to governments the well-tried maxims of sound banking could be put aside. When the World Bank was negotiating a very complicated loan package to a particular under-developed country, a well-known American banker got on the first available plane and offered the same amount with no conditions attached whatsoever.

Thus on many occasions bankers failed to establish what

exactly the money was to finance, whether it was for a specific project that would in due course have an economic value or whether it was to buttress a weak balance of payments or even, to be wasted on armaments. Often no enquiry was made whether the borrower really required a loan or whether risk capital would be more suitable. Nor was any adjustment made for the foolish discrimination against foreign capital practised by many less developed countries. In effect these borrowers were given a blank cheque. Money was literally pushed on them by people who should have known better. In fact if the less developed countries had received sound banking advice they would not have entered into commitments which they could never be in a position to discharge. The debtor countries provided no security other than their own guarantees. And today they resemble badly financed corporations—all debt and no equity.

International bankers also neglected to find out whether the debtor was creditworthy, allowing governments to claim that it was unreasonable for sovereign states to provide details of export earnings and import costs, of reserves of convertible currencies and of other borrowing commitments. Had these essential statistics been on bankers' desks, perhaps they would have realised more clearly that they were vulnerable to a fatal combination—sharply rising interest rates, which became an enormous burden, and deflation, which meant that the borrower's trade balance deteriorated sharply.

As for bankers' own balance sheets, in that regard, too, the old maxims were neglected. OPEC deposits placed with the banks of the Western industrial nations were short-term; these funds were on-lent at medium or long-term to third world governments. Bankers wrongly believed that floating rate loans protected them; in fact this device could only rectify a mismatch between the interest rates they had to pay and what they charged provided everything else was going as planned. It provided no guarantee that the world banking system would carry the sheer volume of credits involved when many of the loans became unsound. Central bank supervisors were similarly gulled, for nothing in their academic training had prepared them for what they actually confronted.

On 12th August, 1982, the music suddenly stopped. For on that day Mexico told the American government that she could no longer meet payments on her external debt. Western governments, the International Monetary Fund, central banks and leading banks cobbled together a rescue package which, with refinements, has been the pattern for every subsequent case. We can now see that the Western reaction was a classic 'papering over cracks'. The technique is that the IMF and the debtor country first reach agreement on a programme of economic retrenchment designed to secure substantial improvements in balance of payments performance.

This involves setting a range of economic and monetary targets for a number of years ahead. At the same time the IMF supports the programme with medium term loans. And the commercial banks are invited to agree a rescheduling of their loans and, most important, at the same time to put up fresh cash. The fatal flaw in this method is that the intensity of deflation required to secure the necessary balance of payments surpluses to pay off external debts is unrealistically severe. In fact Mexico has been the only success, largely because unique among debtor nations it has the benefits of both a strong government and an oil surplus. For the other major debtor countries, nothing has changed except that they have been given time to do what little they can.

In addition any method whereby one bank is rescued while others are allowed to go to the wall could be almost considered a fraudulent preference and even attacked as such in the Courts. Can there be a justification for using taxpayers money to bail out one set of shareholders or one incompetent management team as against another?

The overall problem today is much more serious than it was in August, 1982. I have long argued that the oil price is far too high and that in a decline a whole new set of problems would arise. The spectre of default is visible on all sides. Those who have caused the crisis must stand aside; they cannot solve the problems they have created. A new initiative providing both money and 'human resources' is essential.

THE SALOMON PLAN

My solution is on the same grand scale as Marshall Aid, which rescued a whole continent from penury. It will require agreement between the governments, central banks and commercial banks of the Western nations and must be on a totally *international* scale. Any attempts to solve the problem on a purely national basis are doomed to failure. Some of those politicians, officials and bankers who have failed to solve the problem may have to step aside. Arthur Burns, when Chairman of the Federal Reserve, is supposed to have been asked by some anxious bankers whether the Fed would rescue them if they got into difficulties. 'I will discuss that matter with your successors' was the curt reply.

The main difference between my proposals and Marshall Aid is that the latter was squandered in some countries on social experiments, (e.g. Great Britain) whilst in others (e.g. West Germany) it was used to rebuild industry. Britain's mistake should not be made again.

In formulating my proposals, I have gone to the causes of the present crisis rather than merely trying to alleviate the effects. This is the only way to make a fundamental change.

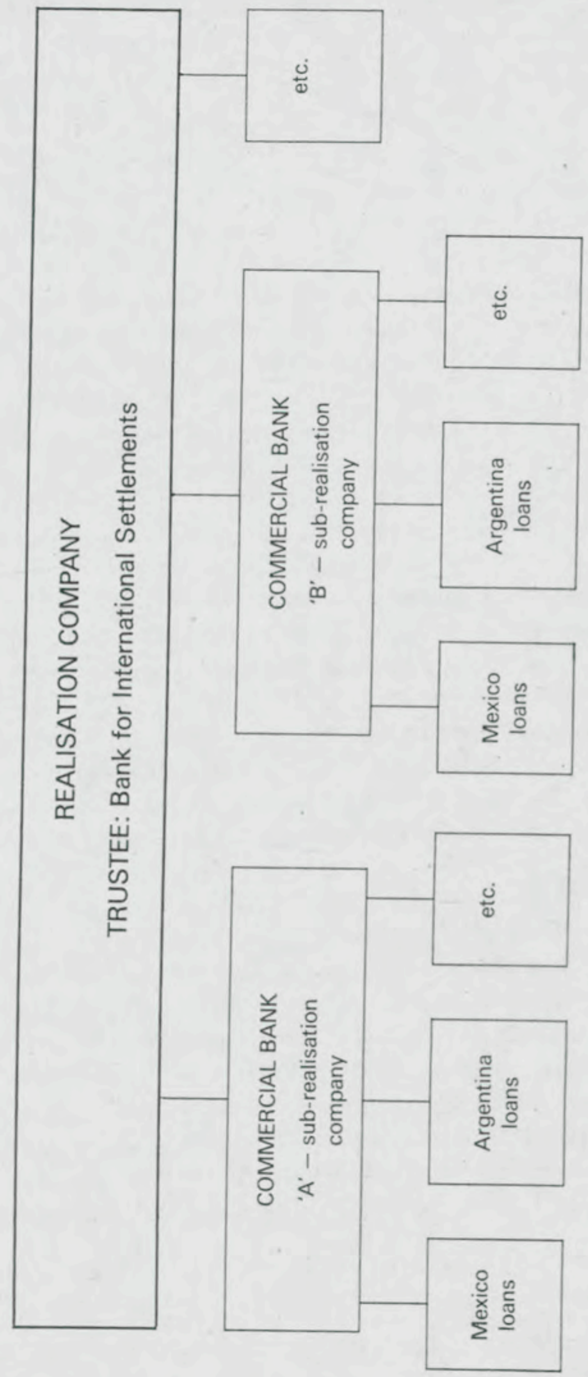
My proposals are:

1. An International Realisation Company should be set up which would have the support of all the Western central banks.
2. It would act rather like a liquidator of a commercial business by reorganising and repackaging any viable available assets, (i.e. loans) for realisation on a commercial basis.
3. It would be managed under the trusteeship of the Bank for International Settlements.
4. All non-performing loans should be taken over from the commercial banks into the temporary stewardship of the Realisation Company.
5. The Realisation Company would be empowered to re-negotiate any such loans to get them onto a sound basis by

which capital and interest can reasonably be expected to be repaid on time.

6. Legislation should be passed in all the relevant parliaments providing special tax credits enabling interest rates on non-performing loans to be reduced and/or sinking funds to be set up. The only proviso would be that all the tax saved should be used to benefit the debtor nations rather than being available to the banks. Sinking funds would be designed to repay loans within a fixed period (say 20-25 years) and interest rates should be drastically reduced—maybe by up to 50 per cent. As a *quid pro quo* for such a reduction, the Realisation Company would require that security such as oil leases, royalty agreements or shares in industrial or commercial undertakings should be provided.
7. The aim of the Realisation Company would be to sell or realise the loans on behalf of the banks as quickly as possible. This may be done singly or in packages, where possible, after renegotiation with the debtors as described above.
8. The Realisation Company would have many sub-realisation companies, each representing the non-performing loan portfolio of a particular commercial bank (see diagram).
9. It would be empowered to repackage loans—for example taking the loan exposure to one country of several banks and amalgamating them into one saleable loan. These loans would be made available on a totally open-market basis to the highest bidder. Many may only yield a fraction of their book value but others, especially if renegotiated to provide proper collateral, may come much nearer to par value and could even conceivably be taken back onto the books of the original lenders. It may also be useful to index loans either in terms of commodity prices or of inflation in the West.
10. Once a partial or whole package of loans from a particular bank had been realised, the Realisation Company would be empowered to make a repayment to the bank concerned, after deducting its expenses. In the cases of banks where lending policy has been reasonably sound, such a dividend could easily amount to close on 100 per cent. of book value and confidence in that bank's balance sheet would quickly be restored.

PROPOSED STRUCTURE OF REALISATION COMPANY



11. The debtor nations would also have to sell assets to settle some of their borrowing commitments. These assets could take the form of oil leases, natural resources operations or shares in industrial or commercial undertakings at present in government control.

12. Some banks, however, would have to accept that much if not all of their capital had been lost and shareholders would have to be prepared to supply new capital for reconstruction, allow other investors to make good the balance sheet or, if neither of these are possible, agree that weak units should be merged with stronger banking institutions.

13. The accounting treatment of any non-performing loans under the stewardship of the Realisation Company in the books of the commercial banks would have to be very closely monitored by the banking supervisory authorities. It would be wrong to say that in every case loans should be totally written off but equally a conservative approach should be taken so that banks are unable to continue to bolster their balance sheets with worthless loans.

14. The Realisation Company would be granted immunity from any litigation from any third party as a result of its stewardship of non-performing loans.

Once confidence has been restored to the world banking system by this method, it will be necessary to agree the following future practice:

1. Less developed countries would have to agree that in return for new borrowings, they would waive restrictions preventing foreigners taking a charge over assets situated within national boundaries. Future borrowings should be on a fully secured basis. These countries should also allow foreign equity capital to play a role in their development.

2. Central banks and other supervisory authorities would have to insist more explicitly than hitherto that banks keep their international lending within prudent limits. Governments would also have to ensure that supervisory bodies had sufficient powers and were adequately staffed with experienced bankers.

3. Where governments want commercial banks to make available credits to particular countries for reasons of national interest, then governments should guarantee these loans. In other words, bank lending for the risk of shareholders should be carried out only on the strictest commercial criteria.

4. Stringent conditions should be placed on what loans are used for, in particular that they are not used to purchase armaments.

Let me explain these principles in some detail.

It is not widely known that the Accepting Houses Committee in London came into existence in similar circumstances as I am proposing for the new International Realisation Company. In 1914, a standstill agreement was reached, and the merchant banks formed themselves into a Committee at the onset of World War I.

At present the big debtor countries are caught in a vicious circle. However large is the surplus that they earn on trade, high interest charges on their existing debt often amounts to an even greater figure. The result is that a certain amount of interest each year must be capitalised and added to the debt total. So the following year there is an even higher interest bill to meet and so on.

Brazil provides a perfect example. Its external debt now totals some $100 bn. The annual interest costs are therefore $11 bn, or perhaps more. Brazil's expected surplus on visible trade this year will easily be an all-time record and almost twice that achieved in 1983. But even so, the projected trade surplus—co-incidentally also $11 bn—would be entirely taken in interest payments, leaving nothing over for imports of services or repayment of principal. Brazil's external debt total, therefore, would still rise.

It is in this context that my suggestions of lowering the effective interest rate and encouraging the release of assets by less developed countries should be seen: acted upon together they would result in a reduction of indebtedness and then a lower interest charge, and so on.

Both principles will no doubt meet strenuous opposition. Many people within the less developed countries see foreign ownership as an infringement of sovereignty and as a licence for exploitation, remembering as they do earlier eras when foreign interests did perhaps sometimes take too much for themselves. But I am not proposing that, say, the entire Mato Grosso should be given to foreign bankers. What I foresee is that they would be offered shares (not necessarily constituting majority control) in productive enterprise as settlement of particular debts. Such shares could then be sold by the banks to industrial and commercial companies that could make a real contribution to the country's development; each transaction being approved by the host government. Britain herself, for instance, has felt able to allow a large number of foreign companies to participate in the development of North Sea Oil without arousing popular fears about foreign control of a valuable national asset.

Equally, many people in the industrialised West will vehemently object to any tax concessions that would ease the debt crisis. They would fear that this would be costly to tax payers, that it would in some way bail out the commercial banks and that it would represent a free gift to undeserving third world nations which have badly managed their economies. I must emphasise that my proposed tax rebate would go back entirely to the debtor countries and not to the banks. And I suggest that tax payers as a whole would benefit to a much greater extent from the increased trade opportunities that an end to the debt crisis would bring.

In any case, it is only when the debtor countries can be seen to be reducing their external obligations that conditions will be suitable for tackling the difficult problem of the solvency of the commercial banks. My solution is based upon the fact that in sophisticated financial markets such as the Western nations possess there is indeed a price for everything. In particular there would be buyers of the banks' loans to the major debtor countries. Assuming that the terms were attractive the purchasers would either be commercial companies doing business with the countries concerned, where settling a loan commitment could be part of a commercial bargain, or long term investors. This latter group has always been prepared to evaluate foreign debt risks, as the flourishing market after 1945 in the foreign bonds of countries affected by the war testifies. What is needed is some way of packaging and displaying the banks' non-performing loans so that both these classes of purchaser may come forward.

That is why I propose an International Realisation Company. It would in effect be a sales agency for the bank creditors, with the job of listing, categorising and re-arranging non-performing loans

into saleable packages. It would also, with the Bank for International Settlements as its trustee, take the lead in re-negotiating more appropriate loan terms with the debtor countries.

Once a market in non-performing loans had been established, it would finally be clear exactly what damage to their balance sheets the commercial bank creditors had sustained. The central banks and banking supervision authorities would be able to assess with a fair degree of accuracy what further write-offs banks would need to make.

I have no doubt that results would be mixed. Some leading banks would emerge from the ordeal reasonably intact. A conventional capital raising exercise would make good any short-fall. Such banks would carry on in their present form. Other famous names would be less happily placed. Some would find that they had lost most or perhaps all of their capital. When it is remembered that leading international banks have generally built up balance sheet totals to 20 times or so their capital and reserves, this is not surprising. Any bank with more than seven or eight per cent of its loan book classified as 'non-performing' has put its entire capital at risk.

There would be no advantage to any particular bank in refusing to join in the scheme as the relevant regulatory authority would examine its books very closely indeed and disregard any doubtful loans in calculating its capital ratios for solvency purposes.

One of the Chairmen of the U.K. clearing banks as recently as 31st July, 1984, was reported as dismissing a secondary market in non-performing loans. He is quoted as saying 'It's not an area in which we have any experience nor do we intend to acquire any'. As the *London Standard* pointed out:

> 'That is the sort of remark which could look silly indeed in a year or two. Imagine the chairman of a bank making the same comment about a secondary market in British Government debt. How we'd all laugh.
>
> But unless or until a serious secondary market in dud loans develops, we shall find it hard to believe in the banks' provisions against them. And where investors don't believe, they knock the share price down accordingly.'

I foresee that badly affected banks would have to be reconstructed. They would be most conveniently divided into an 'old' bank, comprising only the non-performing loans being managed by the International Realisation Company, and a 'new' bank carrying on the rest of the business. The 'old' bank which existing shareholders would own, would in effect be in receivership and its shares would be worth very little if anything. The 'new' bank would require fresh capital. This could be supplied either by the 'old' bank shareholders or by new investors. 'Old' shareholders may be given preferential rights or options that would facilitate their participation in the 'new' bank.

CONCLUSION

How do we avoid all the same old mistakes being made again? I am afraid that as far as many large banks are concerned, burnt fingers are not sufficient warning. For the banks which a decade ago discovered they had lent far too much for property development were five years ago embarrassed by imprudent lending to oil tanker owners and today rue their involvement with Latin America. For this reason I propose some institutional changes.

Lending to sovereign governments and their agencies should be secured by charges on assets in the same way as conventional lending. The precedent has already been set by the Bank for International Settlements which has successfully demanded security (often gold bullion) when making bridging loans to countries engaged in negotiating a medium term credit with the International Monetary Fund.

However, less developed countries should go further than providing security for loans. They should admit foreign equity capital into their development projects in order to provide balanced financing. Such capital could be attracted on terms that would satisfy international investors without damaging national sovereignty or interests. In fact, if this had been a feature of less developed country investment over the past fifteen years, there would be no debt crisis. Equity capital would have performed its historic role of providing a reserve or cushion during hard times.

Banking supervision should be taken out of the hands of the civil servants and fonctionaires who run the central banks. The canons of sound banking are well known and have stood the test of time in many countries. They should form the rules under which banks work. But it is very important that supervision is carried out by people who understand banking rather than by officials who know only government. In London it would not be difficult to imagine an independent supervisory body set up by bankers for bankers which would do the job much better than the Bank of England.

Finally, there remains the sensitive issues of timing and confidence. I have written this paper to stimulate discussion of the dangerous situation we are facing; moreover, I think it is particularly important that the voices of those who bear no responsibility for the present crisis are heard. Yet if the public at large should come to believe as discussions dragged on that the problems were insoluable, confidence in the financial system itself would be shattered. Well-meaning people could bring about the very situation they are trying to avoid.

When a critical mass of support has been achieved, it will be time to talk to the parties involved in the crisis. It may then be possible to see whether the necessary great international consensus involving the World Bank, many national parliaments, the central banks and the world's great commercial banks can be effected. It will need a monumental effort of will from all those concerned and a great deal of cutting through red tape but success would be a prize the value of which we can hardly contemplate.

APPENDICES

BONDS FOR THE ARAB OIL FUNDS

(An article which appeared simultaneously in The Times*, London, and* Die Welt*, West Germany, on 29th January, 1975.)*

The free world's industrial and monetary system is still reeling under the shock of the huge increase in oil prices since October, 1973, which has contributed to recession in industrial activity, to unemployment, to inflation in prices, and to balance of payments problems of vast magnitude.

The strangulation of the up to now powerful industrial nations increases the tendency to war for there is a danger that the oil exporting countries by overplaying their newly gained power will create unstable and untenable geo-political pressures. In this context the sacrifice of Israel as the price for further goodwill is not a solution or even necessarily relevant to oil pricing policy which in any case involves nations other than the Middle East. At the same time it is said (in the Neue Zürcher Zeitung of 24th December, 1974) that the Israelis have the know-how of nuclear weapons and it would be too dreadful to contemplate that in despair they might be tempted to use them. Past experience has shown, particularly in Europe as in the case of Czechoslovakia in the 30's, that long-term objectives cannot be achieved at the expense of other countries.

For the majority of the oil exporting countries a continuation of the developments of the last few months is also undesirable. On the contrary, they are interested in the stability of the monetary systems of the western world. They consider themselves, at least as far as the countries with non-marxist Governments are concerned, as economically integrated with the West.

At the same time one must remember that the oil cartel cannot last for ever and that market forces will produce an adjustment in the long run. Alternative sources of energy will become increasingly important and a relative reduction in crude oil prices is inevitable; in the light of this the oil producing countries have an interest in making provision for the 'lean' years to come in which they can finance with their present earnings their further economic diversification and development.

The solution which has to be found, therefore, is one which will:

(a) enable the economies of the oil importing countries to absorb, and adjust to, the large increase in price of one of their basic raw materials in a way which does not lead to economic and political instability through levels of inflation or unemployment which are found intolerable.

(b) enable the financial mechanisms of the free world to continue to function smoothly by removing the instability caused by huge amounts of petro-dollars swilling around the short-term money markets and representing short-term obligations which cannot be met.

(c) give the oil-exporting countries a claim (on real resources) over a long period of time (when the adjustments in the importing countries have been made) when alternative sources of fuel have been developed, when oil prices fall or when their reserves have become much reduced or depleted and when they are able to absorb their increased revenues—without inflation—through development of their own infra-structure, an increase of population and their standards of living.

The proposal which would meet all these objectives (and which are not met by the present Kissinger/Healey plans because the total amounts are too small and because they merely postpone the crunch for a short period), are as follows:

1. The oil importing countries would pay for their oil, in cash, the same prices (with some adjustment for inflation) as those ruling prior to the October 1973 war in the Middle East.

2. The difference between those prices and those now current would be paid in 25 years bonds.

3. The trusteeship of these bonds will lie with the Bank for International Settlements which is an independent banking organisation and has the experience of the Dawes and Young Loans to draw upon.

4. The B.I.S. will clearly define and limit the tranches of the individual debtor countries—with an overall limit of $300 billion.

5. These bonds will be inflation indexed in accordance with some agreed units of measurement and in order to protect the oil-exporting countries against the erosion of the value of money. In view of this, however, they would carry an interest rate of only 3½% per annum.

6. The oil exporting countries will be able to tender these bonds in payment against the import of goods and services from the oil-importing countries, but not in payment against the acquisition of assets.

7. The bonds will carry a sinking fund.

Arrangements of this nature meet all the requirements laid down in points (a)-(c) above. In a minor and modified form they have already been adopted by Venezuela which has reached agreement with Costa Rica, El Salvador, Gutaemala, Honduras, Nicaragua and Panama under which these countries receive their oil at market prices ($11·90 a barrel) but $6 a barrel will be handed back as a five-year loan at 8 per cent.

The proposals now outlined are, of course, only those of principle; the details and refinements will have to be worked out by negotiations.

ORIGIN AND CURE OF THE INTERNATIONAL BANKING CRISIS

(An article published at the Annual General Meeting of Rea Brothers Plc on 14th April, 1983.)

Central Banks

To a great extent the origin of this banking crisis stems from the fact that years ago the central banks which were in the hands of the market (private enterprise) were nationalised.

When the central banks were in the hands of the market their decisions were founded on commercial considerations based on prudence and foresight. When the State became the owner it could direct the central banks to act in a manner which was totally inconsistent with these principles.

Political considerations played an enormous part and the state (the politicians) at times adopted measures in order to buy the favour of the public for electioneering or other purposes. I said many years ago that in the old days the politicians were accused of buying votes with their own money and in modern times they are being accused of buying them with the taxpayers' money. At the time I posed the question might it not be better to go back to the old system?

We have to realise that in modern times we cannot put the clock back so a denationalisation of the central banks is not within the realms of possibility. However, what is a possibility is that certain safeguards are introduced to prevent reckless and unwise measures based purely on national or international politics.

The central banks could be brought under the control of a totally independent body outside government, and I referred to this in an article which was published in *The Spectator* in 1967 under the heading 'Bankers of the World Unite!'. Alternatively, a separate international central bank would be formed which would be in the hands of the market.

Non-Performing Loans

The present crisis is based on the fact that central banks or other monetary public institutions have encouraged, or if not actively encouraged, have not controlled the international banks in lending money to unworthy debtors; the old principles of sound banking were totally disregarded because many of the loan officers who had to decide about these credits, whilst they might have learned which tools to use, did not learn how to use them.

The extent of the present crisis is shown by the article reproduced on pp. 32-33. It appeared in *The New York Times* on 18th March, 1983 and I have decided to include the full text herewith.

With the decline of the impact of the owner-occupier, as far as the funds of the banks were concerned, ambitious people wanted to compete with other ambitious people.

One of the maxims of a good banker is that if he lends money he will apply a number of different criteria:

(i) if someone wants a loan the banker will first make quite sure that the debtor really needs a loan and that it is not really capital he requires;

(ii) if the banker comes to the conclusion that the former is true then he must find out whether the debtor is credit-worthy;

(iii) once he finds out that the debtor is credit-worthy he must find out whether the cash flow will be sufficient to enable the debtor to fulfil the terms of his loan agreement;

and last but not least:

(iv) if the credit is to be given to a debtor in another country, the banker has to be entirely satisfied that the balance of payments of that country will suffice to cover the terms of the agreement.

But this is only the beginning of the terms at which the banker should look. The following are also of great importance when a banker gives credit:

(i) the size of the total credits he is giving in relation to his capital reserves;

(ii) he should not give one debtor more than a certain percentage of the credit he is willing to give altogether;

(iii) if in trade, or commodities, or industry, the credit should as well be limited in size to a specific percentage of the trade or commodity or industry being financed;

(iv) if it is to foreign countries, again it should be limited to a percentage of the total funds available.

We are at present in the position that many of the leading banks have infringed all or part of these criteria and they now find that a great amount of their capital and reserves is locked up in what are today being called 'non-performing loans'. If this were to happen to a small bank and their funds were locked up in such a manner, the authorities would immediately come and demand the writing off of these loans or the transfer to reserves of sufficient funds to cover them, and would not allow the banks to go beyond that, and here I refer to the new banking supervision, i.e. the agreed ratio on which banks can lend money in relation to their capital and reserves.

We have now the extraordinary position where some of the central banks are actively encouraging their commercial banks to add to the loans already given to non-performing debtors—that means throwing good money after bad—to prevent non-performing debtors from failing in their interest payments. In other words, the new money lent is being added to the already outstanding loans and is being used to meet the interest payments.

One of the basic banking principles is that it is almost a criminal offence to borrow short and to lend long. This is another reason for the present banking crisis. The Governor of the Bank of England said in a recent speech (7th February, 1983):

> 'The foreign branches of banks from some countries in difficulty had taken very substantial short-term deposits from other banks and largely lent them back at longer term to their home countries. These short-term deposits were so large that any significant withdrawal of them would have jeopardised the whole package of support facilities. Moreover, if some banks succeeded in reducing their exposure, others would be strongly tempted to follow suit.'

Finance to Under-Developed Countries

The huge balances which the OPEC countries had with the

international banks have been disappearing, or are about to do so. These balances were more or less all on short term, but were used on a much longer term basis in order to finance the under-developed countries; not necessarily for building up their infrastructure but also for financing their countries' budget deficits. Now these countries cannot pay back the money and the banks have had to find the money to repay the balances owed to the OPEC countries.

I well remember my old friend, George Woods, who was the first President of the World Bank, telling me the terms and conditions on which the World Bank would lend money and he said the loan always had to be for a specific project, well documented and properly supervised. We have come a long way since then and money is often neither lent for specific purposes nor is it well supervised.

One of the results of this is that many countries borrow far too much and do not allow sufficient capital to back up these loans so there is not sufficient ratio between capital and loans. This has arisen because, for nationalistic reasons, countries have been refusing to allow foreigners to participate on the capital side. They discriminate against capital participants by special laws or special taxes.

The present crisis is very often compared with what happened in 1929 when people jumped out of windows because they could not fulfil their commitments. That crisis was small fry compared with what we are facing today and, in fact, the real crisis then only made its full impact in 1932 when against an index of 372 on 24th October, 1929 ('Black Thursday'), or 224 on 13th November, 1929 (the lowest point at that stage) the New York Industrial Average slowly fell to a mere 58 in 1932 (July 8th).

However, the situation at that time was different because even if people had sold their investments in time a great number of the banks in which they deposited their funds failed and they lost their money that way.

The powers that be are today well aware of this and feel that if they were to allow one of the big banks to fail the domino principle would apply. This might well be and I am all for preventing it, but at present I cannot see any necessary measures being taken to do so.

THE TOP 10 U.S. BANKS AND THEIR LOAN EXPOSURE IN THE THIRD WORLD

Bank holding companies ranked by 1982 total assets, all data as of year-end 1982.

	MEXICO		BRAZIL		VENEZUELA		OTHERS*		TOTAL		
	Loans ($ mill.)	% of Tot. Loans	Loans ($ mill.)	% of Tot. Loans	Loans ($ mill.)	% of Tot. Loans	Loans ($ mill.)	% of Tot. Loans	Loans ($ mill.)	% of Tot. Loans	% of Tot. Equity
Citicorp**	3,270	3.8	4,360	5.1	1,090	1.3	1,090	1.3	9,810	11.4	203
Bank America	2,500	3.4	2,300	3.1	2,000	2.7	0	0	6,800	9.2	148
Chase Manhattan§	1,867	3.1	2,362	4.3	1,012	1.8	1,012	1.8	6,073	11.0	220
Man. Hanover	1,730	4.1	2,014	4.7	1,100	2.6	1,967	4.6	6,811	16.0	245
Morgan Guaranty	1,082	3.4	1,688	5.3	543	1.7	759	2.4	4,072	12.8	150
Chemical	1,500	4.9	1,300	4.2	0	0	741	2.4	3,541	11.5	182
Continental Illinois	695	2.1	490	1.5	463	1.4	381	1.2	2,029	6.2	119
First Interstate	680	2.8	474	1.9	0	0	0	0	1,154	4.7	64
Bankers Trust	875	4.2	875	4.2	475	2.3	0	0	2,225	10.6	143
Security Pacific	525	2.1	490	2.0	0	0	175	0.1	1,190	4.8	80
TOP 10 TOTAL	14,544	3.4	16,353	3.9	6,683	1.6	6,125	1.4	43,705	10.3	169

* Includes disclosed exposures of more than 1 per cent to Argentina, Yugoslavia and Chile.

** Loan amounts calculated from a percentage of total outstanding.

§ Loan amounts calculated from a percentage of total outstanding, and the midpoint of the range for each country is listed. Range for Argentina and Venezuela is $675 million to $1.35 billion; for Mexico $1.35 billion to $2.025 billion; and for Brazil $2.025 billion to $2.7 billion.

Source: The American Banker

The nation's 10 largest banking companies had $43.7 billion at risk to financially troubled developing countries at the end of 1982, more than half again the value of their equity, according to figures contained in their recently released annual reports.

That means if none of those loans and investments were repaid, the investments of the banks' shareholders would be wiped out and the banks would not be able to repay all their creditors.

The likelihood of that happening is considered zero by most bankers and bank analysts. Even when a company goes bankrupt, a bank usually gets back at least a third of what it lent.

But some analysts say that the high levels of loans to the troubled countries could mean that the banks eventually will have to raise additional capital at prices well below their nominal book values.

'Day of Reckoning'

'A large portion of these banks' equity capital is effectively tied up or frozen in these various countries,' said Thomas H. Hanley, a vice president and bank analyst of Salomon Brothers. Another analyst, who asked not to be named, said, 'There's a day of reckoning coming when a number of these big banks will have to sell equity capital at punitive prices.'

For their part, however, the bankers contend that they expect to lose very little of their outstanding loans to the troubled nations. These include Mexico, to which the 10 banks lent $14.54 billion; Brazil, $16.35 billion; Venezuela, $6.68 billion; and Argentina, Yugoslavia and Chile combined, $6.13 billion. The exposure of the 10 banks to these countries represented 169 per cent of the banks' equity.

'The chance of losing all these loans is almost non-existent,' said Francis X. Stankard, executive vice president of the Chase Manhattan Bank.

According to figures compiled by the American Banker, *a trade publication, Chase's exposure to Mexico amounted to $1.7 billion, to Brazil, $2.4 billion, Venezuela, $1 billion, and to Argentina, Yugoslavia and Chile, $1 billion. These outstanding loans represented 220 per cent of the bank's equity.*

In relation to its equity, Chase's exposure was the second highest, following the Manufacturers Hanover Trust Company, which had 245 per cent of its equity invested in the troubled countries.

Some bankers questioned the value of the information, which they were required to disclose by the Securities and Exchange Commission. One problem, they said, was that S.E.C. did not clearly define what it wanted and therefore the figures and ratios are not comparable.

Another problem, they said, was that the figures do not include local currency loans made within the foreign countries by branches and subsidiaries of American banks. For example, 40 per cent of Citicorp's earnings from Brazil were from loans made within that country and therefore not included in the report of its Brazillian exposure.

One New York banker, who asked not to be identified, said 'There are no surprises in these numbers. What is surprising is the relative standing.'

Among the top 10, two California banks had the least exposure in terms of equity. They were the First Interstate Corporation, with exposure to the troubled countries representing only 64 per cent of its equity, and the Security Pacific Corporation, with 80 per cent.

An article by Robert A. Bennett which appeared in the *New York Times* on 18 March 1983.

I have read statements in the newspapers by leading personalities saying that the banking crisis is over, that things are under control, etc. etc. It is an attitude of hoping that something will happen to save the situation, and sweeping the dirt under the carpet. I regard this as a very dangerous attitude to adopt and the longer one waits before dealing with the problems in a practical manner the worse the situation will become—I have already pointed out how severe things will be. It may well be that the Russians can safely agree to a reduction in their nuclear armaments and rely on what Lenin once said 'There is no need to worry about capitalism; it will destroy itself through the disintegration of the monetary system.'

Proposed Cure

Now what is the solution?

(i) to prevent governments (politicians) from dealing recklessly with the powers vested in them by virtue of their controlling the central banks, and

(ii) by the commercial banks subjecting themselves voluntarily to the disciplines to which I have already referred. However, before we can come to this we have to straighten out the balance sheet of the banks so that the non-performing loans cannot be counted as assets in considering a loan policy, or rather the relation of capital reserves to the loans they gave. I will refer to this again later.

A very imaginative initiative has to be thought of; something on a very grand scale of the kind which General Marshall introduced at the time with his Marshall Aid Plan, except that this aid should be confined to a very specific purpose. In the original Marshall Plan the disposition of the money was left to the countries which received it. Some, like Germany, used it wisely, rebuilding their industry and trade; some, like Great Britain, used it unwisely, squandering it on social experiments and benefits.

For example an international bank could be started, sponsored by the people and not in the hands of government—and here I would remind you of what happened in Genoa in the 15th century. As a consequence of that city's escapades, the economy of Genoa collapsed in 1405, and many government creditors amalgamated

to form the independent Banco di San Giorgio and save the state by taking over the national debt. In that particular case, however, the bank apparently acquired so many privileges for itself that its power soon rivalled the state itself. This mistake should not be made again.

If an international central bank of the kind to which I have referred, were started by the citizens based on private enterprise, with subscriptions from the public, to the exclusion of politicans—and I do not think this is the time or the place to go into the constitution of this bank—and if (as in the Federal Reserve System of the United States) any bank in the world could become a party to this bank, abiding by the rules and regulations laid down and incorporating the wise and sound principles of banking, then this bank, which could be set up not only in one place but also regionally, could be the lender of last resort. It is for this purpose that the new 'Marshall Aid Plan' should be provided.

As I have already said, non-performing loans which are at present the greatest threat to the international financial system, should all be handed over to a realisation company, managed and controlled by the new international central bank. The capitals of the banks which have, therefore, been denuded of these 'assets' should be replenished by financing facilities from the international central bank and from the public. A condition of this kind of initiative would, of course, be that the commercial banks would abide strictly by and become party to the rules and regulations as laid down by the international central bank, and subject themselves to proper banking supervision in this respect. Should they fail to comply they would be thrown out of the club, which would really mean the end of that particular bank as they would lose all their deposits.

It is, of course, not possible in a short article like this to go into the pros and cons of my suggestions in great depth, but I would suggest that, with great urgency, a committee of real bankers, to the exclusion of those who have contributed to the present debacle, be set up empowered to make a considered report, this committee to have the right to add to its members whomsoever they chose and the banks that wanted to participate finally would have to be very co-operative in providing information to this committee to enable it to make its report.

Conclusion

Now I do not claim that my suggestions are necessarily fool-proof but they are at least a constructive idea on how to solve a problem which, if it is not tackled in a practical and pragmatic way, will lead to a major disaster in the world. New ideas are always attacked as unworkable, cannot be done, etc. etc. Let those come forward who have constructive ideas on how to improve upon the suggestions contained in this article, or show where, for practical reasons, they should be altered.

I have had over many years quite a good track record with the comments which I have made on the economic front.

The crisis which we are now facing was absolutely foreseeable and should have been dealt with a long time ago.

As far as international loans are concerned, I only want to quote from a speech which I made in 1976 when I said:

> 'It is my firm conviction that after facing the traumatic experiences in the financial world a year or two ago, the free world is facing yet another serious crisis. I refer to the international loans which have been given to the developing countries, in many cases without any control and very often for political reasons, and then unloaded in part, to the public, and part kept in the loan portfolios of many of the great international banks. I can foresee the day, if it is not already here, when many of these countries will not be able either to service the loans or make the repayments on the due date; it is quite possible that they will argue that it was, in any case, money owed to them by the free world for what it did to them in the past or, to put it another way, for what it did not do for them in the past, and they will simply say "we owe you nothing". This is propaganda which would be encouraged by the Eastern Bloc and would help further in the ultimate goal to destroy the free world.'

Let's not sit back and throw up our hands in despair. Let's rather remember the old saying by Goethe: 'despite adverse forces, to survive, never to bend and always to walk erect, brings the support of God'.

File

Rey

10 DOWNING STREET

From the Private Secretary

5 September, 1984

ECGD POLICY TOWARDS RESCHEDULING COUNTRIES

The Prime Minister has seen your Secretary of State's letter of 10 July and the replies from the Chancellor, the Foreign Secretary and the Secretary of State for Defence. She has noted that agreement has been reached between Ministers and with OECD partners that ECGD cover could be resumed somewhat earlier for those countries granted rescheduling provided they are implementing an effective adjustment programme approved by the IMF.

I am sending a copy of this letter to David Peretz (HM Treasury), Len Appleyard (Foreign and Commonwealth Office), Richard Mottram (Ministry of Defence), Michael McCulloch (Overseas Development Administration) and to Richard Hatfield (Cabinet Office).

(Andrew Turnbull)

Miss R. Thompson,
Department of Trade and Industry.

RWT

10 DOWNING STREET

From the Private Secretary

(2)

Prime Minister

To note that DTI, Treasury and FCO have agreed a modification of policy on the restoration of ECGD cover for countries. Hitherto a country seeking rescheduling of official debts lost cover and did not regain it until sometime later when a record of creditworthiness was restored.

It has been agreed with OECD partners that cover can be reinstated when a country embarks on an IMF approved programme. This will provide greater incentive for debtors to undertake adjustment programmes.

AT
4/9

International Debt file

Spectator 18 August 1984

City and Suburban

Salomon abdicates

Private banking loses its most public advocate as Sir Walter Salomon slips into the wings. He has ended 34 years as chairman of Rea Brothers, the City bank which,in its present form, is his creation. The smallest of the accepting houses, Rea is on that score conventionally called a merchant bank. No, says Sir Walter, a private bank. It is true that for most of the time Rea keeps out of sight, occasionally looming here or there as the force behind some decisive shareholding. But the standards of the private bankers are for Sir Walter a matter of public importance, and when commercial or central banks forget those standards, they bring many of our present woes upon us. What they lack, he says, is the private banker's discipline of risking his own money: 'With the decline of the impact of the owner-occupier, as far as the funds of the banks were concerned, ambitious people wanted to compete with other ambitious people.' As for the Bank of England and the central banks of other nations, they no longer even risked their shareholders' money. Long before the seeds of today's banking troubles were sown, Sir Walter was arguing, in the *Spectator*, for making the central banks independent of government, or for establishing a new international central bank in the hands of the market. It worked (he told us last year) in 15th-century Genoa. The city state's creditors amalgamated to form the independent Banco di Giorgio, and took over the national debt. They did so well that the bank's power soon rivalled the state's. Our own city state of London, after years of secretly regarding Sir Walter as a vocal eccentric and more recent years of suspecting that he may have been right all the time, will miss those philippics, delivered in that unmistakable voice — not mittel-European, as he would point out, but a good North German accent, from Hamburg. Or have we heard the last? Sir Walter is retiring from Rea's chair and board, Sir Malcolm Wilcox of the Midland becomes chairman, Bill Dacombe comes across from the Royal Bank of Scotland group as managing director. But it is not in the nature of the private banker to walk away.

CC NO

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
TELEPHONE DIRECT LINE 01-215 5422
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JF7144

Secretary of State for Trade and Industry

10 August 1984

CONFIDENTIAL

NB PM
JV
13/8

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

Dear Chancellor,

ECGD POLICY TOWARDS RESCHEDULING COUNTRIES

Thank you for your letter of 30 July confirming your agreement to the proposals set out in my letter of 10 July for some limited relaxation in ECGD policy towards debt rescheduling countries. I have also seen Geoffrey Howe's minute of 3 August. I am pleased to hear that your consultations with other major exporting countries show that they are also working on the same broad lines. While I agree that it will be very desirable to get as much co-ordination of policy as possible - both on resumption and restriction of cover - with other Governments it may not always be possible to achieve a completely concerted view. We shall, therefore, need to be ready to consider exceptions.

2 For political and competitive reasons, it may be particularly difficult to reach firm agreements to restrict export credit cover for countries slipping into difficulties. Nevertheless we should try, and I believe that it is sensible that this should be carried forward within the OECD, as I would be reluctant to see too much power wielded by an institution controlled by the French Tresor.

3 On the question of the implementation of the new policy, our officials are continuing to discuss the detailed accounting and other arrangements. I think Paul

CONFIDENTIAL

Channon or I should make a statement to Parliament early in the next session, but I would like it to be linked with some specific examples of a few countries where some limited resumption of ECGD cover might be justified. I would suggest that the selection should be discussed at official level during the recess. In the meantime I think we must avoid any public disclosure of the new policy until we have had the opportunity to explain to Parliament the basis on which cover will be provided in future.

4 I have also received a letter dated 31 July from Michael Heseltine arguing for the possibility of case-by-case consideration of credits for military projects. I would not wish to be dogmatic here, but I believe that it would be very difficult to find any such projects which are contributing to the economic recovery of the importing country. I would suggest that we should normally wait for the debtor country to have recovered its economic health before offering new credits for defence projects, but I would always be willing to discuss particular cases on their merits.

5 Copies of this letter go to the Prime Minister, the Foreign Secretary, the Secretary of State for Defence, the Minister for Overseas Development and to Sir Robert Armstrong.

Yours sincerely

M McCarthy

pp.

NORMAN TEBBIT

(Approved by the Secretary of State and signed in his absence)

Econ Pol: Industrial Pt 4

SIR WALTER SALOMON

KING'S HOUSE
36-37 KING STREET
LONDON EC2V 8DR
TEL. 01-606 4033

8th August, 1984

Dear Prime Minister,

You will recall my coming to see you after the news broke that Continental Illinois Bank was in serious difficulties. At the time I drew your attention to the serious consequences which would result if the United States government had not stepped in, and furthermore, to the thin ice on which we are at present skating in the world as far as the international banking system is concerned.

I then outlined to you a very rough plan setting out how I imagined the matter could be dealt with. You were kind enough to listen patiently to me and asked whether I could put it into writing. I think I said at that stage that it would not be very easy but I would try. I have now done so and am enclosing herewith a draft of my plan which at this particular moment is only thought to be a discussion paper and still needs to be refined and a great deal of technical detailed work will have to be carried through.

However, as I understand you are going on holiday, and so am I, I thought you might like to take this draft along with you and read it whilst, hopefully, you are enjoying a little bit of peace and quiet.

I would, however, ask you not to discuss the plan with anyone else at this stage because it is not complete and I do not want any kind of leak at this moment. However, I can tell you that the day before yesterday I sent a copy to Alan who rang me last night and seemed to be quite enthusiastic about it and in support of my ideas. The only other person I have given it to is the Governor of the Bank of England.

I do hope you will have a very good holiday which you so much deserve.

With great affection.

Yours ever

Walter H. Salomon

The Rt. Hon. Mrs. Margaret Thatcher, MP

C.D.

NBPM
AT 6/8

FCS/84/228

SECRETARY OF STATE FOR TRADE AND INDUSTRY

ECGD Policy Towards Rescheduling Countries

1. In your letter of 10 July to the Chancellor of the Exchequer you outlined a proposal to alter ECGD's policy towards countries which have rescheduled their guaranteed debts. I have now seen the Chancellor's letters of 13 and 30 July.

2. I welcome your proposal. The Cartagena Conference showed that the majority of Latin American countries are determined to tackle their debt problems constructively. But the moderates' position was to some extent undermined by the subsequent rise in international interest rates. We would strengthen their hand if we were able to show that responsible economic policies will bring tangible rewards. A more flexible approach in providing export credit to certain countries (not only in Latin America) successfully carrying out economic adjustment programmes while rescheduling their debts would be just such a carrot; and would give practical substance to the strategy outlined at the London Economic Summit. It would give a boost to our political and economic relations with the countries concerned. My officials look forward to participating in discussions with yours about which countries should qualify.

/3.

3. I am copying this minute to the Prime Minister, the Chancellor of the Exchequer, the Secretary of State for Defence, the Minister for Overseas Development and to Sir Robert Armstrong.

GEOFFREY HOWE

Foreign and Commonwealth Office

3 August, 1984

Econ Pol
Indebtedness

NBPM

CC AT 3/8

MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000
DIRECT DIALLING 01-218 2111/3

MO 26/9 31st July 1984

Dear Norman

ECGD POLICY TOWARDS RESCHEDULING COUNTRIES

Thank you for sending me a copy of your letter of 10th July to Nigel Lawson, proposing a change in ECGD's policy towards the provision of support to countries which have rescheduled their guaranteed debts. I note that military projects are not included in the proposals to resume credit cover for exports contributing to the economic recovery of these countries. Although I fully understand the rationale for this, I hope that it will still be possible to give consideration to including some military projects, on a case by case basis.

I am copying this letter to the Prime Minister, the Chancellor of the Exchequer, the Foreign and Commonwealth Secretary, the Minister for Overseas Development and to Sir Robert Armstrong.

Yours ever

Michael

Michael Heseltine

The Rt Hon Norman Tebbit MP

Econ Pol

Pt 4 Indebtedness

- 3 AUG 1984

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NDPM

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AT 2/8

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

30 July 1984

The Rt Hon Norman Tebbit MP
Secretary of State for Trade & Industry

Dear Norman

attached with AT

ECGD POLICY TOWARDS RESCHEDULING COUNTRIES

In my 13 July reply to your letter of 10 July, I said I had asked my officials to take soundings with their colleagues in other Finance Ministries about the proposal to relax the terms for resumed ECGD cover for countries that have rescheduled their debts.

These soundings have now been completed, and the officials' report of their colleagues' reaction was moderately encouraging. I am therefore able to agree that we should be prepared, where a country has rescheduled its debts, to resume the provision of cover once it has become clear that the debtor is making progress in adjusting to its situation.

I am sure that both the resumption of cover and, if necessary, its cessation when a country runs into difficulties should be concerted with other major creditor countries, although without insisting that all creditors must act identically. Following a report being prepared by the IMF staff, suitable arrangements for consultation are being set up internationally in OECD. I think we should welcome any such arrangements, provided we make it clear that large sums of money are not involved, and that the cover will only be made available to "convalescent cases" to help them through the adjustment process.

This involves, as your letter implies, a slight change in the undertakings previously given to Parliament about the use of ECGD facilities. I agree with you that it will be necessary to make a statement about this: it is important to protect the position of the accounting officer of ECGD against criticism from the PAC. But this could well be after the recess, when we have some particular cases in prospect. Meanwhile, my officials would be glad to discuss with yours the precise terms of such a statement.

Copies of this letter go to the Prime Minister, the Foreign Secretary, the Secretary of State for Defence, the Minister for Overseas Development and to Sir Robert Armstrong.

Yours ever
Nigel

NIGEL LAWSON

Econ Pol Pt 4

Indebtedness

- 2 AUG 1984

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CONFIDENTIAL

BY BAG

FM UKDEL OECD

TO FOREIGN & COMMONWEALTH OFFICE

TELNO 15 SAVING OF 24 JULY 1984

INFO: BERNE, BONN, BRUSSELS, THE HAGUE, OTTAWA, PARIS, ROME TOKYO, STOCKHOLM, WASHINGTON, UKDEL IMF/IBRD WASHINGTON, UKREP BRUSSELS

COPIED TO: J. G. LITTLER ESQ, HM TREASURY
R G LAVELLE ESQ, HM TREASURY
A. R. H. BOTTRILL ESQ, HM TREASURY

OECD WORKING PARTY NO. 3, PARIS 19 - 20 JULY

Summary

1. The Working Party discussed the medium term prospects for international debt. There were differences about the prospects for world recovery and interest rates, but many felt there were significant risks in the medium term situation and the margin for manoeuvre in achieving a durable solution to debt problems was small. There was an inconclusive discussion of possible conditions for export credit cover when IMF packages and debt rescheduling were being negotiated. The Export Credit Group was asked to study this. A session on current imbalances revealed wide differences between the US and others on the causes and sustainability of the present US deficit.

International Debt

2. The Secretariat paper, CPE/WP3(84)8, showed that on the basis of a medium-term scenario assuming continued modest growth in industrial countries and high real interest rates the main debtor countries were likely to reduce the stock of their debt relative to exports only gradually over the period to 1988. The scenario was based on medium-term projections done for WP1 earlier this year. The main focus was on a sample of problem debtors including Argentina, Brazil, Chile, Mexico, Nigeria, the Philippines and Venezuela. The paper suggested that improved growth prospects and/or lower interest rates might be needed to improve the prospects for debtors.

3. Littler (UK), opening the discussion, said that it was useful to look at the group of major debtors since they accounted for a large part of the overall problem. It was important to remember that although some had taken adjustment measures, others

/had

had not yet. He doubted whether a single base line value for an indicator such as debt relative to exports was an adequate guide to creditworthiness. He preferred to look at the real interest rate relative to real GDP growth. He found aspects of the Secretariat's medium-term scenario implausible, including the continued imbalance in payments flows.

4. He drew attention to the substantial adjustment already achieved by some major debtors, including a significant reduction in their current deficits since 1981. This reflected largely reductions in imports and had been accompanied by falls in output. It was difficult to judge the rate of adjustment which was tolerable - particularly if it had to be sustained over 5 - 10 years - but it was important to keep up pressure on those debtors which had not yet undertaken adequate adjustment. The Secretariat was right to stress the importance of lower interest rates but he did not favour attempts to manipulate them artificially for borrowers. The London Summit had suggested various ways to improve debtors' liquidity and the quality of flows to them, including multi-year rescheduling, encouragement of private investment and bond issues, an increase in IBRD flows and continued access for their exports to industrial countries.

5. Lamfalussy (BIS) said that even on relatively faithful growth assumptions and with continued adjustment by debtors there was no safety margin to cope with a worse outcome on activity in the world economy, high interest rates or political shocks. It was important to seek a bigger margin or to be prepared to meet shocks.

6. There was widespread agreement among the European members that the Secretariat's projections might be on the optimistic side. Flandorffer (Germany) did not believe that US output growth would be sustained. Asbrink (Sweden) suggested there were risks of a cyclical slowdown. Jurgensen (France) shared the pessimism about the outlook for activity in the industrial countries.

7. There was also a preference for looking at debt service relative to exports or to GDP rather than concentrating on debt stocks relative to exports. Sarcinelli (Italy) argued the need to reduce interest rates by changing the mix of policies in some industrial countries. Jurgensen added that it was particularly important for the US to reduce its deficit. He ruled out artificial measures to reduce interest rates, but suggested that there was a need to discuss solutions with the debtors themselves.

8. Sprinkel and Poole (US) both argued that the Secretariat's projections of US growth were too pessimistic. The latest private forecasts were suggesting faster growth for this year. Shafer (Secretariat) agreed with this but said that interest rates were also turning out higher than the Secretariat had assumed. Sprinkel said that he did not expect US interest rates to remain high in

/the

the medium term; they would fall as markets became convinced of the reduction in inflation. He did not believe that the limits of tolerance for adjustment by debtors had been reached. Some had not started to adjust. Others had far to go. It was important to work to a 5 - 10 year time horizon. He hoped there would be more growth in Europe for the sake of both debtors and the US. He was opposed to artificial measures to reduce interest rates.

9. Drabble (Canada) agreed with the Americans that the Secretariat's base line scenario was probably pessimistic. He also shared the US view that increased confidence in lower inflation would reduce both nominal and real interest rates. He believed, however, that it was important to look at growth prospects for debtors to assess the sustainability of their adjustment efforts. It was possible however that some of these were moving towards a mature status and IMF adjustment programmes would help them to improve domestic savings and reduce their reliance on external savings without harming growth.

10. Oba (Japan) suggested that debtors might be encouraged to switch from dollar denominated borrowing to other currencies such as the Yen, Deutschmark or Swiss Franc which had low interest rates.

11. Hood (IMF) said that both lower inflation and slower output growth in the US might help to reduce credit demands and hence interest rates. He agreed that the margins of manoeuvre on the debt problems were limited, but the Fund's own World Economic Outlook suggested that the debt problem was manageable and that developing countries could return to growth in the medium term.

12. Loehnis (UK) agreed broadly with the Secretariat's growth forecast but suggested that depreciation of the dollar might bring a steeper fall in the ratio of developing countries debt to exports than the Secretariat expected. There was no certainty, however, that banks would be content if debtors merely returned to the previous relationship between debt and exports. Banks had become more reluctant to lend generally. Projections by the Bank of England suggested that if debtors were able to continue to increase their exports as the world economy recovered, imports would also rise. This would reduce the temptations of debtors.

13. Henderson (Secretariat) said that the Secretariat had not tried to bias its results in any particular direction. It was also not putting forward any particular solution such as interest rate capping. He recognised that indicators other than the ratio of debt to exports could be useful. The Secretariat would be ready to take forward the technical analysis e.g. with an expert sub-group if the Working Party would welcome this.

14. McMahon (Chairman), summing up, said that even if many people had objected to the use of the ratio of debt to exports,

/most

most had agreed with the broad thrust of the Secretariat's scenario although he recognised that some, such as the Americans, believed the scenario was too pessimistic. Most also believed that the margin for manoeuvre was not great whether on adjustment by debtors, bank lending or industrial countries' growth. Some, such as Jurgensen and Asbrink, believed that the situation was likely to be untenable.

Export Credit (Secretariat Paper CPE/WP3(84)6)

15. Sprinkel argued the case for agreed guidelines on cover offered by export credit agencies when adjustment packages and rescheduling for debtors were being negotiated. The US stayed on cover if a country was following an IMF programme, if bank lending was being increased and in the interests of burden-sharing with other creditors. If agencies followed diverse approaches, debtor countries would be receiving mixed signals. He suggested that the Export Credit Group should discuss suitable guidelines and report back to WP3.

16. Jurgensen said that some agencies continued on-cover too long in some cases but then returned to cover too late especially as debts were rescheduled. There was a need to avoid competition between agencies.

17. Sarcinelli said it would be difficult to harmonise policies since individual export credit agencies had their own balance sheet problems with different spreads of risks. Nevertheless, perhaps the Berne Union or the Export Credit Group could be asked to discuss guidelines.

18. Asbrink agreed that export credit agencies had a role in sustaining capital flows to debtor countries but this should not be expanded excessively. Agencies should not continue to provide cover where a country was in payments difficulties. But they should be ready to restore cover promptly when debtors took action to correct their problem. Perhaps G10 could play a more active coordinating role among creditors when the IMF, governments, banks and export credit agencies were all involved.

19. Ogata (Japan) said that agencies should be ready to reopen short term cover in special cases as rescheduling was taking place, but agencies' finance would be limited to normal trade and they should not become a further source of extra concessional finance. Agencies should share their thinking about credit risks and seek to agree guidelines on the conditions for withdrawal and restoration of cover but this would need to be done on a case by case basis.

20. Drabble said that experience of using export credit to "top up" finance alongside IMF programmes had not always worked well. One problem was that normal imports by debtors had often been reduced as programmes were cut as part of an adjustment effort.

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21. McMahon, summing up, said there was a need to coordinate export credit policies as part of the overall management of debt packages, but WP3 was not the right place to discuss details. There had been a difference of views about the possibility for harmonising policies, but perhaps WP3 could monitor work done elsewhere. The Secretariat agreed that the Export Credit Group would be informed of the WP3 discussion and would itself keep under review the question of harmonising arrangements for providing export cover around the time of IMF debt packages and rescheduling.

Current Imbalances

22. The Secretariat paper, CPE/WP3(84)7, suggested that a major cause of the present US current account deficit was the faster growth in the US compared with other industrial countries since 1982, although past losses of competitiveness as a result of the dollar's high exchange rate had also contributed. It presented simulations to show the effect of a lower dollar or slower relative US growth in reducing the deficit over the period to 1988.

23. Sprinkel complained that the Secretariat paper had concentrated excessively on the US deficit and had ignored the emerging Japanese and European surpluses. It had also not paid enough attention to the effects of slow European growth. It seemed to imply that the US deficit could only be reduced by a US recession.

24. He denied that the US budget deficit had contributed to the current account deficit by stimulating domestic demand. He also denied that the budget deficit had helped to cause an appreciation of the dollar through higher interest rates.

25. He agreed that some of the factors which had contributed to the high dollar exchange rate might now be less important e.g. the relatively good US inflation performance since others, too, were now reducing their inflation rates. He did not, however, expect a sharp fall in the dollar since a lower US budget deficit might strengthen rather than weaken the dollar. He expected faster growth abroad, especially in Europe, to help reduce the US deficit.

26. On the technical side, both the US Treasury and the Federal Reserve believed that the lags between exchange rate changes and trade volumes were shorter than those assumed by the Secretariat and that activity effects on the current account would be bigger.

27. Poole argued that the US current account deficit was not unsustainable if the real rate of return on investments in the US was greater than the return on investments in other countries. Siegman (Federal Reserve) said that the Secretariat had been wrong to start its analysis from 1982 when the US economy was relatively depressed. The Fed's own analysis, starting in 1980 when the US and the rest of the world were in broadly the same cyclical

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position, suggested that much of the increase in the current deficit was due to the appreciation of the dollar with a smaller part due to changes in relative activity. The Fed's own work suggested that a change of 20% in the dollar exchange rate would improve the current account by $55 billion after two years. He denied that the Fed was holding up interest rates in order to sustain the dollar.

28. Ogata suggested that the US removal of withholding tax on non-resident investments in the US and US government plans to issue bonds in the Eurodollar market both seem designed to encourage a high dollar exchange rate. Sprinkel claimed that the removal of withholding tax was designed solely to stop the distortion of capital flows through the Netherlands Antilles. He noted that some Europeans were also considering removing withholding tax. No decision had been taken on issuing US government bonds in the Euromarkets.

29. Oba suggested that it would be difficult to reduce current account imbalances quickly. This would require prudent policies everywhere. In the US it would require a reduction of the budget deficit. Japan's current surplus was largely outside its own control - reflecting lower oil prices, recovery in the US and the high dollar due to high US interest rates. Japan's economy, however, was now growing and imports were increasing, including imports of manufactures. He did not believe that there should be a return to the 1970's "locomotive" experiment which had contributed to global inflation and high budget deficits.

30. Padoa-Schioppa (Italy) said that the US had played the role of a Keynesian locomotive to help world recovery, but there was now a need for greater growth in Europe - although Italy itself still needed to follow restrained policies.

31. Flandorffer said that he expected German growth this year to be 2½ - 3% but accepted the need to improve the prospects for investment through improving market flexibility. Lamfalussy echoed the need for Europe to follow the US example of flexibility to encourage growth.

32. Loehnis suggested that though real wages had contributed to adjustment in the US since 1979, both demand and supply factors had been important. The US was becoming a post-industrial economy with high returns in services. The internationalisation of financial markets was also making US assets close substitutes for domestic assets, so that the limits on the share of dollar assets in investors' portfolios might prove larger than expected.

33. McMahon, summing up, said that it had been useful to concentrate on the long-run determinants of exchange rates and growth prospects for countries outside the US. He noted the US reassurance that prudent American policies would prevent disruptive moves in the dollar.

Footnote

McMahon will address ECSS on 13 September on debt problems. The next meeting in Paris of the WP3 will be on 12 December.

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Prime Minister (2)

To note. Pages 4 and 5 cover the Cartagena debtors conference and an account of the most recent debt negotiations with Argentina.

AT 17/7

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

16 July 1984

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew

INTERNATIONAL FINANCIAL SCENE

I attach the latest report by the Bank on developments on the international financial scene, which has been considered in the Treasury's international debt group.

Despite some favourable signs, the outlook for interest rates seriously increases the downside risks; and the timing of the latest rise in US rates has made it more difficult for the moderate debtor countries to restrain the militants. This is a pity, since the Cartagena meeting, of which we have already sent you a brief appraisal, represented something of a victory for the moderates, although it also marked a further move towards collective action by the Latin American debtors. Another meeting, in Buenos Aires and with an Argentine secretariat, is scheduled for just before the IMF/World Bank meetings in September.

A further possible difficulty ahead is the effect of the increase by 1.2 per cent on 15 July of the OECD export credit consensus rates, under the automatic adjustment arrangements introduced last year. This was, however, an important part of a hard won agreement (against strong French opposition) designed to bring consensus rates closer to market rates to reduce the cost of export credit subsidies, and we should not wish to see any of that agreement unpicked.

Following the London Summit, Treasury officials are working on the practicalities and technicalities of multi-year rescheduling, in consultation with G-5 colleagues. The most likely candidates for official multi-year rescheduling are Brazil and Yugoslavia.

As the attached note indicates, among individual debtor countries Argentina remains the main concern. The position in Nigeria is also worrying. There is still no sign of a Fund agreement there either, and recent political developments have obviously increased the uncertainties. ECGD has substantial sums at risk; failure to agree a refinancing of insured arrears (which is itself contingent on agreement on a Fund programme) could add some £200 million to the PSBR in 1984-85 and some £220 million in 1985-86. We are consulting with our G-5 partners and the Fund on the next steps.

Finally, I should add that at a meeting in Paris a week ago, negotiations between Polish officials and official creditors broke down over Poland's failure to make the down payments agreed as a precondition for further rescheduling. There is as yet no arrangement to resume talks.

I am copying this letter to Len Appleyard (FCO), Callum McCarthy (DTI), and John Bartlett (Bank of England)

Yours ever

David

D L C PERETZ
Principal Private Secretary

TERNATIONAL FINANCIAL SCENE

A combination of factors, notably the Continental Illinois crisis, the renewed pressure on debtors stemming from rising interest rates, and the growing momentum behind debtor co-ordination, now being encouraged particularly by Argentina - a country whose approach to its economic problems is itself a cause for much concern - has served to create an atmosphere of edginess in the financial markets. Brazil and Mexico continue to perform well, but Colombia, which has so far avoided debt problems, may shortly need to apply for rescheduling. Against this background, proposals for medium-term solutions to the debt problem are coming more to the fore: procedures adopted over the last two years are undergoing critical reappraisal, with a stronger demand for more direct involvement by creditor governments.

On balance, the economic news is discouraging. US interest rates rose further in June and are now some 2 - 2 1/2% higher than at the beginning of the year, adding more than $5 bn to the annual interest burden of the Latin American region. Moreover, the signs are that rates may rise again over the coming months. The dollar has appreciated further, while commodity prices weakened significantly in June. On the positive side, growth in the major economies - particularly in the US, Germany and Japan - has been maintained without any sign of a significant acceleration in inflation; and the combined current account deficit of these countries widened further in April. The US continues to be the main engine for this economic expansion and revival of trade, but there are growing doubts as to whether the present rapid growth rate and record current account deficits in the US can be sustained for much longer.

good for inflation though!

Among the debtor countries, Argentina remains the major source of immediate concern. Since a number of US banks have decided voluntarily to follow the more restrictive change in US supervisory rules (which formally come into effect at the end of September), they no longer had the incentive - which they had in March - to extend new money to Argentina in order to preserve existing loans as "performing". However, the banks' Working Committee has been under pressure - from the Fed as well as Argentina - to make a further bridging loan, simply to prevent negotiations from breaking down. The Committee eventually decided to advance a further $125 mn (secured by Argentine reserves held in escrow at the Fed in New York) to help Argentina to reduce arrears of interest by some $400 mn. Meanwhile, the countries which provided temporary support to Argentina in March have put pressure on the Argentines to settle their differences with the IMF, but have extended their own loan for a further month.

Brazil and Mexico continue to register large surpluses on visible trade. The latter is about to begin negotiations with banks on a multi-year rescheduling covering maturities from 1985 to at least 1988. New economic teams in Chile and Peru have satisfied the IMF that their economic policies are acceptable: Chile has accordingly obtained $780 mn of new money from banks for 1984, and Peru has reached agreement with its official creditors on rescheduling maturities up to mid-1985. Bolivia has officially suspended debt service payments to commercial banks, but this merely formalises the earlier position. Bolivia's difficulties are particularly severe, and there is no question of the suspension influencing the attitudes of other Latin American debtors. In Venezuela, where arrears continue to accumulate, an extension of the moratorium at end-July seems inevitable, but some progress was made recently when the government and banks agreed to initiate formal rescheduling negotiations. The authorities will be seeking to negotiate fixed, rather than floating, rates - the first time such a proposal has been made by a debtor country. Prospects do not look at all encouraging in Colombia, which has so far avoided debt servicing problems, but may shortly need to apply for rescheduling and an IMF Standby.

In Eastern Europe, Yugoslavia has signed agreements with its bank and official creditors on restructuring 1984 maturities; and Poland hopes to sign a multi-year rescheduling, covering 1984-1987, with its bank creditors in mid-July, although negotiations with official creditors have temporarily broken down.

Elsewhere, negotiations with the Philippines and Nigeria continue to be delayed by failure to agree programmes with the IMF: the Philippine authorities have gone some way towards meeting IMF requirements, but the Nigerians are still resisting a step devaluation of the naira.

As the debt problems move into their third year, and against the background of a damaging rise in US interest rates, attention is turning towards debt management strategy over the medium-term, with particular reference to ways of alleviating the interest burden on debtor countries. The outcome of the London Summit, which advocated multi-year reschedulings, was generally regarded as modestly helpful, though it did not fully satisfy the debtors' desire for trade, development and finance to be more closely linked. Following their meeting at Cartagena in June, the Latin American debtors responded by reiterating - moderately but firmly - a request (originally made at Quito) for further assistance to enable them to honour their obligations. This movement towards a co-ordinated approach by Latin American countries to debt negotiations is gaining momentum, not least because even moderate debtors have become seriously concerned at the way in which rises in interest rates have eliminated much of the hard-earned gains from their policies of adjustment. Another debtors' meeting is to be held in Buenos Aires around the time of the IMF Annual Meetings in September. The venue and timing, together with Argentina's new key role in the Latin American collaborative efforts, all suggest that a harder line could emerge. Indeed, Argentina is already endeavouring to co-ordinate a Latin American response to rising US interest rates, which could mean that the meeting may be brought forward. Meanwhile, the banks are also considering long-term issues, mainly in the framework of the Institute of International Finance: some preliminary results of their discussions are expected to emerge in July.

More detail about the position in major debtor countries is given below.

(i) Latin America

Regional developments in recent months have been characterised by a greater politicisation of the debt question and by moves towards closer co-ordination of strategies for resolving present problems. On 21-22 June, Latin American Foreign and Finance Ministers, representing eleven countries (Argentina, Bolivia, Brazil, Chile, Colombia, Dominican Republic, Ecuador, Mexico, Peru, Uruguay and Venezuela), met in Cartagena, Colombia, with a view to defining "the most appropriate initiatives and means of action capable of reaching solutions satisfactory to all interested countries". The meeting had been called by the Presidents of Argentina, Brazil, Mexico and Colombia, following a joint declaration, issued on 19 May, warning of the political and economic consequences for the region of high international interest rates and increased protectionism. In the event, the consensus reached at the meeting was relatively moderate in tone and resulted in another general - if more pithy - statement of principles and broad policy objectives designed to ease the region's debt servicing burden. The steadying influence of Brazil, Colombia and Mexico successfully blocked more radical proposals (such as limiting debt service payments to a specific proportion of export earnings) made by hardliners in the Argentine camp, eg Bolivia, Ecuador and the Dominican Republic. The moderates have also been constructive in exerting pressure on Argentina to agree an IMF-approved programme.

The governments represented at Cartagena are to meet again in Buenos Aires in September ahead of the Annual General Meetings of the IMF and IBRD, in order to review the response of western governments to their call for more far-reaching co-operation and assistance to resolve the debt problem. It was agreed at Cartagena that the debt problem must be treated at a political level and cannot be left solely to technocrats and creditor banks; and the Latin Americans are accordingly also seeking a high level political dialogue with governments of the industrialised countries for a "joint reflection" on the debt problem.

The rise in prime rate which immediately followed the Cartagena meeting can only serve to weaken the position painstakingly achieved by the moderates and to strengthen the case of the hawks led by Argentina, which provides both the venue for the next meeting and the group's first temporary secretary.

As regards individual countries, Argentina remains the most worrisome. It has now formally approached the Paris Club, but agreement cannot, of course, be reached until an IMF programme is approved. Although the Argentines have sent a "Letter of Intent" to the IMF Managing Director, they failed to obtain the approval of Fund Staff in advance and a wide gap remains between the two sides. An Argentine mission to the IMF in the latter part of June, and Grinspun's visit to Washington on 26-27 June, failed to make significant progress, although negotiations are continuing. Meanwhile, Argentina pressed the banks' Working Committee to advance a 90-day loan of $125 mn as part of a new package to bring interest arrears more up-to-date. The package was to include a contribution of at least $225 mn from Argentina's reserves (in addition to $100 mn paid to the banks on 20 June) and a 90-day rollover of both the $750 mn outstanding under the 1982 bridging loan and the $100 mn provided under the end-March package. Argentina latterly insisted that the package should go forward without any linkage (as had originally been proposed) to a Letter of Intent being approved by the IMF Managing Director or to any fixed timetable for such approval; the banks were at first ready to consider this demand only if the Managing Director indicated that progress in the negotiation was being made, but he was unable to do so. The Working Committee accordingly decided on 27 June not to advance the $125 mn, but on the following day the US banks were persuaded by the FRB to reverse the decision, on the grounds that the banks would still be reducing their overall exposure to Argentina as a result of the deal, without reducing the pressure on Argentina to reach agreement with the Fund. On 29 June, all members of the Working Committee agreed to participate in the loan, LBI doing so only at the last minute, in order to preserve the unity of the Committee. The terms of the loan require Argentina to have reached agreement with the Managing Director of the IMF by 15 August: if agreement is not reached, the loan falls due for repayment on that date, and irrevocable instructions so to repay it from Argentina's accounts with the FRBNY have, we understand, been given. The other elements of the package (outlined above) were also agreed.

The governments of Brazil, Colombia and Mexico - the position of Venezuela is not clear - had agreed to postpone repayment of their $300 mn contribution to the end-March package until 31 July, despite the US Treasury's decision not to extend its guarantee arrangement beyond 15 June, provided that the banks extended their $100 mn bridging loan for 90 days and that Argentina made some progress in reducing interest arrears to the banks.

Brazil's trade account continues to strengthen, and the cumulative surplus in the first six months of this year amounted to two thirds of the surplus targeted for 1984 as a whole. This improvement should enable the country to absorb the full impact of recent rises in international interest rates - which Brazil has sharply criticised - without jeopardising the target for the current account. In the Phase III negotiations, due to begin later this summer, the authorities may well seek to capitalise on the country's improved performance by requesting a multi-year rescheduling, possibly covering maturities falling due in 1985-87.

It is now widely accepted in the international community that Mexico's successful efforts to adjust should be rewarded with an agreement on a multi-year rescheduling of maturities falling due from 1985 to at least 1988, including debt restructured during 1983. Discussions with the Advisory Group are tentatively scheduled to begin early in July.

Elsewhere, the new economic team in Chile appears to have accepted that, at least for the time being, there is little scope for expansionary policies. This stance paved the way for a succcessful quarterly review of the Fund programme in mid-May and for signature of the $780 mn new money package from banks on 14 June. However, Chile now looks likely to miss this year's IMF target on reserves, essentially because of low copper prices and higher US interest rates, in which event a waiver would no doubt be requested. Against this background, and with the possibility of US restrictions on imports of Chilean copper, the authorities have recently been taking a harder line on regional debt co-ordination and the need to limit debt service payments. Recent economic measures introduced by the Peruvians indicate that their new economic team too has opted - at least for the present - for less expansionary policies. A favourable IMF report enabled the Paris Club to sign a $1.05 bn rescheduling agreement on 5 June, covering maturities due to end-July 1985. However, future adherence to Fund targets must remain in doubt. For Ecuador, the banks will agree to a request for $350 mn in new money only if the Febres Cordero Administration, which takes office on 10 August, adopts a new Fund programme. An application to reschedule Paris Club debt, formally presented in early June, is subject to similar conditions. Venezuela continues to make very slow progress on eliminating interest arrears: renegotiation talks are now scheduled to start on 23 July, and another extension of the moratorium, which expires at end-July, appears inevitable. Finally, Colombia is approaching a foreign exchange crisis: a serious trade imbalance, together with capital flight and a cut-back in bank credit lines, has reduced liquid reserves to a critical level, and the authorities may have no alternative but to turn to the IMF and to reschedule bank debt in the near future.

(ii) The Far East

In the Philippines, the authorities have taken a number of measures - including a further (22%) devaluation of the peso and supporting tax increases - which go some way towards meeting the IMF's requirements for agreeing a Letter of Intent. However, the Fund are seeking further action to reverse the excessive monetary growth of the past nine months and to restore government control of spending by parastatal bodies. Talks with the IMF have resumed after discussion in the Board of the 1984 Article IV paper on 29 June; negotiations with the Advisory Committee of banks meanwhile remain in abeyance. The authorities have requested a further three-month extension (from 17 July) of the moratorium on repayments of principal. Elsewhere in the region, South Korea has completed a successful review of its two-year Standby with the Fund, having met all performance targets in the first year of the programme; and a steady improvement in the current account, now likely to be close to balance this year, has been reflected in finer terms for borrowing in international markets.

(iii) Eastern Europe

The commercial banks hope to sign their multi-annual rescheduling agreement (for 1984 to 1987) with Poland in London on 13 July. The agreement virtually completes the rescheduling of original maturities due to banks and provides an element of new money in the form of trade finance. Meanwhile, at least some governments have received less than they were expecting by way of a down-payment on arrears, which was to be made as a pre-condition of the resumption of official negotiations. As a result, negotiations have temporarily broken down, and it is not yet clear when they will resume. Arrangements with commercial bank and official creditors for restructuring 100% of Yugoslavia's 1984 maturities have been concluded, and the bank which chairs the banks' International Co-ordinating Committee has publicly raised the possibility of a multi-annual rescheduling agreement for Yugoslavia from 1985 (subject to the effective continuance of IMF programmes).

(iv) Southern Europe

Spain and Portugal each continue to make satisfactory progress on the current account of the balance of payments, and Standard and Poor have recently up-graded Spain to "A1 plus" for commercial paper. The Greek current account deficit in the first four months of this year showed no improvement on the same period last year, but the government has ruled out any major change in the direction of policy. In Israel, the introduction of a number of electioneering policies gives little hope of an early improvement in the economic situation.

Little progress has been made by Nigeria in negotiations with the IMF over a three-year EFF, essentially because the Nigerians have not yet agreed on an initial step devaluation. Meanwhile, official credit agencies continue to insist that a multilateral restructuring of insured arrears cannot be negotiated until agreement has been reached with the IMF.

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INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt End-Dec 1983 (except where stated)	British-owned banks' exposure [1] End-Dec 1983	ECGD amounts at risk[2] End-Mar 1984
Latin America			
Argentina	44	2.5	0.2
Brazil	92	6.1	2.1
Chile	18	1.3	0.1
Colombia	12	0.7	0.0
Ecuador	7	0.6	0.1
Mexico	91	6.3	1.6
Peru	12	0.4	0.2
Venezuela	34	2.4	0.1
Eastern Europe (convertible currency)			
East Germany	13-14	0.7	0.2
Hungary	7.4*	0.5	0.1
Poland	27	0.5	0.9
Romania	9	0.3	0.5
Yugoslavia	19	0.9	1.2
Southern Europe			
Portugal	14	1.4	0.4
Greece	12.1	1.6	0.5
Spain	40	2.8	0.3
Israel	29	0.6	0.2
Far East			
Indonesia	31	0.8	1.8
Philippines	25	1.4	0.3
South Korea	40	2.6	1.0
Other			
Morocco	12	0.1	0.3
Nigeria	20	1.3	3.7

* end-September 1983

[1] This column now shows exposure defined as consolidated external claims, adjusted for certain inward and outward risk transfers in respect of guaranteed loans, plus any net claims on local residents in local currency.

[2] Because of differences in definition, these estimates are not directly comparable with the figures in other columns.

File

Rey

cc: P.C.

10 DOWNING STREET

From the Private Secretary

16 July, 1984

CARTAGENA CONFERENCE

Thank you for your letter of 2 July to Andrew Turnbull, enclosing an appraisal of the outcome of the Latin American Conference on debt.

The Prime Minister has noted the assessment and agrees with the Chancellor that our public response should be low key.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office) and to John Bartlett (Bank of England).

(C.D. Powell)

Miss J. Simpson,
HM Treasury

NBPM
AF 218

cc Sir P Middleton
Mr Littler
Mr Unwin
Mr Lavelle
Mr Sedgwick
Mrs Case
Mr Edelshain
Mr Scott-Barrat
Mr Mountfield

CHANCELLOR OF THE EXCHEQUER

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

13 July 1984

The Rt Hon Norman Tebbit MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
London SW1H 0ET

Dear Norman

ECGD POLICY TOWARDS RESCHEDULING COUNTRIES

I agree, as you suggest in your letter of 10 July, that the time has come to review ECGD's policy towards countries that have rescheduled their guaranteed debts - as part of the general post-Summit examination of ways of dealing with the international debt situation.

I think, however, that it will be important first to have some discussion with the other major creditor countries. I have therefore authorised Geoffrey Littler to discuss this subject with his colleagues from other Finance Ministries in the course of various meetings in Paris next week, culminating at OECD's Working Party 3.

I hope you will bear with me if I wait for his report from these international discussions, before I respond to your proposals.

I am copying this letter to the Prime Minister, the Secretaries of State for Foreign and Commonwealth Affairs and Defence, the Minister for Overseas Development and Sir Robert Armstrong.

Yours
Nigel

NIGEL LAWSON

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10 July 1984

INTERNATIONAL DEBT CRISIS

There are a number of ways in which the creation of a market in debt would help solve the international debt crisis.

One way would be for the authorities to set up a market in all international debt from a stated date. All banks would be required to convert a specified proportion of their international bank syndicated loans into tradeable bonds - with the same maturity and interest rate as in the original loan agreements. These would be marketed, and from the prices achieved, banks would be able to work out the true value of their loan books and make appropriate write-offs in their balance sheets. Any bank short of cash would be able to sell off some of its assets.

A second method would be to wait until a bank was in difficulties and then allow it to try and sell on some or all of its international debt. This would not require the same intervention of the authorities nor such a major upheaval as in the first scheme. The individual bank suffering a run on its cash reserves would get temporary assistance from the central bank involved only on the condition that it took action to sell on some of its assets, quantified its losses, and wrote off its shareholders' reserves to pay for the mistakes.

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The third variant would be for the authorities and the leading banks to get together and to decide on a case-by-case introduction of a market in debt. They could decide to take a medium-sized country making progress towards recovery as their starting point and convert all or some of the syndicated loans into tradeable bonds. They would also seek buyers from the institutional funds around the world to help make a good two-way market and establish a true price. If they were successful with the first they could then move on to other territories or other groups of banks or a further tranche of the syndicated loans for the territory concerned, thereby gradually quantifying the losses and increasing the liquidity of the international banking system.

Of all these routes the only one we would recommend is the third. The first is fraught with difficulties. It would be a major operation to try and mount. Some banks and countries may not wish to co-operate. The losses it could reveal for any individual bank could precipitate an immediate run and thereby enforce further federal lending to the banking system. The sums of money involved are so large that it would be difficult to establish a satisfactory market in all the debt in one go.

The second system is even worse than the first. Any bank taking the unilateral action to try and sell on some of its syndicated debt would be making a public statement that it was in grave trouble. This would immediately precipitate a

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run on that bank and probably enforce its closure or bankruptcy. At the same time, that bank's loans would not be very attractive to the potential buyers, who would realise that the bank was a forced seller.

The third system is the best because:

i. the sellers will not be acting under duress;

ii. care would be taken to ensure that there were possible matching buyers from amongst the institutional funds;

iii. it would build on the case by case approach, attempting to deal with some of the easier territories or syndicates first;

iv. it would take it at a pace where agreement and co-operation was feasible;

v. it would, however, gradually return the system to honesty by quantifying precisely what the losses were on categories of debt and giving banks a yard stick by which they could adjust their capital base.

We would therefore welcome a scheme of marketable debt and suggest that the third route is the appropriate one. Such a

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scheme should not become a backdoor means for central banks to subsidise their clearing banks by buying debt from them at unrealistic prices.

JOHN REDWOOD

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Indebtedness

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CC NO

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1-19 VICTORIA STREET
LONDON SW1H 0ET
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Secretary of State for Trade and Industry

10 July 1984

NBPM
AT 19/7

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1

D Nigel,

ECGD POLICY TOWARDS RESCHEDULING COUNTRIES

I am proposing to authorise a change in ECGD's policy towards the provision of support to countries which have rescheduled their guaranteed debts, which should be helpful in the context of the present dialogue with the developing countries on their debt problems. The proposal would be to allow ECGD cover to be resumed at an earlier stage than in the past to support credits for British goods which contribute to the economic recovery of the debtor country. This facility would be reserved for those developing countries which have been taking resolute action to carry out an effective adjustment programme with the IMF. It should therefore help to serve the general policy discussed at the Summit of finding a way of rewarding those debtor countries that are behaving responsibly, in contrast to those (like Argentina and Venezuela) that are at present failing to face up to their responsibilities.

2 The arguments for making this change and the criteria that would apply to the provision of further ECGD cover for certain selected markets are set out in the enclosed paper. These have been discussed and agreed at official level and I suggest that this new policy should be put into operation, subject to the agreement of the Prime Minister and colleagues, on the carefully controlled basis that is proposed. The essence of these proposals is that only the "better performers" among the debt rescheduling countries will be rewarded (for example Mexico, Brazil and Yugoslavia might fall into this category): they will have to be adhering to a strict IMF adjustment programme and meeting their current payment obligations. Ministerial approval will be sought in each case, after discussion at official level in the Export Guarantees Committee, before cover is restored. Normally the level of cover will be set at a lower level than that operating before the debt

JH3APU

rescheduling application was made, but this should not cause problems as imports will generally be constrained by the stabilisation programme. Moreover, it is intended that the credits will be used to support British exports which should contribute to the economic recovery of the debtor country, (so that ECGD cover for prestige and military projects will remain blocked).

3 This change should assist our bilateral political and trading relations with these debtor countries and I am conscious of the fact that the UK was in danger of becoming isolated in this area by having no ECGD capacity to support new business following the successful completion of the IMF and debt restructuring negotiations. Nevertheless, I do recognise that the risks remain high, because even well-intentioned governments may be unable to carry through their adjustment programmes because of internal opposition or the slowness of their economic recovery. I would intend this development in the use of ECGD's Section 2 (national interest) powers to be announced to the House (probably by means of an arranged PQ) in view of past assurances given about the use of these powers: no new legislation will be required. I would also wish to make clear that this change does not mean that there will be any relaxation in the general standards applied by ECGD in underwriting business in other markets. It is important that the risks involved in guaranteeing these new credits should not impinge on ECGD's normal trading operations. I understand that you are willing to agree to an arrangement whereby credits given to an approved debtor country before its return to full economic health will be carried under a special sub-head of ECGD's Section 2 account, and that if any losses should arise - and I naturally hope that they will not - these will be carried by the Exchequer and will not, therefore, lead to premium increases which will affect the competitiveness of British exports to other markets. I should be grateful if you would confirm this if you and others are able to support these proposals.

4 I am sending a copy of this letter to the Prime Minister, the Secretaries of State for Foreign & Commonwealth Affairs and Defence, the Minister for Overseas Development and Sir Robert Armstrong.

Yours
Norman

NORMAN TEBBIT

JH3APU

REVIEW OF ECGD POLICY TOWARDS DEBT RESCHEDULING COUNTRIES

Introduction

1 The policy which is applied by ECGD following a restructuring of official debts guaranteed by the Department has been reviewed by officials in interested Departments (ECGD, Treasury, DTI, FCO, Bank of England and Cabinet Office under the chairmanship of Mr Unwin (Treasury). A change in this policy to allow ECGD support to be given for new credits to certain "deserving" countries is recommended unanimously as set out below.

Background - present policy

2 Like most other official export credit agencies ECGD withdraws cover for new credits when it is evident that a debtor country is to seek a Paris Club restructuring of its official debt (or is to seek such relief outside the formal auspices of the Paris Club). In practice cover is automatically withdrawn for similar credits for new business, (thus for example when Mexico rescheduled its ECGD guaranteed private sector Medium Term debts, cover was still maintained for public sector Medium Term and all Short Term transactions). Such cover is only restored after a "convalescent period" when in the view of the Export Guarantees Committee, the debtor country's creditworthiness has been clearly re-established. The current criteria for the resumption of cover (and the arguments for the maintenance of the present strict policy) are detailed in Appendix 1 attached. No exceptions to current rules have been agreed, (despite considerable trade and political pressure for exceptions to be made for some countries, eg Brazil, Peru, Ecuador, Mozambique and Malawi).

Case for some relaxation of current policy

3 The main arguments for some controlled relaxation of existing policy are as follows:-

a The need to find some means of rewarding those developing countries prepared to take tough measures in conjunction with the IMF.

b The growing evidence that for political and economic reasons other governments are offering new credits to favoured debtor countries; thus the UK is in danger of being isolated because ECGD insists on a "convalescent period" of 2 years or more following the debt rescheduling, whereas other agencies resume cover at an earlier stage.

c The fact that many major export markets are now joining the list of countries with debt service problems and default by these could threaten the international monetary system.

d The heavy short term debt burden of some rescheduling countries (which is so severe that they cannot even pay cash for essential imports needed to maintain the basic productive capacity of the economy).

e The need to prevent over-reaction from private lenders anxious to reduce their current exposures.

f The need to assist UK industry to maintain a stake in significant export markets which seem likely to be able to re-establish themselves as reliable trading partners.

g Wider political and strategic considerations.

Recent developments

4 The main developments in the situation are:-

i The list of rescheduling countries continues to grow and now includes many important trading partners (see Appendix 2). HMG has a very considerable financial interest in seeing these countries nursed back to health as ECGD's existing exposure on them amounts to approximately £6,500m and total UK exports to them in the last year prior to the debt restructuring amounted to over £1,900m.

ii Further evidence that other creditor governments are being more flexible in their approach. It would now appear that the UK is alone among all the major creditor governments in consistently refusing to provide further cover for a period after the approach to the Paris Club. The stated policy of other agencies is described in Appendix 3. There is some ambivalence in the position of a number of our competitors and it has to be accepted that many are not following a consistent policy, but are prepared to make exceptions to a generally restrictive policy where a close political or trading partner is involved. The policy of major creditor countries is briefly as follows:-

USA and Canada - normally maintain cover if an IMF adjustment programme is concluded (believing that the debtor country's prospects have been improved and it is essential to maintain flow of credits to assist the economic recovery);

France, Italy & Spain - frequently support further credits for pragmatic reasons;

FRG, Japan and Sweden - are fairly restrictive but have all agreed to cover new credits exceptionally during the past year.

In practice 15 countries have offered to cover new credits to Yugoslavia (whilst under existing rules the resumption of ECGD Medium Term cover cannot be considered).

iii Pressure from the debtor countries and the IMF has also been increasing. Many debtor countries have been seeking assurances of new credits at the same time as they approach the Paris Club for rescheduling (and Latin American countries are seeking this as part of the Cartagena decision). The IMF generally associates itself with the US government view that maintenance of official export credit support is a crucial and legitimate part of the economic recovery plan and seems likely to press that official export credits should be made available in deserving cases where the debtor country is making strenuous efforts to adhere to a stabilisation programme worked out with the Fund.

Possible Basis for Future Policy

5 In order to sharpen the distinction between the responsible and irresponsible debtor countries and to prevent UK from being isolated (which could be to our future trading and political disadvantage), it is recommended that HMG should establish a capacity to provide new credits to a debtor country which is making strenuous efforts to effect an economic recovery. It is proposed that such support

would have to be agreed selectively on a case-by-case basis and would only be considered if all of the following pre-conditions have been met:-

1 the debtor is committed to a strong IMF stabilisation programme which would justify the multilateral rescheduling of official debts;

2 the stabilisation programme offers a reasonable prospect that the new debt service commitments will be honoured and current payments are being made satisfactorily; and

3 other governments are committed to offer similar support on an acceptable burden sharing basis.

It is proposed that - at least until some experience has been acquired - such cover would be subject to specific Ministerial approval. It would be provided by ECGD using its Section 2 (national interest powers).

6 The conditions on which ECGD support would then be made available in appropriate cases would normally be based on the following guidelines:-

A No irrevocable commitment to provide new cover should be given until after the IMF programme has been approved and the multilateral debt rescheduling negotiations have been completed.

B Provision should be made for the suspension of cover in the event that the debtor country is in breach of its obligations under the rescheduling or IMF agreements.

C New cover should normally be pitched so as to sustain trade at a significantly lower level than prior to the debt rescheduling.

D Wherever possible, commercial interest rates should be charged both under the rescheduling agreement and for the new credits, (exceptions may have to be made where this was clearly beyond the debt service capacity of the importing country, but in any event operating administrative costs should be recouped).

E Cover should be tied to imports of UK goods and services contributing to the economic recovery programme or the immediate welfare of the debtor country.

F As far as possible, the credit terms should be tailored so that repayments fall outside the most critical years for debt service payments.

G New cover for project business should be given only exceptionally for key projects vital to economic rehabilitation and given the IMF/IBRD seal of approval, (and preferably where the risks are being shared with other governments or the IBRD, IDB or similar international institutions).

7 It is hoped that as a corollary to the adoption in the future of a more liberal policy towards the resumption of cover on debt rescheduling countries as recommended above, it might be possible to take a harder line on the maintenance of cover on other countries drifting into difficulties. However, it has to be recognised that without any system of co-ordinated action with other major exporting countries, such early avoidance of future debt service problems is difficult to achieve taking into account the highly competitive situation in export markets.

Accounting Responsibility

8 No new legislation would be required as cover would form part of ECGD's Section 2 operation. However, as the provision of new cover, even on the carefully controlled basis set out above, would involve high risks on countries with heavy debt burdens, it is proposed that liabilities for such credits should be shown separately in ECGD's Section 2 accounts until such time as the economic health of the debtor country has been restored to a state which permits ECGD cover to be provided on the basis of normal underwriting criteria. During this convalescent period any losses would be borne by the Exchequer and consequently would not lead to pressure on ECGD to raise its premium charges for exports to other markets. It will be necessary for a Trade Minister to make a statement to the House:-

a to avoid any conflict with previous assurances that the House would be informed of any unusual use of ECGD's Section 2 powers, and

b to make clear that this change of policy does not represent any general lowering of ECGD's standards of country assessment.

ECGD
July 1984

Appendix 1

ECGD POLICY TOWARDS RESCHEDULING COUNTRIES

CURRENT CRITERIA FOR RESUMPTION OF COVER

1 Before restoring cover the EGC would normally expect that most of the following conditions should have been satisfied:-

A The bilateral agreement covering the rescheduling of guaranteed debt should be in force.

B The satisfactory performance of its obligations by the debtor country should have been demonstrated over an adequate period.

C There should be no prospect of a further major rescheduling of debt.

D There should be no delays in payment for current commercial imports.

E Our assessment of balance of payments prospects should provide a reasonable assurance that future debt service obligations will be honoured.

F The debtor country should be complying with the conditions of any stabilisation programme agreed with the IMF.

G The political situation should be stable and the general management of the economy adequate.

CASE AGAINST ANY RELAXATION OF POLICY

2 The main arguments for the maintenance of the current restrictive policy are briefly as follows:-

a the need to maintain international financial discipline;

b the risk of a general degeneration of credit terms;

c the implications for the balance of payments and on ECGD's own finances;

d the reluctance to provide "double relief" (as the deferment of existing debt should enable trade to continue on a cash basis).

Most of these arguments continue to have validity and if a rescheduling becomes too easy an option there is a real risk of proliferation. Moreover it now seems that an impetus towards softer credit terms will arise not only from the extensions involved in the rescheduling operation itself, but also because Medium Term credits will be sought for imports of essential industrial raw materials, food etc. which are normally sold on cash or Short Term credit, thus making it more difficult to hold to traditional terms in more creditworthy markets. It should be noted that in addition to the above policy arguments, there is a legal constraint which would prevent ECGD covering new credits maturing within the consolidation period under the rescheduling agreement. This would be barred by the simple common law principle that insurance cannot be given against a certainty. Thus if debts falling due in 1984 have been rescheduled. ECGD cannot cover new credits maturing in that year if there is a likelihood of the cut-off date for contracts covered by the consolidation being rolled forward. However this legal obstacle could normally be circumvented, as payments maturing in later years could be insured.

ECGD
July 1984

ECGD - LIST OF RESCHEDULING COUNTRIES - SUMMARY

Country	Debt ɸ Consolidated	Cover withdrawn	Cover restored	UK annual exports before rescheduling ≠ (£m)
a Running agreements				
1 Central African Rep	MT 1980/81	7/80	Not yet	7.74
2 Costa Rica	MT 1982/83	8/81	" "	5.45
3 Cuba	MT 1982/83	1/83	" "	64.45
4 Ghana	MT 1972/74	4/71	" "	87.85
5 Guinea Rep	MT 1968/76	9/67	" "	3.64
6 Indonesia	MT 1966/72	5/67	Yes in 8/71 Case-by-case, then 2/72 gen.	5.9 (1965)
7 Liberia*	MT 1980/84	5/80	Not yet	46.35
8 Madagascar*	ST & MT 1980/84	2/81	" "	11.82
9 Malawi*	MT(public)82/84	7/82	" "	20.85
10 Peru (1)	MT 1979	10/78	Yes in 11/79	
(2)	MT 1983/84	7/83	Not yet	39.4
11 Poland	MT 1981	1/82	" "	296.16
12 Romania	MT 1982/83	9/81	" "	150.26
13 Senegal *	MT 1981/83	11/81	" "	26.28
14 Sierra Leone (1)	MT 1975/78	3/76	" "	21.10
(2)*	MT 1979/84	3/79	" "	
15 Sudan*	ST & MT 1979/84	4/80	" "	114.08
16 Togo	MT 1979/83	5/79	" "	18.16
17 Turkey	ST & MT 1979/83	9/77	Yes in 7/83	211.44
18 Uganda	MT 1981/83	7/76	Not yet	27.20
19 Zaire	ST & MT 1975/84	5/75	" "	23.61
20 Zambia	ST & MT 1982/83	4/79	" "	68.22
21 Yugoslavia	MT 1983/84	9/81	" "	158.84
b Awaiting signature				
22 Ecuador	MT 1983/84	7/83	" "	60.78
23 Mexico	ST & MT(Private) 1983	5/83	" "	162.91
24 Morocco	MT 1983/84	9/83	" "	95.46
25 Niger Rep.	MT 1983/84	9/83	" "	17.44
c Under negotiation				
26 Brazil	MT 1983/84	8/83	" "	158.77
27 Ivory Coast	MT 1984	2/84	" "	25.59

NOTES
* Includes further agreement currently in negotiation or awaiting signature;
ɸ Shows years covered by all or part of the consolidation;
≠ Figures given are for last full year prior to the current rescheduling and therefore relate to different years.

ECGD
July 1984

CONFIDENTIAL

Appendix 3

OTHER GOVERNMENTS STATED POLICY TOWARDS RESCHEDULING COUNTRIES

The following table is based on the statements made by OECD representatives at the Export Credit Group Meeting in May 1984 supplemented by further bilateral discussions between ECGD and their counterparts.

I WITHDRAWAL OF COVER

Nearly all official export credit agencies withdraw cover for new credits following an application by the debtor country to the Paris Club (or an equivalent body). The major exceptions here are the USA and Japan. The US Eximbank frequently regards the approach as a welcome sign and offers new credits to offset any curtailment in US bank lending. Normally these are not confirmed until after the IMF programme has been approved by the Board but it is significant that in the case of the Philippines Eximbank/FCIA cover is being maintained even though agreement has not been reached on an IMF programme. Japan is exceptional in that cover is not formally withdrawn until after signature of the Paris Club multilateral agreement(but we understand that in practice very little additional exposure is accepted during the negotiating period.)

II RESUMPTION OF COVER

A Cover resumed prior to signature of Paris Club/bilateral rescheduling Agreements

USA/Eximbank, FCIA	Generally cover is not totally withdrawn but in any event it is resumed on a case-by-case basis provided debtor country is in compliance with the IMF programme.* US Government believes that countries with liquidity problems should not have access to export credit facilities closed.

B Cover resumed once Paris Club/bilateral agreements concluded

AUSTRIA/OKB	Yes, but on a restricted basis*.
CANADA/EDC	Not automatic,* take into consideration immediate and long term creditworthiness of debtor country as well as need to sustain international liquidity and Canadian exports.
GERMANY/HERMES	Consider reinstatement of cover but look at following factors: i economic outlook; ii willingness and ability of country to meet obligations under rescheduling agreement.*
ITALY/SACE	Yes, but on informal basis, ie case-by-case.*
NETHERLANDS/NCM	Similar policy to Germany.*

Appendix 3 (Continued)

SPAIN/CESCE	Normally resume cover subject to some form of ceiling but if country's economic position very poor, will await positive experience under rescheduling agreement. However, if close commercial relations exist, resume cover straight away after Paris Club agreement concluded.

C Cover resumed when clear that IMF programme is being implemented

BELGIUM/OND	Yes.*
FINLAND/VTL	Resumption of medium term cover is generally on a gradual basis.*
FRANCE/COFACE	Resume cover on case-by-case basis, taking into account debtor country's willingness to implement IMF measures.*
JAPAN/MITI	All cover withdrawn (ie both ST and MT) for a period and resumed on cautious basis, ie case-by-case.*

D Cover resumed when clear that both IMF and bilateral agreements are being honoured

DENMARK/EKR	Normally want to see some payments being received under the rescheduling agreement. For countries with more than one rescheduling stay off cover for longer period.* But policy under review.
AUSTRALIA/EFIC	Resume cover on restrictive basis for traditional trade.*
PORTUGAL/COSEC	Generally with reduced commitment limit and for short term business only.
SWITZERLAND/GERG	Normally resume once seen that agreement has been adhered to for some time.*
UK/ECGD	Consider resumption when seen how debtor country is complying with Paris Club and IMF programmes.

*NB There is evidence that in practice a more liberal policy is being applied than the stated policy given here in selective cases where important political/trading relationships are involved, (eg all of these countries agreed to offer export credits to Yugoslavia as part of the IMF package, the USA is maintaining cover with the Philippines where conclusion of the IMF negotiations has still not been reached, and Japan has also recently offered new MT credits to Brazil).

B/F in two weeks
AT 18/7

(4)

PRIME MINISTER

INTERNATIONAL DEBT CRISIS

Sir Walter Salomon put forward a suggestion for dealing with bad and doubtful international debts on the balance sheets of the banks. He has not spelt out his scheme in any detail but it seems to involve dividing a bank's assets into two. The sound assets would be included in a new smaller balance sheet, backed by A shares which would receive dividends based on profits in the normal way. The unsound assets would be held by a realisation account, backed by B shares. These shares would have a low value and would be rewarded by whatever the account managed to realise by selling the assets or by receiving a reduced flow of interest.

Sir Walter's scheme appears to be part of the family of schemes which seek to write down LDC lending to closer to its real value. The attached note by John Redwood distinguishes between various ways in which such a market could be created. As far as one can discern, Sir Walter's scheme appears to belong more to the second group which looks inferior, at least to the third approach.

AT

Has Alan had a talk with Sir W.S.?

9 July 1984

Is there anything we can do with John Redwood's suggestions. If the situation gets worse we may need course 3 - but it's all affects the U.S far more than us. M

2:70

ECPC ②

Prime Minister ②

CDP
2/7.

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

2 ~~June~~ JULY 1984

A Turnbull Esq
10 Downing Street
LONDON
SW1

Dear Andrew,

CARTAGENA CONFERENCE

The Prime Minister may like to have the attached brief appraisal of the outcome of the Latin American Conference on debt held in Cartagena, Colombia on 21 and 22 June prepared by Treasury officials in consultation with the FCO.

As the note makes clear many of the proposals put forward look unacceptable. Officials will however be doing more work on the specific issues and we will take the opportunity of the G5 and G10 Deputies meetings in Paris next month to sound out the views of other creditor countries. The proposals from the Conference have not been put to us formally and there is time therefore for more considered analysis before we need to respond in detail.

In the meantime the Chancellor suggests that our public response should be low profile, but that we should as necessary refer to the Conference's positive aspects (no collective repudiation or default) as a means of encouraging the more moderate Latin American countries.

I am copying this letter to Len Appleyard and to John Bartlett.

Yours ever,

Judith

MISS J C SIMPSON
Private Secretary

CARTAGENA CONFERENCE

1. The Latin American conference on debt financing and trade was held in Cartagena, Colombia on 21 and 22 June. Foreign and Finance Ministers from 11 countries participated (Argentina, Brazil, Bolivia, Colombia, Chile, Ecuador, Mexico, Peru, Dominican Republic, Uruguay and Venezuela). It was a continuation of the process which began at Quito in January and encompassed the 19 May statement by 4 Latin American Heads of State and the pre-Summit message to the Prime Minister from 7 Latin American Presidents. Its purpose was to draw the attention of the industrialised countries to Latin American concern about the debt problem.

2. The conference directed a largely moderate message to world opinion, outlined in a 'consensus' parameters for debt negotiations and agreed to meet again under Argentine Chairmanship in three months time.

3. The "consensus" called for practical measures to ease the burden on debtor countries. The 17 proposals are intended to provide a consistent framework for bilateral negotiations with Banks and Governments. A number of the proposals such as the need for a reduction in interest rates and the lowering of barriers to trade are consistent with the London Economic Declaration. But the majority of the proposals would shift the burden from debtors to creditors. They would require additional financial contributions from the banks in the form of lending at cost, minimisation of all fees and charges, interest deferral without penalty and debt servicing limits proportional to export earnings. From Governments they would require more generous terms and preferential interest rates in debt negotiation and export credits. Governments would be called upon to make further contributions to the international financial institutions and to relax conditionality.

4. None of the proposals in the consensus is new. In particular cases it may be possible for creditors to meet some of these demands, but most are clearly unacceptable. It remains to be seen how far individual debtor countries will press these in bilateral negotiations. The current Argentine negotiations will be important as will the Brazilian negotiations later in the year.

<u>Comment</u>

5. There was division at Cartagena between "hardline" countries (eg. Argentina, Bolivia and the Dominican Republic) and "moderates" like Brazil and Mexico.

MHAAFA

There was however no general support for the idea of a collective repudiation or default. Many of the countries have undertaken major adjustment efforts in response to their debt difficulties. But there was a growing feeling that they had done as much as they could and that the debt problem would only be solved by recognising the "co-responsibility" of both debtors and creditors. The cost of meeting the debt burden in terms of damage to the long term economic development of the area was re-emphasised. The calls for action on the part of developed countries referred particularly to high interest rates.

6. In general, Latin American countries appear to have been reasonably satisfied with the response to their concerns in the Summit Economic Declaration, so far as it went. To some extent this is reflected in the (narrow) victory of the moderates in Cartagena. But the increase in the US prime rate which followed hard on the conference will provide further ammunition for the hard liners. We shall need to continue to monitor developments closely and to encourage moderate countries like Brazil and Mexico to pursue their present policies and use their influence to persuade others to do likewise.

7. While there has been some suggestion of a meeting between debtors and creditors collectively, no official invitation has emerged from the Cartagena meeting, nor indeed have we received any other official communication from it. Formally there is no call for us to respond in terms to the positions taken at the meeting but we should take opportunities to refer publicly and in our private contacts to its positive aspects.

MHAAFA

Economic Progress Report

Published by the Treasury

No. 169 July 1984

International debt

International debt has been much in the news and was one of the subjects discussed at the recent London Economic Summit (see pages 2-3). This article sets out the historical background.

During the 1960s, the economies of many developing countries grew relatively rapidly. Export markets in the industrialised countries expanded, and developing countries' productive capacity grew quickly. Direct investment by foreign companies (for example to finance purchases of factories and equipment) and official funds (such as government aid) accounted for most external development finance. Commercial bank lending was not very important. Official finance is generally on relatively easy terms, while returns on direct investment to the parent company are related to the investment's performance, and indeed are often reinvested. This meant that over this period debts owed abroad did not generally cause problems. Interest rates, too, tended to be low in both nominal and real terms.

Changes were, however, already occurring in the late 1960s and early 1970s. International banks were finding developing countries to be increasingly attractive customers. For their part, developing countries were attracted by the greater opportunity to decide how bank borrowing should be used than, for example, was available with direct investment. Long-term borrowing from financial institutions by the 25 major borrowers grew annually at an average rate of over 30 per cent between 1967 and 1973.

The first oil shock

The 1973 oil price rise greatly increased the import bills of those developing countries which did not produce oil themselves. This was followed by slower growth in their export markets, and a worsening in their terms of trade (the prices received for their exports compared with the prices paid for their imports). So their current account deficits widened, doubling as a percentage of exports.

Many developing countries attempted to maintain their growth rates by stepping up substantially their borrowing from commercial banks. They met with ready lenders, for several reasons. Banks were flush with funds because many oil producers put their export earnings into bank deposits. Many developing countries still appeared to have large potential for growth, while the recession in the industrialised countries limited the scope for profitable lending there.

Although nominal interest rates rose, real interest rates generally stayed low or even negative as world inflation continued high. Non-oil developing countries' debt service* payments as a percentage of exports rose only moderately, from about 15½ per cent in 1973 to about 18 per cent in 1979. But the pattern of financing had changed. In the years immediately after 1973 the share of bank finance doubled to around 60 per cent, while the shares of private direct investment and official finance declined.

The second oil shock

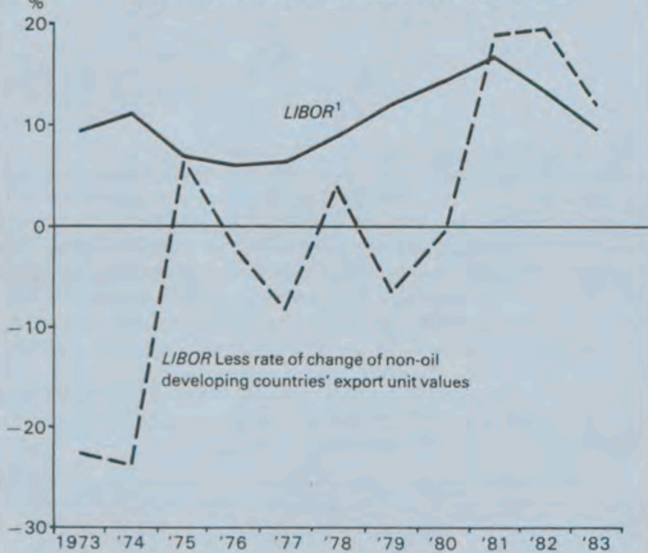
Most developing countries failed to adjust their policies to the changed economic climate following the 1973 oil price rise. Their increased reliance on bank lending left them in difficulties, which were intensified by the second oil price rise in 1979-80 and its aftermath. Again oil import bills rose (although at first oil exporters like Mexico, Venezuela and Nigeria benefited from this). Again export markets contracted, and terms of trade deteriorated.

Much as after the first oil shock, developing countries stepped up their bank borrowing to finance their wider current account deficits, rather than adjusting economic policies to keep them to what could be prudently financed. The share of bank borrowing in total finance rose to over 70 per cent, and became increasingly short-term as banks became less willing to lend for long periods. This time, however, industrialised countries, in contrast to their reaction to the first oil shock, tightened economic policies in order not to accommodate the inflationary impact of higher oil prices. Real interest rates rose substantially (see chart 1). The exchange rate of the dollar, in which some four fifths of the debt of developing countries is denominated, rose sharply, increasing the share of export revenues needed to service their debts.

*Interest payments and repayments of principal.

Chart 1

Nominal and real interest rates 1973-83



[1]London interbank offered rate on three-month U.S. dollar deposits

Source: IMF

The result was that the total external debt of non-oil developing countries from all sources, which had risen from below $200 billion in 1973 to $330 billion in 1978, rose sharply to $670 billion in 1983. Over $600 billion was concentrated in the 25 major debtors, of which the most important are listed in the table below. The five largest (Mexico, Brazil, Argentina, South Korea and Venezuela) account for almost half of the total. The increase in debt between 1973 and 1980 had been matched by generally buoyant export growth. But after 1980 the ratio of debt service payments to export earnings rose steeply, particularly because of general failure to predict the effect of the world recession on exports (see chart 2). For the major 25 borrowers, the peak in 1982 was over 32 per cent.

External debt

(Estimated totals outstanding end-1983, £ billion)

Mexico	95	Indonesia	25-30*
Brazil	90	Poland	28
Argentina	44	Philippines	25
South Korea	40	Yugoslavia	19
Venezuela	34	Chile	18
		Nigeria	15

*Precise figure uncertain — Source: Bank of England

External debt and debt servicing, 1973-83

Chart 2a Non-oil developing countries*

Chart 2b

*Excluding China — † % of exports — Source: IMF

The 1980s

Difficulties had already started to appear in some Eastern bloc countries. But by 1982 it became clear that the process of continual increases in borrowing, to finance current account deficits perpetuated by overambitious aims for economic expansion, was leading to more general problems, particularly in Latin America. With over a third of total non-oil developing country debt now subject to variable interest rates, compared with less than one tenth in 1972, debtors were much more exposed to the effects of higher rates. As the share of short-term debt* in their total debt rose from one tenth in 1974 to one fifth in 1982, they were increasingly vulnerable to severe shortages of liquidity when creditors were reluctant to roll over their short-term commitments. And since 1982 new lending generally has slowed down markedly.

Many developing countries therefore took steps to adjust economic policies to improve their balance of payments and capacity to service their debt. Current account deficits fell on average by about a fifth in 1982 from their peak in 1981.

A growing number of debtors have sought longer periods to pay back their loans (rescheduling agreements). The average number of countries making such arrangements rose from less than four a year during 1974-78 to around nine a year during 1978-82. In 1983 alone some 30 countries, including almost half of the major 25 debtors made, or were engaged in making, rescheduling agreements.

A key role in such agreements has been played by the International Monetary Fund (IMF). Creditors have generally looked for an adjustment programme agreed with the IMF before debt renegotiations are completed.

As commercial lending to developing countries fell from two thirds of their external borrowing requirement in the late 1970s to two fifths by 1983, the IMF's lending rose, reaching a record $10 billion by 1983. The IMF has been making loans, to which it attaches conditions relating to economic policy, to about 40 countries for the last year or so.

Despite the efforts made by debtor countries and banks to deal with the problems, many remain. International debt is likely to stay in the news for some time to come.

*Debt with an original maturity of less than one year.

The London Summit

The heads of government of the seven major industrialised countries and the president of the Commission of the European Communities met in London from 7-9 June 1984 for the tenth annual Economic Summit. The primary purpose of these summit meetings is to bring these people together to discuss economic problems, prospects and opportunities. The agreements reached on this occasion, in particular on the conduct of macro-economic policy, international debt and trade issues, were set out in an economic declaration, issued at the end of the meeting. This contained a ten-point action programme for the next twelve months.

The strategic thinking behind the action programme was contained in the opening section of the declaration, which traced global economic development since the 1983 Summit:

'At our last meeting, in Williamsburg in 1983, we were already able to detect clear signs of recovery from world recession. That recovery can now be seen to be established in our countries. It is more soundly based than previous recoveries in that it results from the firm efforts made in the Summit countries and elsewhere over recent years to reduce inflation.

'But its continuation requires unremitting efforts. We have to make the most of the opportunities with which we are now presented to reinforce the basis for enduring growth and the creation of new jobs. We need to spread the benefits of recovery widely, both within the industrialised countries and also to the developing countries, especially the poorer countries who stand to gain more than any from a sustainable growth of the world economy. High interest rates, and failure to reduce inflation further and damp down inflationary expectations, could put recovery at risk. Prudent monetary and budgetary policies of the kind that have brought us so far will have to be sustained and where necessary strengthened. We affirm the commitment of our Governments to those objectives and policies.'

The action programme

The leaders set out the following heads of agreement:

(1) to continue with and where necessary strengthen policies to reduce inflation and interest rates, to control monetary growth and where necessary reduce budgetary deficits;

(2) to seek to reduce obstacles to the creation of new jobs:

— by encouraging the development of industries and services in response to demand and technological change, including in innovative small and medium-sized businesses;

— by encouraging the efficient working of the labour market;

— by encouraging the improvement and extension of job training;

— by encouraging flexibility in the patterns of working time;

— and by discouraging measures to preserve obsolescent production and technology;

(3) to support and strengthen work in the appropriate international organisations, notably the OECD, on increasing understanding of the sources and patterns of economic change, and on improving economic efficiency and promoting growth, in particular by encouraging innovation and working for a more widespread acceptance of technological change, harmonising standards and facilitating the mobility of labour and capital;

(4) to maintain and wherever possible increase flows of resources, including official development assistance and assistance through the international financial and development institutions, to the developing countries and particularly to the poorest countries; to work with the developing countries to encourage more openness towards private investment flows; and to encourage practical measures in those countries to conserve resources and enhance indigenous food and energy production. Some of us also wish to activate the Common Fund for Commodities;

(5) in a spirit of cooperation with the countries concerned, to confirm the strategy on debt and continue to implement and develop it flexibly case by case; we have reviewed progress and attach particular importance to:

— helping debtor countries to make necessary economic and financial policy changes, taking due account of political and social difficulties;

— encouraging the IMF in its central role in this process, which it has been carrying out skilfully;

— encouraging closer cooperation between the IMF and the International Bank for Reconstruction and Development (IBRD), and strengthening the role of the IBRD in fostering development over the medium- and long-term;

— in cases where debtor countries are themselves making successful efforts to improve their position, encouraging more extended multi-year rescheduling of commercial debts and standing ready where appropriate to negotiate similarly in respect of debts to governments and government agencies;

— encouraging the flow of long-term direct investment; just as there is need for industrial countries to make their markets more open for the exports of developing countries, so these countries can help themselves by encouraging investment from the industrial countries;

— encouraging the substitution of more stable long-term finance, both direct and portfolio, for short-term banking.

(6) to invite finance ministers to carry forward, in an urgent and thorough manner, their current work on ways to improve the operation of the international monetary system, including exchange rates, surveillance, the creation, control and distribution of international liquidity and the role of the IMF; and to complete the present phase of their work in the first half of 1985 with a view to discussion at an early meeting of the IMF Interim Committee. The question of a further allocation of Special Drawing Rights is to be reconsidered by the IMF Interim Committee in September 1984;

(7) to carry forward the procedures agreed at Versailles and at Williamsburg for multilateral monitoring and surveillance of convergence of economic performance toward lower inflation and higher growth;

(8) to seek to improve the operation and stability of the international financial system, by means of prudent policies among the major countries, by providing an adequate flow of funding to the international financial institutions, and by improving international access to capital markets in industrialised countries;

(9) to urge all trading countries, industrialised and developing alike, to resist continuing protectionist pressures, to reduce barriers to trade and to make renewed efforts to liberalise and expand international trade in manufactures, commodities and services;

(10) to accelerate the completion of current trade liberalisation programmes, particularly the 1982 GATT work programme, in cooperation with other trading partners; to press forward with the work on trade in services in the international organisations; to reaffirm the agreement reached at the OECD ministerial meeting in May 1984 on the important contribution which a new round of multilateral trade negotiations would make to strengthening the open multilateral trading system for the mutual benefit of all economies, industrial and developing; and, building on the 1982 GATT work programme, to consult partners in the GATT with a view to decisions at an early date on the possible objectives, arrangements and timing for a new negotiating round.

Economic indicators[1] (seasonally adjusted)

PUBLISHED MONTHLY	Unit	1981	1982	1983	1983 Q4	1984 Q1	1984 Mar	1984 Apr	1984 May	
1 Output of production industries	1980=100	96.3	98.0	100.9	103.0	103.1	101.9	101.7	—	1
2 Unemployment (excl. school-leavers)[2]	000s	2,413.1	2,793.2	2,970.2	2,946.1	3,011.6	3,011.6	3,010.9	3,028.6	2
3 " " " "	% of all employees	10.0	11.7	12.4	12.2	12.5	12.6	12.6	12.7	3
4 Retail sales (volume)	1980=100	100.4	102.5	107.8	110.3	108.5	108.3	112.2	110.3	4
5 Exports f.o.b.[4]	£m	50,977	55,565	60,658	16,225	16,853	5,691	5,370	5,635	5
6 Imports f.o.b.[4]	£m	47,969	53,181	61,158	16,220	16,912	5,918	6,207	5,953	6
7 Balance of payments current balance	£m	+6,574	+5,774	+2,924	+596	+838	+72	−588	−69	7
8 £'s effective exchange rate (average for month)	1975=100	95.0	90.5	83.2	—	—	81.0	79.9	80.0	8
9 Official reserves[5] (end of period)	$m	23,347	16,997	17,817	17,817	17,728	17,728	15,941	15,835	9
10 Retail prices[5]	Jan 1974=100	295.0	320.4	335.1	342.8	345.1	345.8	350.1	351.3	10
11 Tax and price index[5]	Jan 1978=100	152.5	167.4	178.0	178.0	179.4	179.4	178.8	179.6	11
12 Average earnings (whole economy)[3]	Jan 1980=100	125.8	137.6	149.2	152.5	154.9	154.4	155.5	—	12
13 Monetary growth to mid-May (per cent changes)			May banking month	3-month annual rate		6-month annual rate		last 12 months		13
M0			+0.5	+ 4.2		+3.9		+5.1		
£M3			+0.9	+10.5		+9.2		+8.6		

PUBLISHED QUARTERLY		1982	1982	1982 Q4	1983 Q1	1983 Q2	1983 Q3	1983 Q4	1984 Q1	
1 Output (gdp) at constant factor cost	1980=100	99.4	101.0	101.4	103.4	103.7	103.5	105.8	103.5	1
2 Manufacturing industry's fixed capital expenditure	£m 1980 prices	4,457	4,373	1,115	1,042	1,083	1,077	1,171	1,236	2
3 Consumers' expenditure	£m 1980 prices	139,390	144,812	35,573	35,505	36,095	36,527	36,685	—	3
4 Balance of payments, current balance	£m	+5,551	+2,924	+2,180	+1,589	−89	+828	+596	+838	4
5 Balance of payments on invisible account	£m	+3,167	+2,549	+1,066	+891	+423	+901	+334	+750	5

1. Many of the most recent figures are provisional and may be subject to revision. 2. Figures on the new claimant basis (see *Economic Progress Report*, December 1982). 3. Excluding Northern Ireland. 4. Visible trade (balance of payments basis). 5. Not seasonally adjusted.

Company sector finances in the recovery

Company profits and the overall financial position of the company sector have improved strongly over the last two years against a background of steady growth in the domestic economy, a recovery in overseas markets, and some easing of cost pressures. This article describes how industrial companies have rebuilt their profits and improved their financial situation since 1981 and how this improvement in liquidity is now being reflected in increased business investment. The box describes the main terms used in the article.

Profits and profitability

In manufacturing industry strong growth in productivity (around 6 per cent a year in both 1982 and 1983), a slowdown in wage inflation, and cuts in the national insurance surcharge have contributed to much slower growth in unit labour costs. With imported materials prices also rising much less rapidly, manufacturers have been able to rebuild profit margins (roughly speaking profit as a proportion of sales). Table 1 and chart 1 show that, although margins on export sales were squeezed more sharply than those on domestic sales, their recovery has recently been stronger, helped by the depreciation of sterling around the start of 1983.

Chart 1

Indicators of Manufacturers' Profit Margins

(1978 = 100, See table 1)

Company sector finances — main terms

Industrial and commercial companies (ICCs)	Broadly, all UK corporate bodies other than public corporations, banks and other financial institutions.
Gross profits (net of stock appreciation)	Trading profits arising in the UK from UK companies, and UK branches and subsidiaries of overseas parent companies net of stock appreciation and gross of depreciation.
Saving (undistributed income)	Difference between ICCs' income (profits, rental and interest income) and allocations of income (tax, dividend, interest payments).
Financial surplus/deficit	In broad terms, measures the extent to which ICCs' savings exceed or fall short of their domestic investment on fixed assets and stock.
Net borrowing requirement (NBR)	The financial surplus/deficit does not show the full picture of ICCs' actual cash position. NBR represents net cash borrowing and is analogous to the public sector borrowing requirement.
Net pre-tax real rate of return	Trading profits and rental income (net of stock appreciation and depreciation) as a ratio of net stock of fixed capital assets plus book value of UK stocks.

Table 1

Indicators of profit margins in manufacturing

(% changes)

	Costs			Prices		Ratio of selling prices to main unit costs *(1978 = 100)*	
	Unit labour costs	Imported input costs	Main unit costs[1]	Exports[2]	Sales[3]	Exports	Domestic sales
1978	15.0	0.9	10.3	10.5	9.9	100	100
1979	16.7	7.9	13.7	8.3	10.9	95.2	97.5
1980	21.2	10.8	17.7	14.3	14.0	92.5	94.5
1981	7.4	7.2	7.3	7.0	9.5	92.2	96.4
1982	4.1	8.4	5.5	7.5	7.8	94.0	98.4
1983	2.3[4]	7.2	3.9	7.8	5.4	97.5	99.9

1. Main unit costs defined here as weighted sum of unit labour costs (2/3) and imported input costs (1/3); taxes and administered prices are excluded.
2. Manufactures export unit value index. (Standard international trade categories 5 to 8, less erratic items.)
3. Producer output prices.
4. Unit wage and salary costs. 1983 figures for unit **labour** costs are not available until September 1984.

Table 2

ICCs' financial accounts

(£ billion, figures rounded to nearest £½ billion)

	Income[1]	− Allocation of income	= Saving[2]	− Expenditure	= Financial surplus	+ Other financial transactions	+ Balancing item	= Net borrowing requirement (borrowing positive)
1979	32	18	14	15½	−1½	−2½	−1½	5
1980	35	23	12½	12	½	−4½	−2	5½
1981	39½	25	15½	12	3½	−4½	−1½	3[3]
1982	44½	27½	18	13	4½	−5½	−4½	5½[3]
1983	53½	31	23½	15½	8	−4½	−2½	−1½

[1] Net of stock appreciation.
[2] Including capital transfers.
[3] The net borrowing requirement was distorted in these years by the civil service strike which, by delaying tax payments, reduced the NBR in 1981 and increased it in 1982.

However, as shown in chart 2, profitability has declined for much of the last twenty years. Even with recent improvements, rates of return - especially for non-North Sea companies - remain well below levels of the 1960s. Although it is difficult to make more than a rough allowance for the change in tax payments made by companies, a general easing in the burden of company taxation probably means that post-tax rates of return showed a less marked decline over the period as a whole.

Improved profit margins, and a recovery in sales volume have led to substantial growth in company profits since 1981. Gross trading profits of ICCs (net of stock appreciation) are estimated to have risen by a sixth in 1982 and by a quarter in 1983. Increases in non-North Sea and North Sea companies' profits were much the same in this period. Profits continued to improve strongly into the first quarter of 1984.

Company saving

Trading profits account, on, average for around three quarters of company income. Income from overseas activities (which rose only 7 per cent between 1981 and 1983, reflecting the weakness in overseas economies) and rental and interest income (which rose only 10 per cent over this period) account for the rest. Out of their income, UK companies pay tax, interest and dividends and allocate any profits due overseas to parent companies. Some of these payments are to a greater or lesser extent at companies' discretion. For example, dividend payments did not fall as sharply as company income in 1979 and 1980, and have not risen as quickly between 1981 and 1983. Lower levels of interest rates have helped keep interest payments down. In addition, tax payments are made in the year after profits are earned, so, for example, the tax liability incurred on the substantially higher profits in 1983-84 will not in general be paid until 1984-85. Also, for manufacturing companies at least, the increase in tax payments has been modest because losses incurred in earlier years have meant that offsets can be made against tax payments on profits.

The recovery in profits and other items of income, together with the more restrained increase in allocations out of income, have meant strong growth in company saving (see table 2).

Financial surplus

Increases in profits and incomes encourage higher company expenditure on fixed investment and stocks. There has been some tendency in the past for turning points in company spending to lag behind those in company incomes (see chart 3). This has also been the pattern of the current cycle; for example, manufacturing investment fell by around one third between 1979 and 1982 before picking up during 1983, and companies have been hesitant in rebuilding stock levels. Given this lag, companies have been running a large financial surplus, that is to say their saving has exceeded their expenditure on capital and stocks through the recovery.

More recently, business investment has begun to grow quite strongly, with an increase of 8 per cent in the six months to March 1984 compared with the preceding six months. The May Department of Trade and Industry intentions survey pointed to increases of 12 per cent in manufacturing investment between 1983 and 1984 as a whole, with an 8 per cent rise in services investment. It is the normal cyclical pattern for spending to increase faster than income at this stage and for the financial surplus to tend to diminish.

Company borrowing

Information on the financial surplus is built up from identified company income and expenditure (using national accounts data). It does not measure what companies actually raise in cash to meet their overall borrowing needs. The 'net borrowing requirement' provides such a measure of companies' net cash borrowing. It comprises borrowing from banks, borrowing from other sources (for instance from overseas and by issuing shares) and possibly from running down financial assets (a build-up being counted as negative borrowing). In theory, the net bor-

Chart 2

ICCs' Net Real Rate of Return

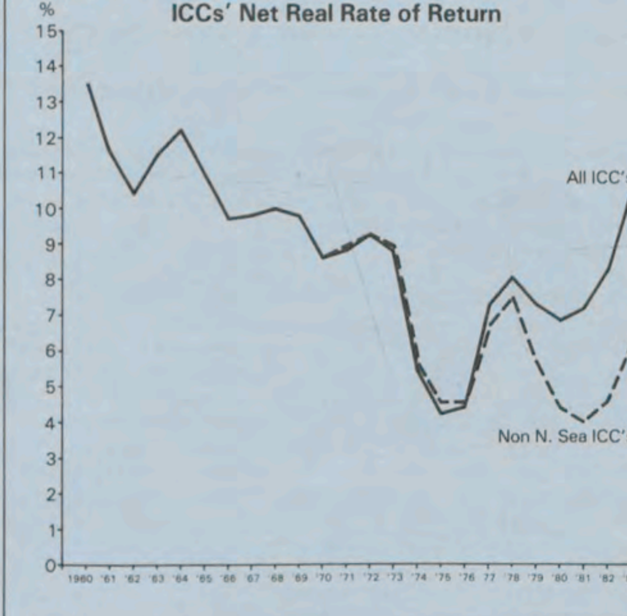
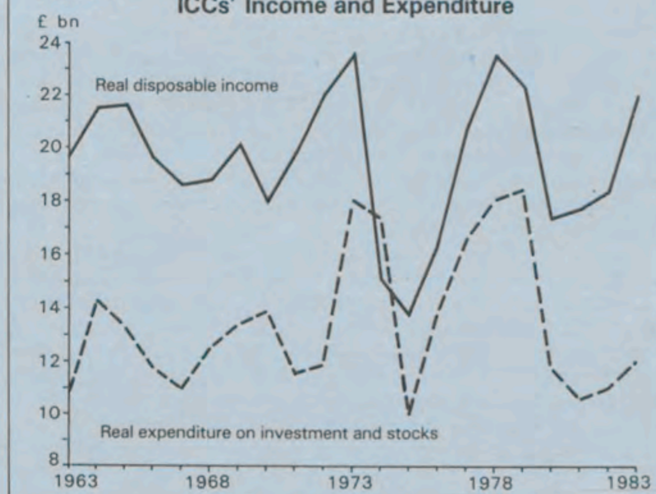


Chart 3

ICCs' Income and Expenditure



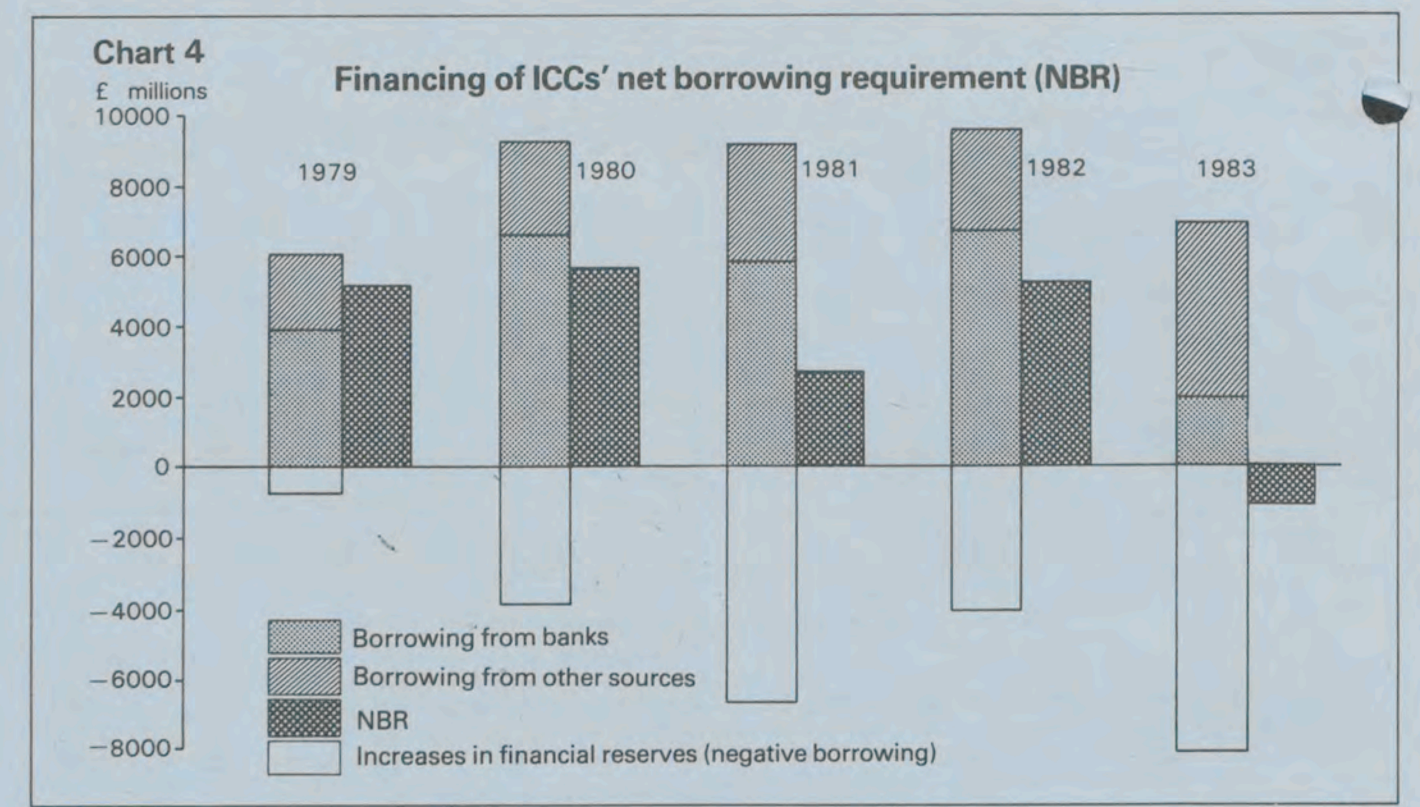


Chart 4
Financing of ICCs' net borrowing requirement (NBR)

rowing requirement should also be equal to the financial surplus adjusted for companies investment overseas and other miscellaneous financial transactions. In practice, these estimates differ. The discrepancy is the 'balancing item' shown in table 2. This represents either overrecording of receipts, or an underrecording of payments made, or errors in the measurement of financial transactions. The balancing item is volatile and can be substantial. This sometimes makes it difficult to interpret movements in companies financial surplus and borrowing.

Financing company borrowing

Chart 4 shows how companies have financed their borrowing requirement since 1979. There was a sharp build-up in bank borrowing between 1979 and 1980, which remained high through to 1982 as companies attempted to restore depleted reserves. Within an overall fall in borrowing in 1983, companies restructured the pattern of their financing away from bank borrowing and towards other sources of borrowing; in particular, companies were able to increase their share issues substantially as trading prospects improved and inflation and interest rates fell. There was also a sharp build-up of liquid assets by companies 1983.

Monthly economic assessment

Based on information† available up to 5 July.

- **Retail price inflation remains steady; survey evidence shows fewer manufacturers expect to increase selling prices.**
- **GDP growth is continuing at an underlying rate of around 3 per cent a year.**
- **Company profits continue to grow strongly and this is now being reflected in sizeable increases in business investment.**
- **There has been continued nervousness in financial markets particularly concerning the course of US interest rates.**

Financial developments

The **public sector borrowing requirement** was estimated at around £3½ billion in the first two months of the 1984-85 financial year, including borrowing of around £1¼ billion in May. Almost all of the PSBR for 1984-85, forecast at £7¼ billion at Budget time, is expected to occur in the first half of the financial year (April to September). This is partly because some of the Budget measures, in particular changed arrangements for payment of VAT on imports, will boost tax receipts considerably in the second half-year.

Monetary growth and public borrowing were lower in May than markets expected, allaying some fears about the domestic situation and helping to take some of the upward pressure from interest rates. However, markets became more nervous late in June with the release of second quarter US gross national product figures, which showed continued rapid growth. This raised fears of further increases in US interest rates. Lloyds and the National Westminster raised their base rates by ¼ per cent to 9¼ per cent at the end of June, bringing them into line with the rate charged by the other major clearing banks since early May.

†Figures seasonally adjusted unless marked *.

US interest rates have been a major factor in the strength of the **dollar** against most other currencies, including sterling, in recent weeks. **Sterling** has been very steady against European currencies, however, and in effective terms has remained within a band 1 per cent either side of 79½ in the last three months.

Costs and prices

The year-on-year rate of **retail price*** inflation has been little changed over the last six months, at around 5 per cent. The rate in May stood at 5.1 per cent. Year-on-year increases in **producer output prices*** have also been fairly stable. Increases of about 6½ per cent over the year to April and May were slightly above the twelve-monthly increases recorded in the first quarter of 1984, but this was partly attributable to excise duty increases in the Budget. Both the May and June CBI industrial trends enquiries showed reductions in the number of firms expecting to raise selling prices in the next few months. **Import prices** are rising somewhat faster than domestic costs. In the three months to May finished manufactures import prices were around 5 per cent above their level a year earlier, with increases of 7 and 13 per cent in semi-manufactures and basic materials prices over the same period.

Table 1

GDP and expenditure components

% change in half-year to March compared with a year earlier to nearest ½ %

	Consumers' expenditure	General govt. expenditure	Total fixed investment	Stock building	Exports of goods & services	Imports of goods & services	GDP (expenditure measure at market prices)	GDP (average measure factor cost)
(1983 level £ billion, 1980 prices)	145	50	40	½	63	60½	238	—
% change over year to six months ending:								
1982 Q1	0	−½	½	2*	3	10½	½	2
1983Q1	3½	4	6½	0*	0	1½	4	2½
1984Q1	2½	½	8½	0*	4½	9½	2	3

*contribution to growth

Year-on-year increases in **underlying whole economy** and **manufacturing earnings** were 7¾ and 9½ per cent respectively in April, little different from twelve-monthly increases recorded during the last eighteen months or so. **Wage settlements** in manufacturing are running at around 6 per cent according to the CBI pay databank, probably somewhat higher than in the economy as a whole. Perhaps 1 per cent of the difference between settlements and earnings in manufacturing is attributable to payments for increased hours worked — continued growth in economic activity increasing overtime and reducing short-time working. Increased productivity and bonus payments contribute to the remaining gap between settlements and earnings.

A gradual deceleration in the growth of average earnings, coupled with significant improvements in **productivity**, have helped reduce the year-on-year increase in **manufacturers' unit wage and salary costs** from a peak of over 25 per cent in 1980 to around 2½-3 per cent during the last year (see chart 1).

Chart 1
Earnings, productivity and unit wage costs; manufacturing (year-on-year % changes)

Gross domestic product

Provisional estimates for **gross domestic product** (GDP) in the first quarter of 1984 confirm that activity continued to grow at an underlying annual rate of about 3 per cent. Movements in the output, expenditure and income measures of GDP continue to diverge somewhat, though their broad trends are similar (see chart 2). All three measures of GDP in the first quarter were depressed somewhat by reduced coal output resulting from the miners' dispute.

The **expenditure measure** of GDP has moved unevenly in recent quarters. It is clear, however, that **investment** and **exports** are playing a more important role, and consumer spending a less important role than hitherto in overall expenditure growth.

Within total fixed investment, capital spending by **manufacturing industry** — which fell by around a third between 1979 and 1982 — picked up particularly strongly in the course of 1983 and into 1984 with an 11 per cent increase now estimated in the six months to the first quarter of 1984 compared with the previous six months.

The **income measure** of GDP has also moved unevenly recently though strong growth in company profits, up by almost a quarter betweeen he first quarter of 1983 and the first quarter of 1984, has been a consistent feature for the last two years.

The **output measure** of GDP, usually considered the best indicator of

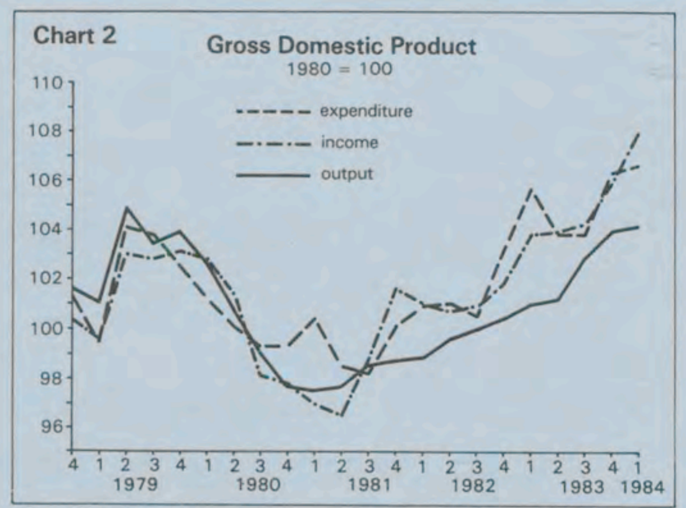


Chart 2
Gross Domestic Product

quarter-to-quarter movements, was little changed between the fourth quarter of 1983 and the first quarter of 1984, but was 3 per cent above its level a year earlier. The level of total output in the first quarter was affected by the reduction in coal output resulting from the miners' dispute. **Output of production industries** (energy and manufacturing industries, together accounting for around a third of total output) was little different in the first quarter of 1984 from its level in the fourth quarter of 1983; reduced coal output offset increases elsewhere. There were small falls in distribution activity, partly because consumer spending eased, but output of other services continued to grow. In the three months to April the output of production industries other than coal and coke industries was about 5 per cent up on the same period in 1983.

Current account

The **current account** moved into a small deficit over the three months to May reflecting some deterioration in both oil and non-oil visible balances.

Total export volumes (excluding erratic items — ships, North Sea installations, aircraft, precious stones and silver) fell 2 per cent in the latest three months compared with the previous three months, but were 9 per cent up on the same period last year. The underlying trend of non-oil exports has levelled out in recent months after rising rapidly in the second half of 1983.

Total import volumes (excluding erratic items) rose 4½ per cent in the latest three months, mainly due to an increase of around two fifths in fuel imports (reflecting a rebuilding of oil stocks by oil companies and also higher oil imports resulting from the miners' dispute). Growth in non-oil imports has eased recently.

A deterioration in the **terms of trade*** also contributed to the deficit on the visibles balance. Import prices rose 1 per cent faster than export prices in the three months to May compared with the previous three months.

Table 2

Current account

£ billion, rounded

	Visible trade non-oil balance	Oil balance	Invisible trade balance	Current account
3 months to Feb	−2	2½	1	1½
3 months to May	−3	1½	¾*	−½

*Invisible balance is a projection, subject to substantial revision.

READERS' ENQUIRIES

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Editorial enquiries

Communications about the contents should be addressed to the Editor, *Economic Progress Report,* Information Division, HM Treasury, Parliament Street, London SW1P 3AG.

Labour market

Adult unemployment (seasonally adjusted, excluding school-leavers) rose by 8,000 in June to 3,036,000 (12.6 per cent of all employees). The rise in the second quarter of 1984 averaged 8,000 a month. This compared with a rise averaging 22,000 a month in the first quarter, which included erratically large increases (of about 30,000) in January and February. The stock of **unfilled vacancies** rose by 3,000 to 159,000 in June. Vacancies have recovered since falling back somewhat at the turn of the year, but remain below the average levels for the second half of last year.

Forward indicators

The **June CBI industrial trends enquiry** points to further increases in manufacturing output with, if anything, an easing of pressure for increases in selling prices. Chart 3 shows output expectations of manufacturing industry in the UK and in the EC as a whole. UK output expectations weakened in mid-1979, somewhat ahead of the EC average, but picked up in late 1980, before the rest of the Community. Both UK and EC expectations weakened again during 1982 before making a firmer recovery through last year and into 1984.

There have been falls recently in the CSO's **shorter and longer leading indicators** of activity, but more complete data are required to determine whether these are more than temporary effects. The overall assessment of movements in the indicators is that recovery will continue into 1985.

Future financing of the European Community

The Stuttgart European Council in June 1983 agreed that action should be taken to relaunch the European Community and that major negotiations should tackle the most pressing problems. These included additional finance or 'own resources',† the need for a fairer sharing of financing of the Community Budget, Budget discipline, the accession of Spain and Portugal, and the development of new Community policies.

The Fontainebleau agreement

The negotiations were successfully concluded at the Fontainebleau European Council on 26-27 June 1984. The main elements of the agreement are:

- The UK will get a final *ad hoc* refund of £590 million for 1984, to be paid in 1985. With effect from 1986 the UK will get a refund each year of 66 per cent of the difference in the previous year between its share in the Community's VAT own resources and its share in expenditures from the 'allocated'* Community Budget. The system of budgetary refunds will be legally binding and incorporated in the new decision on own resources (see below) which cannot be changed without the UK's agreement. This ensures that the refunds will continue as long as the 1.4 per cent VAT ceiling lasts.
- These refunds will be effected by an abatement of UK VAT payments to the Budget. They will be paid automatically. This will avoid the annual haggle with other member states and the European Parliament which has occurred in the past.
- Measures to guarantee effective budgetary discipline will be introduced. The aim will be to reduce the share of agricultural expenditure in the budget and to set strict limits on the growth of both agricultural and other expenditure.
- Subject to the agreement of Parliament and the legislatures of the other member states the ceiling on the Community's VAT revenues will be increased from 1 per cent to 1.4 per cent.
- The agreement refers to a possible further increase in the VAT ceiling to 1.6 per cent. This could only take place with the agreement of the UK Government and the approval of the House of Commons.
- France and Italy have withdrawn their objections to payment of the UK's outstanding rebate of £440 million in respect of 1983.

Financially this agreement is better than the arrangement on offer at the March European Council and far better than the alternative of having no agreement at all. Failing an agreement the refunds due to the UK this year would have been lost. Moreover there would have been no agreement on refunds for any future years.

Without any increase in the 1 per cent VAT ceiling, the UK's net contribution would have been around twice as much as under the new system now negotiated.

The agreement has the following further important features:—

- The UK's effective VAT rate under the system now agreed upon will remain less than 1 per cent for the foreseeable future, while all other member states will pay more than 1 per cent.
- The UK's net contribution to *new* Community expenditure will not exceed about *7 per cent* in contrast to the current maximum marginal net contribution of about 21 per cent.
- The new 1.4 per cent VAT figure is a maximum; it will not all be used up immediately. The purpose of the new arrangements on budgetary discipline is to see that the Community lives within the new limit for as long as possible.
- Germany will remain, and France will become, substantial net contributors, so they too will have a strong interest in effective budgetary discipline.

The European Council also confirmed that the negotiations for the accession of Spain and Portugal should be completed by 30 September 1984. It stressed the importance of early completion of the negotiations on the renewal of the Lomé agreement. There was also some discussion of the future development of the Community, during which the British Prime Minister particularly emphasised the importance of achieving a genuine common market in goods and services, which would create new jobs throughout the Community.

†'Own resources' consist of agricultural levies, customs duties on imports from outside the EC, and the proceeds of a flat rate on transactions in the VAT harmonised base (which consists of a standardised range of goods and services related to spending on consumption).

*Over 90 per cent of Community expenditure is assigned ('allocated') to recipients in particular member states. 'Unallocated' expenditure is mainly overseas aid.

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3.11 Indebtedness

CONFIDENTIAL

cc JR
NBPM
AT 10/7

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000 2 July 1984

Andrew Turnbull Esq
10 Downing Street
LONDON
SW1

Dear Andrew

BANKS' INTERNATIONAL LENDING

You wrote to me on 6 June about international debt schemes.

I attach the promised copy of the most recent survey of these schemes by the Bank of England.

The Mackworth Young scheme is listed on page 9 of the Bank's survey. Essentially it involves the creation of a new international body to act as receiver, relieving the banks of their debt (at a price) in exchange for its own guaranteed paper. It was first put forward two years ago. I attach a copy of a letter which the Chancellor has recently sent to Mr Mackworth Young about it.

The scheme proposed to the Prime Minister by Sir Walter Salomon, which you described in your letter, is not included in the Bank's survey. Its underlying approach - to introduce the market directly into the valuation banks' sovereign debt - is an attractive one. There would be a number of advantages if greater marketability of banks' international debts could be achieved. It is also clearly an advantage that under the scheme it would be bank shareholders rather than governments who would have to bear the cost. On the other hand, the proposition in the particular form put foward by Sir Walter Salomon would of course be a major step for any bank to take. It seems unlikely that it would be contemplated except in extreme circumstances. And in any circumstances there would be the risk that the adjustment to balance sheets might be too abrupt for confidence, leading to a major run on the banks. There have however, been some spontaneous moves towards increasing the marketability of banks' international debts, although so far only on a very modest scale, and we are doing further work on this approach in conjunction with the Bank of England.

As you will see from the Bank's survey - which I hope you find useful - a very large number of such schemes have now been put forward either publicly or in private conversation. Almost all start from the presumption that a significant proportion of the debt will not be repaid. Most go on to assume that either banks or debtors (or both) need to be protected from the consequences - usually in ways which involve costs to governments (ie taxpayers) in creditor countries and which would cut across (and probably cause to seize up) present arrangements for securing adjustment. It is, of course, largely for these reasons that we have set our face firmly against any global scheme in favour of the existing strategy as elaborated at the Summit - a case-by-case approach built around adjustment by the debtors, a central role for the IMF, a limited flow of new money, and encouragement to the banks to make adequate provisions. If successful this approach will give time for the debtor countries to put their houses in order and time for the banks to build up adequate provisions and strengthen their capital base.

Yours ever
David

D L C PERETZ
Principal Private Secretary

SURVEY OF RESCUE SCHEMES

ANNEX A

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Sprinkel

Source US Treasury Paper 27. 9.82

Concept

A new IMF borrowing arrangement would be established - the so-called 'emergency fund' - to supply stand-by lines of credit in "extraordinary or crisis situations that could seriously threaten the stability of the international monetary system". Participation would be open to any country prepared to make a minimum commitment, and provision would be made for countries to join at any time, and for individual countries to share their contribution on a formula related to the size of GDP and reserves, other than gold. It would be similar in nature to the oil facility and in addition to any general quota increase.

Mechanism

The new fund would be available to participants as very much a final resort and only usable when the following criteria were satisfied:

(a) "the country's balance of payments problem was likely to pose a serious threat to the international monetary system;"

(b) "the country's financing requirements were very large in relation to its IMF quota and normal access to IMF resources;"

(c) "a comprehensive and exceptionally strong IMF programme had been agreed;"

(d) "the funds required were in excess of amounts available from regular IMF quota resources."

The size of the drawings would be flexible (not necessarily related to quota size) and large, with repayments due between three and five years after the drawing and not permitted to remain outstanding beyond five years. However, the facility would not provide 'quick money' because an adjustment programme would have to be agreed before the arrangement could be activated. Access would be limited to the larger debtors because the smaller countries would be excluded by the implication of criterion (a).

However, generalised financing problems which collectively posed a real threat may allow individual countries to draw on the facility, even though their problems in isolation would not be a serious threat. Money to come from (i) official lenders (ii) market borrowing and (iii) new issues of SDRs (possibly).

The relationship between the new facility and GAB would need to be considered - perhaps GAB could be integrated into the new fund?

This proposal is the initiative which in fact gave rise to an increase in IMF resources through an enlargement of GAB. The Sprinkel plan was eventually superseded because of the political sensitivity of a policy which could be seen to be discriminatory in its allocation of funds (see criterion (a) overleaf) - a criticism which it is widely recognised was impossible to over-ride.

Bell i

Source Times 16. 7.82

Concept

This involves a proposed 'safety net' for the international monetary system in which the IMF would borrow money in the markets (a figure of $20 bn was mentioned) and operate a 'special' fund along the lines of Sprinkel, to help out countries facing immediate liquidity problems but which had a satisfactory long-term outlook. An informal co-financing arrangement is envisaged, with disbursements from the fund being made alongside commercial credits, in order to rebuff any suggestions that the scheme is merely a safety net for the banks.

Mechanism

The aim would not be to 'bail out' the banks by allowing any reduction in their exposure, but rather to increase the lending capacity of the IMF and thus have a stabilising influence on bank confidence. Details are vague, but presumably all member countries would be eligible and it is (apparently) envisaged that some sort of international consultative and liaison group set up by the G30 in conjunction with the IMF Board of Directors would administer applications to the fund as well as terms and conditions of lending.

ii

Source Times 15. 3.83

Concept

This proposal suggests that the commercial banks should establish an international lending facility linked to the IMF in order to bolster banking confidence. It is suggested that the benefits would be widespread - the IMF would be certain of new money from the commercial banks if and when necessary, the developing countries would be encouraged to agree to IMF conditionality assured of the Fund's supplementary resources and the criticism of 'bailing out' the banks would be met head on by such an initiative from their own numbers.

Mechanism

The international lending facility would technically, be a stand-by commitment of participating banks to borrowing countries, made available under the aegis of the IMF. The IMF would assess the borrower's needs and then negotiate with the commercial banks to draw an appropriate amount from the facility. It is recognised that some sort of carrot might need to be offered to the banks to get such an initiative off the ground and one might be to link it to a possible re-discounting facility for outstanding loans.

Williamson

Source Chapter 7 in 'Development Financing - A Framework for International Financial Co-operation' edited by Salah Al-Shaikhly 'The how and why of funding ldc debt';

Concept

Williamson advocates a new financial technique as a means of insulating what he sees as the necessary and desirable ldc borrowing from unexpected variations in the rate of inflation and from vulnerability resulting from short maturities and high nominal interest rates. The scheme involves an existing international institution 'sponsoring' the issue of 50 year indexed bonds denominated in SDRs on behalf of a collective of developing countries. This would ensure risk spreading for both borrowers and lenders. It would allow borrowers to vary their debt-service obligations with their ability to pay and it would also spread the lenders' risk over a number of borrowing countries, some of which would be unable to borrow on their own credit rating.

Mechanism

The technicalities of indexing are spelt out in the original paper (see reference above); briefly, the indexation formula would link the issue-date SDR with the current value of the SDR . If 'world prices' were to rise then the interest coupon payable would rise accordingly. The problem of finding a suitable index of 'world prices' could be resolved by using a price index of traded goods, which should be universal and would stabilise the purchasing power of the bond-holder for a country with a typical import composition.

The bonds issued by the Sponsor would be with recourse to the countries on whose behalf the funds are being raised, but there would still be an important place for guarantees from the Sponsor or third parties - limited, perhaps, to sums less than the total value of the bonds issued.

The essential aim would be to allow the investors to treat the bonds as low risk - perhaps through insurance with the proposed International Credit Guarantee Fund. Means of preventing countries from irresponsible borrowing would be devised through a maximum debt:GDP ratio.

This proposal was supported in the Treasury and Civil Service Committee's report on International Lending by Banks, in which it was suggested that it would help to remove current regulations preventing long-term institutional investors acquiring such assets and also permit the sponsoring organisation to set conditions which would ensure that prudent policies were adopted by the borrower.

Barclays Scheme

Source Attached to letter from Timothy Bevan (Barclays) to the Deputy Governor 1.3.83

Concept

This involves a scheme to improve banks' liquidity through the rediscounting by central banks of foreign debt with recourse to banks, and is proposed for liquidity purposes and also to remove the necessity for raising prudential deposits and liquidity. In order to prevent a general reduction of new commitments to international lending by the banks and thus delay the world recovery substantially, Leslie envisages a facility to rediscount a proportion of locked-in loans with the central bank. Clearly the central bank would need to lay down certain conditions and may only be prepared to rediscount a proportion of certain debts.

Mechanism

The rediscount facility would remain in force for the period of the loan and would immediately take not only the amount of the loan out of the balance sheet, but would also imply room for new lending. Leslie suggests that it would however be necessary to show the items as contingent liabilities since the central bank would retain recourse in the event of ultimate non-payment, although this in effect alters the scheme.

NB This proposal has been taken up publicly by Mr Timothy Bevan, Chairman of Barclays Bank - Guardian 8. 3.82.

Magnifico

Source Times 15.12.82

Concept

The IBRD would issue bonds with an average maturity of, say, twelve years to finance 'consolidation' loans to developing countries which would be required to use the proceeds to repay some of their short-term commercial bank debt. Magnifico suggests that the role proposed for the World Bank would reduce the need for international liquidity creation and reduce the strain on monetary policy. It is suggested that the value of using the IBRD in this way is that its reputation in the bond market would reduce the need for government guarantees.

Mechanism

The bonds would be placed through banking consortia, established jointly with the lending banks and a range of private and official investors (including the low-absorbing OPEC countries). The scheme envisages that the loans would be dependent on the adoption of short-term and structural adjustment programmes agreed with both the IMF and IBRD. It is implied that the scheme would have general application where serious debt-servicing problems existed.

There is also an assumption that the space created in the banks' portfolios by the relief of some of the debt burden would leave them willing to meet the ldcs' new requirements.

Mackworth-Young

Source 'The International Banking System': A Non-Inflationary Lifeboat' Note of 14. 9.82 to Bank of England

Concept

This scheme envisages a new institution, the International Debt Holding and Realisation Agency (IDHRA) under the aegis of the IMF (or BIS) and guaranteed by the G10 and OPEC central banks (though this would entail burden-sharing arrangements between governments and the passing of national legislation). Instead of providing for repayment in cash of the relevant debt (like the Magnifico plan), the IDHRA would substitute its own securities and in effect become the "receiver", while the governments through their ultimate assumption of the claims would be in effect the creditors. (A much simpler version had been proposed, with the IMF or World Bank acting as the receiver for ldc debt in exchange for say, 5-10 year non-marketable IMF/IBRD notes.)

Mechanism

The IDHRA securities would be capital-certain but initially non-interest-bearing or else realisable at discounted values in the market. Banks could convert these assets into low-coupon, freely marketable, IDHRA guaranteed bonds and would lose some income but have longer maturity assets discountable at their own central banks.

The IDHRA, in taking over some of the debt, should earn some net interest to set against deficiencies in its net assets.

Leach

Source Letter to David Hancock, Cabinet Office 9.11.82 World Debt Crisis

Concept

Similar to Mackworth-Young's scheme: involves the establishment of a new institution, again under the aegis of the IMF and World Bank which would be prepared to assume up to 30% of banks' sovereign exposure to selected countries within a stipulated time and with certain conditions attached, including the proviso that a volume of new lending (equal to half the amount of debt transferred) should be directed to the ldcs via the institution. The details concerning the nature of the debt to be transferred are vague, but it is implied that it would be maturing debt either being rescheduled or about to be so.

Mechanism

The scheme envisages a yield penalty for the banks which would take the form of a 6% discount of the capital value of the transferred assets, but the substitute claims would get market rates. Half of the institution's capital would be raised by a compulsory subscription from the banks at the rate of 2% of country exposure transferred to it, and the other half by matching government injections. Unlike Mackworth-Young, who proposes a guarantee of the whole institution by central banks, Leach proposes that the only interest obligations would be guaranteed by the shareholder governments.

Leach suggests that the institution would have "a strong debt: maturity profile, enabling it to negotiate with debtor countries without undue pressure", and thus absorb any short-term debt shocks. He foresees it aiming at profitability through earnings on its capital and the spread between its own cost of borrowing and the income on its assets.

Kenen

Source Financial Times 14.2.83 Wall Street Journal 10.2.83
New York Times 14.2.83

Concept

The creation of a new international institution is envisaged to be called the International Debt Discount Corporation which would issue bonds guaranteed by the major industrialised countries' governments to the banks in exchange for the debts of developing countries. The IDDC would confine itself to countries that recognise it as successor claimant to the banks and to government debts or debts with government guarantees. The institution would need to retain a certain amount of capital as a reserve against default.

Mechanism

The commercial bank debt would be transferred at a discount (say, a 10% loss) and the banks would receive a long-term bond, maturing in anything between 10 and 20 years, with a lower rate of interest than that on the ldc debt. The institution would then reschedule the debt owed to it by the developing country, converting it into a debt of the same maturity and interest rates as the organisation was paying to the banks.

The commercial banks would not be allowed to choose which debts they discounted with IDCC, but would be required to present a percentage of their claims on every country doing business with the IDCC. Nor would they be allowed to hold on to their risky claims until they deteriorated even further and thus use the IDCC to minimise risk rather than resolve the debt problem.

This proposal was considered to be unrealistic by the Treasury and Civil Service Committee, who doubted whether the political will existed to support such a major extension of the role of official international institutions. It was suggested that such a scheme would create an overwhelming incentive for banks to avoid lending more to a country likely to rediscount its debts with the IDDC.

Rohatyn

Source FT 14. 2.83 Testimony to Subcommittee of International Economic Poilicy of the Senate Foreign Relations Committee; 19. 1.83

Concept

To "stretch out" the debt overhang and end the "fiction" that the current burden is made up of short-term, high-interest loans, a subsidiary of the World Bank or the IMF, or a totally new institution, guaranteed by various governments is envisaged. Rohatyn suggests that the mechanism for such a stretch out would not be difficult to determine once it had been decided how to allocate costs.

Mechanism

The institution would acquire the banks' credits (it is not specified at what stage or what proportion) in exchange for long-term, low-interest bonds of its own. The new entity would become the substitute creditor, on the same long-term basis, to the present borrowers. The banks would suffer loss of income, but owing to an increased security could be encouraged by the authorities to maintain their balance sheets intact or schedule a gradual and limited withdrawal.

This proposal was examined by the Treasury and Civil Service Committee and found to be unsatisfactory on the same counts as the Kenen scheme.

Lever i

Source Times 7.12.82 1982 Churchill Lecture "Deficit Finance - Bankers and Governments' 3. 8.82 New York Times 4. 6.82, 24. 9.82

Concept

Lord Lever suggests that, as an ideal there is a need for an International Bank both to regulate international finance and to act as lender of last resort. But, in practice his scheme proposes that the individual central banks should support their own commercial banks by protecting their liquidity. The central banks would have to act in harmony in order to avoid foreign exchange distortions and to prevent a widespread withdrawal of funds from the system through a collapse of confidence in an individual bank where lending has been normal and "broadly prudent".

Mechanism

Each central bank should offer to discount the paper of the lending banks and to roll-over interest and repayment to match any delays or defaults by the borrowers. Alternatively, the central bank could buy assets guaranteed by the private banks and accept delays in interest and repayments, subject to a commitment whereby the commercial banks would transfer out of their future profits or out of any future repayments from the debtors, funds to the central bank to meet their liability.

Such a scheme would sustain the banking system by enabling it to extend the period required to write down doubtful loans, without calling into question their liquidity or solvency.

The problem of future lending would be dealt with by a committee of central banks, which in collaboration with their governments would prepare a forecast of the volume of likely bank lending needed. This would then be apportioned via the banks to the borrowers and all loans would be registered with the committee.

The committee would guarantee the liquidity or solvency problems of the banks [international lender of last resort] while they in turn would be required to submit consolidated balance sheets so as to bring the overall Eurodollar lending under bank supervision.

Lever ii

Source 2. 6.83 Paper delivered to Trilateral Commission

Concept

In essence the proposal is to extend the power of the export guarantee agencies to cover some exports of capital aswell as those of goods. The agencies would insure not only trade flows but also appropriate ldc current account deficits. The agencies would have to act in co-ordination in setting country limits for such insurance and would also stipulate that the insurance facilities would be subject to IMF approval of the borrowers' economic policies. It would also be the role of the IMF to make the recommendations to the agencies for the insurance of capital export credits through the banks up to the amount of each year's reasonable current account deficit.

Mechanism

No detailed mechanism has been worked out, but Lord Lever believes that with insured credit to cover the current account deficit, each ldc central bank would be in a position to meet interest payments on existing debt, and avoid the debt servicing difficulties currently being experienced. It is also envisaged that the trading deficit would be met and thus the breakdown of the export insurance system would be avoided. It is assumed that existing debts would cease to be non-performing assets as "the normal action by their central banks as lenders of last resort would be available to deal with any cash flow problems arising from the rescheduling of capital repayments".

Brandt

Source Brandt Reports I and II "Common Crisis: North-South - Co-operation for World Recovery"

Concept

The Brandt Commission originally suggested that World Bank guarantees might stimulate additional commercial lending to ldcs. The IBRD is already empowered to provide guarantees to member governments for specific projects, but had not used them because direct lending had been regarded as most appropriate on a cost basis and to avoid the stiffer conditions of commercial lending. The IBRD staff had concluded full guarantees would still be of little use and although partial guarantees may be more favourable, they would still carry risks for the Bank.

The second report suggests that the IMF should undertake borrowing programmes from central banks and the private capital markets, in addition to any increase in quotas. IMF conditionality ought to be altered significantly to shift the emphasis away from short-term BoP adjustment towards longer-term structural changes. The report states that "the above measures would create a framework of confidence in which private bank lending to developing countries would be able to expand". One further measure advocated was "consideration of an Investment Credit Guarantee Fund to promote project lending by commercial banks".

Bailey

Source Wall Street Journal 3. 3.83

Concept

The plan proposes the creation of a new financial instrument, the Exchange Participation Note, issued by a debtor country's central bank to give creditors a claim on a certain percentage of the country's future foreign exchange earnings. The aim would be to reduce the debtor's burden of principal repayment in the short term - as the borrowing country would only pay within its immediate means - and at the same time the creditors would avoid the cumbersome organisation of repeated reschedulings. It is suggested that a secondary market for the notes may emerge.

Mechanism

Instead of receiving principal payments as scheduled, creditor banks would receive the notes, entitling them to say 3% of the country's foreign exchange earnings. The notes would only be applicable to some of the foreign debt - excluding particularly projects earning foreign exchange. In the long term, a creditor could be paid more quickly, in theory, than under the original terms, and this incentive for bankers and debtors to fund projects that generate foreign exchange is seen as an important advance on the more usual bridging loan, which eventually only succeeds in adding to the debt servicing burden.

Pierre-Brossolette

Source - Report of G30 study on longer term evolution of International Financial Institutions 24. 1.83

Concept

This proposal has two broad aims; the first is to reduce the debt servicing burden for the ldcs on a long-term basis - through linking the annual debt repayment to a certain percentage of export receipts. A new international agency, linked to the IMF, would be established to purchase at its own risk a certain pecentage of the commercial banks' outstanding foreign loans. These purchases would be priced slightly lower than nominal value. The second aim would be to maintain a flow of new funds within the ceilings stipulated, through the agency operating refinancing lines or giving a performance guarantee in respect of a certain percentage.

Mechanism

Certain criteria would have to be met for debtors to be offered help in this way:

- the production of regular, full statistics on the amount and composition of their debt;
- an undertaking not to contract further debts which would result in future repayments exceeding the agreed level;
- the creation of negotiable securities, as the counterpart of the new rescheduled debt.

The agency would have a small called-up capital base as the operations would be financed on the commercial markets.

Hudson Institute

Source: Wall Street Journal

Concept

The main idea of this proposal, suggested by Mr Jimmy W Wheeler, is to index the principal on the developing countries' bank loans to the rate of inflation. With inflation currently receding, it is argued that the plan is not as drastic a change as it was when first proposed in the late 1970s, and potential disruption is now minimal. As with all indexing schemes, however, there would be a problem in agreeing on an index - as the wrong inflation indicator could cause distortion.

Mechanism

Instead of tying the interest rate to inflation, as is the current practice, the Hudson plan (tying the principal to inflation) would push the inflation-added payments towards the end of the loan. At the moment, interest payments move up and down with inflation which in effect transfers longer-term to short-term debt, as in inflationary times high interest rates push up current payments, while inflation eats away at the value of the remaining principal (inflation accelerating amortisation).

Under current conditions if a borrower has a $10 mn loan, with a ten-year maturity, inflation is at 10% and the interest rate is 15%, the borrower will be paying $1.5 mn interest the first year and $1 mn in principal (totalling $2.5 mn). Under the Hudson Institute plan, if the principal is indexed to the 10% inflation rate, the interest rate would drop to the real rate of 5%, or $0.5 mn in the first year and the principal repayment would remain at $1 mn - totalling $1.5 mn. The $1 mn "saved" would be added to the loan itself and amortised over the remaining nine years.

Muldoon

Source   Report of North-South Group, OECD - 16. 3.83

Concept

This proposal suggests the establishment of a Facility under which short-term debt (both of original final maturity of less than x years and a remaining final maturity of less than x years) would be consolidated into long-term fixed interest bonds, under international guarantee and supervision. All developing countries would be eligible for assistance in such restructuring and the eligible debt would include official and officially-guaranteed debt both in the form of bank loans (but excluding ECGD-backed loans or their equivalents) and public bond issues. Membership of the Facility would be open to all countries; with each member committing a maximum liability for guarantee purposes. In the event of the Facility having to honour its guarantee, funds would be called from members up to and in proportion to their maximum liabilities. It is envisaged that total guarantees should not exceed maximum liabilities.

Mechanism

With the agreement of the Facility and of individual creditors, the borrowing country would issue bonds to replace its existing obligations. The detailed structure remains vague at the moment, but it is proposed that they would be of medium to long-term maturity (fifteen years has been suggested as a norm), interest rates would be fixed possibly in proportion to the SDR rate or linked to the rate of charge on the use of IMF ordinary resources. The replacement of existing obligations would take place either at par or at a uniform discount, although some degree of flexibility might necessitate individual discounts agreed for the particular debtor.

Taylor

Source Guardian 24. 3.83; speech to American Chamber of Commerce

Concept

Arguing that existing schemes only tackled past debts and would probably lead to a further contraction of working capital, Taylor advocates a 'scheme' under which international agencies would guarantee new bank loans in order to maintain an adequate flow of funds. The guarantees should be of the kind used by export credit agencies, but for less than the 80-90% cover usual in current export and commodity credit agreements ["to keep the banks honest"].

Mechanism

No details available.

N.B. Taylor suggested a proposal such as this should be on the agenda of the Williamsburg Economic Summit - the subject of a current congressional resolution by St Germain (Chairman of the House Banking Committee).

Laulan

Source Outline attached to note for record on meeting between M Laulan and Mr Burns HMT 17. 3.83

Concept

This proposal is concerned with two broad aims - to bolster banks' confidence and to ensure that future lending will be utilised more effectively than in the past. It is entirely prospective and fails to mention anywhere the problem of the present stock of debt. . The idea is of one setting up "upstream" new procedures between the IMF and the banks and "downstream" methods of guaranteeing loans.

Mechanism

Before a loan is granted, it would be necessary for the banks to engage in very detailed consultations with the IMF, if the loans are intended for balance of payments financing or the World Bank if the loans are related to project financing. The purpose of these "upstream' consultations would be to obtain a "stamp of approval" by the official institutions who, it is claimed, are in a better position to assess country risk and appropriate use of the funds than the commercial banks.

"Downstream" - it would then be necessary to offer some sort of guarantee to the banks and institute effective risk-sharing in order to maintain a flow of funds. Laulan himself admits this idea is "rather simple" and suggests that the BIS or Central Banks could also play a role, particularly in the case of smaller, regional banks.

Zombanakis

Source The Economist 30. 4.83

Concept

The IMF is seen as the indispensable element in any new initiative and an increase in its resources are of paramount importance. In consultation with the IMF and the creditors, countries in a critical situation should draw up adjustment programmes as at present, but over a longer timescale of say 13 years. Such a programme would thus be less restrictive for the borrower than a short-term rescue and release some restrained demand to help world recovery.

Arrangements under the agreed programme would be interrupted or made conditional if the IMF and creditors were uncomfortable with the borrower's progress.

Mechanism

Once new repayment schedules had been arranged, the IMF would guarantee amounts due in the final three years (ie years 11-13 of the example). This guarantee would be viewed by the creditors as the means of securing repayment of their claims at the time it is applicable. With this security, the banks could resume their consideration of new loans, provided they were within the IMF programme. If the borrower were to fail on its commitments, the guarantee could be revoked. This would be a safeguard against banks offloading their debts on to the guarantee in the final three years. Only if the IMF conditions had been met in the first ten years, could the guarantee be used in years 11-13.

In order to lessen pressure on the eurodollar market, lending banks from strong creditor countries should be asked to convert claims on borrowers to their own currencies. This would increase confidence of the lending banks and reduce pressure on the dollar.

For all rescheduled loans, a new set of terms should be worked out by negotiation. The banks should accept an interest rate comparable to the return on government paper available to them. The difference between the original rate and the new rate should be charged to the borrower as a guarantee fee. This amount, accruing over the years, would contribute towards the guarantee's funding requirements.

The IMF is not at present empowered to give guarantees and a fund would have to be established - the Guarantee Loan Fund (GLF) - made up of contributions from countries in an enlarged G10. This facility would be provided with standby letters of credit by the G10 creditors drawn to meet guarantee payments and repaid under conditions worked out subsequently.

Schumer

Source Press release by C Schumer 7. 3.83

Concept

This scheme (like Rohatyn) proposes the conversion of short-term, high-interest debt into more manageable lower interest debt stretched out over a longer period. It suggests extended co-operation between the IMF, central banks, indebted countries and private banks in devising acceptable restructuring of the debt. The indebted country's rearranged annual repayments of interest and principal would be set at a prudent percentage of its annual export earnings. An IMF 'insurance fund' in case of default is suggested, financed by a small surcharge on the renegotiated balance and paid jointly by debtors and commercial banks.

Mechanism

Schumer suggests that the Bank Examination Council would require each bank to increase loan loss reserves, whenever a bank's loans to foreign, public or private borrowers cannot be honoured according to the original terms and conditions without additional borrowing or a major restructuring. Such loan loss reserves will not be required if new loans or terms form part of an IMF-negotiated restructuring.

In tackling potential future problems, Schumer proposes that the Bank Examination Council should enforce country lending limits on US banks as a percentage of an insured bank's capital. Decisions would be taken outside the bank in this procedure - and the Council will report the limits to Congress, together with an estimate of the amounts of convertible debt. Schumer recommends that the IMF would seek to establish uniform country lending limits for all banks involved in international lending.

Aliber

Source Statement to Sub-committee on International Trade, Investment and Monetary Policy 26. 4.83

Concept

Aliber suggests the establishment of a new US government agency - New Government Credit Agency (NGCA) - to buy debt sold by the US commercial banks. NGCA would be financed by special Congressional Appropriations and from selling its own securities in the capital markets with a US Treasury guarantee.

Ideally, NGCA would be established and never used; its very presence would reduce the likelihood that it might be used. It is suggested that its willingness to provide banks with capital would ensure the stability of the banking system, even though banks have already incurred large loan losses on ldc debts. The risk to NGCA itself would be modest, for these losses have already occurred, even though they have not yet been recognised.

Mechanism

NGCA would be ready to lend to the banks at commercial market interest rates. These loans, subordinated to deposits and to other types of debt issued by the banks, would be arranged in combination with warrants to buy shares of the bank's stock. These warrants would carry a modest exercise price so the banks would receive new equity capital if the warrants were exercised.

The terms offered by NGCA would be sufficiently attractive so that the size of the banking system would not be reduced. The terms must not be so severe that the bankers prefer a reduction in the size of the banks to borrowing from NGCA.

Sumitomo i

Source - Sumitomo Bank Review April 1980

Concept

To help recycle liquidity to non-oil ldcs, two options were suggested. (The liquidity at that time was in the form of OPEC surpluses). First, to improve or expand the function of existing official institutions such as the IMF and the World Bank. Such strengthening could be achieved through various means - easing the lending conditions of IMF facilities, enabling the World Bank to raise funds through massive capital increases or issuing bonds and establishing an international development fund (as proposed in the Brandt report).

The second option would be the establishment of a new international credit guarantee system to strengthen the "recycling" channel of commercial banks. Advantages were seen to be the imposition of BOP discipline at times of insolvency and a relatively light financial burden achieved by paying only the interest portion at the time the guarantee is used.

Mechanism

The system would guarantee bank loans to the non-oil ldcs and collect guarantee fees from borrowing countries. If a country experienced difficulties on amortisation, the system would give guidance on economic management and repay the bank all or part of the outstanding interest. Funds would be raised through a transfer of part of the IMF gold facility to the system and through contributions from IMF member countries and by any other country desiring to make use of the system's facilities.

Sumitomo ii

Source - The Eagerly Awaited Creation of the "Life-Boat" System

Concept

The "life-boat" system proposed is that of an emergency SDR facility - "a renovation of the current SDR system". This involves an increase in SDR resources, with the IMF reserving the right to distribute the increase in SDRs, and an emergency SDR facility. It is argued that because indebted countries will be bound to repay as early as they can under the facility, international liquidity will only show a temporary increase and that for most industrialised countries acceptance of SDRs will be nothing but a shift from foreign currency reserves and will impose no financial burden.

Mechanism

When any debtor country is on the verge of defaulting on its obligations, the IMF will make an emergency allocation of SDR regardless of the ceiling imposed on the country in question, which will carry a commitment to repay as early as possible.

NB See note by FGA 30. 6.83

II(15)A19

Morgan Guaranty

Source World Financial Markets June 1983 (monthly publication of Morgan Guaranty Trust Co.)

Concept

The aim is to keep channels of private finance to ldcs - in this case primarily higher - and middle-income countries - open directly (as opposed to indirectly, through a mechanism such as IMF borrowing in the market) by using IMF and World Bank resources to back portions of international loans to them, and to promote productive investment.

Mechanism

i) IMF scheme

IMF assets (amount not specified) would be set aside to establish an insurance pool, which would back portions of international loans to ldcs called for as part of an IMF stabilisation programme. Developing countries would have to pay an insurance premium (presumably to the IMF), but would pay lower spreads over Libor to banks because of the IMF guarantee.

ii) World Bank scheme

A new subsidiary of the World Bank would be created, to participate with banks in eurocurrency syndications. Credits would be extended at commercial rates and tied to World Bank project loans. This scheme does not entail guarantees as such, but, rather, a strong incentive to borrowers to maintain the servicing on these loans - in that failure to make regular payments would lead to the halting of disbursements of (all current) World Bank project loans.

This mechanism is regarded as a suitable means of stimulating commercial flows and improving control over their use, with the aim of benefitting economic growth in the borrowing country.

Griffith-Jones & Lipton

Source International lenders of Last Resort: Are Changes Required

Concept

The initial assumption on which the proposal is based is that the purpose of a lender of last resort is to "ensure a stable ... flow of credit to sound borrowers": an assumption which may be open to debate. The proposal is not strictly intended as a rescue scheme for the current international debt problems, but more of a contingency plan, for use as part of an LOLR call when needed by a bank.

Mechanism

In the event of a bank calling on the LOLR facility, the LOLR would purchase some or all of the bank's claims upon sovereign debt at a substantial discount. This would impose a de facto "penal rate" but the bank's deposits and, above all, its capacity to lend would be protected.

Afterwards, the LOLR would negotiate with borrowers to recover the debt - at a considerably lengthened maturity - at a rate between the discount price paid to the bank and the original rate due.

Atkinson

Source Bow Group Paper: "No Equity in International Debt"
28. 6.83

Concept

In order to establish stability in the international monetary system, the author proposes an expansion of non-bank aid and equity investment in specific developing country projects. It is suggested that the IMF and the World Bank establish a subsidiary organisation - the International Resources Development Agency (IRDA) to shift the emphasis from debt rescheduling and macro-economic considerations to a more equity-based, micro-economic approach to borrowing countries. The IRDA would include representatives from the Chambers of Commerce and Overseas Development Agencies (or equivalent) of IMF member countries, who would have a dominant role in the IMF team sent to negotiate with a debtor country.

Mechanism

It is advocated that the personnel and resources already devoted by national governments to Third World development would be used to:

(i) shift the emphasis of IMF-type conditionality towards the promotion of resource development through foreign equity investment

(ii) provide International Equity Guarantees for inward equity investment into countries with debt problems. Such guarantees would insure against political dispossession, not commercial failure

(iii) collect micro-economic data, help a debtor country to identify economic distortions, resource and skill shortages and international markets for foreign exchange earning exports

(iv) co-ordinate the provision of administrative and civil service expertise by developed countries to developing countries.

Only if a significant percentage of the debt servicing problem could be relieved through foreign corporate investment and aid programmes, would the IMF recommend and co-ordinate further injections.

Friedberg

Source   How to Solve the International Debt Crisis 27. 4.83

Concept

The "debt work-out" proposed has three elements. First, banks need to recognise losses in an orderly manner. Second, greater incentives must be provided for the debtors to adopt IMF approved sacrifices and third, the debt relief should avoid the "socialisation of bailing out costs". To achieve this third goal Friedberg suggests a series of squeezes - initially on shareholders, then on the largest and most sophisticated depositors and only as a last resort on the nation's taxpayers.

Mechanism

In the first instance, Friedberg proposes to replace the current practice of rescheduling at increased spreads, with a lower rate of interest tied to a commitment by the borrower to reduce its principal. He suggests that banks could offer a one percentage point reduction in interest for every half-point amortization of principal.

Friedberg sees the plan benefitting both sides; the ldcs will view this as a gesture of goodwill and sacrifices will seem more worthwhile if the debt burden is actually diminishing, while the banks will be forced to accept reality. Interest rate reduction will be offset by healthy domestic earnings, while losses will be tax deductible and would become smaller over time. However, Friedberg provides some startling figures - a 5 per cent interest rate reduction on loans to financially troubled ldcs would reduce in the first year Citicorp's pre-tax profits by 38%, Bank of America's by 62% and Chase Manhattan's by 75%.

In a second phase to his proposal, Friedberg suggests that loans to ldcs could be amortised to zero over 20, 30 or 40 years. This may run into problems, as psychologically it lets the debtor off the hook by removing any compelling reason to repay. It also runs counter to tax rulings which prevent provisions over 2% of loans. The solution suggested is the on-selling of troubled loans by banks in the open market and by tender.

The banks would keep a number of these loans equal to 2% of their total loan portfolio. Individuals and other financial institutions would be eligible to purchase loan participations, which would continue to be monitored and serviced by the originators. The risk would thus be spread through the greater number of participants.

The market would price the loans and before their sale interest rates would be reduced as a pre-requisite for a similar (though half as large) reduction in principal. The loans would be more attractive because of the lower risk involved - lower because the interest cost would be more manageable and because of the yearly sinking fund.

II(8a)B28&29

Bolin

Source - The Economist Financial Report 21. 7.83

Concept

Bolin suggests the establishment of an Export Development Fund, which would be closely allied to the World Bank, but backed by the export credit agencies of the industrial countries (similar to Lord Lever's second plan - page 14).

Mechanism

The new fund would be in a position to make loans beyond the optimum maturities favoured by private banks (7-8 years) and less than the 15-year or longer maturities that the World Bank favours. The new organisation would obtain its loanable funds by placing its own floating-rate 8-14 year notes with investors in the Euromarkets. It is envisaged that initially, these notes might be taken up by the commercial banks involved in the loans. Over time, a secondary market might be developed.

Zolotas

Source - Times 11. 1.83

Concept

This proposal suggests a new fund in which the guarantors would be the IBRD, the IMF, the surplus OPEC countries and the highly industrialised countries. Membership would be open to all World Bank member countries. All major international lenders deemed to be applying prudent banking practices would be eligible for guarantees, which would be extended to balance of payments and development lending.

Mechanism

The fund would be income-generating so that after a few years of operation sufficient reserves would have accumulated gradually to reduce the risk of guarantors. Guarantees could be a fixed percentage of loans, or the percentage of coverage (a maximum ceiling of say 70 per cent) could be open to negotiation between the bank and the fund. It is envisaged that lending to ldcs who do not have access to the private capital markets could be covered up to 90 per cent.

Yassukovich

Source The Guardian 10. 8.83.

Concept

A three stage plan is proposed aimed at removing commercial banks from the mechanism of sovereign lending and replacing them by the international institutions. The key to the scheme is its long-term nature - Yassukovich estimates it would take 20 years to achieve an orderly transfer of sovereign debt from the commercial banking system to those official agencies which, representing governments, are the only means of enforcing adjustment on ldcs while minimising adverse political consequences.

Mechanism

The first stage would be to convert the new loans recently negotiated between banks and debtor countries into IMF facilities. These would be funded directly by the banks in the same proportions as their existing commitments to the new money facilities. The banks would fund the IMF on interbank terms but they would be relieved of the additional credit exposure to the countries in difficulty. This would not be viewed as market borrowing by the Fund, but as a similar operation to reserve requirements or special deposit schemes which require national banking systems to hold central bank assets.

The second stage would involve the gradual assumption by the IMF of the agent bank roles currently carried out by members of existing syndicates representing the bulk of the external debt of the countries concerned. The banks would effectively become sub-agent to the Fund and the IMF would assume the role of principal counterparty on behalf of international lenders to the governments concerned.

The third stage would involve a gradual redistribution of commercial bank exposure. A consortium of official lenders, consisting of the IMF, the IBRD, the regional development banks and central banks would assume, over a predetermined period of time, the banks' credit exposures, while the banks retained the funding exposure at the outset. Gradually the funding exposure would also be run down through the issue of marketable securities by the consortium which could be sold on the capital markets.

Source - Letter in 'Euromoney' May 1983 P.9

Concept

This scheme proposes to establish a new institution, the International Debt Redemption Bank (IDRB), which would create a secondary international currency called Special Redemption Units (SRU) and would purchase outstanding loans to ldcs at a discount in terms of SRUs at a fixed par value. It is envisaged that the capitalisation of the IDRB, initially at $10 billion, would be provided by the IMF, World Bank, commercial banks and governments. While on the one hand a commercial bank would obtain security for its existing loans, and be in a better position to increase its exposure, on the other hand a debtor would have to observe some form of IDRB - imposed conditionality.

Mechanism

The IDRB would create SRUs to the value of fifty times its capital - which is roughly what the present global debt is estimated at. It is claimed that since the SRUs would be freely acceptable and rediscountable with other banks, the bank that discounts its sovereign debt with the IDRB would be assured of the safety and liquidity of its loan. SRUs would be accepted in all international transactions by countries dealing with the IDRB. Like the Eurocurrencies, SRUs would be accepted as bank deposits and be interchangeable among these currencies and SDRs at a pegged exchange rate.

Rao argues that while the World Bank lacks the resources to discount sovereign debt, the IDRB would create secondary money in SRUs. A liability would be created in the form of an SRU against an asset of a sovereign debt. SRUs would operate through two rates: a par value fixed higher than the dollar to cover expenses, rate of return for holding the debt till maturity and the risk, and a discount rate, which would include provision for a minimum dividend to be distributed to shareholders and minimum contribution to the general reserve fund. Therefore when a sovereign debt discounted by IDRB matures, there will be a contractionary impact on world liquidity.

Dale

Source Financial Times 31. 8.83

Concept

The proposal is based on the premise that it is advisable to leave the stock of debt to take care of itself and to concentrate on sustaining international credit flows. The suggestion is that the IMF formally guarantees new bank loans to the extent that its own lending programmes are conditional on additional bank credits.

The assurance of renewed credit flows would sustain the international banking system awaiting an upturn in global economic activity and initially, at least, there would be no debt relief and no losses imposed on the banks. If, however, the debt burden of the ldcs becomes unmanageable because of unfavourable economic developments, the scheme could be adapted to provide debt relief - for instance by having banks write off some proportion of their old loans over a period of time.

Mechanism

The guarantees would be sold to the banks either at a uniform rate of, say, two per cent per annum or at a variable rate reflecting the perceived creditworthiness of the borrower. To counter the criticism that banks were being "bailed out" , old debt could be subordinated to the new as is the case under corporate debt restructuring.

The scheme could be used as a tap to control the flow of new credits as changing economic conditions dictate. The ultimate objective would be, however, to allow market forces to take over as early as possible.

Brunner

Source "International Debt, Insolvency and Illiquidity" in Economic Affairs, April 1983

Concept

The authors* outlined a seven-point policy as follows - points 2 and 3 of which may be regarded as constituting a rescue scheme.

1 Explicit formulation of a long-term strategy - governments need to discriminate between countries which are unlikely to repay in the future and countries that can be expected to repay principal and interest after a rescheduling. The former should be declared in default.

2 Rescheduling the maturity structure of outstanding debt - the magnitude of the problem and the long-term requirements of the solution suggest that rescheduling should be arranged at regular intervals. Domestic adjustment policies, accepted as conditions of rescheduling, could also be monitored effectively.

3 Gradual adjustment of new loan extensions - loan extensions need to be tied to the debtor nations' commitment to alter their domestic policies. Otherwise, interest payments may depend on further loan extensions even after the improvements expected with recovery from the current recession. This solution merely postpones the problem to some future date, by which time its repercussions will have become more serious.

4 The role of the IMF - monitoring and assessment of both debtor and creditor nations from a crucial part of the scheme - a task for which only the IMF is suited. It would involve a re-examination of the IMF's usual 'austerity measures' that encourage debtors to reduce imports. Financial policies and the creation of incentives to produce and export should be the major targets of the IMF.

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* Karl Brunner, Michele Fratianni, Morris Goldman, Jerry L Jordan, Allan H Meltzer, Anna J Schwartz.

little benefit from a diversification beyond three or four developing countries, provided that the cross-correlation between these countries of the various risks involved is small; furthermore, the developing countries are themselves only one part of a bank's wider international portfolio. The "big four" borrowers therefore offer a reasonable degree of diversification in this context, comprising as they do a major oil exporter; a rapidly industrialising country with diversified exports and rich in natural resources; a self-sufficient country with considerable potential; and a successful producer of manufactured goods.

However, it is not immediately evident that this portfolio diversification reasoning provides the correct criterion by which to judge the appropriate degree of concentration. Certainly, many countries were excluded almost entirely from bank lending for either political or economic reasons, or both. This is in part because political factors have proved particularly difficult to assess, not least for the banks themselves, while the relevant economic indicators in this context remain elusive, encouraging a degree of conservatism in banks' behaviour. In practice, there may be an element of circularity - through self-fulfilling expectations - in any ex post assessment, since some countries may have been able (or unable) to realise their potential only because of the availability (or non-availability) of the external finance required for development.

Another important determinant of the banks' lending policies may have been the favourable response of the authorities - governments and central banks - of the developed countries both to "recycling" in general and to specific types of lending. At a minimum, the absence of active discouragement - in relation either to the overall level of international lending or to its distribution, and either as part of overall economic policy or as a purely supervisory interest - is perhaps as significant as the presence of active encouragement.[8]

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8 As early as February 1975, the Governor of the Bank of England was able to say - in a speech at the Overseas Bankers Club - that "the speed and flexibility with which [the world banking system] dealt with the [oil moneys] has provided time for other and longer term channels for investment to be opened up ...". In a similar speech in February the following year, he said: "The international banking system [has] made an important contribution [but] commercial banking cannot cover the whole need ..... The emphasis must therefore turn to more official financing". Despite this clear recognition of the dangers of unbalanced financing, little positive was in the event done to prevent it.

Montagnon

Source Financial Times 30. 9.83

Concept

This proposal envisages a free market approach to the debt crisis which will has the advantage of avoiding demands on public expenditure. It suggests that the World Bank takes $1 bn from its liquid resources and uses the money to establish a new affiliate - an investment bank which could borrow in the money markets. With a prudent gearing ratio of nine to one, the new affiliate would have at its disposal a fund of $10 bn to lend to those ldcs which are experiencing immediate debt-servicing problems. The bank itself is unable to increase its one to one gearing ratio, as its existing bond holders have been promised that the ratio will never be changed.

Mechanism

Montagnon offers two possible roles for this supplementary fund. It could be used to extend the maturities of the troubled debtors, or more imaginatively, to extend loans to the IMF itself. Montagnon suggests that this would relieve the Fund from the humiliation of repeated recourse to the BIS and avoid the "radical" changes of character necessary if the Fund were to engage in direct market borrowing.

Source Financial Times 29. 9.83

Concept

Brittan identifies the "steep and unexpected" rise of the dollar as the unforeseen element which contributed to the ldcs' debt-servicing difficulties. His proposal is that of an interest-rate subsidy, which would be granted to developing countries to compensate them for all or part of the increase of the real value of the dollar as determined by the Managing-Director of the IMF since some appointed date, perhaps 1980, when the dollar last appeared to be near a "normal" value.

Mechanism

The value of the subsidy should be adjusted according to the prevailing value of the dollar. It is intended to phase out the subsidy in any case after, say, five years. If the value of the dollar is still unreasonably high, it is something that the rest of the world will have to adjust to, but the developing countries will have been given time to make the adjustment.

It is suggested that the best form which the subsidy could take would be outright, but it may be necessary to disguise it in the form of an SDR allocation, longer-term concessionary IMF credits or relief channelled via the banks.

The suggested subsidy should be applied to the interest payment, in order to remove the doubt over interest-servicing and to create a situation in which the principal could be restructured with confidence.

Witteveen

Source Per Jacobsson Lecture 25. 9.83

Concept

Witteveen suggests the creation of a loan insurance facility for the new commercial bank finance required under the IMF adjustment packages, which would insure against political risks, comparable to the national export credit insurance agencies' function in trade finance. He notes Lord Lever's suggestion of a centralised international agency to fulfil this role (see page 14) and the US Exim Bank's attempt to set up similar arrangements for Mexico and Brazil, but suggests that the IMF itself should establish such a facility.

It is suggested that a system of IMF-insured loans would stimulate borrowers to meet their obligations to a greater extent, as failure to do so would jeopardise further financial assistance and access to the financial markets, although there may be a danger that the IMF-insured portion of a borrower's external debt would assume 'preferred creditor' status and discourage non-insured flows.

Mechanism

The insurance would only be forthcoming if the debtor country were to meet the IMF agreed performance clauses (Witteveen does not make clear at precisely what stage the insurance would be given - presumably after time has been allowed to monitor the debtor country's progress). The percentage to be insured and the premium paid by the banks for this protection should be flexible according to the needs of the situation. It is envisaged that some part of the risk, say 25%, should in all cases remain with the banks.

As the amount of the insured credit grows, the IMF's resources will need to expand in parallel, possibly in the form of guarantees by participating governments. Witteveen states that the IMF would assume the role of assuming a sufficient flow of international credit to troubled countries, and central banks could then "focus unambiguously on their national supervisory tasks".

Needham

Source Wall Street Journal 3.10.83

Concept

Needham suggests that the parallel between sovereign and corporate borrowers' liquidity problems should point to a similar solution and her proposal is that the banks become equity participants in the debtor nations' enterprises. It is claimed that the benefits deriving from such a move would include a halt in the current cash haemorrhage which would allow borrowers to devote capital to production and trade, healthier bank balance sheets with a decreased proportion of doubtful assets and an avoidance of demands on public expenditure to compensate for the bad judgement of borrowers or banks. The capacity of the ldcs to absorb such participation is not seen to be a problem; it is pointed out for instance that Brazil has nearly 500 state-owned enterprises.

There would be no need for radical changes in US banking laws, as banks are permitted to own stock from debt previously contracted (DPC).

Mechanism

One method of conversion would be to establish stock arrangements similar to closed-end trusts. The debtor government could create a pool of a variety of stocks, and the banks would own a proportion of a diversified group of common stock. Banks could become board members of a holding consortium and provide advice on such matters as export potential. It is suggested that where a country borrowed for activities peripheral to revenue-generating business, the state could "swap" some of that particular debt for equity in its other enterprises.

An alternative mechanism would be for the sovereign borrower to establish a holding company of stock in state enterprises, in which banks would hold shares.

In the short-term bank earnings may suffer, and auditors may argue that the current market appraisal is in reality less than its book (loan converted) value, but Needham believes such problems are overcome by the simple fact that equity in potentially successful businesses is preferable to defaulted loans.

Goldsmith

Source   Wall Street Journal (Europe)

Concept

Goldsmith's plan is the only one covered to date that discriminates between borrowers from the "free" world and "hostile, Communist" debtors - his greatest concern is to avoid the leftward shift that might follow over austere adjustment. He also considers it unreasonable to force banks to recognise losses on loans at "too brutal a pace" because "pressure was applied to them by Governments, central banks,. etc..... to act as the conduit for recycling petrodollars to poorer nations".

Two possible solutions are analysed - debtor countries could be given "time to pay their debts progressively - if they take whatever internal measures are necessary" or they could be bankrupted.

Mechanism

The self interest of the "free" world should be the only consideration. Those countries whose debt is worth rescheduling are to be given, say, a 20-year grace period with repayments only to be made over the following 5 years and interest fixed at the "currently low figure of 6 to 7%". Interest payments would be guaranteed by the IMF or central banks but because, discounted over 25 years, principle repayments are of only lesser importance, they need not be covered. In return for the interest guarantee, the original creditors must hold loans to maturity, so reducing liquidity creation. (If repayments were considere unlikely, present limits on the deductability of provisioning at a rate greater than 2% pa could cause problems.) For those countries who are to be bankrupted central banks would buy up loans at a discount not too onerous to the original lenders, presumably on the grounds that only the official sector could successfully follow through the receivership of a sovereign state. (In the apparently unlikely event of it being considered worthwhile to give communists more time to repay their debts, provision should be made for official purchases of loans at any time in the future that strategic interest dictates a switch from accommodation to liquidation).

[It should be noted that, under present rules, Sir James appears to consider all $450 bn of developing country debt as unsustainable.]

Guenther

Source Financial Times International Banking Report 14.10.83.

Concept

Guenther sees the need for a "giant step" to alter the fundamental conditions which are at the heart of the present problems. He envisages some kind of creditor-initiated moratorium or grace period of, say, three-years on all external debt for an individual country - in effect a comprehensive rescheduling. From a regulatory point of view, in the US, while reschedulings must be publicly reported, rescheduled loans even with a grace period need not be classified as sub-standard or non-performing assets, and thus the impact on banks' balance sheets could be minimised.

Such a plan would offer meaningful relief to the debtor, in the form of a breathing space to achieve results from macro-economic adjustments.

Mechanism

He suggested solutions to the expected critcisms that the costs would not be borne equitably and that some large creditor banks would be in danger. It is proposed that the creditor banks' governments would issue interest bearing certificates equal to the present value of the deferred maturities of the recheduled debt. These could be held by the banks as assets until the end of the grace period when they would be cancelled. The interest yield would be below that on the rescheduled debt, to reflect lower risk, and possibly also below the market yield for government securities, in order to apportion some of the cost of adjustment to the banks.

The banks would be subject to a surtax on interest receipts on the rescheduled debt to offset the earlier drain on federal or national treasuries in servicing the certificates.

Such a system, it is suggested, would place tight controls on future external financing, while the banks would benefit from healthier debtors and an avoidance of writing down assets on a potentially dangerous scale, while at the same time they would receive a reduced, but certain income flow.

De Groote

Source Financial 3.12.83

Concept

The proposal is broadly that loan repayment by the developing countries should be tied to the pace of recovery of their economies. It is envisaged that constant rescheduling would thus be avoided.

Ad hoc emergency rescue packages needed to be replaced by long-term co-operation between the IMF and the commercial banks. It would be necessary for the IMF to provide more information to commercial banks on BoP forecasting without breaching confidentiality on exchange rate policy or similar matters. The banks in return should be prepared to allow fluctuations in debt repayments.

Mechanism

A minimum repayment level is envisaged, with movements above this rising and falling in line with export revenue. It is suggested that the scheme could be implemented without the need for international intervention or legislation by the authorities. (No distinction is made between interest and principal repayments.)

Lira

Source Journal of Commerce 7.10.83

Concept

This is specifically designed as a rescue scheme for Brazil, but could be applied to any of the large debtor nations. Lira proposes a temporary and partial 'disengagement' from the international borrowing system by the borrower in order to achieve stability - and suggests a period of five years.

The disengagement would be partial for two reasons. Borrowing relationships with multilateral development agencies would continue as they still provide positive resource transfers. In addition short-term trade-related financing facilities would also be maintained - although in practice, there may be problems of definition involved here.

Lira views the plan as a logical extension of the Mexican moratorium in 1982.

Mechanism

For all external debt, apart from the categories mentioned above, the Brazilian Treasury would assume the obligations and would maintain interest repayments as specified on the original agreements. During the fourth year of the disengagement, the Brazilian government would indicate conditions of repayment beginning at the end of the fifth year, and to calculate appropriate repayment schedules for the principal.

It is suggested that outstanding loans would be classified "as if performing" for the five year moratorium as the interest income would continue, although Lira coes not rule out the need for some banks to mark down the value of their loans to meet goverment requirements.

One of the chief advantages from such a scheme would be to let the domestic rate of interest be determined by domestic savings and investment, rather than being "propped up" by the abnormal levels of the international rate. It is not envisaged that such a move would cause friction with the IMF - in fact Lira suggests that Brazil would abandon some exchange restrictions to which the Fund objects.

Ogden

Source Tomorrow and Beyond - Some Thoughts on Issues Ahead for the World Economy 9.11.83

Concept

Ogden suggests the establishment of Regional Stabilisation Funds as Phase II of the debt management policy in an attempt to address the problems in political as well as economic terms. These facilities would be available to countries which have reached agreement with the IMF and which have and are projected to continue to have significant trade surpluses.

It is suggested that such Stabilisation Funds, managed by the World Bank, in tandem with the IMF Standby Agreements, could provide a more orderly mechanism and a better assurance of sufficient funds to provide for economic growth in the debtor countries. The IBRD could establish a buffer amount of, say $500 mn in the funds.

Mechanism

Countries would agree to donate to the Fund a fixed percentage of their export proceeds and creditor banks would contribute a certain percentage of their existing loans to each member country of the Fund. The creditor banks would continue to accrue interest under the original terms of the loans, but once accrued the interest claims would be surrendered to the Fund in exchange for negotiable instruments. These instruments would call for fixed annual repayments, initially applied to interest and secondly to reduction of principal, as general obligations of the Fund, backed by an assignment.

At the time of joining the Fund, each member country would negotiate with the Fund the annual interest rate applicable against claims surrendered to the Fund. The difference between this rate and the commercial rate accrued by the banks would affect the number of years export proceeds would be so dedicated. Surrendered export proceeds would initially be directed to interest claims and then to the reduction of principal. It is suggested that the debtor countries would thus fix one variable for planning purposes - the interest rate - as long as they remain in good standing with the

Stabilisation Fund. Ogden also makes the suggestion, admitting that it is unrealistic, that shortfalls within the range of export proceeds could in part be made up by other member countries separately from the Fund agreement.

McNamar

Source: Remarks to 5th International Monetary & Trade Conference 5.12.83

Concept

McNamar suggests the implementation of a five-point strategy for what he terms as phase III of the ldc debt difficulties ("the time for an orderly work-out of the debt problems in the coming years") following phases I and II - the crisis mentality and a recognition of the need to take action by industrialised and developing countries alike.

He lists five criteria necessary for the "orderly work-out" without giving any detail of how they are to be achieved or maintained, and in fact he states little more than the obvious.

He goes on to list three major threats to resolving the problem as protectionism, a possible resurgence of high interest rates and potential oil price increases, and considers that protectionist policies by the industrialized nations are the most serious threat.

Mechanism

McNamar's five components of a successful recovery are as follows:

1 industrialised governments should adopt policies to sustain non-inflationery growth;

2 ldcs must be encouraged to follow sound economic policies to allow them to live within their resources;

3 the IMF and other international financial institutions must be strengthened to meet the growing needs of the system;

4 continued commercial bank lending must be encouraged; and

5 there must be continued willingness and capability to provide bridge financing where necessary.

McNamar merely encourages institutions to continue current policies rather than outlining an original approach. Under points 4 and 5 above for example, he states that new lending and refinancing through rollovers and extension of maturities must occur, and the BIS must continue to meets its challenge.

Roosa

Source - Ernest Sturc Memorial Lecture - Washington 2. 11.83

Concept

An extension of the role of the IMF is suggested, in dealing with banking syndicates faced with a succession of borrowing countries in distress. In addition to working with the indebted countries in developing economic programmes, Roosa suggests that the IMF should involve itself in the settling of financing terms - both for new credits and credit renewals.

Complementing this role of the IMF, the IBRD would work towards programmes aimed at longer-term structural adjustment (supported by the IFC in the case of the more advanced developing countries and by the IDA in countries qualifying for its concessionary assistance). Roosa favours extending the scope of cofinancing not only with banks, but also with other institutions more appropriate for long-term international commitments. He sees a parallel between an extension of the international institutions' powers in this way and the procedures developed in handling domestic indebtedness, in the case of Lockheed, Chrysler and International Harvester in the USA. If pursued alongside a strengthened policy of bank examination and supervisory procedures in the major lending countries, cumbersome mechanisms involving new institutions, are avoided.

Mechanism

The IMF programmes would include the following essentials, while varying in detail from country to country:

- a comprehensive programme, addressed both to the private sector and to government, combining corrective retrenchment with structural rehabilitation.

- an agreed grace period of several years for the payment of all principal due over those years and a rescheduling of future principal repayments to be determined towards the end of the grace period, and related to projections of future foreign exchnage earnings.

- reduction of interest rates on all new or renewed loans close to LIBOR, with provision for reductions to or below LIBOR at annual intervals in relation to success in meeting targets in the above-mentioned programme.

- participation in the programme for longer-term reconstruction by the IBRD, IFC or IDA. The World Bank group would serve as a catalyst for co-financing on terms consistent with the grace period and interest rate provisions of the IMF side of the programme.

- provision of short or medium-term credits from the IMF, and other sources, with funds released in accordance with progress towards agreed objectives.

It is envisaged that there would be terminal dates for any interest rate concessions and provision could also be made for supplemental "catch-up" payments as certain agreed benchmark points are reached in the recovery path.

Gill

Source - paper attached to letter to Mr R H Gilchrist 6. 1.84.

Concept

Gill proposes the establishment of national investment trusts in the form of closed end funds as a way of converting outstanding bank debt into equity. He suggests that these would provide a permanent pool of foreign savings with secondary market liquidity. Gill maintains foreign equity investment should not only be seen as a welcome source of long-term finance but also as preferable to direct investment because the equity investors would be passive and holding relatively small positions in the shares of any one company.

Mechanism

The funds could hold marketable equities, debt instruments or a combination of the two. If an external equity fund were to sell at or above net asset value foreign banks would have an incentive to convert loan claims into fund shares and subsequently onsell them for foreign exchange through a secondary market. There are two possible type of bond funds - external and domestic currency, but debt conversion via this route would imply significant book losses, which the commercial banks have not yet appeared willing to suffer in exchange for a reduction in their ldc loan exposure.

Lindbeck

Source - 'The International Economic Turmoil and the Developing World' 27. 1.84

Concept

Lindbeck proposes that existing commercial bank debt should be transformed into long-term bonds, possibly even consols, which could be sold through secondary markets. In order to sustain new capital flows it is suggested that the debtor nations should issue "priority bonds" approved by the IMF, possibly in cooperation with the World Bank. The idea would be to create a new debt instrument which could generate additional capital flows and attract new lenders, with less concentration than at present on the holdings of the claims.

Mechanism

It is envisaged that the national central bank, or some other public agency, of the creditor countries would offer to take up part of the bond issue of the existing consolidated debt - in order to limit the fall in market value of the claims. Lindbeck also suggests that existing lenders could hold the securities as long-term investments or sell them at a discount - thus realising the losses against which most European lenders have already made provision.

Guttentag and Herring

Source - "International Banking: Vulnerability and Crisis"
(summary by JSB - 13. 2.84)

Concept

The proposal aims to replace the present arrangements with a system designed to keep funds flowing in the short term and simultaneously introduce long-run structural reform. The latter would be engineered through the establishment of a reliable secondary market in all cross border lending - relying on a conduit role for the IMF, IBRD or some new entity by their buying loans, pooling them and selling participation interests in the pooled funds. It is suggested that the conduit might provide guarantees of some kind to the certificate holders.

Mechanism

Action intended to resolve the current crisis would include the raising of new money by the debtor nation through issues of marketable, floating rate, consol certificates to which previous debt would be subordinated. Issues would be approved by the IMF, which together with the IBRD, would acquire a portion. IMF control and surveillance would continue until the consols had been retired. It is also proposed that a large proportion of the old debt would be purchased by a sovereign entity of the borrower country (eg its central bank) which would issue a new floating rate consol certificate. The debt, currency by currency, would be homogenised and carry a single penalty spread, in order to reduce the liquidity burden while maintaining pressure on the real burden to encourage the debtor to clear the outstanding stock.

Kanitz

Source - 'A proposal for Renegotiating the Brazilian International Debt' October 1983

Concept

Kanitz sees the primary cause of Brazil's international debt problem as the indexing of creditor country inflation into international interest rates; he therefore proposes a system of lending based instead on real interest rates, which would maintain the purchasing power of principal, and make possible a build up of reserves. It is suggested that the scheme would help to calm the international financial market by stabilising interest rates and allowing room for growth by the developing countries.

Mechanism

To resolve the current financial impasse, Kanitz proposes the following seven-point agenda of international lending reforms:

(i) interest rates should not reflect international inflation, but debtor countries should pay real, rather than nominal, rates of the order of 2.5% to 3.5%;

(ii) this could create a form of real international prime rate, which would be welcome by investors, avoiding the extensive volatility of real interest rates over the past five decades (including negative rates at times - most recently in the late seventies);

(iii) as a result, the lender's principal would be assured against inflation - measured against some criterion such as the CPI of the lender country;

(iv) higher real interest rates should be paid for longer term loans, helping to revitalize the market in this area, which is now practically non-existent;

(v) spreads would be set at 20% of real interest rates which Kanitz considers to be "a just renumeration for the financial institutions involved";

(vi) borrower countries would commit themselves to achieving trade surpluses 50% greater than their interest payments under the new system and

(vii) would also pledge to safeguard reserves generated by these trade surpluses until they formed 20% of the debt, in order to restore confidence.

Following the implementation of these proposals, Kanitz suggests three further options to follow:

(i) a portion of debt could be liquidated;

(ii) the reserve - debt ratio could be raised further or;

(iii) the reserves could be used to attract additional loans - providing these remained below 20% of the reserves.

Griffiths

Source - 'Responsibility for Solving the Debt Crisis' 6.12.83

Concept

Griffiths believes that piecemeal solutions are preferable to global solutions, as the latter involve unacceptably high risks, political difficulties or an unrealistic burden of adjustment. He advocates the principles of minimal institutional change and, not surprisingly from his particular political standpoint, the use of free enterprise and the market economy.

Griffiths believes that responsibility for a solution must lie with all parties concerned - thus, in a combination of sound medium-term monetary policies by the developed countries, co-operation between the international financial organisations and the commercial banks and continuing adjustment policies by the ldcs.

Mechanism

High real growth in OECD countries is seen as a pre-requisite for improved conditions in the ldcs, but cannot usefully be achieved from a traditional fiscal boost. Griffiths suggests that the key to medium term stability is the pursuit of declining targets for monetary growth and public expenditure as a proportion of GNP, combined with an initiative aimed at reducing protectionism. The IMF should continue to play an important role in co-ordinating the management of international debt difficulties, but it would be unwise to increase the Fund's (or the IBRD's) powers permanently at the expense of individual nations.

The ldcs themselves need to change their development strategy to give higher priority to export growth, and seriously consider the possibility of exchanging debt for minority equity participation - overcoming political reluctance. The main responsibility of the banks is to continue the rescheduling process, but in a way which writes off amounts of ldc debt, so that book value approximates market value, and they should be prepared to hold equity in public sector ldc corporations in exchange for debt. Griffiths considers that central banks ought to encourage a secondary market in government guaranteed ldc debt, which would clarify the valuation of the loans and provide the banks with greater liquidity.

Wallich

Source - International Commercial Banking from a Central Bank viewpoint 29.12.83 FT 5.11.83

Concept

Wallich suggests a pooled insurance scheme to replace the implicit self-insurance undertaken by lenders at present, who charge a risk premium as part of the interest rate and set aside reserves. He states that pooled insurance, where it is possible, is clearly cheaper because it allows for better spreading of risks, but he does question whether it is applicable to the risk of ldc lending and if so, why the market has not already developed some sort of insurance scheme. To calculate an appropriate insurance premium for this type of risk, and to gather together the resources that would make the insurance credible, would not be an easy task.

Mechanism

Wallich proposes that the banks should resist pressure to lower interest rates charged to ldcs in difficulties and instead use part of their interest receipts to establish a common insurance scheme. He suggests that the banks could initially set aside one or two percentage points of their interest charged on new Third World loans. The resulting pool of funds would then be used to cover participating banks against loan losses on up to around 2% of their total portfolios - admittedly very limited, but exceeding the current average loan loss provision of 1.2% made by US banks.

De Vries

Source - International Ramifications of the External Debt Situation - November 1983; Dealing with External Debt - Long-term Finance for Restructuring the Debtor Economies - January 1984

Concept

De Vries considers the present problem to be one of liquidity. He believes in the underlying solvency of the ldcs, solvency which it is acknowledged is crucially dependent on a resumption of growth in the Third World, a quick reversal of the outward resource transfers now occuring and a halt to the spreading of protectionism. Besides aiming to restore the liquidity position of debtor countries, three additional areas need addressing: a policy of restructuring and encouragement of new investment in the debtor economies; the mobilisation of new long-term funds distinguished from short-term finance and the continued efficiency of the international financial system.

Mechanism

De Vries believes that action is needed to reduce short-term credits to more normal levels consistent with individual country requirements for trade finance. He does not rule out the possibility that in some countries part of the short-term debt may have to be consolidated into longer-term obligations.

The sharp rise in interest rates is seen as the most serious blow to the debt-servicing capacity of the ldcs and it is proposed that an analysis of interest rate levels compatible with the prospects of individual borrowing nations should be undertaken by the World Bank. It is suggested that a critical level of borrowing costs - related to growth and export capacity - can be worked out for each country and that any rise in interest rates above this will automatically be followed by an unsustainable burden of debt. The ceiling will vary from country to country, but for the majority real interest rates in excess of 3% are probably unmanageable and for poorer economies the critical level is probably much lower.

De Vries suggests that attention needs to turn to limiting the high premia charged over the basic lending rate and also to offering some form of compensation to be applied when rates exceed certain specified levels, through some mechanism like the IMF Compensatory Finance Facility. In order to limit costs, it would be necessary to limit compensation to loans related to either IMF programmes or development banks.

Soros i

Source - The International Debt Problem: Prescription 22. 3.84

Concept

Soros sees a need for a fundamental change to the present "collective" system of lending, which he feels is vulnerable to collapse because of its inflexibility on interest rate levels. A new source of credit is needed, in addition to interest rate relief, since for the latter alone to be effective, the reduction in interest rates would bankrupt the banks. Soros proposes consolidating the existing debt and establishing an international agency for future lending, funded by a sort of insurance premium charged on the consolidated debt. IMF members would need to provide guarantees initially, but it is intended that the scheme would eventually be self-financing and the guarantees would not be invoked.

Mechanism

Existing debt, including short-term trade finance, would be consolidated into long-term bonds. These would yield interest at LIBOR, but a substantial part of the interest would be witheld and paid to the new agency - the International Loan Assurance (ILA) - as a kind of insurance premium to be used to ensure a continuing flow of credit. The ILA's capital base would be provided by this premium income derived from the bonds. The ILA, working in close association with the IMF, would be a self-financing institution. It is envisaged that it would sell its own obligations to the public, achieving the necessary creditworthiness through the use of guarantees from the industrialised nations for its premium income. This premium would vary according to the viability of the country in question and to the banks' ability to absorb the loss of interest income from that country. Although the guarantee coverage would diminish, ILA paper would continue to be considered as a moral obligation of the governments which established it.

The bonds would be redeemable not at par, but at a discount corresponding to the reduction in current income embodied by the premium paid to ILA. To moderate the impact on the banks, the bonds would have lengthy maturities, of say 25 years, and the banks could write down the bonds to their redemption price during their lifetime. It is suggested that to counter the effect of banks carrying bonds in their balance sheets at a price substantially above the market value, central banks would have to agree to accept the bonds at their discount windows at book value. Discounting would be with recourse to the bondholders and as long as the banks could absorb a low annual average loss over the 25-year period, the central bank would itself suffer no loss. It is admitted that this would be a radical step for the central banks, but it is seen to be far less worrying that the current gap between the losses banks can absorb and the resource transfers the debtors are able - or willing - to sustain.

Soros ii

Source - Debt Reform Proposal: Summary May '84

Concept

Soros has refined his earlier ideas into a three-stage proposal which places a new body, the International Lending Agency (ILA) at the centre of an institutionalised system of lending. All outstanding loans - apart from trade credits and funds from specified international agencies - would be kept in place and be used as a source of funding for the ILA. The loans would be extended for an initial period (to be kept as short as possible, say 5 years) with interest rates pegged within a band of 10 to 12%. A premium charged on the extended loans would enable interst payments to be met and would avoid the need for additional provisions. Matching escrow accounts would be paid by the debtors backed by international guarantees. At the end of this period, it is envisaged that the ILA would be creditworthy without any guarantees and in the transitional stage these could be used to refinance the outstanding debt through long-term bonds of 8 to 12 years maturity. In the final stage, the insurance premium would be payable by the debtor countries and the ILA would be operating on a higher gearing.

Mechanism

The capital of the ILA would be derived from the premium accounts - annual payments by the holders of existing loans - and escrow accounts contributed by the debtors, applicable also to new loans. The escrow accounts could be counted as part of the borrowers' reserves, but would also be part of the ILA's assets. The accounts would be invested in loans to other countries and thus give borrowers a direct interest in the performance of other indebted nations. Premium and escrow account rates would be the same for every country. The ILA would also borrow in the international markets and issue short-term instruments. International guarantees would back the ILA's commitments - it is suggested that the IMF would make a contingent allocation of SDRs, with the approval of Congress. The ILA would be designed to be self-supporting. Aggregate lending limits would be established by the ILA, to ensure total debt remains within servicing capacity and the ILA would meet the aggregate limit if other sources fell short. It is envisaged that the ILA would deal mainly with highly indebted nations, which nevertheless have a viable long-term future as judged by the ILA. Other concessions by the lenders would be needed if the ILA were to lend to non-viable countries. The problem of fluctuating interest rates could be met by the establishment of an interest equalisation account to be debited (or credited) against the ILA's capital.

When the ILA was able to borrow in the markets without international guarantees and when the debtors were able to borrow at acceptable rates with an ILA guarantees, the transitional stage would begin. ILA-guaranteed long-term bonds would replace the existing debt, while premium and escrow account rates would be fixed on the basis of a particular borrower's performance. It is suggested that banks would pay an up-front lump payment after which all obligations would cease, but the banks' capital might need replenishing - an easier task than at present, as doubtful sovereign debt would have been removed from their balance sheets.

Keller

Source - The Latin American Debt Crisis, September 1983

Concept

Keller believes that the measures implemented to date have mistakenly been of a short-term nature and have only postponed the crisis, possibly to a stage where it is beyond salvage. A viable, long-term solution would have to envisage the rescheduling of the entire debt burden of the countries on a timescale that would allow both interest servicing and principal repayment from no more than 25-30% of conservatively estimated foreign exchange earnings. Such a time period would have to be at least 25 years and in some cases far longer.

Mechanism

It is envisaged that where interest payments alone exceed the amount of foreign exchange allotted for debt servicing, part of it would be capitalised or possibly written off. The sacrifice involved on the part of the creditors needs to be seen as preferable to the present practice of "gambling on risks which cannot be assessed". The timescale involved would mean that the scheme would be implemented within the existing institutional framework, but Keller believes that the IMF, if it is to be the agent for negotiating long-term solutions with the debtor nations, will need to be more sympathetic to the debtors' priorities and to take a more realistic attitude towards their capacity for adjustment.

Southeast Bank (Oakley Cheney/J Antonio Villamil)

Source - Debt Rescheduling (internal memo) 3. 7. 83

Concept

Southeast Bank believe that US regional banks are seriously frustrated by the lack of information and consultation they receive from the steering groups on sovereign rescheduling. In addition they feel that attitudes towards different debtor nations on the part of the banks could allow for a more flexible, country-by-country approach instead of a blanket repetition of the previous year's agreement. In particular, Southeast Bank feel that in some cases many regionals would be content to capitalise interest, receive interest in local currency or participate in a deposit scheme for some part of the interest, provided such a scheme resulted in their not having to advance new money in the future.

In the case of Brazil, it is suggested that many US regionals would be willing to follow a policy of interest rate relief and capitalisation or deferral of interest in order to allow the debtor to expand its export base, rather than servicing interest payments. Southeast Bank believe such an approach would possibly avoid the need for additional new money next year, encourage more non-US dollar foreign currency lending and more trade finance.

Mechanism

The following programme is proposed for Brazil and while it is recognised that some other countries would benefit from the scheme, it is felt that such a move should be limited.

- Trade credit should continue to be priced at "market" rates.
- Any short-term debt which is not clearly trade related should be converted to term debt.
- All term debt should be priced at LIBOR + 1% or the reserve adjusted CD rate in 1985, without US Prime Options.
- Interest paid to the banks would be at a 5% rate and the difference between 5% and the accrual rate would be deposited in the Central Bank. These deferred interest deposits would earn interest at LIBOR + 2% - to be paid quarterly. After 5 years, any balance remaining would convert to a term loan with a two or three year maturity.
- Prinicpal on the deposit accounts would have to be paid on the basis of an agreed formula, such as an amount equal to 50% of any balance of payments surplus.
- Any new money required would be provided on a voluntary basis if necessary by governments and/or official agencies.

-

Provost

Source - letter in 'Financial Times' 11. 5.84

Concept

Mr Provost believes that there is a need for the international banks to recognise the reality that the debtor nations cannot service their interest payments and that the only way out would be through a moratorium. This would be achieved by the provision of interest free loans to borrowers deemed to be creditworthy, financed by interest free deposits placed with the central banks - a "liquidity" requirement of say 5 or 10 per cent of gross deposits. This will have the effect of widening the spreads between the banks' borrowing and lending rates, and ultimately achieve a fairer distribution of burden-sharing.

(RS(A2)

ECLA

Source: "Towards More Equitable Renegotiations"

Concepts

ECLA's solution is presented within a scenario that assumes GDP growth for Latin American nations of 5% per annum in 1984-6 which they believe will necessitate rescheduling all amortisation payments and an average 80% of interest liabilities. It is felt that any rescheduling package should at a minimum cover the years 1984-6, although ideally a policy of restructuring the entire stock of debt owed to banks should be pursued. ECLA believes that it is essential to avoid the traumatic annual rescheduling exercises and, ideally, a debt relief package providing a once-and-for-all rescheduling is required. Such a package would be deesigned to coincide with the IMF's extended adjustment programmes, providing a continuation of the security afforded by Fund conditionality.

Mechanism

ECLA believe that creditors should provide guarantees to refinance 80% of interest payments, which would be conditional on compliance with IMF adjustment programmes. A sliding scale of the amount of interest payments to be refinanced could be considered: say 90% in 1984, 80% in 1985 and 70% in 1986, to take into account the possibility of a continuing improvement in the world economy and lower world interest rates.

The repayment terms would be 10-12 years, with a 6 year grace period, although ideally ECLA would prefer 15 years (6 years grace), with margins at LIBOR + 1%, or that originally contracted, whichever is the lower, and no commissions. A scheme may be devised whereby payment of commission could be agreed in exchange for further reduction in interest payments. It is further suggested that "if and when the world economy returns to a degree of stability", interest rates could be stabilised at 2% per annum real, with the balance being capitalised.

Colchester

Source - Financial Times 3. 5.84

Concept

It is suggested that relief is needed for selected international borrowers from fluctuations in US interest rates, to be afforded by the IMF along the lines of its special facilities to compensate for the effects of oil and commodity price changes on developing countries. The facility could be funded through normal IMF channels, but it is suggested that it would be more farsighted to extend such interest relief in the form of an IMF grant, to be financed from either sales of IMF gold or through an issue of Special Drawing Rights.

Mechanism

On condition that a country is engaged in an IMF programme, it would receive from the IMF on an annual basis compensation equal to its net floating rate dollar debt (loans less deposits) multiplied by the number of percentage points by which Libor exceeds a base level - of say 10% - over the year. In this way the borrower would be compensated for the actual impact on it of any rise in Libor over the base rate.

It would be necessary to alter the IMF articles in order to permit a selective issue of SDRs, but the sum involved would be less than the generalised annual issue of SDRs which has been called for elsewhere. If Libor were to average 15% over a twelve-month period (which is unlikely), then the facility would need to pay out $7.5 bn; ie 5% of the $150 bn total of floating rate debt owed by the forty countries with IMF agreements, compared to a $12 bn annual issue suggested by some developing countries and others, including France.

/my/

cc Sir P Middleton
Mr Littler
Mr Unwin
Mr Lankester
Mr Lavelle
Mr Mountfield
Mr Sedgwick
Mr C W Kelly
Mr Harrison

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

22 June 1984

G W Mackworth-Young Esq
23 Great Winchester Street
LONDON
EC2P 2AX

Dear Bill

Thank you for your letter of 1 June enclosing an updated version of our outline scheme for restructuring international debt.

A number of general schemes for international debt have been put forward, of which yours was one of the first. All involve protecting banks or debtors (or both) from the consequences of past action and a cost, or a potential one, to taxpayers in creditor countries. They would also cut across the existing arrangements for securing adjustment. The Treasury and Civil Service Select Committee, when it came down in its 1983 report on international debt against global schemes, made the point that were such schemes to be considered the process could actually discourage new money and the return to normality.

For my part I am not persuaded that we need a new global strategy. Nor were any of my colleagues when we discussed debt at the recent Economic Summit. Far better in my view to persist with the existing case-by-case strategy built around adjustment by debtors, a central role for the IMF, a limited continuing flow of new money and encouragement to the banks to ensure adequate provisioning. The existing strategy also to my mind has the merit of putting an appropriate responsibility for the response to the debt problem on the parties who contributed to it.

But I am conscious that this is a developing situation which needs to be kept regularly under review.

Yours
Nigel

NIGEL LAWSON

10 DOWNING STREET

Prime Minister ②

As expected LBI caved in when isolated, but they are aware of our disapproval. The fact that some of the loans will still be non-performing may be useful; it will help the markets come to terms gradually with what will be an increasing problem.

Attached is a telegram reporting more fully M. de Larosière's position.

AT

29/6

CONFIDENTIAL

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

Andrew Turnbull Esq
Private Secretary
10 Downing Street
SW1

29 June 1984

Dear Andrew

ARGENTINA

As I reported to you on the telephone, we heard this evening that LBI have now agreed to participate in the new Working Committee proposals summarised in my letter to you of yesterday evening.

Their decision follows intensive discussions between the banks and with the Fed during the day. We understand that the outcome of these was that, except for minor reservations by one or two of the other banks, all had agreed to accept the new proposals except LBI, who had up to then resisted the package in the light of the views the Bank, at our request, had expressed to them.

We were ourselves approached at senior official level by the US Treasury. They claimed that their own position was still neutral, but that they wanted to be sure that we were fully appraised of latest developments. They confirmed the details of the proposed arrangements to us, and explained that, even if the new payments were made today, US banks, under recently revised official guidance, would still be obliged to show losses in respect of loans to Argentina in their second quarter reports which will appear early next month. The effect of the new deal will be to reduce the extent of those losses.

We explained our reasons for disapproving of the deal and confirmed that we had conveyed these to LBI. We had made it clear that they would have to make their own commercial judgement, but that if they decided to accept the package, we should feel free if pressed to express criticism of it. Our view would be that it would have been better to follow the normal practice of linking such a package to negotiation of a satisfactory Fund programme.

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

Yours ever
David

D L C PERETZ
Principal Private Secretary

GR 650

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DESKBY 290800Z
FM UKDEL IMF/IBRD WASHINGTON 290322Z JUN 84
TO IMMEDIATE FCO
TELNO 132 OF 28 JUN

I M F: ARGENTINA.

1. IN A SEPARATE CONVERSATION TODAY AND IN A MEETING OF G5 EXECUTIVE DIRECTORS, THE MANAGING DIRECTOR GAVE THE FOLLOWING REPORT OF HIS DISCUSSIONS WITH GRINSPUN.

SUMMARY

2. NO PROGRESS ON SUBSTANCE. GRINSPUN HAS NOW RETURNED TO BUENOS AIRES TO CONSIDER HOW TO MEET THE FUND'S POSITION. FURTHER DISCUSSIONS ARE PLANNED FOR AROUND JULY 10. THE MD HAS SOME IMPRESSION OF A GREATER SENSE OF REALISM IN THE ARGENTINE TEAM.

DETAIL

3. THE MD SAID THAT HE HAD GIVEN GRINSPUN A LIST OF THE ISSUES ON WHICH THE FUND AND ARGENTINEAN POSITIONS DIFFERED. THE MAIN ELEMENTS IN THE LIST ARE AS FOLLOWS.

BUDGET

4. THE MD HAD TACKLED THE MOST DIFFICULT AREA OF BUDGET POLICY BY ASKING GRINSPUN FOR HIS VIEW ON THE LARGEST BUDGET DEFICIT COMPATIBLE WITH A SIGNIFICANT REDUCTION IN INFLATION OVER THE YEAR. GRINSPUN VOLUNTEERED THAT AN INITIAL INFLATION TARGET MIGHT BE 300 PERCENT COMPARED TO THE EXISTING 550 PERCENT. THE ARGENTINE ''LETTER OF INTENT'' WAS PREDICATED ON A BUDGET DEFICIT OF 8.8 PER CENT OF GNP THOUGH THE PRECISE MEASURES FOR ACHIEVING THIS HAD NOT BEEN DEFINED. THE MD THOUGHT THAT THE BUDGET DEFICIT OBJECTIVE SHOULD BE 7 1/2 PER CENT. HE HAD QUESTIONED THE AUTHORITIES' BUDGET STRATEGY WHICH AIMED AT REDUCING THE DEFICIT BY INCREASING REVENUES. MANY OF THE REVENUE INCREASES WOULD INCREASE PRICES. THIS WAS UNDESIRABLE IN VIEW OF THE FEEDBACK THROUGH THE WAGE INDEX SYSTEM ON WAGE LEVELS. THE MD HAD SUGGESTED BUDGET DEFICIT CUTS WOULD BE BETTER ACHIEVED BY EXPENDITURE REDUCTIONS. EXPENDITURE REDUCTIONS RAISED THE ISSUE OF WAGE INCREASES, SINCE WAGES WERE A LARGE PERCENTAGE OF PUBLIC EXPENDITURE.

BALANCE OF PAYMENTS

5. HERE THE MD EMPHASISED THE NEED FOR AGREEMENT ON A CURRENT ACCOUNT DEFICIT WHICH WAS FINANCEABLE. HE ALSO WANTED INFORMATION ABOUT THE SOURCES OF EXTERNAL FINANCE. ACTION WAS NEEDED TOO ON EXCHANGE RESTRICTIONS AND ON THE EXCHANGE RATE.

CONFIDENTIAL

/MONETARY

MONETARY POLICY

6. THE ARGENTINEANS WERE ARGUING THAT THE DEMAND FOR REAL MONEY BALANCES WOULD INCREASE AS INFLATION FELL AND THAT THIS WOULD MOP UP LIQUIDITY. FUND EXPERIENCE SUGGESTED SOME SCEPTICISM HERE, THOUGH THE MD EMPHASISED THIS DIFFERENCE OF VIEW WAS NOT GREAT. THERE NEEDED TO BE UNDERSTANDINGS OF A MORE ACTIVE INTEREST RATE POLICY.

DESIGN OF THE PROGRAM

7. THE ARGENTINEANS HAD ASKED THAT PERFORMANCE CRITERIA SHOULD BE EXPRESSED AS A PERCENTAGE OF GDP RATHER THAN AS ABSOLUTE NUMBERS. THE MD COULD NOT ACCEPT THIS.

8. GRINSPUN HAD UNDERTAKEN TO STUDY THESE ISSUES WITH HIS AUTHORITIES AND RETURN TO WASHINGTON ABOUT JULY 10.

TALKS WITH BANKERS

9. EARLIER THE MD HAD TOLD ME THAT HE HAD NOT TOLD THE BANKERS' ADVISORY COMMITTEE THAT HE ''APPROVED'' THE EXTENSION OF THEIR LOAN. HE HAD RESISTED THEIR PRESSURE TO GIVE A VIEW. INSTEAD, HE HAD DECIDED TO RETAIN HIS CREDIBILITY BY TELLING THEM THE TRUTH. THIS WAS THAT HE HAD HAD EXTENSIVE DISCUSSIONS WITH THE ARGENTINEANS ON ALL ELEMENTS OF AN ADJUSTMENT PROGRAM: THE ATMOSPHERE HAD BEEN FRANK AND CORDIAL: THE DISCUSSIONS HAD BEEN POSITIVE IN THAT PROGRESS HAD BEEN MADE IN ''DEFINING THE ISSUES'' (THE MD EMPHASISED THAT THIS CAREFUL DRAFTING HAD NOT REFERRED TO PROGRESS ON SUBSTANCE): FURTHER DISCUSSIONS WERE NECESSARY AND WERE PLANNED: HE WOULD NOT SPECULATE ON THE TIMETABLE: AND A LOT OF WORK NEEDED TO BE DONE AND POLICY DECISIONS TAKEN.

10. THE MD EMPHASISED TO ME HIS NEUTRALITY IN THE BANKERS' DISCUSSIONS WITH THE ARGENTINEANS. HE COULD LIVE WITH THEIR PROPOSAL BUT IT WAS THEIR DEAL.

11. SUMMING UP HIS DISCUSSIONS, THE MD SAID THESE DISCUSSIONS WITH GRINSPUN GAVE HIM THE IMPRESION, BUT NO MORE, THAT THE ARGENTINE AUTHORITIES HAD A GREATER SENSE OF REALISM. BUT THIS COULD NOT YET BE COUNTED ON. HE CERTAINLY COULD NOT SAY THAT A ''LETTER OF INTENT'' WOULD BE SIGNED BY AUGUST 15, THE DATE REFERRED TO IN THE PROPOSED UNDERSTANDING BETWEEN THE BANKERS AND ARGENTINA.

12. FCO PLEASE ADVANCE TO UNWIN AND MOUNTFIELD (TREASURY), TAIT (ERD) AND LOEHNIS AND GILCHRIST (BANK OF ENGLAND).

WICKS

(ADVANCED AS REQUESTED)

MONETARY
FID

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ADVANCE ADDRESSEES.

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GRS 170
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FM UKDEL IMF/IBRD WASHINGTON 271505Z JUN 84
TO IMMEDIATE FCO
TELEGRAM NUMBER 130 OF 27 JUNE

MY TELNO 129 OF 25 JUNE : IMF AND ARGENTINA

1. THE MANAGING DIRECTOR'S DISCUSSION YESTERDAY WITH GRINSPUN MADE LITTLE PROGRESS. THE MD DESCRIBED TO GRINSPUN, IN EMPHATIC TERMS, THE POLICY GAP BETWEEN THE ARGENTINES' QUOTE LETTER OF INTENT UNQUOTE AND THE ADJUSTMENT POLICY WHICH FUND MANAGEMENT BELIEVED NECESSARY. TO THAT EXTENT THE ISSUES AT STAKE ARE NOW BETTER DEFINED. THE MD WILL SEE GRINSPUN AGAIN THIS (WEDNESDAY) AFTERNOON AND PERHAPS TOMORROW AS WELL. THERE IS NO EXPECTATION HERE THAT ANYTHING CONCRETE WILL EMERGE.

2. THE MD IS CONTINUING TO MAINTAIN NEUTRALITY IN THE BANKS' DISCUSSIONS WITH THE ARGENTINES, DESPITE PRESSURE FROM CITIBANK'S RHODES, CHAIRMAN OF THE ADVISORY COMMITTEE, TO GIVE HIS VIEW ON WHETHER BANKS SHOULD DISBURSE THE LOAN BEFORE THE END OF THE MONTH. FUND SOURCES TELL ME THAT THE BANKS ARE MAINTAINING THE HARD LINE WITH GRINSPUN THAT MORE ARGENTINE FOREIGN EXCHANGE RESERVES MUST BE USED TO HELP CLEAR ARREARS.

3. FCO PLEASE ADVANCE TO UNWIN AND MOUNTFIELD (TREASURY), TAIT (ERD) AND LOEHNIS AND GILCHRIST (BANK).

WICKS

MONETARY
FID
PS
MR D. THOMAS

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ADVANCE ADDRESSEES.

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10 DOWNING STREET

From the Private Secretary

29 June 1984

ARGENTINA

The Prime Minister saw your letter to me of 28 June. She was disturbed to learn that, with the encouragement of the Fed, the banks' Working Committee was considering making available new funds without a satisfactory IMF agreement. She has commented that if the release of new funds is not made conditional upon agreement with the IMF the borrowers are controlling the lenders and will continue to do so. She agrees, therefore, that LBI should be pressed to resist vigorously and that if, in the last resort, they do decide to participate, they must be aware that the Government might make public its disapproval.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office) and John Barlett (Bank of England).

(ANDREW TURNBULL)

David Peretz, Esq.,
H.M. Treasury.

PRIME MINISTER

I have spoken to Andrew Turnbull and these are his comments:-

This comes as no surprise. It was too much to hope that the resolve of the US authorities to make new money, conditional on agreement with the IMF, would hold firm as the end quarter for the Banks approached. It is a pity that the fund is not defending its interests more vigorously. It seems likely, in the end, that LBI will join the package, as not to do so may lose them a position of influence on the Banks' Argentina Committee.

Agree:

(i) We continue to press LBI to resist. - Yes resist vigorously

(ii) If LBI do participate, we take the line suggested by the Chancellor.

The release of new funds must be tied to a satisfactory IMF agreement. Otherwise the borrowers are controlling the lenders & will continue to do so. MT.

SH.

Duty Clerk
28 June, 1984

3.15

CONFIDENTIAL

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

28 June 1984

Andrew Turnbull Esq
10 Downing Street

Dear Andrew

ARGENTINA

There have been developments this evening on the bank loans to Argentina which you will wish to draw to the Prime Minister's attention.

In brief, a new proposal has come forward from the banks' Working Committee, with the strong backing of the Fed. The main elements in this are:-

(i) Argentina releases some $350 million to pay off interest arrears due to the banks up to 2 April;

(ii) the 11 Working Committee banks (including LBI) agree to:-

(a) roll over existing $750 million and $100 million bridging loans to 15 and 30 September respectively;

(b) make available tomorrow a new loan of $125 million which would be repaid by the Argentines on 15 August if no Letter of Intent with the Fund had been agreed by then; or on 30 September if a Letter had been agreed;

(iii) the 4 Latin American governments would agree to roll over their end March loan of $300 million until 31 July.

It was claimed that the Managing Director of the Fund approved the proposals, on the basis that they would give a further incentive to the Argentines to reach agreement with the Fund. We understand, however, from Nigel Wicks, who has spoken to him this evening, that the Managing Director is maintaining a studiously neutral position. He has told the banks that he has had extensive discussions with the Argentines on an adjustment programme "in a frank and cordial atmosphere". The discussions were "positive in defining the issues", and further discussions will take place in due course. But, although he had "no hostility" to the proposals, it was "up to the banks themselves to decide what to do".

The proposals would not increase the banks' total exposure in Argentina, and would secure an immediate release of funds from the Argentines' reserves. But the Chancellor does not think they should be accepted. There is still no evidence of progress in the negotiations with the Fund on a new programme; nor is it clear that the Argentines need new funds. There is no reason why they should not dip further into their own reserves. To agree to this package and to abandon the previous linkage of new money to agreement on a Letter of Intent approved by the Managing Director would be a further erosion of the banks' and, we believe, the Fund's negotiating position with Argentina.

We have, therefore, through the Bank of England conveyed these views to LBI and made it clear that we do not think these proposals should be accepted and hope that they will decide not to participate in them.

LBI, who have been taking a very robust position in the Working Committee on the need to link provision of new money strictly to an agreed Letter of Intent, are now consulting the other banks. Although they have indicated that they might not find it possible to hold out in the last analysis if they are isolated, they have agreed to make a further effort to persuade some of the other banks to stick to their previous position. If they were unsuccessful, and the proposals did in the end go forward, we should certainly need, as before, to make it clear as necessary that our view remains that the release of new funds should be tied to agreement on a satisfactory Fund programme.

We will, of course, keep you in touch with any further developments.

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

Yours ever
David

D L C PERETZ

 1 CP 2. Prime Minister
To note
AT 22/6

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

22 June 1984

Andrew Turnbull Esq
No 10 Downing Street
LONDON SW1

Dear Andrew

ARGENTINA

The Prime Minister may like to have the following summary of latest developments on Argentina, particularly in view of the French role (see below) and the possibility that President Mitterand may refer to this at Fontainebleau.

The French Treasury telephoned us this afternoon with a confidential account of the visit made to Argentina earlier this week, at the request of de Larosiere, by M Camdessus, the Director General of the French Treasury and Chairman of the Paris Club. Camdessus had lengthy discussions with both Alfonsin and senior Argentine Ministers, and reports that in his view the Argentines are now willing to negotiate more seriously and accept a proper adjustment programme. He believes he persuaded Alfonsin to accept a number of specific new policy changes. These include positive real interest rates, devaluation of the peso, and further expenditure cuts, including a specific programme of reductions in military spending. These measures would be included in a new Letter of Intent which Grinspun will visit Washington to discuss on Monday. The Letter would apparently contain no explicit reference to salary reductions, but be drafted in terms that left open the possibility of a period of negative real growth in the immediate future. Alfonsin himself has already included in a speech to Argentine Parliament a reference, agreed with Camdessus, to the need for a return to a period of austerity.

Camdessus, who will be reporting the outcome of his visit directly to de Larosiere, is a good deal more optimistic than before and thinks there is a genuine possibility of agreement with the Fund. The French have so far taken a line very close to ours on the need for agreement with the Fund on a tough adjustment programme as a pre-condition of any further financial assistance, which adds some credence to Camdessus' assessment.

It accords also with our latest reports from the US Treasury. They told us yesterday that, following their decision last week not to renew their guarantee of the Latin American loan, and the announcement this week by the US Regulatory Authorities of tougher interpretation of the US Accounting rules for bank treatment of "non-performing loans", the Argentines are now beginning to adopt a more sensible and realistic approach. But given previous events, the Chancellor thinks that we must suspend judgement on all this until we see the terms of the proposed Argentine Letter.

There have been no further significant developments on the negotiations between the Argentines and the commercial banks. The latter are to meet again in New York next Monday, but as we understand it, they are still sticking firmly to the position that any further release of funds remains contingent on signature of a satisfactory Letter of Intent commended by the Fund's Managing Director.

It is worth mentioning briefly also that first reports from the current Latin American Debt conference at Cartagena seem encouraging. We have not yet seen a communique, but on present information it seems unlikely to contain any extreme resolutions or demands. There seems to be no disposition to set up a debtors club, but rather to concentrate attention on what they see as the positive aspects of the London Summit communique.

I am copying this letter to Len Appleyard (FCO), Callum McCarthy (DTI) and John Bartlett (Bank of England).

Yours ever

David

D L C Peretz

GR 550

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AMENDED DISTRIBUTION 20 JUNE 1984

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FM PARIS 191810Z JUN 84
TO IMMEDIATE F C O
TELEGRAM NUMBER 767 OF 19 JUNE
INFO SAVING WASHINGTON, UKDEL NATO, BONN.

FROM PS/LADY YOUNG

LADY YOUNG'S VISIT TO PARIS: MEETING WITH M. GUTMANN.

1. LADY YOUNG HAD 45 MINUTES THIS AFTERNOON WITH GUTMANN (SECRETARY GENERAL AT THE QUAI). THE MAIN POINTS WERE AS FOLLOWS:

LATIN AMERICAN DEBT

2. GUTMANN SAID THAT MITTERRAND INTENDED TO REPLY TO THE LETTER HE HAD RECEIVED BEFORE THE ECONOMIC SUMMIT FROM SEVEN LATIN AMERICAN HEADS OF GOVERNMENT AFTER THE MEETING OF THEIR FOREIGN AND FINANCE MINISTERS IN CARTHAGENA. IT WAS CLEAR THAT THE LATIN AMERICANS HAD BEEN SOMEWHAT DISAPPOINTED BY THE PASSAGE ON DEBT IN THE SUMMIT COMMUNIQUE BUT THEY HAD DONE THE SUMMIT PARTICIPANTS A FAVOUR BY MAKING THEM FOCUS ON THE PROBLEMS CAUSED BY HIGH INTEREST RATES. THE DEBT PROBLEM WAS A SERIOUS ONE AND HE HOPED THAT IT WOULD BE TACKLED AS SUCH. GENERALISED REMEDIES WERE NOT THE ANSWER AND HE WAS NOT CONVINCED THAT UNILATERAL MEASURES SUCH AS THE RECENT ARGENTINE LETTER OF INTENT WERE THE BEST WAY OF PROCEEDING. LADY YOUNG AGREED BUT EMPHASISED THAT SOME ELEMENTS IN THE LONDON COMMUNIQUE SHOULD BE HELPFUL TO DEBTOR COUNTRIES.

ARGENTINA

3. LADY YOUNG DREW ATTENTION TO OUR CONCERN AT THE RECENT DELIVERY OF EXOCETS. GUTMANN SAID THAT THE FRENCH AUTHORITIES WERE WELL AWARE OF THIS QUESTION AND OF ITS POLITICAL AND PSCHYCOLOGICAL IMPORTANCE TO THE UK. THEY HAD TRIED TO DELAY THE EXCUTION OF EXISTING CONTRACTS AND TO PUT THE BRAKES ON NEW ONES. THEY WOULD LOOK AT THE QUESTION OF FUTURE ARMS SALES IN THE LIGHT OF THE PM'S REMARKS TO PRESIDENT MITTERRAND AT THE ECONOMIC SUMMIT. BUT GIVEN ARGENTINAS ECONOMIC PROBLEMS IT WAS UNLIKELY THAT THEY WOULD DEVOTE MUCH PRIORITY TO BUYING ARMS. NO FRENCH CREDIT WAS AVAILABLE FOR THIS PURPOSE. !

WEU

4. GUTMANN SAID THAT THE FRENCH HAD NO INTENTION OF MAKING WEU INTO ANY KIND OF EUROPEAN DEFENCE COMMUNITY. THE ORGANISATION COULD BE USEFUL IN ENABLING ITS MEMBERS TO DISCUSS DEFENCE QUESTIONS AND ARMS COOPERATION. THIS WOULD NOT PREVENT OTHER AGENCIES FROM CONTINUING THEIR WORK. THE FRENCH GOVERNMENT HAD NOT, HOWEVER, UNDERTAKEN A GRAND INITIATIVE AND THE IMPORTANCE OF THEIR IDEAS SHOULD NOT BE OVER OR UNDER-RATED. THEY INTENDED TO PROCEED PRAGMATICALLY AND TO DO NOTHING DRAMATIC.

20.

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NO PASSPORT EXCURSIONS

5. LADY YOUNG SAID THAT WE VERY MUCH HOPED THAT GUTMANN COULD AGREE TO AN EARLY MEETING WITH MR WHITNEY TO DISCUSS NEW PROPOSALS WHICH MIGHT ENABLE THE EXISTING ARRANGEMENTS TO CONTINUE (YOUR TELNO 460). GUTMANN READILY AGREED AND SAID THAT, SUBJECT TO THE AVAILABILITY OF THE APPROPRIATE OFFICIALS FROM THE MINISTRY OF THE INTERIOR, HE WOULD BE HAPPY TO OFFER TALKS AND A WORKING LUNCH ON 28 JUNE (GUTMANN'S OFFICE HAD EARLIER TOLD THE EMBASSY THAT 22 JUNE WAS A POSSIBILITY: THE EMBASSY ARE SEEKING CLARIFICATION). IT WOULD BE HELPFUL TO RECEIVE BEFORE THEN AN INDICATION OF WHAT OUR PROPOSALS MIGHT CONTAIN. HE WARNED HOWEVER, THAT IT WOULD BE WRONG TO HOLD OUT MUCH HOPE OF A POSTPONEMENT OF THE TERMINATION OF THE EXISTING ARRANGEMENTS AND QUESTIONED THE ADVISABILITY OF INCLUDING IN THE DELEGATION A REPRESENTATIVE OF THE GENERAL COUNCIL OF BRITISH SHIPPING. HE HOPED THAT THIS WAS A SERIOUS ATTEMPT TO REACH AGREEMENT AND NOT MERELY DESIGNED TO BUY TIME FOR THE PRESENT ARRANGEMENTS. LADY YOUNG EMPHASISED OUR DESIRE TO RESOLVE THE MATTER SATISFACTORILY AND UNDERTOOK TO REFLECT ON THE OTHER POINTS GUTMANN HAD RAISED.

F C O PLEASE PASS SAVING ADDRESSEES.

FRETWELL

STANDARD (PALACE) / MONETARY
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NOTE FOR THE RECORD

Argentina

Judith Simpson from the Treasury rang me over the weekend to provide a further report on the banks' negotiations with Argentina. The banks have agreed to take a tough line and to offer Argentina two alternatives:

i) They would keep on the table the three-part programme put forward a few weeks ago involving a letter of intent, some new loans from the banks, and a contribution from Argentina's own reserves. This offer would remain open until 28 June, provided that Argentina agreed a letter of intent with the IMF and provided $100 million from the reserves as a contribution towards interest arrears.

ii) If Argentina could not settle this by 28 June the banks would keep open an alternative offer until 31 July. This would also involve agreement on a letter of intent but in order to keep this option open Argentina would be required to contribute $350 million from it reserves by 28 June.

Finance Minister Grinspun did not react favourably to these offers but is considering them and is likely to give his reaction during the course of this week.

AT

ANDREW TURNBULL
18 June, 1984

GRS 700
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DESKBY 160800Z
FM UKDEL IMF/IBRD WASHINGTON 160005Z JUN 84
TO IMMEDIATE FCO
TELEGRAM NUMBER 122 OF 15 JUNE

mr

IMF: ARGENTINA

SUMMARY.

1. THE MANAGING DIRECTOR REPORTED THAT THERE WAS A WIDE GAP BETWEEN THE ARGENTINE AUTHORITIES AND THE FUND MANAGEMENT ON THE FUNDAMENTALS OF AN ECONOMIC ADJUSTMENT PROGRAM. A TECHNICAL MISSION WOULD VISIT WASHINGTON NEXT WEEK. SERIOUS NEGOTIATIONS WERE NOT EXPECTED BUT DOORS HAD NOT BEEN CLOSED FOR FUTURE DISCUSSIONS.

DETAIL.

2. THE MANAGING DIRECTOR WARNED DIRECTORS NOT TO UNDERESTIMATE THE THREE SIGNIFICANT AREAS OF DIFFERENCE BETWEEN THE FUND MANAGEMENT AND THE AUTHORITIES. FIRST, INFLATION HAD TO BE REDUCED FROM ITS PRESENT RATE OF 550 PER CENT A YEAR IF A FIRMLY-BASED ADJUSTMENT PROGRAM WAS TO BE ESTABLISHED. BUT THE MEASURES WHICH THE ARGENTINE AUTHORITIES WERE PROPOSING WOULD NOT REDUCE INFLATION AND MIGHT EVEN EXACERBATE IT. SECOND, A PROGRAM SHOULD AIM TO REDUCE THE BALANCE OF PAYMENTS DEFICIT AND SO MODERATE THE RISE IN INDEBTEDNESS. BUT THE ARGENTINEANS COULD NOT ACCEPT THE NECESSARY POLICIES. THIRD, THERE WAS NO RECOGNITION THAT RELATIVE PRICES NEEDED TO BE ADJUSTED SO AS TO BRING THE ECONOMY INTO THE BETTER BALANCE WHICH COULD GENERATE MORE EXPORTS.

3. SINCE THERE WAS NO AGREEMENT ON THESE THREE FUNDAMENTAL OBJECTIVES
,
THE FUND COULD NOT DISCUSS DETAILS OF FISCAL, MONETARY, EXCHANGE RATE AND PRICING AND WAGE POLICIES. THE MANAGING DIRECTOR OBSERVED THAT DIFFERENCES WITH MEMBER COUNTRIES ON ADJUSTMENT HAD USUALLY CENTRED ON THE TIMING OF THE IMPLEMENTATION OF THE NECESSARY MEASURES
.
IN THIS CASE, ALMOST UNIQUELY IN HIS EXPERIENCE, THE DIFFERENCE WAS ABOUT THE BASIC APPROACH. HE HAD TOLD THE ARGENTINE AUTHORITIES THAT WHILE SUCH DIFFERENCES EXISTED, HE COULD NOT PROPOSE A PROGRAM TO THE BOARD.

4. THE MANAGING DIRECTOR SAID THAT ONE FAVOURABLE ELEMENT WAS ARGENTINA'S CLEAR WISH FOR NEGOTIATIONS TO CONTINUE. A TECHNICAL MISSION WOULD THEREFORE VISIT WASHINGTON ON WEDNESDAY, JUNE 20. MINISTER GRINSPUN MIGHT COME AT A LATER STAGE THOUGH NO DATE HAD BEEN ARRANGED. THE MD SAID THAT THE PRESENT PLAN WOULD BE TO CIRCULATE AN ARTICLE IV PAPER NEXT MONTH FOR DISCUSSION IN LATE AUGUST.

5. THE MANAGING DIRECTOR REFERRED QUESTIONS ABOUT THE BANKS' REACTIONS TO THE BANKS.

6. WIESNER (DIRECTOR, WESTERN HEMISPHERE DEPARTMENT), WHO HAD LED THE RECENT IMF MISSION, SAID THAT THERE WAS A WIDE GAP BETWEEN THE FUND STAFF AND THE ARGENTINE AUTHORITIES ON THE OBJECTIVE FOR

FUTURE FISCAL DEFICITS, ON THE PATH FOR REDUCING INFLATION AND ON THE FINANCING OF THE BALANCE OF PAYMENTS. THE AUTHORITIES WANTED TARGETS IN THE LETTER OF INTENT'S PERFORMANCE CRITERIA EXPRESSED IN TERMS OF PERCENTAGE INCREASES, RATHER THAN IN ABSOLUTE AMOUNTS. THIS WAS UNACCEPTABLE. THE PATH FOR THE REAL WAGE INCREASE WAS NOT AN ISSUE IN ITSELF, BUT POLICY ON WAGES INEVITABLY PERMEATED THE ECONOMY'S PERFORMANCE GENERALLY. DISCUSSIONS HAD BEEN FRANK AND COURTEOUS. BUT THERE WAS NO AGREEMENT ON THE STRATEGY, MAINLY BECAUSE THE ARGENTINE AUTHORITIES SEEMED TO HAVE A DIFFERENT CONCEPTION OF ECONOMIC POLICY TO THE FUND'S. THERE WAS NO INCLINATION TO TAKE THE NECESSARY POLITICAL DECISIONS. WIESNER HAD MET PRESIDENT ALFONSIN TWICE WHEN DISCUSSION HAD FOCUSED ON THE IMPACT ON THE FISCAL DEFICIT OF THE AUTHORITIES' COMMITMENT TO INCREASE REAL WAGES BY 6-8 PERCENT. THE PRESIDENT HAD REFUSED TO RESCIND THAT COMMITMENT AND APPEARED WILLING TO PROCEED WITHOUT AGREEMENT WITH THE IMF. WIESNER HAD EXPLAINED THAT IT WAS IMPOSSIBLE TO SIMPLY INCREASE REAL WAGES BY DECREE. THE INCREASE HAD TO BE EARNED. THE ARGENTINE AUTHORITIES REJECTED THAT ARGUMENT AND THE EARLIER HISTORY OF THEIR OWN COUNTRY AND OF OTHERS AS IRRELEVANT TO THE ARGENTINE SITUATION. LATER IN THE DISCUSSION, MY (CAMBRIDGE-EDUCATED) CHINESE COLLEAGUE ASKED FOR AN EXPLANATION OF THE OTHER SECTORS IN THE ECONOMY WHICH WOULD LOSE REAL INCOME IF REAL WAGES WERE PERMITTED TO RISE BY 6-8 PERCENT. THE STAFF'S REPLY WAS THAT THE ARGENTINEANS EXPECTED THAT PROFITS WOULD BE SQUEEZED. BUT IN FACT, PROFITS IN MANY INDUSTRIES WERE ALREADY LOW AND NEEDED INCREASING IF THE COUNTRY'S PRODUCTIVE CAPACITY WAS TO BE SUSTAINED.

ASSESSMENT

7. THE MANAGING DIRECTOR SEEMED COMMENDABLY RESOLUTE AND NO DIRECTOR QUESTIONED HIS APPROACH. HE IS ANXIOUS NOT TO SLAM THE DOOR ON FUTURE NEGOTIATIONS.

8. YOU MAY WISH TO CONSIDER WHETHER I SHOULD TELL THE MD THAT HE WOULD HAVE OUR STRONG SUPPORT IN INSISTING ON A PROPERLY ROBUST PROGRAMME.

9. FCO PLEASE ADVANCE TO PS/PRIME MINISTER, PS/SECRETARY OF STATE, PS/CHANCELLOR OF THE EXCHEQUER, LITTLER, UNWIN, AND MOUNTFIELD (TREASURY), LOEHNIS AND GILCHRIST (BANK OF ENGLAND), AND TAIT (ERD).

WICKS

[ADVANCED AS REQUESTED]

MONETARY

FID
PS
MR D THOMAS

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PS/CHANCELLOR)
MR LITTLER)
MR UNWIN) TREASURY
MR MOUNTFIELD)

MR LOEHNIS)
MR GILCHRIST) BANK OF ENGLAND

CONFIDENTIAL

ccNO.

Prime Minister (2)
To note, X in particular.
AT
15/6

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

15 June 1984

Andrew Turnbull Esq
10 Downing Street

Dear Andrew,

ARGENTINA

This letter reports the latest developments on Argentina, of which the Prime Minister may wish to be aware.

The IMF Board will meet later today (Washington time) to hear a report from the Managing Director on the Letter of Intent which, as you know, the Argentines have submitted direct to the Board. We understand that his first reaction, like ours, is that it is unacceptable. Among a number of unsatisfactory features it still, as widely reported in the press, envisages substantial real wage increases, which the Fund could not possibly endorse.

The Managing Director has already told the Argentines his reactions, but has indicated a willingness to help keep negotiations open (there may be resumption of work by an IMF technical mission early next week). He is not, however, hopeful of any early resolution of the problem, given the need for a substantial change in Argentine attitudes.

We have also been informed this afternoon by the US Treasury that they will be announcing later today that they will not renew their guarantee of the end-March loan by the four Latin American Governments (which expires today). The decision has been referred to the President himself and although there is still concern about the impact of the announcement, the US Administration have decided that it is unacceptable to be strung along by the Argentines any further. The press notice announcing the decision will, however, be emoliient, and indicate willingness to consider any request for further bridging aid, provided the Argentines make progress with the Fund. Secretary Regan will also be in touch personally in the course of today with the four Latin American Governments concerned.

X We have told the US Treasury that we think their decision absolutely right and that for our part we have made it clear to the British banks involved that we would strongly deprecate the release of any further funds to Argentina unless genuine progress is made in the negotiations with the Fund. The Working Committee of the principal banks is in fact also due to meet in New York later today, but in the circumstances we would not expect them to take any new decisions.

I am copying this letter to Len Appleyard at the FCO and John Bartlett at the Bank of England.

Yours ever,

Judith

MISS J C SIMPSON
Private Secretary

15 JUN 1984

Debt file 47

13 June 1984

MEETING WITH GORDON RICHARDSON, FORMER GOVERNOR OF THE BANK OF ENGLAND

I bumped into Gordon Richardson and heard his views on the international debt situation.

He is an enthusiastic supporter of the step-by-step approach and is a critic of any grand scheme for alleviating the burden.

He believes that the case-by-case approach will at times have to demonstrate more "flexibility", but accepts that this flexibility or generosity should only be demonstrated as and when the countries take strides towards adjusting their internal economies.

He believes it is important to go on monitoring the political and social state of the debtor countries on a case-by-case basis, and to reconsider action on any one if dangerous warning signs appear.

His best proposition was that it is at the very point where the case-by-case approach is beginning to work, but where people are becoming bored by it, that the dangers lie, as it is then that people will argue most persuasively in favour of a more whole-hearted or planned approach which could be disastrous.

JR

J.R.

LAUABH

International Debt

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DESKBY 130800Z
FM WASHINGTON 130100Z JUN 84
TO IMMEDIATE FCO
TELEGRAM NUMBER 1848 OF 12 JUNE

ARGENTINA AND THE IMF

SUMMARY

1. THE US TREASURY, STATE DEPARTMENT, AND THE FEDERAL RESERVE ARE TRYING THEIR BEST TO BE OPTIMISTIC ABOUT THE ARGENTINE GOVERNMENT'S INTENTION TO PRESENT THEIR OWN ''LETTER OF INTENT'' TO THE IMF. BUT THEY ACCEPT THAT THE WEEKEND'S EVENTS IN ARGENTINE REPRESENT A REAL SETBACK. THEY EMPHASISE THAT THE WAY IS STILL OPEN FOR DISCUSSIONS TO CONTINUE BETWEEN THE FUND AND THE AUTHORITIES.

DETAIL

2. MULFORD (ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, US TREASURY) EMPHASISED THAT NOTHING HAD BEEN SAID WHICH WOULD PREVENT FURTHER DISCUSSIONS AND NEGOTIATIONS BETWEEN FUND STAFF AND THE AUTHORITIES. THERE HAD BEEN ENORMOUS PROGRESS, IN HIS VIEW, IN THE LAST FIFTEEN DAYS IN ACHIEVING THE POLITICAL CONSENSUS BETWEEN THE ARGENTINE POLITICAL PARTIES ABOUT ECONOMIC REFORM. FROM HIS OWN TALKS WITH PRESIDENT ALFONSIN HE WAS CONVINCED THAT THE PRESIDENT WANTED AN IMF PROGRAM AND KNEW THAT THERE WAS NO ALTERNATIVE TO ONE IF HIS COUNTRY'S DEBTS WERE TO BE REFINANCED.

3. MULFORD ADMITTED THAT EVENTS OVER THE WEEKEND AND THE PUBLICATION OF THE SO-CALLED LETTER OF INTENT RAISED DIFFICULTIES. PRESIDENT ALFONSIN HAD PUT HIMSELF INTO A TIMETABLE BOX BECAUSE OF HIS DEPARTURE FOR SPAIN. MULFORD EMPHASISED THAT THE PUBLICATION OF THE LETTER OF INTENT NEEDED TO BE VIEWED AGAINST THE ARGENTINE LOCAL POLITICAL CIRCUMSTANCES. IT WAS OF PARAMOUNT IMPORTANCE FOR THE GOVERNMENT TO BE ABLE TO DEMONSTRATE TO THEIR OWN PEOPLE THAT ANY ECONOMIC AUSTERITY PROGRAM ADOPTED WAS THEIR OWN (UNDERLINE LAST WORD) PROGRAMME, AND NOT ONE FOISTED UPON THEM FROM OUTSIDE. IT REMAINED TO BE SEEN WHETHER THIS APPROACH COULD BE RECONCILED WITH THE NEEDS OF THE IMF.

4. ON RENEWAL OF THE US TREAUSRY GUARANTEE (WHICH WAS AN ELEMENT IN THE END-MARCH FOUR-COUNTRY/BANKERS PACKAGE), MULFORD SAID THAT IT WAS THE TREASURY'S PRESENT (UNDERLINE LAST WORD) INTENTION NOT TO RENEW THIS FACILITY AFTER IT EXPIRED ON JUNE 15. BUT NO FINAL DECISION HAD YET BEEN MADE, LET ALONE COMMUNICATED TO THE ARGENTINEANS.

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/5.

5. TRUMAN (DIRECTOR OF THE DIVISION OF INTERNATIONAL AFFAIRS AND THE FED) WAS MORE GLOOMY THAN MULFORD. HE SAID THAT THE ''LETTER OF INTENT'' SEEMED TO BE MORE IN THE NATURE OF AN IMF STAFF APPRAISAL RATHER THAN AN ORTHODOX LETTER OF INTENT. IT WAS UNHELPFUL BECAUSE IT WAS TOO SPECIFIC ABOUT THE FUTURE ECONOMIC POLICY. HE DID NOT SEE HOW THE US TREASURY COULD RENEW THEIR GUARANTEE. THOUGH HE KNEW THE UK AUTHORITIES TOOK A DIFFERENT VIEW, HIS PERSONAL VIEW WAS THAT THE BANKS WOULD BE WELL ADVISED TO DISBURSE THE REMAINING PART OF THE MEDIUM-TERM LOAN AT AN EARLY STAGE. THEY WOULD THEN AT LEAST OBTAIN THE BENEFIT OF THE DLRS 400 MILLION FROM THE ARGENTINE RESERVES. THIS MIGHT NOT BE ON OFFER LATER ON.

6. JETT (STATE DEPARTMENT OFFICE FOR SOUTHERN CONE AFFAIRS) ALSO DID HIS BEST TO BE OPTIMISTIC. THE ARGENTINE ACTION HAD NOT BEEN ALTOGETHER UNEXPECTED BUT THAT THE TIMING HAD TAKEN THE STATE DEPARTMENT A LITTLE BY SURPRISE. THIS LATEST DEVELOPMENT SHOWED THAT, FOR NOW, DOMESTIC POLITICAL CONSIDERATIONS HELD THE UPPER HAND IN BUENOS AIRES OVER FUND/ECONOMIC CONSIDERATIONS. JETT CLAIMED, HOWEVER, THAT DISCUSSIONS WERE STILL CONTINUING BETWEEN THE AUTHORITIES AND FUND STAFF. HE FELT THAT THE REAL WAGES ISSUE WAS AT THE HEART OF THE PROBLEM. THE PERONISTS WERE NOW CLOSELY IDENTIFIED WITH THE GOVERNMENT'S STANCE AND, WITH THE UNIONS THREATENING FROM THE WINGS, IT REMAINED TO BE SEEN WHETHER SUCCESSFUL FURTHER NEGOTIATIONS WERE POSSIBLE AGAINST THIS WAGES BACKGROUND.

7. JETT AGREED THAT THE US WAS A KEEN AS EVER TO SEE AN IMF PROGRAM AGREED. HE CONFIRMED THAT THE ARGENTINES WERE CONTINUING TO STRESS TO THE AMERICANS THAT THIS WAS, FUNDAMENTALLY, A POLITICAL ISSUE. PRESSED, JETT SAID THAT HE BELIEVED ANOTHER COMPROMISE OF SOME SORT WOULD BE REACHED IN THE END, SINCE NO ONE HAD AN INTEREST IN FAILURE (PARTICULARLY HAVING COME THIS FAR). BUT HE DID CONCEDE THAT THE ARGENTINE LETTER HAD CAUSED SOME IRRITATION TO THE BILATERAL RELATIONSHIP. HE RECOGNISED THAT OTHER DEBTORS WOULD BE WATCHING CLOSELY FOR PRECEDENTS.

8. JETT DID NOT FEEL THAT THE JUNE 15 DEADLINE FOR THE US GUARANTEE WAS TOO SIGNIFICANT. EVEN IF IT WAS NOT FORMALLY EXTENDED, THE AMERICANS COULD STILL BAIL OUT THE MEXICANS, COLOMBIANS, VENEZUELANS AND BRAZILIANS ONCE AN IMF PROGRAM WAS IN PLACE. JETT HINTED THAT SOME INFORMAL AND UNWRITTEN UNDERTAKING BY THE US TO DO JUST THAT WAS NOW UNDER CONSIDERATION. HE HOPED, HOWEVER, THAT THE POSITION WOULD BECOME RATHER CLEARER OVER THE NEXT WEEK, HIS GREATEST CONCERN WAS THAT, BY THE END OF THE MONTH, US BANKS SEEMED LIKELY TO HAVE TO DECLARE A LARGE NUMBER OF ARGENTINE LOANS AS ''NON-PERFORMING''. THIS THREAT WOULD OF COURSE ENCOURAGE THE AMERICANS TO TRY TO SEE THAT AGREEMENT WAS REACHED. (TRUMAN, UNLIKE HIS CHAIRMAN IN HIS CONVERSATION WITH YOU ON MAY 31, WAS NOT TOO CONCERNED AT THE PROSPECT OF THE US BANKS HAVING TO DECLARE THEIR ARGENTINE LOANS AS ''NON-PERFORMING''. THE MARKET MUST HAVE ALREADY DISCUOUNTED THAT PROSPECT).

CONFIDENTIAL

ASSESSMENT.

ASSESSMENT

9. THOUGH DISMAYED BY DEVELOPMENTS, THE US AUTHORITIES SEEM READY TO GIVE THE ARGENTINEANS THE BENEFIT OF THE DOUBT AND ARE ANXIOUS FOR THEIR DISCUSSIONS WITH THE FUND TO CONTINUE. THE SCOPE FOR A SUCCESSFUL OUTCOME TO SUCH DISCUSSIONS WILL DEPEND, IN PART, ON THE PRECISE TERMS OF THE ''LETTER OF INTENT'' AND ON THE COMMITMENTS WHICH THE ARGENTINE GOVERNMENT HAS ENTERED INTO WITH CONGRESS ABOUT IT. IF THE GAP BETWEEN THE FUND AND THE ARGENTINEANS LOOKS TO BE BRIDGEABLE, THE US AUTHORITIES CAN BE EXPECTED TO BRING CONSIDERABLE PRESSURE TO BEAR ON FUND MANAGEMENT TO AGREE A LETTER OF INTENT.

10. FCO PLEASE ADVANCE TO LITTLE, UNWIN, AND MOUNTFIELD (TREASURY), LOEHNIS AND GILCHRIST (BANK OF ENGLAND), TAIT (ERD).

WRIGHT

MONETARY
ERD
FID
SAMD
NAD

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Debt file

10 DOWNING STREET

Prime Minister (2)

You may wish to note that while the commercial banks have agreed to negotiate multi-year rescheduling for Mexico, this has not yet been completed. We should therefore avoid forms of words which imply that such rescheduling is already in place.

AT

12/6

3.56 CONFIDENTIAL DIUP 1316

CCNO

Prime Minister (2)

To note

AT 7/6

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

7 June 1984

Andrew Turnbull Esq
10 Downing Street
LONDON
SW1

Dear Andrew

INTERNATIONAL DEBT

I sent over to you on 17 May the latest in the regular series of reports on the international debt situation. You may like to have available, as background for the Summit, the attached note prepared by the Bank which describes more recent developments.

The note contains the Bank's latest information from the banks on Argentina. Negotiations are continuing. An IMF team, with very senior representation, is in Argentina and hope that a Letter of Intent will be submitted to Alfonsin for approval by the weekend. US Treasury representatives in London for the Summit assure us that they are putting maximum pressure on the Argentines to accept the Letter before 15 June when the US Treasury guarantee of the end-March loan by the four Latin American governments will expire. The US Treasury also strongly deny reports that they have been pressing the banks to make concessions. For their part, the banks are refusing to extend any further bridging facility unless a Letter of Intent is signed and forwarded to the IMF Board with the approval of the Managing Director. The Chancellor's view remains that, so far as the British banks are concerned, we should continue to maintain our "arms length" position. Separately, but as expected, the Argentine government has submitted a formal request to the Paris Club for the rescheduling of official and officially guaranteed debt, and we are considering how to respond to this.

The note also describes the 19 May statement from the Presidents of Argentina, Brazil, Mexico and Colombia. This, and the following up letter to the Prime Minister reported in yesterday's press, but which we have not yet seen, are clearly an attempt to put pressure on heads of Government attending the Summit. The statement needs to be taken seriously but is not in itself a cause for increased alarm about Latin American attitudes. Even the Governments directly involved as signatories have different perceptions of the way forward. In the Chancellor's view we should seek to build on these differences, and hence reduce the risk of a debt "block" being formed - for example by encouraging ideas like multi-year rescheduling for those debtor countries (such as Mexico) that are committed to sound policies. He hopes that in this context we will be able to strike the right note in the Summit communique.

I am copying this letter to John Bartlett, Bank of England, Callum McCarthy, DTI and Len Appleyard, FCO.

Yours ever
David

D L C PERETZ
Principal Private Secretary

INTERNATIONAL FINANCIAL SCENE: LATEST DEVELOPMENTS

On 19 May, the Presidents of Argentina, Brazil, Mexico and Colombia jointly warned that higher international interest rates and increased protectionism threaten the trend towards democracy in Latin America and the region's "economic security", and called on the international community to co-operate "without delay" in the formulation of concrete measures to change existing international trade/financial policies and help resolve the crisis. They also announced that a meeting of foreign and finance ministers of the four countries would be held as soon as possible, to which ministers from other Latin American countries would be invited, aimed at defining "the most appropriate initiatives and means of action capable of reaching solutions satisfactory to all interested countries". A firm date and venue have yet to be announced, though it looks as if these may be 17-19 June in Bogota.

Argentina

The Working Committee of banks and an Argentine delegation met in New York on 30-31 May. The Argentines have dropped their request for the release of the $1 bn balance of the medium-term loan and instead presented other proposals to bring interest arrears owed to banks on public sector debt current to 2 April. On condition that a Letter of Intent is signed by 15 June and the MD undertakes (subject only to a critical mass of new money being committed for 1984) to forward it to the Fund's Executive Board recommending approval of the programme, the Committee has offered Argentina:

(a) to recommend to all the banks concerned a 90-day rollover of the $750 mn outstanding on the bridge loan to 15 September;

(b) to agree a 90-day rollover of the $100 mn contribution of the Working Committee to the end-March package, ie to 30 September, although the US Treasury has only renewed to 15 June its $300 mn commitment to take out the four Latin American governments;

(c) to advance a new bridge loan of $125 mn until 30 September (guaranteed by earmarked deposits with the Fed) provided

Argentina commits a minimum of $275 mn of new money plus the balance undisbursed from the end-March operation (perhaps $100-125 mn). These resources would be used to pay interest arrears due up to 2 April or later (some $450-500 mn). Over the weekend Argentina offered to commit new money of $225 mn.

LBI has notified the Chairman of the Working Committee that it formally agrees to the Working Committee's offer.

Bolivia

On 30 May the government announced a temporary suspension of payments of interest and principal on external debt to commercial bank creditors. (In fact, the Bolivians have not been paying interest since March or principal for a year.) The Foreign Minister subsequently stated that there was no intention to repudiate, but rather a desire to negotiate on rescheduling with the commercial banks.

Brazil

Following the President's visit to Japan, the Japanese have agreed to grant $100 mn of new medium/long-term export credit and announced that they will re-open short-term cover for Brazil.

Ecuador

Ecuador has approached the Paris Club to reschedule around $250 mn of capital and interest payments falling due in 1984 and 1985. Meanwhile, capital and interest payments on this debt have been suspended.

Mexico

The Mexican government is considering a new rescheduling package covering a number of years, so as to avoid the problems created by the "repayment hump" (starting in 1986). We know that the plan commends itself to the Fed and that Chairman Volcker is giving it a push at the International Monetary Conference.

It seems that nearly all of the $3-5 bn of private sector unguaranteed suppliers' credits have been repaid by various means, thus reducing the stock of debt at end-1983 to about $92 bn.

Nigeria

The IMF team which visited Lagos in early May left without securing agreement on the step devaluation of the Naira or the reduction of petroleum subsidies which the IMF regard as essential parts of any deal. At the 24 May London meeting, ECGD, HMT and Trichet (for the Paris Club) discussed with the Nigerians the framework of a possible multilateral refinancing of insured arrears, but reiterated that such an arrangement remained conditional on agreement with the IMF.

Philippines

The election procedures have still not been completed and there has been no material progress towards putting in place the economic programme which is required by the IMF.

Poland

The Poles were due to have paid 20% of arrears under the 1981 official rescheduling by 31 May, as a precondition to the opening of negotiations on rescheduling later maturities (1982 onwards). ECGD, at least, had not received the 20% downpayment by 1 June; but it is possible that the payment had been only temporarily delayed by an error. Failure to pay by the Poles would almost certainly lead to a postponement of the Paris Club negotiations due to be held in July.

Yugoslavia

The failure of the Yugoslavs to lift the price freeze on 1 May to the extent required under the IMF standby arrangement breached a performance criterion and rendered Yugoslavia ineligible to make its first drawing. But agreement has now been reached and a request for a waiver and modification of performance criteria is to be considered by the IMF Board on 6 June. Official creditors signed the Agreed Minute rescheduling 1984 maturities in Paris on 22 May. The provisions of the Agreed Minute will not be implemented until creditor governments have been informed by the Fund that Yugoslavia is entitled to purchase under the standby.

Bank of England
5 June 1984

07 JUN 1984

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UNCLASSIFIED
FM UKDEL IMF/IBRD WASHINGTON 070022Z JUN
TO PRIORITY FCO
TELEGRAM NUMBER 111 OF 6 JUNE
INFO MEXICO CITY

PHILADELPHIA MONETARY CONFERENCE: ADVISORY COMMITTEE STATEMENT ON MEXICO

1. TEXT OF STATEMENT REFERRED TO IN MIPT FOLLOWS:
QUOTE SENIOR REPRESENTATIVES OF THE COMMERCIAL BANKS FORMING THE ADVISORY COMMITTEE FOR MEXICO MET YESTERDAY IN PHILADELPHIA TO RECEIVE A REPORT FROM THE MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND, COVERING MEXICO'S PERFORMANCE IN THE SECOND YEAR OF ITS PROGRAM WITH THE FUND. ON THE BASIS OF THE SUBSTANTIAL PROGRESS MEXICO HAS MADE UNDER ITS ADJUSTMENT PROGRAM, THE ADVISORY COMMITTEE HAS AGREED TO NEGOTIATE WITH THE PERTINENT MEXICAN AUTHORITIES SPECIFIC ARRANGEMENTS FOR A RESCHEDULING OF ITS PUBLIC SECTOR DEBT ON A MULTI-YEAR BASIS COMPATIBLE WITH ITS MEDIUM-TERM FINANCIAL OUTLOOK. THIS MULTI-YEAR APPROACH SHOULD FACILITATE MEXICO'S PLANS FOR AN EARLY RETURN TO NORMAL MARKET ACCESS. UNQUOTE

2. FCO PLEASE ADVANCE TO PS/CHANCELLOR, LITTLER, LAVELLE (FOR WICKS) AND DIGGLE (HMT), PS/GOVERNOR, LOEHNIS AND GILCHRIST (BOE) AND TAIT (ERD).

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FM UKDEL IMF/IBRD WASHINGTON 070020Z JUN 84

TO IMMEDIATE FCO

TELNO 110 OF 6 JUN

INFO MEXICO CITY

PHILADELPHIA MONETARY CONFERENCE: RESCHEDULING FOR MEXICO.

1. THE MANAGING DIRECTOR OF THE IMF CALLED A MEETING THIS MORNING OF THE SEVEN '' SUMMIT '' EXECUTIVE DIRECTORS TO REPORT ON DEVELOPMENTS IN PHILADELPHIA ON A MULTI-YEAR RESCHEDULING FOR MEXICO.

2. THE MD SAID THAT HE HAD MADE A SHORT PRESENTATION TO THE BANKS' ADVISORY COMMITTEE ON MEXICO'S ECONOMIC PROGRESS UNDER THE FUND PROGRAMME. HE HAD STRESSED THAT THE PERFORMANCE CRITERIA OF THE PROGRAMME HAD BEEN OBSERVED THROUGH 1983 AND SO FAR IN 1984: THAT THE TARGETS WERE, INDEED, BEING MET BY LARGE MARGINS: AND THAT THE BALANCE OF PAYMENTS POSITION IN PARTICULAR WAS TURNING OUT STRONGER THAN EXPECTED. THERE WAS, HOWEVER, ONE BLEMISH. INFLATION REMAINED WELL ABOVE THE 40 PERCENT PER ANNUM ORIGINALLY ENVISAGED -IT WAS IN FACT RUNNING NEARER 5 PERCENT PER MONTH. IN CONSEQUENCE, THE MONTHLLY EXCHANGE RATE ADJUSTMENTS OF ABOUT 2 1/2 PERCENT WERE PROVING TOO SMALL TO MAINTAIN COMPETITIVENESS. THE EFFECT ON TRADE FLOWS HAD NOT SO FAR BEEN SIGNIFICANT (THE MD COMMENTED THAT NON-OIL EXPORTS WERE ''ABSOLUTELY BOOMING'') BUT SIGNS OF PRESSURE WERE EMERGING, FOR EXAMPLE IN THE GROWTH OF INFORMAL CROSS-BORDER TRANSACTIONS. THE MD SAID THAT THE MEXICAN AUTHORITIES WERE DETERMINED THE SITUATION SHOULD NOT BE ALLOWED TO DETERIORATE FURTHER.

3. ON THE FINANCING PROPOSALS, THE MD BEGAN BY NOTING THAT NO NEW MONEY WAS LIKELY TO BE NEEDED IN 1985. HE NOTED FOUR MAIN REASONS FOR PROMOTING A MULTI-YEAR RESCHEDULING:

(THE ''HUMP'' IN MATURITIES, WHICH FOR THE NEXT FEW YEARS WOULD BE AROUND DOLLARS 12 BN PER YEAR (ON TOP OF A ROUGHLY COMPARABLE SUM FOR INTEREST PAYMENTS).

(B) MARKET SENTIMENT HAD NOT YET FULLY REFLECTED THE STRENGTHENING OF FUNDAMENTALS IN THE MEXICAN ECONOMY AND SOME ADDITIONAL MEANS OF SECURING GREATER FINANCING STABILITY WOULD THEREFORE BE HELPFUL:

(C) A CLEAR RECOGNITION FROM CREDITORS OF GOOD PERFORMANCE WOULD HAVE A POWERFUL INCENTIVE EFFECT ON THE MEXICANS THEMSELVES: AND

(D) THIS RECOGNITION WOULD ALSO PROVIDE A HELPFUL SIGNAL TO OTHER DEBTOR COUNTRIES, ESPECIALLY VALUABLE IN ADVANCE OF THE PROJECTED BOGOTA MEETING.

4. THE MD SAID THAT THE ECONOMIC SUB-GROUP OF THE ADVISORY COMMITTEE WOULD BE VISITING MEXICO. AFTERWARDS, NEGOTIATIONS WOULD BEGIN ON THE PRECISE TERMS OF THE RESCHEDULING ARRANGEMENT.

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15

5. THE MD MADE CLEAR THAT HE HAD NOT OFFERED SPECIFIC VIEWS ON THE TERMS OF THE RESCHEDULING. THIS WAS SOMETHING FOR NEGOTIATION BETWEEN THE MEXICAN AUTHORITIES AND THE BANKS. FURTHER, A NUMBER OF TECHNICAL ISSUES REMAINED TO BE CLEARED UP, RELATING, FOR EXAMPLE, TO THE TREATMENT OF MATURITIES WHICH HAD ALREADY BEEN RESCHEDULED. THE MD HAD, HOWEVER, INDICATED THAT HE FELT THE TERMS SHOULD BE ''MODERATE'' IN RELATION TO SPREADS AND COMMISSIONS, AND ALSO THAT THERE SHOULD BE A ''REALISTIC'' STRETCHING OUT OF MATURITIES. HE FAVOURED A RESCHEDULING OF, AT LEAST, MATURITIES IN 1985 THROUGH 1988, AND PERHAPS ALSO IN 1989 AND 1990. THE ADVISORY COMMITTEE HAD, THE MD SAID, BEEN FULLY ON BOARD IN ENDORSING THE PROPOSALS. THE MEXICANS HAD BEEN KEPT CLOSELY IN TOUCH AND HAD BEEN EXTREMELY PLEASED WITH THE OUTCOME.

6. THE MD DISTRIBUTED COPIES OF A STATEMENT ISSUED YESTERDAY EVENING ON BEHALF OF THE ADVISORY COMMITTEE AND ASKED THAT THE TEXT SHOULD BE TRANSMITTED BACK TO CAPITALS, AGAINST THE BACKGROUND OF THE COMMENTS REPORTED ABOVE. THE TEXT FOLLOWS IN MIFT.

7. THE MD LATER GAVE AN ABBREVIATED ACCOUNT ALONG SIMILAR LINES AT TODAY'S BOARD MEETING.

8. FCO PLEASE ADVANCE PS/CHANCELLOR, LITTLER, LAVELLE (FOR WICKS) AND DIGGLE (HMT), PS/GOVERNOR, LOEHNIS AND GILCHRIST (BOE) AND TAIT (ERD).

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File

Indebtedness (with AT)

10 DOWNING STREET

From the Private Secretary

6 June 1984

BANKS' INTERNATIONAL LENDING

During the course of their bilateral today, the Prime Minister and the Chancellor discussed various mechanisms by which banks could restructure their balance sheets to take account of bad or doubtful loans. The Prime Minister said Sir Walter Salomon had suggested a scheme to her under which banks' capital could be divided into A and B shares. The A shares would be backed by the healthy parts of the business while the B shares would be backed by non-performing loans. (Sir Walter would obviously include a great deal more in this category than most other bankers.) Such loans would be held by a realisation trust and the value and return on the B shares would be determined by what in fact was recovered on these loans. The premise behind this scheme was that there would be merit in identifying clearly the healthy and the weak parts of banks' business.

The Chancellor remarked that the proposal bore a resemblance to a suggestion put forward by Mr. Macworth Young. When we discussed this on the telephone, you agreed to let me have a note on these ideas, as part of a larger study of special schemes which have been put forward in this area.

BH

MR. A. TURNBULL

David Peretz, Esq.,
HM Treasury.

CST.

Papers left by Sir Walter Salomon when he saw PM
(NOT COPIED TO HMT)

THE TRUTH ABOUT FOREIGN DEBTS

The Free World is facing yet another serious crisis. I refer to the international loans which have been given to the developing countries, in many cases without any control and very often for political reasons, and then unloaded, in part to the public, and part kept in the loan portfolio of many of the great international banks. I can foresee the day, if it is not already here, when many of these countries will not be able either to service the loans or make the repayments on the due date; it is quite possible that they will argue that this was, in any case, money owed to them by the Free World for what it did to them in the past or, to put it another way, for what it did not do for them in the past, and they will simply say 'we owe you nothing'. This is propaganda which would be encouraged by the Eastern Bloc and would help further in the ultimate goal to destroy the Free World.

(1976)

In contrast with labour-intensive gold production at the *garimpos*, Companha Vale do Rio Doce is engaged in the highly capital-intensive Carajás project, where iron ore production is now scheduled to start up in 1986. Many other minerals, including bauxite, manganese, gold and lead, are present in the same or adjoining deposits in the Serra dos Carajás, a range of hills in the southwestern fringes of the Amazon jungle.

Total capital investment at Carajás is now budgeted at US$3.28-billion, excluding financial costs. Three-quarters of the total has already been disbursed, mainly by CVRD itself. Iron ore output is forecast at 15-million tonnes in 1986, 25-million tonnes in 1987 and 33-million tonnes a year thereafter. □

BG

Profits as the world has breakfast

Brazil's agriculture has diversified enormously in recent years. Although coffee is still an important export earner — and plenty is still drunk in Brazil — it no longer accounts for half of Brazil's export earnings. Soya is now the star performer, with an output of between 15-million and 16-million tonnes, and likely to earn US$3-billion to US$4-billion this year. Other major exports include newcomers such as orange juice, frozen chickens, beef and tobacco. Sugar, a traditional export, has been the disappointment of recent years, because of high subsidies in the European Economic Community. Low prices have also encouraged its use for the manufacture of alcohol.

Methods of production have also changed. There are fewer coffee plantations, employing thousands of workers nearly full-time. Mechanised coffee production is taking over in much of Parana state, once devoted to soybeans. In the hotter São Paulo state, coffee is being displaced by sugar, soybeans and high-value orange juice. Minas Gerais state has become Brazil's leading coffee-producing state, but its coffee tends to be grown on smaller farms than in the south. The newly opened state of Rondonia is also a coffee producer.

Citrus crops, which have replaced coffee over vast tracts of São Paulo, have been record breakers in the past few years. They were first planted on a large scale over a decade ago, following severe frosts in the United States. Brazil now provides 85 per cent of the orange juice traded around the world. Profits from the crop have been so high that Brazil has hovered on the brink of severe overproduction, and has only been saved from disaster by another series of frosts in Florida.

This year, Brazil should earn US$1-billion from orange juice, making it the third agricultural export earner, in front of sugar, and even cocoa, which itself is doing well, following several years of low prices. Last year cocoa earned US$600-million, and most of the 400,000 tonnes produced was exported.

Production of other export performers — chickens, tobacco, and beef — started from almost scratch to earn close to US$500-million each year. Thousands of tonnes of frozen chickens are exported annually, as Brazil takes advantage of its abundant soybean and maize.

Even now, Brazil only exploits a fraction of suitable land, and the past few years have seen many experiments into bringing more land into use. High production and transport costs have made cattle-rearing uneconomic in the Amazon region, but coffee and cocoa has been grown there successfully. The soybean frontier is also moving north. Once large amounts of fertiliser are applied to compensate for mineral deficiencies, impressive yields of soybeans, wheat and maize have been achieved. This augurs well for future progress as Brazil consolidates its position as the world's second largest food producer. □

PK

Benefits from the big bank theory

The UK has its Big Four banks and West Germany its Big Three. Brazil has its Big One – the state-controlled Banco do Brasil. Measured by loans and deposits, Banco do Brasil is bigger than the six biggest private sector banks put together.

Like many of Brazil's state-controlled corporations, BB is partly owned by private shareholders. At the beginning of April, the bank set out to triple the number of its shareholders from 300,000 to 1-million, in a supersale of 2.9-billion of its shares, offered at 60 cruzeiros (then US 4.4c) apiece. Three weeks later all the shares had been taken up. The bank will not know for some time exactly how many individual shareholders it now has as the outcome of the supersale, but the fact that a large proportion of the shares were sold across the counter at remote branches suggests that it has considerably widened its catchment area and that ownership is no longer so densely concentrated in the half-dozen major cities catered to by local stock exchanges.

The three-year recession has taken its toll of banking as it has of other sectors of the economy, but much less fiercely. Banco do Brasil's net profits fell 26 per cent from US$1.33-billion in 1981 to US$992-million in 1982, and fell again to US$849-million last year. There is little danger, though, of banking becoming a loss-maker in Brazil.

Tom Hanley

Facing the world: banks bearing up through the recession

The biggest private-sector bank, Banco Brasileiro de Descontos, has seen its profits fall in each of the past two years on much the same scale as Banco do Brasil, but its 1983 net profit of US$239-million was hardly unhealthy, while Banco Itaú, second of the private-sector banks, actually increased its profit last year from US$139-million to US$194-million.

Most Brazilian banks have diversified their activities in the course of the last few years to include:

□ operations tying savings accounts to mortgage lending;

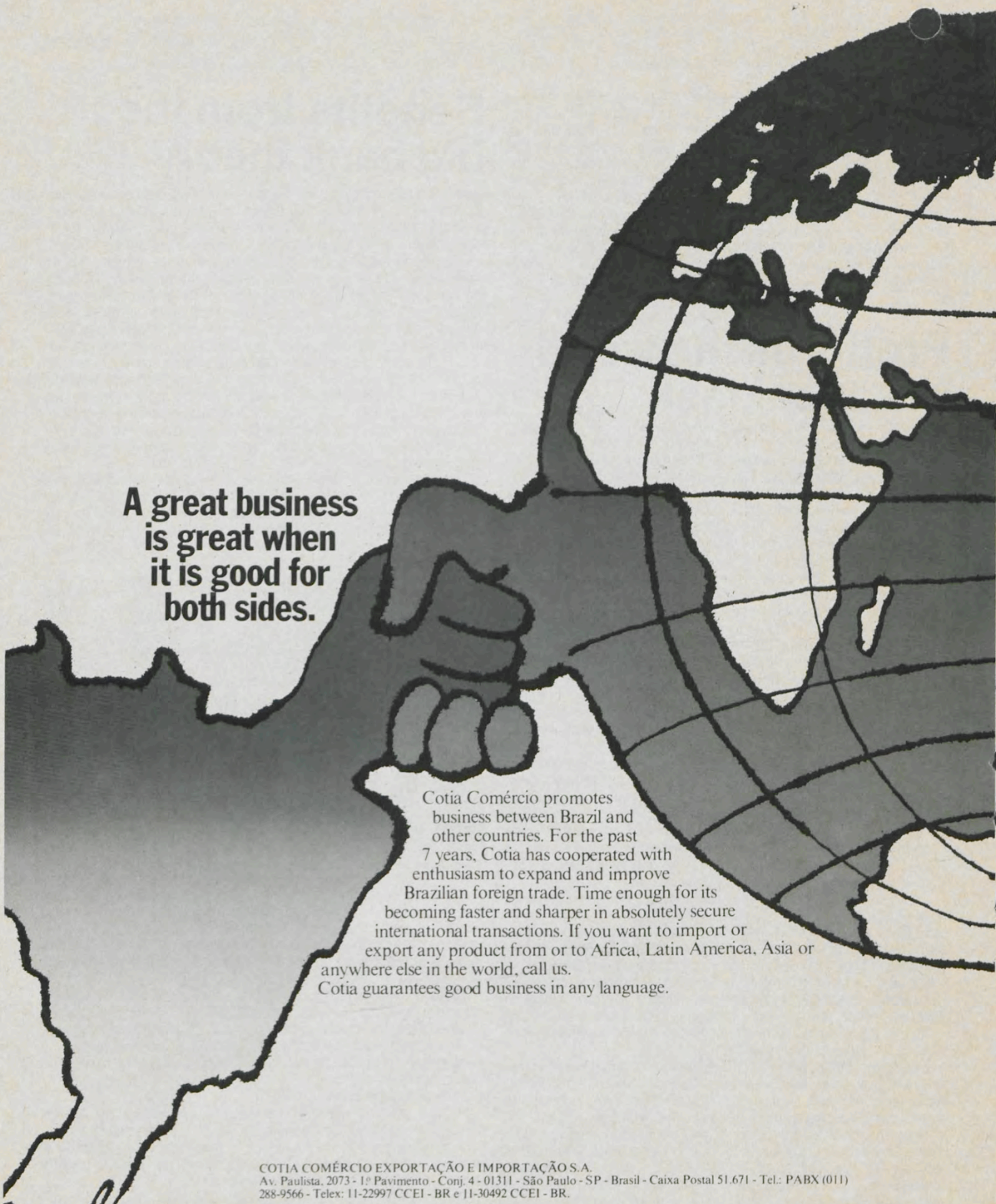
□ insurance, with independent insurance companies being progressively squeezed out of the mass market for home and car insurance; and

□ hire purchase financing.

As an offshoot of the mortgage business, some banks, including Habitasul, are becoming major property developers.

A group based in Porto Alegre is investing US$50-million in the first 300 hectares of what will eventually be a 3,500 hectare holiday complex on Santa Catarina Island.

Even US-owned Citibank, Brazil's seventh biggest private-sector bank in terms of deposits, finds it convenient to invest in property, albeit on a more modest scale. A mild form of urban decay has overtaken the area of São Paulo in which, for many



CITY COMMENT

Oil re-stocking behind leap in trade deficit

Echoes of Bagehot

IT IS PERHAPS as telling a sign as any that we may be passing through a financial crisis — or at least the American banking system is doing so — that Walter Bagehot's writing is suddenly being remembered. His principal work on economics, Lombard Street, published in 1873, contains what is still an extraordinarily accurate anatomy of a panic and Bagehot's advice to the authorities of the day as to what remedial action should be taken remains persuasive.

"Ordinarily discredit does not at first settle on any particular bank," he wrote. "At first incipient panic amounts to a kind of vague conversation: is A as good as he used to be? Has not C lost money? and a thousand such questions. A hundred people are talking about, and a thousand think, am I talked about, or am I not?"

And Bagehot went on: "Every day, as a panic grows, this floating suspicion becomes both more intense and more diffused; it attacks more persons, and attacks them all more virulently than at first."

Now this last comment is a just description of what happened on Wall Street last week. When even Morgan Guaranty's credit is doubted, the attack is virulent indeed.

"All men of experience, therefore, try to strengthen themselves, as it is called, in the early stage of a panic," wrote Bagehot. What this means today is that corporate treasurers, investment institutions, those oil exporting countries that have maintained a payments surplus and other lenders drastically shorten the list of houses with whom they will deal. Many banks suddenly find, therefore, that deposits are not renewed when they reach maturity. This process is going on at the moment.

In London yesterday, for instance, trade in American bank certificates of deposit had almost ceased. American banks were abstaining from making new issues for fear of being snubbed. And the so-called flight into quality went on.

An appetite for United States Treasury bills, coupled with distaste for commercial bank paper, opened up a yield gap in favour of the former amounting to slightly over $1\frac{1}{2}$ percentage points, the widest differential there has ever been.

What to do? "A panic, in a word, is a species of neuralgia, and according to the rules of science you must not starve it." So Bagehot's remedy was that the holders of the cash reserve — the modern central bank — must be ready to "advance it most freely." They must lend "to merchants, to minor bankers, to this man and that, whenever the security is good."

Or, as Bagehot put it in a later passage, referring to the Bank of England: "The holders of the Bank reserve ought to lend at once and most freely in an incipient panic . . . they ought to know that this bold policy is the only safe one, and for that reason they ought to choose it."

Thankfully, judging by its actions so far and remarks made over the weekend, the Federal Reserve in the United States well understands Bagehot's lesson.

Banks fear debtors' cartel over $340bn Latin loans

From Bailey Morris, Washington

Fears were growing among international bankers in Washington last night that Latin America is about to form a "debtors cartel", with news that Brazil's Central Bank president had slipped in for closely-guarded talks.

Senhor Affonso Pastore was having private talks with officials of British and American banks yesterday, after a week-end communique from the debt-laden nations which bankers believe could signal a new confrontation over repayments.

Both the International Monetary Fund and the Brazilian Embassy refused to comment on the talks, saying Senhor Pastore was on a private visit after giving an address at the University of Virginia.

But diplomatic sources said that arrangements had been made by the Banco de Brazil in Washington for Senhor Pastore to meet the commercial bankers who believe increasingly that their Latin American loans, estimated at $340 billion, are at risk.

Commercial bankers were anxious to meet Senhor Pastore, whom they regard as both politically moderate and influential in the region, to relay their concern to other debtor nations over the fast-approaching June 30 deadline facing American banks, which must then decide whether to declare some delinquent loans as non-performing.

Debts of the big Latin American borrowers ($ billion)

Argentina	44
Brazil	93
Chile	18
Mexico	89
Peru	12
Venezuela	34

The meeting was urged in a communique from the Presidents of Argentina, Brazil, Mexico and Columbia, who said the recent rise in interest rates was straining their ability to repay debts. They demanded both a reduction in rates and longer repayment periods and said these and other "statisfactory solutions for all involved" would be discussed at the "debtors summit".

Some bankers fear that Argentina, which had earlier refused to meet scheduled loan repayments, is pressing other debtor nations to take similar action to increase the region's bargaining power with international banks.

Latin American debt exposure of five biggest US banks ($ billion)

	Total assets	Estimated exposure
Citicorp	134.7	10.2
Bank of America	121.2	7.2
Chase Manhattan	81.9	6.2
Manufacturers Hanover	64.3	6.4
J. P. Morgan	58.0	4.2

Until recently, there had appeared little support for this bankers' nightmare. Mexico, which had already secured easier terms from commercial banks, was anxious to maintain a good credit rating both for itself and the entire Latin American region.

But this was before the recent rise in US prime lending rates from 12 per cent to 12.5 per cent. It put new and some say, intolerable strains on Latin American nations whose foreign debt repayments float with movements in the US prime.

The one half of a point rise in the prime rate two weeks ago, for example, added $200m a year to Argentina's payments, and an extra $300m for Mexico, $350m for Brazil, and $150m for Venezuela.

This came at a time when the political will to continue economic austerity measures, prescribed by the International Monetary Fund, has been strained severely by riots in São Paulo, Santiago, Lima, Rio de Janeiro and the Dominican Republic.

The upshot was the unprecedented call over the weekend for an emergency meeting of debtor countries.

Although the tone of the communique was moderate, it nevertheless marks the first time Latin American nations had banded together to seek better terms.

"Our nations cannot indefinitely accept the hazards to democracy and development posed by existing repayment terms," the leaders said.

● President Augusto Pinochet of Chle, which owes $20 billion yesterday expressed support for the call for a regional meeting to discuss renegociation of foreign debt.

Financial Times Thursday May 31 1984

Midland, Lloyds 'most exposed' in Latin America

BY DAVID LASCELLES

TWO OF the large British clearing banks, Midland and Lloyds, have a proportionately greater loan exposure to Latin American countries than any of the large U.S. banks according to an analysis by de Zoete and Bevan, the London stockbroking firm.

This finding counters the generally held view that the U.S. banks are the most vulnerable to the debt crisis in the region.

The analysis shows Lloyds' and Midland's exposure to Latin America (excluding Mexico) at the end of 1983 as 228 per cent and 213 per cent respectively of shareholders' funds. The most exposed U.S. bank was Manufacturers Hanover at 165 per cent.

For the purposes of the comparison, the UK bank figures were adjusted by de Zoete's analysts to conform to U.S. accounting principles. The figures are at best a rough-and-ready guide, they say, but give a useful indication of the relative positions of U.S. and UK banks.

Midland's heavy exposure comes through Crocker National Bank, its 57 per cent-owned California subsidiary. Lloyds has traditionally been a heavy lender to Latin America through its international banking subsidiary, Lloyds Bank International.

Exposure to Latin America (except Mexico) at end 1983

	per cent of shareholders' funds
Lloyds	228
Midland	213
Man. Hanover	165
Chase Manhattan	147
Citicorp	124
NatWest	100
J.P. Morgan	96
BankAmerica	87
Barclays	75

NatWest and Barclays both have fewer loans out to Latin America and a larger capital base, which reduces their relative exposure.

The British banks' position has probably worsened since the end of 1983 because of the big dent made in their shareholders' funds by the Budget decision to phase out capital allowances.

However, UK bankers said last night that the figures did not come as a surprise and reiterated past assurances that they believed the Latin American debt problem could be handled.

clout and a determination to use it, however muddled they may be about what they are trying to achieve. Muddled becaus[illegible]h are in dispute to preserve jobs but the way they are going about it, by weakening their own industries, is the best way to destroy them.

Potential bidders for Sealink assume Slater's strategy is to so devalue its worth in their eyes that they will sail away, leaving British Rail lumbered with it. There is a theory that this outcome would not leave BR too unhappy.

To some extent this belief has been reinforced by BR's slowness in disclosing to bidders the all-important details of the commercial contracts that govern, for example, how much money Sealink makes from carrying Freightliner traffic.

But this delay is probably due more to the complexity of the task rather than deliberate procrastination. It is much nearer the mark to believe that having settled on privatisation both the Secretary of State for Transport, Nicholas Ridley, and BR's chairman, Bob Reid, are agreed on achieving it and will not be deflected by the NUS.

AMONG insiders, there is a growing conviction that Ridley, incensed by last week's strike which coincided with the half-term holiday and was a deliberate attempt to disrupt the first busy week of the holday season, is prepared to reverse his decision to sel Sealink as a whole and to dispose of it piecemeal if necessary.

Not surprisingly, the transport department is saying there has been no such change of course, but at least one bidder has drawn up a contingency plan to cover buyin the parts rather than the whole.

The break-up would have interesting consequences. It would probably allow European ferries and P & O – who have been barred on monopoly grounds from bidding for Sealink – back into the game. It would also permit the separation of the ports from the ferries: many of the people involved with Sealink's biggest port, Holyhead, claim its development has suffered badly and that it has been neglected by management in distant London.

Ridley ought to be thinking of trying to fragment the ferry business rather than let Sealink's massive whole continue. The cross-Channel freight boom means the seamen are acquiring a sort of stranglehold on trade the miners hoped they had on energy. The growing dependence on NUS-crewed ferries is a powerful argument for union-free Channel crossing.

A further consequence of the [illegible]'s attitude, is that if it does provoke a break-up, it will hurt the chances of the buy-out by the group that includes the Sealink management.

This group also includes an other, highly successful privatisation, National Freight Consortium. The parallel with Sealink is that there was also union opposition to that sale. As a result many employees did

by tickets with restrictions on the length of stay that KLM and BA wanted to sell.

The chances of agreement emerging at this week's meeting are slim as BCal this week-end said that it will not back down. In this event, the dispute will probably be referred to the transport secretary, Nicholas Ridley, who will have to resolve it with his Dutch counterparts. Until then, the cheapest fare will remain at just under £90.

Redundancy row at yard

SHOP STEWARDS at the crisis-hit Cammell Laird shipyard on Merseyside have accused the company of victimisation after being served with compulsory redundancy notices as part of British Shipbuilder's rescue plan for the yard. If the company find no new orders half the 3,300 jobs at the yard will be at risk.

The rescue plan involved 360 voluntary redundancies, but by the deadline on Friday less than 300 had opted to leave. Cammell Laird says the enforced redundancies are necessary for a continued future and has served a 90-day notice on a further 190, men, including three boilermaker's shop stewards.

The three are refusing to go and say they will remain at their jobs for at least the 90 days required by law.

Call to drop area grants

DELOITTE Haskins & Sells has called for the abolition of regional development grants and a move to 100% selective assistance.

In a submission to the DTI responding to the government's December white paper on regional industrial policies, the accountants say the RDGs should be phased out and funds transferred for use on a discretionary basis. The government said grants should be aimed more precisely at job creation, and widened to cover parts of the service sector.

Deloitte wants a much better targeting of resources but is concerned at the proposed cuts in the aid budget. Maintenance of present levels of funding should be regarded as a minimum, it says.

Dunlop lobby

ANGRY Dunlop shareholders are to set up an action group to lobby for management changes in the wake of last Tuesday's tempestuous annual meeting. The group is headed by Victor Murrell, who holds over 200,000 shares and who will be writing to the national press this week to lobby his fellow shareholders. Murrell wants a "critical review of the remaining assets" and moves to strengthen the board. Contact him at 100, Addiscombe Road, Croydon.

TEN TOP DEBTORS

	Debt ($ billion)
1 Brazil	93
2 Mexico	89
3 Argentina	44
4 Venezuela	34
5 Indonesia	25
6 Philippines	25
7 Chile	18
8 Turkey	17
9 Algeria	15
10=Malaysia	12
10=Nigeria	12

. . . and thirteen unlucky banks

Loans to Brazil, Mexico, Argentina and Venezuela as approx % of share capital

Manufacturers Hanover	240
Lloyds	228
Midland	213
Chase Manhattan	175
Citicorp	170
Chemical	165
Bankers Trust	150
Bank of America	145
J P Morgan	125
First Chicago	115
Continental Illinois	110
Nat West	100
Barclays	75

Debt fears lift on eve of summit

by David Lipsey and Isabel Hilton

WESTERN leaders at this week's London summit are expected to reject major new moves to tackle the $700 billion world debt crisis. Confidence is growing among participants that the debt problem can be contained by the present case-by-case approach.

Their renewed optimism has been fuelled by reports from Latin America which suggest that the threat of concerted debt default is receding. Argentina's proposal for a debtors' conference, to be held on June 15-17 seems in some disarray. In Colombia, a government spokesman denied reports that Bogota was to be the venue; while Venezuelan participation now seems in doubt.

In Buenos Aires, the President of the Central Bank, Enrique Garcia Vasquez said, "There is no proposal to form a debtor's club. Each of the debtors has very different problems. We are acting in good faith and we will pay."

Optimism has also been fuelled by a dramatic turnround in Latin America's trade, which has accelerated over the past two months, enabling the region to increase its imports by $30 billion a year, relieving key shortages, according to pre-summit calculations in Whitehall.

Garcia Vasquez said that Argentine officials would discuss the final details of their country's letter of intent with IMF officials tomorrow. He expected the letter to be signed towards the end of this week.

In Bolivia, the government strenously denied rumours that it might default. Reports that Bolivia had suspended debt service were a major factor behind last week's crisis of confidence on world stockmarkets.

Optimism that the line would hold was also fostered by rising hopes that American interest rates might fall, encouraged by President Reagan's pre-summit interview.

Proposals to "cap' interest rates, by setting a limit to the interest on loans have been shelved. They surfaced in April when US rates began to strengthen, at a top-level conference called by the Federal Reserve Bank in New York. But little hedway has been made. "I've yet to see a single properly articulated proposal for capping, one British official said last night. Garcia Vasquez insisted that capping was one of the Argentine proposals in negotiations with creditor banks.

Mrs Thatcher, hosting the summit, made her opposition to a "magic formula" on debt clear last week. "I do not see any alternative to dealing with it on a case-by-case basis" she said on American television.

The summit might however agree to set up a study of ways of managing debt better.

synergy a ti[illegible] much more lo[illegible] doubt tha[illegible] products g[illegible] and missiles."

A link wi[illegible] the possibility world-class [illegible] "capable of [illegible] Boeing and Mc[illegible] on equal terms.

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THE United States is allow private satellites voice, data and televisi[illegible] the Atlantic for the fi[illegible] The expected go-ahead for businesses and T[illegible] panies, and not for switched telephone tra[illegible] major breakthrough f[illegible] competitive teleco[illegible] cations, and will lower The decision, possib[illegible] month, could also lea[illegible] loosening up in British t[illegible] munications, bringing a[illegible] skies" satellite policy.

Tories' favourite comp[illegible]

London foreign exchange brokers and banks confirming deals worth a total of up to $80bn on an average day will replace manual methods. Back Page.

Fed pledges that it will 'lend boldly' to help banks

BY PAUL TAYLOR IN WASHINGTON AND WILLIAM HALL IN NEW YORK

PRESTON MARTIN, vice-[chai]rman of the U.S. Federal [Res]erve Board, said yesterday the Fed was willing to do [wha]tever is needed to maintain stability of the U.S. banking [syste]m.

[It] was prepared to "lend, boldly and keep on lend-[ing]" should any more big banks [run] into liquidity problems, he

[Hi]s remarks were seen as [perha]ps the strongest attempt [b]y U.S. bank regulators to the nerves of the financial [marke]ts and head off any addi-[tional] rumours like those which [hit] the markets last week. [Two] weeks ago the Fed was [forced] to help to halt a run on [Conti]nental Illinois, Chicago's [bigges]t bank and the eighth [larges]t in the U.S.

[Sinc]e then, attention has focused on the major [b]anks' lending, especially [Lat]in America. Last week [seri]ous erosion of investor [confide]nce sent bank stocks [tumbli]ng, battered the dollar [an]d to a "flight to quality" [inv]estors scrambled to buy [sho]rtest and safest paper— Government Treasury

[The] investors' fears were [heigh]tened yesterday with the [release] of figures on the banks' [exposu]re to the four most indebted Latin [Americ]an countries.

[The f]igures show that the U.S. [region]al banks have cut their exposure roughly three [times as] quickly as the nine [U.S.] money centre banks [since t]he start of the inter-[national] debt crisis.

[At th]e end of 1983 the nine [mo]ney centre banks had $40.4bn (£29.2bn) out-[standing] to Mexico, Brazil, [Venezuel]a and Argentina, [according] to figures published [by] U.S. bank regulators. [This is n]early a third more than [their ent]ire capital of $31.5bn.

[Since] Mexico's financial crisis [in the a]utumn of 1982 the nine [money c]entre banks have increased their lending to the four countries by $2.6bn. The next 15 biggest U.S. banks had increased their lending by $1.5bn to $13.7bn, but the 185 regional banks had reduced their lending by $600m to $12.7bn.

U.S. BANK LENDING TO MOST HEAVILY INDEBTED LATIN AMERICAN COUNTRIES	Top 9 banks	Next 15 banks	Regional Banks	Total
($bn, at end 1983)				
Mexico	14.1	5.3	6.9	26.3
Brazil	13.3	4.3	3.1	20.7
Venezuela	7.6	2.1	1.5	11.3
Argentina	5.4	2.0	1.2	8.5
Total	40.4	13.7	12.7	66.8
Capital	31.5	14.9	33.0	79.4
Growth (fall) since June 1982	2.6	1.5	(0.6)	3.5
Exposure as a percentage of capital	128	92	38	84

Source: Federal Financial Institutions Examination Council

At the end of 1983 the combined exposure of the nine money centre banks to the four countries had reached 128.3 per cent of their capital. The next 15 biggest banks' exposure was equal to 91.9 per cent of their capital, and the regional banks to 38.5 per cent of their capital.

The regional banks' relative exposure has fallen sharply from 50.4 per cent of their capital base in June 1982. The nine money centre banks, which have had the benefit of $4.4bn of extra capital, have been able to reduce their relative exposure only from 139.4 per cent to 128.3 per cent of their capital.

The next 15 biggest U.S. banks have been less successful still, managing to cut their relative exposure from 96.1 per cent to 91.9 per cent—half the rate of reduction of the money centre banks.

Speaking on television yesterday, Mr Martin strongly denied that the U.S. was on the brink of a major banking crisis and added: "The situation in Chicago has stabilised. It is a sound bank. What the people who are making progress there need is time." The Fed, together with other U.S. bank regulators and big U.S. banks, put together a $7.5bn rescue package for Continental Illinois and the Fed allowed the Chicago bank to borrow an estimated $4bn to ease its liquidity problems. This effectively gave the bank an unprecedented guarantee to cover its deposits. Asked whether the Fed was willing to act again, Mr Martin said: "Indeed we are."

He also said that "fear and concern" in the markets was keeping interest rates high. "There is no economic reason for them to be that high," he said.

His comments appeared to echo those of President Reagan who said in his weekly radio broadcast that the increase in U.S. interest rates was caused by pessimists who feared that inflation would soon be out of control again.

The Administration would not "panic or be buffaloed" into a policy change, the President said. He was determined to see that inflation was not coming back.

Argentina speeds talks, Page 2
Lombard, Page 15
Eurodollar deposits, Page 17
U.S. bonds, Page 18

optimistic. We may well downgrade those numbers again next month," said Dr Egil Juliussen.

Software publishers are even more gloomy. "I think the size of the home computer market has been grossly overstated," said Mr Gary Carlston, vice-president of Broderbund Software, a computer games company.

Mr Trip Hawkins, president of Electronic Arts, publisher of several top-selling computer games, calls previous industry forecasts "completely ridiculous."

"If we (the industry) have a good year there will be about 1.5m units sold in the U.S., perhaps 2m worldwide."

Chip makers have noticed a downturn. Last week the Semiconductor Industry Association attributed a 2 per cent decline in industry order rates last month to personal computer makers' shrinking requirements.

Several factors have contributed to declining home computer sales. Consumers became disillusioned with "toy computers that do very little," suggested Dr Juliussen.

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Conti...

[P]aris-Bonn pact on EEC budget

[BY DA]VID MARSH IN PARIS

[PRESIDE]NT Francois Mitter-[rand of F]rance and Chancellor [Helmut Ko]hl of West Germany, [yesterday] forged a common [approach to] press for British [concessions] over the EEC [budget iss]ue ahead of next [week's Co]mmunity summit at [Fontaineble]au.

[Their inte]nt to stand firm over [British bud]get demands came on [the first] day of a two-day [Franco-Ger]man summit meet-[ing] ... uncompromising. Following a first round of talks yesterday afternoon between the two leaders, a German official said that the two sides had underlined that Mrs Margaret Thatcher was up against a "firm position of the Nine."

Terming the majority Community offer to Britain at the Brussels summit in March as "the last word" the official said: "It is up to the British to move."

Yesterday's meetings, which extended into a formal dinner at the Rambouillet chateau ... laboration between France, Germany and Luxembourg's communications company, Compagnie Luxembourgeoise de Telediffusion, in the launching of France's own television satellite, also planned for launch next year.

The helicopter project, in which the two countries hope eventually to interest Britain and other Nato members, will result in planned French and German orders for 427 machines worth DM 7bn (£1.84bn) for use in the 1990s.

[... p]art of the govern-[ment's pla]ns for closer ties [... ra]nge of political and ...

Interational Debt file

NOT FOR RELEASE BEFORE DELIVERY
at 2:00 P.M. EDT
Monday, June 4, 1984

Remarks by J. de Larosière
Managing Director of the International Monetary Fund
before the International Monetary Conference
Philadelphia, June 4, 1984

I greatly welcome the opportunity to participate in this year's International Monetary Conference. The theme of this session--the Role of the Commercial Banks in the Prospective World Environment--is a broad and important one. I shall begin my remarks by taking stock of the progress--the very considerable progress--that has been achieved over the past year and a half in managing the debt problems. Next, I shall explain why the resolution of these problems can be viewed today with greater confidence than a year ago, in spite of some important difficulties which need to be tackled. Finally, I want to draw the lessons of recent experience for future policies and action on the part of governments and the commercial banks.

I. Managing the debt problems: progress to date

I need hardly remind this audience that the debt crises that erupted less than two years ago posed a real threat to the integrity of the international financial and trading system. There was a great deal of pessimism at that time. Some people felt that the burden of debt servicing facing a number of countries--including some of the largest debtors--simply could not be managed in a world marked by deep recession, historically high interest rates, and a sharp curtailment of commercial lending.

But the skeptics have been proved wrong. Developments over the past eighteen months have been encouraging. The various authorities and institutions responsible for international finance responded swiftly and decisively to the crisis. A cooperative strategy was set in place comprising two essential elements:

- concrete steps on the part of indebted countries to address the root causes of their financial difficulties by means of what we call "adjustment programs,"

- and concerted action on the part of the international financiers to maintain financial flows in support of those adjustment efforts.

The strategy has worked well. Let me give you the highlights.

1. Adjustment

Nearly all of the problem countries have sought the assistance of the Fund in drawing up and helping to finance adjustment programs. These programs are designed to correct the weaknesses in demand management and to remove or reduce the rigidities and distortions that have contributed to the problems. They have to be carefully tailored to the specific circumstances of each case. But they have one objective in common: that is, to restore a viable external payments position within a few years.

The external adjustment that has taken place has been dramatic. Take the Latin American countries, for example, where much of the attention and concern has been directed: countries in that region with Fund-supported programs saw their combined external current account deficit coming down from $41 billion in 1981 to $11 billion last year while their trade accounts shifted from a deficit of $7 billion to a surplus of $24 billion. More generally, all the non-oil developing countries taken together cut their combined external deficit by half during those two years--from a record high of nearly $110 billion in 1981 to $56 billion last year. It is true that much of this external adjustment involved sharp cuts in imports and growth for many countries that are not sustainable. But a much more severe adjustment would have been inevitable in the absence of the Fund's programs; and the actions of the governments concerned with the Fund's support have helped to bring about the reduction in external deficits to more viable levels in a much more orderly manner than would otherwise have been possible. And it has been achieved without a further increase in trade restrictions which would have been detrimental to the prospects for growth in these countries. In fact, in some cases such restrictions have begun to be scaled down and these countries are now in a better position to resume growth.

2. Financing

The second element has been to keep financial flows moving. The greatly increased activity of the Fund in negotiating adjustment programs has involved a substantial growth in its financing. Since the middle of 1982, the Fund has lent some $22 billion in support of adjustment in 66 member countries. A further $8 billion of commitments are outstanding in support of the 34 programs that are presently in place. Because they have been linked to adjustment, these amounts have catalyzed additional financing on a much larger scale as well as rescheduling.

Rescheduling of official and commercial debt has had to be arranged for an unprecedented number of countries and on an unparalleled scale. In all, during 1983 alone, some 30 developing countries including 11 of the 25 largest borrowers completed or were engaged in debt rescheduling with official or commercial creditors. We estimate that debt restructuring arrangements eased the cash flow situation of the non-oil LDCs by some $40 billion in 1983, equivalent to 8 percent of their exports of goods and services. In virtually all cases the agreements were anchored to a Fund-supported adjustment program.

It has also been possible to muster the essential commercial bank lending to support countries' efforts to adjust--a prospect that was in real jeopardy in late 1982. The indications are that commercial bank exposure in non-oil developing countries increased by some $25 billion in 1983. That amount was broadly consistent with an orderly scaling down of bank lending as well as with manageable adjustment in deficit countries. New bank financing commitments were closely integrated with rescheduling agreements, particularly in the case of the major borrowers.

Net new lending, together with restructuring, has helped to bring about a considerable improvement in the maturity profile of outstanding debt. The share of short-term debt in total external debt for the non-oil developing countries declined to some 15 percent at the end of 1983 from almost 20 percent at the end of 1982. As a result, we have seen the debt service ratio of the non-oil developing countries fall from 24 1/2 percent in 1982 to 21 1/2 percent in 1983. For the Latin American countries the debt service ratio fell from 54 percent to 44 percent over the same period.

II. The debt problems can be viewed with greater confidence today than a year ago

Thus, the strategy has been working, and working well. Better indeed than many had thought possible. And a number of encouraging developments have taken place that are helping to sustain this progress.

1. The Fund's resources have been reinforced

As you know, a number of steps have recently been taken to increase the resources of the Fund. At the end of last year member countries completed action to bring into effect an increase of nearly 50 percent in the Fund's basic capital resources. Agreement has also been reached on a threefold increase in the resources available to the Fund under the General Arrangements to Borrow (GAB), which is a line of credit with the major industrial countries; also, Saudi Arabia has agreed to lend to the Fund under an associated arrangement with the GAB. What is more, the GAB may now be used by the Fund not only for the benefit of Fund members among the Group of Ten major industrial countries but, under certain circumstances, for the benefit of any member country. Finally, the Executive Board has very recently approved other borrowing arrangements, totalling $6.3 billion, with the Saudi Arabian Monetary Agency and a number of industrial countries with the assistance of the BIS. These steps have strengthened the Fund's financial position considerably and thereby its capacity to carry on its role as the agent of orderly and cooperative adjustment in the system. These important decisions were not easy to reach given the difficulties of the time. They are an expression of confidence in the IMF and of commitment to a liberal and open world economy.

2. Other institutional mechanisms have functioned well

The commercial banks, with the assistance of central banks, have developed and expanded their cooperation through advisory committees and their regional groupings in an exemplary manner. As for the Paris Club, it has demonstrated remarkable efficiency in handling the reschedulings of loans from official sources.

3. The world economic setting has significantly improved

With the strong performance of the U.S. economy, the recovery has proved to be stronger than many had anticipated. Growth in the industrial countries in 1983 turned out to be higher than expected and, even on the higher base, the Fund staff now expects a stronger expansion of economic activity in the industrial countries in 1984 than it did last fall. For the industrial countries as a group, we estimate that real output expanded by about 2 1/4 percent in 1983 (on a year-on-year basis) and should grow by 3 1/2 percent this year. Growth in the European countries in 1984, at about 2 percent, would still be behind that of North America and Japan, though it would represent a considerable improvement over last year. The international trade aspects of the picture are also encouraging. According to our projections, world trade will expand quite strongly this year--by over 5 percent in volume terms--after four years of stagnation.

4. Growth is picking up in the debtor countries in the developing world

Higher levels of activity and trade are not limited to the industrial world. The adjustment efforts of the developing countries are now beginning to pay off. Many of these countries are already experiencing a resumption of growth with activity in some sectors accelerating sharply. This is true not only of some of the smaller countries but of large countries too, like Mexico and Brazil, both of which are likely to record positive growth rates this year after a period of stagnant or falling output. In line with these trends, a resurgence of imports is projected for the great majority of countries implementing Fund-supported programs. For the nine largest program countries, the value of imports is projected to increase by 12 percent in 1984, compared with a decline of 9 percent last year. This amounts to a turnaround of nearly $25 billion--an impressive potential stimulus for world trade.

5. The paradox of the present situation

It is therefore somewhat paradoxical that, in spite of the encouraging developments I have just outlined, some observers are showing renewed pessimism as to the manageability of the debt problems. I think that one of the reasons for this paradox is to be found in the lags that always exist between action being taken by debtor countries and positive results becoming known and recognized. The rigor of adjustment which has just taken place still tends to divert attention from the underlying improvements that are being brought about. Another factor has been the recent increase in interest rates. Clearly that is a troubling development. We all know that every additional percentage point on interest rates adds $3 1/2 - 4 billion a year to the interest bill of developing countries. But this turn of events, which is hardly surprising in current conditions, has to be seen in perspective. The stronger-than-expected recovery and the large U.S. trade deficit have meant that many program countries are reaping unanticipated gains in export earnings. And the countries are reaping unanticipated gains in export earnings. And the projections underlying most of our programs had left room for some increase in interest rates in 1984. The external position of debtor countries must be evaluated in the light of all of these elements. In our view, their balance of payments position is, on the whole, better today than our assessment of only six or eight months ago upon which the programs being drawn up at that time were based. What is of concern, however, is the uncertainty regarding the future evolution of interest rates. I shall have more to say on that subject in a moment.

III. What are the lessons to be drawn?

I have outlined the progress that has been made and I have noted that recent developments and the outlook are, on balance, encouraging. All this is not to say that there is any room for complacency: quite the opposite. What is needed now is vigilance and determination to consolidate and extend the progress to date. There are difficult issues that still confront us and uncertainties that will pose new challenges in the period ahead. I now want to draw the lessons of recent experience for future action.

1. We must avoid pessimism and wishful thinking

We are clearly going to have to avoid pessimism and wishful thinking. I have said it before and I shall say it again: there are no magical solutions to the problems we have been facing. Proposals have been made for panaceas such as writing off part of the debts or transferring them wholly or in part to official institutions, for official guarantees, or for techniques for linking debt servicing to one economic variable or another. But these proposals have attracted little support. One reason for this is that each country's debt situation has its own specific features that cannot adequately be taken into account in generalized approaches. Another reason is that these proposals involve financial support, subsidies, or losses to be assumed or provided by entities which the proponents have no power to control. In some ways such ideas tend to raise unjustified expectations and can, therefore, complicate the adjustment process. Also they could well cause certain lenders to turn away from the cooperative process and make it more difficult to maintain the cohesion that is needed to organize new financial packages. Indeed, these techniques must each be judged by their effectiveness and their capacity to keep the various financiers actively involved in the task of strengthening the international financial system.

I am confident that the most productive strategy--which does not preclude imagination and improvements--lies in the present country-by-country approach of the Fund, in collaboration with all the interested parties--governments, central banks, the BIS, commercial banks, and the World Bank--directed toward putting together realistic financial packages linked to adjustment programs that are both forceful and adapted to each country's situation.

2. More needs to be done by all parties

The second lesson is that a lot more needs to be done by all parties--debtor countries, the commercial banks, and the industrial countries--to consolidate the progress made so far and to bring about a lasting solution to the problems.

a. Debtor countries

The implementation of adjustment programs by debtor countries will have to continue. This is obviously a first and paramount necessity. The impressive gains that have been realized in bringing down external deficits to more viable levels need to be followed up by more vigorous and determined efforts to remove the obstacles to domestic growth. There is considerable scope for developing countries to do more in the way of tackling rigidities in their economies that have for years been stifling growth and increasing their vulnerability to external shocks. Though progress has been made, much more flexibility is needed in prices, particularly interest rates and exchange rates, and wages. It is only through such policies, backed by counter-inflationary demand management, that we can expect to see debtor countries achieve the expanded savings, investment, and exports they need to generate productive employment and to fuel their growth and development.

It is also very much in the interest of debtor countries to do more to attract foreign capital especially in the form of direct investment. Clearly, better domestic economic policies are an important step in this direction. But many countries also need to dismantle or relax administrative controls on such flows. Expanded flows of direct investment to the developing countries are in everybody's interest. From the point of view of potential investors, it opens up new opportunities for investment in areas frequently offering high commercial rates of return. From the standpoint of the recipient countries, direct investment represents a more secure form of external finance, and one that does not involve the accumulation of external debt. Also, it carries the advantage of being tied to productive capital formation as well as forming part of a package that includes the transfer of technology and skills. Thus, the developing countries should be encouraged to remove obstacles to such flows and to place greater emphasis on policies designed to attract foreign direct investment as part of their development strategy.

b. The commercial banks

There is also a crucial role for the commercial banks in the future, as in the past, in helping to cope with debt problems and in the provision of new finance. While fully consistent with the basic framework of a country-by-country approach, their role involves a new stage of the effort with a medium-term perspective.

(i) Reschedulings

A longer perspective may be particularly desirable in cases where heavy amortization payments due by some debtor countries over the next few years--countries that otherwise are performing well--impede a return to more normal market conditions. If problems are to be avoided and if we are to foster the conditions for a return to more spontaneous financing, restructuring will need to be looked at more closely in a medium-term context in the light of the resources that individual debtor countries might reasonably be expected to devote to debt servicing. Mexico, for example, faces repayments of principal that average about $12 billion a year over the period 1985-90. Those amounts represent close to a third of its exports of goods and services, not to mention the very heavy interest burden.

In my view, a longer time frame for bank rescheduling arrangements for countries that have made or are making substantial progress towards adjustment would have several advantages. It would be a way in which to reward good performers, while avoiding the necessity for repeated annual rescheduling: it would also help to restore the conditions needed for a return to market access and serve to rebuild confidence in the system. Given the outstanding performance of Mexico, I believe that it would be an ideal time to start tackling this case in a multi-year framework. Other countries, like Brazil whose performance is improving steadily could also qualify if progress is sustained. The periods of consolidation as well as grace would have to be long enough and tailored according to each case.

(ii) New money

In the period ahead the commercial banks will also have a vital role to play in channeling new money to debtor countries implementing adjustment policies. Projections in the Fund's World Economic Outlook envisage a rate of growth of such lending that is much lower than in the years leading up to the 1982 crisis, and one which is consistent with a gradual decrease in the proportion of banks' assets committed to developing countries and a significant decline in their capital exposure to those countries. In addition, reliance on "non-spontaneous" flows will decline as the adjustment process continues in debtor countries. Again, Mexico provides a striking example of how a country making impressive progress toward adjustment is paving the way back to normal access to financial markets. This is reflected in its reduced reliance on organized bank financing: this year's financial package arranged with Mexico's bank creditors amounts to $3.8 billion, compared with a package of $5.0 billion that had to be put together in 1983. Progress is expected to continue and I am hopeful that Mexico will have to raise little or no new money from banks next year, and will be able to look forward to resuming normal market borrowing for what limited amounts may be necessary thereafter--assuming existing debt can be restructured.

Until such time as borrowing countries can regain access to the markets, it is important that all the banks--whether large or small and whether or not their foreign exposure is large-- participate in the provision of new financing justified by sound adjustment programs; this was managed successfully in 1983. The very integrity of the system depends on such cohesion. This is not to ask the banks to cast prudence aside. Quite the contrary. For sure, prudence involves covering risks and maintaining a solid capital base. But it also consists of helping to strengthen one's clients by giving them time to adapt to new circumstances and tackle their balance of payments problems. It would be highly illogical and harmful to the stability of the system if some banks sought to evade the obligations of solidarity at the very time when the strategy adopted in 1982-83 is beginning to bear fruit, as revealed by the progress of the major debtor countries in strengthening their economies and their external positions as well as by the medium-term prospects for a far-reaching improvement in their debt situation.

To achieve the broadest possible participation in the new financing packages, the time may well have come to increase the options open to the banks. One of the approaches that has been suggested deserves careful consideration. That is to allow greater scope for increased trade finance or other medium-term lending to the private sector. Provided that this could be handled in such a way that it would not frustrate the efforts to assure enough new financing to meet the requirements of the public sector that are not directly related to projects, this approach could well be a useful one.

(iii) Terms

It will also be important to see that the terms and conditions of restructuring and new lending are such that a self-defeating impact on the balance of payments and debt service capacity of debtor countries is avoided. Obviously, the demonstrated performance of countries under adjustment programs should be a key factor in the determination of terms. Indeed, there is an underlying logic to this: risk is reduced to the extent that countries perform well, and this should be reflected in appropriately improved terms. We have already seen encouraging moves in that direction with the recently concluded Mexican financial package.

Beyond that, there is the more difficult matter of the uncertainty surrounding the future course of the world economy in general and interest rates in particular. The interest burden is already very heavy indeed, and the banks will have to continue to show flexibility, realism, and pragmatism as the situation evolves.

3. The industrial countries

There is also an indispensable role for the industrial countries in the resolution of the current problems.

(a) Reduce structural budget deficits

In the first place, these countries need to strengthen their financial policies in order to bring about a lowering of interest rates on a non-inflationary basis. Essentially this means keeping a firm rein over monetary policy combined with action, now long overdue, to reduce structural fiscal deficits in a number of cases. Large budget deficits are contributing to keeping interest rates at abnormally high levels, and the most recent trends indicate that the clash between public and private credit demands is intensifying. Over time, this can pose a threat to investment and, hence, to sustained growth. From the standpoint of most of the developing countries, a faltering in the world recovery combined with the direct impact of higher interest rates on their debt service would make the task of adjustment significantly more difficult. Action to deal with budget deficits must, therefore, be taken as a matter of urgency, especially in the United States where the present fiscal situation is of special significance for the entire world economy.

(b) Roll back trade restrictions

Protectionism has been creeping up everywhere particularly over the past two years. The time has come to act to reverse these tendencies. In the present environment of rising growth rates, the industrial countries are now better placed to make good on their commitment to roll back protectionist barriers. At the same time, the developing countries have to be able to export more if they are to meet their debt service payments and to increase their imports. If their imports are to start rising again, debtor countries, many of which are still traumatized by the debt crisis, need a change in the trading environment. They must have a more secure future for their exports to encourage them to persevere with outward-looking adjustment strategies.

In my view, the time is ripe for action in the trade field. A new round of trade negotiations in the framework of the GATT would offer a promising avenue for securing the benefits of trade liberalization on a lasting basis. However, such negotiations are sure to require extensive preparation and complex trade-offs. In the meanwhile, we must get early action to roll back trade barriers as undertaken at Williamsburg and on pragmatic measures to open up access to industrial markets for LDC exports.

(c) Industrial countries must provide the necessary financial backing for adjustment

Governments of industrial countries must also provide the necessary financial backing for adjustment efforts, particularly in the form of guaranteed export credits and long-term capital either bilaterally or channeled through the multilateral development agencies like the World Bank. During the 1970s, too much emphasis was placed on commercial bank borrowing to cover the external payments gaps of developing countries. It is essential that official flows play their role in contributing to the stability of the system and, where possible, to support programs arranged with the Fund. This is essential to facilitate the handling of structural adjustment in a medium-term context. I am convinced that the balance of payments adjustment programs that are being implemented, often at high social cost, must receive greater backing by long-term capital in order to tackle the fundamental obstacles to growth. To this end, continued close cooperation between the Fund and the World Bank is essential.

* * * * *

In the Fund, we have made a careful assessment of the evolution of the debt problems in a medium-term context. That analysis demonstrates that with the right policies, the problems are manageable in the aggregate and in a manner that is consistent with strengthening the international financing and trading system. The prescription is to press ahead with the strategy now in place. That strategy has been working: it must be reinforced. This is not to say that the mechanisms cannot be improved by innovations that are acceptable to the interested parties. Creditors have shown a sense of flexibility and adaptation to changing circumstances. I am confident that they will continue to rise to the challenges with a broad and constructive vision. But let us not forget that it was weaknesses in national policies and undisciplined financing, by borrowers as much as by creditors, that produced the problems. And it is only by continuing to grapple with those fundamentals that we can look forward to re-establishing the underlying conditions for renewed financial stability and a more dynamic and prosperous world economy.

SECRET

4 June 1984

PRIME MINISTER

INTERNATIONAL DEBT CRISIS

There are many solutions on offer:

1. Solutions giving or lending more money to the debtor countries

Reducing interest rates for them.

Offering national loans or loans through international bodies.

Stepping up grants and aid.

Writing off a portion of the debts to ease interest and capital repayments.

In each of these cases, he who makes a bold initiative may end up writing out the first large cheque. These "solutions" do not solve the problem, they merely postpone the day of reckoning. It does not help a drug addict to give him more drugs to keep him going, although it is painful to face up to the need to withdraw from the drug on which he is hooked.

Encouraging payment of interest and repayment of capital is a poker game. If the West look as if they are softening, they could bring on the very crisis of non-payment they dread.

Some modest strengthening of the IMF/World Bank resources has been and may be necessary, however, if their new lending or replacement lending is firmly linked to policies which encourage adjustment within the borrowing countries.

2. <u>Schemes which encourage adjustment within the debtor countries themselves</u>

Forcing or encouraging domestic austerity in debtor countries, to divert their resources to exporting.

Encouraging more equity financing of new projects within debtor countries from overseas, and encouraging asset sales by debtor countries.

Discouraging Western protectionism against Third World exports, so they can trade their way back to honesty.

These schemes have more to recommend them. Austerity alone can bring political problems in the debtor countries, and limits world economic recovery. More emphasis needs to be placed on encouraging trade and equity investment. Mexico's oil is a saleable capital asset (the UK was happy enough to encourage foreign equity capital to finance part of its North Sea development). Brazil's agricultural and lumber resources are also saleable.

3. Policies which encourage adjustments by the Western banks

Creating a market in debt would enable banks, depositors and regulators to determine how serious the problem is. The lack of any precise quantification of bad debts allows rumours to thrive and to threaten the solvency of banks. Quantification would prevent the more silly rumours from running, whilst the market would enable exposed banks to begin selling on some of the debt on their balance sheets to other investors, thereby reducing the bank's risk and raising its liquidity. Syndicated loans could be converted into tradeable bonds, without altering the obligations on the debtors. This can be done gradually, country by country, whilst watching the resulting solvency of the banks. We will then see if the provisions are adequate and banks can come to a better view of what additional capital write-offs they need to make.

What is not to be encouraged is a general move to guarantee all wobbly bank deposits: this can become code for inflating Western money supplies, bringing interest rates down temporarily only to recommence the inflationary process.

Continential Illinois and other banks now need propping up because the more fundamental issues have been ducked.

The only safe way to bring US interest rates down - and therefore alleviate the problem - is by cutting the US deficit, not by swamping the system with more dollar cash. Of course we could temporarily inflate our way out of the difficulties, but then so much of the anguish of adjustment policies against inflation over recent years would have been lost, and a well-based recovery would be that much more distant a prospect.

Conclusion

Beware solutions which encourage a grand plan for the west to pay off or subsidise debt.

Encourage equity finance of LDCs, asset sales by debtor countries, and a market in debt.

Discourage perpetuation of easy money and deposit guarantees.

Strive for proper adjustment of interest rates in the US by tackling the budget deficit and the tax deductibility of interest for private borrowers.

Make the bank shareholders carry their burden manfully.

JOHN REDWOOD

The first oil price rise at the end of 1973 led the less developed countries of the world to begin borrowing very heavily from the governments, the private markets and the banks of the West. They now probably owe around $800 bn., something under half of it to private banks. The bankers gave little serious consideration to the LDCs' inability to service the debt. The LDCs were sovereign borrowers, and for the bankers there default was unthinkable and new credit would therefore always be available. But this ~~was not the case and~~ the process of snowballing debt had a built-in dynamic of incredibility.

For some time now most of the LDCs have been unable to raise the money on the private markets to meet their debts to the private banks: they have been obliged to renegotiate them, usually on consideration of agreeing to alter their economic policies. This process known as "rescheduling" is simply an agreement on the terms for deferring capital repayment obligations and interest payments.

All of this has been done on a "pragmatic" case by case basis, which means that each debtor country's situation has been dealt with separately. Where you are dealing with the difficulties of an individual debtor this response is all that is required to provide the necessary breathing space within which resumed payment can be organised. But where most of the debtors cannot meet their obligations punctually there is a generalised international debt problem, and a more fundamental analysis is required to discover what has gone wrong and how to put it right. Unfortunately no such analysis, or outline strategy derived from it, has been attempted by the leading governments concerned.

The central question which must now belatedly and explicitly be asked is whether a system of large-scale, purely commercial lending by the private banks to poor countries is sustainable. Commercial lending is based on the assumption that the transfer of resources which it makes possible will strengthen the wealth-creating ability of the borrower sufficiently to allow him to pay interest on his loan and ultimately repay the capital; the lender would correspondingly come to enjoy a rentier income until the repayment occurs.

When the lending is across frontiers, the borrowing country starts off with a trading deficit, reflecting the inflow of imports obtained on credit. If the debt involved is to be serviced, the borrower must at some future time achieve a trading surplus. For the present rescheduling operations could only to provide a solution, if we therefore, ~~we~~ must believe that the debtor countries will at some point start to run large and continuing trading surpluses with the developed world.

But the sums to be serviced are already gigantic, and the rolling over up (rescheduling) of interest payments adds to them enormously. In addition, many of the borrowers may need fresh capital on top in order to resume development. No one has so far been bold enough to estimate

it would be reasonable to expect these debtors

the date when most of these debtors might reasonably expect to achieve the export surpluses required to meet their ever increasing interest payments, let alone repayment of the debt. This is no surprise, because the size and duration of the surpluses required are historically unprecedented and the countries involved are exactly those who have the least chance of generating them.

Achieving a trading surplus is a much more complicated and costly process than neatly depriving your citizens of an equivalent amount of consumption. The whole economy has to be bludgeoned, and even the best-run societies suffer a loss in wealth production that is far greater than the surplus required, witness France at the present time or the UK in the 1960's and 1970's. The LDCs are not among the best administered societies and the degree of real control that governments have there is tenuous. The notion that they could generate the surpluses required to service existing debt is, in my view, in the highest degree improbable. The performance will vary from country to country, but the result for most can be in little doubt.

There is a second problem. However vigorously their economies may grow, the debtor countries will in the foreseeable future always have an income per head very much less than that of their creditors. Will it be politically feasible for the governments of the debtor countries on a sustained basis to enforce the measures that would be required to achieve even the payment of interest? To say, as some do, that there is no need for the capital to be repaid is no comfort because that would mean paying interest on the debt to all eternity. Can it be seriously expected that hundreds of millions of the world's poorest populations would be content for long to toil away in order to transfer resources to their rich rentier creditors?

But let us make the assumptions that the debtor countries will at some distant date be able to pay, and that their people will over a lengthy period assent to the exactions required. There is still a third difficulty. Can the lending countries themselves deal with the problems of becoming rentiers on this scale? The required trading surplus of the debtors could be obtained only by a major reduction in their manufacturing imports and by a vast increase in their manufacturing exports. This would create adjustment problems for the developed world much larger even than those raised by the present Japanese export surplus. The structural changes which would be required inside the advanced countries to accept a continued export surplus in manufactures from their debtors would be very great indeed. A number of European countries, the UK, Norway and Holland, have some recent experience of rentier status through the development of North Sea oil and gas. We have found, to our cost, that the practical consequences are by no means all good, whatever the textbooks

These are not fantasy problems of the future. Even now, the relatively modest attempts by the LDCs to eliminate their current account deficits have raised very great difficulties for them and for us. They have suffered a fall, in some cases a sharp fall, in living standards. For countries like Brazil and Mexico real living standards have dropped by 15% in the last 3 years and in other countries it is much worse. We have felt acute pressures in some industries and have seen a rapid increase in protectionist sentiment. Any movement towards protectionism would, of course, make the ability of the LDCs to achieve a trading surplus even more hopeless. But what we have seen so far is as nothing compared with what would be needed by both of us to adapt to the trade performances required to service these debts in the future. Anyone who has studied the experience of recent years will not find credible the proposition that either party can make the necessary adjustments without enormous mutual injury.

To sum up. I judge that the great majority of the debtor countries will be unable to pay back most of the lending and that, even if they could, their people would not allow them to make the payments. Further, I do not believe that even if these countries could, should and would be able to pay in real terms that we have the ability to cope with the role of rentier on the scale that would be involved. For the most part The reality is can't pay, won't pay and couldn't be accommodated. In short, the modern world's

None of this means that the transfer of resources to the LDCs should not have taken place. Nor is to deny that the best, and perhaps the necessary, way of doing so was through commercial agencies, but only with active and direct government involvement. What it does mean is that our authorities should belatedly recognise that the bank lending which they encouraged and permitted must now be supported funded by them, after the event, in order to preserve the proper functioning of their banking system, to avoid serious disruption of world trade and to play a supportive role in the political and economic development of the LDCs

The first of these, the proper functioning of the banking system, is now urgently coming under question. To some this merely reflects the current high levels of interest rates. In my view the problem is more structural, more fundamental. The 9 biggest banks in America have lent to Mexico, Brazil and Argentina sums equivalent to 250% of their capital and reserves resources. If only less than half this money were to prove irrecoverable they would be without any capital at all. But even if a very much smaller percentage were suddenly lost, the impact could endanger their be very dangerous for stability and ultimately that their existence and for the stability of the whole American banking system. The position is to a lesser extent applicable to all the great banks of the world. We are not dealing with the isolated misjudgments of a few banks but with the worldwide overcommitment of an interlocking banking system. Moreover, the banks did not act in isolation. Their decisions were approved and encouraged by the authorities. The governments and banks were in this system of lending together, and only together can they come out of it without major damage to the financial and economic system.

A number of proposals to relieve the situation have been made, in many cases by people of considerable experience. These range from rather vaguely formulated international guarantees of existing debt to transfers at a discount of some or all of the bank debts to an international institution. This is not the place for a detailed critique of these proposals, but few of them envisage a sufficient release for the banks from the deadweight of existing non-performing debt and most assume unrealistic demands on the LDCs. In my view, the minimum required to preserve the effective functioning of our banking system is that the leading governments should create the machinery, and provide the funds, whereby current interest on the debts can be paid by the debtors to the banks. Given a guaranteed flow of interest for a sufficient number of years ~~in the years immediately ahead~~, the banks could ~~begin~~ cope with the necessary write-down of bad debts. Precisely how much it will be necessary for them to write-down is not yet clear but it follows from the foregoing that I would judge it to be a very considerable proportion of the whole. However, if the banks are given sufficient time and are guaranteed their interest due, the write-down is feasible. In my view, a realistic write-down over an extended period of time is the maximum burden that can be safely imposed on the banks. What they cannot sustain is a loss of interest payments combined with a

This operation should not be conceived as bailing out the banks. Rather, it is an attempt to protect the basic financial and economic structures of the developed world and of their debtors from the consequences of the imperfect emergency measures taken to deal with the oil price rises. Without bank lending there would have been a world crisis long ago, which is why the lending was approved by the creditor governments in the first place. Though a purely bank intermediation of the OPEC surplus was by no means ideal, no other method was available at that time.

In addition to securing the soundness of the banking system, the authorities must also decide what genuinely new funds should be provided to the developing countries to enable them to resume some economic growth. I am not here attempting to assess what is required but I am urging that, for the first time, the political leaders at the Summit come at least to outline decisions on (1) whether there should be new funds provided, (2) if so, how much, on what terms and how they should be apportioned, and (3) what the mechanics are available to achieve such transfers? In my view, there ought to be such transfers but on a much smaller scale than that of the last ten years. Further, it should be made available not on conditions designed to secure early repayment but exclusively conditioned on productive usefulness to strengthen the economies of the recipient countries. I believe that these terms could be acceptable to the borrowers, would be in the interest of both lenders and borrowers and has had up to now.

Many still live with the comforting assumption that the present we have achieved piecemeal actions are enough ~~the broad outlines required~~ to deal with the threats to the financial systems of the creditors and debtors. I believe this proposition to be manifestly unsustainable. We have built up a vast debt time bomb because we too readily accepted the false assumption that sovereign risk was no risk and that indefinite refinancing in monetary terms would be available to the debtors. We are now living with the illusion that emergency patchwork measures will prove adequate to sustain a dangerously ~~basically~~ unsound edifice. So long as we leave ~~Having left~~ the central issue untackled, far from solving the problem we are deferring it and allowing it to grow ~~making it bigger~~ as the debt mounts.

Unfortunately, the difficulties which deterred the governments from strategic analysis in 1974 exist with even greater force now that they have ~~problem is~~ to deal with the huge past debt as well as the future investment needs of the LDCs. Moreover, the problems can only be solved by ~~operation would need to be a~~ co-operative and collective action ~~concerted one~~ by the OECD governments. This is wholly ~~so much~~ at variance with the authorities preferred role of case by case crisis managers. Only a radically changed posture by them will offer protection ~~that it is difficult to be optimistic that proper decisions will be taken before financial panic begins.~~ from the very grave dangers which threaten us.

If we are told that there is insufficient political will available to move to an intelligent, coherent and sustainable solution to our problems, then for my part I must warn that this is equivalent to there being insufficient political will to avoid an impending series of the most dangerous and escalating financial, economic and political crises.

HAROLD LEVER

Foreign and Commonwealth Office

London SW1A 2AH

PERSONAL

4 June 1984

A J Coles Esq
No 10 Downing Street

AJC. 4/6

p.a.

Dear John,

1. You may remember that at the Prime Minister's meeting on 31 May she said that she believed that Mexico would move into deficit in 1984. I then remarked that Mexico would still have a surplus on trade account.

2. In case the subject comes up again you might like to know that the IMF projections based on an IMF paper of 13 January are that Mexico will have a deficit of US $ 1 billion on current account but a surplus of US $9.9 billion on trade account. I add that Mexico had a somewhat artificial current account surplus of US $4 billion in 1983 due to drastic cuts in imports, and that the deficit of US $1 billion forecast in 1984 is a product of the increased payments necessary due to higher US interest rates. Indeed I should not be surprised if, following the further increase of US interest rates, the deficit is not bigger.

Yours ever

Crispin

Crispin Tickell

SECRET

4 June 1984

PRIME MINISTER ②

AT 4/c

A useful summary

INTERNATIONAL DEBT CRISIS

There are many solutions on offer:

1. Solutions giving or lending more money to the debtor countries

Reducing interest rates for them.

Offering national loans or loans through international bodies.

Stepping up grants and aid.

Writing off a portion of the debts to ease interest and capital repayments.

In each of these cases, he who makes a bold initiative may end up writing out the first large cheque. These "solutions" do not solve the problem, they merely postpone the day of reckoning. It does not help a drug addict to give him more drugs to keep him going, although it is painful to face up to the need to withdraw from the drug on which he is hooked.

SECRET

Encouraging payment of interest and repayment of capital is a poker game. If the West look as if they are softening, they could bring on the very crisis of non-payment they dread.

I agree with this though Alan Walters might not. AT

Some modest strengthening of the IMF/World Bank resources has been and may be necessary, however, if their new lending or replacement lending is firmly linked to policies which encourage adjustment within the borrowing countries.

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JOHN REDWOOD

1 June 1984

PRIME MINISTER

In view of the Bolivian suspension of repayments and your meeting today with the Chancellor and the Governor, you might like to have the following figures to hand. The table beneath shows the total amount of Latin American debt exposure of the 4 UK clearers. It also shows what it would cost the clearers if the LDC demands to cap interest payments came into operation. It is assumed, for the sake of illustration, that instead of paying interest at 12 per cent, they paid it at 10 per cent. As this table reveals, letting the LDCs off some of their interest would not jeopardise the position of any of the UK clearing banks, but it would leave Midland more exposed than the rest, in view of its relatively low profitability, and relatively high advances to Latin America.

£m: forecasts by Messel

Bank	Latin-American exposure	Interest Receipts 12%	Interest Receipts 10%	Lost int. as % of est.1984 pre-tax profits
Barclays	3,370	404	337	10%
Lloyds	3,760	452	376	16%
Midland	4,200	504	420	35%
Natwest	2,400	288	240	8%

In the game of poker there now has to follow between the West and the LDCs, pressure does have to be maintained to achieve adjustment within their domestic economies through deflationary forces. If anything is to be conceded, it would be best to achieve longer maturities for their debts, and try and edge them towards a market in some of the debt to establish accurately banks' capital losses. Only when people can quantify the damage precisely will unreasonable fears in the market settle down for good.

JOHN REDWOOD

10 DOWNING STREET

Prime Minister

The Governor of the Bank of England is joining your bilateral on Friday with the Chancellor after an hour. The main item for that part of the meeting will be international debt. The significance of the Bolivian default can be examined.

AT

30/5

CONFIDENTIAL

30 May 1984

MR TURNBULL

BOLIVIA DEBT

Bolivia announced today that it was temporarily suspending interest payments on its commercial debt. The Bolivian Government's finances have been deteriorating over the past 3 years, and the final straw seems to have been the rejection by Bolivian trade unionists of a 130 per cent pay offer. The figures below, obtained from the Bank of England, put the Bolivian debt problem into perspective.

Bolivia's total external debt at the end of 1983 is estimated at about $3.4 billion. Up to $1.5 billion of this is private sector debt caught by today's announcement. The following is the detailed breakdown of Bolivia's total debt:

	$m
Multilateral Agencies	815
Bilateral from Governments	1,180
Suppliers	207
Miscellaneous Bonds	40
Commercial Banks	986
Other Private Sector	200
	3,428

The BIS published figure for commercial bank debt is $607 million, rather lower than the Bank of England's own internal estimate of almost $1 billion. And, on the BIS analysis, only about $83 million of the debt is owed to UK-owned banks. There is no significant representation by any one UK bank in this figure.

The Bank of England appeared to be taking today's decision in a relatively cool way. They expect the commerical banks to do the same, and not to take legal action against Bolivia, hoping that they will soon resume interest payments.

D L Willetts

DAVID WILLETTS

CONFIDENTIAL

LATAAW

②

PRIME MINISTER

Mexican Economy

You asked whether Mexico was now in surplus. The Treasury tell me that figures supplied by the Mexicans themselves a few days ago show that in 1983 Mexico had a current account surplus of $5.6 billion. But a deficit of about $1 billion is projected for 1984.

A.J.C.

30 May 1984

FILE

RM

10 DOWNING STREET

From the Private Secretary

21 May, 1984

ARGENTINA

The Prime Minister has seen and noted without comment your letter to me of 18 May reporting on further developments on Argentina's debt position. She has also noted the Chancellor's doubts about whether a default by Argentina would create a domino effect.

(A. Turnbull)

Miss J. Simpson,

HM Treasury

CONFIDENTIAL

NR.

2

Prime Minister
To bring you up to date.
FERB
18.5

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

18 May 1984

Andrew Turnbull Esq
10 Downing Street

Dear Andrew,

ARGENTINA

This letter reports further developments in the Argentine debt situation since David Peretz's letter of 17 May recording the views expressed at the G5 Debt Deputies meeting.

The Working Committee of commercial banks, of which LBI is a member, met unexpectedly in New York on Tuesday to consider a proposal from the Argentines for release before the 30 June deadline of the outstanding $1 billion remaining undrawn from the 1983 $1.5 billion medium term loan. The new proposal is that the $1 billion should be used as follows:-

(i) $750 million to repay the outstanding principal of the bridge loan which falls due in mid June;

(ii) $100 million to repay the banks' share of the US-organised March package; and

(iii) the balance of $150 million, together with about $350 million from the Argentine reserves, to extinguish banks' interest arrears up to 30 April.

The drawdown would be on condition that the Argentines made a firm statement that they had made substantial progress on the measures in the Letter of Intent, together with explicit endorsement and commendation of this by the Managing Director of the Fund and satisfactory resolution of various outstanding aspects of the package put together at the end of March and the rolled-over bridging loan.

The Working Committee's reaction to this proposal was in general positive. When they sought the IMF's reaction, the Managing Director is said to have told them that progress remained slow and negotiations were a long way from resolution, but that a favourable response from the banks would be helpful to the IMF cause because it would add a further element of pressure on the Argentine Government to conclude a satisfactory agreement with the Fund. (There seems to be some breakdown of communication within the Fund on this point. The Deputy MD says the Fund has not been approached and would be unenthusiastic.)

LBI, who informed the Bank of this proposal, have since reported that the UK clearers on balance support it. Their main consideration is that it would clear the decks on existing arrears and the outstanding bridging loan. The Chancellor's view is that the proposals should not have the Government's blessing. This latest proposal is considerably weaker than the earlier two tranche proposal (under which a second $500 million tranche would be released on condition that the Managing Director had forwarded a Letter of Intent to the IMF Board and recommended its approval but release of the final tranche of $500 million would depend on actual Board approval of a satisfactory programme). The Prime Minister endorsed this in March, provided there were no further concessions. Although it could provide the Argentines with an incentive to come to terms with the Fund, the new proposal would establish an unwelcome precedent for the release of funds before a Fund programme is assured. Even when a satisfactory Letter of Intent has been signed and commended, a good deal will need to be done before the Board can be confident of Argentine intentions.

On the Chancellor's instructions, the Bank therefore told LBI that they must form their own view of their best commercial interest but that the proposal did not commend itself to HMG. If the banks were to go ahead, the Government would consider itself free to say publicly that in their view it would have been better to wait until the Argentine Government had undertaken a new programme which satisfies the Fund.

The banks have considered this message seriously, and at least two of them have consulted their Chairmen. Nevertheless, taking into account the tremors caused in the US banking system by the Continental Illinois crisis, and the desire of all parties including the IMF to encourage responsible behaviour by the Argentine Government, the banks have authorised LBI to signify its agreement to the proposed reply by the Working Committee to the Argentine request. Assuming that other banks on the Working Committee react similarly, the next step would be to commend the proposal to the other banks. A final decision will not be made until after this process of consultation; and final release only if the conditions were met.

If the loan were to go ahead, as seems likely, the possibility of Argentina defaulting is less. In any event, the Chancellor feels that the Prime Minister's comment during her talks on 15 May with Sir Robert Muldoon that "if Argentina were to default, the domino effect would be very serious" probably overstates the case. If Argentina did decide to repudiate its debts, it would put its Latin American neighbours into a very difficult position, especially in those countries where political pressures are already acute and where they will have been strengthened by recent increases in interest rates. On the other hand, several of the major countries now have rescue packages in place and therefore a vested interest in discouraging actions by more recalcitrant neighbours. Their involvement in the recent Argentine bridging loan demonstrated this. The Chancellor considers that, although the risk of a domino effect cannot be entirely ignored, it is unlikely that other Latin American countries would follow suit. The consequences of such action in terms of the drying up of international credit and trade lines would be considerably more serious for most of them than for Argentina which is not heavily dependent on imports for either energy or food. Brazil, for example, is not so well placed. Nevertheless, one aspect of the contingency planning we have in hand is the role of sanctions or the threat of sanctions which would deter copycat action elsewhere.

Yours ever,

Judith

MISS J C SIMPSON
Private Secretary

CONFIDENTIAL

20 NO

Prime Minister (2)

On X there is a further minute updating the situation. No need to read past page 3 though the table on page 9 is interesting.

AT 18/5

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

17 May 1984

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew

INTERNATIONAL DEBT

I attach the latest in our series of regular reports, prepared by the Bank of England and discussed at a meeting of the interdepartmental group of officials chaired by the Treasury.

Since that meeting was held, we have had a meeting in London of the "Debt Deputies" of the G5, and an IMF representative, from which the following further points emerged.

The first concerns the recent meeting of Central Bankers in New York. All the G5 representatives, and the Fund representative, were anxious to play down the significance of this meeting, which was an entirely informal and non-executive affair, at which no generalised solutions were sought. There will be no follow-up; all the ideas will be further considered by Central Bankers. In particular, nothing happened to alter the American position, which a White House meeting recently reaffirmed. American statements (eg at this week's OECD Ministerial meeting and the Summit) are still expected to reaffirm their existing policy, concentrating on the need for strong adjustment programmes in debt countries and the case by case approach.

On Argentina, the Debt Deputies were more optimistic than we are. Both the American and IMF representatives were reasonably confident that a satisfactory IMF programme would, with patience, eventually be agreed. It might well not be approved before 30 June, but the Americans say they have no intention of mounting another major international rescue operation. (They strongly insisted that the March package was put together in response to Latin American political pressure, and not as a bailing out operation for US banks.) We remain more sceptical about the prospects for progress and, although the possibility of default was not thought sufficiently serious to merit concerted contingency planning at this stage, we secured the agreement of the US Treasury to accept responsibility for consulting the other G5 members and concerting appropriate action should the situation deteriorate. In the meantime, we shall continue our own domestic contingency work.

Copies of this letter go to John Bartlett (Bank of England), Callum MacCarthy (DTI), and Len Appleyard (FCO).

Yours ever

David

D L C PERETZ
Principal Private Secretary

CONFIDENTIAL

INTERNATIONAL FINANCIAL SCENE

Argentina's problems continue to be the main focus of concern, although tension has temporarily eased somewhat since March. Elsewhere in Latin America and in Eastern Europe, there have been a number of favourable developments. More consideration is now being given to the new methods of management which will be required in the next - medium-term - phase of handling the international debt situation.

Recent developments on the economic front are not entirely encouraging. The US-led recovery in most of the large industrial economies continues to benefit LDC exports, but there is growing concern about the impact of high US interest rates on major debtors. There is an increasing sense of frustration among the major debtor governments; a greater risk, following the Quito conference, of a more collective approach to debt issues; and more insistent calls for fresh thinking on methods of dealing with debt service problems. Brazil and Argentina are leading the demand for a reduction in interest rates. On 9 May, the Brazilian Government issued a statement calling on creditor governments to consider the repercussions of their policies on debtors.

GNP in the USA rose by an estimated 2% in the first quarter of 1984, compared with 1 1/4% in the previous three months, and recovery also appears to be continuing in most other large economies, leading to a further improvement in the current account position of developing countries, notably in Latin America. Commodity and oil prices have remained stable in recent weeks. At the same time, dollar interest rates continued to rise during April, with long-term rates reaching their highest point since August 1982. This heightens the dilemma facing the US monetary authorities who remain determined to control inflation by monetary means while recognising the impact which a tighter policy would have on major debtors. The dollar has also recovered still further from the low point reached at the beginning of March, which will tend to accentuate most developing countries' debt servicing problems.

Latest BIS data show that international lending rose sharply in the fourth quarter of 1983, in particular to Eastern Europe (USSR and

Hungary) and to non-oil developing countries (notably Thailand, Korea and Israel). Lending to Latin American countries was mainly unspontaneous. Over the year as a whole, banks in the BIS area increased their exposure to non-oil LDCs by only 5%, but the rise might have been around 7% if part of the rescheduled debt had not been taken over by national export credit agencies. Even so, it is clear that financing pressures on the LDCs remained severe: indeed, in the eighteen months after the onset of generalised debt problems in June 1982, lending to Latin American countries fell by 7 1/2% on the previous eighteen months. There are, however, some tentative indications that the recovery in the fourth quarter may have continued in the early months of this year. If so, the IMF forecast of a rise of 5-7% (equivalent to around $20 bn) for the year as a whole might have a reasonable prospect of being achieved, particularly as Brazil and Mexico have already secured more than $10 bn.

The BIS data also show that some developing countries (notably Mexico and Brazil) have been able to build up their deposits with banks - reflecting not only the disbursement of bank loans, but also a very marked improvement in the trade balance. (Indeed, Mexico ran a current account surplus last year.)

Turning to individual countries, Argentina is still the main cause for concern. Although the end-March accounting problem for US banks was overcome (see below), the government has yet to demonstrate the will or capacity to tackle its debt problems. Consequently, it is still not possible to predict when an IMF programme will be implemented and a rescue package agreed. Meanwhile, arrears continue to accumulate, and the accounting problem for US banks will recur at the end of June.

Elsewhere in Latin America, developments have generally been encouraging. Mexico has at last secured the signature of its $3.8 bn loan for 1984, and Brazil's liquidity is much healthier, with nearly $4 bn of this year's new money already disbursed and a further improvement in the trade balance. Peru has reached agreement with the IMF, but delays persist in negotiations with Ecuador and Venezuela. Following a Fund mission to Chile to confirm the Stand-by programme with the new Ministers, an IMF Board discussion took place on 14 May.

There has been some further improvement in Eastern Europe. The USSR and Hungary are successfully tapping the market, and even the GDR has been able to return to it in a small way. Commercial bank negotiations with Poland have been successfully concluded. The Yugoslav restructuring is agreed in principle with both banks and official creditors, although the Yugoslavs are objecting to some aspects of the draft governmental agreement.

Progress has been made in Nigeria's negotiations with its uninsured, but not its official, creditors. As regards the Philippines, the banks expect that a new money package is not likely to be assembled until several months after an IMF agreement has been reached.

For the future, now that 1984 new money for Mexico and Brazil has been secured, attention has turned to Argentina, where the delays and problems noted above could well make banks reluctant to meet a financing requirement estimated at $4 1/2 bn. Brazil is also expected to make a request in the autumn for some $3 bn of new bank money for 1985: here, too, experience with the last package suggests that at least some of the smaller banks may be unwilling to participate. On the other hand, it is possible that Mexico may be able to meet part, or even all, of its requirement for bank finance in 1985 (estimated at some $4 1/2 bn) through normal market borrowing.

More generally, attention is beginning to focus on ways of managing the next - medium-term - phase of the debt problem, including the treatment of interest payments and the problem of maintaining cohesion in assembling financial support packages. The co-ordinated approach adopted in Quito by debtor countries has maintained its momentum, but it is not yet clear how far this may influence the balance of power between banks and borrowers or present case-by-case methods. Meanwhile, study groups set up by banks under the auspices of the Institute of International Finance to examine such issues are expected to produce interim reports early in July.

More detail about the position in major debtor countries is given below.

(i) Latin America

Argentina remains the major problem at present for the financial community. Following the breakdown of negotiations for reinstating the 1983 new money loan, a $500 mn emergency financial package was arranged to enable Argentina to pay interest on its public sector debt up to 2 January, and thus avoid the need for US banks to classify loans as non-performing when reporting first quarter earnings. The package included loans totalling $300 mn from Mexico, Venezuela, Brazil and Colombia, to be taken over by the US Treasury on signature of a Letter of Intent with the IMF, $100 mn from the banks, and $100 mn out of Argentina's own reserves. The banks have also had to roll over (to 16 June) the $750 mn outstanding under the 1982 bridging loan. Progress on a new IMF programme is still proving very difficult; meanwhile, government policy is having little impact on the country's economic problems.

The improvement in Brazil's liquidity has been maintained: a further tranche of new money (totalling $875 mn) was drawn on 13 April, and the trade balance has improved further. All arrears (other than those which might qualify for Paris Club rescheduling) were eliminated by end-March. Official attention has now switched to inflation: it remains to be seen whether a decline in the monthly rate in April was the start of a downward trend. The Fund Board met on 9 May to consider a recent Article IV Consultations paper, an EFF review, and a request for a CFF.

The $3.8 bn new money loan for Mexico was finally signed on 27 April and a first drawing (of $950 mn) is expected to be made in mid-May. Little information is so far available on Mexico's economic performance this year, but it is becoming increasingly clear that the target for inflation (40% year on year in December) is unlikely to be achieved.

Elsewhere, a major Cabinet reshuffle took place on 2 April in Chile, which included new Ministers of Economy and Finance. A Fund mission has confirmed the programme for the second year of the Stand-by with the new Ministers, and a Board discussion is scheduled for 14 May. Meanwhile, commitments to this year's new money from banks have reached 95%, and signature is expected early next month. Although a new team in Peru tried to secure modifications to a recent Standby, the programme approved by the IMF Board on 26 April does not differ substantially from the earlier agreement. However, it remains to be seen whether the authorities will be able or willing to implement its terms in the run-up to next year's Presidential elections, although in the short term the agreement with the IMF should facilitate early signature of the 1984/85 refinancing package. In Ecuador, agreement in principle has been reached on the 1984 refinancing package, which incorporates much better terms than last year. But creditor banks are reluctant to sign until the outcome of the second round of the Presidential elections becomes known in May and a new Standby has been agreed with the IMF. As regards Venezuela, there are signs that the authorities are beginning to show real willingness to accommodate their creditors: arrears of interest on public sector debt had been eliminated by mid-April (though they are beginning to build up again), and action is being taken to speed up payment of private sector interest arrears. The Advisory Committee has accepted a further extension of the moratorium until end-July, but it is not yet clear whether an agreement on rescheduling can be reached without the need for an IMF programme. Progress on such an agreement will not be helped by the publicity given to a recent requirement of the US regulatory authorities that US banks should classify loans to Venezuela as "sub-standard".

(ii) The Far East

In the Philippines, substantive progress towards signing a Letter of Intent - the main essentials of which are agreed - awaits implementation of a number of policy measures which the authorities would not undertake before the 14 May Parliamentary elections. The moratorium has been extended for a further 90 days to 12 July and, as negotiations with the banks are expected to be protracted into the late summer or autumn, at least one further extension is likely to be necessary. The Advisory Committee of banks met again on 7-8 May in an effort to seek a compromise over the treatment of the frozen deposits with Citicorp, Manila. Elsewhere in the region, Indonesia's highly successful euro-loan in March, together with an expected satisfactory outcome at the annual meeting of the Inter-Governmental Group on Indonesia, should mean that the country's financing needs for the year ahead have now been effectively secured. With comfortable reserves and low short-term debt, Indonesia is now unlikely to face a payments crisis.

(iii) Eastern Europe

There is further evidence of an improvement in market sentiment towards Eastern Europe. A syndicated loan to the USSR, which was oversubscribed, was increased from $150 mn to $250 mn, and is to be shortly followed by a loan for $100 mn for the Moscow-based International Investment Bank. Hungary, which has already been active in the market this year, is seeking further large co-financing loans. Even the GDR is currently testing the market with a modest $50 mn "club" loan for five years, on terms (1% over LIBOR) which compare very favourably with the high rates recently being paid on its shorter-term paper; and there are suggestions that Bulgaria may be contemplating a loan of $50 mn.

Approval of the new Stand-by Arrangement for Yugoslavia has paved the way for creditor governments to sign the framework agreement rescheduling all medium and long-term maturities falling due in 1984 over seven years, including four years' grace. However, the Yugoslavs have taken exception to some aspects of the draft agreement, and signature could therefore be delayed. Signature of the series of agreements with the commercial banks will start on 16 May. The banks have reached agreement with Poland on a multi-year rescheduling and the provision by end-1985 of some $700 mn trade finance, of which just under half will be new money. Signature is expected in July and will complete the rescheduling of virtually all the original stock of debt due to banks. The Poles now seem to have accepted the provisional agreement on settlement of arrears under the 1981 rescheduling agreement with official creditors, reached in Paris in March. A Task Force is due to meet the Poles later this month, and negotiations may begin in early June.

(iv) Southern Europe

After a successful $150 mn FRN issue last month by Greece, a favourable reception to a 7-year syndicated credit has prompted the authorities to raise the amount from $350 mn to $400 mn. The coupon, at 5/8% over LIBOR, is the same as was obtained on the $500 mn credit raised by the Bank of Greece in March 1983. To some extent, this relatively favourable response reflects a shortage of better quality borrowers in the market. Meanwhile, the central bank's recent Annual Report includes some measured criticism of current economic policies, emphasising in particular the need to reduce the current account deficit and the dangers which would flow from an increase in real wages this year.

Turkey's new one-year Stand-by has been approved, but unless the pace of external adjustment turns out to be faster than currently envisaged, the country could well experience payments difficulties within the next three years, when debt service payments peak. The OECD takes a gloomier view than the IMF and does not rule out the need for special assistance in 1985, when rescheduled debts being to mature.

Provisional figures for the first quarter of 1984 show that Spain's external position improved further, with the trade deficit less than half as large as in the corresponding period last year. Medium and long-term debt rose by only $3/4 mn during 1983, compared with $1 1/2 bn in 1982 and $3 1/2 bn in 1981. Substantial capital inflows in recent months have prompted the authorities to encourage early repayment of foreign debt.

Portugal's external adjustment effort is beginning to show results, with a current account deficit last year of $1 3/4 bn, compared with an IMF target of $2 bn and an outturn of $3 1/4 bn in 1982. Nevertheless, external indebtedness remains uncomfortably high, at $14 1/4 bn in September (of which $3 1/2-4 bn short-term), and is projected to rise further in the medium-term. Against this background, conditions for borrowing in external markets remain far from easy.

In April, the Nigerians made an offer to uninsured commercial creditors, after securing agreement in principle from a representative group of major creditor companies. An IMF mission arrived in Lagos in early May to resume negotiations of a three-year EFF. The mission's departure was conditional on official willingness to make an initial devaluation against the dollar, and had been delayed by earlier Nigerian reluctance to take this key step. The recent Budget proposals, although making no reference to devaluation, are in most other respects likely to meet with Fund approval.

INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt End-Dec 1983 (except where stated)	British-owned banks' exposure [1] End-Dec 1983	ECGD amounts at risk[2 End-Dec 1983
Latin America			
Argentina	43.6	2.5	0.1
Brazil	91	6.1	2.1
Chile	17.4	1.3	0.1
Ecuador	6.6	0.6	0.1
Mexico	95.3	6.3	1.5
Peru	13	0.4	0.2
Venezuela	34	2.4	0.1
Eastern Europe (convertible currency)			
East Germany	13	0.7	0.2
Hungary	7.4*	0.5	0.1
Poland	27	0.5	1.0
Romania	9	0.3	0.5
Yugoslavia	18.8	0.9	1.3
Southern Europe			
Portugal	14.2*	1.4	0.4
Greece	12.1	1.6	0.4
Spain	40	2.8	0.2
Israel	29	0.6	0.2
Far East			
Indonesia	31	0.8	1.7
Philippines	25.6	1.4	0.3
South Korea	40	2.6	1.0
Other			
Morocco	11.5	0.1	0.3
Nigeria	20	1.3	4.1

* end-September 1983

[1] This column now shows exposure defined as consolidated external claims, adjusted for certain inward and outward risk transfers in respect of guaranteed loans, plus any net claims on local residents in local currency.

[2] Because of differences in definition, these estimates are not directly comparable with the figures in other columns.

Indebtedness

CONFIDENTIAL

Prime Minister (2)
To note
AT 11/4

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

11 April 1984

Andrew Turnbull Esq
10 Downing Street

Dear Andrew,

ARGENTINA: BANK LENDING

In his letter of 5 April about the international financial scene, David Peretz said that there was a further deadline on the Argentine bridging loan to be met on 16 April, when the banks' original bridging loan fell due for replacement. He told you that we were in touch with the Bank of England about how this might be handled.

The Bank now report that the Working Committee is likely to propose a further roll-over of the bridge loan. No new conditions are likely to be attached to the roll-over, which is seen by the banks as unavoidable and now almost routine. The British clearers have told Huntrods, of Lloyds Bank International, that he can follow the majority of the other members of the Working Committee banks on this issue and agree to a 2 month roll-over to 16 June, or a slightly longer extension to 30 June. They do not see the date as vital to UK banks' interests, and given the co-operation of other Working Committee banks on issues more central to UK interests, feel that LBI should be accommodating. This is not a matter on which UK banks have a blocking vote, and if they decide on their own commercial judgement to fall in with the majority view, we shall say that it was a decision for them, without giving further comment.

There are press reports today that Argentina has now signed a Letter of Intent to the IMF. We have, as yet, no confirmation of this. We expect tohear more on the Chancellor's return at the weekend from the Interim Committee.

I am sending copies of this letter to Len Appleyard (FCO), Callum McCarthy (DTI) and John Bartlett (Bank of England).

Yours sincerely,

Margaret O'Mara

MISS M O'MARA

Econ Pol
Indonesia
Pt. X

11 APR 1984

CONFIDENTIAL

cc Press Office
PG

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

5 April 1984

Andrew Turnbull Esq
No 10 Downing Street
LONDON SW1

Prime Minister
To note. You need read only to page 3 plus the paragraph on page 7 relating to Nigeria.
AT 6/4

Dear Andrew

INTERNATIONAL FINANCIAL SCENE

... I enclose the most recent report on developments in the international financial scene. As usual, this was prepared by the Bank of England, and revised in the light of discussions in the Treasury's interdepartmental group on debt problems. It has been further revised to take into account this weekend's developments in Argentina.

I sent you a separate report on the Argentine bridging loan, on 2 April. This operation, which as you know we view without enthusiasm, has only bought a limited amount of time. Some small progress has now been made in discussions with the Fund on a few policy objectives but not as yet on implementation. There is a further deadline to be met on 16 April, when the banks' original bridging loan falls due for repayment, and we are in touch with the Bank of England about how this is likely to be handled by the banks concerned.

We reported last month on the outcome of the Quito meeting. There has been further discussion of this at the Inter-American Bank Meeting last week; but in general the moderate line taken by the Latin American debtor countries has been reassuring.

The Prime Minister might also like to note in particular the developments on Poland and on Nigeria. On the former, talks on rescheduling official debt have at last begun again. In the latter case, the UK has taken the lead in trying to organise a collective approach by the creditors to the Military Government, with the object of persuading them to negotiate an appropriate adjustment programme with the Fund, to enter into serious talks with the government creditors, and to produce an acceptable solution to the problem of uninsured trade creditors. We do not yet know whether this has been successful.

Copies of this letter go to Len Appleyard (FCO), Callum McCarthy (DTI) and John Bartlett at the Bank.

Yours ever
David

D L C PERETZ

INTERNATIONAL FINANCIAL SCENE

Attention has tended to focus on Argentina in recent weeks, with market sentiment affected by renewed uncertainties about the intentions of the government. Meanwhile, the short-term outlook for Brazil has improved somewhat, but progress on Mexico's new money has been disappointingly slow - perhaps (perversely) because the sense of crisis is no longer there. The picture in other debtor countries is similarly mixed.

The Bank's latest forecasts, which are broadly in line with those of the IMF, predict average growth of 3.9% this year in the seven major industrialised countries, and an increase of over 6% in world trade, which should benefit exports of developing countries. However, there are some indications that the pace of recovery in the US - it is estimated that real GNP will rise by 7% at an annual rate in the first quarter - and the size of its current account deficit may already be beginning to put pressure on prices, the dollar, and interest rates. Consumer prices have been edging upwards in recent weeks, while the dollar has come down from its mid-January peak. But the associated relief to the debt burden of developing countries will have been offset by a rise of about one percentage point in key US interest rates over the same period. Commodity prices have recovered after a modest decline in February; oil prices remain unchanged.

Argentina's continued failure to tackle its economic and debt problems, not least the continued accumulation of arrears, together with recent rumours of a possible siege economy, have created serious concern among the banks and within US official circles. Around the middle of March, the banks' Working Committee offered to make a two-stage disbursement of last year's new money loan, subject to quite tight conditions. This offer was rejected by Argentina: so it appeared that interest arrears owed to banks would not be paid by 31 March and that, for arrears outstanding for over 90 days, US banks would be obliged to declare such loans non-performing, and would not be allowed to accrue interest on them when they reported first quarter earnings. Such earnings would also have been adversely affected by adjustments for income accrued in the last quarter of 1983. However, towards the end of March, a compromise proposal was worked out between the governments of the US and of four Latin American countries (Mexico, Brazil, Venezuela and Colombia), which was accepted by Argentina and the Working Committee. The Latin American countries have lent Argentina $300 mn, to be repaid by the US Treasury when Argentina agrees a Letter of Intent with the IMF; and the Working Committee has lent $100 mn, to be repaid from the next drawing of the medium-term loan, or by 30 June (whichever is the earlier) from the Argentine central bank's account with the Federal Reserve Bank. These loans, together with $100 mn from Argentina's own resources, are to be used to eliminate arrears up to 2 January on debt owed to non-Argentine banks. A further breathing-space has thus been provided to allow negotiations on debt to continue. The Alfonsin government has consistently aimed to complete negotiations by 30 June, when the banks' share of the new facility expires; but Argentina's good faith in continuing negotiations remains to be proved. In this context, the involvement of the four Latin American states and of the US government may strengthen the hand of the creditors.

Elsewhere in Latin America, recent developments in Brazil, Venezuela, and Chile have generally been favourable. In particular, the short-term outlook for Brazil now seems rather better, thanks to a considerable improvement in liquidity, although the trend in inflation is still a major cause for concern. On the other hand, the resignation of the Minister of Economy in Peru has given rise to uncertainty about the government's commitment to the new IMF programme. And progress on Mexico's new money loan has proved disappointing, with many small banks still not committed, so that final signature is now not likely until mid-April at the earliest. A delay of this length, for a country making such a remarkable economic recovery, is a setback to hopes that economic success might be seen to bring its own rewards, and points up the growing difficulties likely to surround successive loan packages - particularly in circumstances where, as in the present case of Mexico, the sense of crisis and urgency has waned perceptibly.

The picture is also mixed in other problem countries. In Eastern Europe, some countries have recently been able to tap the markets; and Yugoslavia has made positive progress with the IMF, official creditors, and commercial banks. Some headway has also been made on Poland's debt problem. But another round of negotiations with the Philippines has again proved inconclusive, leading to a request for a further extension of the moratorium and delay in establishing an IMF programme; while an agreement between Nigeria and its official creditors is now likely to take several months.

Latin American countries are continuing to pursue the Quito initiative for a co-ordinated approach to debt problems - notably at meetings of the Inter-American Development Bank and the Economic Commission for Latin America at the end of March and the beginning of April - but the tone remains moderate. In contrast, there are signs that the solidarity of banks may be weakening: European banks are reported to be considering the establishment of pressure groups to represent their interests more effectively against those of American banks in debt negotiations and discussion of long-term issues.

(i) Latin America

Immediate concern is focused firmly on Argentina. The latest interim solution to the problem of interest arrears was described above. Meanwhile, serious negotiations on rescheduling have yet to begin; and progress on a new IMF programme is also proving very difficult, with formal agreement now unlikely before June, although Argentina has expressed the hope of signing a Letter of Intent by the end of April. It is already clear that the government's piecemeal economic policy is having little impact on the country's problems, but there is little sign that the authorities are willing to adopt a more soundly-based and cohesive economic programme.

The short-term position in Brazil has eased appreciably. In particular, liquidity has improved considerably in recent weeks, largely because the first drawings of new money (amounting to $3 bn) have now been made. The Brazilians are accordingly expected to have eliminated all payments arrears (other than those which might qualify for Paris Club rescheduling) by end-March. Against this background, the authorities have decided to decentralise foreign exchange transactions, which had been under the control of the central bank since last August.

As regards the IMF programme, the main concern remains the rate of inflation which reached 230% (year-on-year) in February. If the upward trend is not reversed by April/May, current policies may need to be reassessed in association with the IMF. The Fund Board is due to meet in April to consider papers on the recent EFF review and Article IV Consultations.

In spite of Mexico's good progress on the economic front and the IMF Board's recent approval of the programme for the second year of the EFF, the $3.8 bn new money loan from the commercial banks is not yet finalised. Banks were requested to increase their exposure by 6% this year: a full response would produce just over $4 bn, in which case each bank's contribution would be proportionately reduced. Although commitments currently amount to nearly $4 bn, some $700 mn of this is conditional upon 100% participation: about 65 banks (out of a total of 530) have still to be rounded up and, even if this can be accomplished quickly, the Advisory Group estimates that signature cannot now take place before mid-April.

Elsewhere in Latin America, further progress has been made, although many difficulties remain. The IMF Board is expected to approve Chile's 1984 programme in early April, provided that creditor banks agree to participate in the proposed $780 mn new money facility. Although the Chileans have obtained from the Advisory Committee better terms than last year, the banks' initial response appears to be favourable. The Peruvians have also secured improved terms for refinancing 1984 and 1985 maturities, but are not seeking new money from banks this year. However, a major uncertainty has now arisen with the resignation on 19 March of the Minister of Economy, following widespread internal political opposition to austerity policies agreed with the IMF: it remains to be seen whether his replacement will accept the new Standby agreement scheduled to be discussed by the IMF Board on 6 April. In Ecuador, no progress on rescheduling 1984 maturities is expected until the outcome of the second round of the elections becomes known in May and a new Standby has been agreed with the IMF. As regards Venezuela, formal debt rescheduling talks are now due to take place in April, and the new Administration is hoping for an early agreement. Although a recently-announced economic package appears to have ruled out the possibility of an IMF programme, it may prove to be an acceptable alternative to the banks. However, interest arrears are reported to have risen to over $1 bn.

(ii) Far East

Further negotiations between the Philippine authorities, the IMF and the Advisory Committee have been inconclusive; and no further progress is now expected before the Philippine elections on 14 May. Any subsequent agreement with the Advisory Committee on a new money/rescheduling package is further complicated by lack of progress over the freezing of deposits with Citicorp, Manila. Meanwhile, an application is to be made to extend the moratorium for a further 90 days from 15 April. Elsewhere in the region, Indonesia continues to show steady improvement, and has recently signed a $750 mn loan agreement which was on favourable terms and over-subscribed.

(iii) Eastern Europe

Some East European countries have recently been able to raise funds in the market. A $150 mn syndicated loan for the USSR was over-subscribed and may be followed by another operation for $100 mn on finer terms. Recent loans for Hungary have received a mixed response, but the authorities may shortly seek further co-finance on a major scale. Czechoslovakia, which raised $50 mn last summer, is expected to return to the market later this year for a bigger loan on improved terms. But neither the GDR (in the absence of a further West German guarantee) nor Romania (which has put itself in technical breach of its rescheduling agreements with the banks by failing to notify them of the premature termination of its Standby arrangement in January) could hope to approach the market at present.

Yugoslavia recently agreed a Letter of Intent to the IMF, and its new Standby arrangement is expected to be approved in the second half of April. Meanwhile, the official creditors, meeting in Switzerland on 24 March, endorsed their earlier decision to reschedule medium and long-term maturities falling due in 1984 over seven years, including four years' grace. Both the Agreed Minute and the commercial bank agreement - which is on more favourable terms than last year - are likely to be signed in May. The banks are still discussing the possibility of a multi-year rescheduling arrangement with Poland and considering how far and in what form they might provide any new money. Some progress was made by the official creditors in their meeting with the Poles in Paris on 21 March, and serious negotiations may begin at the next Paris Club in early May.

(iv) Southern Europe

The general conclusion of a recent IMF Board discussion of Greece was that a more rapid and decisive adjustment was required; that the government's targets for 1984 were inadequate; and that these were unlikely to be met by current policies. However, both the Prime Minister and the Economy Minister, probably with the European elections in mind, have publicly rejected the Fund's call for greater urgency as unworkable in the Greek context, and have re-affirmed the government's gradualist approach. The latest official forecast of a current deficit of around $2 bn in 1984 - over-optimistic in the IMF's view - implies that the gross external borrowing requirement will be much the same as last year ($1.9 bn). The Bank of Greece is arranging a $500 mn package - a Floating Rate Note issue for 10 years at 1/4% over LIBOR, and a $350 mn syndicated credit for seven years. The terms for the FRN primarily reflect the current popularity of this instrument, rather than the market's perception of Greece; terms for the syndicated loan are not yet known.

After a poor performance under last year's Standby arrangement for Turkey, associated with a sharp deterioration in the economy, the programme has been abandoned, and the Government has negotiated a new one-year Standby to run from April. The pace of adjustment envisaged may not be fast enough to reassure the banks, in view of the prospective hump in debt service from 1985 onwards.

From Spain there are reports of substantial capital inflows in recent months and of official encouragement for the early repayment of external loans by Spanish borrowers. This year's estimated external borrowing requirement is down to $850 mn (from $1.1 bn in 1983), of which around one half is said to have already been raised, and there are signs that market sentiment has become even more favourable to Spain: a recent FRN for the Kingdom was increased from $200 mn to $250 mn, despite the low (1/8%) spread, while the larger semi-state borrowers have been able to command a spread of LIBOR + 1/2% on recent credits, compared with the typical 5/8%-3/4% paid last year. In spite of Portugal's continuing efforts to tighten economic policy, the size of its external debt has - unlike Spain - so far prevented any improvement in the terms of borrowing.

Nigeria's negotiations with the Fund for an EFF are likely to be protracted, as official attitudes towards the step devaluation advocated by the IMF are hardening. To encourage a more flexible stance by the Nigerians, the UK has suggested a concerted approach by the major creditor governments to press for early agreement with the Fund. It has also been agreed to propose to the Nigerians an exploratory meeting to discuss restructuring of official debt (while emphasising that no commitments can be made before negotiations with the IMF have been successfully concluded). While Governments cannot negotiate formally on behalf of the uninsured creditors, the UK interests in Nigeria/ are very large Nigeria is about to make a 'take it or leave it' offer to these creditors which some at least find unacceptable, and is refusing to talk to Morgan Grenfell, who represent a large grouof trade creditors. DTI and Treasury have therefore engineered a meeting in London between the Nigerian authorities and a selection of the creditor companies in an attempt to negotiate a settlement. This approach has the support of other governments.

2 April 1984

INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt	British banks unguaranteed claims	ECGD amounts at risk
	End-Dec 1983 (except where stated)	End-June 1983	End-Dec 1983
Latin America			
Argentina	43.6	2.4	0.1
Brazil	90	4.6	2.1
Chile	17.4	1.1	0.1
Ecuador	6.6	0.5	0.1
Mexico	91.3≠	5.4	1.5
Peru	13	0.4	0.2
Venezuela	34	2.3	0.1
Eastern Europe (convertible currency)			
East Germany	13	0.6	0.2
Hungary	7.4*	0.5	0.1
Poland	28	0.6	1.0
Romania	9	0.3	0.5
Yugoslavia	18.8	0.9	1.3
Southern Europe			
Portugal	14.5	0.8	0.4
Greece	11.5	0.9	0.4
Spain	29**	2.4	0.2
Israel	29	0.5	0.2
Far East			
Indonesia	31	0.7	1.7
Philippines	24.5	1.3	0.3
South Korea	40	1.9	1.0
Other			
Morocco	11.5	0.1	0.3
Nigeria	15	1.1	4.1

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

≠ excluding unguaranteed suppliers credits of some $3 - 5 bn
* end-September 1983
** excludes short-term debt

Econ Pol.
Pt 4 Indebtedness

CC Press Office

CC P.C.

Prime Minister ②

This fills out the account I gave you on Friday night. I will have the Line to Take available for Questions.

AT 2/4

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

2 April 1984

Andrew Turnbull Esq
10 Downing Street
LONDON
SW1

MT

Dear Andrew,

ARGENTINA

The Chancellor, who is in Luxembourg today, asked me to let you have a fuller report on the rescue package for Argentina which the United States authorities managed - just - to put together late on Friday, 30 March. Our first news of their efforts to mobilise a package came during Friday, and as you know it was only very late on Friday that the extent of US Treasury involvement became clear, and that it began to look as if there was a chance of a positive result.

Details of the Package

The total package provides $500 million to be applied to the payment of arrears owed by Argentina on commercial bank loans, so as to avert the immediate threat that many outstanding loans, particularly from US banks, would have had to be classified as "non-performing". The sum is made up of:

- $100 million from Argentina itself;

- $300 million from other Latin American governments (100 each from Mexico and Venezuela and 50 each from Brazil and Colombia). In respect of this sum, the US Treasury has offered to take out the full $300 million on signature by Argentina of a Letter of Intent to the IMF. The US Treasury would itself be repaid out of subsequent IMF lending to Argentina (probably the first two tranches of such lending);

- $100 million from the 11 "lead" commercial banks representing the syndicate of all commercial banks involved in loans to Argentina, pro rata among the participants. The sole British bank involved is Lloyds Bank International (LBI), and its share is reported as $7.8 million. Repayment details are still not entirely clear. There appears to be a dual arrangement, either repayment from future commercial bank lending under the outstanding syndicated loan, which might be available when IMF lending has been finally agreed, or repayment on 30 June by Argentina out of funds held and earmarked with the United States Fed.

A further provision in the package is an undertaking by Argentina to reach a preliminary agreement with the IMF within 30 days.

CHANCELLOR OF THE EXCHEQUER

Background and Comment

We knew that the US authorities were bringing very great pressure to bear on Argentina last week in the hope of securing some payments which would avert the threat of "non-performance" had arrears been left through the end-March deadline. It seems that, in the course of discussions with other Latin American governments, they were offered by the Mexican Finance Minister the idea of some joint operation, and they jumped at the possibility.

On Friday morning, the US authorities were working on a slightly larger package of $610 million (with 150 from Argentina and 160 from commercial banks), and were still not certain of the 300 from other Latin American governments. By late on Friday, everything was in place except the commercial bank participation, on which the target had been reduced to 100 million. The US banks had been persuaded to join in; others were reluctant and insisting on "all or none". The US authorities evidently worked on each individually, to the point where LBI were the only bank holding out. In the last stages on Friday - very late by our clocks - there were calls here from McNamar and Sprinkel of the US Treasury, to try to persuade HM Treasury to encourage LBI to participate and thus avoid the last-minute collapse of the package. We refused, and the Deputy Governor of the Bank of England made it clear that LBI must make their own decision and could not look for comfort from statements by HMG.

Eventually, Sir Jeremy Morse (who happened to be in the United States and exposed to very strong direct pressure from Sprinkel and Volcker) felt that he could no longer stand out in isolation and agreed to participate. In the circumstances, his decision is an understandable one.

As regards the package as a whole, I have to say that the Treasury here and the Bank of England have some doubts. It is ingenious, it has elicited another promise from Argentina, for what that is worth, and it has mobilised what could be important pressure from other Latin American countries. On the other hand, there is a sense in which the debtor has called the tune, and the participation of other Latin American countries both raises the stakes on any future disagreement and threatens to bring in an element of debtor solidarity which could be dangerous. The US Treasury could face a good deal of domestic criticism for an operation which can be represented as a "bail out" both for Argentina and for commercial banks.

Line to Take

I suggest we should try to avoid comment, but if questions have to be answered the line should be:

- On participation by a British bank: the decision was a matter for the bank itself.

- On the package generally: HMG and the Bank of England played no part in this operation, which appears to have been mobilised largely by the United States Treasury and Fed.

- If pressed: the following additional points could be used:

  - understand that the whole $500 million (including $100 million from Argentina itself) will be applied directly to settlement of arrears due to commercial banks, including British banks.

- Essential need for Argentina is to reach agreement with the IMF. Understand the US authorities are hoping that this new loan, with participation by other Latin American governments, will bring pressure on Argentina to reach agreement with the IMF.

Copies of this letter go to Len Appleyard (FCO) and John Bartlett (Bank of England).

Yours ever,
David

D L C PERETZ

Econ Pol:
Indebtedness
Pt 4

-2 APR 1984

CONFIDENTIAL

NBPM

AT 29/3

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

28 March 1984

The Rt Hon Nicholas Ridley
Secretary of State for Transport

Dear Nick

NIGERIA: ECONOMIC RELATIONS

Thank you for your letter of 22 March.

I am sure it is right to wait until we see the terms of the Nigerian offer to the uninsured creditors. I understand that the Nigerian Government is now willing in principle to talk to a representative group of the creditors about this offer, provided that Morgan Grenfell is not directly associated with any meeting. The Government itself, of course, cannot negotiate directly on their behalf, but I agree that we must be careful not in any way to prejudice B.Cal's rights under the Air Services Agreement.

I am sending copies of this letter to the recipients of yours.

Yours

Nigel

NIGEL LAWSON

Econ Pol Indebtedness Pt 4

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

NBPM
AT 23/3

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
LONDON SW1P 3AG

22 March 1984

Dear Nigel

NIGERIA: ECONOMIC RELATIONS

Thank you for your letter of 12 March about the special problems of British Caledonian.

I am very disappointed that despite the arguments in my earlier letter you feel unable to take any special action to help British Caledonian obtain prompt repatriation of their outstanding balances in Nigeria.

The company is continuing to press its case with the Nigerian authorities and there seems some reason to believe that the Nigerians themselves recognise the company's special position and will be prepared to contemplate some administrative device which will help BCAL to some extent (although going only part of the way to meeting its problem) without setting a precedent which could be embarrassing in their relations with other British and foreign creditors.

In the circumstances I agree that we should await the Nigerian offer to the uninsured creditors and see what line BCAL take about it. If we are to adopt this policy, however, it is essential in my view that during any inter-governmental discussions with the Nigerians we should avoid any suggestion - let alone any commitment - which would in any way affect BCAL's rights under Article 12 of the Air Services Agreement to repatriate the excess of its earnings over its expenditure in Nigeria. Sir Adam Thomson would have a legitimate ground for complaint (which I am sure he would pursue with both of us) if in the context of negotiating a wider debt settlement we in any way weakened his negotiating position vis a vis the Nigerians. His rights under the Air Services Agreement are an important feature of his case and we must avoid prejudicing them.

I am sending copies of this letter to those to whom I sent copies of my letter of 22 February.

NICHOLAS RIDLEY

Econ Pol. PT 4

Indebtedness

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File

085

10 DOWNING STREET

From the Private Secretary 16 March 1984

ARGENTINA: COMMERCIAL BANK LENDING

The Prime Minister has seen the Chancellor's minute of 15 March. She is content that the British banks should go along with the release of a second $500 million tranche of the loan, subject to the four conditions set out in paragraph 3 and on the understanding that there should be no further concessions made to Argentina.

I am sending copies of this letter to Peter Ricketts (Foreign and Commonwealth Office), John Bartlett (Governor of the Bank of England's Office) and Richard Hatfield (Cabinet Office).

Andrew Turnbull

John Kerr, Esq.,
H.M. Treasury.

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Prime Minister (1)

Chancellor, supported by Foreign Secretary, recommends not standing in way of an agreement to a further tranche of the loan on conditions which are somewhat easier than those being sought earlier by the British banks.

Are you content?

AT 16/3

Yes MT.

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

PRIME MINISTER

ARGENTINA: COMMERCIAL BANK LENDING

You will recall that the British banks concerned with the medium-term loan to Argentina have been arguing that the release of the second $500m tranche should be conditional on Argentina reinstating its IMF programme, and remaining in conformity with it.

2. In my minute of 7 February I reported that the British representative on the Working Committee handling the loan had become isolated in opposition to a proposal to allow a looser linkage, to a letter of intent by the Argentine Government rather than to the actual reinstatement of the fund programme. The line has nevertheless held, through a number of Working Committee meetings.

3. A new proposal has emerged at a Working Committee meeting this week. It is that release of the second $500m tranche should be allowed, provided that:-

a. Larosiere has forwarded a letter of intent to the IMF Board, and recommended that it be agreed;

b. any measures in the Fund programme for Argentina which require the approval of the Argentine Congress have already obtained it;

c. Argentina agrees to contribute $110m from her accumulated foreign exchange reserves to supplement the second tranche, and clear interest arrears; and

d. it is understood that

/the release

the release of the final \$500m would depend on the IMF Board approving the new programme.

4. The British banks are not yet committed to accepting this proposal; but they are likely to want to accept it. They have to respond on 19 March, and are meeting tomorrow to decide how to do so. Acceptance would undoubtedly represent a slight softening of their position, but the conditions on the loan would remain pretty tight. It is virtually unprecedented for the IMF Board to repudiate a letter of intent recommended by the Managing Director, and it seems clear that Larosiere does not intend either to accept a weak programme or to be fobbed off with a letter of intent unlikely to be implemented. Moreover, I attach importance to the requirement that the Argentine Government should dip into its own reserves, which have been building up quite sharply. And all or most of the \$500m, like the additional \$110m, would probably be used immediately to repay accumulated arrears.

Foreign Secretary agrees with Chancellor's line.

5. I understand that the Governor's view is that the British banks need not be urged to stand out against the new proposal. I agree with him; and, subject to your views and those of the Foreign Secretary, propose to ask him to indicate to the banks that we would not wish to dissuade them from going along with a consensus in favour of the new proposal, if they judge that to be in their commercial interest. To avoid the risk of a slippery slope, I think that it would be right also to warn the banks that we assume that no further concessions would be made in response to any Argentine resistance to any of the four conditions.

6. Copies of this minute go to both the Foreign Secretary and the Governor; and also to Sir Robert Armstrong.

N.L.

N.L.

15 March 1984

Indebstadnes

CONFIDENTIAL

NB/PM

AT 13/3

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

12 March 1984

The Rt Hon Nicholas Ridley MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
LONDON SW1P 3EB

Dear Nick

NIGERIA: ECONOMIC RELATIONS

Thank you for your letter of 22 February about the special problems of British Caledonian.

I delayed my reply because I wanted to see if, in the light of a broad hint from the Nigerians that some solution would be found, a visit by BCal representatives to Lagos produced any result. Unfortunately, it did not, and BCal must therefore remain in the same position as the ordinary uninsured creditors, despite the existence of the Air Service Agreement. This means that they will face a long wait for money due to them for 1983. They must also, of course, be concerned about continued prospects for remittance of their 1984 earnings.

I understand that the Nigerian Government are now considering a draft offer to all the uninsured creditors, including airlines, which may be issued in the next week or two. In addition, the Nigerians have told us that they will do their best to maintain a free flow of foreign exchange during 1984. Given the normal delays in transmission, it is too early yet to be sure whether they will honour this undertaking.

In the circumstances, I suggest we await the Nigerian offer to the uninsured creditors, and see what line BCal (along with the other creditors) take about it. Despite the existence of the Air Service Agreement, I am reluctant to put particular pressure on the Nigerians on behalf of a single creditor, although I did take the opportunity to mention BCal when the Nigerian Finance Minister came to see me on 20 February.

Copies of this letter go to the recipients of yours.

Yours

NB

NIGEL LAWSON

Econ Pol : Pt 4
Indebtedness

Prime Minister (2)
To be aware
AT 9/3

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215) 5422
GTN 215)
(Switchboard) 215 7877

JU933
Secretary of State for Trade and Industry

9 March 1984

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
London SW1

D Nigel,

pt 3

NIGERIAN DEBTS: BRITISH CALEDONIAN AIRWAYS

I have seen a copy of Nicholas Ridley's letter of 22 February to you.

2 I see dangers in further Government action arguing for special treatment for British Caledonian's uninsured debts in the present Nigerian situation. In the context of the present debt restructuring exercise I think that BCal should be prepared to make an equitable contribution to the debt relief operation along with other British creditors - many of whom are owed more than BCal and have been awaiting payment for much longer. I do not see how we could justify an argument for preferential treatment for BCal and not, say, for Unilever in the present situation - unless and until it can be established with precision whether or not the current foreign exchange transfer delays constitute a breach of the Air Services Agreement. But even here we have to bear in mind that debt restructuring negotiations have begun in order to secure fair treatment for all creditors because the Nigerian situation does not permit everyone being paid at once.

3 As you know, we have a responsibility to ensure that all the uninsured trade creditors should receive a fair deal on the basis of a settlement broadly comparable with that for the insured creditors. You specifically mentioned this in the BCal context when you saw Dr Soleye on 20 February. The fact that your message was well taken has since been confirmed in the current debt discussions where the Nigerians have made particular reference to BCal's arrears. They have given no indication, however, that they intend to treat BCal any more differently from other uninsured creditors than they already have. If BCal themselves can persuade the Nigerians to take a more positive view of airline remittances, so much the better, but I do not think that this is a matter in which we should intervene.

4 A copy of this letter goes to the recipients of yours.

Yours
Norman

NORMAN TEBBIT

Econ Pol
Indebtedness
PE 4.

Prime Minister (2)

To note AT 6/3

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

5 March 1984

A Turnbull Esq
10 Downing Street
LONDON
SW1

MT

Dear Andrew,

INTERNATIONAL DEBT PROBLEMS: ARGENTINA AND YUGOSLAVIA

In my letter of 24 February, I undertook to keep you informed of any major developments on the commercial bank loan for Argentina.

We understand that the UK banks are still not isolated in insisting on tight linkage of further disbursements to agreement with the Fund. No new decisions seem imminent, though the banks' Working Committee will review the situation on 7 March. More worrying, however, is the increasing evidence that the Argentine administration are not getting to grips with their economic problems, and therefore that an early agreement with the Fund is unlikely. We are reviewing our contingency planning and shall monitor developments closely.

All the more reason for UK banks to take a firm line.

Incidentally you may also like to know that the IMF have successfully concluded negotiations with Yugoslavia on a programme for 1984.

I am copying this letter to Brian Fall at the FCO, Callum McCarthy at DTI, and John Bartlett at the Bank.

Yours ever,
John Kerr.

J O KERR
Principal Private Secretary

Econ Pol: Indebtedness Needs New File (pt. 4).

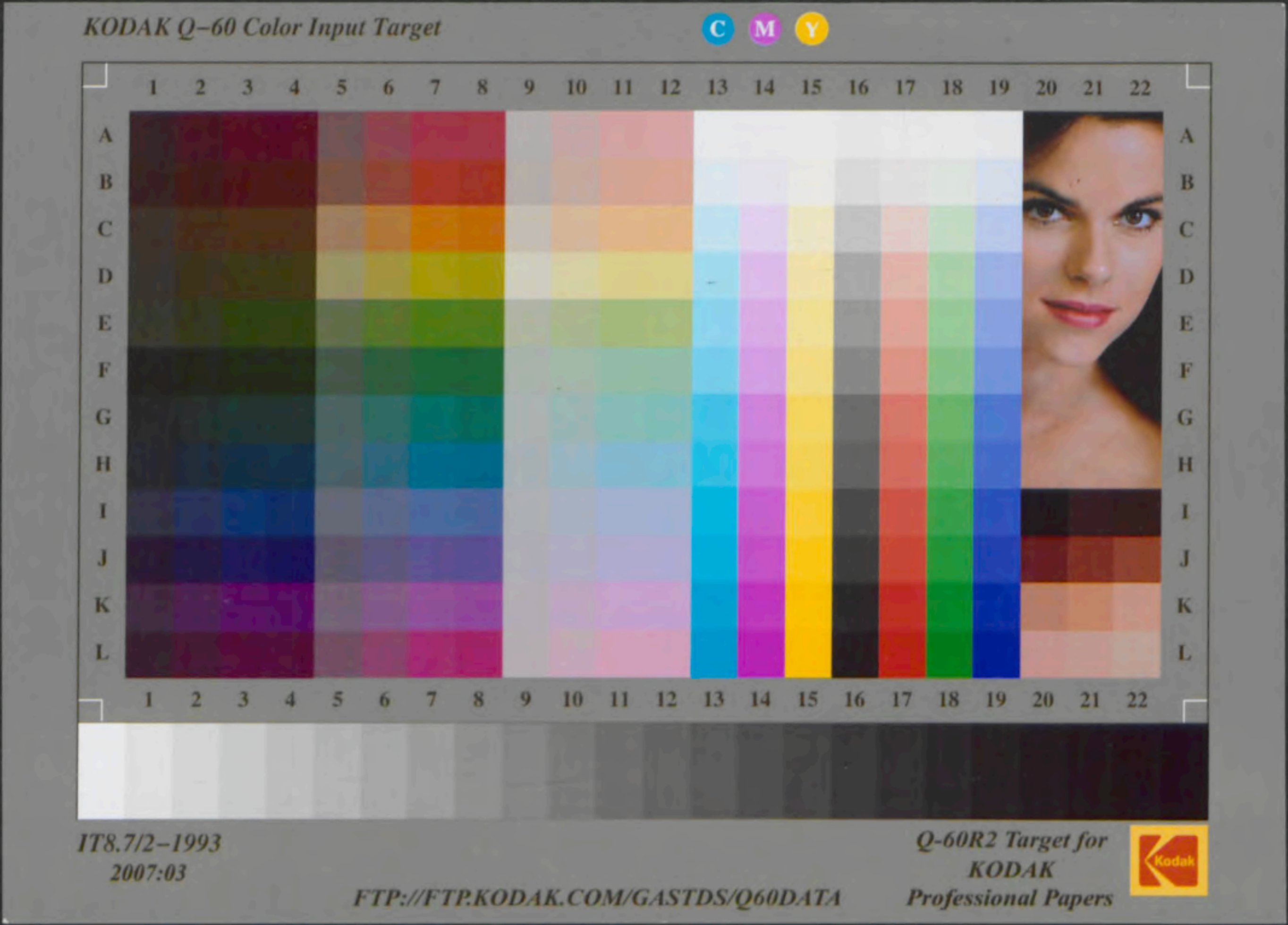
- 6 MAR 1984

PART 3 ends:-

HMT to AT 24.2.84

PART 4 begins:-

HMT to AT 5.3.84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