PART 5

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SECRET

Confidential Filing

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

S 812

ECONOMIC POLICY

Pt 1: AUGUST 1982

Pt 5: JANUARY 1985

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PART 6 begins:-

HMT to CDP [illegible] 86

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cc DJW

Prime Minister
CDP 7/2

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

Charles Powell
10 Downing Street
LONDON
SW1

5 February 1986

Dear Charles,

INTERNATIONAL FINANCIAL SCENE

I enclose the latest in the regular series of reports on developments on the international debt front.

The major factor in the economic outlook is clearly the sharp fall in oil prices. The benefits of this in terms of higher world growth will be less immediate than the problems caused by the fall in export earnings for major oil producers such as Mexico and Nigeria. Our judgement is that if prices were to stabilise at around $18 to $20 a barrel, this should be manageable even for the hardest hit. At lower prices, however, the situation would become increasingly difficult. In an immediate response to the situation Mexico and Venezuela are reported to have called for a meeting of the Cartagena Group. Other, non-oil factors, in particular interest and exchange rate movements, have been moderately helpful.

On the institutional front, reasonably positive progress is being made in the wake of the Baker initiative. The IBRD have been working hard behind the scenes on structural programmes for most of the major debtors, although a "candidate" for Baker treatment is unlikely to emerge until the April Interim and Development Committee meetings. Indeed, real identification of such candidates will only be possible over time as changes in gross flows can be measured. It is also worth noting that the recent Inter-American Development Bank Conference in London, which attracted many senior Government figures from Latin America, took a generally moderate tone, whilst we are also making some progress with the concept of using a co-ordinated approach to export credit as an additional lever in the debt discussions. On the negative side, however, is the reluctance of Brazil and Nigeria to negotiate with the Fund on Standby Arrangements which would be the key to rescheduling by both commercial banks and the Paris Club.

On individual countries, there are no significant changes to the list of those giving cause for concern but the fall in oil price has significantly worsened the outlook for some of those already on the critical list, in particular Mexico and Nigeria. Mexico will clearly need considerably more new finance than originally forecast. M. De Larosiere in his discussions with the Chancellor this week took the view that successful handling of Mexico's problems was the single most important issue in the current debt outlook. Despite the forceful tone of his speech to the IADB Conference, Finance Minister Herzog pledged a continuing commitment to adjustment policies in his conversations with both the Chancellor and Governor. The position in relation to Nigeria is discouraging. The recent budget did not go far enough, at least on the external side. The need to do so is now increased by the fall in oil prices, but the Government is distinctly unimpressive and so far, despite the oil price fall, appears to continue to see devaluation as politically impossible. Without it the Fund are most unlikely to agree to an SBA. In these circumstances, it may not be easy to avoid default. The prospects will be clearer after senior Nigerian officials have held talks this week in Washington and the Fund have made a fuller appraisal of the Nigerian economy in the course of subsequent Article IV consultations.

On Brazil, the problem remains her relationship with the Fund. The agreement with the commercial banks to reschedule 1985 medium term maturities and roll over 1986 maturities and short term trade lines was only agreed after the banks requested (and got) some signal of greater commitment by Brazil to the Fund (in the form of a letter to the Managing Director promising closer co-operation in future). It remains to be seen what this will amount to in practice. Something more concrete will be needed for the Paris Club. More generally much will depend on whether Brazil's recent impressive trade and growth performance can be sustained and her inflation brought under better control. The latter prospect is not enhanced by the weakness of the Government.

In Eastern Europe, Poland's official creditors are keeping up pressure on the Poles for comparable treatment with the banks in relation to Poland's limited capacity to repay debt. The Poles have now taken this up with the commercial banks who have yet to react formally. On Yugoslavia, difficulties with the Fund on interest rate policy now seem to have been resolved. This will allow the banks to activate their MYRA and the UK bilateral agreement on restructuring 1985 debts to be resolved.

Finally, the last two reports noted Egypt as a potential addition to the list of major debtors. This now seems inevitable given the direct and indirect consequences of the fall in oil prices for her economy and the reluctance of the Egyptian Government to take any early measures of adjustment.

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

Yours ever
Rachel.

RACHEL LOMAX

Annex to COP 5/2. International Financial Scene

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INTERNATIONAL FINANCIAL SCENE

1 The statements supporting Baker from the US and UK banks (and the statement issued after the meeting of European banks in Zurich in November) which were noted in the last Report were followed later in December by statements also from the Japanese, French, Canadian and Italian banks; more recently Saudi, German, Dutch and Swiss banks have expressed their support, and Belgian banks are expected to make their own statement shortly. Meanwhile, the Cartagena group of countries met in Montevideo on 16 December, and gave a guarded welcome to the Baker initiative whilst expressing a considerable number of reservations and re-stating some of its own earlier objectives: thus the initiative still seems to be having some success in holding in check the rhetoric that had been rising rapidly in the lead-up to the Annual Meetings in Seoul.

2 Discussions are continuing on how to take the initiative forward: the MD of the IMF and the President of the World Bank met nine senior bankers from six countries earlier this month and discussed how the initiative might work. Ecuador, Argentina and Mexico had all been mentioned as early recipients of "Baker funds", with opinion shifting repeatedly as to which would be the first to qualify. The President of Ecuador announced on 17 January that his country was the first to "sign up to the Baker plan". (It might be argued, however, that, as negotiations over Ecuador's package had largely preceded Baker, this was not "true" Baker money; in any case it is clear that success with Ecuador will not have as much impact on sentiment amongst banks and debtors as would success with a major debtor. And, even for Ecuador, there is a long way to go before any funds are disbursed.) The Fund has been playing its part fully in seeking to put together Baker packages; and despite initial suggestions, particularly from the banks, that the World Bank was not responding with sufficient urgency to the enhanced role that had been envisaged for it, it too is working intensively, preparing medium-term studies of the Baker countries. Co-operation between the two institutions is reported to be very good. However, if no clear progress has been made on the Baker initiative, say, by the time of the Interim Committee meetings in April, there is a serious danger that the debtors will become disillusioned.

3 Discussion of the Baker proposals for the poorer debtors, mainly those in Africa, was taken forward on 29 January in the IMF Board, with consideration of proposals to use IMF Trust Fund reflows to provide concessional assistance for the poorer debtors. On 27-28 January IDA Deputies met in Paris to consider the size of IDA 8, which is due to begin spending in 1987. It is reported that a replenishment within the range of $10 1/2-12 bn might be agreed.

4 Perhaps even more important than the Baker proposals is the question of the role of the IMF in any future debt negotiations. Brazil is insisting that it will not accept Fund conditionality for the time being, although it is seeking Fund endorsement of its own economic programme (which it regards as non-negotiable); the Nigerian authorities too have bowed to domestic public opinion and have rejected borrowing from the Fund, although they have taken a number of the measures which the Fund would probably have recommended, and are seeking approval of their strategy from creditor countries. Peru has built up substantial arrears to the Fund, and has stated that it will not try to reach any agreement with it - but, in a reversal of previous policy, the Peruvians have now suggested that they would be willing to allow a Fund mission to visit the country for Article IV consultations. And in the Philippines the major Opposition candidate in next month's Presidential election has stated that she would not accept a Fund role in the policies of her country in the near future.

5 The banks seem prepared to go along with some weakening of the IMF's role, to a limited extent, in some cases. In the case of Brazil, for instance, the Advisory Committee are reported to have proposed a rescheduling over about seven years of $6 bn 1985 past due maturities, but have proposed no more than a one year extension to March 1987 of some $8 bn of 1986 maturities and $16 bn of short-term loans. In part this reflects a desire by the banks not to precipitate any crisis, and a recognition of the reduced vulnerability of some of the debtors following the drastic external adjustment that they have achieved: Brazil's position, for instance, is greatly strengthened by its ability to do without new money for the time being. On the other hand, the banks have so far shown very little inclination to reach agreement with Peru, although here too they have shown themselves unwilling to take any action that might exacerbate the situation. Banks have until recently resisted negotiating with Nigeria whilst the country refused to go to the Fund, but there are signs now that they may be wavering. In the case of South Africa, where an IMF programme would be clearly impossible, there are reports that banks might be prepared to go along tacitly with revised South African proposals - recognising the desirability of being able to get at least some of their money out of the country

within the next few years - as long as the new proposals show that the South Africans have responded to some of the concerns which the banks had expressed earlier.

6 Authorities in creditor countries are likely to have to form a view as to whether to seek to dissuade banks from accepting a dilution of IMF authority. On the one hand, a reduction in banks' reliance on Fund endorsements of particular countries might be seen as a step towards "normality"; and, given the revolving nature of the Fund, it might perhaps be argued that the institution should for a while dis-engage somewhat from some of the countries with which it has been involved over the past few years. However, reluctance to deal with the IMF generally implies a reluctance to undertake important parts of IMF packages - action to cut inflation by Brazil, or to devalue the naira by Nigeria - and thus reflects a lack of commitment to undertaking, or persisting with, the required adjustment. For most debtor countries such an attitude might be considered, at best, premature, and acceptance of it by the creditors would seem bound to lead to rapid contagion to other debtors in similar positions.

7 Looking at the world economic environment, the major uncertainty over the past six weeks has been over oil prices. Prices fell sharply following the OPEC announcement in December that they would seek to "secure and defend for OPEC a fair share in the world oil market" and have been extremely volatile since then. Whilst the price trend is at the moment clearly downwards, the magnitude of the eventual fall is difficult to forecast. Recent evidence suggests that, with Saudi output rising from a 20-year low of 2.4 mbd in August to 4.7 mbd in December, the country has, at least partly, abandoned its role as swing producer. With some oil now trading below $20 pb, this implies a price fall of 25% from the level of last autumn. This is is already having a serious impact on the outlook for Mexico and Nigeria; other oil exporters, such as Venezuela and Indonesia, will be affected if the price falls much further. But oil importers, such as Brazil and poorer African debtors, will of course stand to gain.

8 There has been a reversal over the last six weeks in the downward trend of aggregate non-oil commodity prices, but this is due almost entirely to rises in certain food prices. In the six weeks to mid-January the Economist Index of non-oil spot commodity prices rose 8.6% in SDR terms (10.1% in $). Food prices rose by 10.6% over this period, largely because of fears that the drought in Brazil had seriously damaged the 1986 coffee and soya crops; coffee prices themselves rose by 56%. The rise in coffee prices clearly brings an immediate gain to those

exporters (such as Colombia) whose crop has not been affected. For Brazil the impact is unclear - coffee accounted for almost 10% of exports in 1984, and it is estimated that up to half of this year's crop may have been lost - but much of the reduction in volumes is likely to be made up by the increase in prices, and the country may be able to dispose of existing stocks. The Brazilians themselves are claiming that they will be net beneficiaries to the tune of $700 mn this year. Meanwhile, most other commodity prices continue to decline. Wheat prices stand about 25% below their level of a year ago: this has caused, for instance, an 8% decline in revenue earned by Argentina from wheat exports in 1985 despite the country increasing the volume exported by over 20%. Tin trading on the LME remains suspended; on the (thin) secondary markets, prices are now over 30% below the LME price at the time of suspension of trade. As noted in the last Report, most major producers have diversified away from dependence on tin: the only debtor likely to be seriously affected by a collapse of the tin price is Bolivia.

9 Interest and exchange rate developments continue to be mildly favourable to debtor countries. Long-term interest rates fell in the US in December, following the signing into law by President Reagan of the Gramm-Rudman bill to reduce the fiscal deficit, and on perceptions of improved inflationary prospects arising from the fall in the oil prices. However, this fall was partially reversed in January, as expectations about future growth improved, and amidst increased market concerns about the consitutionality of the Gramm-Rudman measures and hence their likely impact on future federal deficits. For the longer-term doubt remains as to whether political will exists to implement Gramm-Rudman fully. The three month eurodollar rate remains around 8 1/4%. Meanwhile the G5 Finance Ministers suggested after their meeting on 18 January that future moves in interest rates ought to be down rather than up. Following the announcement of the freeze on Libyan assets the dollar fell briefly, but it has recovered more recently, and is now roughly back to its level of the beginning of the year, about 10% in effective terms below its level at the time of the Plaza Agreement.

10 The unemployment rate in the US fell to 6.9% in December from 7.0% in November; and, as already noted, expectations of growth this year have been raised slightly. The immediate protectionist threat to the debtors from the US also seems to have lifted following President Reagan's veto of the bill passed by Congress which would have limited imports of textiles, copper, and shoes from eleven Asian countries and Brazil; an attempt to override the veto is expected to be made this August, and it remains to be seen whether the waning of protectionist pressure in Congress since the Plaza Agreement will endure. Elsewhere, growth in Germany appears to be stronger than expected, but growth in Japan is expected to slow.

11 Within the debtor countries themselves, the pattern outlined in the last Report seems to be persisting. Brazil exceeded its external trade surplus target in 1985, whilst making very limited progress in reducing its fiscal deficit and none in its inflation rate. In Argentina, the 'austral' plan still seems to be effective in controlling inflation and maintaining creditor confidence, although the country remains in deep recession and the combination of deteriorating terms of trade and worsening competitiveness on manufactured goods makes the external outlook rather unpromising. The situation in Mexico continues to be worrying, with the fall in oil prices adding to the country's economic problems, on both the external and internal sides; however some reassurance may be gained from the firm fiscal measures recently announced by the authorities.

12 The banks have rejected the proposals which the South Africans put forward last November for handling the country's debt. Revised proposals are being worked out which will be put to the banks by Leutwiler at a meeting on 20 February. Reports suggest that the banks may be more inclined to go along with these proposals, at least tacitly, as long as the South Africans have responded to some areas of particular concern (in particular on the absence of any repayments until the end of the decade), as they consider that the South Africans would otherwise (at best) seek to impose the original proposals unilaterally.

13 LDCs borrowed a total of $1.5 bn in the FRN market in December, almost one third of their 1985 totals. Most of the better known Asian borrowers were involved (South Korea, Malaysia, Thailand, Hong Kong and India); there was negligible use of other borrowing instruments.

Further details on individual countries are given below.

14 Latin America

The Foreign and Finance Ministers of the 11-member Cartagena Group met in Montevideo on 16 December to formulate a response to the Baker initiative. The participants issued a joint communique at the end of the meeting which gave a guarded welcome to the initiative but also restated many of their earlier demands including (inter alia) the relaxation of IMF and IBRD conditionality and the limitation of debt service payments to a level consistent with sustained growth (on a case-by-case basis).

15 At an earlier meeting in San Jose, the small Latin American debtors warned that, collectively, their debts could pose an even greater threat to the international banking system than those of the larger debtors in the region. They demanded equality of terms for the region's debtors and increased dialogue between the small debtors and their creditors. This message was subsequently endorsed by the Cartagena Group.

16 Turning to events in individual countries, Argentina continues to hold the support of the international financial institutions which it gained through the implementation of the 'austral plan' last summer. The country may well be an early candidate for funds under the Baker initiative, although the timing of this is uncertain as the Argentinians have indicated that they wish to consolidate the economic adjustment already achieved before seeking a formal package. Meanwhile, inflation remains at its relatively subdued level of less than 3% per month as against 30% in June 1985 before the introduction of the 'austral' plan, although it remains to be seen whether the momentum of the anti-inflationary drive can be maintained if and when price and wage controls are removed. The government has taken the first step towards relaxing the wage freeze by offering a 5% across-the-board salary increase from 1 January, with private sector companies allowed to give up to a further 5% as a productivity bonus. Although the end-September public-sector performance criteria were not met, the IMF has agreed tc set revised criteria for end-March 1986, and expects to complete successfully the second review, at present under way, of the country's performance under the SDR 1.4 bn SBA, thus paving the way for the next purchase of SDR 236.5 mn and the disbursement - probably in February - of the third and penultimate tranche ($0.6 bn) of the $4.2 bn bank loan. For 1986 the Argentinians have estimated their financing needs at $4 bn, in addition to the restructuring of $5.9 bn of bank debt falling due this year. This may be met by new bank money of $1-2 bn, a follow-on SBA (possibly for SDR 1.5 bn) as well as new project lending from the World Bank group and the IDB.

17 Brazil's trade surplus in 1985, at $12.4 bn, exceeded its target for the year, and was only slightly down on 1984's record $13.1 bn; real GDP grew by 7.4% over the year. The authorities have been encouraged by this performance into adopting harder negotiating positions on debt issues, and this is posing a number of immediate problems for the international financial community. The Advisory Committee resumed negotiations with the Brazilian authorities in New York in the week beginning 13 January, following two rounds of talks in December which failed to produce agreement. The Advisory Committee requested a greater commitment from

Brazil to the IMF, and Brazil sent a further letter to the Fund MD which promised closer co-operation with the Fund in the future, as a prelude to a MYRA. The Committee then agreed to offer Brazil a limited package involving the rescheduling of 1985 public sector maturities over six or seven years, and the rollover of $8 bn of 1986 public sector maturities and of $16 bn of short-term facilities to March 1987. The Advisory Committee have telexed an outline of the package to banks worldwide, together with a request from the Brazilians for an interest rollover to 15 March, and negotiations with the Brazilians are likely to resume in the first week of February. These are expected to centre on the pricing of the rescheduled loans, on the provision by the Brazilians of withholding tax certificates, the location of jurisdiction for the agreements, and on re-lending conditions. A subcommittee of the Advisory Committee will be exchanging views with the Brazilians on these issues in Brazil before the full Advisory Committee reconvenes.

18 As regards official debt, the Paris Club has stipulated that it will only reschedule 1985/86 official debts if Brazil agrees a formal IMF programme; meanwhile, the country has built up substantial arrears on payments due in 1985. The stance taken by the Brazilian authorities with regard to the $0.5 bn of medium and long-term debts (known as "Resolution 63" loans) of the three Brazilian banks liquidated in November is proving to be an area of continuing difficulty in the negotiations. The Brazilian position, as put to the Advisory Committee in December, is that at least 25% of the collapsed banks' liabilities will be met, but that any excess over 25% would only come from the sale of assets of the banks. The foreign creditor banks regard this as inadequate. The Brazilian team have since indicated that the authorities may honour at least 50% of the loans, but it is not yet clear whether this offer is a firm one.

19 In Mexico, the latest forecast is for a current account deficit of $600 mn this year (based on a $2 pb lower oil price in 1986 than in 1985) but this is widened appreciably as oil prices fall from Mexico's assumed average of $22.50 per barrel. On the basis of this forecast, which already appears to have been overtaken by events, $2.5 bn of net new financing will be required from banks in 1986 (after allowance for capital outflows and a rebuilding of reserves), and the authorities have indicated that they wish to take advantage of the Baker initiative. In addition, they hope to refinance $250 mn of principal due this year under the existing MYRA and to reschedule (over 12 years) the $950 mn pre-payment of 1983 new money which was postponed for six months following the earthquake. As yet, the banks have not reacted. They may, however, have been reassured by the disbursement earlier this month of the $300 mn Fund facility for earthquake reconstruction, and by the toughness of the Mexicans' 1986 budget.

20 The situation in Jamaica remains critical. The "fresh look" mission (comprising the IMF, World Bank and USAID) arrived in the country on 27 January; but the hoped-for short-term revival of the SBA has not, so far, been agreed with the IMF, although some progress has reportedly been made in talks between the staff and the authorities.

21 Turning to the smaller South American countries, most have signed new money and/or rescheduling packages with commercial banks in recent months, or expect to do so in the near future; and most are making progress under their various arrangements with the IMF. The major exception is Peru. Bolivia signed a draft Letter of Intent to the IMF on 12 December which is believed to include a request for a one-year SBA for SDR 50 mn. The authorities are also reportedly seeking a CFF drawing of SDR 55 mn to compensate for the loss of tin export revenues since trading was suspended in October. The Cabinet resigned on 21 January, but in introducing his new Cabinet President Parz emphasised that economic policy would still be based on the austerity measures introduced in August. The banks are now said to be receptive to Bolivia's need to reschedule 1984/85 maturities. Chile continues to make progress towards resolving its external financing problems. The $1085 mn new money deal from commercial banks ($300 mn of which is in the form of an IBRD co-financing) was finalised in mid-December when Banca Nazionale del Lavoro exchanged its participation in the Chile package for Midland's participation in the $4.2 bn loan for Argentina: Chile thereupon received $740 mn from the banks. In November the country had drawn down the first conditional tranche under the SDR 750 mn EFF, as well as the first $125 mn under the IBRD $250 mn SAL, but it failed to meet some of the 1985 IMF end-year performance criteria; however, agreement has now been reached with the Fund to relax slightly some of the 1986 performance criteria.

22 Colombia's $1 bn new money loan was signed on 17 December: drawings are subject to the country meeting quantitative economic targets under IMF enhanced surveillance and also IBRD conditionality relating to trade and exchange rate policy. Although the IMF mission currently in Colombia has yet to give an assessment of the country's end-1985 performance, the end-September targets were met comfortably. On 19 December, Ecuador signed a rescheduling with banks covering $2.5 bn of public sector maturities due between 1985 and 1989. The country remains in good standing with the Fund, and the President has claimed that his country is the first to "sign up to the Baker plan". (Whether Ecuador really is a beneficiary of the Baker initiative is open to question, as negotiations over the present package were largely completed before the initiative.) Separately, Ecuador is

hoping to resume normal market borrowing in the near future (as is Colombia), and is hoping to arrange a $300 mn bankers' acceptance facility early this year.

23 In contrast, Peru's relations with its creditors have continued to deteriorate. In December, the government announced that the country would suspend all repurchases from the IMF until August 1986; this seems to be the first occasion on which a country has announced such a move. By 6 January Peru had accumulated arrears to the Fund totalling SDR 68.2 mn. The Fund Board gave the Peruvians one month to resolve the problem or else to be declared ineligible to use IMF resources. (Ineligibility would threaten Peru with the loss of further IBRD disbursements as well as those from the Fund.) In response Peru is reportedly now budgeting to pay $300 mn to the Fund, $270 mn to the IBRD, and $30 mn to the Fondo Andino this year. The banks' Advisory Committee held talks with the Peruvian authorities on 15 January: no real progress was made, and the banks are pressing the Peruvians strongly to make a substantial payment of interest on 12 February, to reduce arrears by 90 days. The Peruvians for their part stressed the importance of their change of direction towards the Fund and suggested that they might now be willing to allow a Fund team into the country to carry out the 1985 Article IV consultation.

24 Uruguay has reached agreement in principle with its commercial bank creditors on a MYRA covering $1.6 - 2.0 bn of maturities falling due between 1985 and 1989. It is expected that the MYRA will be signed in the near future. Final signature of Venezuela's MYRA has been held up by administrative delays on the Venezuelan side and by the need to reach agreement on the terms of a re-lending facility. Signature is not now expected before February. There has been further progress towards the rationalisation of private sector debt, with the exchange controls office RECADI announcing that $6.9 bn of private sector debt, 45% of the total covered by applications, has been approved for servicing at subsidised exchange rates. On the economic front, results for 1985 are likely to have been moderately encouraging, but prospects for 1986 are less good, with the abolition of the OPEC price structure having already resulted in a fall in the price of Venezuela's heavy crude oil.

25 South and East Asia

The Philippines' IMF programme is once again back on course following agreement with the IMF to relax the end-year fiscal target. This will release $525 mn of commercial bank new money. However, economic performance in 1985 was dismal (GDP fell 4.5%) and prospects this year remain relatively bleak. In an uncharacteristically frank annual report, the State Bank of Pakistan has called the country aid-dependent and living beyond its means; although the government has begun structural and fiscal reforms, there remains considerable scepticism on its ability to see them through. Prices for tea, which accounted for over 40% of Sri Lanka's export revenue in 1984, fell by half in 1985. With other export receipts and workers' remittances and tourism also depressed, there was a current account deficit of 5% of GNP, and the debt service ratio rose over the year from about 17% to almost 21%. Moreover the Tamil/Sinhala conflict continues to threaten external viability. Both Pakistan and Sri Lanka were expected to request IMF Standby programmes in 1985, but both have so far managed to avoid the necessity.

26 Elsewhere in the region South Korea's export performance picked up at the end of 1985, with exports for the year up 3.5% on 1984 levels. GNP growth of 7% has been officially targetted for 1986, following a growth rate of about 5% last year. The authorities are also aiming for a balanced current account, and inflation of 3% or less. Indonesia's prospects for 1986 are not encouraging. A particularly austere budget for 1986/87 (beginning April) has just been presented, including a 22% cut in development spending, but budget projections have been based on a rather optimistic assumption of $25 per barrel for average oil prices. The current account deficit can be expected to widen significantly this year if oil prices fall sharply. However, bankers continue to be impressed by the authorities' resolution, and a $300 mn FRN was well-received in mid-January. In Thailand the authorities appear to be sticking to their austerity programme in the face of considerable political difficulties.

27 Eastern Europe

Poland's official creditors met in Paris on 17-18 December and agreed to roll over until end-March the $550 mn moratorium interest due at end-1985 under the 1982-84 rescheduling agreement. The payment of some $200 mn principal due in January under the 1981 agreement has not yet been made, although the banks received almost $200 mn of interest during this month. A further meeting with the Poles on 24 January, (which followed a meeting of the technical "Task Force" on 23 January) gave preliminary consideration to 1986 maturities and outlined in greater detail governments' wishes for comparable treatment with the banks; the next session in planned for 6-7 March. The Poles agreed to put the question of comparable treatment to the banks at their meeting in Vienna on 28 January. Yugoslavia has refused to increase interest rates under the formula laid down in the current SBA, thereby rendering the agreement technically inoperative and making itself ineligible to draw the next tranche due at end-February. A Fund mission was in Belgrade on 23-25 January to try to resolve the interest rate question; it will report to an IMF Board meeting on 10 March. Under the terms of the banks' MYRA, signed on 18 December, the first refinancing loans (due to commence on 12 March, covering 1985 and 1986 maturities) will proceed only if the SBA is in order. Official creditors are showing increasing irritation; many are disinclined to view an official MYRA with favour. In the meantime no date or venue has been set for official creditors to meet the Yugoslavs, although a Geneva meeting seems possible.

28 Southern Europe

In Greece there has been no sign of a relaxation of the tighter policy initiated in the October package and reinforced by the conditions attached to the ECU 1.75 bn loan under the Community Loan Mechanism, the first three tranches of which have recently been raised. The government also plans to raise $1.5 bn directly from the markets in each of the next two years, partly to refinance the expected hump in external debt repayments. The Portuguese government continues with the policy of "controlled expansion" it adopted after the inconclusive elections last October. Whilst this expansion is likely to lead to some deterioration of the current account in the future, the external position is at present still continuing to improve. Market confidence has also been bolstered by EC accession, and the country has been able to restructure its short-term debt to reduce the proportion at short-term. It has been announced that the monthly depreciation of the escudo will be resumed in April.

29 Africa

The IMF has advised Egypt that until economic reforms are implemented, rather than talked about, and an effort is made to close the country's 1986/87 external financing gap (which is projected to be in excess of $2 bn), the Fund can do no more than lay the ground work for a programme. An approach to the Paris Club seems unavoidable, and Egypt's situation continues to deteriorate as the oil price falls. Negotiations regarding Moroccan rescheduling of 1983-4 commercial bank maturities broke down on 6 January. This followed the failure, for the second time in succession, by the Moroccans to make an initial payment of some $80-85 mn, necessary to effect the agreement. The first review of the 18-month IMF Standby arrangement (approved last September) took place in early December; the IMF Staff were, however, unable to complete the review because of Morocco's failure to meet performance criteria, including agreement with the commercial banks on reschedulings of 1983-84 and 1985-86 maturities. An IMF mission will return to Morocco in February. In Libya commercial arrears have risen to $4-$5 bn and military debts are of similar magnitude. Clearing arrears by oil-barter arrangements is becoming increasingly difficult in the face of falling world oil prices, and the authorities cannot continue to draw down reserves of foreign currency at the rates seen in the early 1980's. The direct effect of US sanctions is likely to be modest.

30 The Nigerian authorities announced on 12 December, after a national debate which showed widespread hostility to the Fund, that they would not to agree an IMF programme. On 31 December the authorities announced in their 1986 budget that they intended limiting debt service to 30% of export earnings this year. (Estimates for the debt service ratio without the ceiling and without rescheduling are around 45% for 1986.) Although this was later presented as a negotiating position, the then Finance Minister Kalu subsequently appeared to say that 30% was the maximum Nigeria could pay after rescheduling and that he was seeking an even lower level of debt service, possibly in the context of a MYRA covering 1986-88. The budget was heralded as an "IMF budget without the IMF" and has been enthusiastically received in Nigeria. It seems to adopt policies with some of the objectives favoured by the IMF (on exchange rate adjustment, subsidy removal and trade liberalisation), but allows a more gradual approach, and aims to introduce a series of financial reforms as well as to reduce dependence on oil. It remains to be seen how far the authorities go in implementing these policies. At the moment the authorities appear to hope that the Fund will endorse retrospectively their adjustment programme and so open the doors to a rescheduling. Initial reports indicate that the Fund staff will be reluctant to do this, though an Article IV mission in March/April will allow the dialogue to resume.

31 Creditors have so far declined to reschedule medium and long-term debts in the absence of a Fund programme. On 19 December Paris Club creditors reaffirmed their refusal to reschedule debts or offer new medium-term credits in the absence of a Fund agreement. The need for IMF endorsement was relayed to Professor Akinyemi the Minister of External Affairs during his recent visit to the UK and other Western countries. The UK also offered to negotiate a new line of credit which would be activated by a Paris Club rescheduling. The banks have been resisting requests for a London Club rescheduling of commercial debt, again pending agreement of an IMF programme. Kalu subsequently announced that Nigeria would seek to reschedule some of its medium and long-term debts on a loan by loan basis. Meanwhile, progress on the rescheduling of short-term trade arrears continues to be slow. In a Cabinet

reshuffle on 24 January Kalu changed places with Minister of National Planning Okongwu. Kalu's move has been attributed to annoyance at his pro-IMF stance; it remains to be seen whether he will still visit the UK on 11 February.

32 Sudan's Finance Minister Magid resigned after the Council of Ministers rejected a proposed Fund package on 2 December. No progress had been achieved in producing an alternative programme before the Fund Executive Board meeting on 3 January, which had been called to consider the country's eligibility to use IMF resources, and it was decided that the country would be declared ineligible from 3 February, unless there were major positive developments before then. The new Finance Minister Osman, appointed on 2 Janaury, is reported to have said that the government was considering the earlier proposed package.

33 Middle East

The high cost of the Gulf war has driven Iraq to seek an increasing number of bilateral rescheduling agreements, some of which have included attempts to settle outstanding debts with oil.

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INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1985*	End-June 1985	End-Sept 1985 [2]	End-Sept 1985 [3]
Latin America				
Argentina	51	2.5	0.2	0.2
Brazil	100	6.7(0.6)	0.8	1.8
Chile	20	1.3(0.1)	-	0.1
Colombia	14	0.6(0.1)	-	0.2
Ecuador	8	0.6	0.1	0.1
Mexico	98	6.4(0.3)	0.5	1.3
Peru	14	0.3	0.1	0.1
Venezuela	38	2.3(0.1)	-	-
Far East				
Indonesia	36	0.7(0.3)	0.8	1.6
Philippines	27	1.3(0.1)	0.2	0.2
South Korea	46	2.2(0.5)	0.4	0.8
Eastern Europe (convertible currency)				
Hungary	11	0.5(0.1)	-	0.1
Poland	30	0.5	1.2	1.3
Romania	6	0.2	0.3	0.5
Yugoslavia	18	0.9(0.1)	0.7	1.0
Southern Europe				
Greece	16	1.3(0.2)	0.3	0.4
Portugal	16	1.2(0.1)	0.2	0.3
Turkey	22	0.4	0.2	0.4
Africa				
Egypt	34	0.4(0.3)	0.2	0.9
Morocco	14	0.2	0.1	0.2
Nigeria	19	1.3(0.1)	1.9	3.3
South Africa	22	4.0(0.5)[4]	0.8	2.8
Sudan	9	0.0	0.2	0.2
Middle East				
Israel	30	0.5	0.1	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.
Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans.
[2] Defined as unrescheduled principal disbursed, plus political claims paid and claims under examination.
[3] Defined as guaranteed principal and contractual interest, plus political claims paid and claims under examination.
[4] Data not compatible with those previously shown, because of deconsolidation of subsidiaries which are no longer majority owned.
* current estimate

OVERDUE FINANCIAL OBLIGATIONS TO THE FUND*

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding (SDR mn)
Kampuchea	13 March 1975	27.5#
Guyana	31 May 1983	27.8#
Viet Nam	6 February 1984	47.2#
Sudan	12 July 1984	208.0
Liberia	19 December 1984	34.3
Sierra Leone	25 January 1985	13.3
Tanzania	15 March 1985	20.1
Gambia	7 August 1985	5.3
Peru	9 September 1985	68.2
Somalia	21 October 1985	13.0
Jamaica	24 October 1985	25.5
		490.2

NB The above figures are derived from Fund papers issued with respect to individual country complaints. There will have been further overdue obligations falling due subsequently, so the figures are not completely up-to-date. A Fund source indicates that total arrears were 620.3 mn as at 2.1.86 but this figure is not divided country by country.

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

\# Guyana and Viet Nam are ineligible. Kampuchea is out of contact with the Fund.

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(US$ millions)

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TABLE A

Current Country List	BIS reporting area banks: End-Sept 1985 Claims	Liab-ilities	Net claims	Changes on year before: Claims (Increase +)	Liab-ilities	Banks in the UK: external sterling and foreign currency claims and liabilities*: End-Sept 1985 Claims	Liab-ilities	Changes on year before: Claims (Increase +)	Liab-ilities	UK-registered banks' consolidated external claims in sterling and foreign currencies**: End-June 1985	Changes on year before (Increase +)
Argentina	28,398	9,020	19,378	+ 2,080	+ 810	4,360	169	+ 520	+ 9	3,384	- 57
Bolivia	681	207	474	- 8	- 19	159	18	+ 22	- 1	114	- 15
Brazil	77,405	16,722	60,683	+ 1,270	+ 752	13,480	2,040	+ 554	+ 136	9,461	+ 431
Chile	13,776	2,774	11,002	+ 169	- 832	2,469	262	+ 310	- 344	2,112	+ 186
Colombia	6,888	3,443	3,445	- 89	+ 473	715	201	+ 2	+ 28	737	- 90
Costa Rica	889	193	696	+ 18	+ 3	277	14	+ 19	+ 5	198	+ 14
Ecuador	5,103	2,006	3,097	+ 239	+ 281	708	59	+ 56	- 15	789	+ 53
Jamaica	596	306	290	+ 18	+ 10	73	52	- 9	- 14	51	- 5
Mexico	72,390	21,537	50,853	- 1,180	+ 72	12,688	2,230	+ 628	- 761	8,855	+ 119
Peru	5,747	2,551	3,196	- 126	- 418	663	225	+ 145	- 7	707	+ 3
Uruguay	2,126	2,491	- 365	+ 252	+ 215	348	158	+ 47	- 3	391	+ 15
Venezuela	25,525	19,873	5,652	- 231	+ 538	3,593	947	+ 305	- 40	2,821	+ 46
Indonesia	14,810	6,091	8,719	+ 354	+ 555	1,462	632	- 2	- 22	1,450	- 213
Pakistan	1,182	1,588	- 406	+ 268	+ 143	602	975	+ 167	+ 89	245	+ 50
Philippines	13,590	2,922	10,668	- 187	+ 622	1,558	288	- 242	+ 66	1,570	- 79
South Korea	33,114	5,356	27,758	+ 2,847	+ 429	3,167	941	+ 145	+ 7	2,675	- 280
Sri Lanka	695	450	245	+ 7	+ 40	187	205	+ 51	+ 68	102	+ 11
Thailand	7,481	1,980	5,501	+ 272	+ 336	588	510	- 57	- 31	403	- 97
Hungary	8,511	2,472	6,039	+ 1,872	+ 1,239	2,179	916	+ 593	+ 635	698	- 25
Poland	9,394	1,675	7,719	+ 165	+ 110	2,302	279	+ 41	+ 47	1,157	- 167
Romania	3,096	323	2,773	- 307	- 343	1,096	100	+ 1	- 109	618	- 64
Yugoslavia	9,949	2,748	7,201	+ 198	+ 187	2,974	452	+ 66	+ 6	1,786	+ 80
Greece	13,761	6,741	7,020	+ 1,455	+ 1,020	5,943	3,797	+ 397	+ 493	1,489	- 68
Iceland	1,036	104	932	+ 92	+ 16	483	42	- 15	+ 11	314	+ 16
Ireland	8,697	3,910	4,787	+ 907	+ 716	5,276	3,222	+ 279	+ 767	1,244	- 346
Portugal	11,843	4,907	6,936	+ 418	+ 1,435	4,156	1,584	+ 83	+ 609	1,257	- 190
Turkey	6,434	2,490	3,944	+ 1,344	+ 425	1,228	737	+ 453	+ 222	542	+ 96
Congo	1,026	205	821	+ 117	+ 79	104	11	+ 7	-	64	+ 12
Egypt	6,753	8,262	- 1,509	+ 139	+ 563	1,323	3,714	- 168	+ 21	829	- 96
Ivory Coast	2,858	1,109	1,749	+ 16	+ 467	512	397	- 1	+ 172	358	+ 18
Kenya	661	1,251	- 590	+ 15	+ 126	329	1,123	+ 7	+ 132	244	- 25
Libya	1,025	5,005	- 3,980	- 134	+ 1,825	222	1,320	- 48	+ 567	80	- 20
Morocco	4,669	743	3,926	+ 262	- 20	628	28	+ 37	- 14	377	+ 5
Nigeria	8,722	1,721	7,001	+ 423	+ 368	3,790	1,218	+ 242	+ 182	2,549	+ 15
South Africa	16,649	2,398	14,251	- 1,042	+ 37	7,944	1,382	+ 132	+ 634	4,526	-1,036
Sudan	976	1,005	- 29	+ 69	+ 137	293	812	- 2	+ 219	96	- 36
Tunisia	1,450	622	828	+ 233	+ 118	149	84	+ 28	- 23	70	+ 4
Zaire	676	899	- 223	- 17	+ 14	169	52	- 13	+ 2	104	- 5
Zambia	465	245	220	+ 6	+ 38	378	205	+ 41	+ 37	316	+ 69
Zimbabwe	731	275	456	- 51	+ 120	485	187	+ 39	+ 84	312	- 72

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TABLE A

(US$ millions)

Current Country List	BIS reporting area banks: End-Sept 1985 Claims	Liab-ilities	Net claims	Changes on year before: Claims (increase +)	Liab-ilities	Banks in the UK: external sterling and foreign currency claims and liabilities*: End-Sept 1985 Claims	Liab-ilities	Changes on year before: Claims (increase +)	Liab-ilities	UK-registered banks' consolidated external claims in sterling and foreign currencies**: End-June 1985	Changes on year before (increase +)
Iran	1,358	6,943	- 5,585	- 125	- 402	138	3,316	+ 8	+ 523	43	- 23
Iraq	4,567	1,160	3,407	+ 1,415	+ 171	456	616	+ 195	+ 60	227	+ 71
Israel	5,551	6,910	- 1,359	- 374	- 465	1,155	2,465	- 302	- 450	449	- 81
Jordan	1,183	2,108	- 925	+ 305	+ 42	201	1,193	- 18	- 126	180	+ 38
Syria	950	1,257	- 307	+ 224	+ 94	184	340	+ 34	+ 35	122	+ 7
1 Total	443,387	166,998	276,389	+13,598	+12,127	91,194	39,518	+ 4,777	+3,906	56,116	-1,731
2 Total claims/liabilities to countries outside BIS reporting area, offshore centres and international organisations (but inc Ireland)	611,477	386,561	224,916	+33,878	+29,926	124,548	109,509	+ 7,893	+7,419	74,474	-2,579
1 as % of 2	72.5	43.2				73.2	36.1				

* S1 & S2 data
** C1 data

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TABLE B

CONSOLIDATED EXTERNAL CLAIMS AND UNUSED COMMITMENTS OF UK-REGISTERED BANKS IN STERLING AND FOREIGN CURRENCIES

End-June 1985 ($ millions)

	Total lending	Lending to banks	Lending to public sector	Maturity Analysis					Exposure*	Unused commitments	
				Under 6 months	6 months - 1 year	1-2 years	2-5 years	Over 5 years		Total	Of which: Exposure **
Argentina	3,384	928	1,671	803	273	354	674	433	3,394	297	289
Bolivia	114	24	79	28	14	20	12	5	102	3	1
Brazil	9,461	2,750	4,437	1,484	537	1,000	3,229	3,136	10,058	1,000	635
Chile	2,112	1,050	765	449	135	239	794	474	2,078	98	62
Colombia	737	159	407	216	67	73	240	121	752	156	60
Costa Rica	198	50	143	34	12	31	67	31	195	26	25
Ecuador	789	102	585	220	54	112	321	29	784	45	35
Jamaica	51	3	45	13	7	8	13	3	45	3	-
Mexico	8,855	2,362	4,251	1,549	639	1,008	3,281	2,191	8,806	455	291
Peru	707	92	543	157	33	72	185	87	649	72	33
Uruguay	391	35	294	89	22	55	182	28	386	21	21
Venezuela	2,821	590	1,279	1,245	173	247	583	172	2,812	51	55
Indonesia	1,450	35	820	395	91	136	391	379	858	677	335
Pakistan	245	10	134	59	14	37	115	12	228	219	134
Philippines	1,570	371	703	711	87	150	321	194	1,386	144	80
South Korea	2,675	855	765	542	169	325	1,063	550	2,862	564	605
Sri Lanka	102	10	46	17	10	20	45	8	62	49	41
Thailand	403	97	142	106	52	63	129	43	487	289	277
Hungary	698	207	467	211	100	118	174	91	699	83	60
Poland	1,157	176	918	163	84	159	499	222	735	122	24
Romania	618	133	420	110	58	110	268	68	413	105	33
Yugoslavia	1,786	758	638	337	157	245	673	320	1,364	133	106
Greece	1,489	314	640	299	121	180	577	265	1,865	199	232
Iceland	314	126	80	133	26	12	43	98	295	67	73
Ireland	1,244	436	413	577	85	96	207	269	1,835	314	318
Portugal	1,257	43	942	165	84	146	547	272	1,539	169	146
Turkey	542	157	243	152	98	71	172	38	482	189	161
Congo	64	1	30	10	8	18	25	3	24	33	20
Egypt	829	417	117	509	85	63	110	38	682	459	281
Ivory Coast	358	31	287	39	24	41	167	81	324	34	16
Kenya	244	14	161	54	29	25	100	16	133	147	43
Libya	80	56	4	58	4	7	9	1	88	50	50
Morocco	377	35	270	64	47	55	104	46	293	33	12
Nigeria	2,549	304	1,960	597	312	378	827	318	1,559	510	148
South Africa	4,526	1,748	1,500	2,136	466	491	934	475	4,310	1,056	492
Sudan	96	12	72	52	4	4	12	1	93	9	9
Tunisia	70	20	30	20	8	4	13	22	56	63	63
Zaire	104	-	67	8	7	14	38	29	70	-	-
Zambia	314	30	220	182	37	20	56	-	328	54	31
Zimbabwe	312	10	218	77	26	60	108	33	188	274	147

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TABLE B

CONSOLIDATED EXTERNAL CLAIMS AND UNUSED COMMITMENTS OF UK-REGISTERED BANKS IN STERLING AND FOREIGN CURRENCIES

End-June 1985 ($ millions)

	Total lending	Lending to banks	Lending to public sector	Maturity Analysis: Under 6 months	6 months - 1 year	1-2 years	2-5 years	Over 5 years	Exposure*	Unused commitments: Total	Of which: Exposure **
Iran	43	5	1	25	5	1	1	-	41	22	33
Iraq	227	66	85	51	54	73	41	-	108	298	133
Israel	449	328	26	303	70	22	42	1	596	59	55
Jordan	180	17	81	31	14	21	62	39	240	199	152
Syria	122	105	1	98	4	7	9	-	108	21	22
Total	56,114	15,072	27,000	14,578	4,406	6,391	17,463	10,642	54,412	8,871	5,839

** Total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans.

* Total lending, adjusted for certain inward and outward risk transfers in rexpect of guaranteed loans, plus any net claims on local residents in local currency.

	Disbursed Debt - $ bn				Debt Service ratios Total Debt Service as a % of exports of goods and services (Long Term Debt Service as a % of exports of goods and services				Debt exports ratios Total Debt Outstanding/ exports of goods and services (Long Term Debt Outstanding/ exports of goods and services				Debt/GNP ratios: Total Total Debt/GNP (Long-term debt/GNP)			
	End-1984 Public	Private	Total	End-1985 Total	1983	1984	1985	1986	1983	1984	1985	1986	1983	1984	1985	1986
Hungary	8.8	n/a	8.8	11.0	66(34)	81(43)	76(49)	70(47)	1.5(1.1)	1.5(1.3)	2.1(1.8)	1.8(1.6)	0.5(0.3)	0.5(0.4)	0.5(0.5)	0.5(0.4)
Iceland	0.9	0.6	1.5	1.8	25(21)	30(24)	45(25)	54(24)	1.2(1.2)	1.4(1.2)	1.6(1.3)	1.4(1.2)	0.6(0.6)	0.7(0.6)	0.8(0.7)	0.8(0.7)
Israel	15.6	14.4	30.0	30.2	73(41)	75(42)	72(39)	67(36)	3.0(2.7)	2.9(2.5)	2.9(2.5)	2.7(2.3)	1.2(1.1)	1.3(1.2)	1.4(1.2)	1.2(1.1)
Poland≠	27.0	n/a	27.0	29.7	59(33)	47(23)	64(55)	72(..)	4.5(4.2)	4.2(4.0)	4.8(4.7)	4.3(..)	0.4(..)##	0.4(0.4)##	.. (..)	.. (..)
Romania	7.1	n/a	7.1	6.1	38(24)	33(26)	33(29)	30(25)	1.3(1.2)	0.9(0.9)	0.8(0.7)	0.6(0.6)	0.2(..)	0.2(..)	.. (..)	.. (..)
Turkey	19.4	1.9	21.3	22.2	51(28)	51(25)	62(28)	66(26)	1.9(1.6)	1.8(1.4)	1.7(1.3)	1.6(1.1)	0.4(0.3)	0.4(0.3)	0.4(0.3)	0.4(0.3)
Yugoslavia	9.9	7.9	18.8-	18.5	57(40)	54(43)	53(45)	48(40)	1.8(1.7)	1.7(1.6)	1.6(1.5)	1.4(1.3)	0.4(0.4)	0.4(0.4)	0.4(0.4)	0.4(0.4)
Greece	9.0	5.9	14.9	15.5	77(28)	83(33)	109(37)	109(42)	1.9(1.2)	2.0(1.3)	2.2(1.5)	2.1(1.5)	0.4(0.3)	0.5(0.3)	0.5(0.3)	0.5(0.4)
Ireland	11.0	2.8	13.8	13.9	22(..)	22(..)	18(..)	17(..)	1.4(..)	1.3(..)	1.2(..)	1.1(..)	0.8(..)	0.9(..)	0.9(..)	0.7(..)
Portugal	6.2	8.8	14.9	16.0	101(32)	97(43)	83(39)	78(34)	2.4(1.8)	2.1(1.7)	2.1(1.7)	2.1(1.7)	0.7(0.5)	0.8(0.6)	0.8(0.7)	0.8(0.7)
Argentina	38.5	10.2	48.7	51.1	154(57)	153(54)	161(58)	154(60)	4.8(3.8)	4.7(3.9)	4.5(3.3)	4.6(3.5)	0.7(0.6)	0.7(0.6)	0.7(0.6)	0.8(0.6)
Bolivia	3.3	0.8	4.1	4.3	115(43)	117(46)	146(49)	138(47)	4.8(4.5)	5.2(4.9)	6.0(5.7)	5.9(5.6)	0.7(0.6)	0.5(0.4)	0.5(0.5)	0.5(0.5)
Brazil	74.8	22.2	97.0	100.0	95(52)	68(44)	80(77)	90(86)	3.8(3.4)	3.2(2.9)	3.6(3.3)	3.5(3.2)	0.4(0.3)	0.4(0.3)	0.4(0.4)	0.4(0.3)
Chile	11.9	7.1	18.9	19.9	116(50)	101(53)	97(53)	91(51)	3.6(3.1)	3.9(3.5)	4.2(3.8)	3.9(3.5)	1.0(0.8)##	1.0(0.9)##	1.3(0.7)##	0.7(0.6)##
Colombia	9.2	3.3	12.5	14.0	123(41)	118(40)	104(45)	93(43)	2.9(2.0)	2.7(2.1)	2.8(2.2)	2.6(2.1)	0.3(0.2)	0.3(0.3)	..(..)	..(..)
Ecuador	7.0	0.2	7.2	7.8	..(34)	..(35)	..(37)	..(38)	..(2.6)	..(2.4)	..(2.7)	..(2.6)	..(0.7)	..(0.7)	..(0.6)	..(0.5)
Mexico	78.2	18.5	96.7	97.6	149(54)	94(48)	102(55)	97(50)	3.5(2.9)	3.2(2.8)	3.4(2.8)	3.5(3.1)	0.7(0.6)	0.6(0.5)	0.6(0.5)	0.6(0.5)
Peru	11.3	2.0	13.3	13.9	52(49)	72(68)	66(61)	60(55)	3.2(2.9)	3.3(3.0)	3.7(3.4)	3.5(3.2)	0.9(0.8)	0.8(0.7)	0.8(0.8)	0.8(0.7)
Uruguay	2.8	0.9	3.7	3.8	66(40)	75(45)	86(47)	80(45)	2.5(2.1)	2.7(2.1)	2.9(2.4)	2.8(2.2)	0.7(0.6)	0.7(0.6)	0.8(0.6)	0.8(0.6)
Venezuela	26.4	13.4	39.8	38.1	162(29)	133(27)	144(37)	141(46)	2.4(1.5)	2.4(1.4)	2.5(1.5)	2.3(1.9)	1.0(0.6)	0.8(0.5)	0.7(0.5)	0.7(0.6)
Indonesia**	25.7	7.1	32.9	35.9	36(17)	41(21)	43(24)	45(26)	1.6(1.4)	1.5(1.3)	1.8(1.6)	2.0(1.8)	0.4(0.3)	0.4(0.3)	0.4(0.4)	0.5(0.4)
Pakistan	..	..	13.3	..	..(..)	27	..(..)	..(..)	..(..)	1.5(..)	..(..)	..(..)	..(..)	0.4(..)	..(..)	..(..)
Philippines*	..	..	25.4	27.2	165(36)	180(43)	152(38)	147(42)	3.3(2.0)	3.3(2.0)	3.1(2.1)	3.3(2.0)	0.7(0.5)	0.8(0.5)	0.8(0.5)	0.8(0.6)
South Korea	..	..	42.7	45.6	61(21)	58(23)	58(24)	53(24)	1.3(0.9)	1.3(0.9)	1.4(1.0)	1.3(1.0)	0.5(0.4)	0.5(0.4)	0.6(0.4)	0.6(0.4)
Sri Lanka	2.5	0.6	3.1	3.4	..(24)	..(17)	..(21)	..(..)	1.4(..)	1.3(..)	1.3(..)	..(..)	0.6(..)	0.5(..)	0.5(..)	..(..)
Thailand	8.5	7.0	15.5	16.7	57(23)	57(24)	56(26)	50(24)	1.5(1.2)	1.5(1.1)	1.5(1.2)	1.4(1.1)	0.4(0.3)	0.4(0.3)	0.4(0.3)	0.4(0.3)
Costa Rica	..	..	3.5	3.6	63(37)	53(30)	82(54)	73(51)	3.4(3.2)	3.2(3.0)	4.0(3.7)	3.3(3.1)	1.1(1.0)	1.0(0.9)	1.0(0.9)	1.0(0.9)
Jamaica	..	..	3.2	3.5	..(27)	..(19)	..(26)	..(38)	.. (2.3)	.. (2.4)	.. (2.8)	.. (3.1)	.. (0.8)	.. (1.3)	.. (1.9)	.. (2.1)
Egypt	..	..	31.8	34.1	81(..)	91(..)	98(..)	92(..)	2.7(2.2)	2.8(2.2)	3.2(2.5)	3.2(2.5)	1.4(1.1)	.. (..)	.. (..)	.. (..)
Morocco	9.5	3.8	13.3	14.4	..(53)	..(40)	..(42)	..(41)	4.2(..)	4.2(..)	4.5(..)	4.5(..)	0.9(..)	1.1(..)	1.2(..)	1.1(..)
Sudan																
Syria																
Tunisia	..	..	3.8	4.0∅	17	20	21	20	1.1	1.2	1.3	1.3	0.4	0.5	0.5	0.5
Congo	1.4	..	..	1.5∅	49(..)	49(..)	53(..)	58(..)	2.0(..)	1.6(..)	.. (..)	.. (..)	1.1(..)	1.0(..)	.. (..)	.. (..)
Ivory Coast	5.5	..	..	6.8∅	42(..)	20(..)	20(..)	34(..)‡	2.6(..)	2.1(..)	2.4(..)	2.3(..)	0.8(..)	0.8(..)	0.9(..)	0.9(..)
Kenya--	2.8	..	..	3.1	26(..)	27(..)	30(..)	28(..)	3.2(..)	2.8(..)	3.0(..)	2.9(..)	0.5(..)	0.5(..)	0.5(..)	.. (..)
Nigeria	18.3	..	18.3	18.7	29(20)	39(30)	57(49)	47(39)	1.7(1.6)	1.6(1.5)	1.6(1.5)	1.5(1.4)	..(..)	..(..)	..(..)	..(..)
South Africa	11.1	15.9	27	22.1	75(16)	87(18)	63(19)	..(19)	1.1(0.5)	1.4(0.7)	1.1(0.6)	..(..)	0.3(0.1)	0.4(0.2)	0.3(0.2)	..(..)
Zaire	..	4.4	4.4	4.4	20(15)	29(19)	58(45)‡	50(39)‡	2.6(2.4)	2.4(2.3)	2.3(2.1)	2.0(1.9)	..(..)	..(..)	..(..)	..(..)
Zambia	3.4	0.3	3.7	4.0	79(29)	81(34)	127(83)	124(72)	3.3(2.8)	4.0(3.5)	4.0(3.6)	4.5(4.1)	1.1(0.9)	1.2(1.1)	1.3(1.2)	1.5(1.3)
Zimbabwe	2.4	0.1	2.5	2.6	21(17)	25(22)	26(22)	28(24)	1.8(1.8)	1.8(1.8)	1.9(1.8)	1.8(1.8)	..(..)	..(..)	..(..)	..(..)

≠ Assumes capitalisation and rescheduling of nearly all interest arrears, estimated at $4.0 bn at end-1984.
** Financial year figures (April-March)
* Figures include debt to BIS area banks by the offshore centres.
‡ Before rescheduling
\- Includes unclassified short-term debt

.. Not available
n/a Not applicable
∅ Public debt only
-- Short-term debt can be assumed negligible

Debt/GDP

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TABLE D

RESCHEDULING AND RELATED DEVELOPMENTS

Agreements reached since the last report

Debtor country	Type of Operation	Date of Agreement(s)	Consolidation period (years)	Amount ($ mn)	New Terms Maturity	Grace	Interest rate
Ecuador	Commercial	19 December	5	2,473	12	3	1 3/8
Poland	Official	18 December	-	600	[3-month postponement of interest due end-1985]		
Yugoslavia	Commercial	18 December	4	3,600	9 1/2-10 1/2	3-4	1 1/8

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

ccPC

Prime Minister 2

You need read only the covering letter.

N.L.W.
20.12

Nigel Wicks Esq
10 Downing Street
LONDON
SW1

19 December 1985

Dear Nigel,

INTERNATIONAL FINANCIAL SCENE

...I enclose the latest in the regular series of reports on the major debtor countries.

As the Bank's paper makes clear the external economic environment for the debtors has been broadly favourable. However, an important new factor is the uncertainty in the oil markets. Although the overall position is not very different from the expectation of a fall in the real oil price built into our earlier forecasts, it will put additional pressure on the oil-producing debtor countries, especially Nigeria and Mexico. If the price settles towards the lower end of the range it is difficult to see how they would cope. Venezuela and Indonesia would also be hard hit.

On the policy front, the focus continues to be the Baker initiative. The action so far has centered on the commercial banks. The American, British and Japanese banks have each welcomed the initiative and in rather similar terms confirmed their willingness to play their part provided that all other parties do the same. The French and Belgian banks are thought near to making a similar declaration. Thereafter, the focus is likely to move to the official institutions, particularly the IBRD but also export credit agencies.

The Cartagena Group met on 16 December. First reports suggest that the Group's members have not been moved to reduce their list of bids by the Baker initiative, despite the improvement in the general climate.

The real test will come with the selection of a first candidate for the new initiative. Although Argentina looks like the favourite candidate, on the basis of her current economic performance, Mexico could come up from behind. Generally, there may be problems in matching those who need the Baker initiative (both extra funds and further adjustment) with those who are willing to participate and to accept the conditionality involved. This could give rise to credibility problems, as could developments in some African indebted countries, eg Zambia which is willing to accept conditionality but where it may be difficult to put together sufficient resources to enable an adjustment programme to be carried out.

On individual countries, Brazil gives cause for concern. The Government recently made it clear that they wanted neither an IMF programme nor enhanced surveillance and a bank MYRA. However the Brazilians will need to roll over some $16 billion of short term credit lines on 17 January. The commercial banks are still divided on how to deal with this in the absence of any Fund endorsed programme or policies. Mexico, too is worrying. Her economic prospects have deteriorated and the Government estimates a need for $2.5 billion of new money next year. It remains to be seen how effectively the Government can implement the necessary adjustment measures.

President Babingda has now announced that Nigeria will not take an IMF loan and will discontinue negotiations with the Fund. The Government seems likely to implement the sort of adjustment measures advocated by the Fund without the formal Fund endorsement which would provide the key to rescheduling. Special treatment for Nigeria would be extremely difficult given the pressures currently being put on the arrangements for handling the debt situation by countries such as Brazil and Peru. The Paris Club will be sending a message to the Nigerians encouraging them to seek Fund endorsement.

Finally, the South African Government has extended the debt moratorium, from end December to end March 1986 and has made proposals on rescheduling to the major creditor banks concerned. These will be discussed in the New Year. The question mark over Egypt, noted in our last report, remains.

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

Yours ever
Rachel

RACHEL LOMAX

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INTERNATIONAL FINANCIAL SCENE

Consideration of the Baker initiative, and of how to take it forward, continues to dominate discussions on debt questions. The World Bank President and the Fund MD have issued a joint statement supporting the initiative; a number of national authorities including the UK have also expressed their support. For their part, the banks continue to meet in various groupings, in order to flesh out their responses. Major US banks are reportedly close to agreement on a 'pledge' of support for the initiative; a group of European banks met in Zurich on 28 November, and have sent a statement of support from themselves to the World Bank President and Fund MD. In addition, they agreed that banks would issue a further statement of support on a country-by-country basis. The group will meet again on 19 December to decide whether it would be appropriate to issue also a longer statement setting out in more detail a number of pre-conditions for banks' participation in the initiative. Meanwhile, the Presidents of both Argentina and Brazil have expressed a guarded welcome for the initiative, although a number of countries have suggested that its scope is far too restricted to have much effect on the overall debt situation. Yugoslavia has stated that it does not wish to be included with the Baker countries, considering that inclusion in this group would carry a stigma which it does not wish, and does not need, to bear. As attention turns towards selecting the first debtor country that should participate in the initiative, this seems increasingly likely to be Argentina which continues to impress bankers and international organisations with the seriousness with which it is tackling its economic problems. Mexico also has a need for new money in 1986, but in present circumstances might have more difficulty in reaching agreement on an IMF programme.

External economic developments for the debtors continue meanwhile to be broadly favourable. The US dollar continues to fall, and is now over 9% (in effective terms) below its level at the time of the G5 Plaza Agreement and almost 20% below its February peak. Protectionist pressure in the US seems for the moment at least to be receding slightly. With the US authorities wishing to see a gradual decline in the dollar, there seems to have been no tightening in monetary policy since September; and, recognising that there have been serious distortions in the recent behaviour of the monetary aggregates, Volcker has said that the Fed has decided "not to more aggressively to tighten" in response to rapid monetary growth, and that above-target M1 growth over 1985 H2 "would be acceptable". Eurodollar interest rates have edged up only slightly in response to the dollar depreciation; three month rates stand around 8 1/4%. Real GNP is now estimated to have grown by 4.3% (ar) in the third quarter, and real personal consumption rose by 5.6% (ar), its highest rate this year, but other economic data covering Q4 suggest a less buoyant picture.

Commodity prices remain almost 12% below their levels of a year ago, although there has been at least a small temporary reversal of the declining trend. In November the Economist Index of non-oil commodity prices rose 0.5% in SDR terms: within this, food prices rose by almost 2% whilst industrial input prices fell by around 1%. Oil prices, of course, have differing impacts on the various debtors. Most oil prices rose in November: North Sea prices rose in SDR terms by 3.5%, and reached their mid-1984 levels, although they have subsequently fallen back sharply, and there is at present great uncertainty over oil prices following OPEC's reported decision to attempt to increase its market share. The London tin market remains closed, pending resolution of the financial difficulties of the buffer stock manager: a sharp fall in prices is inevitable when the market reopens. But perhaps of more concern to the overall debt situation is the demonstration effect to debtor countries of the apparent reluctance of some members of the International Tin Agreement to honour their contractual obligations.

Looking at the debtor countries themselves, it has become clear in recent weeks that some of those countries that are now in no immediate need of new money are prepared to adopt a harder line in negotiations with the Fund and/or the banks in order to defend their own domestic objectives. Brazil, for instance, has announced that it is no longer interested in a bank MYRA, or in negotiating any agreement with the Fund, as it intends to give priority to achieving 5% pa domestic growth, which the Fund considers is not yet warranted, given Brazil's lack of internal adjustment. Similarly, South Africa has adopted a more expansionary domestic stance which is bound to reduce the country's current account surplus and hence the amount available to repay bank debt. The Brazilians are likely to have to ask the banks to extend the present agreement to maintain their trade and interbank lines when the agreement expires on 17 January; the South African moratorium on short-term debt which was due to expire on 31 December has now been unilaterally extended to end-March 1986. Although banks are unlikely to be happy with either of these developments, they may decide to go along with them, for fear of the increased risks if there were a serious confrontation.

Mexico, on the other hand, has admitted that it will need $2.5 bn of new money next year. With its economic prospects apparently still deteriorating, the country has introduced further austerity measures and is aiming for (at best) virtually no growth over the coming year. The severity of the country's problems, and the uncertainty over whether the country has yet fully got to grips with them, seem, however, to be making the Fund and the banks reluctant to use Mexico as an early Baker candidate. Nevertheless, a further small return by Mexico to the markets has been achieved with a private placement by PEMEX of bonds worth Yen 10 bn ($40 mn) with Japanese investors in early November.

Peru meanwhile continues to state that it will limit its debt-servicing to 10% of its export receipts (although currently there is little evidence that it is making any payments on public sector commercial bank debt); the country appears to be continuing to transfer deposits to the BIS and the Panamanian banks, and arrears to the Fund are mounting. President Marcos of the Philippines publicly endorsed the Peruvian example recently, but there are so far no signs that the Philippines intends to adopt a similar policy. Meanwhile, Costa Rica convened a meeting of smaller debtors* on 9 December, to co-ordinate a response to the apparent disparity of treatment between themselves and the larger debtors due to the lack of interest by creditors and multilateral organisations in countries that do not appear to pose a systemic threat. The Cartagena Group itself is due to meet again on 16 December. The extent of progress on the Baker initiative by that date is likely to influence the mood of the meeting.

Market borrowing by LDCs and Eastern Bloc countries, at $429 mn in November, fell to only 30% of October's figure. The USSR was the only Eastern Bloc borrower. Among, LDCs, the fall in total borrowing is largely explained by the absence of South Korea from the market. This may reflect resistance on the part of lenders in the face of South Korea's mounting debt, or may simply indicate that the country has achieved this year's borrowing target.

Further details on individual countries are given below.

(i) Latin America

Economic developments in Argentina continue to be broadly reassuring. Monthly inflation rates remain at the relatively subdued levels achieved over the last few months (although there is some concern that inflation could revive when the present price controls are relaxed), and the authorities are reported to be finalising details of the 1986 budget which should consolidate the reforms introduced last June. Given the present generally favourable economic climate, US Assistant Treasury Secretary Mulford had talks with President Alfonsin in the week beginning 4 November, against a background of speculation that Argentina might be the first beneficiary under the Baker initiative. The Argentines gave a basically favourable reaction to the plan, while echoing the feelings of other debtor countries that the plan does

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* The countries involved were Guatemala, El Salvador, Honduras, Nicaragua, Dominican Republic, Bolivia and Panama as well as Costa Rica itself. Ecuador attended as observer, but did not sign the final communique.

not go far enough. The Economy Ministry subsequently confirmed that Argentina will require additional external financing in the early months of 1986. Volcker visited the country in the week beginning 25 November to discuss the June austerity package and currency reform as well as the implications of the Baker initiative. On 26 November, Argentina drew down the second ($800 mn) disbursement of its $4.2 bn bank loan; on the same date, about $340 mn in interest payments were made, and the authorities now claim that interest is current on all public sector debt owed to banks.

In Brazil, the political situation remains volatile after the November mayoral elections, the first electoral test for the ruling Democratic Alliance since the return to civilian rule. The PMDB, the main party in the Democratic Alliance, won the majority of mayorships in the state capitals but lost in four of Brazil's biggest cities. In the short-term Sarney's position is likey to be unaffected but further changes in party alignments may erode his support in Congress. Finance Minister Funaro visited the United States on 23 November for talks with de Larosiere and Baker. At a press conference in Washington afterwards, he said that Brazil would not now propose an accord with the IMF, arguing that it is "unnecessary at the present time". He also announced that, instead of negotiating a MYRA, the country would now attempt to agree a further temporary freeze on debt repayments and a one or two year extension of short-term credit lines totalling $16 bn. Brazil intends to submit an economic programme to the IMF, but it will be non-negotiable. This represents a change of course following nine months of negotiations with the IMF on a new economic programme which could have paved the way for commercial and official MYRAs, and without which ECGD and other official export credit agencies have said medium-term cover for Brazil will not be resumed. If the Brazilian stance is serious (and some bankers still regard Funaro's statement with scepticism), it may influence foreign banks' decisions about the short-term credit lines when the current extension expires on 17 January (previous rollovers were only agreed on the recommendation of de Larosiere) and how to deal with medium-term debt in the absence of a Fund programme. This new situation could increase the risk of a split among creditor banks, between those willing to do a deal without any Fund programme and others insistent on a Fund agreement. The picture may be clearer after the next meeting of the Advisory Committee on 12 December.

The attitude of foreign banks to Brazil will have been further coloured by the Brazilian authorities' response to the recent collapse of three domestic banks, Banco Comind, Banco Auxiliar and Banco Maisonnave. Although the authorities have announced that they will honour the banks' short-term external debts ($150-$180 mn), they have yet to clarify their position on the medium and long-term foreign debts (about $450 mn). Central Bank President Bracher stated that these debts would not be assumed by the authorities: later reports suggest that creditors will receive up to 40-50% payment for their claims, from the proceeds of sales of the failed banks' assets.

In Mexico, the authorities unveiled both their "General Criteria for Economic Policy" and the 1986 Budget in mid-November. The principal targets will be GDP growth of between plus and minus 1%, inflation of 50%, a public sector deficit of 5% (after an expected 9 1/2% this year), and a current account surplus of no more than $500 mn. The authorities have ruled out the possibility of a debt moratorium, but have stated that they will be seeking a reduction in the cost of debt-service. In line with moves towards greater trade liberalisation, the Mexicans have also announced that they will try to negotiate entry into GATT. Mexican officials met the banks' Advisory Committee on 2-3 December to discuss progress on the economy and the prospects for 1986 and beyond. The Mexicans publicly stated that discussions would begin with the IMF with a view to agreeing a new programme, probably a Standby, and that no additional purchases under the existing EFF would be requested; they hoped for agreement with the Fund in early 1986. Discussions with the Advisory Committee will resume in January to detail the banks' role in meeting Mexico's 1986 borrowing requirement. Earlier speculative pressure on the free market rate of the peso has somewhat abated in recent weeks; with the controlled rate (at which 80% transactions are undertaken) increasingly depressed as a result of the poorer trade performance, there has been a narrowing in the differential between the rates (to 28% from 36% in mid-November).

In mid-November, Chile was granted a waiver by the IMF of the Q3 performance criterion for reserves, pending receipt of the first disbursements of the $1085 mn new bank package (signature of which has been held up by the refusal on political grounds of three Italian banks to participate). The waiver enabled Chile to draw down the first conditional tranche under the SDR 750 mn EFF and the first $125 mn tranche under the $250 mn IBRD SAL. It is however reported that Chile is seeking to modify the IMF targets for the 1986 public sector and current account deficits, and might also seek to renegotiate the recent 'mini' Paris Club deal to increase the amount of official debt relief. Meanwhile, Ecuador has unified its exchange rate in line with the requirements of its IMF programme. Chemical Bank, which chairs Colombia's Consultative Committee, has announced that the banks' 1985-86 $1 bn loan to the country will be signed around 19 December, after circulation of documentation to creditor banks.

Agreement has now been reached between the Advisory Committee of banks and Venezuela on the draft contract for the $21.2 bn public sector MYRA following a compromise on the Venezuelan request for a contingency clause to reopen negotiations in the event of adverse external circumstances; signature is expected early in the New Year. In October, the UN Secretary General appealed for $150 mn in international assistance for Bolivia. Responses so far have been favourable: Colombia has pledged $10 mn, Argentina $20 mn, Venezuela $25 mn, Brazil $15 mn, Spain $20 mn, and the Andean Development Corporation $10 mn. Peru's Finance Minister has announced a moratorium on payments to the IMF until August of next year. If the authorities carry out this threat, it could lead to the accumulation of arrears totalling SDR 170 mn by that date (cf 41 mn on 19 November). Jamaica failed to meet the end-September performance criteria under its SDR 115 mn SBA (only approved in July); in addition, the country has also built up arrears to the Fund totalling SDR 20 mn. However, a "new look" mission comprising the IMF/IBRD/USAID, is to visit Jamaica to re-examine the structural adjustment programme; it is expected to take at least two months to report. Meanwhile, outline agreement has been reached with the IMF on a package of measures which might allow the stalled SBA to continue until results of the mission are known.

(ii) Far East

In the Far East there are signs that the IMF Standby for the Philippines may soon be back on course. Following a recent mission to Manila the staff will propose a waiver of the September 1985 net financing target for the fiscal deficit on the basis that the breach will occur as a result of revenue shortfalls associated with weak domestic conditions (GDP is likely to fall by around 5%) and reduced collections of import duties rather than because of expenditure overruns. In addition, the authorities have agreed to a significant reform of the tax structure, and to introduce previously promised, but unfulfilled, reforms in the coconut and sugar sectors early next year. The staff review of the Standby is due to be discussed at Board level on 20 December. If supported, this would release the third and fourth drawings (SDR 212 mn) and the second instalment of commercial new money ($475 mn). Nevertheless, the staff remain concerned about weak export performance, prospects that in 1986 major payments will be needed to offset losses of largely bankrupt public corporations, and that the authorities will relax their policy stance in advance of the presidential elections Marcos has called for 7 February.

In South Korea growth is now expected to be only 5% this year (compared with 7.5% in 1984), but official forecasts show a revival to 6.5% in 1986, as a result of stronger export performance following recent export-stimulating measures and a small upturn in the US market. This could lead to a small trade surplus and the virtual closing of the current account deficit. As regards Indonesia, recent projections of the Institute of International Finance indicate only 1% growth in 1985 and 2.5% in 1986 (lower than official expectations) ~~and suggest that~~ import contraction this year could reduce the current account deficit for 1985 from earlier projections. The government is hinting that an austere budget is likely for 1986/7 (starting April), with the final version depending on oil developments in the interim.

(iii) Eastern Europe

Official creditors meeting in Paris on 19 November signed an agreement rescheduling 100% of Poland's principal and non-moratorium interest (approximately $1.4 bn) due in 1985 over ten years including five years' grace. Further talks are due to be held on 17-18 December about a possible adjustment of the $520 mn moratorium interest due on 31 December under the 1982-84 rescheduling agreement signed in July. (The UK bilateral was signed on 30 November.) Official creditors called in Paris for comparability of treatment between creditors in the future: the Poles for their part accepted the need to reopen their 1981 bank rescheduling (although they expressed the fear that to do so might lose them some of the short-term credit facilities the banks have been making available) and the Chairman of the banks' Steering Group has been advised (in strict confidence) that the Poles will seek shortly to defer the $245 mn principal repayment due on 10 December under the 1981 agreement. This should lead the way to an informal meeting between the banks' representatives and the Chairman of the Paris Club. However, it remains unclear whether the Poles will take the action they have promised. Press reports give the impression that the payment to the banks might still be made. Meanwhile reports suggest also that the Poles intend to cut imports further following a $700 mn shortfall on exports this year.

Yugoslavia seems convinced that its official creditors have assured it of a block MYRA covering eligible maturities from mid-May 1986 to end 1988, with enhanced surveillance rather than an IMF programme. Official creditors have, however, mandated the Chairman of the Paris Club to inform the Yugoslavs that there was no consensus: while the IMF are clearly unsure what their future role in Yugoslavia should be, a number of creditors, the UK included, would prefer continued Fund involvement, regarding it as inconsistent to give a MYRA without an SBA because of the difficulty in setting targets. Meanwhile, the commercial bank

MYRA is due to be signed in the week beginning 16 December. Elsewhere in Eastern Europe the $400 mn facility for Hungary has been signed, thereby completing the country's financing requirements for 1985. There is, however, some concern that the Hungarian authorities are becoming complacent about their ability to raise funds in the market; the convertible currency current account is expected to record a deficit of between $100-200 mn this year, as against a original target of a $300 mn surplus. Despite earlier reports, it is now clear that Romania has only raised one loan so far: the $150 mn credit discussed in June, and agreed in September, and now expected to be signed this month.

(iv) Southern Europe

Following the announcement by the Greek government on 11 October of an austerity package, including a 15% devaluation of the drachma, mandatory import deposits, partial dismantling of wage indexation and a profits tax, agreement was reached on the provision of an ECU 1.75 bn ($1.5 bn) conditional loan under the Community Loan Mechanism. The six-year loan will be disbursed in two equal instalments, the first as soon as funds have been raised by the EC and the second by end-1986, provided economic performance targets have been met. These include stipulated reductions in wage and price inflation, in the PSBR:GDP ratio and in the current account deficit (now expected to be $2.8 bn this year). The recently-announced budget aims also to achieve a 2 1/2 percentage point reduction in the CGBR:GDP ratio (to 10.6%), through increased tax revenue and cuts in public expenditure plans.

As widely expected, Portugal's newly-elected minority government has drawn up a programme of "controlled expansion" aimed at achieving growth of up to 4% next year. Interest rates have already been reduced by 4 percentage points to stimulate investment and the crawling-peg depreciation of the escudo has been suspended until April, when it will be resumed at a slower pace. Recent significant increases in administered prices nonetheless demonstrate the authorities' commitment to further adjustment.

(v) Africa

In Egypt, an IMF mission has just completed discussions in Cairo on a possible Standby Arrangement. No details are yet available, but the authorities appear (at least in private) to have accepted the Fund's estimates of outstanding external debt (hitherto a sticking point). Both the President and the Prime Minister have also reiterated Egypt's readiness to undertake the kind of economic reforms advocated by the Fund, although no substantive measures have yet been announced. Meanwhile Egypt (like some other countries in the region including Iraq and Libya) has sought bilateral rescheduling of some trade credits and military debt.

In Nigeria, there are indications that the government may now be prepared to implement structural reforms through the forthcoming budget. However, public opposition to the IMF may result in the government introducing the reforms without accepting an IMF loan or formalising an agreement at this stage. As regards the reconciliation of trade arrears, the Central Bank of Nigeria extended the deadline for receipt of amended submissions only to 30 November, and the Paris Club have sent a further message to the Nigerian authorities drawing attention to specific difficulties which have arisen in the reconciliation exercise. The accumulation of new arrears on letters of credit, totalling at least $1 bn, has meant that many foreign banks are not rolling over payments received into new credits.

In Morocco, the first review of the 18 month IMF Standby Arrangement, approved in September, is now being held. Reportedly, the performance criteria regarding the elimination of external arrears and the fiscal target have not been met. The prospects for agreeing a suitable programme for 1986 (also a condition for successful completion of the first review), and for covering the projected 1986 financing gap of some $490 mn, are not encouraging at this stage.

The South African government appears to be continuing to move away from its previously deflationary stance; on 19 November it announced a range of tax cuts and reduced the bank rate by a further one percentage point to 13%. At the same time, largely because of the past depreciation of the rand, inflation continues to increase: the year-on-year consumer price index rose by 16.8% in October, its highest post-war rate of increase. Meanwhile, there is continuing uncertainty over the debt negotiations. Dr Leutwiler, the mediator between the South Africans and the banks, postponed the meeting between the creditor banks and the Standstill Co-Ordinating Committee (due on 26 November), on the grounds that he was not yet in a position to circulate papers sufficiently in advance of the meeting to make it a useful exercise. He has now sent to the 30 major creditor banks a package which contains the promised figures on debt and the South African government's proposals on rescheduling. These envisage, not a further one-year extension of the moratorium as the banks had expected, but retaining the present short-term obligations for varying periods of 4-6 years. The debt standstill, which was originally scheduled to last until end-December, has now been extended to end-March 1986. Both Leutwiler and Governor de Kock have warned the South African authorities that political reforms will be necessary if agreement with the banks is to be achieved.

In Sudan, the Committee of Ministers has rejected or failed to implement adjustment measures agreed with the IMF in early November and the Finance Minister has offered to resign, but this has so far not been accepted. Official creditors remain reluctant or unwilling to help Sudan clear its IMF arrears, and little progress has been made towards covering the large external financing gap projected for 1986. The chances of the IMF approving a $40 mn Standby Arrangement in early January, as earlier hoped, now appear remote.

CONFIDENTIAL

27.11.85

INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1984	End-June 1985	End-Sept 1985 [2]	End-Sept 1985 [3]
Latin America				
Argentina	48	2.5	0.2	0.2
Brazil	100	6.7(0.6)	0.8	1.8
Chile	19	1.3(0.1)	-	0.1
Colombia	12	0.6(0.1)	-	0.2
Ecuador	7	0.6	0.1	0.1
Mexico	97	6.4(0.3)	0.5	1.3
Peru	14	0.3	0.1	0.1
Venezuela	39	2.3(0.1)	-	-
Far East				
Indonesia	35	0.7(0.3)	0.8	1.6
Philippines	26	1.3(0.1)	0.2	0.2
South Korea	43	2.2(0.5)	0.4	0.8
Eastern Europe (convertible currency)				
East Germany	13	0.5(0.1)	0.1	0.1
Hungary	9	0.5(0.1)	-	0.1
Poland	27	0.5	1.2	1.3
Romania	7	0.2	0.3	0.5
Yugoslavia	19	0.9(0.1)	0.7	1.0
Southern Europe				
Greece	16	1.3(0.2)	0.3	0.4
Portugal	15	1.2(0.1)	0.2	0.3
Spain	39	2.4(0.9)	0.1	0.1
Turkey	21	0.4	0.2	0.4
Africa				
Egypt	32*	0.4(0.3)	0.2	0.9
Morocco	12	0.2	0.1	0.2
Nigeria	18	1.3(0.1)	1.9	3.3
South Africa	27[4]	3.9(0.5)[5]	0.8	2.8
Sudan	9	0.0	0.2	0.2
Middle East				
Israel	30	0.5	0.1	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.
Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans.

[2] Defined as unrescheduled principal disbursed, plus political claims paid and claims under examination.

[3] Defined as guaranteed principal and contractual interest, plus political claims paid and claims under examination.

[4] Total debt estimated at $24 bn at end-August 1985

[5] Data not compatible with those previously shown, because of deconsolidation of subsidiaries which are no longer majority owned.

* current estimate

LP6.24

SECRET

eDP
20/xi

6

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

FOREIGN AND COMMONWEALTH SECRETARY

Thank you for your minute about my meeting with Dr Kalu of Nigeria.

I fully understand the sensitivities you mentioned which affect the UK's relationship with Nigeria. I also hope very much that it will be unnecessary for me to press Dr Kalu to do a deal with the IMF. You will by now have seen today's report from Lagos which suggets that the Nigerian Government has already taken the decision to negotiate with the Fund. If true, this would confirm reports we have had from other sources, including Warburgs, the Nigerian Government's advisors. However, while avoiding giving any impression of hounding Nigeria towards the IMF, I think it would be quite wrong for me not to encourage Dr Kalu to negotiate with the Fund. Given that we have consistently been urging the Nigerians to do just this and that they now seem to be about to do so, such a course would risk misunderstanding.

I hope to be able to encourage the Nigerians by stressing the benefits which would flow from an agreement with the Fund and the assistance which the UK might give. On the last point I will of course tell Dr Kalu that if an acceptable agreement can be reached between the Fund and the Nigerians, we will support it strongly in the Board. However, it would be wrong to let them think that we would interfere in the negotiations between the staff and the Nigerians. False hopes of this on the Nigerians' side could only lead to further difficulties in our relations later.

SECRET

Finally, like you, I doubt whether Kalu will raise the oil proposal, especially in the post-IMF form to which you refer. Even if he did, I do not think we would want to encourage the Nigerians to think in these terms.

I am copying this minute to the Prime Minister, the Secretary of State for Trade and Industry and the Secretary of State for Energy.

NL

N.L.
19 November 1985

ECON P02 : Indebtedness: Pt 5.

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CDP

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CHANCELLOR OF THE EXCHEQUER

Nigeria: Your meeting with the Finance Minister

1. As you know, there are currently a number of problems affecting our relationship with Nigeria, not least that of the two Bristows engineers. Senior members of the Nigerian Government, in public and private, have made it clear that better economic relations would make it easier to solve these problems.

2. Many senior Nigerians are regrettably still under the impression that we are not doing all we could to help them overcome their economic difficulties. It is important for us to disabuse them of this, and to convince them that, within the constraints imposed by economic prudence and our international obligations, we are doing all we can to help. I appreciate that our attitudes to Nigeria cannot be treated in isolation and that our interests, as well as Nigeria's, will be best served by the Nigerians agreeing a programme with the IMF. Although the Nigerian authorities have adopted many of the elements of a typical IMF programme, with the inevitable austerity that this entails, it is still politically very difficult for them to adopt the final, important, economic measures - especially devaluation - on which the IMF would insist. Some well-informed Nigerians have now predicted Babangida's downfall (which would not be in our interests) if he does "submit" - as they see it - to the IMF. I think that these reports are exaggerated, but the strength of anti-IMF feeling in Nigeria should not be underestimated.

/3.

3. We know that Dr Kalu is one of the few Nigerian politicians arguing strongly for a Fund package, but for political reasons we do not want him to report back to Babangida that we are leading the pack of those who are hounding Nigeria towards the IMF. I therefore hope that when you see him on Wednesday you will not press him to do a deal with the IMF but rather stress our desire to assist Nigeria, and draw him out on how he sees the Nigerian Government's moves after conclusion of the present public debate on policy towards the IMF. In the light of his replies, I hope you could explore what action we might realistically take to aid the Nigerians. It would be helpful in this context if you were to repeat to Kalu what you told Sir Peter Emery on 7 November, namely that the UK would use its good offices in the IMF to ensure that any terms they sought from Nigeria were not unduly rigorous.

4. I doubt whether Kalu will raise the oil proposal which the Secretary of State for Energy mentioned in his minute to the Prime Minister of 5 November, because it has previously been handled by the Nigerians as a sensitive subject and on strictly unofficial channels. However when I gave the Nigerians a discouraging reply this was on the assumption that the proposal was not preceded by an IMF agreement. If the Nigerians were to achieve the latter, it might be worth reconsidering, for the reasons the Secretary of State for Trade and Industry adduces in his minute to the Prime Minister of 13 November, although I recognise the difficulties. If Kalu nevertheless does raise the question of a post-IMF oil deal, I hope you could be non-committal.

/5.

5. I am copying this minute to the Prime Minister, the Secretary of State for Trade and Industry, and the Secretary of State for Energy.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
19 November 1985

Econ Pol: Indebtedness Pt 5

The Sampson Letter 29

19th Nov 1985

A fortnightly report on world politics and finance

Dollars, protection and managing the Casino

WASHINGTON - The 'Congressional summit' on the dollar, which I have just been attending in Washington, certainly reveals a major change in American thinking about the world economy.

To Europeans present, it marks an uncanny contrast with American attitudes a year earlier, when phrases like monetary reform or debt crisis sounded almost like treason. Now the talk of a new Bretton Woods for managing currencies has become almost commonplace.

It looks even odder to find such a summit organised by Jack Kemp, a non-intellectual tax-cutting Republican, in alliance with the Democratic senator Bill Bradley. Both of them are plausible presidential candidates for 1988; and Kemp looks still more plausible having just raised 2 million dollars in New York.

But Kemp also represents a fundamental kind of neo-conservatism which believes in growth globally as well as domestically, and which attacks the IMF for being too austere with developing countries. And he calls himself 'an unabashed free-trader'.

Kemp is now convinced that in order to avoid protectionism, which is now rampant, the US must reform the world monetary system to provide a lower and more stable dollar which can make American exports competitive again. And the exchange rates, which most Americans never used to notice, have become a hot political issue.

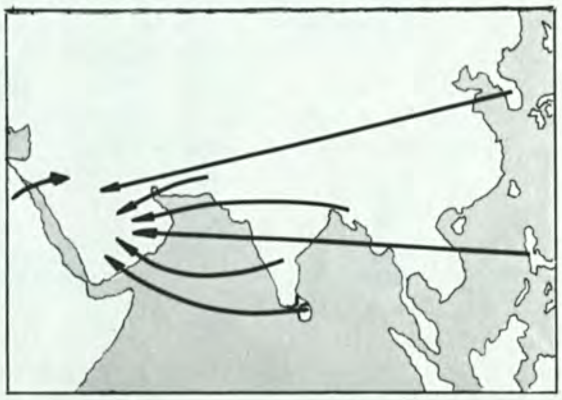
BRINGING DOWN THE DOLLAR

So Kemp, (who has been known for good political timing) found himself with a hotly topical summit. He invited experts to fly in from all over the world to talk for five minutes each. It was a symbol, if nothing else, that the US is again beginning to notice the rest of the world.

Kemp's summit was made much more topical by the dramatic change of direction by Jim Baker, the Treasury Secretary, who two months ago successfully intervened (with the four other finance ministers) to bring down the dollar.

All the countries involved seemed rather surprised by its success at the summit. But Baker himself said that there was 'an awful lot more to be done'; and that it was 'not a one-shot effort but a step in a continuing process.'

The analysis of that intervention was an important part of the summit; and everyone listened anxiously to the



Asian countries providing migrant workers to the Gulf are feeling the effects of the lower oil-price, reducing both the wages and numbers: see the report on p.6.

This Letter also includes:

** A letter from Arthur Schlesinger about Castro, his revolution and his latest views on debts (p.8)*

** Will the Afrikaners abandon their monopoly in S.Africa? (p.7)*

** The Saudi's new problems with oil and arms deals (p.4)*

ANTHONY SAMPSON

Japanese who sent a high-powered team. 'We convinced the market that they had a wrong perception', said Toyoo Gyohten, the very articulate expert from the Japanese Ministry of Finance who played an important role in the strategy: 'it was like throwing a bucket of water over a drunken man who was already regretting his over-drinking.'

Gyohten clearly thought that Tokyo could bring the yen further down - to below two hundred to the dollar and that it would eventually find its own equilibrium in the market.

But nearly everyone at the summit agreed that even with continuing intervention the world's exchanges would still be chaotic, as the surging flows of capital across borders made currencies still more volatile.

The Group of Thirty, which advises the IMF, will soon release figures showing that $150 billion crosses the exchanges everyday - twice as much as five years ago (with London being the leading financial centre, closely followed by New York).

THE JUNK-BOND CASINO

Several experts gave their own estimates of the massive increase in international financial operations. Henry Kaufman of Solomon's reckons that the Eurocurrency market went up from $200 billion in 1972 (just before floating exchange rates) to an expected $2500 billion this year.

Felix Rohatyn of Lazards (who still hopes to be the next Treasury Secretary under the Democrats) described how capital flows were now fuelled far less by trade than by new inventions, such as options, swops, straddles, or futures. 'We must take care that the world does not become a junk-bond casino.'

Two industrial chief executives, Edward Jefferson of Du Pont and Paul Oreffice of Dow Chemicals, described the difficulties of making corporate plans with volatile currencies. 'Floating rates are not a system,' says Oreffice, 'they are chaos.'

And several speakers explained how floating rates have been exacerbated by the global financial revolution, while the boom in financial services has shifted incentives away from industry.

Rainer Gut, the chairman of Credit Suisse, claimed that the inventiveness of the junk-bond casinos was not necessarily bad. But Pierre Uri, (the veteran French economist who helped to plan the European Community) was indignant: 'What has financial innovation contributed to growth and relieving unemployment?'

And many economists pointed out that, however much swops or futures markets could balance short-term risks, they could not protect against the ultimate risks of currencies and credit. 'These new risk management techniques', said Kaufman, 'do not reduce, and may even increase, credit risk.'

NO CHANGE WITHOUT COLLAPSE?

Among the eighty speakers, nearly all agreed that some change in the monetary system was essential, but was America, or the world, ready for it? 'Changes are not made', warned Robert Strauss, the former special trade representative, 'until economic conditions are critically felt at the political level.' And he was worried that the voices of American exporters, including farmers, have been weakened.

Lester Thurow, the economist at MIT, warned that in the past new economic systems had only been introduced when the old systems had collapsed. We may have to wait, he said, until the US debt becomes impossible, as Mexico's did three years ago.

There were certainly many signs that American political attitudes were beginning to change. The worries about American industry and exports had forced politicians to become much more aware of

the dollar's instability than they were a year ago.

But the protectionist lobby is still getting stronger, while the free trade lobby is far weaker than it was twenty years ago. Can the politicians really convince out-of-work textile workers in

North Carolina that they would be saved by international monetary reforms?

Even with a lower dollar there are real doubts as to whether many US industries can recover the markets they have lost to foreigners. Some brave speakers, including a Japanese, suggested that volatile currencies might have actually been good for industry in forcing adjustments. But to talk about adjustment sounds less comfortable in North Carolina.

GOLD AND THE ECU

If floating rates are so clearly not working, what can be put in their place? Can the dollar really remain the dominant currency while the US is soon to become the world's biggest debtor?

The word GOLD still glitters in the background. Jack Kemp himself, influenced by Professor Mundell of Columbia, is attracted to some kind of gold standard. And the expectations of gold-bugs at the summit were aroused by the arrival of Paul Fabra, the French economist from Le Monde who recently advocated a kind of gold standard in the Wall Street Journal with some support from the Journal itself.

But Fabra did not expect, or gain, much American encouragement, and Kemp played down the gold connection. There were obvious worries that the main beneficiaries of returning to gold would be South Africa and the Soviet Union.

Instead the French (who took the summit far more seriously than the British) stressed the importance of the European Monetary System and its currency the Ecu.

President Mitterrand's special adviser, Jacques Attali, produced his own analysis and plan with his master's blessing, proposing a managed exchange rate system, with 'reference loans' of currencies, a kind of modified version of the EMS to include the dollar and the yen.

Both Attali and his treasury colleague Jean-Claude Trichet, were clearly hopeful of the future of the EMS and look forward to Britain soon joining the system - particularly since the pound seems less linked to the oil-price. And Robert Triffin, the economist at Louvain who helped to invent the EMS, gave a convincing account of how the members overcame their differences.

Several Americans looked forward to the Ecu, together with the yen, taking over more of the task of absorbing the huge capital flows - as well as uniting Europe.

'Jean Monnet believed that the industrial forces would create a united Europe', said Rohatyn: 'They did not, but financial forces may ultimately achieve what Monnet tried to achieve.' But the Americans recognised that the EMS was part of a political convergence in Europe which would not easily connect with the Atlantic or the Pacific.

There were various suggestions for diminishing the dollar, or sharing its burden. Triffin and others proposed that the US should stock pile other currencies. But speakers from all sides insisted that the US, even if it moved further into debt, could not abdicate its leadership. 'If this is the American century,' said Mundell, 'then the US must lead the system.'

MEETING OF BODIES, NOT MINDS

So what are the prospects for future agreement? Many people talked about 'a new Bretton Woods', where the world's leaders could thrash out a new system (a slogan which used to be largely confined to the left, or to developing countries).

But there was little use (said Charles Kindleberger from MIT) in having a meeting of bodies without a meeting of minds. The minds at this summit were still a long way from meeting. And Kemp and Bradley were still far ahead of most of Congress in recognising the urgent importance of monetary reform.

Yet there is no doubt that the mood at the summit - and the response to it in Washington - represented a fundamental change from the political atmosphere a year earlier, when laissez-faire still prevailed as the basis for both international debt and currencies.

The Americans have once again taken the Europeans by surprise, in their ability to suddenly seize on a problem, analyse it, and try to push for a solution. The fact that this initiative comes from Republicans, and from strongholds of American industry, makes it all the more hopeful.

The reformers will face many pitfalls and many critics argue that they are doing too little, too late, but at least they have recognised the danger of doing nothing. And this looks like the beginning of a new road much more than the end of an old one.

People and pointers

SAUDI OIL AND THE TORNADOS

The Saudis continue to provide puzzling clues to both their chief export, oil, and their chief import, arms.

Sheikh Yamani has repeated his warnings about an oil-price war, which looks more credible since the Saudis have bumped up production to over 4m barrels a day. The fixed OPEC prices now look dead; or as Yamani puts it, they will 'hang up in the air as an indicator'.

The Saudis are no longer prepared to lower their production indefinitely; and by next spring the competition among producers will be more intense, while world consumption still declines: it was down 5% in Japan last quarter, compared to last year; and down 3.5% in Europe.

But Yamani has provided more confusion, in both oil and arms circles, by saying that the Saudis 'most probably' will not now use oil in part payment for the 72 Tornado fighters they plan to buy from the Anglo-German consortium.

British defence officials are now worried that this may re-open the whole contract, which so far only has a 'memorandum of understanding'. The French could not sell their Mirages, they say, because they would not accept oil in exchange; but now they may try again.

The Tornado deal remains full of complications. British Aerospace officials have just been to Saudi Arabia to negotiate $1600m in offset agreements, on the same basis as the previous Saudi deal with Boeing. And colleagues of Adnan Khashoggi, the doyen of arms dealers, now claim that he will receive 2.5% in commissions for the arms deal, whose total value is over $5b.

Prince Sultan, the Saudi Minister of Defence, has insisted that he no longer does any deals through Khashoggi; and this new claim, together with reports that Sultan's son, Prince Bandar, will get 5% of the Tornado payment, is now causing concern both in Washington and London.

UNESCO'S LAST BID

The visit to London next week of the Director-General of Unesco, Amadou-Mahtar M'Bow, - as part of his organisation's fortieth anniversary celebrations - has been awaited with special interest.

For now that the United States has withdrawn its contribution, Unesco desperately needs Britain's support to maintain its credibility in the English-speaking world.

The British government will decide in the next month whether to cancel its $7-million-a-year contribution to Unesco. The Foreign Secretary, Sir Geoffrey Howe, wants to stay in, as do most of a national commission appointed to advise the government. But right-wing lobbies, including the American Heritage Foundation, have been lobbying heavily; and Mrs Thatcher still seems determined to pull out.

Unesco's main division, which almost tore it apart, has been between North and South - particularly over the idea of a New Information Order to provide fairer reporting of the third world. But there has also been a much older division over the dominant language, French or English.

The Francophone countries have always seen Unesco, being based in Paris, as the one French-speaking stronghold among the UN agencies. And M'Bow himself, who comes from Senegal, insists on speaking French in America, though he has adequate English. Will he agree to speak English in England?

But M'Bow is very unlikely to continue after his term ends in two years time, particularly since he has lost the support of the Soviets. And bilingual successors are already being canvassed, ranging from Pierre Trudeau to Prince Sadruddin Aga Khan.

SOUTH AFRICA'S ALL-WHITE SOLUTION

The elegant English country-house of Ditchley Park near Oxford has become a favourite setting for Anglo-American weekend conferences on the future of the world.

Ditchley has sometimes been accused of being out of touch with the real world. But this weekend they are leaving the real world right outside. They have put together a conference on South Africa which - to the amazement of many of their conferees - does not include a single black man.

The guests include the usual chorus of British ex-ambassadors, led by the director of Ditchley, Sir Reginald Hibbert, and by the conference chairman, Sir John Killick, who was ambassador to NATO before running Dunlop in South Africa. (Visitors might assume that Ditchley is financed by the Foreign Office; but its funding is quite independent.)

There are some more interesting American guests including Senator Paul Sarbanes, Congressman Stephen Solarz and HJ Heinz II. And there are some white South Africans including two opposition leaders, Van Zyl Slabbert and Colin Eglin.

But not a single black South African was included. One or two white guests, on seeing the list, refused to attend.

WILL AFRICA JOIN EUROPE?

After all the publicity surrounding the rival schemes for a Channel tunnel between Britain and France, much less has been said about a more politically significant tunnel which could well be completed first - between Spain and Morocco across the Straits of Gibraltar.

Both Spain and Morocco are agreed about the urgent need for the link, which (like the Anglo-French tunnel) has been discussed over the last hundred years. And the engineers have now solved the difficult technical problems of the rough waters where the Atlantic meets the Mediterranean.

The technical study, which is due to be finished next year, is likely to favour a tunnel rather than a bridge. It would carry two railway lines underwater for 29 kms - about the same distance as the English Channel.

The tunnel would transform the communications of North Africans who have felt themselves more distant from Europe since the Second World War, or since the extraordinary brief period of air travel before the war when the only way to fly from Europe to America was via West Africa and Brazil.

The geopolitical implications of a Spanish-Moroccan tunnel are much greater than the Channel tunnel's. It would provide a direct link between Europe and West Africa, which NATO politicians see as an important means of countering Soviet influence. And its importance would be reinforced by the projected highway all the way from Amsterdam to Dakar.

CHEAP FLIGHTS IN EUROPE

How serious are the European airlines about wanting to bring down their fares, after all these years of their cartel?

The airlines remain very divided: the cartel lobby is led by Alitalia, Olympic and Air France; the liberals are led by British Airways, British Caledonian and KLM. But the distinction is blurred: Aer Lingus and Swissair, for instance, who want to get into other airlines' markets, are liberal about capacity, but not about fares.

Others are slowly changing: Lufthansa, which has traditionally been very defensive, now (at last) has some Young Turks who believe that their airline can hold its own in a free-for-all.

1986 is a hopeful year for cheaper fares, when first the Dutch, then the British preside over the European Community, and their ministers will want to show some achievement.

But all the Europeans are anxiously watching the confused signals about deregulation in the United States, and the signs that the American giant airlines, the 'gorillas' are becoming still more dominant as they capture global routes.

It is now forty years since the world airline system was established at Chicago, when the smaller nations protected themselves against America with bilateral deals rather than allow 'open skies'. And as the world's airlines again look with dread towards America, the skies remain closed to any real free-for-all.

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The Philippines and the glut of 'warm bodies'

The falling oil revenues in the Middle East are beginning to have harsh consequences for the contract workers from poorer developing countries who have been flocking to the Gulf over the last twelve years.

The mounting competition for jobs, intensified by 'labour auctions', are drastically pushing down wages. The Philippines - the country which has been the most aggressive marketer of labour - is becoming specially worried at a time of political crisis. And the Philippine Overseas Employment Administration is planning an international conference on contract workers next March.

The Filipinos, like other Asians, saw a huge increase in their overseas workers after the oil shock of 1973. In 1972 they had 12,000 under contract; last year they had 425,000. In Europe their biggest destination is Italy, where there are about 80,000 Filipinos - most of them technically illegal immigrants or 'clandestini'.

But the great majority of Filipinos - over 80% - go to the Middle East, where their future prospects depend heavily on the oil-price. And like other exporters of labour they are now feeling the effects of the price-falls, as the Saudis and other oil countries are able to bid down the cost of their labour.

The Philippines try to insist on a minimum rate of $208 a month; but the Saudis are thought to have recently engaged some foreign workers at only $80 a month - which includes food and lodging. And even this wage has the recruitment fees deducted for the first few weeks.

DEFYING ECONOMIC ANALYSIS

The Manila conference will be a much-watched event, because the movements of migrant workers have never been adequately studied. The numbers of illegal workers have defied economic analysis: even the numbers of Mexicans crossing into the US is subject to wildly different estimates. Many large movements across frontiers, like the Yemenis coming into Saudi Arabia or the Egyptians going to Iraq, are impossible to track.

One guesstimate of the numbers of migrant workers reckons that there are a total of 25 million in the world. This includes 3 million in the Gulf (who have doubled in 12 years), 9 million in the US from Mexico and Central America, [illegible] million inside Latin America and 2-3 million within Africa.

But the great new magnet for migrants has been the Gulf, which has attracted labour from all over South East Asia and the subcontinent, as far as Sri Lanka, the Philippines and Korea. The oil-boom, coinciding with the jumbo jet, produced sudden new patterns of trade and political relationships. Many individual construction projects have been linked to separate countries, like Sheik Zayed's city in Abu Dhabi, built by Bangladeshis.

Saudi Arabia is now believed to have 2 million more expatriates than Saudis - with layers of nationalities all the way from Americans in top jobs, via Egyptians and Palestinians in the middle, to Yemenis on the bottom.

'The Arabs in the Middle East couldn't do without migrant labour,' says Aminur Doha, the former Foreign Minister of Bangladesh: 'no Arab is now going to clean the streets for the salaries that are offered.'

The migrants' wages are low compared to the average wages in the host countries, and are likely to be lower; but they remain high compared to wages at home. A Sri Lankan who earns $100 a month in the Middle East may earn only $6 in his own country.

	Remittances	Trade Balance
INDIA	$m	$m
1978	1147	-884
1982	2599	-4820
PAKISTAN		
1978	1420	-1824
1982	3114	-2725

Source: IMF International Financial Statistics, March 1982

Many developing countries have become dependent on the remittances for their balance of payments, with contract labour becoming a central element in their economies.

'Migrant labour has an important influence on other parts of economic policy,' says Nigel Harris of the Development Planning Unit of London University: 'they set a definite limit on import controls.'

But this 'trade in warm bodies', as it is sometimes called, can never be seen in purely economic terms. 'People are not of course commodities', says Professor Meghnad Desai of the London School of Economics, 'and substantial social problems arise in their movements. Any drastic reduction in the flow of immigrants will have financial consequences for the home countries.'

CLOSING THE SAFETY-VALVES?

All the labour-exporting countries are now facing political problems with the more intensive competition and the falling oil price, which has cut back the huge construction projects. But they also face the wider problem of dependence on the fluctuating world economy.

Many countries like Sri Lanka have tried to solve their unemployment problems by opening themselves up to the world labour market, whether by exporting workers or by developing factories in their own free-trade zones.

'Let the people of the world come', said the Sri Lankan President Jayawaradene in a famous and controversial statement in parliament about the Sri Lankan free trades zone at Katunayake: 'and make it a 'robber baron's area'.'

But they are now feeling the full ruthlessness and selectiveness of that global market-place. (Whether for electronic factories at home or domestic service abroad, most clients prefer young childless women who are soon discarded.)

For the Philippines specially, the prospect of numbers of unemployed returning from the Gulf is just what the Marcos government does not want. The Filipinos have put enormous efforts behind their contract deals, with special packages of people for each importing country.

The scope for Filipinos to work abroad - whether in apartments in Rio, in hospitals in London, or in duty-free shops in Bahrein - has provided a kind of safety-valve for troubles at home. And shutting down the exit-routes, whether in the Philippines, Mexico or Sri Lanka, will give the governments even less room for manoeuvre.

The Afrikaner monopoly

What now are the prospects of a peaceful solution in South Africa after the recent white by-elections? Does the pronounced swing to the right indicate an end to hopes of reform? A well-informed Afrikaner correspondent has written to me:

It's unrealistic to expect President Botha to move any further towards significant reform. He's reached the end of his tether with his own party, and he doesn't want to preside over the destruction of Afrikanerdom.

The Afrikaner right-wing parties, the CP and the HNP, certainly have scope for growth; and the government Nationalist Party can't expect to win them back. But it's a mistake to think of the problem simply in Botha's terms.

The real question is whether the Afrikaners can hold on to their monopoly of power, whether they can continue to exclude the English-speaking population from any role in the decisions. So long as they maintain that monopoly, they won't be able to make any real concessions to the blacks.

Botha may well try to gain more support from the English-speakers: and he can conduct another referendum which is one way of appealing to them without giving them any say in running the country.

Over forty years the Afrikaners have got used to the idea that all the top jobs go to Afrikaners. They consult with the English-speaking businessmen and then decide for themselves.

There's no doubt that Botha is now furious that the business leaders have attracted so much interest to the African National Congress. But the government can't ignore the views of the business community, many of whom are now Afrikaners.

With a continuing recession and an acute shortage of capital it's quite possible to imagine a different alignment emerging after Botha, with Afrikaners sharing power with English-speaking members in the PFP, in order to bring back international capital into South Africa.

And they might even be able to reach some interim agreement to begin negotiating with the black leaders, including the African National Congress, and find some common ground.

Castro's revolution in trouble but embargo maintains it

Dear Anthony,

You will remember that I had a talk with Fidel Castro last May about the Latin American external debt. His argument was that the debt was unpayable and uncollectible, and that the only solution would be for the United States and other industrial countries to assume the debt, paying for it out of reduced military spending. I had another talk with him in Havana on October 18th.

Castro is unimpressed by the proposals of James Baker, the Secretary of the US Treasury, to resolve the Latin American debt problem. He welcomes the change in direction but thinks the figures are hopelessly inadequate. 'In 1984,' he told me, 'Latin America lost $37b in interest payments, $10b in capital flight, $20b because of the decline in terms of trade, $5b because of the over-valued dollar. In short, $72b left Latin America in a single year for the industrial nations.'

'The US now proposes to pump in $29b over three years for the entire Third World. Obviously this does not come close to matching the sums the Third World is sending the West. It is like a glass of water in the desert.'

'The debt will continue to grow. Baker's proposal aggravates the problem. In the long run it will make the debt even more uncollectible. The US is trying to cure cancer with aspirin. Cancer requires surgery.'

I asked whether he was disappointed by the response of Latin American governments to his own proposals. 'Everyone has been discreet,' he said, 'but they are happy we have raised the problem.'

'However, I do not see an immediate consensus or a debtors' club. Countries will continue to make unilateral decisions. The crisis will not be met initially by prior consensus but by an accumulation of separate actions.'

Garcia's declaration, he added, was one such action. While Castro described it to me as 'an important step forward', he sent his comrades to their computers; and the resulting calculations, he said, prove that the debt, compounded under the Garcia formula, would grow remorselessly even in optimum conditions.

'When I made my own proposal,' he said, 'I did not expect other Latin American countries to endorse it. I was presenting an analysis. I know that most Latin American governments are absolutely convinced that the debt cannot be paid. But they don't feel it prudent at the moment to endorse my solution. As the debt crisis grows, the facts will confirm my analysis. I am not worried. Time is completely on my side.'

That may be, so far as confrontation with the debt is concerned. But the visit reinforced my impression that, despite Castro's agility and virtuosity, his revolution is in trouble.

His main exports - sugar, coffee, tobacco, nickel - are all waning assets in the world market. His quarter-century attempt to diversify the Cuban economy has failed. The Russians are probably getting tired of subsidising him.

His best hope for earning foreign exchange is tourism, which may be one reason why he is refurbishing Havana. His other hope is to get into the US market. So he wants to come to terms with the US, at least to the extent of ending the embargo.

But, once he opens up Cuba to American trade and tourists, I do not see how his revolution can survive. The embargo is the best guarantee of the integrity of the Cuban revolution.

The irony is that Castro wants to end the embargo, though this may destroy him, while Reagan wants to maintain the embargo, though this will protect Castro and the Cuban revolution.

Yours ever,

Arthur Schlesinger

P.S. Castro has now given up cigars. Last May, he puffed a single small cigar through a long evening. This time no cigars at all. When I asked him about this, he said bravely, 'I have gone 53 days without a cigar.'

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10 DOWNING STREET

Prime Minister

I suggest you skim the covering letter and the first 5 pages of the note up to (X) as well as the page on S. Africa at Flag.

N.L.W.

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

18 November 1985

Nigel Wicks Esq CBE
10 Downing Street
LONDON SW1

Dear Nigel

INTERNATIONAL FINANCIAL SCENE

I enclose the latest in our regular series of reports on the major debtor countries.

Objectively, the prospects for the majority of debtor countries look a little better than they did two months ago. This is the combined result of the weaker dollar, following the Plaza agreement, and the resulting perceptible weakening, for the time being at least, of Congressional pressure for protectionism. On the other hand the prospect of a lower oil price is bad news for Mexico, Venezuela and Nigeria.

Subjectively, the debt problem, as perceived by the debtors themselves, is significantly eased following the two related initiatives taken by US Treasury Secretary Baker at Seoul, foreshadowed in our last report. The first of these, related to the major debtors, mainly in Latin America, has been fairly well received. It seems for the moment to have stopped the Cartagena Group of debtors in its tracks. We continue to have serious reservations about some aspects of the US move, particularly the way in which it could interfere with the commercial judgement of the banks. But provided that the banks genuinely see it in their own interests to maintain the flow of funds to debtors, we can welcome the US proposals - particularly the renewed emphasis on conditionality and the central role of the IMF alongside an enhanced role for the IBRD.

The second US move couples the release of IMF Trust Fund reflows with increased (or diverted) multilateral and bilateral aid flows to the poorest countries, mainly in Africa. This seems to have been more cautiously received. But it is encouraging to find the US inhibitions over IBRD removed. A US team were in London on 12 November to explain these proposals in detail. They claim that despite its present emphasis on cross-conditionality, there will be support for their scheme from the (mainly African) beneficiaries. A problem for the UK is likely to be in the contribution the Americans hope we will provide from our own bilateral aid resources. This is an issue which Ministers will have to decide at a later stage.

Turning to the individual debtors the main point to note is perhaps the unexpected and possibly temporary emergence of Argentina as the leading 'model pupil', while Mexico and Brazil, the previous favourites, have dropped lower down the class. It is too early to be satisfied with Alfonsin's ability to go on delivering economic progress, but the measures he has already taken seem well-designed.

The continuing problems with Nigeria and Poland are worth noting too. We should know fairly soon whether Babangida is ready to tackle Nigeria's trade and payments imbalance as part of his December budget. If he does finally swallow his pride and accept the need for an IMF programme (including devaluation), it will allow us to start regularising the enormous arrears of debt which have done such damage to ECGD's finances. By contrast Poland, ECGD's other major debtor, seems to be running into even deeper trouble. It is now seeking renegotiation of the very generous debt rescheduling terms agreed earlier this year.

South Africa is not a normal debt problem. But despite its recently-strong trade performance, capital flight and a sharp reversal of trade lead and lags have exhausted its reserves. There is a small danger of inadvertent default which is probably at its peak between now and January, when the banks will almost certainly have to acquiesce in an extension in time of the present moratorium. The Chancellor continues to watch this situation closely.

Finally he thinks the Prime Minister should know that Egypt (mentioned in the present report for the first time) is also showing signs of serious payments strain. This is worrying because of the large UK export business in that market. The prospects here will be reviewed more fully in the light of the latest IMF study.

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

Yours sincerely

Tony Kuczys

A W KUCZYS
Private Secretary

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CONFIDENTIAL

INTERNATIONAL FINANCIAL SCENE

At the IMF meetings in Seoul, and subsequently in other fora, US Treasury Secretary Baker unveiled a package of new proposals for handling the debt situation. These involve a much enlarged role for the IBRD, which (together with the IDB) should provide an extra $9 bn to debtor countries over the 1986-8 period; the adoption by debtor countries of structural adjustment policies that should provide a framework for sound economic growth; and the provision by the commercial banks of $20 bn of additional money to fifteen selected debtor countries. Many of the details of the proposals have yet to be worked out, and indeed some of the details that have been put forward may well be modified. But the importance of the initiative lies anyway in its indication of a significant shift in US attitudes away from earlier hostility both to further official involvement in international debt problems in general and to an increased role for the IBRD in particular.

Inter American Development Bank

Interest now centres on how the various parties will react to these proposals, and how these proposals may be modified in response to these reactions. Sixty commercial banks met in Washington under the auspices of the IIF on October 28 in order to consider the proposals. The reaction was broadly favourable, but the banks wanted to see the extent of government commitments before they would commit actual sums themselves. They were unhappy at the absence of cross default clauses on the proposed new IBRD lending and at the idea of allocating bank lending to debtor countries as a collective entity; but many banks appeared to recognise the impossibility of inducing the smaller banks to participate in the initiative in the same way, and accepted in principle the idea of some form of 'trust fund' through which the small banks might channel a final contribution and then be eliminated from further debt negotiations. In response to questioning from the banks, the US Treasury representative

International Institute for Finance

indicated that Exim Bank was ready to come back on cover immediately for debtors considered to be performing satisfactorily, but suggested that other countries' export credit agencies were dragging their feet. The IIF has now formed a small Steering Group of banks which will meet over the coming weeks in New York and Washington before moving on to Europe. It seems likely that the banks will offer at least nominal acceptance of the Baker initiative, but maybe with some (possibly substantial) suggested modifications.

Meanwhile, the authorities in other creditor countries have declared themselves generally supportive of the thrust of the initiative, although some have expressed concern in a number of areas, including problems of giving implicit official guarantees if banks have to be persuaded to participate, of maintaining the quality of IBRD lending as the quantity of lending increases, of preserving the pressure for adjustment on debtor countries, and of not raising unrealistic expectations amongst debtors. Debtors themselves seem to have suspended judgement, perhaps not surprisingly, as the details of the proposals are not yet clear, but the initiative seems for the moment at least to have broken the momentum of pressure from the debtors which had seemed to be building up after hard-line speeches at the United Nations in September by the Presidents of Brazil and Peru.

In a parallel exercise to his commercial bank initiative, Baker also presented at Seoul a plan for using official funds on a concessional basis to help the poorest countries, many of whom are in Africa. The aim would be to combine reflows from earlier IMF Trust Fund loans with various IBRD resources and perhaps some bilateral funding in order to create a pot of some \$6-\$7 bn. This would be available over the next five years to make loans to the poorest countries facing protracted balance of payments difficulties and who are willing to undertake programmes of structural reform. The US envisage extremely close Fund/Bank co-operation in this exercise, extending as far as joint missions and papers to the respective Boards. Although it is not clear how much, if any, of the funding of this new Trust Fund is additional, the US ideas are generally to be welcomed as a recognition of the large and growing problem of the inability among some of the very poor countries to put their economies on a sound and sustainable footing. We are not alone, however, in seeing some specific difficulties - for example the possible use of World Bank profits to provide resources and the extremely mechanistic proposals for tying the Fund and Bank together. It should be possible to achieve greater practical collaboration and also a larger structural element in any programmes while stopping short of formal cross-conditionality which would be likely to alienate potential recipients.

The Baker initiative, and the G5 agreement on exchange rates, took place against developments in the US that were threatening to exacerbate debtor countries' difficulties. First, the dollar's downward trend had been reversed through most of September. Secondly, and not unrelated, over 300 protectionist Bills had been placed before Congress, including Bills directed specifically at some major LDC borrowers, such as Brazil and South Korea. Since the G5 agreement, however, the dollar has fallen by 8% in effective terms, and is now more than 17% below its February peak. Moreover, protectionist pressure appears to have eased somewhat: although the House and Senate have now voted in favour of freezing or reducing textile imports from a number of countries, the majority in favour in both cases was well below the two-thirds needed to overturn the threatened Presidential veto. (Due to procedural technicalities, the Senate measure will need a further vote anyway.) And House Democrats have also unveiled a trade strategy which appears less protectionist than even a short while earlier, and much closer to the Administration's own stance on the issue.

Other recent economic developments have been mixed. Estimates of real GDP growth in Q3 in the US have been revised upwards, to 3.3% (ar), but import volumes into the US rose by only a negligible magnitude over the period and recent economic data suggest that the underlying rate of growth in the economy is not particularly buoyant. Interest rates have remained broadly stable over much of the recent period; it was hoped that changes in sentiment about the dollar after the G5 agreement might permit some falls in interest rates elsewhere: however, in late October there was a significant rise in interest rates in Japan, possibly as the authorities sought to prevent a reversal of earlier rises by the yen. Whether this upward move in interest rates represents just a temporary reversal, or whether it will be more enduring and have serious knock-on effects elsewhere, remains to be seen.

Economic developments in the debtor countries themselves appear increasingly divergent. Although Brazil continues in many respects along the economic pattern established for many of the debtors over the past three years - ie strong export growth and over-achievement of external targets whilst making very limited progress in tackling inflation and public sector deficits - Argentina seems to be performing well on the domestic side whilst its external sector may be running into difficulties. Mexico's position on both the domestic and the external side gives increasing concern: the recent earthquakes will have added to the deterioration in the country's position, but the subsequent aid and insurance inflows, and the deferral of pre-payments to the banks, will have brought some temporary relief. The political environment, with Presidential elections - at the end of a long run-up period - in 1988, will not remain conducive to getting to grips with intractable economic problems for long. Developments in some other countries, for instance Colombia and Ecuador, continue to be broadly satisfactory.

Attitudes to the IMF too appear to be increasingly divergent. A number of countries (eg Ecuador, Chile, Argentina) have recently activated or re-instated earlier Fund agreements as they managed to bring their programmes back on track or obtain their required new money commitments from the banks. On the other hand, the Philippines is increasingly critical of the approach of the IMF, and its programme has now been formally suspended, whilst Peru is refusing at the moment to deal with the Fund at all and has even threatened to leave the organisation. Nigeria is conducting a vigorous public debate on whether to aproach the Fund (and government advocates seemed for a while to be losing the argument, although the position at the moment is not clear), whilst Brazil is insisting that any Fund programme should be consistent with 5%

real growth per annum and that monitoring should be confined to external indicators only. The commercial banks, for their part, have so far generally insisted on maintaining the conventional role of Fund conditionality, and have not responded to attempts by those countries (Peru, Brazil) that have sought to by-pass the Fund and deal with the banks alone. US regulators at their meeting in October downgraded Peruvian loans to "value-impaired" status, forcing US banks with such loans to set aside mandatory reserves of 15% of exposure. It is the first time the regulators have taken this step with a major Latin American debtor.

South Africa's debt situation is increasingly being recognised as sui generis. At a recent meeting in London with Dr Leutwiler, the mediator between South Africa and the banks, it became clear that the banks would not be willing to sign conventional rescheduling agreements with the country. It seems likely now that the South Africans, while continuing to pay interest on their debt, will unilaterally extend the current moratorium, with the banks seeking to influence what should be included or excluded. A further meeting has been arranged for later this month.

Many debtor countries continue to be adversely affected by the weakness of commodity prices. In the seven weeks ending 22 October the Economist Index of spot commodity prices fell 3.4% in SDR terms (although it remained unchanged against the weaker dollar). Within this index, metals and industrial materials fell fastest (by 7% and 6% respectively) whilst food prices fell only marginally. In SDR terms, the index is now at its lowest level since the beginning of 1983, whilst in dollar terms prices are at about the level of their 1982 trough. Since May 1984 food prices have fallen 22% and agricultural raw materials 16%; industrial raw material prices have fallen by 14%.

X

The present crisis in the tin market was prompted by the International Tin Council's decision on 24 October to suspend buffer stock operations until further notice. This led to the suspension of trading in tin on the LME. It is likely that the tin price will fall significantly when trading resumes. The impact of lower tin prices on debtor countries is, however, likely to be very limited. Bolivia stands alone as being highly dependent on tin exports: in 1984 tin represented 34% of export revenue. The most important members of the International Tin Agreement have reduced their dependence on tin exports in recent years, and do not rely on tin for a major percentage of their export revenue: in 1984 tin accounted for no more than 3% of the exports of Malaysia, Indonesia, and Thailand. Brazil and Chile, who have recently been wooed by ITA members because of their rapid increase in production (Brazil has almost tripled its export revenue from tin since 1980), both earned well under 1% of export revenue from this source in 1984. The crisis in the tin market could however have knock-on effects on the prices of other metals traded on the London Metal Exchange, which could in turn affect other debtor countries.

Borrowers from non-OECD countries have taken just over $2.8 bn from the international capital markets since 1 September, with terms and conditions for most continuing to improve. Particularly large borrowings were a $650 mn FRN for Malaysia, a $500 mn syndicated credit for Iraq and a Yen 70 bn ($290 mn) euroyen loan for Thailand. Hungary continued its use of the markets with borrowings in all sectors, including its first note issuance facility, and with Eastern bloc countries at present the most favoured borrowers in the syndicated credits market, Romania returned for its first loans since June 1981. Poland is now left as the only Eastern bloc country which has not returned to the markets.

Further details on individual countries are given below.

(i) Latin America

Having satisfactorily met the performance criteria of the reinstated SDR 1.4 bn Standby, Argentina made the first conditional purchase under the Standby in September, the proceeds of which were used to repay the balance of the June BIS bridge. The purchase also triggered disbursement of the first $2.2 bn of commercial bank new money ($4.2 bn in total), which was used, inter alia, to repay the $750 mn outstanding from the 1982 bank bridge and to bring bank interest current to 1 September. On the broader economic front, the radical measures introduced in June appear to be working, at least in regard to inflation: prices rose in October by only 1.9% (cf over 30% in June). Furthermore, the 1985 budget, which will allow the remaining fiscal measures announced in June to be implemented, has now been passed. However, not all developments have been encouraging. First, the monetary base has been growing strongly, which could indicate a future resurgence of inflation. Secondly, although the central government is balancing its books, provincial governments do not seem to have curtailed their spending in line with the authorities' wishes. And thirdly, the export sector appears to be suffering from the fixing of the austral to the US dollar and from the weakness of world prices for Argentina's main commodity exports.

Economic developments in Brazil continue broadly as before. The economy is growing strongly (real GDP could rise by 7% this year), and substantial trade surpluses are being recorded each month. However, inflation remains a major worry. Although price rises declined to 9% in September, the year-on-year rate of inflation remains in excess of 220%. The Brazilians continue to argue that any IMF programme should be consistent with at least 5% real GDP growth per annum, and there is little likelihood of agreement being reached with the IMF in the near future. Indeed, the Brazilians seem instead to be setting their sights on an alternative package - for which there is, as yet, no precedent - which should include a bank MYRA, possibly with $2.5 bn of new money in 1986, backed by enhanced IMF surveillance of external (not domestic) economic indicators, and no more 'Letters of Intent'. There is no indication that the banks will be ready to proceed on this basis, but latest reports indicate that the Brazilians will present a 'non-negotiable' programme to the IMF later this month.

In Mexico, the balance of payments position has continued to deteriorate and the current account is likely to move into deficit this year. The recent earthquakes may have exacerbated this deterioration and, to support the reconstruction effort, the

Mexicans have asked the banks to defer for six months the scheduled $950 mn prepayment of 1983 new money. Looking further ahead, the authorities have now identified a need for $2.5 bn of bank new money in 1986. An IMF team is now in Mexico City to discuss a new programme (probably a 15-month Standby).

Of the other countries in Latin America, Chile has made progress in recent months towards resolving its immediate debt problems. The three-year EFF has now been activated, following the commitment of a 'critical mass' of banks to the $1,085 mn new money request. The new money agreement was signed at the beginning of November; however, the new money will not be disbursed yet as three Italian banks have so far refused to sign Meanwhile, the IBRD Board met on 22 October and approved Chile's request for a $250 mn SAL. Pending receipt of the first drawing of new money, the IMF has granted Chile a waiver of the international reserve performance criterion. The bank Consultative Committee for Colombia still expect signature of the country's proposed $1 bn new money agreement to take place in November or early December, although a number of banks have not yet committed. The replacement of Roberto Junguito by Hugo Palacios as Finance Minister in September is not thought to signify a change in the policy stance, which is regarded as remaining broadly satisfactory.

In Ecuador, purchases under the SDR 105 mn Standby, agreed in March, have resumed, following action taken to transfer the bulk of foreign exchange transactions from the subsidised official exchange rate to the more competitive commercial intervention rate. The $200 mn of bank new money was fully disbursed in September and used mainly to clear arrears on trade debt to the banks. The Ecuadoreans might now approach the markets shortly for a $300 mn acceptance facility for pre-finance of oil exports. Uruguay has successfully negotiated $45 mn of 'voluntary' new money from the banks for the first year of its MYRA. Panama has also signed a debt package, involving a rescheduling of $579 mn of maturities falling due in 1985-6 and $60 mn of new money. But the signing of Venezuela's $21.2 bn MYRA has been put back yet again, and is not expected until the end of this year or the beginning of 1986.

Although Peru was to some extent isolated at the IMF/IBRD annual meetings, the government continues to attack the IMF. Recent expansionary measures take the country away from the path that would be consistent with IMF prescriptions. Ominously, perhaps, arrears to the IMF are building up; the country has also been withdrawing money from commercial banks (including banks in the UK) and building up deposits at the BIS.

(ii) Far East

The IMF programme for the Philippines is now formally suspended, following the country's failure to complete the programme's second review, as the Philippines continues to distance itself from the Fund. As a result, \$525 mn still undrawn under the commercial bank new money facilities is now technically frozen. However, a Fund team is now in Manila, and some reports suggest that it may be possible to reach agreement in the not-too-distant future. Meanwhile, restrictions on non-essential imports into South Korea have led to a significant narrowing of the trade and current account deficits over the first nine months of the year, and exports in September appear to have responded well to recent promotion measures. However, with 35% of its exports destined for the US, Korea would be particularly vulnerable if the US introduced significant protectionist restrictions.

In Indonesia falling oil exports, and disappointing growth in other exports, will lead to a widening of the current account deficit from 2% of GDP in FY 1984/85 (ending March) to at least 3.2% of GDP this financial year. Ample reserves and over \$2 bn of undrawn credits make it unnecessary for the Indonesians to seek any more commercial loans for the moment, but longer term prospects are perhaps less certain.

(iii) Eastern Europe

Poland has been making efforts to pay 1984 arrears due under the 1981 rescheduling agreement, and as far as the UK is concerned has fully paid the amounts due. The meeting of the Paris Club to discuss rescheduling of 1985 maturities is planned for 19 November. The Poles, who almost certainly will not be able to meet payments due at the end of the year, have indicated that they will wish to reopen the 1982-84 official Agreement at this meeting, and that they will also be seeking talks with the banks thereafter. Yugoslavia is expected to sign its commercial bank MYRA in early December and begin negotiations with official creditors on its request for a MYRA to cover maturities falling due between mid-May 1986 and end-1988 in January. Romania, which raised a five-year $150 mn syndicated credit last month, has raised a further $150 mn on similar terms. Unlike the earlier loan, this is not tied to any repayment obligations. A $400 mn facility for Hungary, comprising a $150 mn Note Issuance Facility, $150 mn banker's acceptance facility and a $100 mn credit (at Libor + 3/8% - 1/2%) is currently undergoing syndication, while Bulgaria has returned for a further $150 mn at reduced margins (Libor + 1/4% - 3/8%).

(iv) Southern Europe

The Greek government has introduced a major package of measures to tighten economic policy, following a rise in inflation (to 20.1%), a current account deficit of $2.1 bn between January and August (cf target for the year of $2 bn) and an expected fiscal deficit of 19% of GDP. The measures include a 15% devaluation of the drachma, import deposits and a partial dismantling of wage indexation. Despite continuing improvement in inflation and the balance of payments, Portugal's economic outlook still appears uncertain, following the inconclusive general election in October. The recently-formed minority Social Democrat government may find difficulty in tackling the country's structural problems. The IMF team recently in Turkey were reasonably encouraged. Performance in recent months suggests that the budget is under greater control, that domestic demand has been restricted, and that the current-account deficit for 1985 could be reduced to around $1 bn ($1.4 bn in 1984). The authorities do not envisage a new Standby and foresee only modest foreign borrowing over the next year.

(v) Africa

Nigeria seems no closer to resuming contacts with the IMF about a programme. A national debate on the IMF issue is proceeding vigorously, but an official study committee appointed by the government will not make its recommendation until late November. A decision is expected in the context of the budget discussions due to take place in December. Little progress has been made with rescheduling short-term trade arrears, and the suspicion grows that debt registration difficulties are being deliberately designed to conserve scarce foreign exchange. A further batch of $116 million of promissory notes has been issued to uninsured creditors, and some $40 million of officially insured debts were approved at the same time.

Egypt's external position continues to weaken, and moves to put an IMF programme in place appear to have stalled. A mission was due to visit Cairo in early September, to prepare the ground for a possible Standby, but was cancelled at the request of the Egyptians who were in the midst of a ministerial shuffle. However, the authorities have reaffirmed Egypt's intention to undertake the reforms already promoted by the Fund. The long-awaited signing of Morocco's agreement with the commercial banks to reschedule 1983-84 maturities took place in late October, with the agreement expected to take effect on 12 December.

Economic developments in South Africa have been overshadowed by the consequences of the debt standstill and the continuing debate on sanctions. The first meeting between the South Africans' Standstill Co-ordinating Committee (SCC) and a representative group of creditor banks took place in London on 23 October. At the meeting the South Africans outlined the country's current debt status, and the reasons for the imposition of the standstill, and gave a presentation on the country's recent economic development and medium-term economic outlook. Although no specific proposals were put forward, the banks indicated that they were not prepared to participate in a conventional rescheduling. They will, however, certainly try to influence any arrangements which the South Africans put in place unilaterally. There will be a further meeting between the Standstill Co-ordination Committee and the banks in the last week of November. We understand that the South Africans have asked the IMF for technical assistance, but that the Fund has now withdrawn from its initial inclination to agree.

Sudan's growing arrears to the IMF, and the country's acceptance of the need for adjustment, were discussed in the margins of the annual meetings in Seoul. A timetable for resolving outstanding problems has been drawn up with the aim of putting a new Standby in place by January 1986, although formidable problems, eg payment of IMF arrears, remain to be solved before a new SBA can be agreed. An IMF mission has just left Khartoum, having reportedly narrowly missed reaching agreement. It is not clear what the next step will be.

(vi) Middle East

Monthly inflation in Israel fell to below 4% in both August and September (from 27.5% in July) as a result of the wages and prices freeze introduced in July. Wage and price controls have been extended until June 1986. The $750 mn US supplementary economic assistance was transferred in September.

CONFIDENTIAL

4.11.85

INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1984	End-June 1985	End-June 1985 [2]	End-June 1985 [3]
Latin America				
Argentina	48	2.5	0.1	0.2
Brazil	100	6.7(0.6)	0.7	1.7
Chile	19	1.3(0.1)	-	0.1
Colombia	12	0.6(0.1)	-	0.2
Ecuador	7	0.6	0.1	0.1
Mexico	97	6.4(0.3)	0.5	1.3
Peru	14	0.3	0.1	0.1
Venezuela	39	2.3(0.1)	-	-
Far East				
Indonesia	35	0.7(0.3)	0.8	1.6
Philippines	26	1.3(0.1)	0.2	
South Korea	43	2.2(0.5)	0.4	0.8
Eastern Europe (convertible currency)				
East Germany	13	0.5(0.1)	0.1	0.1
Hungary	9	0.5(0.1)	-	0.1
Poland	27	0.5	1.1	1.3
Romania	7	0.2	0.2	0.5
Yugoslavia	19	0.9(0.1)	0.7	1.0
Southern Europe				
Greece	16	1.3(0.2)	0.2	0.4
Portugal	15	1.2(0.1)	0.2	0.3
Spain	39	2.4(0.9)	0.1	0.1
Turkey	21	0.4	0.2	0.4
Africa				
Egypt	32*	0.4(0.3)	0.2	0.9
Morocco	12	0.2	0.1	0.2
Nigeria	18	1.3(0.1)	1.9	3.3
South Africa	27[4]	3.9(0.5)[5]	0.8	2.8
Sudan	9	0.0	0.1	0.2
Middle East				
Israel	30	0.5	0.1	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.
Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans.

[2] Defined as unrescheduled principal disbursed, plus political claims paid and claims under examination.

[3] Defined as guaranteed principal and contractual interest, plus political claims paid and claims under examination.

[4] Total debt estimated at $24 bn at end-August 1985

[5] Data not compatible with those previously shown, because of deconsolidation of subsidiaries which are no longer majority owned.

* current estimate

CONFIDENTIAL

4.11.85

INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1984	End-June 1985	End-June 1985 [2]	End-June 1985 [3]
Latin America				
Argentina	48	2.5	0.1	0.2
Brazil	100	6.7(0.6)	0.7	1.7
Chile	19	1.3(0.1)	-	0.1
Colombia	12	0.6(0.1)	-	0.2
Ecuador	7	0.6	0.1	0.1
Mexico	97	6.4(0.3)	0.5	1.3
Peru	14	0.3	0.1	0.1
Venezuela	39	2.3(0.1)	-	-
Far East				
Indonesia	35	0.7(0.3)	0.8	1.6
Philippines	26	1.3(0.1)	0.2	
South Korea	43	2.2(0.5)	0.4	0.8
Eastern Europe (convertible currency)				
East Germany	13	0.5(0.1)	0.1	0.1
Hungary	9	0.5(0.1)	-	0.1
Poland	27	0.5	1.1	1.3
Romania	7	0.2	0.2	0.5
Yugoslavia	19	0.9(0.1)	0.7	1.0
Southern Europe				
Greece	16	1.3(0.2)	0.2	0.4
Portugal	15	1.2(0.1)	0.2	0.3
Spain	39	2.4(0.9)	0.1	0.1
Turkey	21	0.4	0.2	0.4
Africa				
Egypt	32*	0.4(0.3)	0.2	0.9
Morocco	12	0.2	0.1	0.2
Nigeria	18	1.3(0.1)	1.9	3.3
South Africa	25[4]	3.9(0.5)[5]	0.8	2.8
Sudan	9	0.0	0.1	0.2
Middle East				
Israel	30	0.5	0.1	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.
Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans.

[2] Defined as unrescheduled principal disbursed, plus political claims paid and claims under examination.

[3] Defined as guaranteed principal and contractual interest, plus political claims paid and claims under examination.

[4] Total debt estimated at $24 bn at end-August 1985

[5] Data not compatible with those previously shown, because of deconsolidation of subsidiaries which are no longer majority owned.

* current estimate

CONFIDENTIAL ANNEX

Throughout the following notes on individual countries, "exposure" is defined as consolidated gross 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. ECGD amounts at risk exclude claims paid (net of recoveries).

0060u

ARGENTINA

Total external debt was $48 bn at end-1984.

On 30 September, Argentina made its first conditional purchase (SDR 237 mn) under the reinstated SDR 1.4 bn Standby. This was used immediately to repay the $230 mn outstanding from the $460 mn BIS bridge advanced in June. The purchase from the IMF also triggered the disbursement of the first ($2.2 bn) tranche of the $4.2 bn of commercial bank new money agreed in September; the proceeds of this were used to repay the $750 mn outstanding from the 1982 bridge and to reduce bank interest arrears by some $800 mn, thereby bringing interest current to 1 September. A further drawing of $800 mn on the new money facility is scheduled for end-October.

Argentina's radical counter-inflation strategy seems to be working, at least on some of the economic indicators. There was a further reduction in the inflation rate in September, with prices rising by only 2.5%, compared with 3% in August and over 30% in June, the month in which President Alfonsin introduced his economic reforms. Furthermore, the 1985 budget has now been approved, including the enforced savings legislation, and capital has continued to flow back to Argentina. Meanwhile, the authorities have rejected calls for a general wage increase in the run-up to the November elections, which appear to have been won by President Alfonsin's Radical Party. However, there are some less encouraging signs. First, the monetary base has expanded rapidly, which could be an indicator of future inflation. (The increase since the June reforms has been nearly 100%, only half of which can be accounted for by the increase in international reserves.) Secondly, on the fiscal side, a 15% increase in pensions has been introduced and, although central government is now balancing its books, provincial governments have been issuing bonds instead of cutting back their borrowing. Finally, there are worries about Argentina's export performance (for which, unfortunately, no up-to-date figures are yet available).

Although the authorities have reduced some of the export taxes introduced in June, the export sector appears to be suffering from the fixing of the austral to the US dollar in the face of continuing inflation differentials and from low international prices for major commodity exports (notably wheat and beef).

At end-June 1985, ECGD had an estimated $205 mn at risk. At end-June 1985, British-owned banks' exposure to Argentina totalled $2,493 mn and consolidated external claims $2,481 mn, while UK registered banks' exposure was $3,397 mn and consolidated external claims were $3,386 mn.

0061u

BRAZIL

External debt at end-1984 totalled $100 bn.

In recent weeks, there has been a hardening in the Brazilian stance in debt negotiations. Talks with the IMF on a new Standby have been held up owing to policy disagreements, with the Brazilians insisting that any targets agreed with the IMF for the public sector deficit, inflation and the money supply must be "realistic" and consistent with 5% real GDP growth per annum. Some Brazilian spokesmen have begun recently to argue that the IMF should restrict its involvement with the Brazilian economy to balance of payments aspects, and should not concern itself with domestic financial and economic issues. They also suggested to commercial banks in the margins of the IMF/IBRD annual meetings that IMF involvement should be restricted to a form of enhanced surveillance, as in the case of Venezuela. The banks (together with the IMF and the Paris Club) have so far resisted these arguments, arguing that there is a large difference between the economic situation in Brazil and that in Venezuela. Nevertheless, Finance Minister Funaro has announced that, in future, Brazil will no longer submit Letters of Intent to the IMF, but will instead send it details of the government's social and economic programme. These are likely to be submitted later this month.

As regards the Brazilian request that $16 bn of trade and interbank lines be rolled over from 31 August to 17 January 1986, well over 50% of banks have now agreed (85% in the case of trade lines). Only one UK bank has formally refused.

Brazil is now likely to exceed its official $12 bn trade surplus target for 1985. Exports in the first nine months of the year totalled $23.9 bn (cf $22.7 bn in 1984), whilst the trade surplus was $9.14 bn (cf $9.6 bn in 1984). Both exports and the trade surplus reached their highest levels this year in September. However, on the domestic side, inflation and the fiscal deficit remain of concern. The monthly inflation rate for September declined to 9.1%, from its record 14% level in August, bringing the year-on-year rate to 223% (cf 227% in August). The government is now forecasting 7% real GDP growth this year (cf 4.5% last year).

At end-June 1985 ECGD had an estimated $1,718 mn at risk. At end-June 1985, British-owned banks' exposure to Brazil totalled $6,668 mn and consolidated external claims $6,038 mn, whilst UK-registered banks' exposure was $10,006 mn and consolidated external claims were $9,461 mn.

0062u

CHILE

Total external debt at end-1984 was an estimated $18.6 bn.

Chile has made significant progress in resolving its immediate financing problems. The three-year EFF for SDR 750 mn was activated in September when banks' subscriptions to the $1,085 mn new money loan reached the "critical mass" of 90%; the new money agreement was signed on 1 November although a number of Italian banks refused to sign. The accompanying MYRA, for $5.99 bn of public and private sector debt due 1985-87, is due to be signed by mid-1986. The IBRD Board met on 22 October and approved Chile's request for a $250 mn SAL.

On the economic front, the government appears to be on track for meeting the IMF programme target for the 1985 public sector deficit (3.0% of GDP) and, with a trade surplus of $520 mn in the first eight months of the year, the (revised) 1985 IMF target of $0.8 bn is within reach. However, the improved trade performance has not prevented gross international reserves from falling to $1.5 bn at end-July (cf $2.3 bn at end-1984), and the Chileans now think that the IMF reserves target for 1985 will not be achieved. As for inflation, the price index has risen by 21% in the first nine months of the year and, although prices are now rising more slowly than earlier, the IMF target of 25% for 1985 looks rather ambitious.

Meanwhile, there are growing signs of political tension in Chile; for the first time since Pinochet took over, the non-Communist opposition has united in its call for a speedy transition to full democratic rule. Despite declarations of support for the opposition from many groups both within Chile and outside, Pinochet at present shows no signs of capitulating.

At end-June 1985, ECGD had an estimated $61 mn at risk. At end-June 1985, British-owned banks' exposure to Chile totalled $1,296 mn and consolidated external claims $1,319 mn. UK-registered banks' exposure was $2,082 mn and consolidated claims were $2,116 mn.

0063u

COLOMBIA

Total external debt at end-1984 was $11.5 bn.

There has been some delay in completing the $1 bn new money package, with banks' commitments to the loan having remained at $988 mn since the end of September. Nevertheless, Colombia's Consultative Committee, which met in mid-October, does not apparently foresee any major obstacles to signing the loan by mid-November. Meanwhile, the disbursal has taken place of the first $150 mn tranche of the IBRD export diversification loan approved in May. The disbursal of the second tranche is conditional on the IBRD's assessment of Colombia's economic performance and trade policy in six months' time. Agreement has now been reached on a $410 mn rescheduling of commercial bank debt owed by Banco de Colombia: $320 mn will be rescheduled over 7 (2 1/2 grace) years at LIBOR + 1 5/8% or US Prime + 1 3/8% and $90 mn over 2 years at LIBOR + 1 1/2% or US Prime 1 1/4%.

The Finance Minister, Robert Junguito, resigned in mid-September for personal reasons. His successor is Hugo Palacios, who was in turn succeeded as Governor of the Banco de la Republica by Francisco Ortega, a career central banker. Although Junguito has been seen as the architect of Colombia's recent financial programme, the change is not thought to indicate a shift in policy. Meanwhile, domestic financial indicators continue to look moderately encouraging. The inflation figure for the first nine months of 1985 was 18.7%, so the government's 1985 target of 22% may be within reach. International reserves stood at $1,950 mn (gross) at end-September, up $260 mn from end-June.

At end-June 1985 ECGD had an estimated $184 mn at risk. At end-June 1985, British-owned banks' exposure to Colombia was $590 mn and consolidated external claims $585 mn. UK-registered banks' exposure was $752 mn and consolidated external claims $737 mn.

0064u

ECUADOR

Total external debt at end-1984 was an estimated $7.2 bn.

The $200 bn of commercial bank new money, agreed in August, has been fully disbursed and used mainly to reduce trade debt arrears to the banks. The bank MYRA covering $4.2 bn of maturities falling due in 1985-89 is expected to be signed in November. As for the Paris Club MYRA agreed in May, most of the bilaterals, including the UK's, remain outstanding; they are expected to be completed by end-December.

On 20 September the IMF approved the resumption of purchases under the SDR 105 mn SBA, agreed in March. Purchases under the 18-month arrangement had been suspended in August: although all macroeconomic performance criteria had been met, Ecuador had failed to unify its foreign exchange rates. In September most transactions were transferred to the more competitive rate, and the Ecuadoreans were given a waiver by the IMF to cover the few small transactions being temporarily kept at the subsidised rate.

Ecuador has had talks with OPEC on a proposed increase of 100,000 barrels per day on its official production quota of 183,000 bpd., but OPEC has rejected this request. In response, the government has stated that it will remain in OPEC, but that it will continue to press for a quota increase, arguing that this would have a marginal effect on the world oil market.

Ecuador is exploring the possibility of a $300 mn bankers' acceptance facility on the US and European markets. This would be used to prefinance oil exports and thus improve Ecuador's cash flow. It would also make Ecuador one of the first Latin American countries to return to voluntary borrowing since the debt crisis began.

At end-June 1985 ECGD had an estimated $67 mn at risk. At end-June 1985, British-owned banks' exposure to Ecuador was $594 mn and consolidated external claims were $594 mn. At the same date UK registered banks' exposure was $785 mn and consolidated external claims were $789 mn.

0065u

MEXICO

Total external indebtedness at end-1984 was estimated at $96.6 bn.

Following the earthquakes of 19-20 September, the Finance Ministry has estimated reconstruction costs at around $3 bn. Within the total, foreign currency costs are put at $750 mn, adding $300 mn to the import bill this year, and $450 mn in 1986. Net external financing requirements for 1986 are estimated at $4.8 bn: this assumes that $0.8 bn (net) will be forthcoming from a new IMF programme, while net new money from commercial banks amounts to $2.5 bn (representing an increase in banks' exposure of some 3%). To support the reconstruction effort, Mexico requested that pre-payment to banks of $950 mn of the 1983 new money - which formed part of the MYRA - be deferred for six months. (Mexico is now technically in default on the MYRA on two counts - failing to complete the EFF, and to pay over the $950 mn this year.) An IMF team is now in Mexico City to discuss a new programme (probably a 15-month SBA) ahead of Mexico's 1986 Budget, which is scheduled to be put to Congress in mid-November.

The Mexicans have also produced major revisions to earlier forecasts for the 1985 balance of payments. A trade surplus of only $7 1/4 bn is now predicted (more than $3 bn lower than initially expected), while an original surplus of $2 bn on current account has now been revised to a deficit of $1/2 bn. Reserves are predicted to fall by some $2 1/2 bn over the year (the target under the EFF was a rise of $1/2 bn). The latest forecast for 1986 shows a current account deficit of $1 bn, but a rise in gross reserves of $2 3/4 bn.

At end-June 1985, ECGD had an estimated $1,255 mn at risk. At end-June 1985, British-owned banks' exposure to Mexico totalled $6,408 mn and consolidated external claims $6,309 mn. At the same date, UK-registered banks' exposure was $8,811 mn and consolidated external claims $8,860 mn.

0066u

PERU

Total external debt at end-1984 was an estimated $14 bn.

At the UN General Assembly, and subsequently at the IMF/IBRD annual meetings, the Peruvian government made strong attacks on the IMF (even threatening to leave the organisation), and restated its intention to by-pass the Fund and negotiate directly with the country's creditors. Informal contacts with the authorities suggest that they may, in fact, find some form of indirect IMF involvement acceptable, but it is scarcely conceivable that creditors will accept this in the Peruvian context. Ominously, perhaps, Peru has built up arrears of SDR 27 mn to the Fund.

President Garcia's policy on the IMF, and his insistence that Peru will only devote 10% of export earnings to (medium-term*) public sector debt servicing until end-1986, are continuing to hinder negotiations with the banks. The banks are also unhappy with the Peruvian statement that institutions which are continuing to provide new money (specifically, the IBRD and IADB) will receive priority when interest payments are made. The Advisory Committee met recently to consider a Peruvian request that repayment of maturities due between 1 August and 31 January 1986 be deferred until the latter date. As the Peruvians gave no date for the resumption of interest payments, the Committee issued no formal recommendation to banks. On 22 October the US Interagency Country Exposure Review Committee declared US bank loans to Peru "value-impaired", so that provisioning against Peruvian exposure is now mandatory for US banks. This is the first time a major Latin American debtor has had its loans downgraded to this status.

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* It should be noted that servicing of short-term debt has been continued and is outside the 10% of exports limit.

Peru's net international reserves have risen from $897 mn at end-July to $1.14 bn at end-September, probably reflecting in part the sale of private sector dollar balances in Peru to the authorities. (Since 1 August such balances have been subject to a three-month freeze, but while dollars may not be withdrawn they may be sold for local currency; tight liquidity in Soles may have forced some sales.) Further measures were taken in early October in an effort to stabilise prices and to boost economic activity. Imports of 217 non-essential products were banned, exporters were authorised to retain 20% (previously 15%) of export proceeds in foreign exchange, and the Government stated that there would be no further devaluation of the Sol this year. Other measures included a widening of the price freeze introduced on 1 August to cover all State-produced goods and services, and a further sharp cut in domestic interest rates. Inflation has eased for the time being, with consumer prices rising in September by 3.5% compared with 10.8% in August and 10.3% in July.

At end-June 1985, ECGD had an estimated $135 mn at risk. At end-June 1985, British-owned banks' exposure to Peru totalled $329 mn and consolidated external claims $387 mn. At the same date, UK-registered banks' exposure was $649 mn and consolidated external claims were $707 mn.

0067u

VENEZUELA

Total external debt at end-1984 was an estimated $39 bn.

With continuing delays in reaching formal agreement, Venezuela's $21.2 bn public sector MYRA is now not expected to be signed until the end of this year or the beginning of 1986. One recent cause of delay has been a request from the Venezuelan authorities for the inclusion in the MYRA of a contingency clause, under which the repayments schedule would be altered in the event of sharp increases in international interest rates or decreases in oil prices. The banks' Advisory Committee met informally with Venezuelan officials in the week beginning 14 October to discuss drafts of the thirteen MYRA contracts for the MYRA; they plan to meet formally shortly to finalise approval.

Recent developments concerning private sector debt have been mixed. The exchange controls office, RECADI, has now confirmed that it is unlikely to finish processing all private sector debt ($13.8 bn) before the end of the year; it remains unclear whether this will affect the signing of the MYRA. More positively, progress has reportedly been made in the continuing refinancing negotiations involving several of the major private sector debtors. The finance company, FINALVEN, for instance, expects to refinance $292 mn by means of zero coupon bonds, while provisional terms are reported to have been agreed for the issue of bonds to refinance $230 mn debt of the state-intervened bank, BTV. However, discussions with the creditors of Electricidad de Caracas, the largest private sector debtor, appear, at least temporarily to have reached a stalemate.

On the domestic front, the authorities have reduced their projection for 1985 oil export revenue from $13.6 bn to $12.7 bn. Year-on-year inflation has continued to ease, registering 11.6% at end-September, while the money supply remains almost stagnant, having grown by 4% in the first nine months of the year (cf an IMF quantitative target of 11.7% growth over the year). In an attempt to make credit more attractive and thereby increase money supply, the Central Bank reduced interest rates for the third time this year on 10 October. The recently-published Central Bank Report shows that real GDP fell by 1.1% in 1984 (IMF preliminary figure: -1.7%).

At end-June 1985, ECGD had an estimated $29 mn at risk. At end-June 1985, British-owned banks' exposure to Venezuela totalled $2,254 mn and consolidated external claims $2,257 mn. UK-registered banks' exposure was $2,817 mn and consolidated external claims were $2,826 mn.

0052u

PHILIPPINES

Total external indebtedness (including short-term liabilities of the banking system) amounted to around $25.4 bn at the end of 1984. Current projections suggest that this figure will have increased to $27.2 bn by the end of this year.

Disenchantment with the IMF programme, both at the Central Bank and on the political level, appears to be growing. At a recent gathering of finance ministers and central bank governors from Latin America, President Marcos publicly criticised IMF prescriptions to the debt crisis as ineffective and unduly severe. Meanwhile, the government has downgraded its estimate of GDP for 1985 as a whole from zero growth to a fall of 2-3% (whilst private analysts are predicting a fall of 5-6%). This follows a 5.3% fall in real GDP in 1984.

Meanwhile, the third tranche under the IMF's Standby facility remains undrawn, as a result of the failure to complete the programme's second review. The authorities appear to be requesting that the target for the 1985 fiscal deficit be widened to 1.5% of GNP (from 0.9% of GNP); for their part, the IMF considers that, without additional measures designed to improve revenue mobilisation and restrain expenditure, the deficit would amount to 2.5% of GNP. The IMF also remains concerned that monopolies operating in the sugar and coconut sectors are not being reformed quickly enough, and Fund staff have remarked privately that the Filipino proposals for tax reforms represent nothing more than further procrastination. With the IMF programme formally suspended for the time being, the Paris Club rescheduling arrangements are technically frozen, as is $525 mn still undrawn under the commercial bank new money facilities.

As regards economic developments, the IMF is known to be happy with a small relaxation in monetary policy given that reserve money figures are well under target and inflation, on an annualised basis, has fallen from over 60% in October of last year to around 13% currently. Consequently, in early October the Central Bank of the Philippines cut by one percentage point, to 23%, the level of reserves that commercial banks are required to place with it against deposit liabilities, freeing around Ps 1 bn ($55.5 mn).

As at end-June ECGD had an estimated $239 mn at risk. At end-June 1985 British-owned banks' exposure to the Philippines totalled $1,263 mn and consolidated external claims $1,443 mn. At the same date, UK-registered banks' exposure totalled $1,386 mn and consolidated external claims $1,570 mn.

0044u

POLAND

Poland's hard-currency debt at end-May 1985 stood at $27.4 bn.

All official creditors appear now to have received the payments due by end-August (arrears from 1984 under the 1981 Agreement) and are willing to finalise details for the rescheduling of 1985 principal and interest. A meeting with the Poles has been arranged in Paris on 19 November. In addition, the Poles have indicated that they wish to revise the schedule of payments under the 1982-84 Agreement. It is not yet known how official creditors will react to this request when a number of countries have yet to sign the bilateral agreements, although they have for some time been fully aware that the Poles would almost certainly not be able to meet payments due at the end of this year and would face a much larger financing gap in 1986.

The Poles have also said that they envisaged holding talks with the commercial banks after the Paris Club meeting. This is the first indication from the Poles that they will be seeking such talks.

At end-June, ECGD had a commitment of $547 mn (excluding $714 mn already paid). At end-June 1985, British-owned banks' exposure to Poland totalled $480 mn and consolidated external claims $895 mn (compared with $466 mn and $894 mn respectively at end-June 1984). UK-registered banks' exposure at end-June 1985 was $735 mn and consolidated external claims $1,157 mn ($710 mn and $1,146 mn).

0048u

GREECE

Total external debt at end-December 1984 is estimated by the OECD at $13.5 bn (40.5% of GNP) and by the IMF at $12.8 bn (38.4% of GNP).

Following its election victory in June, the Socialist (PASOK) government began to signal that the gradualist approach towards economic adjustment which it had pursued in its first term (1981-85) was being considered. On 11 October a major package of measures was announced including a 15% devaluation of the drachma, a system of import deposits (imposed after consultation with the EC), modification of wage indexation, a temporary profits tax and price controls on imported goods. The government also stated its intention of reducing the public sector deficit by four percentage points in 1986 from the expected outturn of 19% of GDP this year. Greece has not yet made a formal application for a loan from the EC under the Community Loan Mechanism, although Economy Minister Simitis has publicly spoken of the possibility of a loan, and a request for $1.5 bn has been rumoured.

Inflation, which had shown some improvement in recent months, increased to 20.1% in September, and is now expected to reach around 24% year-on-year by December, against an original end-year target of 16%. Provisional data suggest that the growth of broad money (M3), at 32.4% year-on-year in May, is significantly overshooting the target corridor of 22-24%. The current account deficit reached $2.12 bn in the first eight months of the year (cf $2 bn original target for 1985 as a whole), owing to rising imports and a fall in the invisibles surplus. The government now expects a current account deficit of $2.8 bn this year and has announced revised targets of $2 bn for 1986 and $1.6 bn for 1987.

At end-June 1985, British-owned banks' exposure to Greece totalled $1,340 mn and consolidated external claims $1,104 mn.
UK-registered banks' exposure totalled $1,866 mn and consolidated external claims $1,489 mn. ECGD had an estimated $379 mn at risk at end-June 1985.

0047u

PORTUGAL

Total external indebtedness at end-1984 was estimated at $14.9 bn.

The inconclusive outcome of the 6 October general election has cast even greater uncertainty over Portugal's economic prospects. Although the Social Democrats emerged as the largest party in Parliament, they failed to secure an absolute majority, and their attempts to form an effective coalition with other political parties have met with little success, so that Portugal will face the challenge of EC accession with a minority government. Despite the improvement in the external position (the current account deficit is now officially projected to fall to $150 mn this year) and declining inflation, the minority government may experience difficulty in maintaining the present degree of tightness in policy. A strong recovery in domestic demand could cause the current account to deteriorate again in the manner of the early 1980s.

At end-June, ECGD had an estimated $271 mn at risk. At that date, British-owned banks' exposure to Portugal totalled $1,186 mn, and consolidated external claims $993 mn. UK-registered banks' exposure totalled $1,539 mn and consolidated external claims $1,257 mn.

0152u

EGYPT

Total external indebtedness is currently estimated at between $30 and $40 bn.

The current account of the balance of payments is causing increasing concern. There have already been delays in both current and capital payments this year, and the authorities have been seeking actively both a programme with the IMF and a rescheduling of some trade credit and military debt.

Egypt and the IMF have not enjoyed the best of relationships in recent years, but following a number of policy changes earlier this year (including the reform and simplification of Egypt's multi-tier exchange rate system, the devaluation of the Egyptian pound and a reduction in a number of state subsidies), the chances of putting a medium-term programme in place looked more reasonable.

However, a mission from the Fund, which was to have visited Cairo in early September to prepare the ground for a possible Standby, was called off by the Egyptians at the last minute as it coincided with the appointment of a new Prime Minister, Dr Ali Lutfi. Nevertheless, President Mubarak has since re-affirmed his commitment to further reforms - including those recommended by the Fund on eliminating state subsidies and liberalising the exchange rate regime. The President has also instructed government authorities to stop foreign borrowing except for projects which are export-oriented. No new Fund mission has yet been announced.

The Reagan Administration has welcomed Mubarak's statements, but the indications are that Mubarak returned empty handed from Washington in September, as he did last January when he requested some bilateral rescheduling. Nevertheless, substantial aid continues to flow from the US under existing agreements and, despite the awkwardness caused by the Achille Lauro incident, this source will continue to be relied upon.

Debt service payments are currently estimated at $3.6 bn per annum, assuming that short-term debt is rolled over. However, the Fund has been unable to establish to what extent reported amortization payments (a) do not include interest payments and (b) do include payments on military debt.

ECGD's total amount at risk to Egypt at end-June 1985 was $850 mn. At end-June 1985, British-owned bank's exposure to Egypt totalled $367 mn and consolidated claims $513 mn. At the same date, UK-registered banks' exposure was $682 mn while consolidated claims amounted to $829 mn.

0034u

MOROCCO

Total external indebtedness at end-1984 was around $12.4 bn.

The Moroccans agreed a $1.5 bn rescheduling package with the steering committee of the commercial banks in early February. However, following numerous technical difficulties with the documentation, the agreement has only just been signed by all the banks; latest information suggests that it will be effective from 12 December. As part of this package, a total of $535 mn of medium and long-term maturities in 1983/84 is to be rescheduled over eight years, with four years' grace, at 1 3/4% above LIBOR as from September 1983; $750 mn of trade credit is being rolled over and $200 mn of new trade credit extended on similar terms. The Moroccans are now seeking a further agreement relating to about $850 mn of 1985/86 debt obligations and in addition are believed to be requesting some new credit to help close a projected financing gap of SDR 450 mn next year. Judging by the precedent of the 1983/84 agreement, it is thought that the negotiations over the question of new credit could not only disrupt short-term trade credit lines but also require the provision of a further letter of comfort from the Central Bank, which itself could seriously delay the rescheduling.

On 12 September the Fund Board approved a new SDR 200 mn Standby to expire at end-February 1987 as well as an SDR 115.1 mn CFF. Drawings under the Standby are, however, limited to SDR 10 mn pending agreement, at the first review in November, upon both commercial bank rescheduling of maturities up to <u>end-1986</u> and upon a suitable programme to cover <u>fully</u> the remaining projected financing gap for 1986 of SDR 450 mn.

On 17 September, the Paris Club agreed terms for rescheduling of official and of officially guaranteed medium and long-term debt totalling about $1 bn. The agreement covered arrears of principal and interest outstanding at 31 August 1985 as well as principal and interest falling due between 1 September 1985 and

28 February 1987, but it also includes a goodwill clause agreeing to consider further rescheduling on appropriate conditions.

ECGD's total amount at risk to Morocco at end-June 1985 was $213 mn. At end-June 1985, British-owned banks' exposure to Morocco totalled $152 mn and consolidated claims $201 mn. At the same date, UK registered banks' exposure was $293 mn while consolidated claims amounted to $377 mn.

0032u

NIGERIA

Total external indebtedness at end-1984 was around $18 bn (including just under $7 bn of arrears).

On 2 October President Babangida declared a state of economic emergency for the next 15 months. This was accompanied by a package of measures which included an overhaul of the import licensing system, a ban on maize and rice imports, a speeding up of the issue of promissory notes (although only fully documented debts would be admitted) and a ban on countertrade deals involving consumer goods. The measures were announced without the knowledge of Finance Minister Kalu who was abroad at the time.

On the economic side, a good harvest has for the moment helped to keep food prices down but, in the absence of an IMF programme, increasing economic difficulties are likely when import shortages spread as banks continue cutting back confirmation lines. No recent economic data are available. In 1984 the budget deficit was cut to $5.2 bn, from $9.2 bn in 1983 (equivalent to 5.2% and 11% of GDP, respectively), and the current account deficit reduced, on IMF estimates, to $1.2 bn, from $4.8 bn in the same period. But the economy suffered a combination of recession (real GDP fell by 0.6% in 1984), high and rising inflation (reaching 40% in 1984), increasing underutilisation of industrial capacity, and unemployment.

The benefits which would accrue from reaching agreement with the IMF were stressed by Sir Geoffrey Howe during his visit to Lagos in early September and repeated in later discussions in Seoul. This message is to be reinforced further in a letter from Sir Geoffrey to the Nigerian Foreign Minister. Nigeria's internal IMF Study Committee has hitherto been receiving memoranda and organising debate; an interim report is expected to be submitted to the government in late November. The national debate has been lively, particularly in the Lagos press, with considerable opposition to the prospect of devaluation, trade liberalisation and removal of trade subsidies. Should it become widely known that Fund drawings would probably be limited to some $600 mn for a one-year Standby - rather than the $2.5 bn for a three-year programme anticipated in Nigeria - the opposition would, no doubt, intensify.

Nigeria's creditors are becoming increasingly frustrated by slow progress on rescheduling short-term trade arrears. After well over a year, only 35-40% of creditors' claims (by value) have been reconciled with submissions from importers, and only about half of these reconciled claims have been dealt with, either as promissory note issues or official debt confirmations. As regards unmatched claims, the Central Bank of Nigeria has refused to release copies of debtors' submissions to creditors and, instead, has sent out new forms to both parties for the purpose of resubmitting data, extending the deadline for receipt of amended claims by just one month, to 15 November. The CBN's intransigence, and Babangida's recent statement that Nigeria would accept responsibility only for debts "incontrovertibly established", are grounds for suspicion that only the arrears so far reconciled will ultimately be honoured and a large number of valid debts will be excluded in order to conserve scarce foreign exchange. A further small batch of promissory notes, worth $116 mn, was issued to uninsured creditors on 20 September under the terms of the April 1984 agreement, bringing the total of note issues to date to $984 mn.

Official credit agencies remain insistent that a restructuring of insured trade arrears should be negotiated within a multilateral framework, and be conditional on agreement being reached with the IMF. Although the Nigerians are paying interest back-dated to 1 January 1984 on reconciled insured arrears, this will not affect the form of the full settlement which will only follow eventual agreement with the IMF. The total of reconciled insured arrears is believed now to stand at about $330 mn. ECGD's claims position is deteriorating as delays on short-term payments lengthen.

At end-June 1985, ECGD's total amount at risk was $3,307 mn. At end-June 1985, British-owned banks' exposure to Nigeria totalled $1,258 mn and consolidated external claims $2,122 mn. UK-registered banks' exposure at end-June 1985 amounted to $1,559 mn and consolidated external claims $2,549 mn.

0073u

SOUTH AFRICA

Total external debt at end-August 1985 is estimated at $24 bn.

On 1 September the South African Government announced a four-month moratorium on external debt repayments, including funds borrowed in the interbank market. Certain types of debt are exempt, and interest payments are continuing to be met. In the breathing space provided by this standstill the South African authorities hope to reach agreement with their creditors to reschedule some of their short-term debt, which is currently estimated at some $14 bn out of total external debt of $24 bn.

The South African Standstill Co-ordinating Committee (SCC) has sent out questionnaires to all South African residents with outstanding foreign liabilities, asking for details of their foreign indebtedness in order to identify authoritatively external debts outstanding at 31 August. Provisional data currently available indicate that, at end-August, external debt could be broken down as:

US $ bn

Public Sector	12
SARB	1.3
Banking Sector	8.7
Private Sector	4.7
	26.7
Less double counting	2.8
	23.9

On 23 October, a meeting was held in London between the SCC and the major creditor banks under the Chairmanship of the independent mediator, Dr Fritz Leutwiler. Only banks with claims on the South African public and/or banking sector of over US $100 mn were invited to the meeting - some 30 banks, compared to the 400 with claims on the country. The pattern of the negotiations is likely to be rather different from that of a conventional rescheduling.

For political reasons, the banks are unwilling to be seen to negotiate a formal rescheduling but instead may try to steer the discussions so that any further unilateral declarations will be acceptable to all parties. It was not intended to present any positive proposals at this stage, but the banks envisage an extension of the moratorium. A further meeting is scheduled for 26 November.

Corporate lenders were not represented at the meeting, and no specific arrangements have been made for communication with non-bank creditors; it is possible that such creditors may lose patience and issue writs. However, in the UK at least, the major banks are prepared, if necessary, to talk to any disaffected creditor about what was said at the meeting and, if appropriate, would put such creditors directly in touch with Dr Leutwiler's office.

As yet, there is no evidence that interest payments are not being made (as provided for under the terms of the standstill). However, a combination of capital flight and leads and lags seems to be more than offsetting the current account surplus and preventing the authorities rebuilding depleted foreign exchange reserves.

ECGD's total amount at risk to South Africa at end-June 1985 was $2,802 mn. At end-June 1985 British-owned banks' exposure to South Africa totalled $3,972 mn and consolidated claims $4,247 mn. At the same date, UK registered banks' exposure was $4,313 mn while consolidated claims amounted to $4,529 mn. These figures are not compatible with data previously given.

0036u

SUDAN

Total external indebtedness is currently estimated at around $9 bn.

Teams from the IMF visited Khartoum throughout the summer to discuss measures which, if implemented, might pave the way for the negotiation of a new Standby arrangement and be commended to official donors as grounds for increased aid.

The managing director of the Fund held a meeting of the G5 plus the Netherlands and Saudi Arabia in the margins of the annual meetings in Seoul, on 9 October. The Fund Staff believe, with some reservations, that the new regime is prepared to adopt the economic reforms required (including exchange rate adjustment) to enable a new programme to be put in place. However, the danger of political instability remains (a counter-coup was put down the week before) as does the problem of getting donors to clear Sudan's growing arrears to the Fund (currently SDR 160 mn) and to agree to closing the $2.8 bn external financing gap which is projected for 1986.

A further staff mission should have already left for Khartoum, charged with drafting the necessary Standby documents for circulation in late November ahead of a Board discussion in mid-December. If arrears can be cleared and a Standby can be drawn up then a meeting of the Paris Club and other donors will be encouraged in late December/early January (we believe that the Fund remain in contact with the "steering committee" of the Arab donor nations who have so far failed to agree upon a further package amongst themselves).

However, agreement has been reached on re-rescheduling Sudan's unguaranteed commercial bank debt and an $800 mn package became effective on 27 September. Debt outstanding under the 1981 rescheduling agreement was divided into two tranches. Tranche-A comprised some $555 mn of debt rescheduled in 1981 and tranche-B some $245 mn of interest accrued but unpaid between 5 April 1982 and 27 September 1985. Repayments under the re-rescheduling will begin in April 1988 and be in 17 equal principal instalments over four years, with tranche-A carrying interest at 1 3/4% above LIBOR and tranche-B 1 1/4%. A further modest amount of new credit, extended between 1981 and 1985, is to be rescheduled in parallel arrangements.

ECGD's total amount at risk to Sudan at end-June 1985 was $153 mn. At end-June 1985, British-owned banks' exposure to Sudan totalled $29 mn and consolidated claims $32 mn. At the same date, UK-registered banks' exposure was $107 mn while consolidated claims amounted to $110 mn.

4.

TOTAL COPIES 12

COPY No. 1

SECRET

Prime Minister

CDP 13/xi

PRIME MINISTER

NIGERIA : PROPOSED OIL/DEBT AGREEMENT

Peter Walker sent me a copy of his minute of 5 November to you about the Nigerian proposal to service their debts to us through supplies of oil.

2. The Nigerians have, in the past, tended to see oil countertrade, to pay for imports or to settle debts, as a means of evading the sort of measures which will be necessary if they are to reach an agreement with the IMF and, as importantly, put their economy on a sounder footing. We have not, of course, wished to encourage this delusion. With our major stake in this market (exports £760m in the first nine months of this year), we are naturally keen to see a Fund programme and adjustment measures in place, so that we can trade on a sound basis and the arrears owed to us can be paid off in an orderly fashion.

3. This has caused us some difficulty in the context of the considerable problems experienced earlier this year by long-standing UK suppliers to the market, following a series of oil countertrade deals which Nigeria had concluded with our competitors (including France). Our approach was to make clear that, while we did not wish to encourage the spread of countertrade and wished to avoid direct Government involvement, we would acquiesce in private sector agreements on countertrade which UK exporters might negotiate in defence of their interests in Nigeria.

SECRET

DW2ACB

999-49

4. The proposal described to Peter Walker seems to avoid at least some of our earlier objections to the extent that the deal would only come into effect after a Nigerian devaluation and, presumably, after an agreement with the IMF (Nigerian reluctance to devalue being one of the greatest obstacles to the latter). By agreeing to it we would not, as possibly in the past, be abetting Nigerian attempts to avoid the essential elements of the debt strategy, but could actually encourage them to accept the need for an IMF programme. The public debate taking place in Nigeria on this issue is still, on balance, opposed to a deal with the Fund and the Finance Minister's approach seems, at least partially, designed to help him allay some of the fears that have been expressed. For these reasons, as well as because the Nigerians have recently made plain that they regard our attitude on export credit and debt rescheduling as the touchstone of our relations, I hope that our response can be a positive and sympathetic one.

5. But I appreciate that there would be other problems, such as those which Peter Walker has mentioned. We should also have to consider our obligations to our partners in the Paris Club. Nor would it seem equitable for us to receive debt service in kind while others were being paid in hard currency.

6. We might therefore point out to the Nigerians that an IMF agreement would open the way for a multilateral rescheduling of all current official debt, as well as existing short term arrears. We could pledge our full support in urging our partners in the IMF and Paris Club to reach an agreement designed to ensure, in the new circumstances, that Nigeria could cope with its debt service burden. To implement this debt restructuring, ECGD would be prepared to enter into a mutually acceptable arrangement for the payment of short term debt and to guarantee new financing loans, as well as to take the lead among export credit agencies in reopening medium and long term credit lines.

7. I am copying this letter to Sir Geoffrey Howe, Peter Walker and Nigel Lawson.

L.B.

L B

13 November 1985

Department of Trade & Industry

DW2ACB

999-49

ECON. POL: Indebtedness : Pt 5

13. XI PM

RESTRICTED

CC BG

10 DOWNING STREET

From the Private Secretary 11 November 1985

The Prime Minister was grateful for your Secretary of State's minute of 5 November about his conversation with Sir Peter Emery.

DAVID NORGROVE

Geoff Dart, Esq.,
Department of Energy

RESTRICTED

010

3

PRIME MINISTER

1. CDP
2. Prime Minister

I believe that Sir Peter was also going to see the Chancellor about this. CDP

Agree to note?
DRN
7/11

Yes

Sir Peter Emery asked to see me this morning for 15 minutes on what he described as an important matter.

He explained to me that the present Finance Minister of Nigeria was an old friend of his and that the Finance Minister had contacted him to explain that he had advised the government of the necessity of making appropriate arrangements with the IMF. These arrangements would require the revaluation of the Nigerian currency.

Peter Emery stated that the Finance Minister had explained to him that the President of Nigeria was willing to accept the necessity for a revaluation and working with the IMF but was unwilling to go for revaluation before next Spring for political reasons. This, the Finance Minister explained, would create an impossible position for Nigeria in servicing its debts, particularly to France and Great Britain. The Nigerian government therefore wanted to service the debts by means of payment in oil. They believed that the French government would be very happy and willing to accept this as a means of repayment and it was important that Britain should accept the same method.

The Nigerian minister has requested that the oil payments should be at an agreed price. Peter Emery said he pointed out that that would be impossible and he felt the only way the British government could accept it would be at current spot prices, whatever they were. The Nigerian Finance Minister explained to Peter Emery that he was already in difficulty with OPEC on their quotas but hoped that OPEC would accept a position where in excess of their quotas they paid a sum of oil at a fixed price to service their debts.

I informed Peter Emery that obviously any question of servicing debts was a matter for the Treasury and not for me. If there was a surplus of oil in the world I thought it was unlikely that Britain would have any desire to be the point where that surplus was dumped. But I advised him that it was his duty to contact the Treasury to discuss these matters with them.

If we did such a deal with Nigeria we would in fact together with the Saudia Arabian deal risk creating a situation where we had such a surplus of oil that the continuance of North Sea production at its present levels would be an absurdity. It is quite probable that OPEC would come to the conclusion that if they could talk us into a number of deals then we would be landed with the direct consequences of continuing North Sea production at a time of surplus. If we unloaded the oil on world markets we would also be seen as the country responsible for bringing down the oil price. From my departmental viewpoint therefore I am most anxious that no such arrangement is made with the Nigerians, and indeed if the deal resulted in a tumbling of the oil price it would not improve the Nigerian governments debt problem, but just the opposite.

I am copying this letter to Sir Geoffrey Howe, Leon Brittan and Nigel Lawson.

pp

SECRETARY OF STATE FOR ENERGY
(Dictated by the Secretary of State
and signed in his absence)

5 November 1985

05. XI. AM 65

GRS 1500

CONFIDENTIAL

CONFIDENTIAL
FROM UKDEL IMF/IBRD WASHINGTON
TO PRIORITY FCO
TELNO 195
OF 052300Z NOVEMBER 85

8 pa

DN to me
CDM

IMF: PROBLEM COUNTRIES

1 ON 4 NOVEMBER, THE MANAGING DIRECTOR HELD A MEETING TO BRIEF EXECUTIVE DIRECTORS ON THE STATE OF PLAY IN SELECTED PROBLEM COUNTRIES.

EGYPT

2 SHAALAN (DIRECTOR, MIDDLE EASTERN DEPARTMENT) REPORTED ON THE DETERIORATING ECONOMIC SITUATION, PARTICULARLY THE BALANCE OF PAYMENTS. IN RECENT WEEKS THE FREE MARKET EXCHANGE RATE HAS DROPPED SHARPLY. HE SAID THAT THE AUTHORITIES WERE NOW SHOWING AN INCREASED AWARENESS OF THE MAGNITUDE OF THE PROBLEM AND A MISSION TO DISCUSS A POSSIBLE PROGRAMME WOULD LEAVE FOR CAIRO THIS WEEK (THE MISSION PLANNED FOR SEPTEMBER WAS POSTPONED BECAUSE OF GOVERNMENT CHANGES).

SUDAN

3 THE LATEST MISSION HAS RETURNED HAVING MADE SOME PROGRESS BUT STILL WITHOUT FINAL AGREEMENT ON A PROGRAMME. I WILL REPORT FURTHER WHEN WE HAVE HAD A CHANCE TO DEBRIEF THE MISSION.

ARGENTINA

4 THE LATEST REVIEW - DUE FOR COMPLETION BY END-OCTOBER HAS BEEN DELAYED AND WILL NOT NOW REACH THE BOARD UNTIL, AT THE EARLIEST, EARLY DECEMBER. AT THE TIME OF SEPTEMBER'S MISSION THE AUTHORITIES HAD NOT FINALISED NEXT YEAR'S BUDGET AND CRITERIA FOR THE REMAINDER OF THE PROGRAMME COULD NOT THEREFORE BE DETERMINED. THE AUTHORITIES HAVE NOW ADVANCED THEIR BUDGET PREPARATIONS AND A MISSION IS CURRENTLY IN BUENOS AIRES. STAFF SEEM REASONABLY HOPEFUL THAT REVIEW WILL BE SATISFACTORILY COMPLETED.

BOLIVIA

5 PRELIMINARY NEGOTIATIONS ON A POSSIBLE ONE YEAR SBA WILL BEGIN THIS MONTH. MIFT 196 WILL GIVE FURTHER DETAILS.

BRAZIL

6 DISCUSSION OF A POSSIBLE 1986 SBA WILL TAKE PLACE WITH THE AUTHORITIES LATER THIS MONTH ONCE DETAILS OF THEIR ECONOMIC PROGRAMME FOR 1986 ARE AVAILABLE.

COLOMBIA

7 AN OCTOBER MISSION TO MONITOR PROGRESS UNDER THE AUTHORITIES' ECONOMIC PROGRAMME HAS BEEN POSTPONED AFTER AN INTERNAL BRIEFING DOCUMENT WAS LEAKED (THERE WAS A PREVIOUS LEAK IN MARCH). THE MD SAID THAT NO EFFORT WAS BEING SPARED TO FIND THE ''TRAITOR''. HOWEVER, THE MD STRESSED THAT DESPITE THIS DEVELOPMENT HE REMAINED ON GOOD TERMS WITH THE AUTHORITIES. HE HAD WRITTEN, DEPLORING THE LEAK AND THEY HAD DONE ALL THEY COULD

CONFIDENTIAL

/TO

TO DEFUSE THE SITUATION. THE MISSION WILL STILL GO AHEAD, PROBABLY BEFORE END-1985.

CHILE

8 PROGRAMME ESSENTIALLY ON TRACK. THE AUTHORITIES HAVE REQUESTED A WAIVER OF THE END-SEPTEMBER INTERNATIONAL RESERVES TARGET AND THEIR NON-COMPLIANCE WITH THE OBLIGATION TO REDUCE EXCHANGE RESTRICTIONS. THIS WAS, WE WERE TOLD, A PURELY TECHNICAL MATTER, ARISING FROM THE LATE DISBURSEMENT OF COMMERCIAL BANK MONEY. BUT YOUR TELNO 206 SUGGESTS THAT THE LATTER MAY BE MORE THAN A TECHNICAL MATTER: WE ARE FOLLOWING UP AS REQUESTED.

GUYANA

9 FUND STAFF MET WITH AUTHORITIES IN SEOUL, BUT STILL NO PROSPECT OF ARREARS BEING CLEARED.

JAMAICA

10 THE PROGRAMME IS OFF TRACK AND JAMAICA HAS NOW FALLEN INTO ARREARS WITH THE FUND. MIFT 197 PROVIDES DETAILS.

MEXICO

11 WORK IS WELL ADVANCED ON THE EMERGENCY ASSISTANCE LOAN BUT THE MD IS STILL AWAITING A FORMAL REQUEST. AS FOR A 1986 PROGRAMME, TALKS ARE UNLIKELY TO BEGIN UNTIL THE BUDGET HAS BEEN SUBMITTED TO CONGRESS (ON 15 NOVEMBER).

PERU

12 THE BOARD RECEIVED FORMAL NOTIFICATION ON 15 OCTOBER OF ARREARS TO THE FUND OF SDR27 MILLION. THESE HAVE NOW INCREASED TO ABOUT SDR38 MILLION. MEANWHILE, THE DEADLINE FOR THE NEXT ARTICLE IV CONSULTATION IS APPROACHING (21 MARCH) BUT THE AUTHORITIES HAVE SAID THEY DON'T WANT A MISSION THIS YEAR.

THE GAMBIA

13 STAFF PLAN TO SEND A MISSION END-NOVEMBER/EARLY DECEMBER, ON THEIR CALCULATION, THEY ARE STILL SDR 11 MILLION SHORT OF FILLING THE ESTIMATED SDR 51 MILLION FINANCING GAP FOR 1986, BUT THIS IS BEFORE TAKING INTO ACCOUNT ANYTHING FROM THE ADB. IN THEIR VIEW, PROSPECTS FOR COMPRESSING THE GAP BY FURTHER FISCAL MEASURES ARE SLIM. GAMBIA'S ARREARS WILL BE DISCUSSED IN THE FUND BOARD ON 8 NOVEMBER.

LIBERIA

14 AROUND ONE-THIRD OF OUTSTANDING ARREARS WERE CLEARED AT END-SEPTEMBER ''WITH THE HELP OF A FRIENDLY COUNTRY'' BUT THEY HAVE SINCE INCREASED TO SDR33.2 MILLION IE EXCEEDING PREVIOUS LEVELS. THE EXECUTIVE BOARD WILL REVIEW THE SITUATION AGAIN ON 25 NOVEMBER. FURTHER CONSULTATION WITH THE AUTHORITIES IS PLANNED BEFORE EARLY NEXT YEAR, CURRENT ADJUSTMENT EFFORTS ARE CLEARLY INADEQUATE.

MOZAMBIQUE

15 THE PROSPECTS FOR 1986 LOOK BLEAK IN THE ABSENCE OF CORRECTIVE MEASURES: DISCUSSIONS WITH THE COMMERCIAL BANKS ON RESCHEDULING HAVE MADE LITTLE PROGRESS AND MOST TRADE CREDIT HAS BEEN SUSPENDED. THE FUND HAS PROVIDED TECHNICAL ASSISTANCE TO

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CREATE A BASIS FOR MONITORING A FIRST CREDIT TRANCHE PROGRAMME. A NEGOTIATING MISSION WILL VISIT MAPUTO BETWEEN 11-23 NOVEMBER.

NIGERIA

16 ALTHOUGH PRESIDENTIAL COMMITTEE ON THE IMF IS STILL TO REPORT, CERTAIN TECHNICAL WORK IS UNDERWAY IN THE MINISTRY OF FINANCE ON A POSSIBLE FUND PROGRAMME. A NIGERIAN DELEGATION INCLUDING THE CENTRAL BANK GOVERNOR AND POSSIBLY THE MINISTER OF FINANCE IS EXPECTED IN WASHINGTON LATE NOVEMBER/EARLY DECEMBER. OUATTARA (DIRECTOR, AFRICAN DEPARTMENT) HAD LITTLE FEEL FOR THE PROSPECTS OF AGREEING A PROGRAMME.

SIERRA LEONE

17 AS REPORTED IN OUR SAVING TELNO 416 OF 7 OCTOBER, THE NEW AUTHORITIES ARE KEEN TO NEGOTIATE A FUND PROGRAMME AND HAVE THEREFORE INTENSIFIED THEIR EFFORT TO CLEAR THEIR ARREARS. AS EXPECTED, THEY MADE A PAYMENT ON 3 OCTOBER BUT THIS HAS NOT PREVENT ARREARS INCREASING FURTHER: THEY NOW STAND AT SDR10 MILLION.

SOMALIA

18 FUND PROGRAMME STILL STALLED AND ARREARS HAVE INCREASED TO SDR9.8 MILLION. HOWEVER, THE AUTHORITIES HAVE EXPRESSED A DESIRE TO REACTIVATE THE PROGRAMME. A MISSION TO COMPLETE THE PROGRAMME REVIEW WILL DEPART IN MID-NOVEMBER PROVIDED THAT PROGRESS IS MADE IN PRELIMINARY DISCUSSIONS, PRIOR TO THE CONSULTATIVE GROUP MEETING. THE AUTHORITIES ARE SEEKING BRIDGING FINANCE TO PAY OFF THEIR ARREARS.

TANZANIA

19 THE ECONOMIC SITUATION HAS DETERIORATED AND ARREARS HAVE INCREASED TO SDR19.5 MILLION. AN ARTICLE IV MISSION DEPARTS 6 DECEMBER.

ZAMBIA

20 LITTLE TO ADD TO OUR REPORTS OF LAST WEEK. AFTER THE MEETING I SPOKE TO OUATTARA AND ACQUAH (DIRECTOR AND DIVISION CHIEF, AFRICAN DEPARTMENT). IN LAST FRIDAY'S AUCTION THE EXCHANGE RATE ROSE TO KWACHA 6.64 TO THE DOLLAR: DOLLARS 7.5 MILLION WERE SOLD. ON THE MODALITIES OF AGREEING A PROGRAMME, OUATTARA STRESSED THAT DETAILS OF HOW THE FINANCING GAP WAS TO BE FILLED WOULD HAVE TO BE TIED UP IN DECEMBER. THE ZAMBIANS WOULD NEED PUSHING BOTH ON POLICY MEASURES AND ON ORGANISING THE NECESSARY BRIDGING FINANCE. I SAID THAT WE WERE UNWILLING TO TAKE THE LEAD IN BRINGING TOGETHER POTENTIAL DONORS/CREDITORS AS WE HAD IN THE CASE OF THE GAMBIA. OUATTARA SAID THE WORLD BANK WOULD TAKE THE LEAD WITH DONORS, THE FUND WOULD ASSIST THE ZAMBIANS IN TALKING TO THE BANKS ABOUT BRIDGING FINANCE. (HE ALSO SAID THAT, SOME MONTHS AGO, CITIBANK HAD TOLD HIM THAT, GIVEN A STRONG AND CREDIBLE PROGRAMME, THEY MIGHT BE WILLING TO BRIDGE IN EXCESS OF THE FIRST DRAWING OF A FUND PROGRAMME - HE DID NOT KNOW THEIR POSITION NOW.)

PHILIPPINES

21 SEE KING'S TELELETTER OF 1 NOVEMBER. WE WILL DEBRIEF THIS WEEK'S MISSION ON ITS RETURN.

CONFIDENTIAL /VIETNAM.

VIETNAM

22 THE AUTHORITIES ARE STILL NON-COMMITTAL ON A TIMETABLE FOR CLEARING THEIR ARREARS. ARTICLE IV DISCUSSIONS ARE SCHEDULED FOR THE SPRING.

TURKEY

23 THE AUTHORITIES HAVE DECIDED THEY DO NOT NEED ANOTHER SBA, HOWEVER THEY HAVE ASKED TO KEEP IN CLOSE CONTACT WITH THE FUND.

GREECE

24 FUND STAFF WILL SHORTLY CIRCULATE AN ASSESSMENT OF THE LATEST MEASURES.

POLAND

25 A DRAFT MEMBERSHIP PAPER, INCLUDING A QUOTA PROPOSAL, IS IN PREPARATION. STAFF UNWILLING TO SAY WHEN IT WOULD BE CIRCULATED.

26 FCO PLEASE PASS TO FITCHEW, MOUNTFIELD AND SHERIDAN (HMT), WARE (BOE), TAIT (ERD) AND E BARNES (ODA).

LANKESTER

MONETARY
ERD
SAMD
CAFD
NAD
SED
WIAD
EED
SEAD
WAD

COPIES TO:
HMT / FITCHEW, MOUNTFIELD, SHERIDAN
BOE/ WARE
ODA/ E. BARNES
ERD/ TAIT.

THIS TELEGRAM WAS NOT ADVANCED

Sir Robert Armstrong

The Sampson Letter

28
CDT. 1/xi
5th Nov 1985

A fortnightly report on world politics and finance

Mr Parch

Thank you. I sh'd be glad to follow you for subsequent numbers, if you will. RTA 5.xi

Politicising the bankers: welcome to the herd

While James Baker tries to work out a rational plan in the US Treasury to increase international lending, the bankers are finding themselves in an increasingly political atmosphere, with still more rapid swings of emotion and fashion.

In two opposite parts of the southern hemisphere - in Peru and South Africa - the bankers have felt the full force of political moods which can turn credit-ratings upside down overnight.

The effects are made much more drastic by the rapid integration of world financial markets, and by the instant global communications - whether through computers or TV screens. It is not just money that can cross the world in a few seconds; it is political moods and emotions, which move money with them.

'The money is like loose ballast,' as one banker put it. 'It swings from one side to another with each roll of the ship.'

And increasingly the banks all swing at once. They watch each other closely and nervously, and all move together - into a country one day, out of it the next.

The bankers had already developed a much greater 'herd instinct' during the perils of the debt crisis; but now the governments are herding them together still closer.

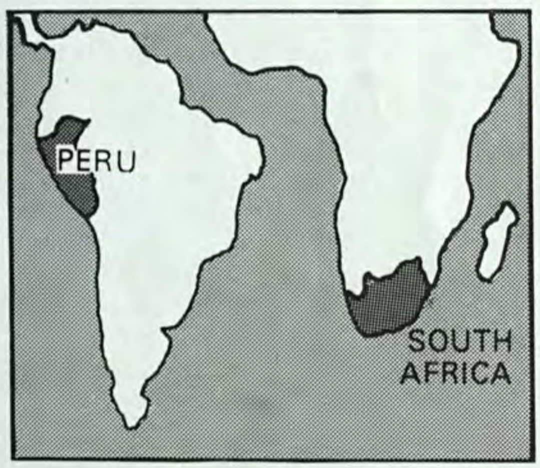
THE PRESSURE AGAINST PERU

The new thinking in Washington (rather prematurely described as the 'Baker Plan') has rightly recognised the political importance of mustering more loans to generate economic growth in Latin America.

But at the same time all the big banks are becoming more caught up in a highly-charged and changeable political climate, which decides which countries are acceptable and which are not.

When the US Treasury discussed its plan with international bankers last week, at the Institute of International Finance in Washington, political pressures soon became much more apparent. The banks were pressed not just to lend to favoured countries, but not to lend to black-listed countries - most notably Peru.

As a sign of the new commitment, the US banking regulators have just insisted that American banks lending to Peru must set aside special reserves. Many bankers welcomed this response to the threats of President Garcia; but others saw it as a worrying new danger. If they were being asked to put up another $20 billion in



PERU AND SOUTH AFRICA have emerged as two pariahs among international bankers, from opposite sides of the political spectrum. This Letter looks at how the banks have become more politicised in their attitudes to debtors and default (p.1-3).

It also includes:

* *The real cost of the new tunnel-mania in Britain and France (p.4)*
* *A letter from Delhi on the problems of Sikh terrorism (p.8)*
* *Japanese suicide-syndrome (p.5)*

ANTHONY SAMPSON

new loans to Latin America, was this the way to attract them?

'The hostility to Peru was palpable,' said one banker present at the IIF meeting. 'Peru was the test-case of the Baker initiative. The Treasury want it to be pushed out of the system - to go the way of Nicaragua.'

But the most extraordinary case of the sudden political hazards for bankers is no longer in Latin America but in South Africa - as has become much more apparent in the last two weeks.

THE SOUTH AFRICAN EXODUS

Only two years ago South Africa was near the top of the country-risk tables - number 25 in Euromoney's annual ratings. Today it is heading towards the bottom, towards Uganda, Ethiopia and El Salvador.

In this case it is not governments that have moved the herd, but public opinion: and the bankers' economic judgments have been drowned by the political waves.

When Dr Fritz Leutwiler tried to begin negotiations between creditors and South Africa in London two weeks ago, no bank dared join a committee, for fear of stirring up new demonstrations and new withdrawals.

The Chase Manhattan and Citibank were more worried by their business with New York State than with South Africa. 'The banks can't be seen as helping South Africa,' complained the central bank governor Gerhard de Kock, 'because it would be seen as propping up apartheid.'

Even Leutwiler himself - a very Swiss Swiss with a determined detachment - now has his own political problem. He is no longer head of the Swiss National Bank, but he is chairman of Brown Boveri, the Swiss engineering multinational with contracts in many developing countries - including China. And the Chinese have let it be known that they have worries about Brown Boveri being involved in any way with helping Pretoria.

The relations between banks and Pretoria remain very tense: the rand remains very weak, and capital is still flowing out. Pretoria will have to extend its moratorium (says de Kock) 'well into next year'; and it may lead to a de facto default.

This bankers' boycott may well provide more effective political pressure against apartheid than any governments' sanctions; and as such (I believe) it is welcome.

But the bankers would be more constructive if they could give a more positive picture of the conditions under which they would lend to South Africa. And the suddenness of their shift, from the right to the left, is another indication of the emotional state of the banking system.

THE NEW LOOK OF DEFAULT

Both South Africa and Peru, from opposite directions, have become pariahs to the bankers, and both teeter on the edge of default. But how serious now is that threat to the bankers?

While the Baker Plan should achieve more lending, it still falls far short of allaying fears about default.

'It doesn't eliminate the net export of resources, which is the only real solution,' says Lord Lever, the British authority on international debt. 'The debt crisis is not resolved: it's still maturing. And the debtors are more able to default: their reserves are in a better state, and they've developed their counter-trade.'

'The Baker Plan doesn't involve any alleviation of the debt-export problem', says Richard Portes, the director of the Centre for Economic Policy Research in London, who has made a special study of defaults in the 1930s. 'It just pushes it back. And it won't solve many countries' problems. The past is worse than the present - so far. But the thirties and the eighties have things in common - including the deteriorating terms of trade for commodities.'

It is true that default is a less frightening word for creditors, since the jumpy days of 1982 and 1983. 'People no longer think that default will change the world as we know it,' says Anatole Kaletsky, whose book The Costs of Default was published earlier this year.

In 1983 a default was seen almost like a nuclear bomb, which would bring down creditors and debtors together; and negotiators on both sides were determined not to provoke the ultimate deterrent. But as bankers become used to moratoria or non-performing loans, the threat begins to look more like conventional warfare.

'The thirties experience showed that the experience after default could be quite favourable to the creditors,' says Portes. 'Default often exhibited mistakes, and brought about a sharing of

the burden. The blame was shared, and so was the cost.'

But default is also less scary for the debtors, who have been carefully building up their reserves and extending their countertrade as defensive precautions. 'Debtors don't default until they have begun to turn round their trade to become more self-sufficient,' as Portes explains.

How far this still represents a real danger to banks and their investors depends on the real nature of the governments' guarantees which will emerge from the Baker Plan. But it seems inevitable that the banks will secure further safeguards in return for their larger loans.

Observers familiar with the history of international lending approach the 'debt crisis' of the 1980s with a sense of deja vu. The debt-servicing difficulties experienced in recent years by many Latin American and Eastern European nations represent only the latest in a series of similar episodes stretching back over a period of centuries. Not in-frequently did the problems encountered by sovereign borrowers culminate in default, the widespread defaults of the 1930s being merely the most dramatic and generalized instance of a repeated phenomenon. Quite often, defaulting debtors were able to re-enter the international capital market only to default again, occasioning criticism of creditors for engaging in reckless lending ascribed to myopia or excessive competition.

Barry Eichengreen & Richard Portes: Debt & Default in the 1930s: Causes & Consequences. Centre for Economic Policy Research

As the New York investment manager Jim Rogers puts it: 'Of course when the government asks the banks to do something the banks expect to get something in return. When the inevitable collapse comes it means that government will have to bail out the banks. Personally I'd prefer to let some banks go bankrupt. It would clean up the system'.

Certainly the nightmare scenarios of the early eighties are looking less nightmarish, as the banks have also built up their reserves. Even Argentina, since its currency reform, begins to look more stable.

Brazil, has become more self-sufficient, with the help of import substitution and new oil discoveries. 'The Brazilians are talking much less about default,' says Kaletsky who has just been in Brazil: 'they are too busy with their own industry to think much about Peru or other debtors.'

But Brazil depends on many uncertain exports, like orange-juice or weapons, to repay its debts. Self-sufficiency creates more self-confidence, while the Brazilians are still in a defiant mood towards the IMF.

MEXICO'S CAPITAL FLIGHT

And Mexico is back again with its problems of capital flight - believed to amount to $4 billion this year - which provides a huge hole in the bucket of loans. And it is one more reminder of how closely linked Mexico is to the US. Whether in Mexico, Peru or the Philippines, American bankers can never forget they are taking political decisions. There is nothing new about that. When the Credit Lyonnais lent to the Tsar in the 1910s, or when Barings lent to Argentina in the 1880s, they were making perilous and very different political judgments. While Barings backed Argentina, Rothschilds backed Brazil. Luckily only Barings was wrong, and went down with the crash of Argentina in 1890.

What has changed is that all the banks are now moving together, with governments whipping them ahead. They are either all right or all wrong - and they can change their minds quickly.

The more Washington involves the World Bank or the Inter-American Development Bank in discreetly underpinning commercial loans, the more the whole banking nexus will be built round a single political judgment. The differing commercial views of the banks will become subordinated to the views of Washington and the IMF.

The herd may seem safer to the banks; but it multiplies the political stakes. And it is much more worrying and unpredictable to the debtors countries which watch the herd galloping in, and galloping out.

People and pointers

STILL MORE OF AN ISLAND

The bidders for a tunnel or bridge across the English Channel are working to a climax of promotion and pressure, before the British and French governments reach their decision in January.

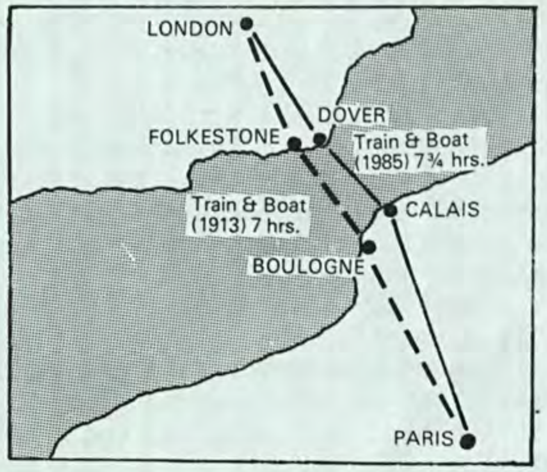
But it already looks likely that, in the end, neither the bridge or the tunnel will raise enough capital; that Britain will be still more of an island; and that, with all the excitement of the rival bids, the surface route will remain as long and uncomfortable as ever.

In fact the journey from London to Paris by train-and-ship today takes longer (7¾ hours minimum) than it did in 1913, when my Baedeker says the minimum time was seven hours.

The trouble with recurring tunnel-mania (the last was only ten years ago) is that it distracts attention from the real problems of the surface route. The incompetent link between train and boat was better managed seventy years ago.

The channel ferries are now heavily advertising their own 'Flexilink', with ghoulish advertisements in Britain showing rats in a tunnel; and they claim that they can cut back the time for formalities. But the fact is that the ferries have shown little progress - apart from the hovercraft - over the post-war decades.

If the British and French railways could be induced to introduce new tracks and high-speed trains, synchronised with boats, the distance of 290 miles between London and Paris could be covered in five hours, providing serious competition to the air-route which remains one of the world's most exorbitant and disagreeable short journeys.



THE AIDS-IMF-MOSCOW CONSPIRACY

The conspiracy lobbies are flexing their muscles in preparation for the dreaded meeting between Reagan and Gorbachov. Perhaps one of the most conspiratorial is the National Democratic Policy Committee, set up by Lyndon LaRouche who campaigned last year to be US President.

Executives of LaRouche's paper Executive Intelligence Review, based in Wiesbaden in Germany, were in London last week to launch their report Global Showdown, describing how The Soviets Have Already Declared War on the USA.

Their campaign has reached a new peak of excitement with the discovery that 'there is a direct one-to-one correspondence between the pro-AIDS lobby and the anti-SDI lobby. They, in fact, are exactly the same people.'

The AIDS lobby, the Review insists, is backed by 'a powerful combination of politicians, including congressmen long associated with pro-homosexual and pro-drug positions and with the de-industrialization genocide policies of the International Monetary Fund and the World Bank.'

A special pamphlet on AIDS explains how by 1991 the entire population of America could be wiped out by the virus, and how data indicate that 'the AIDS virus can be directly traced to the very zone targeted by the IMF ten years ago for development-project cancellation, brutal austerity and credit cut-off.'

ABC ON ITT: FROM AMBITION TO ZAP

Harold Geneen, the former chairman of the ITT conglomerate, still presents himself as the master of management; but the corporation which he built up continues to be threatened by raiders who want to break it up; and it leaves growing resentments and revelations in its broad wake.

The latest fierce critic is a Swedish former ITT executive, Bengt Beckmann (who now runs his own Air Rescue firm in Kenya), who has written an explosive book called ABC on ITT.

The alphabet begins ominously with Ambition, Bribery and Copying (Killing with Xerox) - a chapter which describes the deadly techniques of sending copies of damaging memos to HS Geneen. It goes on to D for Dita Beard, E for Expenses.

It includes some interesting insights under I for Iran, which led to a lawsuit over Beckmann's commission. And it concludes with Z for Zap, Zeal and Zest, including the author's conclusions about what went wrong. 'Nobody told old Hal where to stop, and what not to do.'

'When recession came,' says Beckmann, 'only the old established telecommunications companies, those which had been around and humming along profitably before Geneen's entrance into ITT, were still well into the black. In Europe, Food is finished, Consumer Products are finished, Nail Polish is gone, Airport Parking is gone or dying. Telecom, the core of the company, is in relatively bad shape, and its competitors have greatly improved their market positions.'

JAPAN'S SUICIDE SYNDROME

Some westerners who try to compete with Japanese industry have decided that their only chance is to wait for the Japanese to collapse from the nervous strain. Is that beginning to happen?

The suicide of Hiroo Tominaga, the maintenance executive of Japan Air Lines who was ashamed of the crash of the JAL plane, has coincided with a new wave of concern with suicide syndromes in Japan.

The conventional belief was that older Japanese commit suicide because they are no longer looked after by the 'nuclear family'. Older Japanese are still more prone to suicide than elsewhere, but middle-aged suicides are also now causing worry, through the 'sandwich syndrome'. Seven supervisers on Japanese Railways committed suicide in two years: all of them, according to a recent study, were 'caught between pressure and hostility from subordinates and lack of support from superiors'.

'The middle-aged suicide crisis', writes the Japan Times, 'might also mean that Japan's commitment to nation-building, at the expense of individual mobility and welfare, is not working well.' It can be seen 'as a warning that devotion and diligence are life-threatening values when held obsessively and compulsively in the name of excessive self-denial and dependence on others.'

At the same time there are growing doubts about 'the fierce corporate loyalty' on which much of the success of Japanese industry depends. Professor Mitsuyo Hanada of Tokyo's Sanno Institute of Business Administration has recently warned that 'the concepts of organizational commitment are drastically changing'. He went on to explain how the eager beavers are now being replaced by a 'me-generation' who want to follow their own pace.

Can these trends seriously encourage western industrialists? Perhaps in future decades they may reduce some of the competitiveness of Japanese exports. But my own guess is that they will benefit newer developing economies like Korea or Taiwan, in the first flush of national commitment, much more than Western Europe or Japan.

Commodities and Countries

ORANGES + DEBTS

The hazards of developing countries which rely on commodities to repay their debts are typified by the case of Brazilian oranges.

Up till recently they were a triumphant success story. Brazil's exports of orange-juice went up from 108,000 tonnes in 1974 to 911,000 last year: the juice is now Brazil's third biggest export earner, next to coffee and soya. Two years of Florida frost crippled a major competitor.

But as exports have gone up the price has gone down - by thirty percent in a year. Brazilians are now appalled that Coca Cola now plan to grow oranges in Belize for their orange-juice subsidiary Minute Maid.

Orange-juice, together with the booming arms-trade, has greatly helped Brazil to keep pace with its vast debt repayments. But like coffee and other commodities, it depends perilously on fickle appetites further north.

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Businessmen, oilmen & the South African showdown

The South African crisis continues to repercuss round the world, creating divisions and dilemmas in its wake.

The leaders of the British Commonwealth who met in the Bahamas remain at odds about how to bring pressure. Mrs Thatcher, who probably has the most influence with Botha, still only accepts 'tiny' sanctions.

All the Commonwealth leaders were (officially) in favour of sanctions - except for Jayewardene of Sri Lanka, who did not want to sacrifice his tea trade with South Africa. Mulroney of Canada and Rajiv Gandhi were carefully chosen, as two handsome men who she liked, to lobby Thatcher; but gave up in despair.

Having agreed to send a group of 'eminent persons' to South Africa the Commonwealth is still vague about what they will do. They will be chaired by Nyerere from Tanzania and will include Gen. Obasanjo, the former Nigerian C-in-C, and Malcolm Fraser the Australian ex-prime minister. But they still do not know whether President Botha will let them in - particularly after his party's by-election defeat.

The eminent group would be bound to talk to the African National Congress, the banned black opposition in exile, thus compelling the British member to talk too. But the ANC suspects that the group could be as unhelpful as the western 'contact group' with Namibia.

DOING BUSINESS WITH BLACKS

In the meantime, businessmen are appearing more adventurous than politicians in trying to resolve the South African deadlock.

A group of South African chief executives are preparing another trip to Zambia to see leaders of the ANC. And 52 heads of American companies, including GM, IBM and Exxon, have just advertised in South Africa, calling for major changes including an end to race discrimination.

But British companies (which have far bigger investments in South Africa than the Americans) remain the most cautious of offending Pretoria - as the President of the ANC, Oliver Tambo, found when he visited London last week for private meetings, including his first-ever talks with British businessmen.

Most of the British business leaders were more worried than their South African equivalents by the ANC's past commitment (in its Freedom Charter of 1955) to nationalising the major companies. They felt the ANC could hardly expect them to help if they were only going to be nationalised in the end; and that as foreigners they were more vulnerable to reprisals from Pretoria than local companies.

Tambo insisted that he was not bound by dogma, and that the ANC's policies would be decided by democratic choice. He made clear that he was aware of the mistakes of other black states in Africa.

He asked the British for help as human beings as much as businessmen, in identifying themselves with black aspirations; and hoped they could press Mrs Thatcher to move further away from Pretoria.

A few British business leaders <u>are</u> pressing their government privately to distance themselves from Pretoria, for the sake of their own long-term self-interest, to try to protect themselves under a future black government. And several intend to continue talking to the ANC leaders.

But Tambo was disappointed by the reluctance of British tycoons to commit themselves. 'They showed some sympathy, some appreciation of our problem,' he said afterwards: 'but I haven't really detected a change of heart.'

OILING APARTHEID

The most controversial companies dealing with South Africa are the oil companies; and the more radical opponents of apartheid are now trying again to stop oil reaching South Africa - which still has to import two-thirds of its consumption.

In theory the UN has endorsed (by 130 votes to six) a voluntary international embargo: the 130 included all OPEC countries, but the six included the US, Britain, France and W.Germany.

Oil is still leaking heavily into South Africa. The Shipping Research Bureau in Amsterdam, which was set up to investigate the oil trade to South Africa, has identified 164 tankers delivering to South Africa over four years to January 1983: 60% from the Gulf and 12% from Brunei (before independence).

A few oil traders have made fortunes

from supplying South Africa, headed by John Deuss of Trans World Oil based on Holland and Bermuda; by Marc Rich of Geneva; and Marimpex in West Germany.

South African oil-buyers had their toughest time after the Iranian revolution (according to Jaap Woldendorp who runs the Bureau), when Pretoria lost its valuable ally, the Shah. Premiums went up to $8 a barrel: now they are down to $2 to $4. But Pretoria is still very worried about its oil, and is pressing ahead with new oil-from-coal plants.

Seamens' trade unions held a conference on oil to South Africa in London last week, to try to prepare for a global embargo. But the profits from smuggling oil remain irresistible. Saudi Arabian oil still finds its way to the Cape, and Oman remains the most persistent oil-leak, sometimes exchanging oil for South African gold.

Ethiopian famine & the problem of 'camp mentality'

It is now a year since the famine in Ethiopia first hit the headlines with television coverage which suddenly shook the consciences of the west.

How far has it changed? I have received this letter from Anthony Smith, the explorer and author who has just returned from Ethiopia.

Dear Anthony,

First problem for the visitor to this contorted landscape is how to travel. The easiest way, seeming wrong initially, but soon gratefully accepted, involves using aid agency transport, planes if possible. Each obligatory minder, from the Ministry of Information and National Guidance, also prefers planes, particularly those heading back to Addis.

The northern civil war is denied officially, but by no one else. Its existence explains sudden inexplicables - runways allegedly water-logged when there has been no rain, the lack of promised vehicles.

Second problem is acquiring wholesale information. Each agency and each camp knows its problems, but total facts - such as the weight of grain going to the greedy rather than the hungry - are difficult.

One truth is that all food distributed within the camps is donated food, and all trucks transporting food are donated trucks (at least in my experience). The supply is now adequate but not abundant: there is enough for the starving and sick, but not a great deal to send back with discharged families - which can lead to people's reappearance the moment their dry rations have been consumed.

Or earlier. A camp mentality is developing to exploit the system. Starve one child, preferably a girl, and the family is entitled to food, both when in camp and in sacks and cans to take back home. The hospital-type bracelet, put on each arrival's wrist, can be prized off and sold as means to further food.

Oxfam clothing, freely donated, turns up in the markets on the following day. And no one believes that all the orphans are without parents. There will have to be a degree of ruthlessness in closing down the camps, there still being 20,000 at Korem (as against 40,000 a year ago, or up to 80,000 earlier this year).

There is certainly some ruthlessness concerning resettlement. Government policy is to move 2 million people by the end of this year, mainly from the north (where the civil war and starvation have dominated) to the south-west (where, allegedly, fertile empty land exists).

By September 530,000 had been moved, with almost as many rumours about their welfare - gun point transportation, death en route, illegal return via Sudan, malaria-infested valleys (explaining their emptiness) and a general happiness at seeing soil to spare.

As for the future, no agency is pulling out - yet. New starving are still arriving. A greater weight of food is required next year. The development projects - millions of planted trees, new terracing (paid for in food rather than in money), agricultural education - need time.

It is ludicrous, say some, that Ethiopia should ever have to import food; it should be one of Africa's great exporters. 'What drought?' said one man, believing people to have been at fault rather than the heavens. So will there be Korem camp this time next year? And Kobbo? And Makele? I suspect so.

Yours sincerely,

Anthony Smith

Sikh terrorism and the Punjab: the lesson for Gandhi

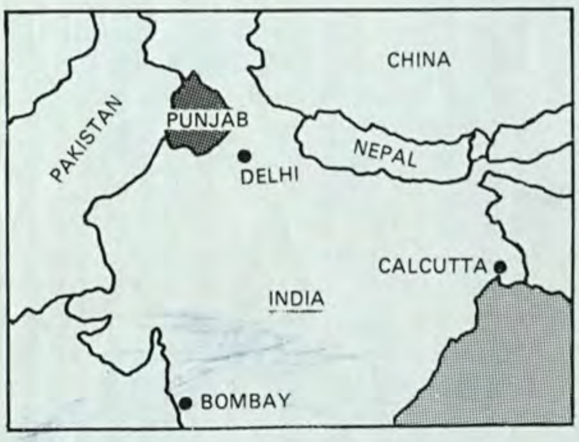
Tke relations between Sikhs and the rest of India remains a crucial test of the political skills of Rajiv Gandhi in Delhi. And the threat of Sikh terrorism has reverberated far beyond India, to Britain and Canada.

Has Gandhi managed to placate the Sikhs? I have received this letter from Patwant Singh, a leader of the Sikh community in Delhi, who next week is publishing his new book 'Punjab: the fatal miscalculation'.

Dear Anthony

Following the release of the Akali leaders from jail, and a series of quiet behind-the-scenes moves conducted in absolute secrecy, the prime minister, Mr Rajiv Gandhi, and Sant Harchand Singh Longowal, president of the Akali Dal, signed a historic agreement.

But a price for the bold initiative was paid by Sant Longowal who fell to an assassin's bullets on August 20, 1985 - less than a month after signing the accord. This was a reminder from a handful of militants on the fringes of the Sikh community; and it quite simply said that the accord was unacceptable to them.



India's Sikh population totals 12 million, of whom 8m live in the state of Punjab. More than 1m live outside of India mostly in Britain, Canada and the USA.

But most people in Punjab think otherwise. The spectacular victory of the Akalis at the polls in September vindicated the late Sant Longowal's decision to end the confrontation. The election of Surgit Singh Barnala, a known moderate, as the chief minister of Punjab at the head of an Akali ministry is another indication of the new mood of moderation in Punjab.

What are the lessons to be learnt from those critical years of crisis? If terrorism is an outcome of situations in which political disputes are permitted - even encouraged - to remain unsettled then extremist actions come to haunt societies which either delay or discriminate in the dispensation of justice.

The moral Rajiv Gandhi can draw from this is that persistence in error should not become a policy of his government, and that the guilty in public life - no matter how highly placed - must not be allowed to commit crimes and get away with them.

If the guilty who connived in the killing of the Sikhs in November 1984 are put on trial and punished, the mood of the majority of the Sikhs will shift dramatically in favour of the young prime minister.

For the more angry and militant among the overseas Sikhs, the message is clear: do nothing to jeopardise the Barnala government's efforts to stabilise conditions in Punjab.

A great deal needs to be done here, at home. A loud and irresponsible rhetoric at rallies thousands of miles away will not help those who are trying to do the difficult job of restoring confidence and stability.

Warmly,

PATWANT SINGH

The next issue of The Sampson Letter will include a special report on the US Congressional Summit on Exchange Rates and the Dollar, from Washington.

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AND TO BUENOS AIRES

VOLCKER'S VISIT TO ARGENTINA

1. REPORTS IN THE WEEKEND PRESS THAT VOLCKER WILL BE SHORTLY VISITING BUENOS AIRES ARE CORRECT. HE WILL BE ACCOMPANIED BY MULFORD (TREASURY ASSISTANT SECRETARY, INTERNATIONAL FINANCIAL AFFAIRS).

2. WE UNDERSTAND FROM OUR CONTACTS IN THE FED AND THE TREASURY THAT THE PURPOSE OF THE VISIT IS TO FOLLOW UP THE US DEBT INITIATIVE. ARGENTINA IS SEEN AS PERHAPS THE FIRST CANDIDATE, EVEN BEFORE MEXICO, FOR BAKER'S THREE-PRONGED APPROACH--I.E. ADDITIONAL IBRD AND COMMERCIAL BANK MONEY IN RETURN FOR STRONGER, GROWTH-ORIENTED ADJUSTMENT. THIS IS BASED ON AN ASSESSMENT THAT ALFONSIN'S ECONOMIC PROGRAM IS GOING WELL AND THAT HE IS SHOWING THE NECESSARY DETERMINATION TO CARRY IT FORWARD AND POSSIBLY STRENGTHEN IT. WE UNDERSTAND THAT VOLCKER INTENDS TO EXPLAIN THE NEW US APPROACH TO THE ARGENTINIANS AND DISCUSS WITH THEM POSSIBLE SUPPLY-SIDE MEASURES, SUCH AS TRADE LIBERALISATION AND REFORMS TO THE BANKING SYSTEM THAT WOULD ENABLE ARGENTINA--AS PER THE BAKER PLAN--TO QUALIFY FOR ADDITIONAL IBRD LENDING AND WHICH WOULD PERSUADE THE BANKS TO MAKE NEW MONEY AVAILABLE. HOWEVER, ON THE LATTER, IT IS THOUGHT UNLIKELY THAT HE WILL GET INTO SPECIFICS.

3. AN IMF TEAM IS CURRENTLY IN BUENOS AIRES REVIEWING THE SBA. (AN EARLIER MISSION IN SEPTEMBER WAS UNABLE TO COMPLETE THE REVIEW BECAUSE THE AUTHORITIES WERE THEN NOT IN A POSITION TO AGREE NEW CREDIT CEILINGS ETC IN ADVANCE OF THE NEW BUDGET.) FUND STAFF ARE REASONABLY HOPEFUL THAT THE REVIEW WILL BE SUCCESSFULLY COMPLETED WHICH WOULD ALLOW ARGENTINA TO MAKE FURTHER PURCHASES UNDER THE SBA.

4. FCO PLEASE ADVANCE TO LITTLER (HMT), LOEHNIS (BANK OF ENGLAND) AND TAIT
(ERD).

WRIGHT

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The Sampson Letter 27

22nd Oct 1985

A fortnightly report on world politics and finance

Banks and governments: a new plan for Latins

The far-reaching change in Washington's attitude to debt (see my last Letter) has become still more apparent since the IMF meeting in Seoul.

The policy now rests on a powerful trio - James Baker at the Treasury, George Shultz at the State Department and Paul Volcker at the Fed - who all share the determination to increase growth in the developing world, particularly in Latin America.

In the Treasury Baker is backed by his deputy Richard Darman, while at State Shultz is supported by John Whitehead, who comes from Goldman Sachs and understands the complex problems. Between them they are pushing the new thinking against the resistance of the Treasury bureaucracy.

The problem remains how to combine guarantees by governments with the normal risk-reward free enterprise of commercial banks. And the US Treasury is now looking with much more interest to the Inter-American Development Bank (IDB) - which raises much of its resources in the capital markets of Latin America and the US.

TOUGH NEW CONDITIONALITY

The IDB has now come up with its own plan proposed by its president Ortiz Mena, a former Mexican finance minister, to increase its lending.

Basically, the private and commercial banks would contribute to a trust fund which would then be administered by the IDB. Loans from this fund would be IDB loans, so that any default on them would be a default to the IDB; a 'cross-default' clause would ensure that a country could not default on a bank without also defaulting on the IDB - which would cut them off from any future loans.

The plan has the clear advantage of linking commercial banks with the public sector, but not too visibly, while providing additional funds.

It is too early to say whether this plan will bear fruit and there remain many problems. The US government insists on tough conditionality, for instance on linking lending to IMF standby agreements and to specific policies in different sectors. And it would like to drive a bargain, allowing a capital increase in return for reducing public spending and opening-up to direct investment.

Such conditions are politically highly-charged for the Latins, particularly at a time when their economies are at their weakest. Reducing the public industries, which have been such a

THE EASTERN MEDITERRANEAN has become the scene of escalating terrorism which is threatening governments far away from the Middle East. This issue includes an analysis by Patrick Seale of changing Arab opinions about the Palestinian problem.

It also discusses:

** The rival ambitions of Singapore and Hong Kong towards China (p.8)*

** New revelations about middle-men and 'skimmers' in Arab deals (p.4)*

** Businessmen's problems extending through Southern Africa (p.6)*

ANTHONY SAMPSON

major past engine of growth, hits hard at the Latin middle class; while opening up to foreign direct investment could potentially create a broad coalition with the left.

But a new deal for the IDB - including raising more capital from Europe, which is under-represented - could provide the means for additional growth and for enabling the IDB to extend from its present constraints.

Up till now, the IDB has been restricted in its lending to the larger Latin American countries. During the seventies Washington wanted to avoid public loans to the biggest Latin countries, to keep pressing them towards commercial loans and foreign direct investment. It led to some absurd anomalies: for instance, the biggest borrower from the IDB is now Chile.

It remains to be seen how far the Treasury has faced up to the failure of that earlier strategy, and to the urgent need for Latin countries to have more access to both the IDB and the World Bank to avert political disasters.

Providing new loans will still be a strain on the US banking system, on top of all its domestic problems including the farm credit crisis. And joint lending will strain the relations between Washington and the banks.

'The Bankers' Collective looks like disintegrating,' says George Soros, the New York investment fund manager who has made a special study of international debt. 'The European and American banks are moving further apart and the marginal members can't be kept in. The central banks will need considerable pressure to persuade the bankers. But they must find a way.'

A PLAN WITHOUT A MECHANISM

Does the new Washington attitude represent a real watershed in international lending? I asked Richard Dale, Professor of International Banking in Edinburgh and consultant to Rothschild's:

The US have really put forward a plan without a mechanism. They have stated their objective with a flourish - that banks should lend between $20-30bn per annum of new money for three years, which would represent an increase in their exposure of 2.5% pa - but they haven't thought out how to meet it.

The vagueness of the idea of a 'Superbank' is a sign that they're still in the early stages of seeking a solution. There have been leaks and trial balloons, but critical questions haven't been answered. Will a World Bank guarantee be forthcoming? Will they do without the small banks - in which case the big banks will have to fill the gap and increase by another 2.5%?

They broached the plan in a hurry to try to take the wind out of the sails of the developing countries, but they hadn't reviewed the machinery. The Treasury has already produced some schemes - including the proposal to use $2.7bn from the IMF trust fund - but they were technically flawed.

Now they're stuck with a tremendous commitment - particularly in view of the risk-aversion of the big banks. It means creating new incentives - whether sticks or carrots. And they can't have small banks jeopardising the operation.

The Superbank would need an organisational structure: it would need to force banks into a mould for new lending. Will the German banks play this kind of game? The Deutsche Bank has already kept out of the International Institute of Finance because it felt it could survive without it. All the German banks are less exposed than the Americans, and they're already feeling bitter about other banks pulling out of South Africa.

But the new policy does mark a watershed, because the US Treasury is committed to making a proper plan, and there will have to be the beginnings of a major initiative.

The crisis in 1982 was a watershed of a different kind. The IMF and the Fed intervened then, but the commercial banks had a collective self-interest in concerted lending: they realised that they had to do it.

Now it's a different stage of coercion: the US Government has explicity stated its objectives, and it recognises that it can't leave all lending to the banks and the IMF.

Of course they still claim that governments will not be involved, but really that has to be read upside down: it means that all governments will have to be involved.

The fact is that there's an increase in the need for financing developing countries, at a time when available financing is falling. How do you meet that short-fall in funds?

RICHARD DALE

Terror in the Mediterranean: the real stakes for Arabs

The last two weeks have still further extended the Palestinian problem. Terrorism and counter-terrorism have spread across the Eastern Mediterranean and governments have felt the shock-waves in Rome, London and Washington - and above all in Cairo.

What are the implications for the peace plans by Jordan and the PLO, for the future of Egypt, for the influence of Iran and Syria? I have received this letter from Patrick Seale, the British Arabist who is currently writing a biography of President Assad of Syria.

Dear Anthony,

The Hussein-Arafat peace strategy was always doomed because too many vetoes were stacked against it. Now Israel's raid on Arafat's Tunis headquarters, the hijacking of the Achille Lauro, and Britain's about-turn on talking to PLO representatives have finally killed it.

Certainly worse turbulence can be expected. Hawks, both Israeli and Arab, are rejoicing, each side believing it can benefit from the violent confrontations ahead.

Even doves are moving right. In Israel the debate is between those who say yes to 'Eretz-Yisrael' (no surrender of occupied territory) and those who say yes to talks with Jordan (limited Palestinian autonomy under some form of Israeli-Jordanian condominium).

No significant group in Israel now advocates negotiations with representative Palestinians, leading to eventual Palestinian self-determination. Shimon Perez himself, the man liberals hoped would be the man of compromise, is turning all his efforts to brand the PLO as international outlaws who have no place in any peace process - a position the United States appears to endorse.

Egypt's prospects are perhaps the most delicate and dangerous. It lent its weight to the Hussein-Arafat initiative, and there is no way in which Egyptian opinion will abandon the Palestinians.

About 100,000 Egyptians lost their lives fighting Israel in the civil wars since 1948. Egyptians are increasingly impatient of the results of the peace treaty with Israel. It has thrust Egypt to the margin of Arab affairs, it has exposed Egypt and the Arabs (especially the Palestinians) to repeated Israeli humiliations, it has contributed to the death of one Egyptian president and is now undermining his successor.

In making peace with Israel, Egypt had hoped that the two countries in partnership would exercise a sort of protectorate over the turbulent Arabs. It was to be a partnership of equals, symbolised by equal political and financial support from Washington. Instead the United States has backed Israel's bid for regional supremacy, first in Lebanon and now in attempting to embrace Jordan while excluding the PLO.

Mubarak is a most unhappy man. He is riding an angry domestic tiger which he needs urgently to placate. Hence his demand for a public apology from Reagan for diverting the Egyptian plane. Egypt is deeply frustrated by its patent helplessness to help the Palestinians.

There is a gulf, full of dangers and uncertainties, separating western and Arab perceptions. The western mind is concentrated on Palestinian and Islamic terrorism - the killing of Klinghoffer on the liner, the killing of the Soviet diplomat in Beirut.

To the Arabs, these are trivial irrelevancies compared to the more than 60 people killed by Israel in Tunis on October 1 and (to be fair) the 2,000+ who died in Tripoli under the siege of pro-Syrian forces.

The West is constantly postulating the possibility of talks with some species of 'moderate', 'peace-loving', if not downright submissive Arabs. But there is no such pressure on Israel to moderate its policy. An inevitable outcome is that the Syrian thesis - that Arab conciliation leads only to further blows, that peace is not for the weak - is gaining converts among the Arabs.

And even Syria is in danger of being outstripped by the two great radical movements (getting more radical with every sorry incident) of Islamic militancy and Palestinian nationalism. The Palestinian movement is still more or less controlled by its various groups and leaders, but the Islamic activists are less structured and therefore more dangerous.

Not surprisingly many Palestinians now look to the methods used in Lebanon by Islamic militants as the only way forward.

PATRICK SEALE

People and pointers

THE TORNADO PAYOFF

Details are already leaking out about the commissions paid for the huge Anglo-German arms deal with the Saudis (see my last two Letters), to sell Tornado combat planes and other equipment for about $6bn - partly in the form of oil.

Arab sources now say that the total commission was around $800m; and that a major beneficiary was the Syrian dealer Mohamed Wafik Reda Said, who lives in London.

But the key beneficiary is said to be Prince Bandar, the Saudi ambassador to Washington who is frequently talked of as the next foreign minister, who was the chief negotiator for the arms deal. The son of the defence minister Prince Sultan, Bandar is an ex-pilot, trained both in Britain and the US, with a relaxed and Americanised style.

Prince Bandar's negotiation, it is suggested, was invaluable not only in getting the order from his father, but in securing American approval. His reward of around $280m is a sign of his growing influence in the kingdom.

THE SKIMMERS

In the meantime many Arab businessmen, particularly Saudis, have been waiting apprehensively for a new book called 'Payoff: wheeling and dealing in the Arab world', which has just been published by Andre Deutsch in London.

It is written by Said Aburish, a former journalist and ad-man who has been agent for many European companies including British Aerospace, Wimpey,and Ericsson in Sweden (all of them, he insists, 'above reproach').

Aburish gives a racy guide to the 'intermediaries' and 'skimmers' who take the biggest commissions, with emphasis on Saudi Arabia, Iraq and Oman; and he includes his own glossary to the language of middle-men: in Saudi Arabia 'a special favourite of the king' means 'one of five thousand Saudi princes'.

He gives special attention to Prince Fahr, the uncle of the Sultan of Oman; to Dr Ruth Fahmy, the only woman arms dealer in the Middle East; to Prince Mohamad in Saudi Arabia, King Fahd's elder brother, 'the largest seller of oil on the international spot market'; and to Prince Sultan himself, 'probably the greatest living example of an institutional skimmer.'

Aburish insists that Western values cannot prevail in the Middle East, and that companies must deal with individuals, not institutions. But he thinks there are limits. 'I believe that the intermediary system is wholly necessary in Middle Eastern business dealings. Sadly, oil and the Arab temperament have pushed things too far...'

HARRODS ON THE NILE

The Al-Fayed family from Egypt are now moving stealthily into the US, with a 7.4% stake in the Texan bank holding company National Bancshares. And they are tantalisingly beginning to disclose, like a dance of the seven veils, some details of how they became rich enough to acquire an empire which includes the Ritz in Paris and Harrods in London.

To the Wall Street Journal they have suggested that they became enormously rich through the Gulf Sheikhdom of Dubai. But in the Egyptian paper October they have just given more details of their friendship with the Sultan of Brunei - whom many people still suspect is the true owner of Harrods.

They got to know the Sultan, they explained, when he stayed at the Paris Ritz - a very noticeable guest since his entourage occupied 111 of the 260 rooms. When the Sultan bought a Boeing 747 from Adnan Khashoggi for $18m and had it refurbished for another $35m, they beat down the price (they say) to $8m.

The Al-Fayeds also reveal that Harrods will soon have a section for Egyptian goods, Egyptian specialities in the food hall, and discounts of 10% for passengers on Egyptair. But I still wonder: is Harrods really so Egyptian?

THE ITALIAN FAMILY

I'm glad to see that a lively new book about Italy by John Haycraft, called Italian Labyrinth, devotes only 37 pages to a chapter on Institutions, while The Family occupies 62 pages.

So many forecasts at successive Italian elections about the impending collapse of the country ignore the importance of the family as the crucial unit, not only of welfare but of the economy: 65% of Italians still depend on the family economy.

'No country in Europe is more prepared for the economic phase we all seem to be reaching,' says Haycraft: 'a small automated industrial base and an accumulation of small businesses which together subsidise mass unemployment.'

But the Italian family is relaxing its hold. 'Their big revolution,' Haycraft concludes, 'is their low birth-rate which is bound, shortly, to change the whole family structure and give more responsibility to the State for care of the increasing number of aged.'

THE THATCHER ITINERARY

The Italian view of the British is illuminated by another new book, Viva Britannia, by one of London's best-informed foreign correspondents, Paolo Filo della Torre of La Republica, who is fascinated by the Thatcher Factor.

The Italian prime minister Craxi said: 'Sometimes when arguing with Maggie, I feel liverish. But I find her attractive and stimulating.' The former president Pertini dreamt of 'waltzing with the beautiful lady.'

But the most extraordinary Italian tribute is the 'Thatcher Itinerary' organised by a travel agent, which takes tourists to her birthplace in the bleak town of Grantham, to Somerville college, Oxford, to her constituency in Finchley and to Westminster and to Downing Street.

NOT JOINING EUROPE

The latest edition of Euro-barometre, the six-monthly poll of European public opinion, makes depressing reading for any Englishman - who looks towards closer integration. It is not just that most British (55%) still think that their country has not benefited from belonging to the European Community.

What is worrying is the British lack of interest in abolishing checks and formalities at the frontiers - which was recommended at the European summit at Fontainebleu in June 1984. Only 27% of the British favour abolition of frontier checks, while 64% are against. By contrast only 14% of Germans were against abolishing restrictions.

Was de Gaulle right when he said if Britain had to choose between Europe and the open sea, it would choose the sea?

ENTREPRENEURS AND GENTRY

One of the stars at the otherwise dull Conservative conference in Britain was the entrepreneur Sir James Goldsmith, who scathingly blamed the British class system (and also Mrs Thatcher) for stifling enterprise.

After the second world war (Goldsmith said) businessmen 'became ashamed of the very virtues that created their and their nation's success. The hunger for gentrification led to a consolidation of the class system.'

This 'gentrification of the over-class' he went on, 'created an extraordinary opportunity for those neither infected with this disease nor trapped in the underclass'; and he listed some of the tiny band of immigrants who built up succesful British companies, from ICI to Warburg's bank.

The criticism has much force: but should it be confined to Britain? Most European countries face the same lack of enterprise, for similar reasons: they prefer a quiet life, and genuine entrepreneurs are thoroughly disruptive.

Goldsmith himself - a Jewish Anglo-French Old Etonian who left school early - is a classic example of the perpetual outsider. 'Dynamism is usually the result of disequilibrium,' he told me: 'my disequilibrium comes from the very simple reason that I'm a foreigner. I'm a Jew to Catholics, a Catholic to Jews, an Englishman to the French and a Frenchman to the English. I've always been neither one nor the other - which is a very unsettling thing to be.'

Businessmen and Pretoria: the dilemma spreads north

The South African economic crisis is becoming increasingly mixed up with the economic crisis throughout Sub-Saharan Africa. And it is also extending the dilemma of bankers and industrialists over the political choices.

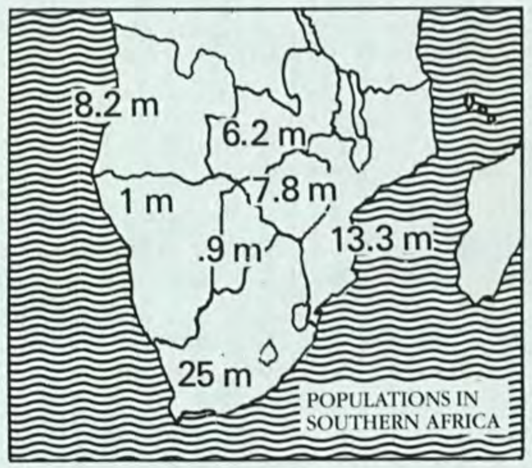
The South African government is now bitterly blaming western bankers for their 'precipitate action' in stopping lending, and pointing out that the whole of Southern Africa will suffer from the shortage of capital in the South.

At the IMF conference in Seoul the delegates from Pretoria stressed their concern for their neighbours' welfare. 'We are saying to the black states: Let's get together and develop sub-Saharan Africa,' said the governor of the South African Reserve Bank, Gerhard de Kock.

'If ever there was a time when man's morality should match his technology,' said the finance minister Barend du Plessis, talking about the future of all Southern Africa, 'it is now. If ever his compassion was to be equal to his skills in material goods and wealth, the time is now.'

And the European and American opponents of sanctions are also now arguing that sanctions will damage not only the blacks inside South Africa, but also the neighbouring black states, as much as Pretoria.

Certainly the black states are in a painful position. At the beginning of this month the Senegalese president



POPULATIONS IN SOUTHERN AFRICA

Abdou Diouf, who is also currently president of the Organization of African Unity (OAU), toured the 'front-line' states - all of which except Swaziland favoured compulsory sanctions against South Africa.

Diouf will take up this position at the UN this month. But those states are also well aware that the implementation of sanctions would hurt them very seriously, and are pleading for aid from the West to compensate them.

THE NEIGHBOURS' DILEMMA

Yet while Pretoria equates its economic crisis with the rest of Southern Africa, its political and military policies are also affecting all its neighbours - and increasingly involving international interests.

(While de Kock compared South Africa's economic role in Africa to West Germany's in contemporary Europe, he could also have compared it to Nazi Germany's role in the thirties - which provided similar dilemmas for other countries' businessmen.)

In Angola, the rebel army of Jonas Savimbi, backed both by South Africa and by powerful western interests (including the Heritage Foundation in the US) has achieved a decisive victory against the government's counterattack.

In Mozambique President Machel has made useful friends in Washington and London (including Mrs Thatcher); but he is still crippled by the rebel troops of the MNR - for whom Pretoria has now had to admit its past support.

South Africa is also extending its military aid much further North: according to the Paris newsletter Confidential Telex it has even made an agreement with Somalia to supply arms, including spare parts for Soviet weapons (which South Africa captured in Angola).

The extension of both economic and political crises from South Africa northwards is raising the stakes for western businessmen and bankers, making it still harder for them to avoid political choices.

South African industrialists are still developing their contacts with the black opposition, including the African National Congress (as British businessmen are beginning to do); some of them are beginning to sound more fearful of the bankers than of the black politicians.

Gavin Relly, the chairman of the giant Anglo American group who initiated

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been unique; not only in being (as a former Lord Chancellor Lord Gardiner described them) 'the most powerful and least accountable of any in Western Europe'; but also in having no separate of riot police like the Caribinieiri in Italy or the Compagnie Republicaine de Securite (CRS) in France, under separate command.

The British have long been proud of not needing a 'third force' which is such an obvious arm of the state; and they have been appalled by the ruthlessness of the Continentals. But now that the British police are appearing in military ranks, armed with riot gear against rioters or pickets, the argument is going into a reverse.

The British police have already been angrily protesting about the lack of preparation and equipment, after one of them was killed by rioters; and Sir Kenneth Newman, the head of the Metropolitan Police, has promised more effective measures.

But some British police experts, including people in Whitehall, are now asking whether it would not be better to have a separate force, so that the ordinary 'Bobby' on the beat, who must remain close to the community, is not identified with this para-military role.

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3. Britain's refusal to cooperate with the cartel has forced the Gulf countries to cut production further than they would otherwise have done. Not surprisingly Britain is unpopular, but it is not clear that maximising revenues in this way is against Britain's national interest.

Yours sincerely,

John Calverley

* I still maintain that Britain's high production is helping to undermine OPEC and thus to threaten Britain's own revenues. And the more rapidly Britain depletes the North Sea, the more difficult will be the transition back to being an oil-importer, with diminishing revenues for the Treasury in the mid-nineties.

It would be less worrying if Britain had been able to use its new oil-wealth to build up a more effective new industrial base. But, as last week's report from the House of Lords makes clear, Britain's manufacturing industry is pathetically weak. And I believe the short-lived oil bonanza has concealed the long-term industrial weakness. A.S.

The Sampson Letter
Despatch Publications Ltd
27 Ladbroke Grove
London W11 2AY
UK

The Sampson Letter
Despatch Publications Ltd
352 Riverside Drive
New York
NY 10025
USA

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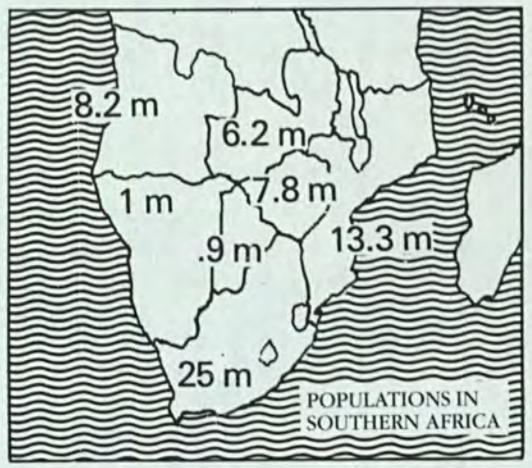

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Gavin Relly, the chairman of the giant Anglo American group who initiated

talks with the ANC, now sees the bankers' boycott of South Africa as a greater danger than sanctions.

'Unless the world's bankers become more judicious in their professional attitudes towards South Africa,' he said two weeks ago, they may 'be in process of bringing about an economic wasteland in South Africa...'

In my last Letter Robert McNamara suggested that western bankers could take a more positive role in pressing for black participation in South Africa. And some American business leaders believe that only a bold initiative to dissociate capitalism from apartheid can safeguard the future of free enterprise in the continent.

British riots and police

The violent riots that have so suddenly broken out in Britain will undoubtedly have far-reaching political consequences. Not only because they are polarising attitudes on the left and right; but because they are calling into question the whole British attitude to policing.

Traditionally the British police have been unique; not only in being (as a former Lord Chancellor Lord Gardiner described them) 'the most powerful and least accountable of any in Western Europe'; but also in having no separate of riot police like the Caribinieiri in Italy or the Compagnie Republicaine de Securite (CRS) in France, under separate command.

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Wasting the North Sea?

Last month in Letter 25 I strongly criticised the British government's policy of pumping the maximum oil from the North Sea, and quoted Yamani as saying: 'your grandchildren will never forgive you for wasting your national asset.'

I have received this reply from John Calverley, economist at the American Express Bank in London:

Dear Anthony,

Your criticism of the British Government's policy of producing as much oil as possible seems to be weakly based.

1. If prices are on a declining trend for the short and medium run then turning oil into money as quickly as possible makes good sense. True, prices will doubtless rise again in the 1990's but they will have to triple by 1995 to make oil in the ground then worth the same in discounted items (at 11% interest rates) as oil turned into money now.

2. Even if Britain was prepared to limit output by between 100,000 barrels per day and 500,000, the maximum likely, this would be insufficient on its own to stabilise the market.

3. Britain's refusal to cooperate with the cartel has forced the Gulf countries to cut production further than they would otherwise have done. Not surprisingly Britain is unpopular, but it is not clear that maximising revenues in this way is against Britain's national interest.

Yours sincerely,

John Calverley

* I still maintain that Britain's high production is helping to undermine OPEC and thus to threaten Britain's own revenues. And the more rapidly Britain depletes the North Sea, the more difficult will be the transition back to being an oil-importer, with diminishing revenues for the Treasury in the mid-nineties.

It would be less worrying if Britain had been able to use its new oil-wealth to build up a more effective new industrial base. But, as last week's report from the House of Lords makes clear, Britain's manufacturing industry is pathetically weak. And I believe the short-lived oil bonanza has concealed the long-term industrial weakness. A.S.

Singapore, Hong Kong and the problems with China

The old rivalry between Hong Kong and Singapore, to be the entrepot and air-hub of the East, is intensifying with the opening-up of China.

Is Singapore finally losing out, after its twenty-year wonder, as Hong Kong comes closer to China, and Singapore loses tourists and business? I talked to Gavin Young, the author and authority on the Far East, who is in Hong Kong after seeing the political leaders in Singapore.

The Singaporeans still think they have good prospects of doing business with China. They have the advantage of appearing under Lee Kuan Yew as a Confucian Puritan state, while the Chinese are becoming more scared of the naughty western influences of Hong Kong.

China needs Singapore's involvement with cities and projects; and it welcomes Singapore as the lynch-pin of the Asean countries, with the same linguistic and racial background as China.

Of course Singapore has already had some pretty grim experience of business with China, with its incompetence, corruption and centralised system. Now Singapore is most interested in tourism, particularly in the provincial cities.

China needs the hard currency and has the historic sites; while Singapore needs a tourist hinterland and its airline can fly anywhere. It hopes to sign a tourist agreement with China early next year.

Singapore will now sell its brain-power and education, rather than cheap labour, for high-tech industries and services. It's looking less to Europe, and more to the whole Pacific basin, and also towards India, as part of the pool of Asian nations which can use their technological services and advice. (Lee Kuan Yew said rather tactlessly recently that if Singapore had been inhabited by Indians and Chinese it wouldn't have become the marvellous place it is.)

Singapore has two main worries: the recession, and the succession. There's a kind of malaise, a trauma after 25 years under a colossus. But there's quite a lot of fat to live off, still a lot of construction, and it's mostly foreign workers who have suffered.

Lee is still hovering over Singapore like a Cheshire Cat; he tries to retreat from the limelight, but he remains the grand old man of Asia.

He thinks there will be troubles ahead, and that Singapore will have rivals and enemies, but he doesn't think apres moi le deluge. His son may become President later, under a new constitution which would provide for the President to be popularly elected.

In Hong Kong the hatred of Singapore is amazing. People talk as if it needs a terrific shake-up. But Hong Kong is going to have very difficult problems inside China - particularly corruption.

Singaporeans now seem to have a homogeneous character - which is quite cautious, unused to taking risks in their tight little island: they don't feel like stretching their wings.

Paradoxically, Hong Kong people, who are nearly all Chinese, are more varied; they come from very different Chinese cultures, with great contrasts in wealth.

Some Singapore people say that China will never really understand Hong Kong - the immense complexity of running it, with all its international links. When it falters, they'll be tempted to tinker.

GAVIN YOUNG

THE OFFSHORE BANKING RIVALS

Hong Kong and Singapore have long been the leading offshore banking centres for the assets of American banks. This month's Amex Review shows that since 1982 Hong Kong's US assets have fallen by 26% to \$3.8bn; Singapore's fell by 30% to \$1.6bn. Hong Kong's fall was certainly influenced by the agreement with China, but all offshore centres except Macao have shown reduced dollar assets since 1982: the Cayman Islands dropped by 70%.

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HER MAJESTY'S TREASURY

WORKING PARTY ON
WORLD ECONOMIC PROSPECTS

I attach a report on the Autumn update of the WEP exercise. Detailed background tables can be obtained from Mr Hennebry - on (233 3829).

Stephen Matthews

STEPHEN MATTHEWS

WORLD ECONOMIC PROSPECTS : AUTUMN 1985

INTRODUCTION AND SUMMARY

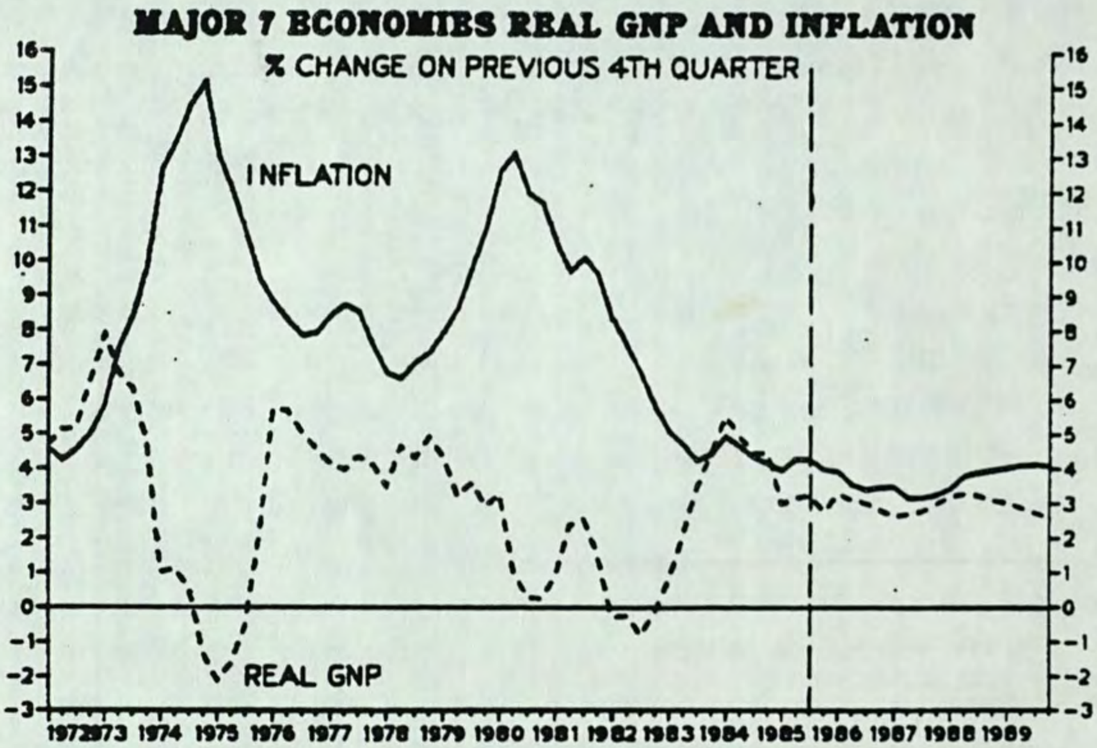
This report describes a favourable prospect for the world economy; it shows output and trade growing steadily at 3 per cent and 4-5 per cent respectively each year, plus some slight slowdown in the rate of inflation assisted by persistent weakness in commodity prices. With the continuing success of firm fiscal and monetary policies in the industrialised countries in bringing down the rate of price inflation, the conditions could perhaps be as favourable for growth over the next few years as they were in the 1960s, especially once the expectations of market operators have fully adjusted to low inflation. As in previous forecasts, the oil producing countries (especially Saudi Arabia) are squeezed by weak oil demand and low prices, and the prospects for non-oil developing countries are difficult but debt problems appear in aggregate to be manageable.

2. However there are clearly risks to such an outlook. The forecast makes no allowance, for instance, for any major spread of protectionism consequent upon the squeeze on US manufacturers; it does not allow for the default of a major country debtor with all its implications for the world's financial system; neither does it allow for any sharp dislocations to the pattern of world trade brought about by either a sudden fall in oil prices or a dramatic realignment in exchange rates leaving the dollar much lower and the yen and Deutschemark much higher than shown here. We do not feel that these events are the most likely - it is against the best interests of too many people for protectionism or default to be allowed to come about except in the last resort - but nevertheless the probability of one or more of them occurring is not negligible and the world economy could take a vastly different path as a result.

Table 1 : Output, Inflation and Trade

% change on previous year	1983	1984	1985	1986	1987	1988	1989
Major 7 real GNP	3	5	3	3	2½	3	3
Major 7 consumer prices (CED)	5	4	4	3½	3½	3	3½
World trade in manufactures (UK weights)	1½	10½	7	5½	3½	4	5

Chart 1:



3. Policy stance in the developed countries could also be significantly different from that assumed; with or without a sharp depreciation in the dollar, governments in Europe and Japan may reduce the current account imbalances by easing fiscal and monetary policies in order to raise their own domestic demand growth relative to that of the US. The forecast assumes that Japan will make a considerable adjustment in its policies (eg liberalisation of its capital markets to assist the yen to rise; lower interest

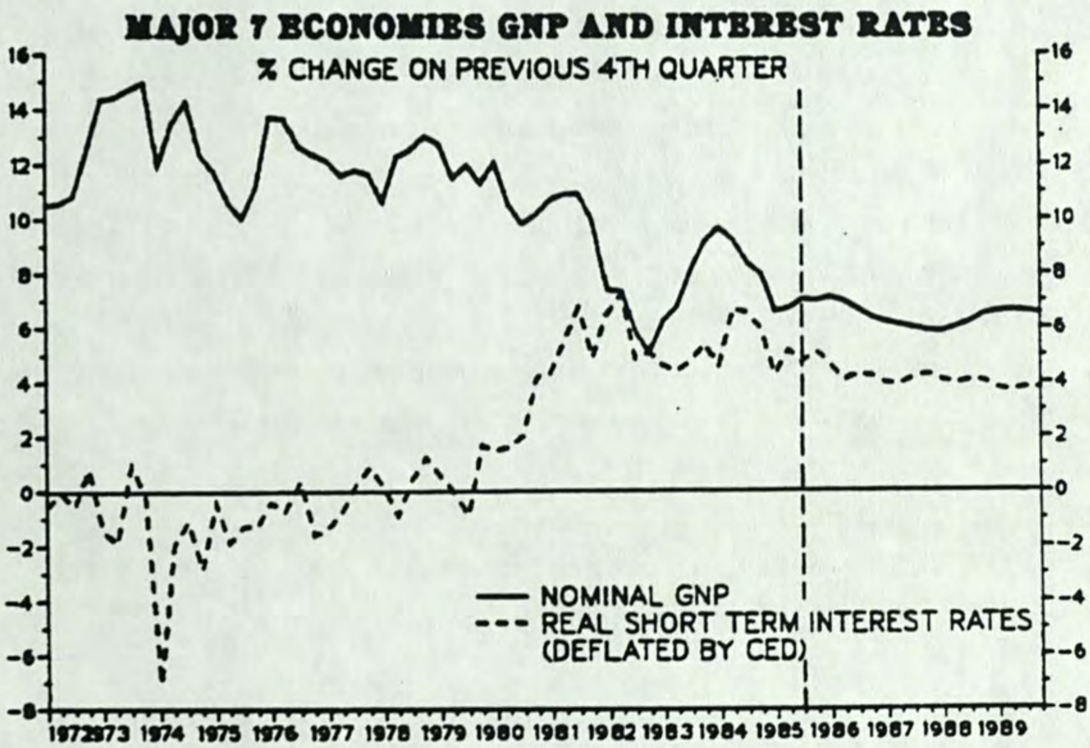
rates and encouragement of domestic consumption and investment; much less reliance on export growth) as a major contribution to the resolution of the world imbalances. However, even with the threat of major protectionist measures against them, the Japanese may be reluctant to undertake all of this adjustment.

4. These issues are discussed more fully elsewhere in this paper.

POLICY

5. In brief we have again assumed that the medium-term policy stance of the industrialised countries will remain slightly restrictive, as evidenced by the slowdown in money GDP growth shown below.

Chart 2:



Firm monetary policies are expected to continue. With government deficits being reduced only slowly as a proportion of GNP, this leads to real interest rates remaining high throughout the forecast period. This may constrain real GNP growth to rates broadly in line with the rough estimates of productive potential expansion shown in table 2.

Table 2: Average growth rates in output and productive potential

	1964-73	1973-79	1979-84		1984-89	
	Growth	Growth	Growth	Potential	Growth	Potential
US	4	2¾	2	2¼	2½	2½
Japan	9¼	3¾	4¼	4¼	4¼	4¼
Germany	4½	2½	1	2½	3	2¾
France	5¼	3¼	1	3	2½	2¾
Italy	5	2½	1	3	2½	2½
Canada	5¾	3¼	1¾	2½	2¾	2¾
Major 7	5	2¾	2	2¾	3	3

6. With their exchange rates strengthening against the dollar, Japan and Europe may allow domestic monetary aggregates to grow a little faster without fearing renewed inflationary pressures, especially since commodity markets look like remaining weak. In the US, the Fed are assumed to attribute much of the overruns in monetary growth this year to a shift in the demand for narrow money; with inflationary pressures receiving less attention, the Fed give greater consideration than hitherto to a range of factors, such as real activity rates, the exchange rate and the problems of financial institutions, when setting monetary policy. The recent G5 agreement on concerted intervention to reduce the dollar's value on foreign exchange markets will leave little room for higher US interest rates in the next few months. Thereafter, there need be no great movement in interest rates; we assume a little upward pressure in the next few quarters and in the longer term real US three-month interest rates should remain at or near 5 per cent.

7. We assume that some limited progress is made in reducing the US Federal budget deficit, but not by the full amounts agreed in the recent Congressional Budget Resolution. On our growth assumptions, this leaves deficits of $150-200 billion in each year, albeit falling in relation to nominal GNP. Some slippage is also likely in Canadian attempts to reduce their budget deficit. Fiscal policy is initially fairly tight in Japan and Europe, but

unemployment remains high in the latter, and the resulting electoral pressures may lead to some fiscal relaxation. In particular, we have explicitly assumed that the German government introduces tax cuts worth DM10-12 billion in each of 1986, 1987 and 1988, which stabilises their deficit to GNP ratio at about 1 per cent. In France, tax reductions next year and general slippage on their fiscal targets are together assumed to lead to no reductions in their deficit in relation to GNP.

Table 3: Average Real interest Rates*

	US	Japan	Germany	Italy
1969-73	2	- ½	2¼	-1½
1974-79	¼	-1	1	-4½
1980-84	6¼	4¼	4¼	2½
1985-89	4	3½	2¼	5½

*Average of annual nominal three-month interest rates less quarterly increase in CED at an annual rate.

Chart 3:

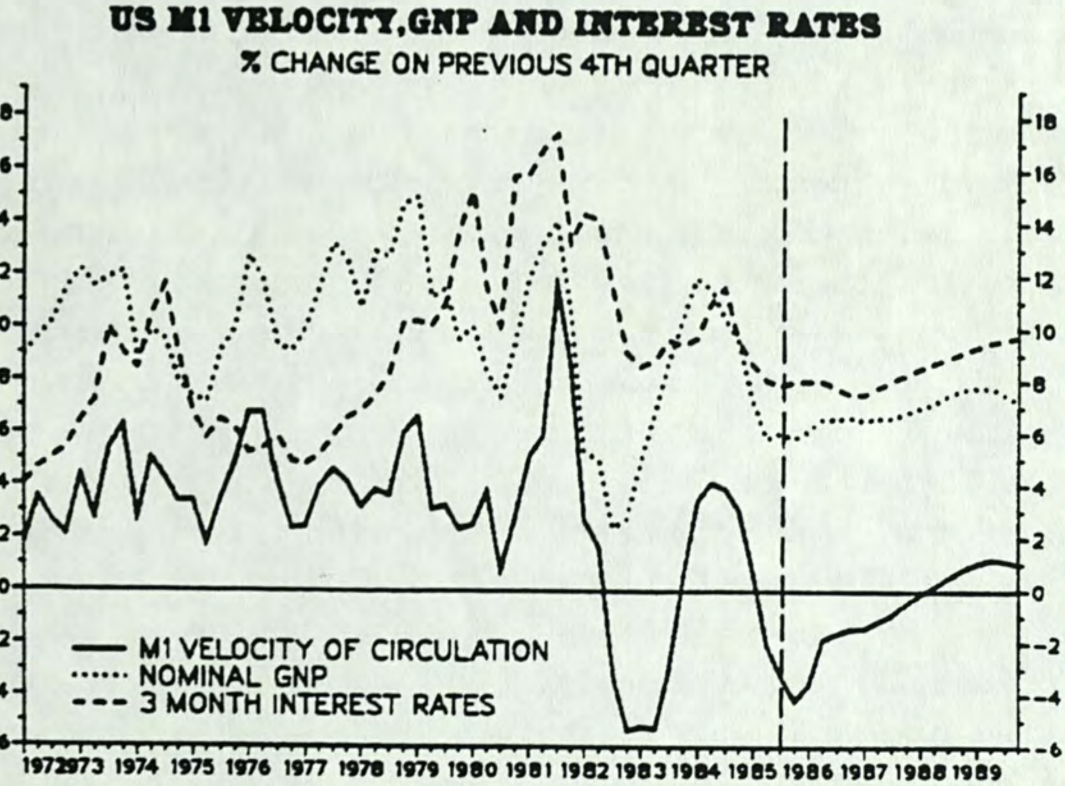


Table 4: General Government Deficits

General government financial balances as % of GNP	US	Japan	Germany	France	Major 7
1969-73	-½	0	¼	½	½
1974-79	-1¼	-3½	-3	-1	-2½
1980-84	-2½	-3½	-3	-2¼	-3½
1985-89	-3	-½	-1¼	-3¾	-3¼

ACTIVITY

8. Real GNP in the United States grew by only 1.9 per cent (seasonally adjusted annual rate) in the first half of 1985. Domestic demand grew strongly by 3 per cent, with consumer's expenditure rising by 5 per cent over this period (all figures seasonally adjusted at an annual rate), but much of the expansion in demand leaked into the external sector - export volumes fell for the first time since late 1982 while imports continued to rise steadily. The 'flash' estimate of GNP growth in the third quarter was only slightly better at 2.8 per cent (annual rate). The recovery is now ten quarters old and is at the point where there is considerable uncertainty as to whether it will continue or whether it will turn into recession. Fears that the economy will turn down centre on the continuing erosion of manufacturing competitiveness, the relatively modest expectations from investment surveys, the moderately low levels of capacity utilisation and the mounting burden of household indebtedness as consumers have been spending on cheap imports. On the positive side, the effects of lower interest rates and continuing good inflation performance should still feed through to residential investment and consumption, stocks are not high by historical standards for the stage of the cycle, and the assumed depreciation of the dollar should start to improve the external contribution to GNP growth from now on. Furthermore although households have taken on a lot of consumer debt, they have built up (financial) assets as well as liabilities and the comparatively comfortable net debt position should minimise the risk of an abrupt halt in consumer spending.

9. The outcome shown in the forecast is therefore for a mild cyclical decline in domestic activity partially offset by a recovery in net trade. Real GNP grows by 2½ per cent this year and 2½-3 per cent in each of the next three years, with the foreign trade sector contributing positively towards growth after 1987. The risks to such a "soft-landing" are clear - the dollar remaining high, interest rates rising sharply, domestic activity falling sharply - but we feel that a sharp US recession is not the most likely outcome.

Table 5 : Real GNP growth in Major 7 Countries

% change on previous year	1983	1984	1985	1986	1987	1988
US	3½	7	2½	3	2½	2½
Canada	3½	5	4	2½	2	2½
Japan	3½	5½	5	4	3½	4
Germany	1½	2½	2½	3½	3	3
France	½	1½	1	2	2½	3
Italy	-½	2½	2½	3	2	2½
Major 7	3	5	3	3	2½	3

10. In Japan, industrial production, business investment and exports bounced back strongly in the second quarter of 1985, although retail sales and investment intentions data have been less encouraging. We expect the economy to grow by 5% between 1984 and 1985 with domestic demand growing steadily but not sufficiently to offset the smaller contribution from external trade. Over the forecast period as a whole net exports worsen as the yen rises strongly against most currencies and growth of export markets slows. Domestic demand growth is assumed to strengthen, reflecting falling interest rates and a gradual decline

in the savings ratio, and this counters in part the negati external contribution to GNP growth. We therefore expect activity to grow at an average rate of about 4 per cent over the rest of the decade, close to estimates of Japan's productive potential growth.

11. German output in the second quarter of 1985 recovered from the poor performance in the previous quarter, which can mainly be attributed to the effects of the severe winter weather. Nevertheless, the sluggish performance in the first half of the year means that growth of only 2¼ per cent seems likely this year. In 1985, as in 1984, German growth is expected to rely heavily on its strong export performance. However the assumed appreciation of the Deutschemark from 1986 onwards is expected to lead to some loss of competitiveness and hence to a deterioration in the contribution of the external sector to growth. Domestic demand is expected to compensate; rising real earnings, together with reductions in the tax burden, lead to appreciably faster growth in private consumption. As a result we are forecasting growth of about 3 per cent through 1986; this translates to year-on-year growth of 3½ per cent due to the low base in the first half of 1985.

12. 1985 seems likely to be another year of slow growth in France, with output expected to be just over 1 per cent higher than in 1984. Consumers' expenditure is the main contributor to growth, with the high level of the first half of 1985 maintained for the rest of the year. Little or no growth is expected in investment as the residential sector continues to be weak. We should see rather faster growth from 1986 onwards. Further increases in real wages, together with some easing of the tax burden, are likely to boost consumption and investment is also expected to pick up. In spite of the assumed depreciation of the Franc external trade makes a negative contribution to growth.

13. Italy looks likely to continue the revival of growth which started in 1984 and growth of 2½ per cent this year should be sustained in later years. This growth is based on domestic demand. Rising real wages and a decline in the savings ratio combine to

produce reasonably strong growth in private consumption. Government consumption is assumed to grow steadily in the absence of convincing action to contain the government deficit. Investment and stockbuilding are also fairly buoyant.

14. As the stimulus fades from trade with the US, Canada relies on a recovery of fixed investment and strong, if slowing, consumption for most of its growth this year and next. Activity remains steady rather than strong for most of the forecast period, picking up a little towards the end of the decade.

15. This picture of steady growth in the major industrialised countries is considerably better than the performance in the 1979-1983 period. Nevertheless, table 2 above showed that growth was unlikely to be greater than our crude estimates of growth in productive potential, constructed on the basis of projections of labour supply and trend productivity growth, in most countries. This is reflected in our forecasts of unemployment shown in table 6. Only in Germany, where output is expected to grow very slightly faster than potential, is there any fall in the unemployment rate and then only a small fall. Growth rates significantly above potential would be needed to make substantial inroads into unemployment, and the associated risk of inflation might be that much greater.

Table 6: Unemployment

%	1974-83 Average	1983	1984	1985	1988
US	7½	9½	7½	7¼	7½
Japan	2	2½	2¾	2½	2¾
Germany	5	9¼	9	9¼	8¼
France	6¼	9	10¼	10¾	11
Italy	7½	10	10½	10¼	11¼

INFLATION

16. We still expect no change in the rate of inflation over the forecast period - some further reductions in European price

inflation are broadly offset by a slight pick-up in the US as the dollar falls. Generally firm fiscal and monetary policies and continuing high unemployment provide a favourable background for low inflationary pressures, enhanced by weakness in commodity markets, especially oil.

Table 7 : Consumer price inflation in Major 7 countries

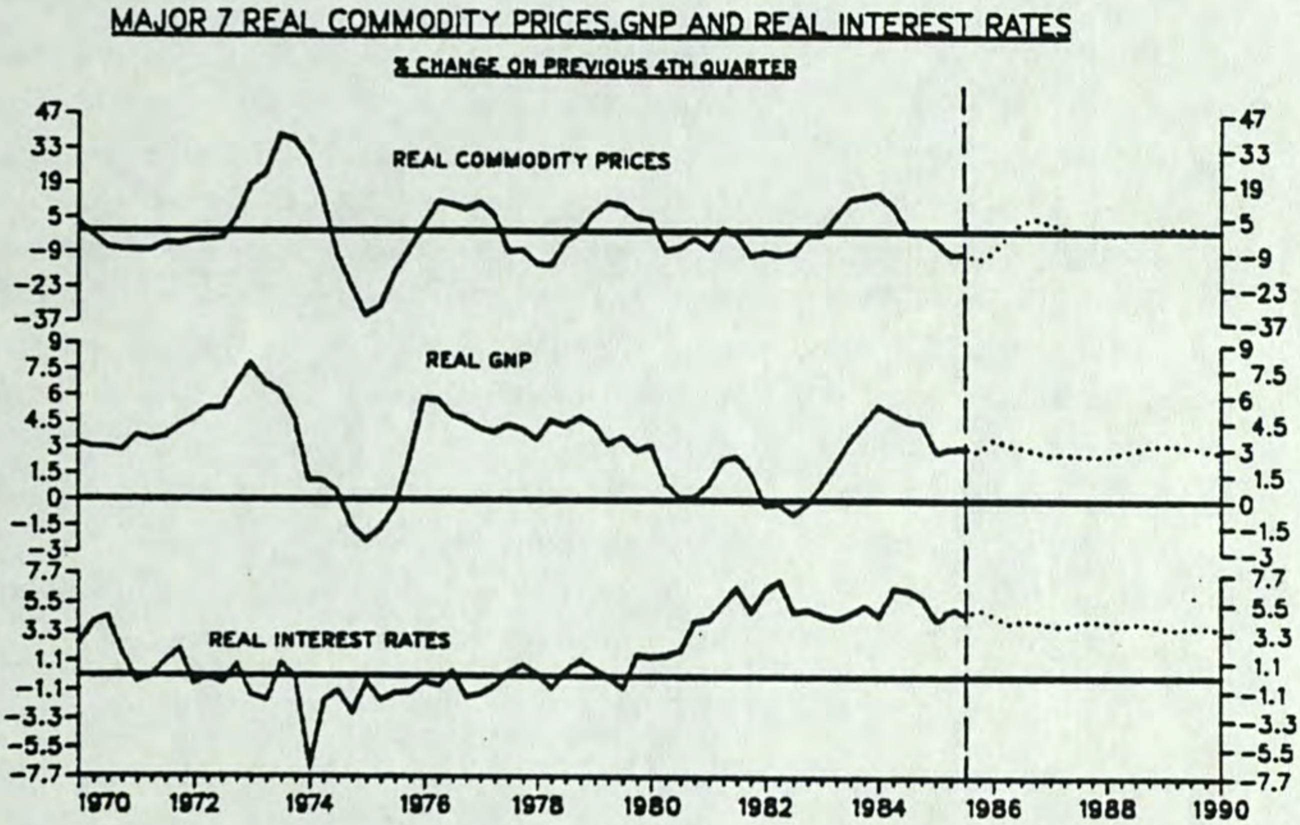
% change in the consumers' expenditure deflator on a year earlier	1983	1984	1985	1986	1987	1988
US	3½	3	3	3½	4	4½
Canada	6	4	4	4	3½	3½
Japan	1½	2	2½	2	1	1
Germany	3	2½	2½	1	½	0
France	9½	7½	6	5½	4½	3
Italy	16	11½	9½	7½	6½	6½
Major 7	5	4	4	3½	3½	3

17. Over the summer months, food commodity prices have weakened almost without exception on world markets. Harvest prospects for 1985 look good with probable record levels of world production of cereals, oilseeds, major tropical products and sugar. Improvements in agricultural technology have raised yields significantly and supply should exceed demand for some time although ultimately low prices should lead to lower production. Food markets are likely to remain depressed for the next year or two, although cuts in US Federal spending on the farm support budget could apply some upward pressure on prices.

18. Agricultural non-food production has also been high and prices correspondingly weak this summer. As a result the prices of industrial materials have been slightly weaker than expected despite some strength in prices of metals and ores. With production high and new capacity ready to be brought on stream at short notice, commodity markets look set to remain weak as long as there is no major upturn in world activity. The oil price has stayed

surprisingly firm through most of the summer, although dollar weakness in July and September has resulted in some fall in the real oil price. We expect a fall in the real oil price of some 30 per cent by 1990, much of this being achieved through dollar depreciation.

Chart 4:



WORLD TRADE

19. We have assumed that the relationship between trade and activity over the forecast period remains much the same as that over the last ten years. Table 8 thus shows a forecast of world import volumes growing by about 5 per cent each year from 1984 to 1989, while real GNP in the major 7 industrialised nations grows by about 3 per cent. We have not allowed for any major increase in protectionism in the forecast; we assume that the free-trade commitment of the US Administration and governments in the other leading developed economies is sufficiently strong to hold back the pressure for trade restrictions by moves such as the recent G5 agreement on concerted intervention to push down the value of the dollar and measures to open up Japanese markets to imported goods. It is against the interests of too many of

the world's trading partners for protectionism to be introduced lightly. If it were, however, this could be expected to show up in slower world trade (and indirectly output) growth and higher trade and domestic prices. The exact impact on growth and inflation would depend on the precise form of trade restrictions (import controls, tariffs, etc) and their geographical impact (whether global or directed against specific countries).

20. After a year of rapid growth in 1984 (world import volumes rose by 8½ per cent over the 1983 level), the picture of world trade is a little obscure in the first quarter of 1985 - import volumes are estimated to have risen by nearly 10 per cent at an annual rate (with North American and German imports being especially strong) while exports remained fairly flat in real terms. Growth in US imports is likely to be slower this year as the dollar has fallen somewhat from its earlier peak values; worsening European competitiveness should conversely attract more imports. The relative strength of European imports, and the declining share of UK exports going to the weak OPEC markets, suggest that UK-weighted measures of world trade, while still slower than unweighted trade growth, will be less unfavourable than in recent years.

Table 8 : World Trade

Average annual % change	1966-73	1973-84	1984-89	1984 weights (%) World exports	UK exports	UK manuf exports
Major 7 Real GNP	5	2½	3			
Imports volumes						
US	11	6½	5	19	14	14
Japan	16	2	9	7	1	2
Germany	9½	4	7	8	11	10
Major 7	11	3½	6	49*	42*	39*
Other OECD	9	4½	4½	23	33	29
Other Developed	5½	3	2	3	4	5
OPEC	10½	10	-4	7	8	10
NODCs	8	5	6	15	11	14
Total world imports	10	4	5	100		
World imports (UK-weighted)	8½	3½	4½		100	
World trade in manufactures (UK-weighted)	10	4½	5			100

*Major 6 (ie excluding UK)

CURRENT BALANCES AND EXCHANGE RATES

21. The figures in the table below show the world current account imbalances becoming even more severe this year and next, both in absolute terms and in relation to nominal GNP. We have, as in previous forecasts, assumed that the dollar weakens in response to the continued current account deficits and the emergence of the US as a major debtor country; but that confidence in the general

strength of the US economy (and expectations of continuing high Federal deficits and consequently strong long-term real interest rates) will prevent any dramatic dollar collapse, notwithstanding the sharp fall in the dollar's value in September. The Yen and the Deutschemark are both forecast to appreciate by some 30 per cent relative to the dollar over the next three years.

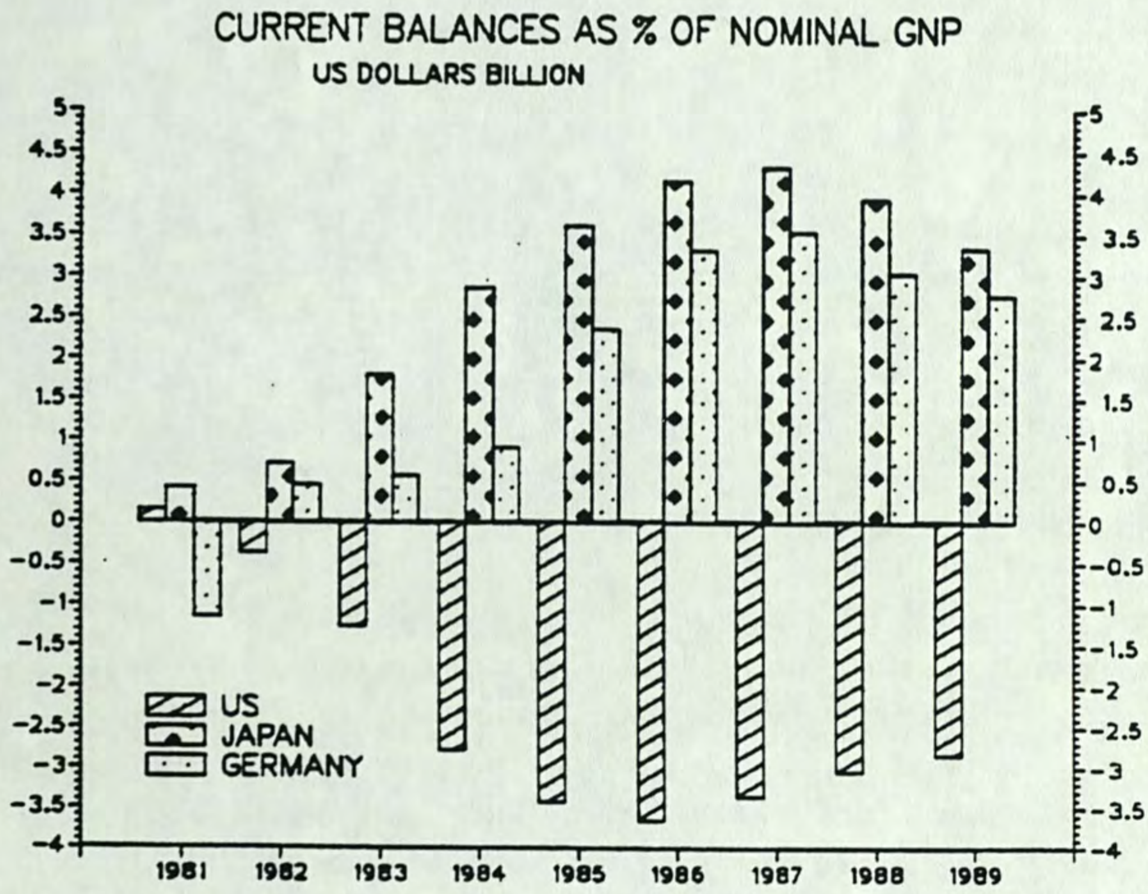
Table 9: Current Balances

$billion	1982	1983	1984	1985	1986	1987	1988
US	- 11	-42	-102	-133	-152	-148	-144
Japan	8	21	35	47	71	89	92
Germany	3	4	6	15	26	33	32
NODCs	- 63	-37	- 26	- 28	- 30	- 33	- 34
OPEC	- 16	-18	1	- 11	- 29	- 35	- 30
World Imbalance	-114	-61	- 85	-111	-102	- 89	- 87
<u>as % of GNP</u>							
US	-½	-1½	-3	-3½	-3½	-3½	-3
Japan	½	2	3	3½	4	4½	4
Germany	½	½	1	2½	3½	3½	3

22. The impact of large exchange rate movements when the initial current account positions are so out of balance is outside our normal experience and it is unlikely that models can contribute much to our projections. There are a number of reasons why the US current account should respond only slowly to the depreciation of the dollar - the large initial deficit (the trade deficit in 1984 is equal to over half the value total US merchandise exports); successive J-curve effects; exporters to the US squeezing their profit margins which they had built up during the dollar's rise, and vice versa for US exporters; and the existence of large deficits with Canada (the Canadian dollar is not expected to appreciate significantly against the US dollar) and other countries who tie their currencies to the dollar.

23. Similar reasoning applies in reverse to the Japanese current account. Here, however, the picture is exacerbated by the weakness in commodity markets and, in particular, oil. Manufactured goods make up only a small proportion of Japanese imports, whereas oil accounts for about a third. The large falls in oil prices in the forecast, with no significant short-run effects on oil consumption, ensure a considerable reduction in the Japanese import bill over the next few years. Hence the Japanese current account moves into bigger surplus because of the favourable terms of trade patterns, even though the trade surplus in constant prices starts to fall after this year.

<u>**Chart 5:**</u>



24. To what extent are these deficits sustainable? Previous reports have discussed the implications for world savings portfolios and debt servicing burdens and concluded that US deficits of 3-4 per cent of GNP can be supported for some years. The Japanese too seem to be quite willing to export capital to the tune of some 3 per cent of their own GNP, but it is not clear that they would wish to go much higher. Sharper exchange rate movements seem unlikely on their own to be sufficient to bring down the Japanese surplus. Policy actions to raise Japanese and European domestic activity relative to that in the US may be more effective; or the more damaging route of protectionism and trade restrictions may be undertaken. The free-trade commitment of President Reagan may not be enough to quash totally the calls for protectionist measures now being heard on Capitol Hill. However the forecast does not make any explicit allowance for the introduction of major trade restrictions, but the possibility should be borne in mind.

25. In the European Monetary System, we have assumed some realignment immediately after the French elections early in 1986. The French and Belgian Francs are both assumed to depreciate against the Deutschemark, the former by about 7 per cent, with some further moves in the same direction later in the same year. The Deutschemark remains strong within the EMS throughout the forecast period.

OPEC AND THE OIL MARKET

26. The world oil price has been surprisingly strong throughout the summer months, buoyed up by worries about Soviet oil production shortfalls and by very low Saudi Arabian output (only just 2 million barrels a day at one point). However demand for oil has been rather weaker than anticipated, and this pattern is expected to persist. World oil demand is likely to show virtually no increase this year or next, and even at the end of the decade is projected to be only about 5 per cent higher than in 1984. With some increase in non-OPEC production, OPEC oil output is likely to be constrained to roughly its present level for the rest of the decade.

Table 10: The oil market

Millions of barrels per day	1983	1984	1985	1986	1987	1988	1989
Demand[1]	44½	45½	45	45½	46	47	47½
Production							
Non-OPEC	26	27	28	29	29	29½	29½
OPEC	18½	18½	17	16½	17	17½	18
Oil Price							
$ per barrel	29.0	28.1	26.9	24.9	23.4	23.5	24.8
Real (1980=100) (relative to world manufactured export prices)	108¾	109	104	84	71¼	66¾	66½

[1]Consumption plus stockbuilding in OECD, OPEC and developing countries.

27. We still think that OPEC will recognise the importance to themselves of holding the cartel together, even if there are periods when squabbles over quotas lead to some temporary loss of control and consequent price slippage. With signs that Saudi Arabia is now pricing its oil on the open market (rather below its contract price) and raising its production, the price is likely to fall over the winter and more especially next Spring - we are projecting a fall of $3 per barrel over the next year. With some rise in oil demand in the later years of the decade, the downward pressure on oil prices should ease and we are projecting no further falls in the real dollar price after mid-1988. Together with the assumed depreciation of the dollar, this gives a fall in the real oil price of some 30 per cent by 1990. If the OPEC cartel were to collapse the fall in oil prices could be much greater; on the other hand we think that it would take much faster growth in world activity or a major cut in oil supply for present prices to be maintained in real terms.

28. Some indication of the sensitivity of the forecast to different oil price assumptions is given in a Treasury Working Paper (no.34, "The Economic Effects of Lower Oil Prices" by Stephen Powell and Geoff Horton, April 1985). This analyses the effects of a 10 per cent reduction in the dollar oil price on both the world and the UK economies with the help of simulations on the Treasury's WEP and UK macroeconomic models. On the assumptions (a) that governments in the major 7 countries keep monetary growth unchanged by adjusting interest rates, (b) that countries with historically high budget deficits (US, France, Italy and Canada) take the opportunity given by the operation of automatic stabilisers to reduce their deficits as a proportion of GNP, but (c) that Japan, Germany and the UK leave their deficits unchanged, the paper estimates that a 10 per cent fall in the price of oil could raise real GNP in the major 7 countries by 0.5 per cent after two years and world import volumes by 0.7 per cent. Major 7 inflation could fall by over half a per cent after two years before the higher world activity pushed inflation back to the base level after four years. Broadly speaking these effects would be reversed if the world oil price were to remain higher than shown in our forecast. However, there are assymmetries involved in this process - the OPEC countries might react more slowly in adjusting their spending (particularly on imports) upwards in response to the gain in income from a higher oil price than vice versa. The reduction in output arising from a 10 per cent higher oil price might therefore be rather smaller than the increase in output for the reverse case. The UK will perhaps do better from higher oil prices than most countries because of the greater share of OPEC countries in our export markets.

29. In the forecast, we assume that Saudi Arabia's budgetary problems will ensure that they produce nearer to their quota by the end of the forecast period, at the expense of OPEC members with better financial positions. Demand for imports by oil producers is likely to remain severely constrained, especially for Saudi Arabia, for some time to come; nevertheless, they continue to run current account deficits and the position appears to be only just sustainable.

NON-OIL DEVELOPING COUNTRIES

30. The proposals for non-oil developing countries (NODCs) balance of payments are summarised in Table 11. The outturn for the current account in 1984 now appears to have been worse than we were assuming at the time of the last WEP, with the balance on invisibles substantially worse. As a result of rapid US import growth and the NODCs substantial gains in market share, the trade balance moved into surplus in 1984. It appears to have returned to deficit in the first two quarters of 1985; and although it is difficult to disentangle the separate effects of prices and volumes at this stage, this is probably a result of weak commodity prices and a consequent deterioration in the NODCs terms of trade.

Table 11 : NODCs Current Account

	1983	1984	1985	1986	1987	1988
Export Volume growth (%)	6½	13½	6	8	4½	6½
Export Market growth (%)	2	9½	5	7	5	5
Import Volume growth (%)	0	8	6½	7	5	5
Current Account ($bn)	-37	-26	-28	-30	-33	-34
of which:						
trade[1]	-15	4	- 2	0	1	5
invisibles	-22	-29	-26	-30	-34	-39
Change in Reserves	2	14	4	11	10	13
Memo items						
Reserve/Import Ratio[2]	23	28½	27	27	27	27½
Terms of Trade (% change)	1½	3.0	- 1½	0	½	- ½
Capital Account ($bn)	41	41	33	41	43	47

[1] fob/fob

[2] end-year

31. The slowdown in US import growth means that NODCs markets will not grow as fast as they did in 1984; but with world trade expected to be fairly buoyant, if there is no significant increase in protectionism, growth in NODCs markets may be around 5 per cent a year. While they are unlikely to repeat the spectacular gains in market share of the past two years, it seems possible that export volumes will still grow slightly faster than markets. Given the assumptions about capital flows, discussed below, the NODCs may be able to increase their imports by 5 per cent a year. With the terms of trade roughly unchanged after the fall earlier this year, this produces a return to small trade surpluses from 1986.

32. With dollar interest rates some 2¼ per cent lower than in 1984, reduced debt servicing costs produce an improvement in the invisible balance in 1985, but it is not sufficient to outweigh the deterioration in the trade balance. Thereafter, growth in the nominal stock of debt and sharply rising cif payments combine to produce a steady deterioration in the current balance.

33. Net capital inflows in the first quarter of 1985 appear to have been far lower than previously forecast, with net bank borrowing actually negative. As a result, NODCs reserves fell. There are some indications that these figures will prove to be atypical and, while this forecast must be treated with considerable caution until the picture becomes clearer, we have assumed that capital flows will pick up over the remainder of the year. Nevertheless only a small increase in reserves over the year looks possible and the reserve/imports ratio is likely to fall. In later years we have assumed a steady increase in concessional lending as the World Bank, in particular, increases its activities. We assume that commercial banks increase their exposure by some 2-3 per cent a year, with new lending concentrated on those countries who have so far avoided debt difficulties. The NODCs as a whole are expected to start making net repayments to the IMF. After the small increase this year, larger reserve increases should be possible over the rest of the forecast period and a constant reserve/imports ratio is maintained.

Table 12 : NODC Debt Indicators

	1977-82 average	1983	1984	1985	1986	1987	1988
Growth in the Stock of debt: nominal	20	6	5½	6	6¾	6¼	6¾
real	10½	10	9¼	5½	-6½	-4	-1
Gross debt/export ratio	1.4	1.8	1.7	1.8	1.5	1.5	1.5
Net debt/export ratio	1.0	1.3	1.2	1.3	1.2	1.0	1.1
Gross interest service ratio	0.1	0.19	0.17	0.16	0.14	0.13	0.13
Net Interest service ratio	0.17	0.13	0.11	0.10	0.09	0.09	0.09

34. The NODC debt indicators shown in Table 12 move favourably over the forecast period and suggest that developments in the world economy, particularly the expected depreciation in the dollar and lower US interest rates permit some easing of debt problems. Even so some countries will still need to reschedule their debt, and in many cases the process of agreeing IMF programs and negotiating these reschedulings could well prove difficult, although we assume no outright debt repudiation.

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Prime Minister
Covering letter only. I suggest
CDP
1/x.

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

Charles Powell Esq
10 Downing Street
LONDON SW1

1 October 1985

Dear Charles,

INTERNATIONAL FINANCIAL SCENE

I attach a summary of our latest assessment of the international financial scene prepared by the group under Roger Lavelle's chairmanship. Two key events of last weekend - the G5 meeting in New York, and the Mexican earthquakes - are both of considerable potential significance in any assessment of the debt prospect, though it is too early yet to say how far reaching they may prove.

Mexico's financial and economic position had been causing concern before the disaster. They had fallen out of compliance with the Fund programme (fiscal policy too loose, inflation too high), while the Mexican administration (traditionally a moderate influence) had been using increasingly hawkish public language on debt generally. This had, in part, reflected their disappointment at the failure of spontaneous renewed bank lending to emerge. Had the earthquake not occurred it had become increasingly likely that a package of concerted lending in parallel with a new Fund programme would be necessary, similar to the events of 1982.

This is to a degree overtaken by the earthquake. Immediately, unconditional Fund assistance under its emergency relief facility will be proposed in the Board (the G5 agreed to this in principle at their recent meeting in New York). Bilateral assistance will also have a part to play. In the longer term a new Fund programme will almost certainly be required when the prospects for the Mexican economy become clearer.

The Mexican authorities will try to use the tragedy of last weekend as a lever to extract easier terms from their creditors. Nevertheless, the prospect of immediate, quick-disbursing Fund assistance together with other bilateral aid may help to bind Mexico more closely to the international community and maintain a relationship with the IMF on which to build negotiations towards a new programme.

Turning to the G5 discussions, to the extent that the dollar continues to soften and interest rates pressures the burden on debtors generally will be reduced. (Not all benefit; for example any additional weakening of oil earnings that may result from the lower dollar could damage Mexico more than other factors will assist her.)

Both the consensus on the over-valuation of the dollar and the effort to fend off protectionist pressures should help creditor nations defend the debt strategy more generally, both at Seoul and afterwards. As Seoul approaches, the Americans are engaged in working out new proposals for the next stage of the debt strategy. Those proposals are not yet finalised, but some form of enlarged role for the World Bank will be the centre piece. However, there are no signs yet that the US is prepared to support the idea of a General Capital Increase for the World Bank.

A strengthened role for the World Bank is in many respects to be welcomed. There are a number of ideas in this area which the UK can support - eg the closer involvement of the Bank in targetting worthwhile projects for export credit support. Others would be less attractive - eg the too ready giving of guarantees for commercial bank lending. We will need to examine in detail any specific proposals which emerge. The Economic Secretary, who will be representing the Chancellor at Seoul, will be so briefed.

Four other debtors are worth highlighting in this report. First, the picture in Latin America remains mixed. Argentina appears at least to be attempting sensible adjustment measures (though their resolve in following through with them has yet to be tested). Brazil, by contrast, is deliberately following a more relaxed fiscal policy than the IMF would advise. Their trade account and reserves are strong enough for there to be no anxiety about an early settlement with the Fund. Nevertheless, it remains difficult to see how the gap between the Brazilian administration and the Fund staff can be bridged.

Peru is also of concern. Since President Garcia's inauguration at the end of July, there had been hopes that, despite his initial rejection of a role for the IMF in resolving Peru's difficulties, in practice Peru's policies might be similar enough to an IMF prescription to allow some informal Fund endorsement of them on which to build towards a settlement satisfactory to Peru's creditors. However President Garcia's hawkish speech at UNGA casts doubts on whether this is a realistic probability, particularly in view of the implication that Peru's unilateral restriction of debt service to 10 per cent of export earnings would apply permanently, and not merely to 1986.

The prospects in Nigeria are also difficult to judge. Immediately after President Babangida assumed power, it seemed possible that he would be able to make use of the window of opportunity available within which he could move quickly to an agreement with the Fund, without the trappings of the previous administration's position to hinder him. More recently there have been increasing signs of delay. Babangida spoke of the need for a national debate on the issue of the Fund's proposals. Now two committees have been set up, one to consider the relationship with the Fund, the other to look at policy on counter-trade.

While it must be hoped that these committes will help the President forge a national consensus in favour of a deal with the Fund, they risk damagingly delaying matters. The UK representatives at Seoul (the Economic Secretary and the Governor) hope to make informal contact with the Nigerian Finance Minister, building on the Foreign Secretary's trip earlier this month and impressing on the Nigerians the urgent need for them to move to a Fund agreement.

The report contains little new about South Africa; the situation is still very confused, but the appointment of Leutwiler as mediator, announced this week, should help.

I am copying this letter and the attachment to Len Appleyard (FCO), John Mogg (DTI) and John Bartlett (BOE).

Yours ever
Rachel

RACHEL LOMAX
Principal Private Secretary

0071u

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INTERNATIONAL FINANCIAL SCENE

The devastating earthquakes that hit Mexico between 19 and 21 September have for the moment turned attention from the country's longer-term debt problems. Full assessment of the economic impact of the earthquakes has yet to be made, but it has been reported that the US Treasury, IMF and IBRD are working together to assemble an emergency rescue package for Mexico, estimated by one source to amount to nearly $3 bn. The country's productive capacity appears to be largely intact, but substantial resources will clearly have to be employed on reconstruction work, and receipts from tourism are bound to fall. There will be further serious upward pressure on the public sector deficit, but the impact on some of the external indicators - such as the level of the reserves - is perhaps less certain.

Until the Mexican earthquakes, South Africa had in the previous weeks probably been the principal concern of many of those involved in debt questions. A number of banks cut their credit lines to South Africa in August following a rapid drop in confidence as a result of internal unrest, political uncertainty, and mounting pressures for sanctions. The country's heavy reliance on short-term debt, as noted in the last Report, made it particularly vulnerable to such swings in confidence, so liquidity problems followed rapidly, and on 1 September it had to call a four month moratorium on principal repayments. Interestingly, and inevitably given the maturity profile of South Africa's debt, in a break from the pattern that had been established with other countries experiencing debt-servicing problems, this time short-term (ie interbank and trade) as well as longer-term debt was included in the moratorium.

Nevertheless, although overshadowed by South Africa, recent developments in Latin America (even apart from the Mexican earthquake) are in some ways perhaps more worrying: amongst these developments are the tougher line on debt issues that the Mexican authorities have recently been taking, and the protracted nature of the negotiations and arrangements for MYRAs for some other Latin American countries.

The final stage of the Mexican MYRA was signed on 29 August. However, earlier expectations that the completion of a MYRA would lead to a more settled debt situation seem to have been misplaced. The Mexican Finance Minister, in the face of a serious deterioration in the economic position of his country, used the opportunity of the signing of the MYRA to assert that new ways would have to be found to ease his country's debt burden: partial capitalisation of interest, and 'voluntary' new lending, were mentioned. With Mexico formerly having been the 'model' debtor, any perceptions that its economic strategy had not brought it success would be bound to have serious implications in other debtor countries regarding their commitment to adjustment policies. Conversely, any concessions that were granted to Mexico would be likely to be demanded by other debtors, and experience of handling the debt situation over the last three years has shown that it is difficult to be selective in granting them.

The impact of the earthquakes on Mexico's attitude to its debt obligations is not yet clear. On the one hand, some might expect that the massive international response to the earthquakes would indicate to the Mexicans the benefits of not cutting themselves off from the international community. Alternatively, however, the Mexicans might feel that the strength of both the economic and the moral case for additional resource flows has now increased, and they may be less willing to accept IMF demands for further austerity.

Mexico is the only important debtor where a bank MYRA is now in operation. Discussions over the Brazilian MYRA seem unlikely to lead to early agreement, and the Brazilians are reported to be prepared to let negotiations go on into the New Year. The signing of Ecuador's MYRA too has been delayed, although it is now expected by the end of the month. The Venezuelans expect their MYRA to be signed in October, but this may be optimistic.

Economic performance in debtor countries recently has been mixed. Whilst Mexico's performance on the external side has so far been considerably less successful than last year, Brazil still seems on course to meet its external targets. Internally, however, whilst both countries have taken measures to reduce their fiscal deficits, both remain well over target. Inflation too remains stubbornly high. In contrast, after the austerity measures and the currency reform announced in June, Argentina's inflation has been cut dramatically, from 30% in June to just 3% last month. With public opinion reportedly still firmly behind the adjustment programme, prospects for Argentina seem at the moment to be much more hopeful than had earlier seemed likely, although the real test will be in the coming months.

On the wider economic field, developments over the past few weeks have been mixed. Eurodollar interest rates have risen slightly (the 6-month rate now lying around 8 1/2%), but are still well below the levels of the beginning of the year. The US economy does not appear to have slowed to the extent that had earlier been feared: revised figures for the second quarter show a growth rate of 2% (ar), and the fall in US unemployment in August - to 7.0%, from 7.3% in July - suggests that growth continued into the current quarter, although some more recent indicators have been slightly more gloomy. On the negative side, from the viewpoint of most debtors, was the reversal in early September of July's depreciation of the dollar: after being relatively stable in August, the US dollar rose strongly at the start of this month, and reached its highest level since April, although in effective terms still 9% below its February peak. Even more worrying, and of course not unrelated to the continued strength of the dollar, was the increasing threat of serious protectionism in the US. In the face of strong Congressional pressure for the introduction of protection, the White House announced its own proposals to move against the "unfair trading practices" adopted by a number of countries, including two of the largest debtors, Brazil and Korea. In response to growing fears about the strength of the dollar, the US invited Finance Ministers and Central Bank Governors from the G5 countries to meet on the weekend of 21/22 September. The resulting announcement that all the G5 wished to see a lower dollar, and were taking action to bring this about, and heavy central bank intervention in the foreign exchange markets since then, have helped to push the US dollar down, by over 4% in effective terms. Whether this downward trend will be maintained, and whether this is sufficient to deflate protectionist pressures in Congress, has yet to be seen.

Non-oil commodity prices continue in general to be weak; the oil price too remains weak, although fears of a more rapid fall have so far not been realised. The new government in Nigeria has expressed its opposition to its predecessor's oil barter policy; how it intends to react to OPEC more generally is not yet clear. The Nigerian government may be adopting a more positive attitude to the Fund: some encouragement may be had from the appointment as Finance Minister of Dr Kalu Kalu, a World Bank economist who has made sensible remarks in public about a realistic exchange rate.

Borrowers from non-OECD countries have taken just over $1.7 bn from the international markets since 1 July. Nearly all of this is split between South Korea ($1.0 bn), Hungary ($0.3 bn) and Turkey ($0.25 bn). South Korea and Hungary borrowed both through syndicated credits and fixed and floating rate bonds, while Turkish borrowers used only syndicated credits. The terms on these loans continue generally to be at similar fine spreads to those achieved earlier in the year. South Africa made three bond issues early in July, amounting to slightly less than $100 mn, but naturally has not been in the market more recently.

Attention will now be turning to the IMF/IBRD meetings in Seoul, where debt issues will be discussed. The paper prepared by the G24 on international monetary reform, for instance, makes a number of recommendations (most of which reflect long-standing themes). These include calls for increased IMF lending, for IMF surveillance to encourage symmetric international adjustment between creditors and debtors, for interest rate reductions, and for developed countries to take action to roll bank protectionist measures and to discourage capital flight from debtor countries. Little progress is expected on these proposals at the meetings, but indications are that debtor countries will not be seeking a confrontational approach; there is no evidence that any debtor is contemplating the sort of radical approach advocated by Castro at the conference on debt which he hosted in Havana at the end of July, nor has any other debtor so far followed the lead of Peru in unilaterally declaring a limit to the debt-servicing it was prepared to offer. Nevertheless, debtor countries are likely to be pressing keenly for action that might ease their debt burdens. The US seems to have become increasingly concerned at the debt situation and is likely to propose a new initiative at Seoul which would involve a greater role for the IBRD.

Further details on individual countries are given below.

(i) Latin America

Argentina's economic policies continue to win endorsements from the IMF and the creditor banks. In June, the Argentine government introduced a currency reform and wage/price freeze which, along with the earlier devaluation of the peso and a number of measures designed to reduce the public sector deficit from 12% of GDP in the first half of the year to 2% in the second half, represented a radical departure from Argentina's earlier half-hearted approach to economic adjustment. In support of the new programme, early in August the IMF Board reinstated the SDR 1.4 bn Standby (agreed last December). The commercial bank debt package has now been signed, comprising $4.2 bn of new money and agreement in principle to the rescheduling of $13.4 bn of public and private sector maturities falling due between 1982 and 1985. The first disbursements of new money will depend upon the Argentines having satisfactorily met the performance criteria of the IMF programme.

Although certain deficit-reducing measures have still to be implemented - for example a banking transactions tax and an enforced savings scheme - measures already adopted - which include increases in oil prices and export taxes - have led to an improvement in public finances: in August Treasury revenues actually exceeded expenditure. Furthermore, price increases have been cut from a monthly rate of about 30% in June to only about 3% last month. Renewed confidence has reportedly also led to the repatriation of significant amounts of capital. The main concerns at the moment are that, in the run-up to the November congressional elections, President Alfonsin may ease back on his counter-inflation strategy, and that the fixing of the austral to the US dollar, and the deterioration in Argentine competitiveness that this is bound to bring about, may lead to a deterioration in the country's trade performance. Overall it is too early to judge how successful the new economic strategy will prove in the short-term or to gauge the political will of the government to maintain appropriate policies over the necessary medium-term adjustment period.

In contrast, recent developments in Brazil have given rise to more general concern about economic policy and prospects for agreement with the IMF, and this has for the time being halted progress towards a MYRA. At the end of August, both Finance Minister Dornelles and Central Bank President Lemgruber resigned because of their opposition to the direction of economic policy. Their replacements - Dilson Domingos Funaro and Fernao Bracher - are, in their dealings with IMF, likely to adopt the more expansionary line advocated by Planning Minister Sayad and Presidental Economic Adviser Rosemberg: namely, that any IMF programme must be consistent with real GDP growth of 5% per annum, and must permit increases in social spending. Meanwhile, although some action has been taken to restrain the public sector deficit, the IMF are urging an even tighter fiscal policy. In response, Rosemberg has apparently proposed a 'shadow programme' for the remainder of 1985 and early 1986, leaving negotiations on a new Standby until next year. This augurs badly for an early agreement on a MYRA. It may also dissuade banks from agreeing formally to the Brazilians' request for a 140-day rollover, from end-August, of $16 bn of short-term lines and Phase 1 maturities. Meanwhile, on the wider economic front, the pattern established in 1984 continues: the trade account is performing strongly, but the rate of inflation, artificially depressed by price controls in the four previous months, sumped by a record 14% in August after the controls were removed, pushing the rate of inflation in the twelve months to end-August back up to 227%.

Even before the earthquakes there were also worrying developments in Mexico, even though the final phase of Mexico's MYRA (covering $20 bn of debt not previously restructured) was signed on

29 August. At the time of the earthquake it had just been announced that Mexico's EFF had broken down: most of the end-June performance criteria were missed - those relating to the public sector deficit and net international reserves by a large margin. No decisions had been taken on the way forward. A Standby arrangement for next year is now a strong possibility, but it will clearly not be possible to formulate a new programme, with targets for the public sector deficit, net reserves etc, until an assessment can be made of the public expenditure implications of the earthquake and of related inflows of aid. Enhanced surveillance by the IMF, due to have started in 1986, must now be deferred. Meanwhile, the inflation forecast for the year has been revised upwards, and is now expected to be close to 60%, whilst the strong trade performance of 1984 has not been fully sustained. At the same time, the general weakening of Mexico's economic position seems to have led to some hardening of Mexico's attitude towards external creditors. Finance Minister Silva Herzog has called for partial capitalisation of interest and for more voluntary lending to Latin America, if necessary throughout the life of MYRAs, whilst President de la Madrid, has called for continuing dialogue and negotiation. The Mexicans are likely to lobby creditors at the IMF/IBRD annual meetings.

Elsewhere in Latin America, a number of debtor countries seem to be getting closer to finalising debt agreements, and some - but not all - of them have resolved outstanding issues with the IMF. In Chile, the attainment in August of a 'critical mass' of commitments to the $1,085 mn of commercial bank new money for 1985 and 1986 activated Chile's SDR 750 mn EFF (agreed earlier this year). However, commitments for $35 mn of the new money facility are still being sought, and the banks do not expect to sign the MYRA until mid-1986. Nevertheless, Chile has reached an agreement with eight Paris Club creditors on rescheduling $170 mn of maturities falling due between July 1985 and end-1986. Colombia's economic programme has been approved by the IMF Board, which also agreed to IMF enhanced surveillance of the economy until the end of 1986. Commitments to the $1 bn of commercial bank new money are still some way short of the total, but the bank Consultative Committee expect the loans to be signed, and the first tranche to be disbursed, this month. Ecuador's $200 mn new money agreement was signed in August and has now been fully disbursed; signature of the 1985-1989 MYRA is expected later this month. There is, however, some uncertainty over the country's SDR 106 mn Standby programme agreed in March. The second drawing, due after 1 August, has not been made, because, although all macroeconomic performance criteria were met, Ecuador has so far failed to unify its official and intervention exchange markets. Although Ecuador transferred most of the remaining transactions to the intervention market in the last week of August, certain transactions have been kept on the official market. The IMF Board is to discuss the situation on 20 September. The signing of Venezuela's $21.2 bn MYRA, for 1985-1989 public sector maturities, has been put back until October, although even this might be optimistic. President Garcia of Peru continues to urge radical solutions to the debt issue. In his inauguration speech of 28 July, he stated that Peru would limit debt service payments to 10% of export earnings and would by-pass the IMF in its negotiations with creditors. Nevertheless, it seems that Garcia may seek some modus vivendi with the IMF. In the meantime, Peru has asked the banks to approve a moratorium on principal falling due before 31 January 1986; the bank's Steering Committee has made no recommendation on how individual banks should respond to this request, partly because the Peruvians have given no indication of when interest payments will be resumed, nor of what their economic programme will be.

(ii) Far East

Within Asia there are increasing signs of strain between the IMF and the Philippines. The country is arguing that the conditions attached to the current Standby Arrangement have been too harsh, and that they are causing unnecessary austerity. Despite this, the IMF are asking for a further tightening of the fiscal position, as well as greater urgency to be given to structural reform. The Philippine authorities are currently assessing the situation.

As regards South Korea, in response to pressure from a number of industrialised countries, the authorities have stated that they would refrain from making drawings under the IMF Standby they have recently negotiated if balance of payments developments should turn out to be significantly better than currently expected. Meanwhile, expected GNP growth for 1985 has been revised down again to 5-6%; and, in order to achieve this rate, the government has moved to reflate the economy. Indonesia's reserves (including foreign assets of state-owned banks) still exceed $10 bn, giving a substantial cushion against the present weakness in the oil market.

(iii) Eastern Europe

Yugoslavia has finally reached agreement with the banks on terms for rescheduling 1985-88 maturities. A meeting between Poland and its official creditors to discuss rescheduling of 1985 maturities, originally set for 16 September in Paris, has been postponed until creditors are satisfied that the Poles have paid interest due at the end of August. An IMF team is to visit Warsaw shortly to assemble the remaining information for the staff paper on membership. Romania has been obliged to accept a split spread of 1 1/4% - 1 3/8% for a 5-year $150 mn loan to ease its current liquidity problems. Hungary, which now seems likely to fall well short of its convertible currency account surplus target for this year, is sounding out the banks on a possible $400 mn financing which could include more flexible options such as a note issuance facility, while Bulgaria has returned to the market for a further $125 mn credit at a margin of 3/8% and Czechoslovakia is to prepay a relatively expensive $50 mn credit arranged in 1983.

(iv) Southern Europe

There is increasing evidence in Portugal of further improvement this year in the external account and a reduction in the rate of inflation. Prospects for 1986 are clouded by uncertainty about the outcome of next month's elections.

(v) Africa

In Egypt arrears are building up on military debt, and, with little propsect of an upturn in most of the major sources of revenue (oil, overseas workers' remittances, tourism and Suez Canal dues) approaches have been made to the IMF for some form of assistance. Morocco's request for a Standby arrangement with the IMF and for a purchase under the Compensatory Financing Facility was approved by the Fund's Executive Board in the second week of September, on the basis of agreement between the banks' steering committee and the authorities on rescheduling 1983-4 commercial bank debt. This approval enabled the Paris Club to agree a rescheduling of official claims on 17 September. The new military government in Nigeria has indicated that it may resume negotiations for an IMF programme, although it is not yet clear what its attitude will be to the major obstacle of devaluation. Foreign exchange shortage has caused some interruption of medium-term debt servicing, and there has been concern about the painfully slow process on issuing notes to uninsured creditors in respect of agreed trade arrears. Restructuring of insured trade arrears awaits an agreed IMF programme.

South Africa announced a four-month moratorium on certain categories of external debt repayments, including funds borrowed in the interbank market, on 1 September. This followed the widespread cutting of lines to the country, particularly by US banks, and severe downward pressure on the exchange rate, in part because of non-resident sales of rand securities. The country will attempt to use the moratorium period to reach agreement with creditors to reschedule debt, but creditors are unlikely to wish to be seen to be too co-operative. The South African economy, however, seems to be in a strong position, with serious adjustment measures already having been undertaken over the last year, and on present economic trends one might expect the country to be able to get by without any need for "new" money. However, the political situation remains highly uncertain, and may lead to further adverse shocks on South Africa's economic performance and its debt-servicing ability. From a systemic point of view, South Africa is perhaps of less concern than other problem debtors, as the contagion from developments in South Africa is likely to be limited. Nevertheless, it remains of particular concern to the UK, not least because the highest exposure to the country rests with British banks.

Discussions continue between the IMF and the Sudanese authorities on measures which could permit a new Standby. The main outstanding issues are the exchange rate and Fund arrears. De Larosiere has invited the UK and other donors to contribute to paying off arrears, and is to call a meeting of the G5, plus Saudi Arabia, Kuwait and the Netherlands in Seoul to sort the matter out. Meanwhile, a re-rescheduling of $800 mn of unguaranteed commercial bank debt has been agreed.

(vi) Other

Following the government-sanctioned price increases in Israel prior to the latest three-month freeze, consumer prices surged by 27.5% in July, bringing the year-on-year rate to 445%. No agreement has yet been reached on measures to follow the freeze, which ends at the beginning of October. The transfer of $750 mn US supplementary economic aid is expected this month. An IMF team have arrived in Turkey for routine consultations, but Government officials have said that there is no intention to seek a further programme. Turkey broke off talks about a further Standby in April following Fund concern about the country's budget deficit and ambitious growth targets.

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INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1984	End-Dec 1984	End-June 1985 [2]	End-June 1985 [3]
Latin America				
Argentina	48	2.5	0.1	0.2
Brazil	100	6.6	0.7	1.7
Chile	19	1.3	-	0.1
Colombia	12	0.6	-	0.2
Ecuador	7	0.5	0.1	0.1
Mexico	97	6.2	0.5	1.3
Peru	14	0.3	0.1	0.1
Venezuela	39	2.2	-	-
Far East				
Indonesia	35	0.8	0.8	1.6
Philippines	26	1.3	0.2	0.2
South Korea	43	2.4 (0.5)	0.4	0.8
Eastern Europe (convertible currency)				
East Germany	13	0.6	0.1	0.1
Hungary	9	0.5	-	0.1
Poland	27	0.5	1.1	1.3
Romania	7	0.3	0.2	0.5
Yugoslavia	19	0.9	0.7	1.0
Southern Europe				
Greece	16	1.3	0.2	0.4
Portugal	15	1.2	0.2	0.3
Spain	39	2.5 (1.1)	0.1	0.1
Africa				
Egypt	32*	0.4	0.2	0.9
Morocco	12	0.1	0.1	0.2
Nigeria	18	1.3	1.9	3.3
South Africa	25	5.0 (1.1)	0.8	2.8
Sudan	9	-	0.1	0.2
Other				
Israel	30	0.5	0.1	0.2
Turkey	21	0.3	0.2	0.4

[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. (End-June 1985 figures will be available in mid-October.)
[2] Defined as unrescheduled principal disbursed, plus political claims paid and claims under examination.
[3] Defined as guaranteed principal and contractual interest, plus political claims paid and claims under examination.
Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans.
* current estimate

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MIPT: MINISTER (ECONOMIC'S) MEETING WITH CHAIRMAN VOLCKER

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1. MIPT REPORTS ON MINISTER (ECONOMIC'S) MEETING YESTERDAY WITH VOLCKER. INTERNATIONAL DEBT WAS MAIN TOPIC AS DESCRIBED IN MIPT, BUT VOLCKER TOUCHED BRIEFLY ON THE FOLLOWING AS WELL.

(A) VOLCKER NOTED THAT WE ARE PAYING LESS AND LESS ATTENTION TO STERLING M3 AND ASKED WHETHER WE WERE PLANNING TO DROP IT AS A TARGET AGGREGATE. LANKESTER SAID THAT THE RECENT RAPID GROWTH OF STERLING M3 IN EXCESS OF THE TARGET RANGE WAS ONE REASON WHY WE HAD BEEN CAUTIOUS ON INTEREST RATES. ON THE OTHER HAND, IT WAS CLEAR THAT THERE HAD BEEN A DOWNWARD SHIFT IN VELOCITY. HENCE WE WERE TENDING TO DOWN-PLAY STERLING M3'S SIGNIFICANCE AND WERE PAYING MORE ATTENTION TO MO AND THE EXCHANGE RATE AS INDICATORS OF MONETARY CONDITIONS. BUT WE HAD NO IMMEDIATE INTENTION OF DROPPING STERLING M3 AS A TARGET AGGREGATE. VOLCKER COMMENTED THAT HE COULD SEE NO INTELLECTUAL JUSTIFICATION FOR MO AS A TARGET AGGREGATE. HE ALSO ASKED IF WE WERE GOING TO JOIN THE EMS, GIVEN THE GREATER ATTENTION BEING PAID TO THE EXCHANGE RATE. LANKESTER SAID THAT MO WAS THE ONE AGGREGATE SHOWING A REASONABLY STABLE VELOCITY TREND. CONSEQUENTLY WE DID REGARD IT AS A VERY USEFUL INDICATOR. AS REGARDS THE EMS, ALTHOUGH THE ARGUMENTS SEEMED MORE FINELY BALANCED THAN IN THE PAST, THERE WAS NO INTENTION AS OF NOW TO SEEK ENTRY TO THE EXCHANGE RATE MECHANISM.

(B) ON THE US ECONOMY, VOLCKER SAID THAT HE WAS CONCERNED ABOUT THE PROSPECT OF ''TOO STRONG'' A RECOVERY IN THE FOURTH QUARTER. (AXILROD (FED STAFF DIRECTOR FOR MONETARY AND FINANCIAL POLICY) TOLD LANKESTER SEPARATELY THAT GROWTH AT AN ANNUAL RATE OF 5 PER CENT IN THE FOURTH QUARTER, THOUGH NOT THE THIRD, NOW SEEMED VERY POSSIBLE IN THE LIGHT OF THE LATEST INDICATORS.) VOLCKER SAID THAT IF THE ECONOMY REBOUNDED TOO FAST, AND GIVEN THE APPALLING FISCAL POSITION, THIS WOULD PUT EXCESSIVE STRAIN ONCE AGAIN ON MONETARY POLICY. HE VIEWED WITH ALARM THE POSSIBLE NEED TO RAISE INTEREST RATES FURTHER. IF INTEREST RATES DID RISE, AND THE DOLLAR FURTHER STRENGTHENED, THIS WOULD MAKE IT MORE DIFFICULT FOR THE ADMINISTRATION TO STAND UP TO THE CURRENT PROTECTIONIST PRESSURES COMING FROM CONGRESS, AND WOULD FURTHER AGGRAVATE THE DEBT PROBLEM.

2. FCO PLEASE ADVANCE TO PS/CHANCELLOR, LITTLER, FITCHEW AND PERETZ (TREASURY), BRAITHWAITE AND TAIT (FCO), AND LOEHNIS AND GREEN (BANK OF ENGLAND).

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INTERNATIONAL DEBT.

1. MINISTER (ECONOMIC) PAID COURTESY CALL ON VOLCKER YESTERDAY. VOLCKER WENT OUT OF HIS WAY TO STRESS THE SERIOUSNESS OF THE CURRENT DEBT SITUATION IN LATIN AMERICA. HE WAS PARTICULARLY WORRIED ABOUT MEXICO AND BRAZIL. THE MEXICANS WERE WEARYING OF SEVERAL YEARS OF AUSTERITY AND THEIR COMMITMENT TO THE QUOTE SYSTEM UNQUOTE SEEMED ON THE WANE. THE BRAZILIANS HAD DONE WELL TO DATE IN TURNING ROUND THEIR BALANCE OF PAYMENTS WHILE MAINTAINING GROWTH, BUT THE NEW ECONOMIC TEAM LOOKED VERY UNPROMISING. OF THE LARGE DEBTORS, ONLY ARGENTINA SEEMED IN RELATIVELY GOOD SHAPE FOR DEALING WITH ITS DEBT PROBLEM, THOUGH WHETHER ALFONSIN WOULD BE ABLE TO STAY THE COURSE WITH HIS ECONOMIC MEASURES WAS ANOTHER MATTER.

2. VOLCKER ARGUED THAT A NEW QUOTE PUBLIC FRAMEWORK UNQUOTE WAS NEEDED IN WHICH THE IBRD WOULD PLAY THE PIVOTAL ROLE. SOMEHOW THERE HAD TO BE A SUBSTANTIAL INCREASE IN CAPITAL FLOWS. THE IBRD COULD PROVIDE SOME OF THIS INCREASE ITSELF AND COULD BE THE CATALYST FOR INCREASED BANK LENDING. THE IMF DID NOT HAVE THE RESOURCES AND WITH ITS ANTI-GROWTH IMAGE LATIN AMERICA WAS TIRED OF DEALING WITH IT. THE IMF WOULD STILL HAVE A ROLE TO PLAY WITH STABILISATION PROGRAMMES AND PERHAPS IN ENHANCED SURVEILLANCE, BUT IT WOULD HAVE TO ACT IN TANDEM WITH THE IBRD. TO INCREASE ITS OWN LENDING QUICKLY, THE IBRD WOULD NEED TO EXPAND ITS PROGRAMME OF STRUCTURAL ADJUSTMENT LOANS. IT SHOULD INSIST ON TOUGH CONDITIONALITY, COUNTRIES WERE MORE LIKELY TO ACCEPT THIS FROM THE IBRD THAN FROM THE FUND. THE IBRD WOULD NEED TO DRUM UP SUPPORT FOR SALS FROM THE BANKS. PREFERABLY, THE IBRD SHOULD NOT ENGAGE IN GUARANTEES A LA THE RECENT URUGUAY PROPOSAL (SEE UKDEL IMF/IBRD TELNO 162). BUT THIS WAS A SECONDARY ISSUE. THE MAIN QUESTION WAS HOW TO INCREASE THE TOTALITY OF LENDING ON ACCEPTABLE TERMS.

3. VOLCKER SAID THAT A GENERAL CAPITAL INCREASE FOR THE IBRD WOULD CLEARLY BE NECESSARY BUT FOR DOMESTIC POLITICAL REASONS HE WOULD NOT PRESS FOR ONE IN THE NEAR FUTURE. INSTEAD THE IBRD SHOULD TAKE A MORE RELAXED VIEW OF THE SUSTAINABLE LENDING LEVEL AND BE PREPARED, IF NECESSARY, TO HAVE A HUMP IN LENDING COMMITMENTS. VOLCKER DID NOT MENTION A SPECIFIC FIGURE FOR INCREASED IBRD LENDING, BUT HE SEEMED TO HAVE IN MIND AN EXTRA SEVERAL BILLION DOLLARS PER YEAR. HOWEVER, HE STRESSED THE NEED FOR GOOD QUALITY LENDING.

COMMENT.

4. VOLCKER HAS BEEN ARGUING FOR SOME TIME THAT THE IBRD SHOULD BE DOING MORE ON THE DEBT FRONT. ALTHOUGH HIS IDEAS DO NOT SEEM FULLY FLESHED OUT, OUR IMPRESSION (FROM SEPARATE CONVERSATION WITH TRUMAN AT THE FED) IS THAT HE IS PUTTING CONSIDERABLE PRESSURE ON THE ADMINISTRATION TO CONSIDER THEM SERIOUSLY. SHOULD THE ADMINISTRATION DO SO, FOLLOWING MAJOR QUESTIONS WOULD ARISE:

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(A) WOULD IBRD SUPPORT (PARTICULARLY IN THE FORM OF GUARANTEES) IN FACT ENCOURAGE VOLUNTARY BANK LENDING OR MERELY ENCOURAGE BANKS TO DEMAND IBRD SUPPORT IN ALL CASES QUES.

(B) WOULD IT BE COMPATIBLE WITH IBRD'S PRIMARY ROLE OF INVESTMENT FINANCE FOR IT TO ASSUME MAJOR ROLE IN BALANCE OF PAYMENTS FINANCE QUES.

(C) DOES IBRD HAVE TECHNICAL AND MANAGEMENT CAPACITY TO PRESCRIBE AND ENFORCE CONDITIONALITY AND CARRY WEIGHT WITH COMMERCIAL BANKS QUES. CERTAINLY IMF SEEMS BOUND TO REMAIN A KEY PLAYER DESPITE ITS RELATIVE LACK OF RESOURCES AND POOR IMAGE.

(D) WHAT ARE IMPLICATIONS OF EXPANDING IBRD LENDING TO HEAVILY INDEBTED COUNTRIES FOR IBRD'S OWN FUTURE FINANCIAL HEALTH QUES.

(E) CAN ONE CREDIBLY ARGUE FOR A LARGER IBRD ROLE IF US STILL HESITATE TO ACCEPT NEED FOR A CAPITAL INCREASE- OR IF ROLE WILL REQUIRE SIZEABLE PAID IN PORTION OF ANY SUCH INCREASE QUES.

5. WE HAVE NO REAL FURTHER INFORMATION ON THE TREASURY'S RE-APPRAISAL OF DEBT POLICY ISSUES (SEE WASHINGTON TELNO 2462). ONE IDEA WHICH SEEMED TO BE GAINING GROUND WAS THAT THERE SHOULD BE A LARGE INCREASE IN IBRD GUARANTEES. BUT DALLARA (TREASURY DEPUTY ASSISTANT SECRETARY, INTERNATIONAL MONETARY AFFAIRS AND FUNDED) TOLD UKDEL THAT US HAS BEEN IMPRESSED BY ARGUMENTS PUT FORWARD BY THE UK AGAINST SUCH GUARANTEES. IN GENERAL, HE HAS CAUTIONED AGAINST OUR GETTING THE IMPRESSION THAT THE US IS ABOUT TO MAKE ANY MAJOR CHANGE IN POLICY.

6. FCO PLEASE ADVANCE TO PS/CHANCELLOR, LITTLER, FITCHEW AND PERETZ(TREASURY), BRAITHWAITE AND TAIT (FCO), AND LOEHNIS AND GREEN (BANK OF ENGLAND).

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FOR RELEASE ON DELIVERY
TUESDAY, SEPTEMBER 3, 1985
7:30 P.M. EDT

Indebtedness

DOES THE DEBT MAKE SENSE?

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

to the

NOMOS III Seminar

Cambridge, Massachusetts

September 3, 1985

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Cambridge, Massachusetts

September 3, 1985

The title of this talk -- "Does the Debt Make Sense?" -- is a phrase that comes up from time to time in discussions. The intellectual debt resulting from such explorations I gratefully acknowledge. But the trend of thought implied I find deeply disturbing. Underlying such views seems to be a feeling that developing countries made a mistake to borrow and that somehow they should call it quits. Sympathy with the tribulations of developing countries as they go through their adjustment process seems to play a primary role. Perhaps a certain lack of sympathy with banks and other lenders sometimes also shows through.

At the same time, there has been an increase in academic and other writings, usually highly sophisticated, that deal with the prospects and risks of default. Here the tendency is to regard default as a matter of possible advantage or disadvantage, and as a strategic element in the bargaining between borrower and lender. In a more moderate key, global modifications of debt contracts are proposed that would bring partial relief to hard-pressed borrowers.

My purpose in this talk is to put these ideas, often prompted by generous motivations, in a broader context. Today's developing country debt is a manifestation of one of the two most important processes in economic life -- that of accumulation of capital, the other being innovation. The two, of course, are linked, each supporting the other. The question whether the LDC debt makes sense questions the validity of one of the two great processes.

Capital accumulation is possible, of course, within economic units of all sizes -- the household, the family firm, the large corporation, the nation, the world. Progress is possible even when these units do not interlink by transferring capital from one to the other. But progress will be much faster if savings are mobile, among savings units in each country and internationally. Typically, savings flow from households to business units and, probably less productively, to governments. Internationally, an important, although by no means the largest, net flow of capital has been to developing countries. The productivity of capital can be expected to be higher where the capital-to-labor ratio is lower, although the vicissitudes experienced by investors in developing countries sometimes might make one wonder whether this is really so. The difference in living standards between the highly and less highly capitalized countries is perhaps the most plausible evidence.

The bulk of investable resources in most developing countries, to be sure, comes from their own savings. Imported capital plays only a marginal role. However, it needs to be remembered that large part of investable resources in any country with significant industry derives from depreciation allowances. These necessarily have to be generated within the investing unit. Net savings, after depreciation, are smaller and imported capital accordingly looms relatively larger.

Some countries seem to have developed almost without importing capital. Japan is such a case. Since there has been neither foreign borrowing by the government, nor on the whole by Japanese businesses, Japan's rapid growth has rested on the very high rate of saving in the Japanese economy both at the household and the business level. Although Japanese banks in the early postwar years did borrow abroad to finance trade, foreign direct or portfolio investors have not contributed significantly to the growth of Japan's economy. With its continued high saving rate and very rapid advance, Japan, of course, long has become a major capital exporter.

Most industrial countries have been simultaneously both exporting and importing large amounts of capital. The net investment position of most industrial countries tends to be small relative to their gross claims and gross liabilities abroad, including equity and debt. In other words, foreign capital has played a much bigger role in financing economic development than would appear from the net investment positions. At present, the United States, as a result of its huge current-account deficits, is ceasing to be a net creditor (including equity) to the world and is becoming a net debtor.

In the business sphere, a telling example of the advantages of being able to attract outside money is provided by the family firm. A firm that refuses to go public can borrow, but only in amounts commensurate to its internally accumulated equity capital. Typically, although not invariably, this has led to competitive inferiority and slower growth for family firms. The same is likely to apply to developing countries.

Most of the examples of capital transfers that I have mentioned have as a common feature the prospective productive use of the money. There is, of course, consumer credit at home and a certain amount of international lending of questionable productivity. In the international sphere, borrowing for consumption, such as to pay for higher priced oil, or for food imports after a crop failure, has as its typical counterpart a decline in the country's savings rate. To be able to maintain their consumption, the people of the country borrowed abroad (an act of dissaving) and paid for the imports, instead of reducing their consumption to finance them. This is a decision that a rational consumer is entitled to make. It may be a decision that would cause a prudent lender to limit more severely the amount or the terms on which he lends. It is not a decision that, if the borrower later gets into trouble, should relieve him from his financial obligations.

In general, a clear distinction between consumptive and productive imports of capital is not easily made. Project loans, such as financed by the multilateral development institutions, indeed are associated with an increase in brick and mortar, productive infrastructure and other standard-of-living-raising elements. But who is to say with certainty that the local authorities would not have financed the same projects out of their own resources and now devote the money saved to other purposes, productive or otherwise. On the other hand, imports need not necessarily consist of capital goods to be productive. Food can be imported with borrowed money, capital goods produced locally. In general, a diversified flow of imports tends to be productive. It has been estimated that a one percent increase in imports raises GNP by 0.25-0.50 percent.

Even borrowings that lead to low imports and little investment are not necessarily a permanent loss. A typical misuse of funds is capital flight. However, it can never be certain whether, in the absence of borrowing, capital flight would have been decisively less. That depends on the national policies pursued and on the priorities of the capital flighters. Moreover, at least part of the money remains available abroad. It could be attracted back home in appropriate conditions, such as positive real interest rates, realistic exchange rates, adequate investor protection, and the right of the owner to take his money out again.

In many ways, the world has entered upon a period of giving great scope to international capital movements. Markets have become increasingly integrated. Financial intermediaries can move large sums more easily than in the past. Above all, a system of floating exchange rates such as we now have permits wide swings in the current and capital accounts of the major countries, as indicated by the large U.S. current-account deficit and the large Japanese surplus. These factors represent great opportunities for international reallocation of capital. They also represent, to be sure, considerable risks for misjudgment by lenders and borrowers.

Today, the limits to prudent international lending seem to have been reached at least temporarily, for many developing countries. In many of the larger debtor countries, evidence of this is reflected in the difficulties that are being experienced. More fundamentally, the approach to these prudential limits is visible in the trade surpluses that are now emerging. Very few as yet have current-account surpluses, with exports of goods and services exceeding imports of goods and services (including interest). The emerging trade surpluses indicate that lenders have told borrowers (or borrowers have come to that realization on their own) that the full interest bill can or should no longer be borrowed and that some of it must be paid out of exports. In the balance of payments of a debtor country, the interest paid very broadly represents the difference between the goods (trade) account and the current account, since most of the other invisible items are small. A current-account surplus would mean that the country has become a net capital exporter. A combination of current-account deficit and a trade-account surplus implies that the country is covering part of its interest bill by borrowing and the rest by its own exports. A trade-account deficit implies that the country is borrowing the entire interest bill and more.

This is an important transition in the evolution of a country as a maturing borrower. In the early stages of a borrowing country's debt, while the debt is still small relative to GDP, the interest bill payable is moderate and can readily be covered by new borrowings. As the debt rises relative to GDP, that may no longer be the case. If all the interest due were to be borrowed year after year, the debt would grow at the rate of interest. In the United States, this kind of borrowing practice is often referred to as a Ponzi game. If the rate of interest happens to be equal to the rate of growth of the GDP, which under rather artificial conditions would tend to be the case, the debt and the GDP would grow at the same rate and remain in constant proportion. If the country were persistently to borrow more, in order to have an opportunity to invest from the borrowed funds, the ratio of debt to GDP would rise persistently and at some point the market would not accept this borrowing.

Indeed, the market may compel the borrowing country to slow down its borrowing for a while until it reaches a more acceptable ratio of debt to GDP. At that point, which can be defined by one or more of the familiar debt ratios, the country would have to pay for at least part of its interest out of its own resources, i.e., out of exports. This is the level of debt ratios at which many countries seem to have arrived at present.

The trade surpluses that we observe, therefore, are a perfectly normal feature in the evolution of a maturing debtor. They do not represent a repayment of capital, or a net resource transfer from the poor to the rich. On the contrary, the borrower's debt continues to grow in absolute terms, even though not in relation to GDP. The net resource transfer, as correctly measured by the current account, is inward, not outward. Interest is paid for the services of the borrowed capital, like other services in the balance of payments. These payments sustain the use of the capital and pay for the benefits that it provides.

It should be clear, therefore, that the emergence of trade surpluses does not, in any economic sense, constitute a justification for modification of loan contracts aiming to hold down interest payments or, in an extreme case, default. The argument made at a theoretical level that the "rational borrower" will default as soon as present discounted value of his future payments begins to exceed the present discounted value of what he can expect to borrow, would put an end to most international lending. Domestically, a similar argumentation would be rejected by the courts where the creditor can enforce his claims. In the international sphere, there is no enforcement.

In the nature of the maturation process of a borrowing country, the point at which part of the interest must be paid out of exports rather than entirely out of new borrowing tends to be reached at a fairly early stage. The concept of "rational default," therefore, would put a very low ceiling on international lending. In a world ruled by contract, such an approach to debtor-creditor relationships would be totally retrograde. It would also be anti-economic in that it would deprive a borrowing country of the benefits from investment of imported capital, which may greatly exceed its cost.

In a more realistic vein, the fact of default would impose substantial costs. The borrowing country would find itself isolated in the world, exposed to legal action, attachment, with a need to manage foreign-exchange balances out of reach of creditors, arranging for transportation in shipping other than his own, and with greatly increased difficulty of access to new technology. Illustrative calculations have been made on the assumption that these costs would amount to 5-10 percent of the value of trade. A plausible case can be made that, combined with the cost of being on a cash-and-carry basis, default would be more costly than a normal rescheduling for the major Latin American debtors. 1/

Discussion of default sometimes focuses on the fact that, historically, defaults have not been altogether rare. Defaults of developing countries (and of states of the Union) have occurred from time to time. The foregoing discussion, however, deals with default as a deliberate instrument of debt policy intended to maximize the borrower's advantage. The usual case historically has been one of *force majeure* imposed on the debtor by circumstances largely beyond his control. In the numerous cases of *force majeure* default, the debtor has not generally been exposed to the full rigor of creditor action so long as he did not repudiate the debt and maintain some semblance of intention to renegotiate it. Even for such less stringent cases, it seems that defaulting countries became unable to borrow in world markets sometimes for several decades. 2/

But it is not only default by which the debtor may lose his credit standing. Any modification of the loan contract that causes the lending bank injury is apt to have an adverse effect. Therefore, if the principal objective of maintaining debt service is to remain creditworthy or return to creditworthiness, even minor modifications of the original loan contract that give rise to a change in supervisory treatment may affect creditworthiness. This is significant because

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1/ Thomas O. Enders and Richard T. Mattione, *Latin America -- The Crisis of Debt and Growth*, The Brookings Institution, Washington, D.C., 1984.

2/ Jeffrey D. Sachs, "LDC Debt in the 1980s: Risk and Reforms," *Crises in the Economic and Financial Structure*, edited by Paul Wachtel, Lexington Books, Lexington, Massachusetts, 1982, pp. 197-243; Anatole Kaletsky, *The Costs of Default*, Priority Press Publications, New York, 1985, p. 88; *World Bank World Development Report*, Washington, D.C., 1984, p. 235.

it may have the effect of impeding moderate changes in the loan contract that, other things equal, would make debt service more convenient or stable.

Numerous schemes have been proposed that would ease the debt burden for developing countries. Some are already in use, and acceptable to banks. These include multi-year rescheduling, reduction in spreads compared to prior reschedulings, and in fees. Others are more severe, including capping of interest rates, capitalization of interest, buying out of banks at a loss, limiting debt payments to some fraction of export receipts, and many others. The proponents of these try to justify the loss inflicted on banks with the need to make the banks share in the cost of a perhaps basically misconceived loan. But loss of creditworthiness for an indefinite future is a high price to pay for current debt relief. In principle it might mean that, if the country amortizes loans already outstanding, it would become a capital exporter. That is contrary to the structure as a developing country. Regularizing the debt service must lead,with a lag perhaps,to renewed creditworthiness as debt ratios are reduced. Creditworthiness must imply ability to replace maturing loans as well as obtain new loans that would raise total indebtedness although not the country's debt ratios.

The premise that a country must continue to borrow and its debt be able to rise over time rests on the willingness of the banks to make such loans. Banks have shown a willingness to continue lending to creditworthy countries. In East Asia, most countries have had no difficulty in accessing the market. In other parts of the world, Turkey has been able to go back to the market after a period of troubled debt. Hungary and the DDR, after some market hesitation but no interruption of debt service, are again welcome in the market. Broad support for lending, therefore, seems to exist, even though some smaller banks have indicated that they wish to withdraw from this business.

In any event, however, banks are limited in what they can do by their capital. Bank capital has been increasing, partly under regulatory pressure, providing a broader base for lending. Nevertheless, it must be recognized that medium-term bank credit is not the ideal form of developmental financing. Neither is floating-rate credit, although it may be the best that can be had under today's circumstances. But the great proliferation of new instruments, and the increase in the mobility of capital, provide opportunities for new efforts of development financing. Many have been suggested. The structurally most appealing would be an emphasis on equity financing. Developing countries have emphasized debt because it was cheapest, at least while real interest rates were low or negative, and because it avoids handing over to the supplier of capital a piece of the action. This is not a sound financial technique where significant risks must be incurred. The growth of corporations has had to have an equity base in addition to debt financing. The same must apply to developing countries. It is in the direction of equity investment, in the form of direct investment, portfolio equity investment, investment funds, and the like, that recent progress in the capital markets can best be put at the service of developing countries.

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Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

as Member of the Overview Panel

at the

Symposium on "The U.S. Dollar --
Recent Developments, Outlook, and Policy Options"

Sponsored by the Federal Reserve Bank of Kansas City

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If I look at the dollar, which is the principal topic of this panel, I think we can fairly say that, at considerable cost to the American economy, considerable benefits have been achieved. At home, inflation has been cut to one-third or one-quarter of its earlier level. Abroad, the United States has acted as a locomotive, pulling the world economy out of a recession. The costs to foreign countries, in terms of higher interest rates and higher prices, are less than the benefits. Higher interest rates are to some extent in the discretion of these countries since on a floating exchange system they can allow their currencies to go down instead of raising interest rates to prevent this. The price increases resulting from the lower value of the currencies evidently have not prevented an almost universal reduction in inflation rates abroad. The reason for this, I would think, is that the prices of many of their imports, although invoiced in dollars, are actually determined by world markets. A strong dollar depresses the price of world market commodities, especially oil. As for higher interest rates and the alleged draining of investment funds from foreign countries to the United States, I would remind you that most foreign countries operate with substantial excess capacity, unemployment, and, therefore, low utilization of potential. Bringing their economies up to full employment would generate additional savings that could offset the drain to the United States.

For us at home, the benefits of the high dollar are, I think, overmatched by its costs. Inflation has been reduced, but some of this gain may have to be given back if and when the dollar comes down. We have had a good investment performance, but not all that much better than in the past. The ratio of business fixed investment to GNP has increased only moderately over past peaks on a gross basis and is lower on a net basis. Meanwhile, the domestic debt burden has increased substantially and the foreign debt of the United States has increased to the point where we have become a debtor country. We have largely lost the net investment income that used to be a great support of our current account.

Even so, if there were a way of changing course now and stopping a continuation of the adverse trends I have cited, one might say that we had incurred an affordable cost in return for substantial benefits. The difficulty lies with the future.

Several of the earlier speakers have focused on the Fed and, in my way of thinking, done us more honor than we deserve. The Fed is not the only game in town; there are others. But even if it were, that does not mean that we should play them all. Neither can the Fed be held responsible for the inability of the original administration program to deliver all it promised.

Rates of growth that would have raised revenues to the point of balancing the budget after massive tax cuts were not prevented by the Fed. In my view, they were unlikely to begin with. I was somewhat startled to hear one speaker say that the administration was prepared to settle for an 8 percent inflation in the near term, instead of the 4 percent that developed. I had not heard this from my Washington friends who stayed with the administration. The clear anti-inflationary stance of the administration, to my thinking, has often been documented.

To underscore my comment that the Fed is not the only game in town, let me draw your attention to some things that are going on with respect to the international monetary system in which the dollar has had such a spectacular career. A study of the areas in which this system could be improved was completed a couple of months ago and will be at the center of discussion at the Seoul meeting of the International Monetary Fund and other bodies hereafter. I am surprised how little attention has been paid at our meeting here to what, after all, constitutes the principal concerted effort of the major industrial countries in the direction of monetary reform. Granted that the results are modest, a fundamental question nevertheless has been put on the table. It is whether the present system of floating rates, which has not performed satisfactorily in the opinion of most observers, is inherently defective, tending to extreme fluctuations, or whether this performance results from inappropriate use made of the system and excessive pressures placed upon it. In the former case, trying to change the system in the direction of greater stability would merely have the effect of pushing some of the inherent instability of the world economy into some area other than exchange rates, for instance, into growth, inflation, and employment. If, on the other hand, the use made of the system was inappropriate, then agreement on better use may be the remedy.

In the report, there is considerable discussion of "convergence" as a means toward more stable exchange rates. The question, not answered very explicitly, is whether this convergence relates to performance or to both performance and policies. While the report was being developed, increasing convergence of performance occurred, especially in the area of inflation control. Almost all major countries were coming below double-digit inflation rates. The three largest countries were coming below four percent. Nevertheless, as inflation performance converged, the dollar took off. This seems to suggest that convergence of performance must be supplemented by convergence of policies. This means, unfortunately, that even if the system is not inherently flawed, improvements needed in its use are of a very demanding kind.

Let me now turn to the area on which much of the discussion at this meeting has focused -- the Federal Reserve's role with respect to the dollar. The great problem that the dollar poses for monetary policy is that the dollar is essentially unpredictable. The papers presented to the conference make clear that we have no reliable theory of exchange-rate determination. In other words, the dollar is a wild card. It is indeed discouraging to find that economics, having demonstrated its inability to predict the stock market and interest rates, now also seems to have failed with regard to exchange rates.

The dollar seems to be determined by forces to which perhaps we can give a name, but the workings of which we do not understand.

If we did understand them, it still is not clear in which way policy should seek to influence them. There are risks and costs associated with both a high and a lower dollar. A high dollar, if maintained, would push us toward protectionism. It would increase our foreign debt at an exponential rate, reaching a trillion dollars within very few years. It would continue to erode the core of our economy, manufacturing industry. As for the ultimate level of the dollar, if and when a rate consistent with some sort of equilibrium is reached, that equilibrium rate would have to be lower the longer it takes to reach it, as annual debt service charges build up.

A lower dollar would cause inflation to accelerate. By improving the current account and so reducing capital inflows, it would drive up interest rates unless the budget deficit had been meanwhile materially improved. The negative effects of a decline in the dollar would be the bigger the less orderly a downward movement, and the more severe the loss of confidence and credibility. A substantial rise in interest rates would carry the threat of recession. Even though a rise in interest rates resulting from smaller capital imports should be compensated to some extent by stronger net exports, the timing probably does not match. Markets might anticipate the movement of interest rates, whereas the improvement in the current account would take time. Indeed, we may not have the productive capacity in our weakened manufacturing sector to step up exports very fast without price pressures. For these reasons, an improvement in the budget deficit that would relieve pressure on capital markets is urgently needed as accompaniment of any decline in the dollar.

It is in the light of these considerations that suggestions made in some of the papers and at this meeting that the Federal Reserve should somehow push down the dollar must be examined. I believe that any such deliberate action would be damaging to inflation expectations. It might be damaging to our prospects of getting long-term interest rates down. The markets would find it difficult to adjust to such a Federal Reserve departure. Unpredictable and possibly disorderly movements in the exchange market could follow. I mention only in passing that a policy of pushing down a falling rate is contrary to IMF rules for floating which to be sure are not very closely observed in practice. It might also bring us in conflict with foreign countries whose views as to the proper dollar rate for their currency might not accord with ours, if we operated so as to make them believe that we had a rate objective.

Other speakers have commented on and, to some extent, criticized the proposal by Ron McKinnon. By this proposal, the Federal Reserve and the central banks of Germany and Japan should coordinate their policies. When one of them found its money supply contracting, the others should expand, and vice versa, keeping the "world money supply" approximately stable. There may be situations in which such a procedure was feasible and desirable. But just to give a contrary example at this time, now that the U.S. money supply has expanded strongly in the middle of 1985, should we urge the central banks of the two other countries to engage in countervailing contraction? Would this not completely ignore the situation of the world economy, which is one of slowing expansion both here and abroad, with inflation still relatively modest? McKinnon's suggestion to give attention to the exchange rate as an indicator of the stance of monetary policy is a good one. It is already being followed by the Federal Reserve, as Federal Reserve policy records and Congressional testimony make clear. But the level of the dollar can only be one indicator among others, although one of growing importance. Targeting on the dollar, especially with a downward bias, would require giving up the existing money-supply targets and risk provoking a new burst of inflation.

Monetary policy, now as on many occasions, is in the difficult position of having to pursue several targets with only one instrument. Except on rare occasions where something is seriously amiss, such as the weak dollar in the fall of 1978, and the acceleration of inflation in late 1979, policy cannot ignore the multiplicity of objectives. It can and must, however, bear in mind that by its nature it can be fully effective only in the pursuit of one objective -- that of price stability. Its influence on growth and employment is transitory, strong in the short run but with counterproductive side effects in the longer run and eventual washing out of growth and employment effects. Monetary policy will be most effective when it avoids overreaching itself.

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REPORT
FROM THE FEDERAL REPUBLIC OF GERMANY

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August 13, 1985

STATEMENT BY FINANCE MINISTER GERHARD STOLTENBERG CONCERNING THE INTERNATIONAL DEBT CRISIS

(Text released by the Federal Ministry of Finance, August 8, 1985.)

In recent weeks public attention has once again focused on the international debt crisis. Several countries, above all in Latin America, have made important decisions in connection with reorienting their economic and monetary policies. New demands have been raised for the industrial countries to take further steps to relieve financial pressures. For awhile, public attention was centered on a call to boycott repayment of debts, heard at the spectacular conference held by Cuban dictator Fidel Castro in Havana.

The size of the foreign debt accumulated in the 1970's continues to be a heavy burden for most of the Latin American countries. At the end of 1984 the foreign debt for this continent alone mounted to about 360 billion dollars while total debt for all emerging and developing countries came to about 800 billion dollars. Since 1982, however, global indebtedness has decreased as a result of a considerable expansion of world trade, assistance from the international monetary fund and numerous domestic readjustment programmes. Thus, the balance of payments deficit for all emerging and developing countries has been reduced from 99.5 billion dollars per year to 43.9 billion dollars in 1984, and in Latin America from 42.1 billion dollars to as little as 5.5 billion dollars.

Negotiations on rescheduling debts at more favourable terms have at least given debtors a breathing space and interest rates have fallen compared with their 1981 - 82 peak levels. However, many countries must continue to devote a very large part of their export earnings to debt servicing and in some countries the situation is deteriorating once again.

Castro repays his quite considerable debts to the Soviet Union on agreed terms, although repayment schedules are occasionally lengthened by agreement. His crisis-ridden country receives about 4 billion dollars per year in financial aid from Moscow partly in the form of loans and partly in the form of outright grants (above all in the military sector). The Soviet leadership, which initiated the political campaign aimed at bringing about a boycott on repayment to western governments and banks, insists on repayment of capital and interest in connection with its own loans. This also applies to the dependent and allied

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Marxist-Leninist regime in Cuba. Moreover, Fidel Castro himself attaches great importance to Cuba's continued credit wothiness with western 'capitalist' governments and banks, to which he owes about 2 billion dollars. Unnoticed by the public he concluded a debt rescheduling agreement stipulating firm conditions for new repayment targets with the western creditor countries within the framework of the 'Paris club' on the eve of his Havana conference of July 18. At the same time he expressed an interest in taking new loans. A similar agreement with the Federal Republic of Germany has not been possible since Castro has thus far refused to accept the internationally recognized inclusion of Berlin in such agreements.

This shows that the cuban slogans lack all credibility. They are designed to exploit the debt crisis as a means of breaking up financial and economic relations between the western industrial countries and as many Latin American countries as possible. At the same time the Cuban dictatorship knows very well that he himself continues to be dependent on capital inflows and, as such, the maintenance of credit worthiness in the west.

The industrial countries, their governments and their banks will have to make considerable efforts to master and gradually solve the international debt problem. These efforts must include the further opening of western markets, more flexible arrangements for long-term debt rescheduling and a concerted domestic economic and monetary policy that will continue to make it possible for interest rates to fall in the future. In this respect the United States has a particular responsibility, given the significance of the dollar.

Contrary to what was said at the Havana conference, the International Monetary Fund and the World Bank will continue to play a central role for the western industrial countries and the vast majority of developing countries. If any deeply indebted country were unilaterally to refuse to meet its financial obligations, it would immediately loose credit worthiness and suffer serious social and economic consequences. However, it remains an important task for all IMF and World Bank member states to continue to improve the instruments needed to master the crisis. The annual meeting of the IMF and World Bank on October 6-12 in Seoul will again address this task.

15. [illegible] PM 3 5

Prime Minister
AT 29/7

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

26 July 1985

A Turnbull Esq
10 Downing Street
LONDON
SW1

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.

In its survey of external economic developments, the Bank's paper notes the continuation of the more favourable outlook noted last month on interest rates and the US dollar. This is offset by uncertainties about economic developments in the US and sluggish commodity prices, including oil, where OPEC have just agreed small price cuts. The extent to which individual debtor countries are affected by these factors varies considerably: most notably in relation to oil. Their positions vary widely and require continuing improvisation in the approach taken by creditor governments.

Uncertainties continue on the political front too. There has been little sign of life from the Cartagena Group since the spring, but it could be fanned into life, either by action in a single country (eg Peru), or by an external stimulus such as the forthcoming Havana conference which is likely to promote a confrontational approach to the debt problem.

On individual countries, it is worth drawing attention to Peru. Last month we reported that the new regime seemed intent on an early break with the IMF and a more radical approach to debt problems, with the risk of a knock-on effect elsewhere. Latest reports suggest a more cautious approach and we have agreed with other main creditors, including the US, to encourage more moderate policies. Further indications of their intentions may become available after Garcia's inauguration at the end of this month.

Poland finally signed, on 15 July, the 1982-84 Paris Club agreement negotiated at the end of last year without promises of new credits. Signature was accompanied by an informal exchange of letters recognising the higher probability of the need for further debt relief towards the end of this year. Thus the Poles have been kept in play for the time being, but the long term financial outlook remains very poor.

In Latin America, Argentina has introduced a shock package, including a new currency and price and wage controls. This is designed to cut inflation and to supplement the measures contained in their June letter of intent to the Fund. The measures have been well received but in the absence of detail on the "follow-through" action to cut the public sector deficit, it is too early to judge the chances of success.

Brazilian negotiations with the Fund are proceeding very slowly. Some measures to reduce the public sector deficit have been taken but more are required. The commercial banks will need to decide whether to roll over on 31 August inter-bank and trade facilities worth some $16 billion. The ease or difficulty with which this can be done is likely to depend on the signals which the Fund can give on progress in the negotiations.

The next report on the International Financial Scene will come forward in late September, as background to the Commonwealth and Fund meetings. Before then the Treasury and Bank will be doing some analytical work on the economic prospects of the main debtor countries. The outcome of this will be taken into account in our September report.

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

Yours ever
Rachel

RACHEL LOMAX

CONFIDENTIAL

INTERNATIONAL FINANCIAL SCENE

The most interesting developments recently have been the agreement of a new Argentine Letter of Intent and the introduction by Argentina of major new measures to reduce quickly and sharply the country's rate of inflation. A number of creditor countries were persuaded on the basis of these developments to give Argentina bridging finance to enable the country to reduce its arrears, thus avoiding the downgrading of the country's loans by the US regulators. The IMF Board will meet (probably around mid-August, although no date has yet been scheduled) to consider whether the adjustment measures taken by the Argentine authorities are sufficient to warrant the re-instatement of their Standby programme which has been in abeyance since last December. Meanwhile, discussions have resumed between Brazil and the Fund to agree a new Letter of Intent. Whilst these developments are certainly welcome, Argentina and Brazil have disappointed expectations a number of times over the past couple of years (and indeed there are reportedly still serious differences between Brazil and the Fund), so it would be premature to claim that a turning point has been reached. Nevertheless, if these two major debtors are able to agree, and adhere to, convincing Fund programmes over the next few months, this could do much to offset the immediate factors that generated gloom over the debt situation in the early part of the year. Conversely, if these debtors fail to agree (perhaps, for instance, as a repercussion from a major row that might develop between Peru and her creditors), this will make the overall debt outlook distinctly more threatening.

Meanwhile, recent external economic developments for most debtors have been broadly favourable. Eurodollar interest rates have stabilised, and the three month rate - now below 8% - is more than four percentage points lower than it was this time last year. Moreover, although growth in the US is apparently slowing down -

GDP in the second quarter grew at a rate of only 1.7% - the US trade deficit (which is more immediately important for the debtors) continues to widen, and is now officially expected to be $30 bn larger this year than last, and further import growth is also expected in the other major industrial countries. The continued weakness of the oil price at the moment benefits the majority of debtors; and the recent depreciation of the dollar helps those debtors whose debt is largely denominated in that currency.

Nevertheless, a number of uncertainties persist. The US current account deficit is clearly unsustainable, and correction will involve some combination of domestic deflation and/or further depreciation and/or increased protection. The great worry is that protection may play a major part in the corrective process. At the same time, whilst it is generally accepted that the US economy will not achieve the growth rates it experienced over the last couple of years, there is no sign that other industrialised countries are willing to take deliberate steps to take up much of the slack. Debtors are likely therefore to experience problems maintaining the volume growth of their exports. With commodity prices still remarkably sluggish for this stage of the economic cycle (non-oil commodity prices slipped back a further 2.4% in SDR terms in the five weeks to the beginning of July, and are now roughly back down to their level of early 1983), primary producers in particular are likely, if world trade slows, to find difficulties in maintaining the prices of their exports. On both counts therefore export values are likely to come under pressure.

The most important of these commodity markets, both for producers and consumers, is that for oil. The real price of oil has, on some measures, fallen by 7% this year. As noted above, falling oil prices should benefit the bulk of debtors. However, for a number of debtors, such as Nigeria, Venezuela, Mexico and Ecuador, oil revenue accounts for the majority of export earnings (for the first two of these countries over 90% of the total), so any fall in the oil price will have serious implications for them. Recent cuts in the price of Mexican and Soviet crude, and - even more importantly - the continued inability of OPEC to reach full agreement, make the prospects of sizeable further price cuts more real. Especially if price cuts are substantial, the relatively limited benefit the importers gain may well be over-shadowed by the serious impact on the exporters. Venezuela may have some cushion against price cuts, but could find its position very difficult if the cuts are sizeable; most of the other oil exporters are facing major problems, even at present price levels.

Further concern derives from the increasing difficulty experienced by a number of countries in filling all their financing gaps. Additional IMF resources are no longer available to several countries, and indeed some of them should soon start making net repayments to the Fund. Banks remain anxious to minimise the commitment of new money, and generally insist as a condition of agreeing a MYRA that no further new money will be provided. The filling of financing gaps in the future may therefore require flexibility and innovation: in the case of Chile, for instance, banks refused to fill the identified financing gap themselves, but Chile managed to fill it by obtaining an additional IBRD B-loan, and by seeking official debt relief from its four major creditors*

Economic performance amongst debtor countries has recently been mixed. The Brazilian trade surplus has revived, and the $11.7 bn target for the year looks attainable. Exports from Korea too have revived, after a sluggish beginning to the year. Mexico's exports on the other hand - both oil and non-oil - remain somewhat depressed, prompting calls for further measures to improve the country's competitiveness. On the internal side, there seems to have been some modest improvement in the performance of a number of debtor countries. In addition, both Argentina and Brazil have introduced significant adjustment measures; Chile too has introduced new measures in line with IMF recommendations. In all of these, however, it is too early to say what impact the measures will have on performance.

Meanwhile, the incoming Garcia Government in Peru has continued to threaten a more radical approach to that country's debt problems, involving a limit on interest-service payments, and no relationship with the Fund. At present there is little sign of

* now extended to a wider group of creditors (including the UK).

this attitude spreading amongst the Cartagena Group (or indeed of quite how seriously it is held within Peru itself), but clearly any action the Peruvians might take, and the response this is perceived to generate from the creditors and the international community, may well have serious knock-on consequences for the debt situation elsewhere. For the moment the Cartagena Group is considering how to take its proposals forward in the light of the replies it has received to its message to the Bonn Summit. Most of these replies re-iterated governments' endorsement of the present ad hoc strategy, but in a separate and tendentious message Cheysson (EC) expressed firm support for the objectives of the Cartagena Group. Meanwhile, the political temperature has been raised somewhat by a Cuban invitation to the Latin American debtors to attend a conference in Havana at the end of the month on easing the debt burden (by confrontational methods).

A significant capital market development has been the $1 bn syndicated loan negotiated for Colombia. Although Colombia is the only major Latin American borrower not to have rescheduled maturing debt, the deal incorporates IMF monitoring of the economy and is thus yet another package (after those for Mexico, Venezuela, and Ecuador) which sets up a long-term role for the Fund. Elsewhere, there have been a number of new loans for countries in Eastern Europe.

More details on the major debtors are given below.

(i) Latin America

In mid-June, the authorities in Argentina introduced a package of far-reaching measures designed to cut inflation drastically and rapidly. A new currency (the austral) was introduced and fixed to the US dollar, wages and prices were frozen, after a sharp rise in public sector tariffs, and interest rates on deposits were cut from 30% per month to 4% per month. With prices having risen by over 1,100% in the year to end-June, the decision to supplement the restrictive demand policies of the revised IMF programme (enshrined in a new Letter of Intent presented on 11 June) with more fundamental reforms, indicates a welcome commitment by the

Argentine authorities to tackling their domestic economic problems. It is, however, too early to assess the impact of these reforms and their chance of success. A better impression may emerge by the time of the meeting of the IMF Board (scheduled for early in August), at which the Argentines' request for reinstatement of the SDR 1.4 bn SBA (agreed last December) will be discussed. The revised programme envisages a reduction in the public sector deficit from 11.3% of GDP in 1984 to 2.6% of GDP in the first quarter of 1986, and settlement of all external arrears by March 1986. It is still uncertain whether the recent reforms will prove compatible with the IMF programme, but it is clear that the Argentines have finally recognised that they have to come to grips with their problems, so that for the moment at least, they are likely to be given the benefit of the doubt. As an example of this, the US, BIS and a number of Latin American countries made a $460 mn bridging loan to Argentina in June to enable the country to reduce interest arrears on public sector debt (making interest current to end-February). Additionally, these developments persuaded the US banking regulators not to downgrade Argentine loans - although they have urged the banks to treat these loans conservatively in their accounts - and should help the banks' Working Committee in its attempts to relaunch the Argentine debt package (rescheduling of $14.5 bn of 1982-1985 maturities and provision of $4.2 bn of new money) this month.

In Brazil, negotiations with the IMF are continuing, but progress has been slow. The existing EFF has been abandoned and the aim is to replace it with a Standby arrangement; the new programme is unlikely to be put to the IMF Board before the end of August. Meanwhile, Finance Minister Dornelles has introduced a number of measures since the end of April aimed at reducing the public sector deficit. Further measures to reduce the deficit are, however, required, and there are reports of continued disagreements between Dornelles and Planning Minister Sayyad over how - and indeed whether - such measures should be implemented. For their part, the banks have agreed a rollover (to end-August) of the interbank and trade facilities which expired at end-May. The banks and the Brazilian authorities are still aiming to complete a MYRA, provided Brazil can reach agreement with the

IMF. Parallel action by governments (although on a smaller scale) will also be necessary: preliminary discussions have been held with the Paris Club Secretariat.

In Mexico, now that the MYRA is in place, worries are emerging that the strong external performance of the previous two years is not being sustained. The prospects for oil are worsening and Mexico has announced cuts in the price of its oil. Non-traditional exports are depressed. In response to this situation, the Mexican authorities recently permitted commercial banks to operate in the 'parallel' market for the peso, and then allowed the, previously unofficial, parallel rate to replace the official free market rate; these changes effected a partial devaluation within the official dual exchange rate system. Official results from the Congressional and State elections earlier this month indicate that the ruling PRI party has gained widespread victories, but the opposition is denouncing the elections as fraud. It is reported that, now the elections are over, the government will be introducing further cuts in public expenditure.

Elsewhere in Latin America, a number of countries have made progress towards resolving their immediate debt problems. In Chile, negotiations with the banks' Advisory Committee have been concluded, with a preliminary agreement covering $1.085 bn of new money in 1985 and 1986 and rescheduling of $5.99 bn of maturities falling due between 1985 and 1987. Of the new money, $300 mn represents IBRD B-loan cofinancing, with the IBRD guaranteeing half of the amount. The package is now in the process of being put to creditor banks, who will need to be assured about Chile's prospects of negotiating the rescheduling of $170 mn of official debt; the Chileans have reportedly been assured by the Chairman of the Paris Club (without proper authority) that this rescheduling will not affect Chile's access to further official cover.. Agreement has also been reached between Colombia and the banks' Consultative Committee on a $1 bn new money deal, involving IMF/World Bank monitoring of the Colombian economy. The "roadshow" took place early in July, the Colombians then aiming (optimistically) to get the package in place by 15 July, when the

IMF Board met to discuss Colombia's last Article IV report. In Ecuador, the moratorium on commercial bank debt has been extended to the end of September to allow the remaining thirty banks to commit to the $200 mn of new money for 1985 and to the 1985-1987 MYRA. It is now hoped that the package will be signed in August. The "roadshow" marketing Venezuela's $21.2 bn MYRA, for 1985-89 maturities, took place in June, and there is every chance that the agreement will be signed in September.

However, no progress has been made with Peru. The spokesmen of President-elect Alan Garcia, who is scheduled to assume office on 28 July, have indicated that the banks can expect no more than token interest payments in the coming months during which period the new team intends to put together a new debt scheme, possibly involving the setting of upper limits on debt service payments and a refusal to allow any IMF involvement in the Peruvian economy. The US banking regulators have decided not to downgrade loans to Peru to the "value impaired" category at this stage, but have kept them in the "sub-standard" category until they have a clear indication of the debt policies of the new administration.

(ii) Far East

Within Asia these is little new to report on the Philippines. It seems, on the basis of limited economic data for 1985, that the authorities have managed to regain control of monetary growth. Inflation is coming down to under 30% (a.r.) in June (from 64% last October) and the trade deficit continues to narrow. South Korea's request for a 20-month SDR 280 mn Standby arrangement was approved by the IMF Board on 12 July. However, it is not yet known how successful the efforts by G5 countries were to persuade the Koreans not to draw funds down unless the country's balance of payments were to weaken markedly. Whilst Korean economic performance has improved over the past few months, a cloud remains over part of the financial sector: from 1 July the Bank of Korea is to provide special soft loans to a number of domestic banks. As regards Indonesia, the Inter-Governmental Group, IGGI, met on 4-5 June when $2.4 bn was pledged in official assistance for FY 1985/86 (the same level as FY 1984/85).

(iii) Eastern Europe

At a meeting of the Paris Club on 15 July, Poland signed the 1982-84 Agreement, but there was an informal exchange of letters recognising the high probability that the Poles will need to return to Paris toward the end of the year to seek further debt relief. Further progress has been made in discussion between the Poles and ECGD on the terms of the bilateral agreement implementing Paris Club rescheduling for 1982-4, but there remain difficulties over the interest rate. It is hoped to sign the 1985 Paris Club Agreement in September provided that the Poles have made the downpayments required under the 1982-84 Agreement by that time. The Yugoslavs and the banks met in Washington on 9 July to discuss monitoring arrangements, and are expected to meet again later this month in an effort to resolve the continuing impasse on pricing in connection with the rescheduling of 1985-88 maturities. Romania, currently faced with liquidity problems, met the four agent banks involved in its earlier reschedulings in London on 26 June and 10 July to discuss its request for a $150 mn five-year syndicated loan; the banks were reasonably sympathetic. Meanwhile, Hungary has warned that its export performance so far this year has been weaker than anticipated, and that its targetted hard-currency current-account surplus of $400 mn is unlikely to be acheived.

(iv) Southern Europe

There are encouraging reports from Portugal of a significant improvement in inflation and of a favourable trade performance in the first four months of the year. Following the collapse of the coalition government, however, a period of political uncertainty lies ahead. The president is to call a general election, probably for early October.

(v) Africa

Morocco has requested both a follow-on Standby arrangement with the IMF and a purchase under the Compensatory Financing Facility to meet excess cereal import costs. The Board was due to consider the request on 12 July, but the discussion has now been put back to August. Nevertheless, final agreement on commercial bank rescheduling of 1983-4 debt is expected shortly and an agreement covering 1985-6 maturities may soon follow. A mission from Warburgs went to Washington on behalf of Nigeria in mid-July following indications that the authorities might now be willing to accept the conditions for a Fund programme, including a substantial devaluation. Depending upon the outcome, a Paris Club taskforce would be ready to go to Lagos if that would help to clinch a deal. A further $539 mn of promissory notes has been issued to a large number of uninsured creditors, the previous two issues having been confined to debts owed to multinational companies. A final, much bigger, issue is expected in August. Progress on reconciling insured creditors' claims with importers' submissions remains slow.

The outlook for South Africa is paradoxical. On the one hand, a sharp deterioration in the South African government's international political standing and behaviour is leading inexorably to the imposition, as a warning shot across its bows, of selective economic measures, notably by the United States. On the other hand an improvement in the current account of the balance of payments, after firm fiscal and monetary adjustment, has made possible significant repayments of short-term debt, which forms the bulk of its external debt. The international measures now being formulated seem unlikely to have much practical economic effect, but more severe sanctions could follow if South Africa fails to undertake further internal political reform. An IMF mission is currently in Sudan to discuss with the authorities the adjustment measures necessary to attract further donor support; provided arrears to the Fund are cleared, a later mission could negotiate a new Standby arrangement.

(vi) Other

Israel has announced a further series of emergency measures in an attempt to halt the continued deterioration in its economic situation. It is hoped that the measures will encourage the US to agree to the release of the $750 mn emergency economic aid approved earlier in the year. There is some concern about Turkey's trade performance; in the first four months of the year the trade deficit widened to $1 bn ($0.6 bn in the same period in 1984), although the May figure showed a considerable improvement. The OECD in its annual report was critical of current policies and warned of the vulnerability of the balance of payments position.

CONFIDENTIAL

INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1984	End-Dec 1984	End-Mar 1985 [2]	End-Mar 1985 [3]
Latin America				
Argentina	48	2.5	0.1	0.2
Brazil	100	6.6	0.7	1.7
Chile	19	1.3	-	0.1
Colombia	12	0.6	-	0.2
Ecuador	7	0.5	-	0.1
Mexico	96	6.2	0.5	1.2
Peru	14	0.3	0.1	0.1
Venezuela	39	2.2	-	-
Far East				
Indonesia	35	0.8	0.7	1.6
Philippines	26	1.3	0.2	0.2
South Korea	43	2.4 (0.5)	0.4	0.8
Eastern Europe (convertible currency)				
East Germany	13	0.6	0.1	0.1
Hungary	8.5	0.5	-	0.1
Poland	27	0.5	1.1	1.2
Romania	7.5	0.3	0.2	0.4
Yugoslavia	19	0.9	0.7	1.0
Southern Europe				
Greece	16	1.3	0.2	0.4
Portugal	15	1.2	0.2	0.3
Spain	41**	2.5 (1.1)	0.1	0.1
Africa				
Morocco	12	0.1	0.1	0.2
Nigeria	18	1.3	1.7	3.2
South Africa	25	5.0 (1.1)	0.7	2.7
Sudan	9	-	0.1	0.1
Other				
Israel	30	0.5	0.1	0.2
Turkey	20	0.3	0.2	0.3

[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] Defined as unrescheduled principal disbursed, plus political claims paid and claims under examination.

[3] Defined as guaranteed principal and contractual interest, plus political claims paid and claims under examination.

** End-June 1984

Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans.undisbursed commitments where these exceed $1/2 bn.

INDEBTEDNESS ccPG

AFRICA: THE CHALLENGE OF ADVERSITY

INTRODUCTION

A quarter of a century ago Harold Macmillan, as he then was, made one of the most memorable speeches of his career to the South African Parliament in Cape Town. One passage has been particularly remembered. ''The wind of change is blowing through this continent and, whether we like it or not, this growth of national consciousness is a political fact. We must all accept it as a fact, and our national policies must take account of it''. It is the wind of change that has largely shaped the Africa of today. I should like to talk about its problems and the implications for us in Britain.

Macmillan was speaking of a continent with which Britain has strong historical links. Much of Africa was once under direct British rule, and still more under British influence. Our intense interest in Africa is therefore understandable but it is not just a reflection of our colonial past. Our interest grows out of deeply held principles - a commitment to peace with freedom and justice and prosperity throughout Africa.

Of course it is Africans who will shape Africa. But we are bound to look at it in the light of the questions: what has Britain contributed to Africa? What can we do now to help - to help ourselves, as well as Africa - on the path to peace and prosperity?

Our contribution to Africa has been diverse. Not everything has survived and indeed not everything deserved to do so. But to our credit we did attempt to implant there many of those institutions which we cherish most highly within our own society: parliamentary democracy; peace, law and order and justice; a non-political Civil Service; education. It was inevitable that institutions nurtured in our own very different conditions should be subject to change and adaptation to African circumstances; but much still remains, a foundation of common heritage which binds us together and on which we can build.

In 1960 Macmillan saw the great issue of the second half of the 20th century as 'whether the uncommitted peoples of Asia and Africa will swing to the East or to the West?' It has now become clear that communism has not provided the answer to Africa's needs. According to definitions of official development assistance endorsed by the United Nations, Soviet economic aid to Africa over the five years to 1983 has only been 27% of that given by Britain alone. In the famine areas the Soviet response to humanitarian needs has been tardy and limited. India has already given ten times more aid to Ethiopia in the past six months than the Soviet Union. Instead the Soviet Union has concentrated in the main on exporting guns and revolution, when the real need is for aid and sensible economic management. Certainly those African countries which have adopted the Soviet model have found their economic problems only exacerbated.

Africans reject the suggestion that they can be bought by either East or West. They wish to remain free to develop in their own way. However, the problems facing them are immense. Since the early 1970s the energy crisis has seriously affected those countries which do not have their own oil supplies, many of them among the poorest. The world recession has undercut export markets. Rising population, environmental degradation and falling production have moved the target of rising living standards further and further out of reach. Africans are themselves the first to recognise that mismanagement, faulty economic policies and corruption have also played their part. Several countries have had to contend with political instability and in some cases civil war.

The West is determined to assist Africa. We can only do this if we remain involved positively and practically and if we ensure that our help is applied in the most effective manner. But most of all, the future of Africa has to rest on the efforts of Africans themselves. The seriousness with which they are facing up to their own future has been demonstrated by the summit meeting of the Organisation of African Unity which has just met in Addis Ababa. What are Africans making of their future? What are we in Britain doing to help? Which way should we now go? In trying to answer these questions I should like to address 3 major problems which now face Africa: the drought and the ensuing famine which have been brought home to us in their full tragedy; the economic crisis, including the heavy burden of debt; and the political situation in Southern Africa.

DROUGHT AND FAMINE

As we all know a band of countries across sub-Saharan Africa are gravely affected by the drought which has held them in an increasingly tight grip for the past two years. This is a major international disaster, on an immense scale. Public attention in Britain has focussed on the famine in Ethiopia and the Sudan but at least three other countries - Chad, Mali and Niger - are also very seriously affected. As many as a dozen other countries in Africa also suffer from heavy reliance upon imports of food, for which they cannot always pay.

In the countries most seriously affected the number of people at risk totals about 20 million, including an estimated 8 million each in Ethiopia and the Sudan. The scale of the human suffering is cruel and devastating. In Britain and across the western world the television pictures - of pitiable conditions, of long lines of our fellow human beings waiting patiently for food and water, of the young and old struggling to keep alive - have had a dramatic impact.

The response to this crisis by the west - by members of the public, by voluntary agencies, by governments - and by international organisations has been very substantial and very swift. In Britain, the public have contributed with great generosity; well over £60 million has been freely given and that does not include the sum raised by the recent Live Aid concerts estimated at over £40 million. Most of this money is channelled through the highly effective voluntary agencies. The Government works in close partnership with them and places a large slice of our assistance through them. We will do all we can to help the agencies ensure that money donated will be used in the best way.

UK role

But what of the British government's response? While we have had to work within the limits of our own need to control public expenditure, we have provided very substantial resources towards dealing with the famine - both for short term relief and longer term needs. In the last financial year, to the end of March 1985, we spent £95 million on famine related operations in Africa. This year we expect to spend at least £70 million bilaterally and multilaterally.

It is not however just the quantity of our response which is significant but also its quality and effectiveness. I think we may also rightly claim to have done much to accelerate the European Community's response. The Community and its Member States, Britain included, are playing a major part in relief efforts in Africa. Generally shipments of grain and other supplies are now sufficient and concerted efforts are being made to distribute it as quickly and effectively as possible to those in need. Through the RAF Hercules in Ethiopia, where the RAF and army team have been doing such a marvellous job there since last November, and the more recent Save the Children Fund air charter in the Sudan, we are making a valuable contribution to the airlifting of supplies. But given the scale of the operations, greater attention must be paid to the effective distribution of supplies by surface routes. In Ethiopia, we have urged the Government to honour its pledge that food aid should reach all those in need throughout the country. We have been pressing the authorities to provide more trucks of their own to increase the off take from the ports and will continue to do so. For our part, we are providing trailers and contributing to the United Nations truck hire fund and we have of course just announced that we will continue the RAF operation until the end of December.

In the Sudan, where the distances to the West are so much greater, we are providing about 100 trucks and the funds to hire 50 more. We are also helping to rehabilitate the railway which should be the main life line. Such emergency assistance will be needed well into 1986 and we will play our part in providing it, through concerted international effort.

AID FOR DEVELOPMENT

The UK can also be justly proud of its major contribution to Africa's long term development.

- Over the last ten years our bilateral aid to Africa has totalled £1984m - nearly £2 billion - of which £1877m went to sub-Saharan countries.
- In 1984 alone we provided £266m of which £248m went to sub-Saharan countries, including £234m for long term development.
- We also make a substantial contribution through multilateral channels notably the European Development Fund through which the Lome Convention is implemented. Our shares of the Sixth EDF will be about £740m.
- We also strongly support the World Bank's recovery programme as a means towards solving Africa's long term problems.

This massive transfer of resources, which comes in the end from taxes paid by all our citizens, must be matched by the pursuit of appropriate economic policies on the part of recipients. It is sad that in countries suffering from drought and famine, internal strife and unsound policies can sometimes divert money, transport and fuel from developmental and humanitarian needs. It is also vital that aid should not distort traditional patterns of life; people must be enabled to go back to their land with assistance to plant their crops as soon as the conditions are right.

Agriculture is of course central. Too many African countries have become increasingly reliant on food imports over the past decade, absorbing scarce foreign exchange and depressing smallholder food production and incomes. Good land use is one priority; and we are helping to tackle environmental degradation by supporting forestry and soil and water conservation schemes in the dry areas of Kenya, Sudan and Ghana. Other problems have arisen with the introduction of cash crops where this has led to people losing their land for subsistence crops. But the main problem is not that cash crops have replaced food crops but that agricultural production has gone down in recent years. There is in Africa the capacity, the potential and the fertility to produce enough to eat and to export.

The Green Revolution has brought astonishing advances in many developing countries. In China grain production has risen by 30% (100 million tons) between 1979 and 1984. India has emerged from the terrible cycle of famine, and this year will be a net exporter of wheat. With perseverance the goal of food

self sufficiency can be won. We believe that one of the key ingredients of success in agriculture must be better incentives for farmers to produce more, as the Chinese example has shown. That is what the World Bank, the IMF and other organisations all stress at present. This means not just higher prices but getting the basic infrastructure right: better research and extension services, more credit and improved distribution, marketing and storage arrangements. Parastatal marketing monopolies, with their high overhead cost and erratic service to farmers should face the discipline of competition in supplying farm inputs and in marketing produce. This may require some countries to change their policies and there will need to be some plain speaking between donors and recipients. In addition many countries will have to tackle the dauntingly high rate of population growth. The World Bank projections show that the population of the six countries worst affected by the drought is set to rise fourfold within the lifetime of many born today. Increases on this scale in these and other African countries will speed up desertification, vastly increase the number of poor needing to be fed in the towns, and so raise the risk of further famines.

I find it heartening that there is a growing consensus in Africa for the reforms that are needed. There have been a number of success stories here, and many in bilateral aid projects.

Success stories: reform

Ghana, for example, is heading this year for a substantial grain surplus, after desperately needing grain two years ago. Good rains helped, but also bold decisions on devaluation and higher agricultural prices. As I saw earlier this year, by taking timely and effective action to phase food imports and mobilise transport and distribution Kenya has been able to avert the worst effects of the drought. Zimbabwe has made a strong recovery after last year's harvest failure and has offered some of its current surplus to Ethiopia. Malawi, despite being among the least-developed, not only feeds itself but has surplus maize for export. These welcome developments give grounds for hope in the many other countries affected by drought and famine.

Success stories: Aid

Let me give a few examples of major British aid projects.

- A new road around the eastern side of Mount Kenya, the Thuchi-Nkubu road, was opened in March to complete the opening-up of the zone of cash crop production on the slopes of the mountain.
- The road between Songea and Makambako will be completed in November enabling a vast area of good agricultural potential in Southern Tanzania to have easier access to ports and markets.

For both these road projects we are of course thinking seriously about longer term maintenance arrangements and we shall look to fitting them into a coherent plan.

- In agriculture, we have been engaged for five years on an Integrated Rural Development Project in northern Zambia. A team of young Britons has worked with the local councils to strengthen rural development capability. The councils and the people themselves have built roads, bridges, wells, health centres and depots. The result has been a dramatic increase in maize production and the standard of living.
- In Zimbabwe we have given extensive support to the government's programme to resettle small farmers on land which commercial farmers left idle after the country became independent.

Life was very hard for the new farmers at first, but this year's rains have brought ample rewards for their efforts and those of the Zimbabwean agricultural and credit services who have been striving to help the farmers increase their production.

- Manpower aid is of prime importance in our African aid programme. Often we supply manpower in association with capital aid projects, including those I have mentioned. But most of our contribution is in seconded staff, experienced officers in the service of African governments whose salaries we supplement, or sometimes pay outright, and the growing band of zealous young - and not so young - people from VSO and the other volunteer agencies. The essence of our approach to developing the quality of management and administration in Africa is to improve the capacity of indigenous resources, using expatriates only where needed.

We have three main objectives in this:

- to concentrate on helping institutions and organisations which are critical to economic growth and development;
- to provide our manpower aid in packages, covering both personnel and training;
- and, having limited resources, to cooperate fully with the World Bank and other donors.

Another effective British contribution to economic development comes through the work of the Commonwealth Development Corporation which has played a significant role in Africa. At the end of last year, CDC's total commitments in Africa stood at £408m. £188m of this was committed to projects in the renewable natural resources field. 16 of the 31 projects to which CDC made commitments last year were in Africa. CDC makes a valuable contribution to food production in Africa. It pioneered the concept of a nucleus estate and outgrower schemes, which enabled farmers to produce cash crops for export , whilst still growing food for local consumption. In 1984 the CDC also promoted two substantial projects in Zambia and Zimbabwe aimed exclusively at providing food locally.

Another success has been the contribution of our military training teams in Zimbabwe and Uganda. The underlying purpose of this assistance, wherever we offer it, is to maintain or restore conditions of political stability without which economic development cannot take place. When I was in Harare earlier this year I heard nothing but praise for the British army personnel who have helped their counterparts to build the Zimbabwe National Army. Our military team in Jinja in Uganda is working to forge a well trained and disciplined cadre of officers and NCOs. Many of you who have read the recent appalling Amnesty International Report on Human Rights abuses and torture in Uganda will ask why we bother. I really do believe, however, that it is better to try and obtain concrete improvements in the security and human rights situations in Uganda, slow though these may be in coming, than to cut and run. Even so the allegations in the Report are shocking.

Malcolm Rifkind made plain to the Uganda High Commissioner on 25 June and thus to President Obote that there must be an improvement in human rights in Uganda, if we are to sustain our present assistance to that country. That is why we are glad that President Obote has invited Amnesty International to send a delegation to Uganda to investigate the alleged abuses described in Amnesty's Report.

DEBT

Debt remains one of the most serious and pervasive problems facing African countries. Latin American debt problems often get more publicity because they are in money terms much greater: at about $100bn total sub-Saharan African debt is about the same as Brazil's or Mexico's. But this masks the magnitude of the problem facing individual sub-Saharan African countries whose average GNP per capita is less than a third of Brazil's and Mexico's, and whose debts are often long term and if anything more intractable. Whereas most Latin American debt is owed to commercial banks, with the exception of Nigeria most sub-Saharan African debt is to official creditors either for export credits or aid loans and to multilateral organisations. With few exceptions the potential export earnings of African countries are less than those in Latin America. Therefore although the same broad principles apply, we have to consider case by case the circumstances and needs of individual African debtors.

Strategy on Debt

There are no easy solutions to the debt problem, but there is a strategy.

- First, it is vital to establish the right international economic environment, and this is mainly the duty of the developed countries. Essentially it means sustaining recovery in the world economy, and maintaining the open trading system; this will give debtor countries the chance to export and grow, and British firms the challenge of competing in expanding markets. The new GATT round will be an important opportunity to roll back trade barriers. High interest rates must be reduced, and we have been encouraged by recent falls in US rates. But it is essential that the US Government takes positive measures to reduce its budget deficit to ensure further reductions in interest rates.
- Second, action by the debtors themselves. African countries will only be able to make the best of opportunities offered by world economic growth if their own economies are sound. Structural imbalances which have grown up over years cannot be put right overnight. Measures to cut bureaucracy, reduce budget deficits, devalue currencies, and increase producer prices can have painful side effects, but without them many countries will not have the chance to restore economic growth and credit worthiness.

And these, together with the adoption of appropriate promotion and protection agreements are a pre-requisite for attracting further inward investment. The longer reforms are delayed the more painful they become.

It is encouraging that some countries have lately been persuaded of the merits of fostering a competitive environment for business with less tariff protection, fewer state monopolies and more incentives for investment. State enterprises, for long a drain on budgets and on bank liquidity are being selectively privatised or revitalised along commercial lines.

IMF: Role in reform

Can outsiders help? Yes. Most countries need guidance on recovery programmes, and the IMF and IBRD are best placed to provide it. Some African leaders have been critical of the IMF; President Nyerere was when he spoke here recently. Of course the IMF does not always get it right: nobody does. Critics should bear in mind that the real purpose of IMF assistance is to provide the necessary Balance of Payments support while the country takes the steps required to achieve a viable external sector position. As such it is the best source of technical advice available. It does not make sense for the IMF so to dilute its advice that it will be ineffective. Nor do they provide blanket advice; they do take into account individual country problems. Conditions are not imposed they are negotiated.

Creditors' usual requirement that an IMF programme is in place is not purely for doctrinaire reasons: it helps to give assurance that the right policies are being pursued to ensure long term economic growth which must be in the best interests of creditors and debtors alike. Countries have to earn foreign exchange, but this does not have to mean cash crops displacing food crop production: a healthy cash crop sector is often accompanied by increased food production. Although some IMF programmes have not met all their targets, the reasons are diverse, and both external and internal. Notwithstanding such problems a number of countries particularly in West Africa have made good progress and got to grips with adjustment programmes. But it will be a long term task for most. The IDA has a major role to play in Africa, both as a provider of much needed finance on very concessional terms and of detailed guidance on economic management and public institutions. The new World Bank Special Facility for Africa is of particular importance in providing funds to help countries tackle their structural problems. We have agreed to provide £75m of our bilateral programmes in association with this; and have already announced our first intended commitment of £10m to Zambia.

Direct assistance with debt

This brings me on to the third strand, which is what direct assistance can be provided to help individual countries' debt problems. We do not believe simply writing off all debts is the answer, not least because without adjustment, developing country economies would be ill-equipped to use the extra resources. Like other creditors we believe in tackling the problem on a case by case basis: each country's problems are different.

UK Role

There is a need for rescheduling, some debt cancellations for the poorest, and for new money. We are helping in all of these areas:

- With other creditors, we reschedule official debts through the Paris Club. Since January 1980 there have been 32 Paris Club reschedulings of official debt for 14 African countries. The terms are generous, even going as far as rescheduling 100% of principal and interest. We have written off the aid debt of 13 African countries totalling about £262m.
- All new aid to countries with an annual per capita income of less than $790m is provided on grant terms.
- From our bilateral aid programme in 1984 we provided £266m to 47 countries in Africa including relief aid. This was 40% of all our bilateral aid.
- We have agreed to provide £401.5m to IDA7 and £740m to EDF VI. About 35% of IDA7 and 90% of EDF VI will go to sub-Saharan Africa. It is

worth recalling that in providing this aid there are substantial returns to British industry: in 1984 about 74% of our bilateral aid was spent on British goods and services.

If these are the main parts of the strategy they are by no means all. We are always ready to talk constructively about debt issues and look for new ways to handle the problem. Multiyear Rescheduling Arrangements, increased direct investment, and the Multilateral Investment Guarantee Agency are only three of the possible ways.

Is the strategy working? Precise measurement is difficult. It is of course impossible to say how countries would have performed without outside assistance. However such general evidence as is available from IMF/IBRD suggests that countries following IMF prescriptions have benefited. Average economic growth in 34 countries, including 16 in Africa, with IMF Standby Arrangements is expected to be about 4% this year. Their imports are expected to be 10% up in dollar terms. This trend is encouraging. Renewed economic growth in African countries is vital to British industry. Our exports to sub-Saharan Africa declined from £3.29bn in 1980 to £2.72bn in 1983, rising slightly to £2.93bn in 1984. Effective management of the debt problem is essential to re-establish growth in the African market.

SOUTHERN AFRICA

It is tragic that recent years should have brought such serious economic difficulties to Africa. As I have said, many governments are tackling them with resolve, especially where there is a firm basis of internal stability. But some serious political problems remain. Most of these are for Africans to solve with the support and encouragement of their friends. But the problems of Southern Africa stand apart. The raids by South African forces, including that into Botswana in June, and the mounting violence in South Africa itself, underline the urgent need for progress on these problems.

It is easy to forget in the face of such outrages that Southern Africa as a whole has seen major changes in the last ten years: the independence of Mozambique and Angola in 1975; the independence of Zimbabwe in 1980; and the Nkomati Accord in 1984. Britain has played a part and we do not intend to opt out. We have watched with great sympathy Mozambique's struggle to overcome threats to stability. We have increased our aid and recently we have agreed, in conjunction with the Government of Zimbabwe, to give military training to selected members of the Mozambican Army within Zimbabwe.

SOUTH AFRICA

Within South Africa there is much of real value which South Africa inherited from its links with Western Europe - a body of law, a legal system, a constitutionally based administration, and a significant role for the press. It is this which needs to be strengthened for the future. South Africa's developed economy could contribute much to the health of the region. Yet so much of what could be intrinsically good is shared on a basis of grotesque inequality.

Let there be no doubt about our abhorrence of apartheid and all the repressive measures used to enforce it. Apartheid is unacceptable, unworkable and indefensible. It is contrary to all British and Commonwealth values. It is given added repugnance by the existence side by side of two communities - a ruling minority and a majority deprived of power - between whom the inequalities, in terms of material possessions, education and expectations are vast. Most repugnant of all is the fact that these inequalities are built upon foundations of racial discrimination.

It is just because we condemn apartheid so strongly that our efforts to promote change in South Africa through continuing involvement in that country are not always understood.

I hope it will be clear from what I have said that our differences are about means rather than ends. We have been following closely the debate on selective economic sanctions in the United States and in other Western countries. Every new outrage in South Africa gives those who press for such measures further ammunition. Western governments certainly ask themselves seriously whether such measures offer the right approach, whether their existing policies have failed so badly that they should abandon them and, in effect, disengage in any constructive sense from the problems. Frankly I do not believe this would be right. We remain firmly opposed to economic sanctions of any kind.

- Sanctions against Rhodesia served to strengthen parts of the white business sector at the expense of blacks. The South African economy is much stronger and more diversified than was Rhodesia's. It would undoubtedly adapt to sanctions.

- The effects of economic measures would of course be felt most keenly by black South Africans. They would also affect the economies of South Africa's neighbours even if the latter did not formally participate in the sanctions policy.

- We oppose sanctions because we believe that economic growth in South Africa offers the most likely route for peaceful political change. We should be looking for ways of strengthening these internal economic forces, especially the growing economic power of the black community; the black trade union movement, and the facilities for training and education of blacks. The application of sanctions would mean an end to all these activities.

As Mrs Helen Suzman remarked recently in Luxembourg, sanctions would in fact "blunt the only weapon that blacks have ... . - the economic muscle that accompanies upward mobility on the ladder by virtue of greater skills and increased consumer power". Alan Paton, too, has argued very recently that his conscience would not allow him to support disinvestment, since in his view those who would pay most grievously for it would be the black workers of South Africa.

I believe that we have been right to draw attention to those reforms that were until recently beginning to emerge. We have emphasised that they were only a small beginning. The lot of some black South Africans had in some respects begun to improve. But the fundamental reforms which we all seek have still not been taken in hand. And tragically such changes as have taken place have been accompanied by repression in its ugliest form. The South African Government's call earlier this year for a dialogue with black South Africans has been flatly contradicted - and indeed frustrated - by the arrest of many of those whom black South Africans regard as leaders. And the State of Emergency declared over the weekend will add to the growing numbers who languish in detention without any legal recourse.

What must be done? The State of Emergency sharply underlines the urgent need to redress fundamental grievances. The South African Government should be in no doubt of our strong conviction that their society must evolve in a way which will provide a system of government which commands the support of the people of South Africa as a whole. It is not for us to prescribe cut-and-dried solutions. The most urgent priority is action, and action of a convincing and effective kind, to create a climate of confidence which will permit a real dialogue with the genuine leaders of the black community, whom blacks must be permitted to choose. The dialogue cannot avoid the fundamental question of the political aspiration of blacks. And the dialogue must be seriously meant and tenaciously pursued. This requires bold steps by the South African Government.

- the unconditional release of Nelson Mandela and other acknowledged political leaders;

- an end to forced removals;

- an end to detention without trial;
- an early end to the State of Emergency;
- the progressive abolition of discriminatory legislation such as the pass laws and the Group Areas Act;

- a commitment to some form of common citizenship for all South Africans.

I am sure that all those who are working for peaceful evolutionary change in South Africa know that an outcome must be found whereby white South Africans are guaranteed their rightful place, but not more than their rightful place, in any future South African political system.

British and other foreign companies in South Africa cannot expect to continue their activities there as though they were in a political vacuum. Many, indeed most, accept their responsibilities willingly. They play constructive and positive roles.

Apartheid is abhorrent in moral and social terms. Beyond that, the practical effects of apartheid hold back South Africa's economic growth potential, based on her vast natural resources, which could contribute much more to the welfare of all her peoples.

The private sector must continue challenging these conditions, which impede its own success as much as they are socially unjust. The EC Code of Conduct can play a very important part in that respect. For it is clear that the further economic development of South Africa will hasten the collapse of apartheid. The commitment to the ending of job reservation, and the acceptance of blacks as permanent residents in the urban areas are evidence of this. There is considerable scope for further initiative by British companies: community works, social welfare of their employees, equal opportunities. And the private sector must play a full part in the broader political life of South Africa, condemning repression and working for peaceful change.

NAMIBIA

I turn now to another issue which is of great concern to the British Government. The settlement of the Namibia problem is long overdue. Namibia needs a truly independent and representative government. This is not only in the best interests of Namibians themselves. Greater stability and an end to cross-border violence is clearly in Western interests too. The world cannot wait for ever while South Africa delays. The South African Government should be in no doubt of the responsibility it bears for its unlawful occupation of Namibia. Nor should it believe that the world will accept the unilateral establishment of an interim administration. Such measures have no status whatsoever under the UN settlement plan.

CROSS BORDER VIOLENCE

There must be an end, once and for all, to the sort of violence we saw recently in Gaborone. The UK is no stranger to terrorism and condemns without qualification violence by the ANC or anybody else who employes it in the course of seeking political change, inside, or outside, South Africa. But nothing can justify the actions which this regional superpower has been prepared to mount against its weaker neighbours. If there is to be any prospect of stability and economic recovery in the region, actions of this kind must cease.

I have explained what I consider needs to be done to solve these complex and deeply worrying problems:

- to secure the independence of Namibia in accordance with SCR 435;
- to press ahead with the changes that are needed to bring apartheid to an end;
- and to prevent a recurrence of the recent attack on Gaborone and the shootings at Uitenhage.

Our approach is shared by our Partners in the European Community. Foreign Ministers of the Ten yesterday issued an important statement about the situation in Southern Africa which reflects very closely the policies which I have just described.

The only course of action consistent with our values and our record is to do what we have done elsewhere - over the major problems of debt, drought and famine: to remain closely and continuously involved and to work for positive, peaceful change. I can assure you - and this is my main message to you today - that the British Government will remain energetically and actively involved in pressing for solutions to all these problems, and in particular in pressing for the establishment of genuine, multi-racial democracy in South Africa.

CONCLUSION

Neither we nor Africa can turn the clock back to 1960 and begin again. There have been successes as well as the tragedies. Africa still faces a hard, uphill grind. We in Britain will play our part. Through history, through human ties, through the Commonwealth and now also through the European Community, Britain is linked to Africa and its problems by common interests and shared aspirations. The ideas which Harold Macmillan so eloquently stated in 1960 must not be allowed to perish in the harsher world of today.

Note i- Told Geoff
Don't matter was being
left to rest

AT 29/7

SECRET AND PERSONAL

COPY NO 1 OF 2.

2

Prime Minister

Agree to let matter rest here?
Perhaps this will be a lesson to
Mr Walker - careless
talk costs money.

AT
25/7

Yes ma

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 7214

Andrew Turnbull Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON SW1

24 July 1985

Dear Andrew,

Thank you for your letter of 17 July, regarding the Prime Minister's concern about press reports of views attributed to my Secretary of State at a meeting he addressed last Monday in Birmingham.

He made no such speech, and there was no press handout. The meeting was in fact of partners of a firm of accountants who, among other places, have an office in my Secretary of State's constituency. As far as Mr Walker was aware there were no members of the media present, although he discovered afterwards that somebody from the Press Association had been informed of the gathering.

The Secretary of State was asked to speak about the problems confronting world business over the next fifteen years. He stated that it was important for there to be sensible arrangements concerning world debts so that growth could take place in some of the major developing countries of the world. He in no way suggested that it should be for countries to refuse to meet their debts, but in answer to a question did say that there must be political dangers of political leaders in such countries fighting elections on the basis that if they were elected they would refuse to service the debts.

Yours ever,

Geoff

G S DART
Private Secretary

SECRET AND PERSONAL

SECRET AND PERSONAL

SRW

file

10 DOWNING STREET

From the Private Secretary 17 July 1985

THIRD WORLD DEBT

The Prime Minister has seen the press reports of your Secretary of State's speech on Monday in Birmingham. From these reports the speech comes over, if not as an encouragement to Third World debtors to default, at least as sympathetic to them should they adopt this course. The Prime Minister would be extremely disturbed if this message came to be thought to represent the policy of the Government. She would be grateful, therefore, for an account of what your Secretary of State actually said.

(ANDREW TURNBULL)

TRG

Geoff Dart, Esq.,
Department of Energy.

SECRET AND PERSONAL

CONFIDENTIAL

Prime Minister (2)
Despite a lower dollar, lower interest rates and lower oil prices, debt problems remain.
AT 17/6

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

A Turnbull Esq
10 Downing Street

14 June 1985

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. Brian Unwin had an opportunity to discuss the main issues with his G5 Debt Deputy Colleagues in London on Thursday last.

2. The Bank's paper notes the rather gloomier picture that is emerging, where in a number of key problem countries a continuing lack of adequate internal adjustment has been accompanied in the first part of 1985 by disappointing trade accounts. These worries are offset only partially by better signs on interest rates and, in some countries, on competitiveness. The continuing attempts to put together bridging support for Argentina have been reported separately in my letter of 7 June. (The attached assessment records the position as at last weekend.) Although Mrs Case's minute of 10 June (copied to you) reported information we had received that agreement had been reached on a bridging facility, this has yet to be publicly confirmed. We will report further if and when it is finalised.

3. There are three other key areas to draw to your attention. First, Peru. This was also the subject of my letter of 7 June. The economic adviser to the President-elect was in London this week and called on the Treasury (as well as on Lady Young, and at the Bank of England). First indications are depressing. The new regime seems set on a showdown with the IMF. We are discussing the problem with other creditors and will report again soon. If there are new developments, for example in the form of decisions by US bank regulators, we will report further.

4. Second, Poland remains a major concern. Ministers have recently decided (following the Chancellor's minute of 10 May to the Foreign Secretary) that there is no case for extending substantial new credits to Poland; a decision parallelled by most other creditor governments. Our continuing aim is to keep the Poles in play in rescheduling negotiations and avert the slide from a de facto moratorium of debt service into an outright default. The next step will be the Paris Club meeting at the end of this month when it is hoped the Poles will sign the draft 1982-84 rescheduling agreement. Creditors have said they would understand if the Poles wished at the same time to make an oral statement about the difficulties they will face in honouring it. The state of these negotiations remains fragile and the Poles could yet decide to break off talks. An informal meeting between the G5 and the Polish negotiators has been arranged ahead of the Paris Club session.

5. On the Cartagena front, Chancellor Kohl has now replied on behalf of all the Summit participants with a skilfully worded letter which needs no amplification by his Summit partners. So far, it has not led to any further group action by the Cartagena countries. Though we have had reports of their continuing dissatisfaction, they have yet to find sufficient further identity of interest to undertake a new demarche. Nevertheless departments are, on a contingency basis, reviewing the range of demands the Cartagena Group might make if they were to renew pressure.

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

Yours ever

Rachel.

MRS R LOMAX
Principal Private Secretary

INTERNATIONAL FINANCIAL SCENE

Although recent developments have not all been unfavourable, sentiment about the debt situation generally continues to be gloomy. As noted in the last Report, attention is turning increasingly to the lack of adequate internal adjustments within several debtor countries. In addition, results on the external side - the success story of 1984 - have for a number of countries been rather disappointing so far this year. Partly as a result of these factors, problems may be arising even for some debtors that either have so far not been in difficulties or that seemed to have already overcome the worst of them. Also, and perhaps most worryingly, increasing difficulties in filling the expected financing gaps, particularly so far for some middle-sized debtors, suggest that there may be renewed pressures to go beyond the established framework - rescheduling maturities and providing new money in exchange for external surveillance - that has successfully contained the debt crisis over the last three years.

These developments have occurred against a world environment that, for the debtors, has recently appeared to be improving. Although GDP growth in the US decelerated to only 0.7% (annual rate) in the first quarter, and industrial production actually fell in April, the US current account deficit has continued to rise: in the first quarter of this year the deficit is likely to have been over $30 billion compared with less than $20 billion in the corresponding period of 1984. In response to the domestic slowdown, the discount rate was cut on 17 May by 1/2 percentage point to 7 1/2%, its lowest level since August 1978. Three month eurodollar rates have fallen by over 1 1/2 percentage points since March and are now below 8%. The recent depreciation of the dollar (on 7 June it was 7 1/2% in effective terms below its March peak) will also be helping to reduce debt-service burdens. Over the longer term, the adverse effects of the falling dollar on the competitiveness of some of the debtors may cause them difficulties in achieving their external targets; but the threat that the US would introduce comprehensive new protectionist measures, which seemed very real at the beginning of the year, seems now to have faded slightly, although increased protection may yet affect individual sectors.

To judge by the rather sluggish performance of exports and/or rapid increase in imports in a number of debtors in the first quarter of this year, the period of continuous over-achievement of debtors' external targets appears in any case to have come to an end. To some extent a reduction in the size of the trade surpluses from last year's levels was to be expected; but creditors are in no mood to give a debtor the benefit of the doubt over what constitutes a satisfactory performance (particularly where, as in the case of Brazil, a small current account shortfall, and an apparent unwillingness to draw down reserves, may mean that new money will be required in 1985). Indeed, export shortfalls in the first quarter of the year in South Korea, which so far has not experienced any debt servicing difficulties, were reportedly causing some banks to re-evaluate their exposure to that country.

The IMF programmes for two of the three largest debtors - Brazil and Argentina - as well as a number of smaller debtors remain in abeyance, because of the debtors' conspicuous failure to achieve internal targets. To safeguard its own credibility and, indeed, to get such countries back on track, the IMF seems less willing than it was earlier to accept target overruns and missed criteria. Yet the internal adjustment necessary to restore relationships with the Fund is likely to prove politically difficult for a number of countries. One such case is Peru where the President-elect, in considering how to resolve the impasse over his country's debt problems, has declared that creditors should accept that Peru's debt payments should be limited to a set proportion (maybe 20%) of the country's export earnings, and that the IMF's prescriptions are unacceptable.

On the other side of the coin, however, there are some brighter areas. Several bank and official reschedulings have recently been signed; the first official MYRA - for Ecuador - has been agreed. Venezuelan performance appears to support its official statements that its debt problems are now largely behind it. Resistance to currency depreciation seems to have weakened in some countries, for instance Mexico and Argentina, in that they have increased the rate of depreciation of their currencies (although in neither case has the rate of depreciation yet caught up with their inflation differentials against the United States). Most debtors now at least recognise the need to deal with their internal problems. The continuing weakness of the oil price, and the possibility of further falls in interest rates, will assist the debt servicing of most countries. And, perhaps most importantly, forecasts (most recently the IMF's World Economic Outlook) continue to suggest that growth in industrial countries will continue to exceed the critical 3% annual rate that will be necessary if debtors are gradually to reduce their debt burdens.

The Interim/Development Committees meetings on 17-19 April were designed as a response to debtors' demands for dialogue. The "Cartagena Consensus" countries put forward a moderate paper, and the meetings passed off without any major confrontation. No plans have been made to continue the dialogue. The Consensus countries, however, were not satisfied by these meetings, and sent a message to this effect to the recent Bonn Summit; Chancellor Kohl has sent an anodyne but skilful reply on behalf of the Summit countries. Although the Cartagena countries have not yet formally re-grouped, the ideas of the Cartagena Consensus continue to be discussed in other fora: for instance, the new Finance Minister of Uruguay recently re-stated the demands at a meeting of the UN Economic Commission for Latin America and the Caribbean in Santiago.

More details on the major debtors are given below.

(i) Latin America

Although monetary and exchange rate policies have been tightened in the last month or so, Argentina will have to act also on fiscal policy before the IMF will agree to reinstate the SDR 1.4 bn Standby programme which collapsed in March. President Alfonsin told his population on 26 April to expect 'wartime economy' measures as part of the attack on inflation, which rose to 939% in the year to end-April; but these measures have yet to be announced. With the public sector deficit in the first quarter running at the equivalent of 10% of GDP - more than double the IMF target for the year - strong action will be required. If and when it does come, it will take place against a background of worrying instability in the financial system. The financial sector was shaken by reforms introduced in April designed to permit more market determination of interest rates; the extent of the sector's difficulties was highlighted by the Central Bank's announcement of the liquidation of the country's eleventh largest bank (Banco de Italia y Rio de la Plata, which owes $230 mn to commercial bank creditors) and the introduction of emergency measures to safeguard the financial system on 17 May. The Working Committee of commercial banks are becoming increasingly frustrated by the Argentinians who, in spite of making a $50 mn payment on 3 May, are now over 180 days overdue on interest payments.

In an attempt to stop the US Regulators, who are meeting on 10 June, from downgrading Argentine debt, the US Treasury are attempting to put together bridging finance, possibly of as much as $670 mn, to enable Argentina to bring down interest arrears to less than 90 days. The bridging loan depends on a statement (which apparently will be forthcoming) from the Fund MD supportive of a new Letter of Intent. But the decision of the Regulators remains in doubt. In the meantime, the UK Argentina Paris Club bilateral took place on 15-17 May, and some progress was made. Talks were to resume in Madrid on 5 June to resolve outstanding issues, notably on interest rates, but have been postponed until late June. Argentina is, however, still refusing to enter into parallel discussions on the ending of commercial restrictions between the two countries.

In Brazil, the death of President-elect Tancredo Neves has brought fresh uncertainty into the negotiations with the IMF and the commercial banks. The new economic team is determined to lower the public sector deficit as the cornerstone of its anti-inflation strategy, but is still debating as to whether to do it by cutting spending or raising taxes. Following the breakdown of Brazil's IMF programme at the beginning of the year, talks are continuing with the IMF, and it now seems probable that the EFF will be set aside and a new 12-month Standby put before the IMF Board in the summer. On the commercial bank front, Finance Minister Dornelles continues to affirm that Brazil will need no new money in 1985 and that he is keen to complete negotiations on the bank MYRA and a parallel Paris Club deal; but, with this year's trade surplus now expected to fall below the level achieved last year, and with Brazil apparently unwilling to draw down its reserves to meet a shortfall, a request for new money later in the year cannot be ruled out. Dornelles has stated that he will not seek to renegotiate the key elements of the MYRA, although he might well wish to obtain some changes so that he can present the MYRA to the Brazilian Congress and people as 'better' than the preliminary agreement reached by his predecessors. In the meantime, the Advisory Committee agreed to recommend a 90 day extension of the trade and interbank lines which expire at end-May, and has obtained a supportive message for the banks from the MD of the IMF offers.

As a refreshing change, Venezuela's economic performance, internal as well as external, has exceeded expectations, and agreement on the terms of a MYRA was reached with the banks' Advisory Committee on 16 May. Under the agreement, $21.2 bn of public sector debt falling due before end-1988 will be rescheduled over 12 1/2 years from end-1984 at LIBOR + 1 1/8%. The IMF will make half-yearly reports available to the banks so that they can monitor Venezuela's economic policies during this period. Roadshows will start in Tokyo in the first week of June, although final signature of the agreement is not expected until September; some banks have already stated that they will not sign the agreement until the Venezuelans have completed the process of registering private debt (not covered by the MYRA).

Given the seriousness of its underlying problems, Mexico's performance too continues at the moment to be reasonably reassuring, but there are rumblings of policy disagreements within the Government about whether the present course should (or can) be held especially in the context of the forthcoming Congressional elections in July. But with its MYRA having been signed at the end of March, uncertainties over Mexico's debt burden have been substantially reduced. However, Mexico's current account surplus in the first quarter of the year was below the level achieved in the same period last year, and while the authorities have now again increased the daily rate of depreciation against the dollar, this still is not quite sufficient to maintain the country's competitive edge.

In April Ecuador was granted a Paris Club three-year MYRA. The deal covers principal only (100% of arrears and 1985 maturities, 85% of 1986 maturities and 70% of 1987 maturities), restructured over 8 years with 3 years' grace. This is less generous than the terms for official rescheduling (85% of principal and interest) which the Steering Committee of the commercial banks had made a precondition of a bank MYRA; how the banks will react is not yet clear. Meanwhile, efforts are being made to bring in the remaining commitments to the $200 mn of new money requested by Ecuador from the banks for 1985. Colombia is edging its way towards an agreement with the banks for nearly $1 bn of project-related new money in 1985/86, with disbursements to be linked to IMF enhanced surveillance of quarterly economic targets. A $300 mn IBRD loan designed to strengthen Colombia's export sector and reduce import restriction has been approved by the IBRD Board.

By contrast, considerable anxiety surrounds developments in Peru and Chile. In Peru, Sr Alan Garcia, leader of the centre-left opposition party, APRA, won the first round of the presidential election on 14 April and, having won the second round at the beginning of this month, will take office in July. Statements by Garcia and his supporters have been very critical of the IMF, and indicate that Peru might seek more generous terms for refinancing its debt, including the limiting of debt service payments to 20%

of export revenue. Garcia also says he wishes to negotiate directly with the banks without IMF involvement. However, these statements may be electioneering rhetoric rather than a considered negotiating position. The FCO is trying to persuade Garcia to visit London before he assumes office, so that Garcia can hear the UK's point of view. Peru paid $16 mn to the banks early in May to reduce interest arrears, on the strength of which a two-month rollover of maturities falling due since March 1984 was agreed. Nevertheless, it is believed that interest arrears to the banks are over the crucial 180 day threshold. US Regulators may therefore downgrade the status of Peruvian loans when they meet on 10 June. In the case of Chile, a programme for a SDR 750 mn 3-year EFF has been provisionally agreed with the IMF, but the financing requirements that remain, even allowing for a small CFF and a large IBRD contribution, imply more new money from the banks in 1985/6 than they are presently prepared to contemplate. A novel proposal worked out by the banks and the IBRD management for bridging the difference, whereby the IBRD would have guaranteed the principal on an additional tranche of bank lending, seems to have been shelved, but a B-loan co-financing for $150 mn is likely to be arranged instead. Despite Government fears that an approach to the Paris Club would either be rebuffed or would bring Chile no benefit because the creditors would remove export credit cover, Chile has reportedly agreed to seek a $150 mn public sector debt rescheduling - although it intends to maintain a pretence that this will not be negotiated within the formal Paris Club arrangements. The UK had already said that, for its part, were Chile to reschedule public sector debt, it would be prepared to resume limited cover quickly, as long as an IMF programme was in place.

(ii) Far East

The commercial bank package for the Philippines was finally signed by the major lenders on 20 May. However, in its first review of the Philippines' SDRs 615 mn Standby the IMF has found that the majority of the performance criteria have been breached. In response, rather than abandoning the facility, the IMF is proposing a restructuring of the remaining disbursements and the introduction of amended performance criteria.

Despite South Korea's disappointing export performance in the first quarter, and reports suggesting that some banks were becoming concerned at their exposure to the country, the Korea Development Bank's recent $600 mn eurocredit was received well by the markets. Finance Minister Kim recently visited major European financial centres, and appears to have reassured the commercial banks that all was well. The authorities are understood to be seeking a further IMF Standby arrangement.

Indonesia's current account deficit in FY 1984/85 was considerably smaller than expected, down to $1.7 bn from $4.2 bn in FY 1983/84. The Inter-Governmental Group on Indonesia (IGGI) is scheduled to meet on 4-5 June, when it is hoped that at least $2.4 bn in official assistance will be pledged for FY 1985/86 (the same level as FY 1984/85).

(iii) Eastern Europe

Poland remains in a very grave condition, but discussions over its debt continue. In order to encourage Poland to sign the 1982-84 agreement, official creditors, meeting in Paris on 17 May, proposed that signature be accompanied by an oral statement to the effect that Poland foresaw difficulties later in the year and might at that point seek further discussion with official creditors. Meanwhile there was agreement, ad referendum, on the main elements of a generous 1985 rescheduling package. However, signature and implementation of these agreements remain in doubt given uncertainties about the balance of payments and the pressures within the Polish leadership. Nothing has yet been heard from Warsaw, and the Chairman of the Paris Club intends to contact the Poles now to establish their position. The IMF Standby arrangement for Yugoslavia was approved on 29 April, but the second drawing has been made conditional on a satisfactory rescheduling agreement being reached with commercial banks by 30 August. Some progress was made at talks with the banks on 22-23 May, but differences over pricing and monitoring arrangements remain. Meanwhile, official creditors signed their multilateral rescheduling agreement on 24 May.

Elsewhere in Eastern Europe the situation is mixed. Bulgaria and Czechoslovakia have returned to the market, for the first time since 1979 and 1983 respectively, for a $100 mn credit each. The Bulgarian credit is for seven years, at Libor + 3/8 for the first four years and + 1/2 for the last three. The latter credit, for eight years, is finely priced, at Libor + 1/4 for the first two years rising to 3/8 for the remaining years. The GDR has returned again for a $200 mn 8-year credit on improved terms of Libor + 3/4 and prime +3/8.

CARE: Paragraph on Romania on this page is SECRET

Romania - which was able to avoid rescheduling in 1984 and hoped to do so again in 1985 - has been forced to approach the four leading banks in the Steering Group for emergency finance in order to help meet the first repayment of principal under its 1982 rescheduling agreement. The banks agreed to advance a credit of $80 mn maturing on 15 October. The Romanians, who blamed the severe winter for their difficulties, expect a further $70 mn shortfall when the November payment falls due; the banks are insisting that all of the Steering Group now be brought in to work out a medium-term solution.

(iv) Southern Europe

An IMF review of Portugal's recent Standby has commented favourably on the success of the external adjustment, but expressed concern at the fiscal position and urged prompt corrective measures. Although an increase in the current account deficit to $0.9 bn is officially forecast for this year, early indications are that domestic demand may be weaker than expected and hence the balance of payments stronger than assumed in the Government's economic programme. A political crisis has been prompted by the decision of the Social Democrats to withdraw from the Government in mid-June after Portugal signs the Treaty of EEC accession.

(v) Africa

Delays in reaching final agreement on commercial bank rescheduling did not prevent Morocco completing all purchases under its $300 mn Standby arrangement with the Fund. Nigerian economic performance remains severely affected by the austerity policies of the military government. Import cutbacks have caused output and employment to fall, and inflation to rise. The IMF's recent Article IV appraisal highlights the need to combine effective demand management with measures to achieve long-term structural adjustment. A UK-initiative is being pursued to try to resolve the long-standing deadlock between Nigeria and the IMF over Nigeria's unwillingness to accept a devaluation of the currency as a key part of any Fund programme, but has so far prompted no reaction from Nigeria. There is no evidence that the Nigerians have modified their stance against the key elements of the Fund strategy. Given this, it is difficult to see how the Nigerians can get through the next few years without rescheduling and/or new money. Meanwhile, official credit agencies continue to insist that insured trade arrears be restructured within a multilateral framework and be conditional on an agreement with the IMF. Full settlement of interest due to official creditors on the debt that has so far been reconciled was made in April. The final tranche of six-year promissory notes - agreed last year as the means for rescheduling uninsured trade arrears - has been delayed until June/July, pending completion of the process of reconciling exporters' claims. In the Sudan, the military coup which overthrew the Numeiri Government has delayed the clearing of Sudan's arrears to the Fund which will be necessary before relations can be normalised. The US is reportedly urging Sudan to use a $50 mn disbursement from AID as bridge finance to reduce arrears to the Fund. A Paris Club meeting has been set for July.

(vi) Other

Turkey's discussions with the IMF on a new Standby arrangement have been abandoned until late summer, pending an evaluation of the effects of current policies. Following a resurgence of inflation in Israel the authorities have announced a number of new measures designed to contain government expenditure and strengthen the external position. The IMF staff, in their recent consultations paper, are highly critical of Israel's economic management, notably the lax fiscal discipline and the increasing resort to exchange restrictions and multiple exchange rate practices.

Bank of England

7 June 1985

Prime Minister (2)

AT 11/6

CONFIDENTIAL

FROM: MRS A F CASE
DATE: 10 June 1985

PS/CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir P Middleton
Mr Littler
Mr Unwin
Mr Lavelle
Mr Mountfield
Mr Sallnow-Smith

ARGENTINA

We have heard within the last hour from the Governor's party in Basle at the BIS that a $500 million bridging facility for Argentina has been agreed. The participants are as follows: US ($150 million), Latin Americans - unspecified - ($150 million), Japanese ($80 million), French ($30 million), Canadians ($20 million) with the balance made up of small contributions from Spain, Denmark and Austria. The Germans have apparently not contributed. There is no suggestion that the BIS be involved.

MRS A F CASE

cc Mr Turnbull - No 10
Mr Maud - FCO

Indebtedness

CONFIDENTIAL

From: J B UNWIN
10 June 1985

PS/CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir Peter Middleton
Mr Littler
Mr Lavelle
Mr Mountfield
Mrs Case
Mr Sallnow-Smith

ARGENTINA

I understand from the Governor's party in Basle at the BIS this morning that discussions are still in train on a bridging facility for Argentina. The Americans have been rather clod footed in sending a peremptory request to the Bundesbank, who are so far unwilling to contribute. The only willing sovereign participants so far are the French. The BIS, however, stand ready to join in provided they are fully guaranteed by central banks.

2. There has been no pressure on the UK to join in, and our position seems to be well understood.

3. Time is now very short, as the US bank regulators are due to start their meeting today. But I should be surprised if a package is not put together, with the US Treasury or Fed if necessary bearing a greater share than they had hoped.

J B UNWIN

COPY FOR

cc also: Mr Turnbull - No 10
Mr Maud - FCO

Indebtedness

R21

CONFIDENTIAL

Prime Minister (2)
To note - with progress report attached. AT 10/6

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

7 June 1985

Andrew Turnbull Esq
10 Downing Street
London SW1

Dear Andrew,

DEBT: ARGENTINA AND PERU

The Prime Minister should be aware that there may be some important developments in the next few days. They arise because the US bank regulators have their regular quarterly review meeting on 10 June, at which they will consider whether the debts of either or both these countries should be downgraded because of interest payment arrears. This could mean that the banks concerned who had not already made adequate provision would need to set large sums aside out of their profits to cover their potential losses.

ARGENTINA
As you know from earlier reports, the banks are assembling a $4.2 billion package which will be approved once the IMF has agreed a new programme to replace the one which collapsed earlier this year. This is taking time to assemble; and the Alfonsin government has been very slow to negotiate a fresh IMF programme. Annualised inflation is now around 1000 per cent and the first quarter public sector deficit, at an annual level of 10 per cent of GDP, was over twice the IMF target. Domestic financial confidence has been damaged by the collapse of the Argentine Banco de Italia. Meanwhile, substantial arrears (over 180 days) have accumulated on overseas debt. This means that under the normal rules, the US banking regulators at next week's meeting may classify the loans as'value impaired' (requiring a 10 per cent provision) or 'substandard' (a less serious problem).

We learnt on Wednesday night that the US Treasury were considering an emergency bridging operation. This would be designed to enable Argentina to bring interest up to 90 days' arrears, sufficient to avoid reclassification. They would, however, only do so on receipt of assurances from de Larosiere that he was satisfied with the progress of negotiations with the IMF. At a meeting of the G5 'Debt Deputies' held here in the Treasury on Thursday, the US Treasury confirmed this and the French representative said (unprompted) that France was ready to join in a bridging operation. The German and Japanese representatives had not been asked. Nor were we: but Brian Unwin made it quite clear that the UK would not be able to join in.

We heard today that Argentina has been added to the agenda of the BIS this Sunday in Basle, apparently at French suggestion, to consider a rescue package. The Governor will be attending. It is not clear whether the UK will be asked to contribute. The Governor however has no intention of doing so. Nor will he seek actively to block a BIS operation, provided Argentina can offer adequate security - probably gold. Treasury officials believe that, if the Managing Director can report satisfactory negotiations with the Argentines, it is in our interests that the bridging operation should succeed.

We subsequently heard this afternoon that de Larosiere has now told the IMF Board that in discussions with the Argentines agreement has been reached on the main elements of a new stand-by programme. This agreement is yet to be translated into a formal Letter of Intent so that no immediate decisions by the Board are required. Details will follow by telegram.

PERU

The outgoing Peruvian government has built up very substantial arrears of debt (to banks and to governments). It will be for the new APRA government, which takes over on 28 July, to straighten out the economy and reach a settlement with its creditors and the IMF. (This may not be easy: the President-elect has publicly attacked the IMF and demanded much easier terms; but privately he seems ready to accept the need for a realistic solution.) Officials under Treasury chairmanship here have been preparing contingency plans against a possible Peruvian default after the change of government and are discussing them informally with other Finance Ministries. But the 10 June meeting of US bank regulators may pose a more immediate threat.

The US Treasury (at Thursday's G5 debt deputies meeting) believe the regulators may be prepared to postpone reclassification until the new government has had a chance to consider its policy. Apparently they have the discretionary powers to do this. But there is still a danger that the loans will be reclassified next week. The regulators may be more disposed to take tough action if the immediate Argentine threat has been lifted, because the effects on the banks generally would be less serious.

GENERAL

In both cases, there are two risks. The more immediate one is that some of the US banks concerned may be badly-hit by the need to make big provisions out of profits, or even out of reserves. We do not know in detail how many banks might be involved. The second danger is that a sharp loss of confidence in Argentina, especialy if coupled with enhanced risk of a Peruvian default, will cause some of the banks progressively to withdraw from Latin American loans, putting an increasing strain on the big money-centre banks and on governments to take over their shares. It is this threat which has apparently led the US Treasury to consider another bridging operation; they profess not to be seriously worried about the immediate impact on their own banks, although this must be very much on their minds after Continental Illinois last year.

Treasury officials are keeping in close touch with the US Treasury, and with the French, German and Japanese Finance Ministries (all of whom met in London on Thursday). The Bank of England is watching the implications for British banks very carefully.

The next regular report on the debt problem generally will be coming forward next week. But because events may move more rapidly in the next few days I am sending you this advance warning now with copies to Len Appleyard (FCO) and John Bartlett (Bank of England).

Yours sincerely

Yours ever
Rachel.

RACHEL LOMAX
Principal Private Secretary

7 JUN 1985

CONFIDENTIAL

CC NO

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
TELEPHONE DIRECT LINE 01-215 5422
SWITCHBOARD 01-215 7877

JU495
Secretary of State for Trade and Industry

24 May 1985

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
SW1P 3AG

NBM

D Nigel.

POLISH DEBT

Your minute of 10 May to Geoffrey Howe concluded that we should hold to our present strategy of refusing substantial new credits to the Poles despite the risks of a default, since to do otherwise would increase the sums at risk without helping to solve Poland's problems.

I agree. It was made clear to the Poles again last week, when their Ambassador came in to see Paul Channon, that the question of new credits could not be discussed until after the debt re-scheduling negotiations have been completed.

As you say, one immediate consequence might be that the Poles could not proceed to the formal signing of the multilateral debt agreement for re-scheduling 1982-1984 debts. However, at the most recent meeting of the Paris Club on 17 May I understand that the Poles undertook to consider their position carefully and may in fact sign, subject to making an oral statement that, while they will do their best to meet their obligations, they may need to return to the Paris Club later in the year for a renegotiation if their financial state becomes impossible. At an earlier meeting in London between ECGD officials and the Poles last week progress was made towards negotiating a UK/Poland bilateral debt agreement, but it stuck over a failure to agree on an appropriate interest rate. For the present at least the Poles are refusing to agree the offered rate of ½% above LIBOR.

I am copying this to the Prime Minister, the Foreign Secretary and to the Governor.

Yours ever,

Norman

NORMAN TEBBIT

999-1

Econ Pol Pts

Indebtedness

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ND/M

AF 20/5

FCS/85/138

CHANCELLOR OF THE EXCHEQUER

Polish Debt

1. Thank you for your letter of 10 May in which you recommend that we should hold to our present approach on Polish debt rescheduling and new credits.

2. I agree with your assessment of the risks and difficulties inherent in our approach and I do not dissent from your conclusion that we should hold to our present course. However, we should recognise that in addition to the risks you mention, there could in the event of a de facto Polish default be adverse consequences for our general policy of seeking to build closer relations with Poland and the other countries of Eastern Europe. A default would represent a severe setback for the more liberal elements in the Polish administration and could call in question the future of economic reform and the strategy of seeking assistance from the IMF. It would be likely to increase Polish political and economic reliance on the Soviet Union. And it could also lead to increased instability in Poland, which could in turn have a destabilising effect on East/West political relations.

3. I agree with your view that in isolation a Polish default would have a serious but containable impact on UK banks and the banking system. But it might be difficult to limit the impact if another major debtor were running into difficulty at the same time. A coincidence of defaults could pose real problems for international debt management.

4. Despite these risks I, like you, consider that there is no alternative to sticking to our present approach. At present there

/ is no

is no assurance that Poland could make effective use of substantial injections of new credit, even if these were available. The amount of credit which Poland is seeking is large and the timescale required to achieve a turnaround in Polish economic performance is very long. None of the other major Western creditor governments appears disposed to offer more than a token amount of new credit. In these circumstances, and in the absence of effective policies by the Polish Government - either to implement economic reform or to achieve internal reconciliation - I see no justification for the UK to adopt a more accommodating line.

5. I am copying this letter to the Prime Minister, to Norman Tebbit and to the Governor.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
20 May 1985

Econ Pol Pts

Indebtedness

CONFIDENTIAL

NBPM AT 20/5

Bank of England

The Governor

London EC2R 8AH

17 May 1985

The Rt Hon Nigel Lawson MP
HM Treasury
Parliament Street
London
SW1P 3AG

Dear Nigel,

Thank you for sending me a copy of your letter of 10 May to the Foreign Secretary about Polish indebtedness.

Our officials have examined the position carefully together and I very much share your doubts that HMG could properly grant further medium-term credit to Poland in present circumstances. Short of such a commitment, however, I see advantage in trying to keep the rescheduling process alive if possible; and I think it could be worth exploring what might be done by way of further debt relief to ease Poland through its payments difficulties in the near future. Meanwhile I hope that we can avoid a situation in which Poland is called in formal default since I fear that, even now, this could have uncertain effects on confidence and risk repercussions outside the Polish context.

I am sending copies of this letter to the Prime Minister, the Foreign Secretary and the Secretary for Trade and Industry.

Yours ever,

Robin

CONFIDENTIAL

FILE

RO

10 DOWNING STREET

From the Private Secretary

14 May, 1985

POLISH DEBT

The Prime Minister has seen the Chancellor's letter to the Foreign and Commonwealth Secretary of 10 May and, subject to the views of colleagues, is content with the approach which he suggests.

I am sending a copy of this letter to Len Appleyard (Foreign and Commonwealth Office), John Mogg (Department of Trade and Industry) and John Bartlett (Bank of England).

(Andrew Turnbull)

Mrs R Lomax
HM Treasury

22/105/30554

NDRM cc [illegible]

AP

14/5

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET

Telephone (Direct dialling) 01-215) 5144
GTN 215)
(Switchboard) 215 7877

From the Minister for Trade

The Rt Hon Peter Rees QC MP
Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON
W1P 3AG

14 May 1985

Dear Peter,

POLAND: RESCHEDULING V REFINANCING

Thank you for your letter of 3 May.

I had hoped that, although you judge the monetary impact to be neutral and the PSBR advantage to be therefore cosmetic, you might nevertheless have agreed to a refinancing of Polish debt because of the benefits to ECGD of relieving its cashflow of the enormous burden of Polish claims. This would not only have been consistent with what we have recently done in respect of Brazilian and Yugoslav debts, but also with the two earlier refinancing loans which we signed up with the Poles in relation to 1981 indebtedness.

Your decision appears to have been strongly influenced by the fact that you consider a refinancing of Polish debt to be "disreputable" because of the difficulties which you believe Poland will face in honouring its obligations under the Paris Club settlement. Whilst I am reluctantly prepared to accept your decision on this as final, I am not happy with this interpretation.

As I see it, when a multilateral debt settlement has been reached through Paris Club or equivalent machinery, the chosen method for the bilateral implementation of that settlement is essentially a matter of mechanics and convenience. There is no question of impropriety or disreputability. Refinancing imposes no additional obligations on the debtor or extra exposure on ECGD by comparison with rescheduling. Indeed, because of the low cost of funding from the capital market there is often an interest rate advantage to be gained which can be shared between a debtor country and ECGD. I therefore see refinancing as the proper and normal technique which we should employ to implement international debt restructuring agreements except where there are compelling reasons to the contrary.

999-3

Trade: ECGD 1/80

We will proceed to negotiate with the Poles on the basis of a rescheduling, rather than refinancing, of their debt. I hope, though, that we will not too readily give up the advantages which refinancing has to offer in future cases.

I am copying this letter to the Prime Minister, to Members of EA and EX and to Sir Robert Armstrong.

Yours

PAUL CHANNON

Paul

14 MAY 1985

999-49

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CONFIDENTIAL

CE/NO

① ~~CDP~~ CDP
② Prime Minister ②

AT
13/5

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

FOREIGN SECRETARY

POLISH DEBT

... I attach a note on Poland which has been prepared by my officials in consultation with other departments and the Bank of England. It reports on the state of negotiations with Poland on debt rescheduling and new credits and sets out our current approach and the risks that approach entails. There is broad agreement between Departments on this approach.

2. Officials' judgement, which I accept, is that we should maintain pressure on the Poles to sign the generous 1982-84 rescheduling agreement and withhold any new credit until after signature. After signature we can look at new credit but I doubt whether more than a token amount of short term credit would be appropriate. Other creditor governments, including the Germans, are taking a similar line. We should not however deceive ourselves about the risks inherent in this approach. Without the promise of substantial new credits the financial attraction of de facto default for the Poles is considerable. Quite how such a default would come about cannot be foreseen at this stage but, on the basis of advice from the Bank, I judge its impact on UK banks and the banking system generally to be serious but containable, provided that Polish default was in isolation. Its impact on ECGD's finances would also be severe, although we have already taken it into account for PSBR purposes.

discussed in para 9 onwards in attached note

3. The conclusion I draw from this is that we should hold onto our present strategy. For us to make concessions on new credit in the absence of substantially improved prospects for the Polish economy would increase the sums at risk without bringing nearer a solution to Poland's difficulties. In presenting our case to the Poles, we should continue to emphasise our goodwill and the purely financial considerations underlying our decisions. In the longer term, we must hope that IMF involvement will be a catalyst for much needed reforms but these are at present a long way off.

4. I do not think it is necessary for Ministers to meet to review the position. There is close agreement between Departments on the general approach, while you, Paul Channon and I have all spoken on similar lines in recent foreign contacts. But I am circulating the note now so that Ministers know of the line the UK will take (and the risks it runs) at the bilateral and multilateral meetings on 13 and 17 May.

I am copying this letter to the Prime Minister, to Norman Tebbit, and to the Governor.

Rachel Lomax

N.L.

10 May 1985

(Approved by the Chancellor & signed in his absence)

CONFIDENTIAL

POLISH DEBT

NOTE BY TREASURY OFFICIALS

This note sets out the current state of play on rescheduling Poland's officially guaranteed debt and considers the implications of our current approach. It recommends that despite the risks of default by Poland and the consequences of that for the commercial banks and ECGD, we should hold to that approach.

State of play and current approach

2. Since the Poles initialled in January 1985 a rescheduling agreement covering 1982-84 maturities and of resumed payment of arrears under the 1981 agreements, we have been participating in a further round of multilateral discussion with the Poles, within the Paris Club, on the rescheduling of 1985 maturities (these will continue on 17 May), and are shortly to begin bilateral talks on the 1982-84 agreement (on 13-14 May). The approach adopted to date - reflected in this agenda of talks - has been that the UK is willing to sign the initialled draft agreement rescheduling maturities falling due in the 1982-84 period as soon as the Poles are ready; that we are similarly prepared to negotiate both on the bilateral agreement covering 1982-84 and on rescheduling terms for 1985 maturities (multilaterally and bilaterally); though none of these agreements can proceed to signature before the 1982-84 text has been finally signed. That in turn requires payment of 50% of outstanding arrears under the 1981 agreement.

3. The factor inhibiting further movement is the Polish demand for promises of new credit before they sign the 1982-84 agreement. They have lobbied all their main creditors with substantial quantified demands, amounting for the UK

to $250 million in 1985 and $240 million in 1986. The Foreign Secretary was pressed on this point during his recent visit to Poland and it will most likely be raised again during the visit of Lord Jellicoe, as Chairman of the BOTB, next month.

4. The UK line on new credits has been clear. We have said that we could not consider them until Poland has signed the 1982-84 agreement, started to develop a track record in honouring it (by which we have in mind the payment, due on signature, of the remaining 50% of arrears outstanding under the 1981 rescheduling), and good progress has been made towards the 1985 agreement. At that point we would be prepared to look at the case for new credits but only a small move (say £20m) on short term cover is likely to be justified. In practice this may enable the PVC plant to be finished, but most certainly this would not extend to completing the URSUS tractor project. (Both projects were caught by the imposition of sanctions.)

<u>Other creditors' views</u>

5. Other official creditors appear inclined to do the same, though exceptions may emerge. The Germans have already appeared to go further, in that Bangemann seems to have made a commitment but the Germans are unlikely to do more than we are prepared to contemplate ie about DM100 million of short term cover. The Americans are likely to be even tougher.

<u>Polish reaction</u>

6. Poland's financial prospects are grim, though the speed with which they will get into payment difficulties is inevitably unclear. They may be able to muddle through into 1986. But at some stage our calculations suggest that the Poles will be unable or unwilling to honour their commitments without substantial new credit or further debt relief.

7. This does not mean that we should relax our position on new credits. Until we can be certain they would be used to increase foreign currency earning capacity, it makes little

sense to give the Poles new credits, particularly medium or long term, when we have such serious doubts about their ultimate ability to repay. We do need however to take full account of the likely consequences of a breakdown in the rescheduling process. Judgements on this depend on the form of the breakdown if it occurs.

8. The least bad outcome in the short term from the UK Government's point of view would be for Poland to sign the 1982-84 agreement on present terms, to bring their arrears on the 1981 rescheduling up to date, and to sign a generous 1985 agreement giving virtually total relief on the current year. That at least would bring some small net flow back of funds to the UK. Our tactics in the Paris Club are directed to, and justified by, this end, but this will only provide a short term solution and further problems are likely to emerge in 1986. An alternative perhaps more likely outcome is that the Poles will refuse to sign up 1982-84 on present terms and continue a de facto moratorium on official debts, though fall short of repudiation of them. If they take this course and hence in effect receive 100% debt relief from their official creditors, Poland is likely to be able to continue to service its commercial banking debt at least for the time being. A further alternative - between these two - would be to recognise the financial pressure on the Poles to default but to forestall any such action by reopening agreements already reached and providing more generous terms. This would provide the official creditors with the leverage to ensure that commercial banks took their share of the burden of Poland's non-payment. Such an approach was briefly touched upon at last month's Paris Club; but the French Chairman deliberately steered the meeting towards a less generous and more conventional settlement. As a tactical move, this was probably wise.

Possible consequences of Polish default

9. In judging whether we can accept the type of breakdown in the process of rescheduling Poland's official debts that our position on new credits could well precipitate, we need

to consider the likely consequences for the banking system and ECGD. At present the banks' debts are being serviced and can probably continue to be. How they react to events in the official sphere is likely to depend on the manner of the breakdown. If there is no outright repudiation of debt and the Poles play for time, (continuing to pretend to want to service their debt if only new credits were made available), we would expect the banks to be fairly relaxed, provided no Government called a default. The banks may even as a last resort be prepared to provide some credit if it became necessary to keep their own rescheduling agreements viable, though they are most unlikely to consider spontaneous new lending.

10. If the Poles were to repudiate their debt or if some official creditors formally called Poland in default, both of which seem unlikely, so that the default became de jure and not simply de facto, the situation would be more uncertain. The declaration of a default could trigger cross-default clauses in the banks' documentation, though it would not do so automatically - banks representing the larger share of the debt would need to be in favour. The banks might well in such an event be forced to write off the balance of their loans to Poland not already provided.

11. Though this would be unwelcome to British-owned banks, the Bank of England judge it would in isolation be containable. Provisioning policy varies from institution to institution but the banks have on the whole already gone a long way towards providing against the debt and we judge that losses arising from such write-offs would dent their profits but not seriously damage their financial health. A similar judgement probably applies to the banking sectors of other creditors though we are checking this with other G5 creditors.

12. If the problems were confined to Poland, we can be reasonably confident that the impact on the banks of an overt default and consequent write off would be manageable. But although Poland may now widely be regarded as sui generis,

it cannot be ruled out that any actual declaration of default could have serious repercussions for some other East European countries and lead to damaging uncertainty among the bankers about the extent of Western Governments' commitment in respect of major debtors elsewhere. This suggests that in handling the situation official creditors should keep in mind the desirability of, so far as possible, avoiding such a formal declaration and generally reassuring banking sentiment.

13. We must recognise, however, that it is unlikely for our reaction to Polish default to go unnoticed by other major debtor countries. If Poland is not called into default by its official creditors there is the serious risk that other countries will decide to honour their payments to banks but not to governments. This has to be balanced against the greater risks involved in calling Poland into default, without actually being able to bring any sanctions to bear. Our line therefore must be to proceed with caution.

14. It must also be recognised that a de jure Polish default would have very serious consequences for ECGD. The effect on the PSBR has largely been anticipated, but we would have to look again at the treatment of their finances in public expenditure terms and the presentation of their accounts.

Conclusion

15. Nevertheless the conclusion we draw is that we should hold to our existing strategy. To do so risks, in the unlikely event of Poland being called in default, a write off of debt, but the impact on the banking system should be manageable provided that the default did not trigger or coincide with difficulties with other major debt countries, while the impact on ECGD would have to be faced when we see the circumstances in which default occurs. For us to make concessions on new credit in the absence of substantially improved prospects for the Polish economy would increase the sums at risk, without bringing nearer a solution to Poland's difficulties.

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R3.68

NAPM

AT 8/5

~~EC~~ NO.

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

7 May 1985

Andrew Turnbull Esq
10 Downing Street
London SW1

Dear Andrew

INTERNATIONAL DEBT

On 24 April the Paris Club agreed the first multiyear rescheduling (MYRA) of officially guaranteed debt in the case of Ecuador. This represents an immediate response to the endorsement of the role of such agreements at the recent IMF meetings, though it is the product of much labour over a lengthy period.

The agreement covers three years. Rescheduling in years 2 and 3 is conditional on continued adjustment by the debtor monitored by either standby arrangements with the Fund or carefully focused surveillance by the Fund and creditors. The framework and precedents it has created should be helpful for other countries for whom a multiyear rescheduling may be appropriate.

Although Ecuador is not a major debtor, the conclusion of this agreement is a helpful development on the debt front. Indeed there may be some additional political advantage in having negotiated the first multiyear rescheduling of officially guaranteed debt with one of the smaller debtor countries, thus showing that Governments are prepared to be flexible wherever this is warranted and not just in the case of the major debtor countries.

Yours ever
Rachel.

RACHEL LOMAX

015/1282

cc NO

NDPM
AT 3/5

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Paul Channon MP
Minister for Trade
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1H OET

3 May 1985

Dear Paul

POLAND: RESCHEDULING V REFINANCING

You wrote to me again on 30 April about refinancing Polish debts.

Your letter raises no new points. As I explained, in my letter of 29 April, the "painless" sparing of the PSBR from refinancing Polish debt will not bring commensurate monetary benefits, while in circumstances in which Poland seems unlikely to be able to service its debts, let alone repay them in the foreseeable future, the refinancing technique seems to me to be a disreputable one.

I remain convinced that the proper course is to reschedule and not refinance Poland's debts and, given the urgency of the matter, hope that a draft rescheduling agreement can be sent to the Polish side without delay.

I am copying this letter to the Prime Minister, to Members of EA and EX and to Sir Robert Armstrong.

Yours ever Peter

PETER REES

Trade [illegible]

NBPM

MF 1/5

MR TURNBULL 1 May 1985

ECGD: POLAND RESCHEDULING

Paul Channon has suggested that the Polish Debt should be refinanced under ECGD guarantee to improve ECGD's financial position. This would involve City lending under guarantee, and the replenishment of ECGD's cash flow.

Peter Rees opposes this on the grounds that it would not be right to issue a fresh guarantee because there is serious concern and uncertainty over Poland's ability or willingness to repay. He feels that the loans should be rescheduled in the Paris Club negotiations, aimed at getting some inflow of funds to the UK and ECGD, but that we should go no further.

We support the Treasury view and do not feel that the financial position of the UK is so serious that this kind of manoeuvre should be resorted to in order to improve ECGD's apparent financial position.

David Hobson

DAVID HOBSON

8/304/18588

CC PS
NO

From the Minister for Trade

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215) 5144
GTN 215)
(Switchboard) 215 7877

~~1) AT~~
2) NBPM
CDP 30/4

The Rt Hon Peter Rees QC MP
Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

30 April 1985

Dear Peter.

POLAND - REFINANCING

Thank you for your letter of 29 April in which you reject the idea of refinancing Polish debts guaranteed by ECGD.

To the extent that ECGD's cash deficits form part of the PSBR, I accept that the Treasury should have the major say in the way they are financed. However, I must say that I do not find your reasons for rejecting a refinancing deal with Poland at all convincing. It is not every day that we are faced with a relatively painless way of sparing the PSBR (and ECGD's cash flow) to the tune of nearly £½ billion and I hope you will give the matter further thought before ECGD officials open up serious talks with the Poles. There would be no administrative problems in refinancing buyer credit payment obligations which constitute the bulk of the debt which has to be restructured in the wake of the Paris Club settlement, and on the Brazilian precedent, we could probably find cheaper sources of long term funds through the City than the normal banking channels.

I am copying this letter to the Prime Minister, to members of EA and EX, and to Sir Robert Armstrong.

Yours,

Paul

PAUL CHANNON

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Trade Jan 80
E(GD)

018/106

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1) AT
2) NBPM
DP
29/4

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Paul Channon MP
Minister for Trade
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1H OET

29 April 1985

Dear Minister

POLAND RESCHEDULING

Thank you for your letter of 16 April about the desirability of refinancing rather than rescheduling debt agreements under the auspices of the Paris Club.

On the general issue my view is that the method of restructuring such debts should continue to be considered case by case. If propriety and considerations of cost to ECGD permit - and the debtor can be persuaded - refinancing should be the preferred route. Where it is, care must be taken to minimise its monetary effects. This will generally mean funding by capital market issues rather than by bank lending. Even then the benefit to the PSBR, though welcome, will not be reflected in an equivalent reduction in pressure on interest rates.

We have also considered the two major cases you mention of Nigeria and Poland. On Nigeria, I think we are at one in rejecting for the moment any refinancing of Nigerian claims given its unwillingness to come to an agreement with the IMF and the risk of the Nigerians defaulting on their medium term liabilities.

The Chancellor and I have considered the question of refinancing v rescheduling very carefully in the case of Poland. I cannot agree that judgements about Poland's ability to repay a restructured debt are irrelevant to the choice of method. A refinancing would involve the issue of a fresh guarantee. In the case of Poland, its past record and our serious concern about its future performance means that there is very considerable uncertainty about whether Poland will be able or willing to repay. Even if this falls short of circumstances in which it would be improper in a legal sense for the Department to give its guarantee, I think it would be imprudent, and difficult to justify to Parliament, giving or renewing a guarantee in respect of a risk which seems very likely to crystalise, when an alternative mechanism is available. It would also be open to criticism to choose a restructuring technique which obscured the underlying position and gave a misleading picture of ECGD's and the public finances.

Nor do I agree with your assertion that if the situation is so bad, we ought not to be going along with the Paris Club agreement in its present terms. Our support for that agreement rests on its importance as a means of securing some inflow of funds to the UK and ECGD, as opposed to the 100 per cent moratorium the Poles have benefitted from so far.

I hope therefore you can now accept that Poland's debt should be rescheduled rather than refinanced. Our view has been reached after careful reflection. Since our officials are to meet the Poles multilaterally in the Paris Club on 18 and 19 April and, subsequently bilaterally on 13 and 14 May, the draft form of agreement assuming rescheduling does need to be sent to the Poles without delay.

I am copying this letter to the Prime Minister, to members of EA and EX and to Sir Robert Armstrong.

Yours sincerely

[signature]

for PETER REES

[Approved by the Chief Secretary]

FRANCE: ECGD Jan '80.

29 APR 1985

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7/154/28184

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215) 5144
GTN 215)
(Switchboard) 215 7877

From the Minister for Trade

D/T 1....
2) NBPM

The Rt Hon Peter Rees QC MP
Chief Secretary to the Treasury
Parliament Street
LONDON
SW1

CDP 17/4

16 April 1985

Dear Peter

See TRADE: ECGD Jan. 80.

In your minute of 3 April to the Prime Minister you outlined the steps you and I are taking to improve ECGD's financial position. At our meeting before this, we discussed the relevant merits of refinancing and rescheduling ECGD's overseas debts which are subject to Paris Club treatment.

My starting point is that we should seek to refinance wherever possible on the grounds that this achieves a real improvement in ECGD's cashflow and to the PSBR.

The underlying debt is unchanged, whether we refinance or reschedule, but I attach considerable importance to the presentational advantages of reducing ECGD's cash deficit as far as we can. And I would imagine that you would welcome the relief to the PSBR.

I mentioned at our meeting that there were two big ticket items where in my view refinancing ought to be considered. They are Nigeria and Poland. Nigeria cannot be a serious candidate at this stage in view of their failure to come to terms with IMF: indeed the future prospects are looking somewhat bleak and we have already agreed to revise our projections for ECGD's overall cashflow in recognition that there is now some risk of the Nigerians defaulting on their medium term liabilities in the not too distant future. But Poland is a good candidate and I should like it to be seriously considered since we shall very shortly be talking to the Poles about restructuring their 1982-84 debts. We have already agreed two refinancing loans for Poland and the structure of their 1982-84 debt is such that a further refinancing would be relatively easy to arrange. Moreover, the amount (£486m) is substantial.

I understand, however, that Treasury officials have reservations about a refinancing deal for Poland, mainly on the grounds that their economy is so weak that there must be serious doubts as to whether they will be able to service a new loan over the term already agreed in the Paris Club. I cannot, however, see that this is relevant to the issue of whether the Polish debt should be refinanced or rescheduled. I regard both techniques as of equal merit and I cannot see that the risk of a further rephasing of the terms of the loan should preclude the granting of that loan. If the situation is so bad that we believe the Poles will be unable to pay on the agreed dates then we ought not to be going along with the Paris Club agreement in its present terms.

If on the other hand there are problems in relation to the monetary effects of a refinancing loan then of course we should have to take account of them. but in the absence of any compelling Treasury counter arguments I should like to authorise ECGD to identify the most appropriate refinancing technique and to invite tenders from the bankers.

I should welcome an early reaction since there is not all that much time to do this ahead of the bilateral discussions due to take place at the end of April or early in May.

I am copying this letter to the Prime Minister, to members of EA and EX and to Sir Robert Armstrong.

Yours,

PAUL CHANNON

Paul

999-49

R3.10

010

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CONFIDENTIAL

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

9 April 1985

MS

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Prime Minister
The summary in the first 9 pages of this report are worth glancing at
AT 12/4

Dear Andrew,

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

The report will provide useful background briefing for the forthcoming series of international economic meetings. The overall picture is slightly more pessimistic than in previous reports. This reflects the continuing uncertainty and fragility of the present position, both in relation to the domestic economic problems of the major debtors and to the US economy and the threat of protectionism there. However, current policies, and in particular the case by case approach, should be sustained in the forthcoming meetings eg the Interim/Development Committee meetings in Washington. There may be problems thereafter and we shall be looking further at these.

Our main worry is the major debtors, notably Brazil and Argentina, whose IMF programmes have broken down. Despite the uncertainties created by Neves' serious illness, the economic team in Brazil seem intent on pressing ahead with discussions with the IMF and the commercial banks with the aim of an early reinstatement of the programme. The timetable on Argentina may be slower. The Argentine Government has told the French Tresor that it will not be ready for bilateral Paris Club negotiations with them or the UK which had been suggested for later this week.

Elsewhere the prospect is mixed, with some encouraging developments. But in two countries there is a risk of default. One is Poland, which probably cannot service its debt to Western Governments without substantial new credits. These seem unlikely to be available and would only compound the problem. We are assessing the risk and possible consequences; but it is of course relevant to the Foreign Secretary's forthcoming visit to Poland (and reflected in his briefing). The other is Peru, where a change of government later this year seems likely to bring to power an opposition committed to seek a reduction of the debt burden with or without the agreement of creditors. In this case the UK's exposure - banking and ECGD - is fairly small; but the possible implications for Latin American debt generally will need careful watching.

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

Yours ever
Rachel.

MRS R LOMAX
Principal Private Secretary

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INTERNATIONAL FINANCIAL SCENE

General perceptions of the debt situation seem to have become somewhat more gloomy since the last report, with a number of developments in both creditor and debtor countries serving to underline the fragility of the success that has so far been achieved. Attention will now shift to the Interim/Development Committee meetings in Washington on April 17/19. The risk is that, whatever expectations debtors may have formed about these meetings, they may use what they would claim as inadequate results to justify their adopting a less moderate stance than they have done so far. In addition, Latin American debtors may decide to issue their invitation to the Summit 7 to participate in a "political dialogue" on debt.

Developments in the United States over much of the recent period have in general not been encouraging for LDC debtor countries. Growth in the US seems to have, at least temporarily, slowed significantly: the 'flash' estimate for GNP growth in the first quarter of 1985 was only 0.5% (2.1% at an annual rate), half the rate of the previous quarter. Over the past few weeks US interest rates have edged upwards; the three-month eurodollar rate has moved from 9% to 9 1/4%. Despite the temporary success of the concerted intervention of non-US central banks and the statements by Volcker and others that the currency was overvalued, the dollar continued to rise for much of the period. With the current account deficit exceeding $100 bn in 1984 (the principal counterpart to the substantial improvement in the external postion of many debtor countries over the past year) and expected to rise further this year, fears have grown that if the dollar does not fall substantially the US may introduce major new protectionist measures as a response to a general feeling that their external sector is out of control. In the last two weeks the partial reversal of the dollar's earlier appreciation will have brought some relief to the debtors as some two-thirds of developing countries' external debt is denominated in dollars (although the total benefit to debtors of the dollar's fall will be reduced because of its effect on trade). The immediate impetus to the dollar decline - ie, the run on a number of savings institutions in Ohio - will have done nothing to reassure market sentiment about the condition of US financial institutions more generally. And, with inflation edging up in the United States and elsewhere, earlier limited terms of trade gains for the debtors could well be reversed.

At the same time, with greater attention being paid to internal developments in the debtors, more sombre appraisals have been made of the adequacy of the adjustment they have undertaken so far. Whilst debtors' external performance over the last couple of years has in a number of cases been spectacular, success in meeting internal targets has in general been much less. All the major Latin American countries have, for instance, consistently overshot their inflation targets. Concerns over these failures were highlighted dramatically in February when the IMF suspended new lending to Brazil because of Brazil's excessive monetary growth. Although the Fund had until then repeatedly accepted reformulations of its programmes as internal targets failed to be achieved, on this occasion they were firm that there could be no waiver.

Negotiations over reschedulings seem to be progressing slowly, perhaps partly because of the tendency recently for debtor countries to seek some form of banks' MYRA, with all the additional complications - over eligibility, comparability, conditionality and general technical difficulty - that these entail. The signing of the banks' MYRA for Mexico at the end of March, almost eight months after the initial agreement with the Advisory Group, will have been the first for a major debtor. No further signings of banks' MYRAs for major debtors can now be expected before mid-year. And no discussions on official MYRAs are at present in progress for any debtor.

On the positive side, a number of countries have reached agreement with the Fund, and a number of conventional rescheduling packages have been put in place. Technical questions, such as the mechanics of currency conversion, seem to have found a solution. A number of governments have recently introduced additional fiscal measures in order to bring their countries' economic performance closer to their internal targets, and have accepted further real currency depreciation in order to improve their external positions. The continuing weakness of the oil price (whilst having an adverse effect on Mexico, Venezuela, and a few others - who perhaps are in general better able than others to withstand some reduction in their export revenues) will have benefitted the majority of debtors.

Little has been heard recently of the "Cartagena Consensus" or other regional groupings of debtors. As noted in the last report, the meeting of the Cartagena Consensus countries in Santo Domingo in February drew lower levels of representation than earlier meetings of the Group, and a generally moderate stance was endorsed. The Interim/Development Committees meetings on 17-19 April will be crucial for assessing whether this present moderate stance will persist.

POSITION IN THE MAJOR DEBTOR COUNTRIES

(i) Latin America

804% inflación.

Following Argentina's apparent failure to satisfy several of the performance criteria of its IMF programme during the final quarter of 1984, and de Larosiere's refusal to grant a waiver to allow the first additional tranche of the Standby to be drawn down, the new Argentine Economy and Finance Minister, Juan Sourrouille, has committed himself to bringing the programme back on course. He has already begun discussions with the IMF on ways of doing so, but has stated that the inflation targets in the programme are unattainable: indeed, with prices having risen by 804% in the twelve months to end-February, the aim of reducing the annual inflation rate to 150% in the final quarter of 1985 appears quite unrealistic, and the higher level of inflation will itself prevent achievement of other targets expressed in terms of Argentine pesos. Given the difficulties with the IMF programme, signature of the commercial banks' $4.2 bn loan agreement, scheduled for 29 March, has been postponed. The banks' Working Committee has sent a telex to the banking community informing them of recent developments, included in which was a supportive message from de Larosiere asking the banks to maintain their commitments to the package. Commitments had reached a total of $4.15 bn. Meanwhile, a Fund team has returned to Argentina. The UK's bilateral negotiations with Argentina under the Paris Club agreement were expected to begin on 11-12 April. The Argentines have not yet confirmed these dates to the French Trésor, who are to provide the venue for the meeting. In view of Argentina's difficulties with the IMF it is our intention to proceed with the bilateral discussions but to hold up completion and signature until a revised Argentine IMF programme has been approved by the Fund Board. The breakdown of the IMF programme and the resultant delays in finalising agreements with the banks and official creditors have led to demands by Argentina for bridging finance from the US Treasury and friendly governments, notably Mexico. So far, these requests have not produced results. However, it is possible that the most exposed US banks might be receptive if a request were made for commercial bank bridge finance to prevent interest arrears going beyond 180 days (in which case the US regulators might require them to make some provisions against Argentine exposure).

In Brazil, the new civilian government of Tancredo Neves (inaugurated on 15 March) inherits a difficult situation, not least because Tancredo himself has been unable to assume office owing to a serious illness which has necessitated three major operations. Vice President Sarney is temporarily in charge. As regards economic policy, early indications are that the new economic team are aware of the need for a major tightening of policy; they have already announced a three-month freeze on spending on new projects and a 10% reduction in expenditure by ministries and Federal institutions. Discussions will take place shortly between the new government and the IMF on reinstating the EFF programme, but the IMF Board will probably not see the results of these discussions until May. In the meantime, the Advisory Committee of banks has suspended discussions over Brazil's MYRA and has recommended to the banks an extension of trade credits ($10 bn) and interbank lines ($6 bn) to 31 May. The extension was supported by de Larosiere and has been accepted by the banks with a few minor exceptions. If the programme is not re-instated by the end of May, banks will have to decide whether to extend these deadlines.

There was somewhat better news in Mexico. After seven months of negotiations, the first phase of the banks' MYRA for Mexico - covering $23.6 bn of previously rescheduled debt and $5 bn of 1983 new money - was signed in New York on 29 March. Mexico has agreed in principle a Letter of Intent with the IMF covering the third year of its adjustment programme.

In the case of the other major Latin American debtor, Venezuela, an agreement with the Advisory Committee on the terms of a MYRA is expected in the near future. However, some banks are known to be unwilling to finalise terms until the whole of Venezuela's private sector debt has been registered; Venezuela and the Advisory Committee will discuss progress on this later this month. The 'roadshow' scheduled for April is now unlikely to take place before mid-year.

Chile has reached a provisional agreement with the IMF on a three-year EFF for around $750 mn. In view of the extensive damage caused by a major earthquake early in March, IMF officials are reported to have agreed to a public sector deficit target of 3.5% of GDP compared with an original target of 3%. Negotiations with the banks begin this week on the rescheduling of 1985 maturities and on Chile's request for some $1.1 bn of new money for 1985. Colombia is still holding out against an IMF programme. The IMF has agreed to give the commercial banks an account of the findings of its recent Article IV consultation, and the Colombian authorities hope that when these are made known, the banks will be prepared to put up $550 mn of new money in 1985 without an IMF programme. It is noteworthy that banks have responded well to an $80 mn IADB complementary credit (ie co-financing) for a Colombian power project. A one-year SDR 105.5 mn Standby programme for Ecuador was agreed by the IMF

Board on 13 March. This followed commitment of a critical mass by commercial banks to the $200 mn new money element of Ecuador's debt package. Having already reached agreement with the banks' Steering Committee on the broad outline of a 5-year MYRA, Ecuador has asked the banks for a 90-day extension of the moratorium on debt principal repayments to permit breathing space for further negotiations. The Paris Club is to discuss at the end of April Ecuador's request for a 5-year official MYRA covering 85% of interest and principal. Although there is official reluctance to agreeing a MYRA of this length, it should be possible to agree on something shorter. No significant progress with the IMF or commercial banks is likely in Peru until after the April/May elections; the banks will probably continue to roll over maturities on condition that further efforts are made by Peru to bring interest arrears below 180 days.

(ii) Far East

The signing of the rescheduling/new money package agreed by the Advisory Committee of banks for the Philippines has been delayed following the decision of one of the more sizeable creditors not to participate in the agreement. The package (together with those reached with official creditors) may also be jeopardised by a failure to observe performance criteria set as a condition of the SDRs 615 mn Standby Arrangement; an IMF team is currently in the Philippines for the programme's first review.

Elsewhere in the region, Korea's export performance so far this year has been disappointing. As a result, the country's current account deficit for the first two months of 1985 amounted to almost $600 mn, compared with $400 mn for the same period last year and an official target for 1985 as a whole of $500-700 mn. Although timely action has been taken to curb imports, the official target now looks unattainable. Despite this, and the recent failure of the Kukje Corporation (the country's sixth largest conglomerate), syndication of a $600 mn eurocredit for Korea Exchange Bank on similar terms to those achieved last year has proceeded smoothly.

(iii) Eastern Europe

Because of the failure of some creditors to receive the full 30% downpayment of arrears arising under the 1981 Agreement, the Paris Club did not discuss rescheduling Poland's 1985 maturities and interest payments during its meeting of 5 and 6 March. The agreement in principle to reschedule 1982-84 indebtedness may be in difficulty: official creditors now want it to be signed and operating before they offer any new credit (which is likely to be minimal), while the Poles want to be assured of new credit before they sign. A further meeting is scheduled for 26 April. Yugoslavia has agreed the Letter of Intent for a new IMF Standby programme, which will be submitted to the Board on 26 April. The official creditors initialled a debt-restructuring agreement in Paris on 26 March covering the period 1 January 1985 to 15 May 1986. A further meeting with the commercial banks is scheduled for 11 April in New York when it is hoped that a compromise agreement rescheduling 1985-88 maturities can be reached.

Commercial banks continue to show renewed interest in lending elsewhere in Eastern Europe. The $150 mn credit for the GDR was heavily oversubscribed and finally increased to $500 mn. The Soviet Foreign Trade Bank is currently raising through LBI a £75 mn seven-year credit, believed to be its first syndicated sterling credit, at Libor + 1/4% for three years rising to 3/8% for the balance. These are the same terms as for the recent operation which was finally doubled to Ecu 100 mn. Hungary is expected to approach the banks for a $400 mn co-financing loan in April and will reportedly be seeking better terms than for its borrowings last year (Libor + 1%). This loan may be the last co-financing for Hungary to be considered by the IBRD.

(iv) Southern Europe

Although Portugal is not to seek a new IMF Standby Agreement, a staff paper on the experience of the last Standby, which expired in February, as well as on recent developments, will give an opportunity of assessing the situation in advance of the routine consultations later in the year.

(v) Africa

The terms of the $1.5 bn commercial bank rescheduling package for Morocco, outlined in the last Report, have been accepted by two thirds of the 200 banks involved. The Nigerian government shows no sign of rapprochement with the IMF on the key elements of a Fund programme. A further small issue of notes to uninsured creditors has, however, taken place, and back interest to 1 January 1984 paid. But no interest payments appear to have been made yet on insured arrears, though this may merely reflect an administrative muddle.

A further IMF mission has been despatched to Sudan to encourage the government to clear up arrears so as to move towards the eventual normalisation of relations with the Fund. The steering committee of the commercial banks has endorsed further rescheduling proposals.

Heavy current account deficits in the early 1980s led to a sharp rise in the level of South Africa's external debt - almost all of it short-term. The continuing need to roll over this debt is a focus of attention. Following the sharp depreciation in the rand last summer the authorities introduced an austerity package. Initially the burden of adjustment fell almost entirely on monetary policy, but fiscal policy has now been tightened following the recent budget measures.

(vi) Other

The IMF have so far failed to reach agreement with Turkey on terms for a new Standby programme. Although the Turks are expected to revise the presentation of their current-account data in a way that is likely to show the deficit in 1984 at around $1.5 bn, the outturn on the old basis is unlikely to show any improvement on the 1983 deficit level of $2.2 bn.

While the Israeli budget for 1985/86 has passed its first hurdle in the Knesset, the price, wage and tax agreement reached in February is in danger, with both trade unions and manufacturers threatening to withdraw. The US State Department have made clear their wish to see more determined action by the Israeli Government (particularly over budget cuts), but pressure from Congress may well lead to the Israelis' request for supplementary economic aid being granted.

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INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1984	End-June 1984	End-Dec 1984 [2]	End-Dec 1984 [3]
Latin America				
Argentina	48	2.5	0.2	0.3
Brazil	100	6.6 (0.5)	0.7	1.7
Chile	19	1.3	-	0.1
Colombia	12	0.7	-	0.2
Ecuador	7	0.6	0.1	0.1
Mexico	95	6.2 (0.6)	0.5	1.2
Peru	14	0.4	0.1	0.1
Venezuela	35	2.3	-	-
Eastern Europe (convertible currency)				
East Germany	13	0.6	0.1	0.1
Hungary	8.5	0.5	-	0.1
Poland	27	0.5	1.0	1.1
Romania	8	0.3	0.2	0.4
Yugoslavia	19	0.9	0.7	1.1
Southern Europe				
Greece	12	1.5	0.2	0.4
Portugal	15	1.3	0.2	0.3
Spain	41**	2.8 (1.0)	0.1	0.1
Far East				
Indonesia	35	0.9	0.7	1.4
Philippines	26	1.3	0.2	0.2
South Korea	43	2.7 (0.7)	0.4	0.7
Africa				
Morocco	13*	0.1	0.1	0.2
Nigeria	21*	1.2	1.5	3.0
South Africa	24	4.9	0.8	2.9
Sudan	8*	-	0.1	0.2
Other				
Israel	30**	0.6	0.1	0.1
Turkey	20	0.3	0.2	0.3

[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] Defined as unrescheduled principal disbursed, plus political claims paid and claims under examination.

[3] Defined as guaranteed principal and contractual interest, plus political claims paid and claims under examination.

* Estimates for end-December 1984 ** End-June 1984

Amounts in brackets represent undisbursed commitments where these exceed $1/2 bn.

CONFIDENTIAL

ANNEX

Throughout the following notes on individual countries, "exposure" is defined as consolidated gross 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. ECGD amounts at risk exclude claims paid (net of recoveries).

CONFIDENTIAL

ARGENTINA

Total external indebtedness was estimated at $48 bn at end-1984.

Although details are not yet available, it is now apparent that Argentina breached several of the performance criteria of its IMF programme during the final quarter of 1984. Both its fiscal and monetary targets were probably exceeded, and the Managing Director of the IMF was not prepared to grant a waiver to permit the first conditional drawing on the Standby to be made. The new Economy and Finance Minister, Juan Sourrouille, whilst confirming his commitment to restrictive demand policies, has stated that the inflation targets enshrined in the programme are unattainable. The programme envisages a reduction in the annual inflation rate to 150% in the final quarter of 1985, but, as prices rose by 25% in January and 21% in February (bringing the inflation rate in the twelve months to end-February to 804%), that aim looks scarcely realistic. Talks between Sourrouille and the IMF to consider ways of getting the programme back on course took place in Washington in the third and fourth week in March. Sourrouille also met the banks' Working Committee in New York. President Alfonsin too has visited the US, where he sought greater understanding of Argentina's difficulties and support for his administration's policies.

The talks between the Fund and the Argentines will aim to set new targets for the coming year, but de Larosiere will wish to see two months' good performance by Argentina before being willing to recommend a revised programme to the Executive Board. Before these latest developments, and in spite of the initial apprehension felt by the banks with the sudden ministerial changes, the pace of commitments to the $4.2 bn of new money had quickened somewhat. Commitments are now about $4.13 bn; but given the problems with the IMF programme, signature of the loan agreement has been put back from the scheduled date of 29 March. The Working Committee has sent out a telex to the banks detailing the latest developments. Included in it was a supportive message from de Larosiere asking the banks to maintain their commitments to the refinancing package. The Working Committee had told the IMF that the banks would need such a message if they were to stay in line, and that Argentina would also have to reduce arrears on interest payments on public sector debt which are now over four months overdue.

The switching of Economy and Planning portfolios in Alfonsin's government between Bernardo Grinspun and Sourrouille, and the replacement of Enrique Garcia Vazquez by Alfredo Concepcion as President of the Central Bank, were not intended to signal a shift in the direction of economic policy, but rather to improve the style and cohesion of the government economic team. However, it is thought that Sourrouille will prove more resourceful than Grinspun in applying the government's counter-inflation strategy: in particular, he hopes to win greater support for wage and price restraint from the trade unions and industry. On external policy, Sourrouille will probably continue the practice of daily exchange rate adjustments, with additional intermittent mini-devaluations. In January and February, Grinspun had allowed the rate of depreciation to fall behind the Argentine inflation rate. Sourouille has already increased the pace of depreciation, but the gap between the official and black market rates has so far not closed.

At end-December 1984, ECGD had an estimated $261 mn at risk. At end-June 1984, British-owned banks' exposure to Argentina totalled $2,469 mn and consolidated external claims $2,568 mn, whilst UK-registered banks' exposure was $3,422 mn and consolidated external claims were $3,441 mn.

BRAZIL

Total external debt at end-1984 was estimated at $100 bn.

Following twenty years of military rule, a new civilian government under President Tancredo Neves took office on Friday 15 March. However, Tancredo (who is 75) was taken ill with a serious intestinal complaint the day before he was due to be inaugurated, and has subsequently had three major operations following the emergence of complications. Brazil has consequently been thrown into political turmoil. Vice President Jóse Sarney is temporarily in charge of the government and has received pledges of loyalty from Tancredo's ministerial team. The military are thought unlikely to intervene, but at best Tancredo may be incapacitated for the foreseeable future; at worst, Sarney (who is generally considered a lightweight political figure) may have to assume office in place of Tancredo.

The main figures nominated to Tancredo's economic team are pragmatic and moderate. The Minister of Finance is Tancredo's nephew, Francisco Dornelles, under whom the Ministry will have its former position of pre-eminence; the Planning Minister is Joao Sayad, who had a sound and responsible record as Financial Secretary in the Sao Paulo state government for the last two years; and the new President of the Central Bank, Carlos Lemgruber, is a respected middle-of-the road economist.

The administration inherits a difficult economic and financial situation. It became clear in the week ended 8 February that final agreement between the outgoing Brazilian government and its Advisory Committee of banks on a MYRA would have to be postponed because of difficulties with the IMF programme. These resulted from an excessive rise in the monetary base in December, and therefore for 1984 as a whole, the rise being caused mainly by budgetary expansion in excess of Fund targets rather than, as earlier in the year, by an unexpectedly rapid growth of reserves. Moreover, inflation (year-on-year) was almost as high at end-1984 as it had been a year earlier, at 224% against an original IMF target of 95%; there was no improvement in January-February, and the 1985 target of 120% is probably now unattainable. The worse than expected performance on inflation means that Brazil almost certainly exceeded by a substantial margin the end-1984 performance target for the overall PSBR. It also seems clear that, without a major tightening of policy, Brazil is unlikely to succeed in restricting the growth of the monetary base and the money supply to a targeted 60% in 1985; following December's large increase, further expansion in the first two months of the year brought the year-on-year increase in the monetary base to 269% in February (compared with an end-1984 target of 95% and an outturn of 244%). Because of these developments, the IMF's Managing Director rejected the possibility of a further waiver, and the scheduled March purchase (SDR 374 mn) under the EFF was therefore postponed.

The Fund has already begun preliminary discussions with the authorities on the 1985 programme, but the results are unlikely to come before the Board until April or May. The Fund will doubtless be seeking firm assurances from the new economic team that strong remedial action will be taken, particularly in the area of fiscal policy, to correct the major deviations that have occurred so far in 1985. The early signs are that the new team are aware of the need for strong action. Dornelles has already introduced a number of measures, including an immediate 3-month freeze on spending on new projects and a 10% reduction in expenditure by ministries and Federal institutions. Until the IMF has obtained adequate assurances, and worked out appropriate new performance criteria, it is unlikely that any further progress will be made on the commercial bank MYRA, or on the Paris Club negotiations for a similar deal (although, encouragingly, Dornelles and Lemgruber agreed to meet the Advisory Committee in New York on 1 April).

Because of these setbacks, the Advisory Committee agreed to a Brazilian request to recommend to the banks that they extend the maintenance of trade credits ($10 bn) and interbank lines ($6 bn) to 31 May. On 14 February, the Committee sent out to the banks a telex which was accompanied by a letter from de Larosiere supporting the extension and outlining the position of the Fund.

Doubts about Brazil's prospects for 1985 have been reinforced by the trade figures for the first two months of the year which showed a trade surplus of $1.1 bn, compared with $1.4 bn in the corresponding period last year. These results raise some doubts whether Brazil will be able to achieve the current target of a $12.9 bn trade surplus in 1985, particularly as export subsidies are to be phased out by May.

At end-December 1984, ECGD had an estimated $1,687 mn at risk. At end-June 1984, British-owned banks' exposure to Brazil totalled $6,550 mn and consolidated external claims $5,885 mn, whilst UK-registered banks' exposure was $9,658 mn and consolidated external claims $8,998 mn.

CHILE

Total external indebtedness at end-1984 was an estimated $18.6 bn.

Provisional agreement with the IMF on a three-year EFF for around $750 mn was reached in mid-February. The economic programme envisages a reduction in the public sector deficit from 4.7% in 1984 to 3.0% in 1985, a reduction in inflation from 26% to 23%, and a cut in the current account deficit from $1.8 bn to $1.4 bn. Overall, GDP growth is set at 4%, compared with 5.9% last year. However, after a major earthquake shook the country in early March, causing some $1 bn of damage, including loss of copper production, the new Finance Minister, Sr Buchi, and IMF officials met to consider a relaxation of some of the targets, notably those for the public sector and current account deficits. It now seems that a public sector deficit in 1985 equivalent to 3.5% of GDP has been accepted by the IMF, allowing extra government spending equivalent to $100 mn, which has to be linked to the accelerated drawing of funds from the IBRD and IADB which are to be redirected to earthquake relief and reconstruction work. The Chilean authorities still do not contemplate requesting a rescheduling from the Paris Club.

On 14 March, Buchi presented a request to the commercial banks in New York for a rescheduling of 1985 maturities and a new money loan of $1,050 mn. Their response is not yet known, but in previous discussions they showed considerable reluctance to respond fully to a request for $875 mn of new money. They have, however, agreed to an extension, to 1 July, of the moratorium on maturities falling due, to allow time for Chile to conclude negotiations with the Fund.

In late February, the new Finance Minister announced a package of economic measures and proposals as a prelude to the new IMF programme: they included a devaluation of the peso by 7.7%, the immediate reduction of import tariffs from 35% to 30% (originally planned for July), reductions in government expenditure, and an assurance that the authorities are determined to tighten monetary policy and raise interest rates so that they become positive in real terms. One reassuring development for Chile has been the increase that has occurred in the copper price on world markets, and some observers are forecasting a price of $0.70 per lb by the end of June (from $0.55 at the end of 1984). Without this price increase, Chile's current account target for 1985 would have been virtually unattainable. Government policies, as reflected in the EFF and also in a request for an IBRD SAL, are designed to stimulate exports in the medium-term. In the meantime, the country's payments position continues to be very serious, given the need to raise substantial amounts of new money over the next three years.

ECGD had an estimated $50 mn at risk at end-December 1984. At end-June 1984, British-owned banks' exposure to Chile totalled $1,303 mn, and consolidated external claims $1,295 mn. At the same date, UK-registered banks' exposure amounted to $1,934 mn and consolidated external claims $1,926 mn.

COLOMBIA

Total external indebtedness at end-1984 was an estimated $11.5 bn.

There have been no major developments since the last report in the debt negotiations between Colombia and the banks' Consultative Committee. Discussion of the Colombians' request for $550 mn of new money from the banks in 1985 (revised from an original request for $875 mn) will resume towards the end of March. An IMF Article IV mission, which was brought forward by four months in response to the banks' desire for up-to-date information in the current negotiations, was in Colombia from 11 February to 7 March, and will give the Committee an account of its findings at the beginning of April in advance of the written report (due in May). The Colombian authorities hope that the Fund's report will be favourable enough to persuade the banks to drop their demand that Colombia should apply for a Standby Arrangement. In the meantime, a proposed IADB complementary credit of $80 mn for the Jaguas Hydroelectric development has received a very positive response from European and Japanese banks. The loan, which is being managed by Samuel Montagu and Kleinwort Benson, requires $52 mn from the banks and has been oversubscribed by 70%. The last commercial banks' syndication for Colombia was in the form of $175 mn of a $370 mn IBRD co-financing to the state electricity company, the banks' money being disbursed in December.

The authorities have recently published economic plans for 1985-86, which project a current account deficit of $1.2 bn (cf $1.75 bn in 1984), resulting from a move into small surplus in the trade account (from a deficit of $340 mn in 1984). The improvement is expected to result in part from exports of coal from the El Cerrejon development, which began last month, a year ahead of schedule, and are expected to bring in $500 mn this year. Colombia expects further improvement in its trade account next year as its next oil fields begin production.

At end-December 1984, ECGD had an estimated $184 mn at risk. At end-June 1984, British-owned banks' exposure to Colombia totalled $707 mn and consolidated external claims $671 mn. UK-registered banks' exposure was $882 mn and consolidated external claims amounted to $827 mn.

ECUADOR

Total external indebtedness at end-1984 was an estimated $7.2 bn.

A one year Standby programme for SDR 105.5 mn was agreed by the IMF Board on 13 March. Discussion of the SBA by the Board had been delayed because of the slow progress of subscriptions to the $200 mn new money element of Ecuador's commercial bank debt package, which the Fund stated must exceed a 'critical mass' of 92% before the SBA would be considered. The sluggishness of the commercial banks' subscriptions seems to have derived largely from the reluctance of some smaller (mainly US) banks to increase their exposure to Latin America in general, rather than a lack of confidence in the economic prospects of Ecuador in particular.

Delays with the Fund agreement also led to the postponement of the Paris Club's consideration of Ecuador's request for a five year MYRA covering 85% of interest and principal for maturities of $300 mn. This will now be considered in late April. The Paris Club is unlikely to accede to Ecuador's request in full but seems prepared to grant a two year MYRA, with a trigger for a third year, dependent upon Fund surveillance.

The government's stated economic policy of continued retrenchment and a tightened fiscal and monetary stance, in line with IMF targets, has been threatened by a conflict between the President and the Congress on the question of minimum wages. President Febres Cordero had been anxious to keep any increase in minimum wages to 35% and had recommended to Congress a bill to that effect. (Inflation in the year to February 1985 was 30%.) However, Congress has rejected the President's bill, arguing instead for a 50% increase. A one-day general strike has been called by the unions, in support of the Congressional stance. Another threat to the economic programme for 1985 is the recent cut in the export price of oil (which accounts for 75% of total exports). To countervail the price cut, the state oil company has announced an increase in production, distancing Ecuador still further from OPEC. In an attempt to increase the rate of exploitation over the medium term, the Ecuadoreans intend to sign 20 oil exploration contracts with foreign companies over the next two years, and have already signed one with the US Occidental Exploration Company.

ECGD had an estimated $64 mn at risk at end-December 1984. At end-June 1984, British owned banks' exposure to Ecuador totalled $571 mn and consolidated external claims $583 mn. UK-registered banks' exposure was $726 mn and consolidated external claims were $737 mn.

MEXICO

Total external indebtedness at end-December 1984 was estimated at $94.9 bn.

The legal documentation covering both the $23.6 bn of debt previously rescheduled and the $5 bn of 1983 new money was despatched to all banks, and signing will have taken place in New York on 29 March. A Letter of Intent, covering the third year of Mexico's Fund programme, has been agreed.

The Mexicans have now agreed with the clearing banks on the precise mechanism to be used for the currency switching option. One bank (LBI) will sell sterling and buy dollars on the appropriate dates on behalf of all UK banks. Two reference banks - to be nominated by Mexico - will endorse the rate as truly representative. To eliminate exchange risk, UK banks can then deal with LBI at this rate, though it is not obligatory to take cover in this way: a bank can choose to do its own dealing if it wishes, but the rate at which the dollar loan is re-denominated into sterling must be the endorsed LBI rate.

On preliminary figures, a trade surplus of $12.3 bn was achieved last year ($13.7 bn in 1983), with exports amounting to $24.1 bn ($22.2 bn) and imports $11.8 bn ($8.5 bn). The current account is likely to record a surplus of around $4 bn ($5 1/2 bn in 1983) and reserves will again have risen much more than the IMF's target of $2 bn.

For 1985, the official forecast is for a trade surplus of $10.3 bn and, with interest payments benefitting from the new spreads under the MYRA, a current account surplus of $1.5 bn. With gross reserves expected to rise still further this year, an increase in external debt of $1 bn is projected, mainly to be financed from non-commercial bank sources.

On the domestic front, recent measures to cut expenditure are expected to reduce the public sector deficit this year from the original Budget estimate of 5.1% of GDP to 4.3%; a Letter of Intent will shortly be agreed with the Fund. Inflation is forecast at 35% (year-on-year) at end-December, although private sources are already suggesting that 50% may be more realistic.

At end-June 1984, British-owned banks' exposure to Mexico totalled $6,225 mn and consolidated external claims $6,367 mn. At the same date, UK-registered banks' exposure was $8,520 mn and consolidated external claims $8,736 mn. ECGD had an estimated total amount at risk of $1,213 mn at end-December 1984.

PERU

Total external indebtedness at end-1984 was an estimated $13.5 bn.

After running up more than six months' interest arrears, totalling over $200 mn, on debt to commercial banks, Peru paid $52 mn in early January, and the authorities promised to make further periodic payments in order to keep arrears at, or below, the 180 day threshold. Although Peru has not managed to bring arrears below the threshold, the payment of $52 mn persuaded the banks to agree to a rollover of maturities due on 14 January to 14 February, and a second payment of $24 mn on 14 February secured a further 30-day rollover. The banks seem willing to continue granting moratoria until the new government takes office in July - on the condition that efforts continue to be made to bring interest arrears within the 180 days margin - and they have agreed to a Peruvian request for a 60-day rollover to mid-May. Citibank has estimated that $40 mn a month will be needed to keep arrears within the 180 day margin; it is therefore worrying that the Peruvians are reportedly only willing to make a $15 mn payment for March.

Whilst the remedial action taken by the Peruvian authorities has so far obviated the need for US banks to classify their Peruvian exposure as 'bad loans', US accounting practice requires the banks to classify all loans on which interest payments have been more than 90 days overdue at any stage in one quarter as 'non-performing', unless they are well secured and/or negotiations for a settlement - and IMF package - are in progress: Peru's bank loans will continue to be 'non-performing', even if they are brought within 180 days, unless these conditions are met.

In spite of the build-up of arrears and the breakdown of the IMF Standby programme, however, two recent developments have made banks more favourably disposed towards Peru. First, Garrido Lecca's appointment as Economy Minister in December (in place of Jose Benavides) seems to have eased the previously strained relationship between the government and Central Bank. The second, related, development was a package of austerity measures introduced by Lecca early in the New Year: these measures supplemented the 1985 budget approved on 15 December, and are expected to produce extra revenue equal to 1% of GDP over the next six months and to reduce expenditure by 1.6% of GDP. Lecca has also increased the pace of currency depreciation. Despite the encouragement these measures have afforded the banks and the IMF (who currently have a mission in Lima), the Advisory Committee has refused to agree to a Peruvian request that trade lines be increased to $350 mn from their current level of $300 mn.

At end-December 1984, ECGD had an estimated $124 mn at risk. At end-June 1984, British-owned banks' exposure to Peru totalled $357 mn and consolidated external claims $418 mn. At the same date, UK-registered banks' exposure was $643 mn and consolidated external claims were $704 mn.

VENEZUELA

Total external indebtedness at end-1984 was an estimated $35 bn.

Negotiations on the terms of Venezuela's MYRA have continued over the last month, and an agreement between the authorities and the banks' Advisory Committee is expected in the near future. One remaining area of contention, however, is that of private sector debt payments. Under the scheme set up by the previous administration, private sector debts must be rescheduled with creditors on terms specified by the Central Bank, registered with the exchange control agency RECADI, and then approved by the Venezuelan authorities before payments of interest and rescheduled principal can qualify for preferential rates of exchange. So far RECADI has registered some $6 bn of an estimated $8 bn private sector debt: much of the remainder is trade debt. However, while the Venezuelan government is refusing to include in the proposed agreement a commitment to make speedier progress on registration and payment of private sector debt, some banks have made it clear that they are unwilling to finalise the terms of the agreement until all such debt has been registered. As a result, the 'roadshow' hoped for in April is now unlikely to take place before mid-year. Agreement also has still to be reached on the details of the currency switching procedure.

The Paris Club sent a 'task force' to Venezuela last month to discuss procedures for payment of some $800-900 mn of officially-guaranteed trade debt. The Venezuelan authorities confirmed that unrescheduled Paris Club debt would qualify for preferential foreign exchange, but only on the condition that such debts be registered beforehand.

The authorities have cut their planned increase in budget spending (18 bn bolivares in addition to the existing 103 bn bolivares) to some 6 bn bolivares following OPEC price cuts in February which are expected to reduce the average price of Venezuelan oil exports by $0.50 pb.

At end-December 1984 ECGD had an estimated $37 mn at risk. At end-June 1984, British-owned banks' exposure to Venezuela totalled $2,276 mn and consolidated external claims $2,260 mn. UK-registered banks' exposure was $2,789 mn and consolidated external claims were $2,775 mn.

POLAND

Outstanding convertible-currency indebtedness at end-1984 is estimated at $26.8 bn.

When the creditor governments met the Poles in Paris on 4 March, several of them - including the UK - had not received the full 30% arrears under the 1981 Agreement that were to have been paid on initialling of the 1982-84 Agreement; the governments therefore refused to discuss rescheduling of 1985 maturities. The Poles claimed that the shortfall in payments was due to the fact that they had not paid delay interest where not explicitly provided for in bilateral agreements, and were not prepared to pay penalty interest; but this did not appear completely to explain the shortfall, and in any case was felt to be an unacceptable stance. The meeting ended inconclusively, but the prospects of a breakdown seem real. The Poles have continued to insist that substantial new credits - some $1.7 bn in total - be promised before they sign the 1982-84 Agreement, while most governments have indicated that they would promise nothing before signing. The next Paris Club meeting is scheduled for 26 April.

The first IMF technical mission to Warsaw has been concluded, and a second mission may go out in late March. Although it might be possible to bring Poland into membership later this year, it seems unlikely that agreement could be reached on a programme in time for Poland to borrow from the Fund before late 1986. And agreement on projects that would attract IBRD funding seems, for technical reasons, to be unlikely for several years.

At end-June 1984, British-owned banks' exposure to Poland totalled $521 mn and consolidated external claims $1,081 mn (compared with $538 mn and $1,214 mn respectively at end-December 1983). UK-registered banks' exposure at end-June 1984 was $758 mn and consoldiated external claims $1,324 mn ($778 mn and $1,471 mn). At end-December 1984, ECGD had a total commitment of $1,135 mn (including $576 mn already paid).

YUGOSLAVIA

At end-1984 convertible currency debt was estimated to be just over $19 bn.

Negotiations with the IMF on the terms of a new SDR 300 mn Standby Agreement are almost complete. A substantially agreed Letter of Intent is now being finalised for discussion in the Board on 26 April. A few minor points remain to be settled, but the acceptance of a compromise formula on the question of real interest rates has removed what seemed the most difficult obstacle to agreement. The Fund is willing to provide the "enhanced" Article IV monitoring on a six-monthly basis, as sought by the banks, but seems less prepared to be put in a position of passing judgement on appropriate remedial action in the event of failure to meet targets written into the restructuring agreement between the Yugoslavs and the banks. The new programme is intended to run from mid-May.

Official creditors resume negotiations in Paris on 25 March, but are clear that they will concede no more than a one-year rescheduling for 1985 plus a goodwill clause for subsequent years.

The Chairman of the commercial banks' ICC had further debt discussions in Belgrade in the week beginning 4 February, but failed to reach agreement on the structure and pricing of the prospective rescheduling. The Yugoslavs continued to insist on a four-year block arrangement with an interest margin of 1%, while the banks stood firm on a 2+1+1 formula at +1 1/4%. It seems likely that the Yugoslavs will in due course relax their demands for a four-year block arrangement and that the banks will be prepared in turn to offer some cosmetic concessions on the interest rate. A further meeting is scheduled for 11 April in New York.

At end-June 1984, British-owned banks' exposure to Yugoslavia totalled $944 mn and consolidated external claims $1,316 mn (compared with $934 mn and $1,300 mn respectively at end-December

1983). UK-registered banks' exposure at end-June 1984 was $1,317 mn and consolidated external claims $1,705 mn ($1365 mn and $1,739 mn). At end-December 1984, ECGD had a total commitment of $1,071 mn.

PORTUGAL

Total external indebtedness is now officially put at $14.9 bn at end-1984, slightly below earlier estimates. This represents an increase of $0.5 bn over the end-1983 level.

The 1984 current account deficit, at $0.5 bn (2.5% of GDP), showed a better outturn than previously estimated, and compares with a deficit of $1.7 bn in 1983. The improvement was reflected in a slower growth in the external debt; the increase of 3% in 1984 compares with 6% in 1983 and 24% in 1982.

Following their decision not to seek a further IMF Standby Agreement - the previous Agreement expired at end-February - the Portuguese authorities discussed with the staff the possibility of continuing the Fund's involvement outside the format of a programme. The Portuguese were unwilling, however, to accept the full requirements of enhanced surveillance, especially the need for quantified objectives. A staff team will, nevertheless, prepare a paper analysing recent economic developments and experience with last year's Standby, and there is a possibility of a Board discussion.

At end-June 1984, British-owned banks' exposure to Portugal totalled $1,321 mn, and consolidated external claims $1,145 mn. UK-registered banks' exposure totalled $1,672 mn and consolidated external claims $1,447 mn. At end-December 1984, ECGD had an estimated $275 mn at risk.

PHILIPPINES

Total external indebtedness (including short-term liabilities of the banking system) amounted to around $26 bn at the end of 1984.

The refusal by the National Commercial Bank of Saudi Arabia to participate in the new money/rescheduling package agreed with the Advisory Committee of banks has led to a further delay in the signing of the agreement. Reportedly expressing a desire to negotiate a bilateral agreement with the Filipinos, the Saudi bank has stated that, as it has a policy of reducing its international exposure, it is not prepared to provide its share (understood to be around $13 mn) towards the $925 mn new money. At a meeting in New York in the third week of March, the Advisory Committee agreed not to proceed with the signing until the Saudi bank agrees to participate: at stake is said to be the long-established and central principle that all creditor banks must shoulder their responsibilities equally when dealing with debt-problem countries. At this stage it is not possible to predict how long the impasse will last.

At the time of writing, an IMF team has gone to Manila for the first mid-term review of the SDRs 615 mn Standby Agreement which was approved by the IMF Board in December. Inter alia, the team will be examining whether the authorities will be able to keep to the reserve money target set for end-March. As indicated in the last report, the reserve money target for end-December was breached following an unexpectedly large inflow of funds (in the main from Filipino workers overseas) as soon as the IMF programme was in place, which had the effect of swelling the money supply. If the IMF are content that the authorities have regained control of monetary growth, a waiver for the end-December reserve money target will probably be granted; if not, the programme will be considered to have broken down, which in turn would jeopardise the agreements reached with official and commercial creditors.

As at end-December 1984 ECGD had an estimated $248 mn at risk. At end-June 1984 British-owned banks' exposure to the Philippines totalled $1,279 mn and consoldiated external claims $1,519 mn. At the same date, UK-registered banks' exposure totalled $1,392 mn and consolidated external claims $1,649 mn.

MOROCCO

Total external indebtedness at end-1983 was around $11.5 bn.

The Moroccans agreed a $1.5 bn rescheduling package with the steering committee of the commercial banks in early February. This was the final element of the three-pronged 1983/84 rescheduling negotiations (comprising an IMF programme, the rescheduling of official and officially-guaranteed debt, and commercial bank rescheduling), started in September 1983. Some two-thirds of the two hundred banks involved have already responded; however, it will be some time (perhaps mid-summer) before the commercial bank package becomes operational. As part of this package, a total of $535 mn of medium and long-term maturities in 1983/84 is to be rescheduled over eight years, with four years' grace, at 1 3/4% above LIBOR as from September 1983, together with $750 mn of rolled-over trade credit and $200 mn of new trade credit.

Failure to reach an accord with the commercial banks by 30 November 1984 led to a further interruption of the $0.3 bn Standby (approved in September 1983). Board discussion of the Review Under Standby, scheduled for 30 November, was accordingly postponed until 4 January. At that meeting, however, it was agreed that Morocco could proceed to make purchases under the Standby, notwithstanding any arrears on debts to commercial banks, as final agreement on their rescheduling seemed in the offing.

The IBRD's Consultative Group for Morocco met in Paris between 9-11 January, its first meeting since 1974; subsequently the IBRD representative gave a presentation to the Paris Club on Morocco's medium term prospects. Morocco informed the Paris Club last December of its intention to seek a restructuring of 1985 maturities from the Paris Club, but no meeting has yet been scheduled. In the meantime the Moroccans have undertaken not to interrupt debt service, and to pay an instalment of 2.5% of sums which have fallen due since 1 January 1985.

At end-June 1984, British-owned banks' exposure to Morocco totalled $144 mn and consolidated claims $191 mn. At the same date, UK registered banks' exposure was $293 mn while consolidated claims amounted to $372 mn. ECGD's total amount at risk to Morocco at end-December 1984 was $211 mn.

NIGERIA

Total external indebtedness at end-1983 was around $20 bn (including an estimated $6 bn of arrears).

There has been no progress since the last report 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 authorities remain opposed to the key conditions of an IMF loan - a substantial devaluation, reduction of petroleum subsidies, and liberalisation of import controls. A Fund mission visited Lagos at the end of January to conduct routine Article IV Consultations; the discussions were reportedly amicable but the Nigerians were reluctant to take any measures which would involve price increases. The mission emphasised that, without drastic action on the external side, the benefits of the fiscal adjustment already achieved would be wasted.

Most exporters have agreed to the Nigerian offer, made last April, to reschedule uninsured trade arrears in the form of six-year promissory notes, with 2 1/2 years' grace, at 1% over LIBOR. The issue of notes is to proceed in three stages. The first tranche, valued at $260 mn, was issued on 9 November and covered the dollar-denominated arrears of major companies. The second tranche, worth some $70 mn, was issued on 21 February and covered the same companies' arrears in non-dollar currencies; as with the first tranche, interest back-dated to 1 January 1984 was also paid. The final issue of notes, to all remaining uninsured creditors (some 7,000-9,000 companies), is likely to be delayed until June-July when the process of reconciling exporters' claims is expected to be completed.

Official credit agencies remain insistent that a restructuring of insured trade arrears should be negotiated within a multilateral framework, and be conditional on agreement being reached with the IMF. At a Paris Club meeting on 4 October, it was agreed that, as an interim measure, the Nigerians would make payments equivalent to interest calculable from 1 January 1984, at a rate of 1% above LIBOR, on insured arrears registered at Chase Manhattan and reconciled with importers' submissions to the Central Bank of Nigeria. But it was also agreed that this agreement should in no way prejudice the form of the full settlement which would only follow eventual agreement with the IMF. The first interest payment, due on 5 January, does not appear to have been made.

At end-June 1984, British-owned banks' exposure to Nigeria totalled $1,194 mn and consolidated external claims $2,051 mn. UK-registered banks' exposure at end-June amounted to $1,545 mn and consolidated external claims $2,534 mn. At end-September 1984, ECGD's total amount at risk was $3,037 mn.

SOUTH AFRICA

South Africa's large current account deficits in 1981 and 1982 (which together totalled over $7 bn) resulted in very substantial increases in the volume of external debt, the bulk of it short-term. During these two years total external debt rose by $5.5 bn (32%) to $22.8 bn. Short-term borrowing (particularly through the South African banks' branches abroad) almost doubled to reach $11.5 bn. At the end of 1982, therefore, short-term debt accounted for 50% of the total outstanding compared to 37% two years earlier. External debt increased more modestly during 1983 as the current account recorded a small surplus. At end-December 1983 (the latest date for which comprehensive data are available) total external debt amounted to $24.1 bn and the short-term component $12.6 bn (52% of the total).

The extent to which South Africa has relied on borrowing from the banking system during the latest period of balance of payments difficulties is illustrated by the proportion of total debt represented by claims of BIS area banks; this rose from 42% in 1980 to 71% in 1983. The picuture is even more striking in the case of short-term component: BIS area banks' claims accounted for 90% of the total at end-1983 compared to 39% three years earlier.

Although the South African authorities have a proven track record in dealing with previous external imbalances, the continuing need to roll-over short-term borrowing is a focus of attention, particularly when set against the backdrop of the increasingly vociferous calls for investment sanctions against South Africa. There are currently no indications that institutions are unwilling to roll-over the debt, although clearly attitudes may be influenced by calls for punitive action following the recent brutal events in the Eastern Cape.

Correcting the balance of payments position is seen by the South African Government as the main economic priority, ranking above inflation which currently stands at 16%. The current account is forecast to record a healthy surplus in 1985 even on the assumption that there is no significant recovery in the gold price. Developments elsewhere in the economy are likely to depend heavily on the extent to which the authorities are able to adhere to the tight monetary and fiscal policies that are now in place. Until the recent budget, the burden of adjustment within the economy had fallen almost entirely on monetary policy. On the face of it, the budget measures should ensure that fiscal policy comes to play its part.

At end-June 1984, British-owned banks' exposure to South Africa totalled \$4.9 bn and consolidated claims \$5.3 bn. At the same date, UK registered banks' exposure was \$5.2 bn while consolidated claims amounted to \$5.6 bn. ECGD's total amount at risk to South Africa at end-December 1984 was \$2.9 bn.

SUDAN

Total external indebtedness at end-1983 was around $7.8 bn.

Heavy foreign borrowing undertaken in the mid-1970s has never been fully serviced, and was the subject of Paris Club reschedulings in 1979, 1982, 1983 and 1984 and commercial bank reschedulings in 1981, 1983 and 1984 (with equivalent measures by Arab and other bilateral creditors). Arrears at end-1984 totalled some $260 mn (of which $80 mn was due to the IMF).

Sudan's external public sector debt is divided up as follows: 60% bilateral to foreign governments; 20% to multilateral institutions; 16% to commercial banks. Less than 4% takes the form of supplier credits, and the external debt of the private sector is negligible. The post-rescheduling debt service ratio in 1983-84 was 31%. The latest Fund projections show debt service payments in excess of $1 bn until the end of the decade, with the debt service ratio gradually falling to around 50% from 120% in 1984/85. But it is tacitly acknowledged that Sudan will not be able to meet its commitments.

Bilateral and commercial creditors are pressing Sudan to improve its economic management and debt servicing, but the situation is made particularly difficult by the impasse that has existed between Sudan and the IMF since the breakdown of its current SDR 90 mn Standby Arrangement. This was finalised with great difficulty on 25 June last, but further arrears to the Fund under the Standby began to accrue within two months of its coming into effect and reached some SDR 80 mn by end-December 1984. The IMF and IBRD, and the US government, have sought throughout the last nine months to impress upon the Sudanese the need for economic adjustment. Some adjustment, including devaluation and higher fuel prices, has resulted, and a further IMF mission has just left for Khartoum. The Sudanese hope that this mission will lead to an IMF statement to the effect that the authorities are moving in the right direction and will require further generous support from creditors if they are to succeed. This would not be part of a formal IMF programme, but would be accompanied by a middle to long-term strategy to get arrears paid and the relationship with the Fund back on to a formal footing. (It is generally recognised that the rehabilitation of Sudan will take at least ten years.) But, even if this can be achieved, the prospect of a further substantial external financing gap this year remains.

Meanwhile, the steering committee of the commercial banks (party to the 1981 rescheduling agreement) has endorsed terms suggested by Morgan Grenfell for a further rescheduling. The proposals are that arrears should be treated in two tranches: in both cases there would be no payments until 1988. Arrears of principal as at 1982 would be re-rescheduled, attracting interest at LIBOR + 1 3/4%, up to 1992, while accrued, unpaid and capitalised interest since 1982 would also be re-rescheduled but on an interest-free basis. Some other banks have accepted these terms, but the majority have not yet responded (the deadline is 26 March).

At end-June 1984, British-owned banks'exposure to Sudan totalled $46 mn and consolidated claims $50 mn. At the same date, UK-registered banks' exposure was $127 mn while consolidated claims amounted to $132 mn. ECGD's total amount at risk to Sudan at end-December 1984 was $150 mn.

kv

10 DOWNING STREET

From the Private Secretary

29 March, 1985.

This is just to record that the Prime Minister has seen and noted your letter of 27 March about the decision of the IMF to withhold drawings under the Argentine Standby Agreement.

(Timothy Flesher)

Mrs. R. Lomax,
HM Treasury.

7.96 CONFIDENTIAL

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

27 March 1985

Tim Flesher Esq
10 Downing Street
LONDON
SW1

Prime Minister

To note

Dear Tim,

ARGENTINA

You will have seen from yesterday's press reports that the IMF have decided to withold drawings under the Argentine Standby Agreement signed last December.

As our last general report on the international financial scene made clear, we have always been doubtful about whether the Fund programme would stick given the massive acceleration in inflation. This is indeed what seems to have happened with at least one performance criterion missed at the end of December and attainment of the March criteria very unlikely.

By delaying drawings under the programme the Managing Director has put the Standby on "hold" whilst talks take place with the new Argentine economic team to re-establish the programme. De Larosiere believes that Sourrouille is committed to adjustment and the talks so far, though complex, have been constructive. He will want to see two months' good performance by Argentina before being willing to recommend a revised programme to the Executive Board.

It is not clear how this delay will affect the almost complete commercial bank package. De Larosiere is sending a supportive message to the banks asking them to maintain their commitment to the refinancing package. The extent of the banks willingness to do this may depend on Argentine treatment of interim arrears in the meantime. The latter's room for manoeuvre may be limited. The US Treasury were apparently unresponsive to feelers from President Alfonsin about a bridging loan.

So far as Paris Club debt is concerned we have discussed with other creditor governments, particularly the French, how to handle the bilateral negotiations (which should be completed by end June). The French, and the other creditors, are content to go ahead with bilateral negotiations, without finally implementing their agreements before the Fund programme is back on track. Whatever we do, we will want to reinforce the Fund's pressure on Argentina. The Argentine team will be in Paris on 11 and 12 April, and the Fund have asked us to stand by to go over there and negotiate our bilateral then. But they have received no formal reply from the Argentine side yet to their offer to host these talks in Paris.

I am copying this letter to Len Appleyard, Callum MacCarthy and John Bartlett.

Yours ever
Rachel

MRS R LOMAX
Principal Private Secretary

AF File...

Com

OO UKDEL IMF/IBRD WASHINGTON
GRS 2800
CONFIDENTIAL
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TO IMMEDIATE UKDEL IMF/IBRD WASHINGTON
TELEGRAM NUMBER 41 OF 8 MARCH
FOR N WICKS

SENSITIVITIES

5. THE UK ORIGINALLY ATTEMPTED TO PREVENT THE BRAU STUDY PROCEEDING DOUBTING WHETHER IT WOULD LEAD TO POLICY RECOMMENDATIO HOWEVER WE SUBSEQUENTLY INSTIGATED DISCUSSION ON THE GREATER CONSISTENCY OF COVER POLICY TOWARDS RESCHEDULING COUNTRIES IN BOTH THE G5 AND THE PARIS CLUB. THE BRAU REPORT IS CONSISTENT WITH MUCH OF THE SUBSTANCE OF THAT DISCUSSION AND THE UK WAS GENERALLY CONTENT WITH THE RECOMMENDATIONS BASED ON REPORTS WHICH WERE CIRCULATED TO G5 COUNTRIES ALONE.

6. THE REPORT HAS ALREADY BEEN QUOTED BY THE UK IN ARGUING THAT THE OECD EXPORT CREDIT GROUP (ECG) SHOULD INSTITUTE A REGULAR EXCHANGE OF INFORMATION ON ATTITUDES TO COUNTRIES IN EITHER THE DEBT BUILD-UP OR POST-RESCHEDULING PHASES TO SECURE A MORE CONSISTENT APPROACH. WHILE THIS IS ENTIRELY CONSISTENT WITH BRAU'S APPROACH, ITS IMPLEMENTATION IS CAUSING SOME DIFFICULTIES. THE COMMISSION CONTINUES TO ARGUE THAT THE EC LINE MUST BE CO-ORDINATED AND PRESENTED BY THE COMMISSION ITSELF, THUS HAMPERING THE RAISING OF COUNTRIES OF CONCERN TO THE UK (THIS HAPPENED WITH TURKEY) WHERE OTHERS WOULD PREFER A LOWER PROFILE. THIS IS AN EXTREME EXAMPLE OF THE SENSITIVITIES OF OTHER MEMBER NATIONS INHIBITING THE IMPLEMENTATION OF A NEW SYSTEM. THE FRENCH TOO ARE CONCERNED ABOUT POSSIBLE RESTRICTIONS ON THEIR ABILITY TO DECIDE COVER POLICY INDEPENDENTLY AND THEIR SUSPICIONS ARE FED BY US PRESSURE FOR AGREED RULES IN THIS AREA. THE FIRST ECG DISCUSSION TAKES PLACE ON 11 MARCH.

OVERVIEW

7. THE BRAU REPORT MAKES NO SPECIFIC PROPOSALS. IT IS MORE A SURVEY OF PRACTICE THAN A SET OF RECOMMENDATIONS. NEVERTHELESS IT DOES, AT LEAST BY IMPLICATION, SUGGEST A WAY TO PROCEED. TO SOME EXTENT ITS INFLUENCE HAS ALREADY BEEN FELT (SEE PREVIOUS PARAGRAPH). SO AN EARLIER DISCUSSION WOULD HAVE BEEN HELPFUL.

8. IT IS UNLIKELY THE BOARD DISCUSSION WILL DISAGREE WITH THE PAPER'S HISTORIC DESCRIPTION. WE EXPECT THE DEBATE WILL CENTRE ON THE DEGREE TO WHICH ITS IMPLIED RECOMMENDATIONS CAN BE IMPLEMENTED.

9. THE UK'S VIEW IS THAT THE REPORT'S APPROACH IS LARGELY UNEXCEPTIONABLE BOTH IN ITS MOVE TOWARDS BETTER CO-ORDINATION AND ITS IMPLIED OPPOSITION TO COMPLETE HARMONISATION AND TO GAPOLOGY.

10. THE KEY ISSUE IS HOW TO ENSURE THAT A GENERALISED ENDORSEMENT OF MORE CO-ORDINATION IS IN FACT IMPLEMENTED DESPITE THE INEVITABLE PRESSURE TO THE CONTRARY ESPECIALLY GIVEN FEARS THAT CO-ORDINATION MAY LEAD TO RIGID HARMONISATION.

11. EXPORT CREDIT ISSUES ARE OF COURSE INTERLINKED WITH DEBT PROBLEMS: BOTH THEIR GENESIS AND THEIR SOLUTION. OVER THE LONG TERM AN ORDERLY RETURN TO LESS CONSTRAINED TRADING PATTERNS SHOULD RESULT FROM PROGRESSIVE ELIMINATION OF DEBT DIFFICULTIES.

LINE TO TAKE

GENERAL

12. ENDORSE THE BROAD THRUST OF THE REPORT.

13. IT IS RIGHT TO SUGGEST:

(I) UNCO-ORDINATED WITHDRAWAL AND RESUMPTION OF COVER CAN BOTH DELAY THE ADJUSTMENT PROCESS AND DESTABILISE THE FINANCIAL SYSTEM

(II) RESUMPTION OF COVER NEEDS TO BE CO-ORDINATED BUT SHOULD NOT DEGENERATE TO A GAP-FILLING PLEDGING ROUND

(III) DEBTORS NEED TO BE EDUCATED IN THE MOST EFFECTIVE WAY OF CONDUCTING THEIR DEBT MANAGEMENT VIS A VIS EXPORT CREDIT AGENCIES (ECAS) AND THE PARIS CLUB

(INDEED THIS IDEA LAY BEHIND THE ORIGINAL IDEA FOR THE PAPER).

14. DIFFICULTIES ARE MORE PRACTICAL THAN THEORETICAL. EXPORT CREDIT AGENCIES (ECAS) MUST IN PRACTICE RÉSIST PRESSURES TO GRAB MARKET SHARE? BALANCE MUST BE STRUCK BETWEEN REWARDING THOSE COUNTRIES MAKING ADJUSTMENTS AND A RELAXATION OF NECESSARY DISCIPLINE.

15. FIRST RISK IS THAT ECAS WILL BE SUBJECT TO IRRESISTABLE PRESSURES DOMESTICALLY TO STAY ON COVER EITHER TO ENSURE THAT COMPETITORS DO NOT TAKE A GREATER SHARE OF THE MARKET OR TO TRY TO TAKE ADVANTAGE OF OTHERS' CAUTION TO IMPROVE COMPETITIVE POSITION. THESE RISKS ARE PARTICULARLY GREAT WHERE THE ECA'S EXPOSURE IS INITIALLY LOW, OR AT LEAST WELL BELOW ITS COUNTRY LIMIT, SO THAT TO STAY ON COVER DOES NOT COMPROMISE ITS OWN DECIDED RISK POSITION. IT IS THEREFORE IMPORTANT THAT GENERALLY EXPRESSED GOOD INTENTIONS BY ECAS ARE CARRIED THROUGH. OBVIOUSLY THERE CAN BE NO WAY OF ENSURING THIS. BUT SERIOUSNESS OF RESOLVE ON THE PART OF ALL IS VITAL.

16. THE SECOND RISK CONCERNS THE OVER-RIGID SYSTEM THAT WOULD RESULT FROM A COMPLETELY HARMONISED INTERNATIONAL EXPORT COVER POLICY. THE STABILISING EFFECT OF A DISAGGREGATED SET OF RISK JUDGEMENTS COULD BE LOST IF COVER DECISIONS BECAME OVER-HARMONISED. SUDDEN SWINGS OF COVER AVAILABILITY COULD INHIBIT RATHER THAN ASSIST THE ABILITY OF THE DEBTOR COUNTRY TO ADJUST. THE KEY IS FOR A MEASURED WITHDRAWAL AND PROVISION OF COVER RATHER THAN DESTABILISING SWINGS.

17. NONE OF THE ABOVE MAKES THE DECISION ABOUT WHETHER TO RESUME COVER ANY EASIER. THE ARGUMENTS AGAINST: MAINTENANCE OF INTERNATIONAL DISCIPLINE, RISK OF DEGENERATION OF CREDIT TERMS, IMPLICATION FOR CREDITORS' BALANCE OF PAYMENTS, RELUCTANCE TO PROVIDE DOUBLE RELIEF ETC MUST BE WEIGHED AGAINST THOSE IN FAVOUR: REWARD FOR GENUINE ADJUSTERS, TO WARD OFF DEFAULTS, TO PREVENT OVER-REACTION FROM LENDERS ANXIOUS TO REDUCE EXPOSURE, TO ASSIST INDUSTRIES KEEN TO MAINTAIN MARKET SHARE.

18. THIS DECISION WILL REMAIN A DIFFICULT ONE WHATEVER ARRANGEMENTS ARE MADE TO IMPROVE CO-ORDINATION. PROVIDED THIS IS RECOGNISED, THE UK IS CONTENT WITH THE APPROACH.

SPECIFIC POINTS

19. MOVES TO IMPROVE CO-ORDINATION ALREADY UNDERWAY IN RECENTLY INITIATED REGULAR EXCHANGES OF VIEWS IN OECD GROUP ON EXPORT CREDITS AND CREDIT GUARANTEES (ECG). THIS IS TO BE WELCOMED. (BUT SEE SENSITIVITIES ABOVE.)

20. IMPORTANT TO CO-ORDINATE POLICY TOWARDS UNDESERVING AS WELL AS DESERVING CASES. MORE DIFFICULT BECAUSE OF PRESSURE FROM EXPORTERS TO KEEP IN THE MARKET BUT VITAL NONETHELESS SINCE THE LEVER OF NEW CREDIT MAY BE ONLY LEVER THE CREDITOR GROUP HAS TO APPLY TO THE WORST CASES.

21. THIS UNDERLINES POINT THAT BETTER CO-ORDINATION, WHILE DESIRABLE, DOES NOT MAKE COVER DECISIONS ANY EASIER. ALWAYS IS A BALANCE OF CONSIDERATIONS. BUT PAPER IS RIGHT TO SUGGEST THAT ACTIONS THAT RESULT FROM THESE CONSIDERATIONS NEED CO-ORDINATING IF THEY ARE TO HAVE BENEFICIAL EFFECTS.

22. IF RESTRICTED COVER IS GIVEN, EVEN MORE VITAL FOR IT TO BE EFFECTIVE IN AIDING PAYMENTS DIFFICULTIES. THEREFORE HELP NEEDED FROM EG IBRD TO IDENTIFY EXPORT EARNING, IMPORT SAVING PROJECTS OF KEY IMPORTANCE.

23. ON QUESTION OF EASIER TERMS, WHILE NEED NOT TO OVERBURDEN DEBTORS IS RECOGNISED SO MUST BE NEED FOR ECAS TO REBUILD RESERVES. IT WOULD BENEFIT NO ONE, DEBTORS INCLUDED, IF ECAS WERE WEAKENED SO FAR THAT COVER WAS INHIBITED EVEN FOR GOOD CASES.

24. WHILE AGREEING WITH REPORT'S ENDORSEMENT OF MAINTENANCE OR RESUMPTION OF SHORT-TERM COVER WHERE APPROPRIATE, WE SHOULD TAKE NOTE BOTH OF THE VOLATILITY OF SHORT TERM COVER AND OF THE RISKS IN INCURRING NEW DEBTS TO BE REPAID IN THE SHORT TERM - IE JUST THE PERIOD THAT RESCHEDULING HAS BEEN DEVISED TO KEEP CLEAR OF DEBT BURDENS, SO CAREFUL DOSAGE NEEDED.

25. THE ABILITY OF CREDITOR COUNTRIES TO REFINE THEIR RISK ANALYSIS IN THE DEBT BUILDING PHASE DEPENDS IN PART

ON THE CLARITY OF FUND ASSESSMENTS. THE UK THEREFORE ENDORSES THE REPORT'S INFERENCE (PAGE 22 PENULTIMATE PARA) THAT FUND REPORTS COULD MAKE THEIR UNDERLYING ASSUMPTIONS AND THE KEY PARAMETERS OF THE ANALYSES MORE EXPLICIT.

26. THE FOLLOW-UP TO THIS REPORT WILL DEPEND ON THE OUTCOME OF THE SPRING MEETING DISCUSSION OF THE SUBJECT. SUBJECT TO THAT THE UK WOULD NOT OPPOSE PUBLICATION OF THE REPORT IN ITS PRESENT FORM.

27. BEYOND THAT, THE UK INTENDS TO PLAY ITS PART IN TAKING MATTERS FORWARD: AS IT ALREADY HAS, BOTH IN THE OECD ECG CONTEXT, AND BY INITIATING RELAXATION OF ITS POLICIES ON THE RESUMPTION OF COVER FOR RESCHEDULING COUNTRIES.

BACKGROUND

28. AS BACKGROUND TO THE DEBATE A BRIEF DESCRIPTION OF ECGD'S COVER POLICY, BOTH IN GENERAL AND IN RESPECT OF THE SPECIFIC COUNTRIES MENTIONED IS ATTACHED. BRIEFING ON THE TWO DEBT PAPERS (SM/85/6L AND 62) WILL BE SENT SEPARATELY.

29. THE KEY POINTS OF THE REPORT ARE:-

(I) THE TENDENCY TO REMAIN ON COVER TOO LONG SHOULD BE COUNTER-ACTED BY BETTER RISK ANALYSIS AND COLLABORATION ON SOUNDER LENDING STANDARDS (RESISTING THE CONTRARY POLITICAL PRESSURES)

(II) THERE IS BROAD SUPPORT FOR A MORE CO-ORDINATED CASE-BY-CASE APPROACH TOWARDS THE RESUMPTION OF COVER FOR COUNTRIES TAKING THEIR ADJUSTMENT MEDICINE,

(III) THERE IS SCEPTICISM OF ANY FORMAL PLEDGING PROCESS,

(IV) DEBTORS NEED A BETTER AWARENESS OF THE GROUND RULES IF RESUMPTION OF COVER IS TO BE ENCOURAGED.

30. AS BACKGROUND TO THE RESUMPTION OF COVER QUESTION, YOU SHOULD KNOW THAT, IN DECEMBER THE MINISTER FOR TRADE ANNOUNCED THE UK'S INTENTION TO ALLOW ECGD GREATER FLEXIBILITY SO THAT, IN APPROPRIATE CASES, COVER CAN BE RESTORED AT AN EARLIER STAGE AFTER THE RESCHEDULING OF OFFICIALLY GUARANTEED DEBTS THAN HAS TRADITIONALLY BEEN THE CASE.

THIS IS TO BE IMPLEMENTED ON A SELECTIVE BASIS AND ONLY APPLICABLE WHERE WE ARE SATISFIED THAT THE DEBTOR COUNTRY IS TAKING APPROPRIATE ACTION. IT DOES NOT REPRESENT A RELAXING OF RISK STANDARDS.

31. SO FAR THIS FLEXIBILITY HAS BEEN APPLIED TO BRAZIL AND MEXICO ONLY (BUT SEE NOTE IN PARA 9 OF SECTION ON COVER POLICY), AND ONLY FOR SMALL AMOUNTS OF BUSINESS. THERE IS SOME SENSITIVITY SURROUNDING THE LIMITED NATURE OF THE MOVE, BOTH WITH EXPORTERS AND THE DEBTOR COUNTRIES CONCERNED. HOWEVER IT DOES REPRESENT A POSITIVE MOVE IN LINE WITH THE BRAU REPORT PHILOSOPHY.

32. THE PARIS CLUB ALSO HAS HAD INFORMAL DISCUSSION OF PROBLEM COUNTRIES IN ITS TOUR D'HORIZONS BUT THIS IS NOT THE FORUM FOR CONSIDERATION OF POLICY ON CREDITS. PARIS CLUB HAS TRADITIONALLY KEPT RESCHEDULING/NEW CREDITS SEPARATE.

33. THE PAPER REFERS IN A NUMBER OF PLACES TO THE ACTIONS OF 'ONE AGENCY' OR ANOTHER, NO NAMES GIVEN. AS BACKGROUND YOU SHOULD BE AWARE THAT THE FOLLOWING REFERENCES ARE IN FACT TO ECGD:

PAGE 37 - ARGENTINA (PARA L)

THE REFERENCE TO 'TRANSACTION LIMITS' REFERS TO ECGD'S INTRODUCTION OF A POUNDS STERLING 15 MILLION CONTRACT LIMIT IN 1981.SINCE APRIL 1982 ECGD HAS BEEN OFF COVER.

PAGE 43 - MADAGASCAR (PARA 2)

ECGD WAS THE AGENCY REPORTED TO BE RETAINING COVER ON SHORT TERM TRANSACTIONS ON CILC TERMS.

PAGE 58 - TURKEY (PARA 3)

THE REFERENCE TO ONE AGENCY RESTORING MEDIUM-TERM COVER ON A RISK SHARING BASIS REFERS TO THE DECISION TAKEN BY ECGD IN JULY 1983.

ECGD'S COVER POLICY

1. ECGD'S POLICY MEASURES IN RESPECT OF SOVEREIGN RISK UNDERWRITING ARE APPLIED THROUGH COUNTRY CEILINGS, SECURITY REQUIREMENTS, AND PRICING OF COVER.

RESTRICTIONS

2. EXCEPT FOR A SMALL NUMBER OF MARKETS CONSIDERED UNDOUBTED

FOR THE WIDE GAMUT OF TRANSFER PAYMENT RISKS, ECGD PLACE COUNTRY LIMITS ON THEIR COMMITMENTS SO AS TO CONTROL EXPOSURE. THESE LIMITS CAN SERVE AS STRICT CEILINGS, ABOVE WHICH NO FURTHER BUSINESS CAN BE TAKEN, UNLESS FOR EXAMPLE, A SUCCESSFUL 'NATIONAL INTEREST' CASE IS MADE, OR AS BENCHMARKS, REVIEWABLE AS PRESSURE BUILDS UP. ADDITIONALLY, CONTRACT LIMITS CAN BE SET, PARTICULARLY WHERE THE COUNTRY LIMIT IS RELATIVELY LOW, THUS AVOIDING ONE OR TWO LARGE CONTRACTS PRE-EMPTING COVER ON THE MARKET.

3. COVER IS GRADUALLY CUT BACK, ON CERTAIN VERY HIGH RISK MARKETS, WHERE EXTENSIVE TRANSFER CLAIMS PAYMENTS ARE BEING MADE OR EXPECTED. THIS RESTRICTION GENERALLY APPLIES TO MEDIUM AND LONG TERM BUSINESS AND OCCASIONALLY WITHIN SPECIFIC ST LIMITS. AS A LAST RESORT ALL COVER IS WITHDRAWN ON A MARKET FOR ANY CLASS OF BUSINESS RESCHEDULED (USUALLY MEDIUM/LONG TERM).

SECURITY

4. SECURITY IS TRADITIONALLY SOUGHT THROUGH IRREVOCABLE LETTERS OF CREDIT (ILC), WHERE ECGD IS LOOKING TO THE BUYER'S CENTRAL BANK TO EXERCISE A MEASURE OF CONTROL OVER THEIR FOREIGN CURRENCY ALLOCATIONS. CONFIRMED IRREVOCABLE LETTERS OF CREDIT (CILC) WILL BE REQUIRED WHERE THE RISK OF NON-PAYMENT DUE TO LACK OF FOREIGN EXCHANGE IS CONSIDERED TOO HIGH. THE RISK IS THUS REMOVED TO THE COUNTRY OF THE CONFIRMING BANK.

PRICING STRUCTURE

5. FOR MEDIUM AND LONG TERM BUSINESS, COUNTRIES ARE CLASSIFIED INTO FOUR SEPARATE GRADES ACCORDING TO RISK, AND INDIVIDUAL RATES PER CONTRACT DEPEND ON THE LENGTH OF CREDIT AND THE COUNTRY RISK GRADE. NO DISTINCTION IS MADE CURRENTLY BETWEEN PRIVATE AND PUBLIC BUYERS.

6. PREMIUM FOR SHORT TERM BUSINESS IS ESSENTIALLY FLAT RATE, BUT SURCHARGED WHERE COUNTRIES FALL INTO THE LOWER 2 BANDS OF COUNTRY GRADES.

7. ECGD'S PREMIUM STRUCTURE IS UNDER REVIEW AND THE BASIS OF CHARGING MIGHT WELL CHANGE IN THE FUTURE.

OTHER MEASURES

8. THE CLAIMS WAITING PERIOD CAN BE EXTENDED IN AN ATTEMPT TO OVERCOME PAYING 'TEMPORARILY' DELAYED REMITTANCES DUE TO BOTTLENECKS OCCURRING IN THE TRANSFER OF PAYMENTS TO THE UK. IF HOWEVER, THE DELAYS LENGTHEN CONSIDERABLY, TRANSFER CLAIMS WILL BECOME INEVITABLE AND THIS WILL TRIGGER OFF THE APPLICATION OF RESTRICTIONS AND SECURITY REFERRED TO ABOVE.

COVER FOR RESCHEDULING COUNTRIES

9. THE UK GOVERNMENT HAS REVIEWED POLICY ON EXPORT CREDIT COVER ON RESCHEDULING COUNTRIES AND IT HAS BEEN DECIDED THAT ECGD MIGHT RESUME COVER OUTSIDE THEIR NORMAL ACCOUNTING REQUIREMENTS, IN CERTAIN VERY CAREFULLY SELECTED CASES WHERE COUNTRIES ARE ADOPTING SUCCESSFUL ADJUSTMENT POLICIES, USUALLY IN CONJUNCTION WITH AN IMF PROGRAMME. FIRST CANDIDATES IDENTIFIED FOR EARLY RESUMPTION OF MEDIUM/LONG TERM COVER ARE BRAZIL AND MEXICO (PRIVATE SECTOR - THE PUBLIC SECTOR HAS REMAINED ON COVER). (CONFIDENTIAL: HOWEVER, AS BOTH BRAZIL (IN BREACH OF ITS IMF CRITERIA) AND MEXICO (IN BREACH OF ITS IMF TARGETS) DO NOT HAVE A 1985 PROGRAMME, ECGD WOULD NOT BE PREPARED TO AUTHORISE ANY UPTAKE OF THE DX FACILITY FOR THE TIME BEING. THEY WOULD HOWEVER PROCESS ANY APPLICATIONS WHICH WERE RECEIVED AND ARE SEEKING TO AVOID PUBLICITY FOR THE DELAY IN INTRODUCTION. IVORY COAST HAS ALSO BEEN NOTED AS A POSSIBLE CANDIDATE FOR THE NEW COVER SUBJECT TO SATISFACTORY PERFORMANCE IN RESPECT OF PAYMENTS DUE ON SIGNATURE OF THE BILATERAL RESCHEDULING AGREEMENT.)

10. ECGD WILL ALSO BE PARTICIPATING FULLY IN THE NEW INITIATIVE UNDER THE OECD EXPORT CREDIT GROUP FOR EXCHANGE OF INFORMATION ABOUT CREDIT POLICIES IN RELATION TO CERTAIN COUNTRIES. THIS PROCEDURE IS DESIGNED FOR BETTER CO-ORDINATION IN RELATION TO REMOVAL/RESUMPTION OF COVER - ONE OF THE MATTERS COVERED IN THE IMF REPORT.

ECGD COVER POLICY ON SELECTED COUNTRIES

1. ARGENTINA

ECGD HAS BEEN OFF COVER SINCE APRIL 1982.

2. BRAZIL

COVER IS PRESENTLY FOR SHORT TERM BUSINESS ONLY. BRAZIL WAS IDENTIFIED AS A CANDIDATE FOR RESUMPTION OF MEDIUM/LONG TERM CREDIT COVER ON A LIMITED BASIS UNDER THE NEW FACILITY FOR RESCHEDULING COUNTRIES. THIS WOULD HAVE INVOLVED A MAXIMUM NEW EXPOSURE OF 50 MILLION POUNDS BUT IS NOW DEPENDENT UPON BRAZIL SATISFYING CURRENT IMF CRITERIA, OF WHICH IT IS NOW IN BREACH.

3. MADAGASCAR

SHORT TERM COVER ONLY IS AVAILABLE SUBJECT TO AN IRREVOCABLE LETTER OF CREDIT CONFIRMED BY AN ACCEPTABLE BANK OUTSIDE MADAGASCAR.

4. MEXICO

I SHORT TERM COVER IS AVAILABLE WHERE PAYMENT IS SECURED BY AN IRREVOCABLE LETTER OF CREDIT OR AN ACCEPTABLE BANK GUARANTEE. MEDIUM/LONG TERM COVER IS AVAILABLE FOR PUBLIC SECTOR BUYERS ONLY WITHIN A MARKET LIMIT OF 800 MILLION POUNDS.

II ECGD IS PREPARED TO CONSIDER COVER FOR PRIVATE SECTOR BUSINESS ON A CASE BY CASE BASIS, THOUGH SUCH BUSINESS COULD NOT BE CONFIRMED UNTIL THE 1985 IMF PROGRAMME HAS BEEN RESOLVED.

5. NIGERIA

SHORT TERM COVER ONLY IS AVAILABLE FOR EXISTING POLICYHOLDERS TRANSACTING BUSINESS WITH ESTABLISHED BUYERS, SUBJECT TO PAYMENT SECURED BY AN IRREVOCABLE LETTER OF CREDIT OPENED BY AN ACCEPTABLE NIGERIAN BANK. WHERE POSSIBLE COVER IS BEING RESTRICTED TO CASH AGAINST DOCUMENTS TERMS RATHER THAN UP TO 180 DAYS CREDIT.

6. PERU

SHORT TERM COVER ONLY IS AVAILABLE.

7. PHILIPPINES

SHORT TERM COVER ONLY IS AVAILABLE SUBJECT TO THE SECURITY OF AN IRREVOCABLE LETTER OF CREDIT.

8. ROMANIA

SHORT TERM COVER ONLY IS AVAILABLE SUBJECT TO THE SECURITY OF AN IRREVOCABLE LETTER OF CREDIT CONFIRMED BY AN ACCEPTABLE BANK OUTSIDE ROMANIA.

9. TURKEY

I SHORT TERM COVER IS AVAILABLE SUBJECT TO THE SECURITY OF IRREVOCABLE LETTERS OF CREDIT WITHIN A REVOLVING LIMIT OF 20 MILLION POUNDS. NO MARKET LIMIT IS IMPOSED ON LETTERS OF CREDIT CONFIRMED BY ACCEPTABLE BANKS OUTSIDE TURKEY.

II COVER FOR MEDIUM/LONG TERM CREDIT BUSINESS HAS BEEN AVAILABLE WITHIN MARKET LIMIT SUBJECT NORMALLY TO RISK SHARING WITH THE COMMERCIAL PARTIES (EXPORTER AND BANKER), IE REDUCED INDEMNITY TO AROUND 60 PER CENT ON CERTAIN LARGE VALUE CONTRACTS. THIS COVER IS CURRENTLY FULLY COMMITTED, THE POSSIBILITY OF MAKING FURTHER MEDIUM/LONG TERM COVER AVAILABLE WILL BE CONSIDERED SHORTLY. TOTAL COVER AVAILABLE ON CASH/CREDIT TERMS WAS AROUND 250 MILLION POUNDS.

10. VENEZUELA

SHORT TERM COVER ONLY IS AVAILABLE SUBJECT TO THE SECURITY OF AN IRREVOCABLE LETTER OF CREDIT CONFIRMED BY AN ACCEPTABLE BANK OUTSIDE VENEZUELA.

11. YUGOSLAVIA

SHORT TERM COVER ONLY IS AVAILABLE WITHIN A REVOLVING LIMIT OF 20 MILLION POUNDS SUBJECT TO THE SECURITY OF IRREVOCABLE LETTERS OF CREDIT (ILCS) ISSUES BY YUGOSLAV BANKS.

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CONFIDENTIAL

Prime Minister (2)

AT 1/3

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

28 February 1985

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

MT

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. Brian Unwin had an opportunity to discuss the same issues with his G5 Debt Deputy colleagues in Paris on Friday.

As the Bank's paper notes, 1984 was a satisfactory year for the problem countries, with significant progress made by a number of major debtors. But recent events, stemming from lack of domestic policy adjustment in Brazil, Argentina and even Mexico, together with the continuing resistence by Nigeria to significant adjustment, are casting something of a shadow over the current outlook.

The main worry is Brazil, where the negotiations with the commercial banks on a multi-year rescheduling agreement covering 1985-1991, which were almost complete, have been suspended because of Brazil's failure to comply with its Fund programme. The Fund are not prepared to grant a waiver and this will prevent Brazil's next drawing from the Fund at the end of this month. Serious negotiations with the Fund, the banks and the Paris Club will not to resume until the new government assumes office on 15 March when additional policy measures will be required and may need Congressional approval.

All this will take time. The Fund are now thinking in terms of a new programme running from July 1985. In the meantime, the banking Advisory Committee with de Larosiere's support has urged the banks to maintain until the end of May the very large interbank and trade lines of credit which expire around 19 February. On this round the banks seem to have responded favourably but the whole bridging exercise may need to be repeated

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at the end of May. As a result of this deterioration in performance, the G5 Debt Deputies view last week was that no multi year rescheduling agreement for official debt could be agreed. It must also be uncertain whether the banks will be prepared to resume negotiations on that basis.

It now seems unlikely that any multi year rescheduling agreement, on the lines endorsed at the London Summit, will have been agreed with official creditors, as opposed to bank creditors, before the April meetings of the Interim and Development Committees. However, the French (in their Paris Club role) have agreed to explore the possibility of holding discussions with the Ecuadorians before the April meetings. They want multi-year agreements with both official and bank creditors and their recent track record has been good.

Of the other major debtors, the outlook for Argentina later in the year is precarious - despite her recent agreements with the Fund and both commercial bank and official creditors - with a real likelihood that the Fund programme will go off course. The January inflation figure at an annual rate amounted to some 1200% compared with 150% target for end-1985. The new economic team have a lot to get to grips with.

In Mexico, where the 1985 programme is being discussed with the Fund, the divergences from the earlier programme look containable. There are no signs, despite a recent Fund mission, of any willingness by Nigeria to reach an agreement with the Fund and it remains uncertain whether the rescheduling negotiations with Poland can be brought to a conclusion, given her insistence on promises of new credit from the West before signature.

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

Yours ever
Rachel.

MRS R LOMAX
Principal Private Secretary

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INTERNATIONAL FINANCIAL SCENE

There have been mixed developments since the last Report: Latin American debtors, meeting at Santo Domingo, decided not to press for an immediate political dialogue, but instead appeared content to await the outcome of the April meetings in Washington; and negotiations with a number of major debtors, notably Poland, the Philippines and Argentina, made significant progress. But a major set-back has recently occurred in Brazil, where hope for a multi-year deal between the banks and the outgoing Government has been abandoned; and in Argentina the sudden change of Minister of Economy and central bank President has added a further element of uncertainty. The economic background to the debt problem has not, on balance, showed much improvement.

Real GNP in the USA rose provisionally by 1% in the fourth quarter of 1984 (revised from the "flash" estimate of 3/4%), bringing growth in the year as a whole to 6 3/4%. However, the major contribution to growth in the fourth quarter came from a reduction in the trade deficit, mostly attributable to a fall of 7 1/2% in the volume of imports. Overall, domestic demand in the US was much weaker in the second half of the year than in the first. Three-month euro-dollar interest rates fell steadily from 11 1/2% from the beginning of October to around 8 1/2% at mid-January (helped initially by a relaxation of monetary policy and subsequently by favourable news on inflation), but have since risen by about half a percentage point, reflecting renewed market concern over the "twin deficits", and a growing consensus that monetary policy is unlikely to be eased further. In the short run, rates are, if anything, likely to rise further. Outside the US, the recovery in activity appears to be levelling off: for example, real growth in West Germany is expected to be much the same this year as in 1984, at 2 1/2%. This slow pace of recovery has been accompanied by a continued reduction in inflation in the major industrialised countries. At the same time, many debtor countries have been assisted by firmer prices for a variety of agricultural products and industrial materials, leading to an improvement in their terms of trade for the first time in several years. Spot market prices for oil have firmed recently, after the OPEC meeting at end-January, which brought administered prices more into line with market prices.

Recent BIS data show that total external assets of banks in the BIS area fell in the third quarter of 1984, the first decline since the Herstatt crisis in 1974. Within the total, however, claims on developing countries rose by $1.4 bn, which was wholly accounted for by drawings on new money packages for Brazil, Chile and Mexico. The cumulative rise in loans to developing countries in the first nine months of 1984 was $5.1 bn, or only 2% at an annual rate, compared with the IMF forecast for the year as a whole of 5%. (There was a considerable catch-up in the fourth quarter of 1983, which is unlikely to have been repeated last year.)

After protracted negotiations, the proposed multi-year deal between Brazil and the banks has had to be abandoned for the time being, because of a serious deviation in the fourth quarter from the Fund's target on net domestic assets. New negotiations with the IMF and, subsequently, with the banks and Paris Club members cannot now be concluded until after the new Government takes office on 15 March. Elsewhere in Latin America, final documentation on two elements of Mexico's MYRA (the $23.6 bn of debt rescheduled in 1983/84 and 1983 new money) is shortly to be distributed to the banks, although signing is not expected to be completed before May. Progress on Venezuela's MYRA is also proving to be slow, although "road-shows" may begin next month. The smaller countries are all continuing to experience problems with their creditors, apart from Ecuador which could well be the first Latin American country actually to sign a MYRA, provided that satisfactory arrangements can be made with Paris Club creditors.

At the end of December, the IMF approved Argentina's request for a 15-month Standby for SDR 1.4 bn: this enabled the authorities to draw down a US Treasury loan to pay interest arrears to banks, which in turn allowed US regulators to upgrade loans to Argentina, thus facilitating the task of obtaining the banks' commitment to put up $4.2 bn of new money. However, the unexpected appointment of a new Minister of Economy and central bank President on 18 February has inevitably given rise to uncertainties regarding the Government's commitment to the adjustment programme.

In Eastern Europe, an agreement between Poland and its official creditors was initialled in mid-January, rescheduling arrears of principal and interest due in 1982-4; but provision of new credit and the rescheduling of 1985 maturities have yet to be settled. Negotiations between Yugoslavia and its commercial creditors are to resume later this month, following earlier disagreement over the shape of a proposed MYRA.

In the Far East, the Philippines has now reached agreement on rescheduling official debt, following earlier agreements with the Fund and the banks.

Contact between Nigeria and the IMF has resumed, but the authorities remain opposed to the key elements of a Fund programme.

The much-publicised Citibank-Cigna insurance contract collapsed in early February, when it became clear that Cigna could not arrange reinsurance for the $900 mn deal: the insurance company paid an undisclosed penalty to Citicorp, and refunded the initial premium of some $4.5 mn.

Foreign and Finance Ministers of the eleven Latin American countries comprising the Cartagena Group met in Santo Domingo (Dominican Republic) on 7-8 February to continue their regional consultation on external debt issues. Although Ministers have reportedly renewed calls for more generous rescheduling terms for all countries in the region, the meeting appears to have signalled a greater willingness to discuss differences with creditor governments within the ambit of existing international institutions. Significantly, the Group plans to submit written proposals to the April meetings of the IMF Interim and IBRD Development Committees, and will await the outcome of these meetings before pressing ahead with the idea of a joint political dialogue with major creditor governments.

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

(i) Latin America

Negotiations on Brazil's debt have suffered a major set-back. After final differences had been virtually resolved with the Advisory Group of banks on a MYRA, the deal (covering $45 bn of maturities falling due between 1985-91) has had to be abandoned for the time being. A steep rise in the monetary base in December produced a serious deviation from the Fund programme and prevents the next purchase under the EFF from taking place on 28 February. The Managing Director's view is that there is no question of a waiver. Meanwhile, the rate of inflation rose further to 230% (year-on-year) in January. In spite of emergency measures announced on 7 February, which are designed to cut Treasury disbursements by 80% in February and March, the Fund is now only willing to finalise the 1985 economic programme with the new government which takes office on 15 March.

Without the Managing Director's endorsement, the Advisory Committee are not in a position to recommend the MYRA to creditor banks. Instead, with strong support from de Larosiere, they have telexed banks world-wide, asking them to extend to 31 May the very large interbank and trade lines of credit, which were to have expired on 19 February, in order to allow time for new negotiations to reach a successful conclusion.

President-elect Tancredo Neves had hoped to see negotiations concluded before his inauguration on 15 March. As a result of this set-back, he will now be more open to Congressional pressures when discussions resume after he has taken office.

On 28 December, the IMF Board approved Argentina's request for a 15-month Standby for SDR 1.4 bn and a CFF for SDR 275 mn. Some Board members were sceptical about the programme. In particular, as prices have risen by 760% in the last twelve months, the proposed reduction in the rate of inflation to 300% (year-on-year) by September is very ambitious. The agreement with the IMF allowed Argentina to draw down a $500 mn bridge loan from the US

Treasury. This was used at end-December, along with a $100 mn loan from Mexico and a drawing on international reserves, to pay $850 mn to the commercial banks to reduce interest arrears on public sector debt: subsequently, the US banking supervisors agreed to upgrade Argentine loans from the "substandard" category to "other transfer risk" (under which the desirability of provisions is officially considered to be less strong). In January, the US Treasury loan was repaid following disbursement of IMF funds.However, in spite of these positive developments, some banks - notably Spanish, Italian and Swiss - have held back from committing themselves to the new money request which accompanied the rescheduling proposals for 1982-85. As a result, commitments are still nearly $140 mn short of the $4.2 bn total.

On the official side, the Argentines reached agreement with the Paris Club on 16 January, under which 90% of principal and interest falling due in 1985 ($0.6 bn) will be rescheduled over 10 years (with 5 years' grace), and 75% of arrears of principal and interest ($1.1 bn) over 8 years (3 years' grace). Bilateral agreements will need to be completed by end-June. There have been no formal discussions so far on Argentina's request for $1 bn of new official export credits.

Progress towards completing the debt package may be slowed down by the abrupt replacement on 18 February of the Minister of Economy and central bank President, although the new Minister is expected to comply with the agreements reached by his predecessor with the IMF, banks and Paris Club.

In Mexico, difficulties in devising a standard text for the currency switching option have delayed the finalisation of the MYRA. Documentation relating to the $23.6 bn of previously rescheduled debt and the 1983 new money loan is not likely to be signed before May, while agreements covering the remaining $19.8 bn are not expected to be finalised much before the end of the year. Progress on negotiating Venezuela's MYRA has also been slow, although the Advisory Committee has now reconvened, which may lead to "road-shows" next month. It now appears that Ecuador might be the first Latin American country actually to enter into a MYRA: the authorities are currently marketing a package covering [illegible].3 bn of commercial bank maturities falling due between 1985 and 1989, and response to the "road-shows" has so far been favourable. However, the package is dependent, inter alia, on Ecuador receiving 85% relief from official creditors in each of the years covered by the MYRA, which may not be acceptable to the Paris Club.

Chile is still negotiating with the IMF on a new Standby, and with commercial banks on a one-year rescheduling and a new loan of around $750 mn to $1 bn. Although Peru made a payment to creditor banks of $50 mn in January to bring interest arrears within 180 days, there seems little chance that it will be able to resurrect its IMF programme. Consequently, the banks will almost certainly not release the final $100 mn of new money originally negotiated in 1983, and will probably roll over maturities on a monthly basis until some time after a new government takes office in July. Colombia continues to hold out against an IMF programme, but the commercial banks have notified the authorities that their request for $875 mn of new money would be extremely hard to market without such a programme.

(ii) The Far East

In the Far East, the Philippines has consolidated its agreement with the IMF on the terms of a Standby and with commercial banks on debt restructuring, by concluding a Paris Club agreement for the rescheduling of official debt. However, failure to meet the first quarter's performance criterion on reserve money (notes in circulation, till money and bankers' balances at the central bank), and strict conditions recently imposed on concessional assistance flows this year, do not augur well for the future. Elsewhere in the region, Indonesia's external performance has continued to improve, with the current account deficit for fiscal 1984-85 now projected at $3 1/4 bn (4% of GDP), compared with $4 1/4 bn in the previous year. With reserves at present equivalent to around eight months imports and undrawn commercial credit amounting to some $1.5 bn, reductions in the price and output of oil - costing $300 mn and $1.2 bn per annum respectively - should present no short-term problems. External borrowing by the public sector this year is expected to be under $500 mn, well within the capacity of the markets. In contrast, Korea will again be a major borrower in the euromarkets: syndicated loans amounted to $5.5 bn last year, making Korea the largest borrower after the major OECD countries. The gross external borrowing requirement this year has been officially announced to be $5.8 bn. The current account deficit improved slightly over 1984 as a whole to an estimated $1.4 bn (1.7% of GDP) from $1.6 bn in the previous year.

(iii) Eastern Europe

Poland initialled the agreement to reschedule arrears of principal and interest due in 1982-84 at a Paris Club meeting on 15 January. The Poles are expected to seek new credits in discussions on the bilateral agreements prior to signature of the multilateral agreement (which creditors hope will be in June). Preliminary discussions on rescheduling 1985 maturities are to be held on 4 March. Meanwhile, the Poles have paid over to the UK only part of the 30% instalment of the 1981 debt agreement arrears. A Fund mission has visited Warsaw to familiarise itself with the economy before considering Poland's membership application later this year. The banks failed to reach agreement with Yugoslavia on rescheduling during talks in London from 8 to 16 January; discussions are to be renewed during February. The Yugoslavs are to enter into a follow-on Fund programme for one year, with enhanced monitoring thereafter, and an IMF mission is currently in Belgrade. It is hoped that the Letter of Intent can be approved by early March, and the Yugoslavs have proposed a meeting with official creditors on 18 March.

Hungary, which has decided not to pursue a follow-on programme with the Fund, has taken advantage of continued market confidence by making two FRN issues in January, its first return to the bond market since 1982. The GDR has benefited from US banks' renewed interest in lending to Eastern Europe by seeking a euro-loan (initially for $150 mn, but subsequently raised to $300 mn) for seven years, on better terms (LIBOR + 7/8%) than were obtained last year (LIBOR + 1%).

(iv) Southern Europe

Greece looks likely to have come close to meeting (unambitious) targets for inflation (18%) and the current account deficit ($2 bn) in 1984. But with no tightening in prospect of a rather lax fiscal policy, further progress on both external and internal adjustment seems doubtful, and market confidence appears to be delicately poised.

Portugal again sharply cut the current account deficit in 1984 to $0.8 bn (compared with the IMF Standby target of $1.25 bn). The Standby which expires this month is not to be renewed and, with Presidential elections scheduled for the end of the year, the government is aiming at a modest reflation of the economy: a return to positive real growth is expected to widen the current account to around $1 bn, and the Budget deficit is projected to rise to 9.5% of GDP (compared with 8.5% in 1984). Market sentiment is currently favourable to Portugal, but could be adversely affected by emerging political uncertainties.

(v) Other

The dialogue between Nigeria and the IMF has been resumed with the visit of a Fund mission at end-January for routine Article IV Consultations, but the Nigerian authorities remain opposed to the key conditions for a programme. Progress has been slow on the issue of notes to uninsured creditors, but interest payments have begun on notes already issued. The first interest payment on certain insured arrears was to have been made on 5 January, provided that processing of these arrears had by then been completed; but this was not achieved, and the first payment is not now expected to be made until April at the earliest.

The Israeli Government has secured the agreement of industry and the unions to further counter-inflationary measures, has announced cuts in government expenditure, and taken steps to restrict the outflow of foreign exchange. The current account deficit narrowed last year, partly because of the prepayment of US grant aid, but the US has yet to respond to an Israeli request for an increase in aid this year and next.

The external position of Turkey continues to give cause for concern. The current account deficit last year, at an estimated $1.9 bn, was only slightly better than in 1983. Future projections for the current account, when taken in conjunction with medium-term debt maturities and a growing volume of short-term debt, suggest that greater priority will need to be attached to improving the external position if payments difficulties are to be avoided in the next few years.

Bank of England
February 1985

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INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt	British-owned banks' exposure[1]	ECGD Principal at risk	ECGD Total amounts at risk
	End-Dec 1984	End-June 1984	End-Dec 1984 [2]	End-Dec 1984 [3]
Latin America				
Argentina	48	2.6	0.2	0.3
Brazil	100	6.6 (0.5)	0.7	1.7
Chile	19	1.3	-	0.1
Colombia	12	0.7	-	0.2
Ecuador	7	0.6	0.1	0.1
Mexico	96	6.2 (0.6)	0.5	1.2
Peru	14	0.4	0.1	0.1
Venezuela	35	2.3	-	-
Eastern Europe (convertible currency)				
East Germany	12-13	0.6	0.1	0.1
Hungary	8.5	0.5	-	0.1
Poland	27	0.5	1.0	1.1
Romania	8	0.3	0.2	0.4
Yugoslavia	19	1.0	0.7	1.1
Southern Europe				
Portugal	15	1.3	0.2	0.3
Spain	38*	2.8 (1.0)	0.1	0.1
Greece	10*	1.5	0.2	0.4
Far East				
Indonesia	35	0.9	0.7	1.4
Philippines	25**	1.3	0.2	0.2
South Korea	43	2.7 (0.7)	0.4	0.7
Other				
Morocco	12*	0.1	0.1	0.2
Nigeria	20*	1.2	1.5	3.0
Israel	30**	0.6	0.1	0.1
Turkey	20	0.3	0.2	0.3

[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] Defined as unrescheduled principal disbursed, plus political claims paid and claims under examination.

[3] Defined as guaranteed principal and contractual interest, plus political claims paid and claims under examination.

* End-December 1983 ** End-June 1984

Amounts in brackets represent undisbursed commitments where these exceed $1/2 bn.

- 1 MAR 1985

7.17

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Prime Minister (2)
This is the report the Chancellor mentioned
AT 13/2

CRNO

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

13 February 1985

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

MT.

Dear Andrew,

LATIN AMERICAN DEBT: BRAZIL

In my letter of 7 February, I reported that Brazil has breached its montary base target, and that this could delay both the next purchase under the IMF facility, and the rescheduling agreement due at the end of March.

It now seems that the situation is more serious than we thought, and the deadlines rather nearer. Under the draft rescheduling agreement, reached between the banks' Advisory Committee and the Brazilian Government, about $10 billion of trade facilities and $15 billion of money market facilities are due to be rolled-over on 19 February, probably for a period of 2 years. Final signature of the rescheduling agreement has of course been delayed by Brazil's failure to meet its IMF targets, and the difficulty of settling the terms of the next Letter of Intent until the new government takes office on 15 March. The banks were expected to roll-over these facilities for a short period to bridge this gap. This now seems less likely. The chief British negotiator has now told the Bank of England that some of the banks concerned wouldlike to terminate or reduce their facilities. The dnager is that once a number of them drop out, a larger number will be tempted to follow. The whole operation could then be at risk.

Senhor Galveas, the outgoing Brazilian Finance Minister, was due to meet de Larosiere on Monday. It seems likely that he will ask de Larosiere to make an interim statement to the banks. This would presumably say that the Fund Management were satisfied with the progress being made towards resolving the difficulty. On the strength of these assurances, the Advisory Group could then send a telex to all participating banks before the weekend, recommending

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them to renew the facilities which fall due next Tuesday 19 February. We have not yet heard whether de Larosiere agreed, but the Deputy Managing Director confirms our impression that there is a serious problem.

We are also in touch with the US Treasury, in an attempt to find out what they will do if the Managing Director cannot give such assurances, or the banks decide they are not sufficient.

The Bank of England believe that the British banks will be prepared to leave the facilities in place for a further period. There is thus no further action to be taken in London. But the situation elsewhere could deteriorate sharply during the week. If necessary, the G5 Deputies (who are meeting on Friday in the margins of the Summit preparatory "Sherpa" group), can concert any further necessary action.

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

Yours ever
Rachel

MRS R LOMAX
Principal Private Secretary

MG

Indebtedness: Econ. Pol. 145.

7.11

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Prime Minister (2)

AT 8/2

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

7 February 1985

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew,

LATIN AMERICAN DEBT: UPDATE ON BRAZIL

Although the regular assessment of the international financial scene is not due for 2 or 3 weeks, there have been some developments on Brazil on which I should bring you up to date. The information is based on informal contact in Washington with Fund staff. No formal Fund statements have been made yet but these may follow.

Brazil has breached its monetary base target for end-December by an even larger margin than the Fund's revised estimates allowed. The December increase was 36 per cent, bringing the figure for 1984 as a whole to 244 per cent (compared with an original target of 50 per cent, revised to 95 per cent). The problem seems to stem from a reluctance to raise interest rates.

The immediate effect is to prevent Brazil's next purchase under its Fund facility on 28 February. A Fund team is due in Brazil later this month to discuss a programme for 1985 but the results of this are unlikely to come before the Board before April/May at the earliest. This breach of Fund targets stalls both the commercial bank rescheduling agreement only just agreed (and reported in the Times on 5 February) and the forthcoming Paris Club rescheduling of their official debt, both of which require a Fund programme to be in place before they can proceed.

It now seems increasingly unlikely that there will be an official MYRA (Multi-Year Rescheduling Agreement) in place before the spring meeting. Brazil was the only promising candidate. This will make the presentation of the creditor Governments' case in Washington more difficult, although it may prove possible for the Paris Club to hold preliminary discussions with Brazil against the time when a Fund programme can be put in place.

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

Yours ever
Rachel

MRS R LOMAX
Principal Private Secretary

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JKRAAD
bcPC

10 DOWNING STREET

25 January 1985

From the Private Secretary

ARGENTINA

The Prime Minister has considered the Chancellor's minute of 22 January about follow-up to the Paris Club multilateral meeting to reschedule Argentine official debt.

The Prime Minister agrees that we should accept the French offer to organise a meeting with the Argentines to conduct the bilateral negotiations which are needed to implement the framework agreement reached in Paris on 15 and 16 January. She further agrees that we should not in future regard bilateral rescheduling agreements as international treaties. She acknowledges that we cannot make progress on lifting remaining trade restrictions a pre-condition of a bilateral rescheduling agreement but hopes that we will make the most of this opportunity to resolve the issue of trade restrictions.

I am sending copies of this letter to the Private Secretaries to the Foreign Secretary, the Lord Privy Seal and the Secretary of State for Trade and Industry.

(C.D. POWELL)

Miss Rachel Lomax,
HM Treasury.

E. R.

PRIME MINISTER

This was attached behind the Foreign Secretary's minute last night and I am not certain you saw it.

The Chancellor raises three points:

(i) should we have technical, bilateral talks with the Argentines in a third country to implement the Paris Club agreement?

(ii) should we cease to regard bilateral rescheduling agreements as international Treaties?

(iii) should we use the bilateral rescheduling negotiations to try to get trade restrictions lifted - recognising that we cannot make it an absolute condition?

Agree to all three? Yes mt

C.D.P.

24 January 1985

file PS

10 DOWNING STREET

From the Private Secretary

24 January 1985

RELATIONS WITH ARGENTINA

Thank you for your letter of 23 January enclosing draft instructions to H.M. Ambassador in Berne and a draft message to the Argentines about normalisation of economic and commercial relations.

The Prime Minister agrees these instructions which may now issue.

CHARLES POWELL

Peter Ricketts, Esq.,
Foreign and Commonwealth Office.

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[FCS' submission on Falklands/ Argentina].

10 DOWNING STREET

Prime Minister

The FCO instructions are consistent with the general approach you authorized earlier (e described to Perez de Cuellar).

The only new point is the involvement of the French in making arrangements for exchanges on economic matters.

— As you will see, the Chancellor agrees to using the French.

CDP
23/i

cc ①

Foreign and Commonwealth Office

London SW1A 2AH

23 January 1985

Prime Minister
To see with Chancellor's minute attached about bilateral debt negotiations.
Agree instructions?
CDP 23/i

Dear Charles, Yes ma

Relations with Argentina

The Foreign Secretary proposed in his minute of 4 January to the Prime Minister that we should delay a response to the latest Argentine proposals until after the multilateral Paris Club meeting on the rescheduling of Argentina's official debt.

As you will know, the Paris Club meeting passed off without any problems. I now enclose a draft message which we propose to ask the Swiss to convey to the Argentines. This is along the lines foreshadowed in the Foreign Secretary's minute. I also enclose a draft of the instructions we propose to send to HM Ambassador Berne. As these instructions make clear, we see some advantage in taking up the idea put forward by the Argentines that the French should be asked to make the arrangements for the exchanges on economic matters following from the Paris Club discussions. That would achieve a clear separation from the Berne talks and any suggestion of linkage with the sovereignty issue. We also propose to brief the Brazilians on our message to the Argentines in parallel, to ensure that it reaches the Argentines without any glosses that the Swiss might be tempted to put on it.

Yours ever,

Peter Ricketts

(P F Ricketts)
Private Secretary

C D Powell Esq
10 Downing Street

D 107991 400,000 7/76 904953

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RELATIONS WITH ARGENTINA

1. Ministers have studied Caputo's proposals with care. They are not (not) acceptable. Quote political status of the Islands and their inhabitants unquote is no more than a euphemism for sovereignty. The Argentine demand that we must accept all three phases before the first phase could start is essentially similar to the position which brought the Berne talks to deadlock.

2. We shall maintain our policy of seeking more normal bilateral relations with Argentina, avoiding packages or linkage, and identifying single subjects on which we wish to make progress when conditions are ripe.

/3.

3. One such area is the possible lifting of commercial and financial restrictions. The multilateral Paris Club meeting on the rescheduling of Argentine debts passed off satisfactorily on 15-16 January. We now wish to take the opportunity of the bilateral follow-up meetings to make progress towards lifting economic restrictions. You will have seen from Paris telno 51 that the Argentines themselves suggested that the French should act as intermediary to arrange bilateral meetings between Argentina and UK following from the Paris Club exchanges. We see some advantages in this idea. It would emphasise that these discussions are being treated as a self-contained subject, entirely separate from the Berne talks with their inevitable connotations of sovereignty linkage. It would obviously be important to explain to the Swiss that we saw this as a follow-up to the Paris Club discussions where the French have a special role and not (not) as any change in the Swiss position as our Protecting Power. I am sure you will be able to put this over to them without giving offence.

4. I also see advantage in an early re-statement of our position on a visit to the Falklands by Argentine next-of-kin. Our policy on this remains unchanged. Falklands Councillor John Cheek spoke positively about it in New York last October. If our offer were supported by parallel action through the Catholic Church, as well as the ICRC, it could be more difficult for the Argentines to introduce extraneous sovereignty issues: a separate telegram will follow about this.

5. I should be grateful if you could ask the Swiss to convey to the Argentine Foreign Minister the message in

/MIFT

MIFT. I do not (not) want the Swiss to add any gloss of their own: I see them as acting strictly as a channel of communication, rather than seeking to convoke new talks, still less to mediate between us and Argentina. You may however point out to Brunner that our approach is entirely consistent with his remark last August that it might be possible to circumvent the linkage problem by making progress on one thing at a time through the diplomatic channel (para 7 of your telno 310 of 30 August 1984).

6. For Civil Commissioner, Port Stanley. Although the Argentines have made public statements on very similar lines to their proposals in December, they have not disclosed the fact of their approach. (FCO telno Personal 17 of 10 December 1984). We wish to maintain confidentiality for the time being. When the time comes, we would envisage your briefing Councillors along the following lines:

(a) we have rejected another Argentine proposal in which the sovereignty linkage, albeit stated in a more oblique form, was an integral part.

(b) We have however told them that we are prepared to pursue practical means of improving relations between our two countries, especially in the economic field.

(c) We have reiterated the position regarding the Argentine dead, including our readiness in principle to accept a suitably prepared next-of-kin visit.

Neither (b) nor (c) above go beyond our position at Berne with which Councillors were content.

7. For Brasilia. We shall brief the Brazilian Ambassador here about the Argentine message and our response as soon as the Swiss report that they have taken action with the Argentines. You have discretion to take similar action emphasising confidentiality.

/8.

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8. For other addressees. All the above is strictly for your own information at this stage. I want to give the Argentines some time to reflect on our message without hearing that we have briefed our Allies and Partners. But we shall wish to do so before long.

MESSAGE TO ARGENTINE GOVERNMENT

The British Government have carefully considered the Argentine proposals conveyed orally to the British Ambassador in Berne by the Swiss State Secretary for Foreign Affairs on 4 December 1984.

The British Government continue to attach importance to achieving more normal relations between Britain and Argentina. But, as Dr Caputo's message itself recognises, the restoration of confidence between our two nations will take time. It is therefore all the more important to launch the process without further delay. But the Argentine Foreign Minister's message proposes that even the start of such discussions should be subject to a precondition. His approach would require the British side to commit themselves at the outset to addressing in due course the "political status of the Islands and their inhabitants". There is no difference of substance between this precondition and a commitment to discuss sovereignty, however obliquely stated. As is well known, the British Government cannot agree to an arrangement in which discussion of sovereignty over the Islands forms any part. They cannot therefore accept the Argentine proposal.

The British Government remain strongly of the view that more normal relations between our two countries can best be achieved by dealing with practical issues of interest to both Governments. That was the basis on which the British Government

/Government

Government approached the meeting in Paris on 15/16 January at which agreement was reached on the terms for rescheduling Argentina's official debt. The British Government welcomed the opportunity to play a constructive part on this practical matter. They intend to approach the subsequent bilateral negotiations in an equally positive spirit.

The British Government also wish to see progress in other aspects of economic relations. In particular the restoration of trade between Britain and Argentina would be of clear and immediate benefit to both sides. Moreover, the absence of normal economic and commercial relations with Britain must inevitably hamper the development of broader co-operation between Argentina and the European Community.

The British Government therefore propose that all appropriate opportunities should be taken to make early progress towards the lifting of remaining financial restrictions on British companies in Argentina, as agreed between representatives of the British Government and of the Argentine authorities in September 1982, as well as the reciprocal removal of the restrictions on imports imposed in 1982.

The British Government   take this opportunity to repeat their position regarding the Argentine dead whose remains are buried in the Falkland Islands. The British Government's preference is for the return of the remains to Argentina. Meanwhile, they remain prepared to facilitate a humanitarian visit to the graves by close relatives of those Argentines who died on the Falklands. Such a visit should be sponsored by the Argentine Government and should take place under the auspices of, and be supervised by, the International Committee for the Red Cross. The detailed terms under which the British Government would be ready to accept a visit remain as set out in Note No IE(GB)72/83 of 19 August 1983 from the Swiss Embassy in Buenos Aires to the Argentine Ministry of Foreign Affairs.

ARGENTINA: Relations: Pt 39

23 JAN 1985

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CONFIDENTIAL

c. /BL

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

PRIME MINISTER

Prime Minister
Agree?
CDP 23/1

Yes MT

In my minute of 7 December I sought your agreement that officials should attend the Paris Club multilateral meeting this month to reschedule Argentine official debt. Your agreement was recorded in Mr Flesher's letter of 24 December.

2. That meeting took place on 15 and 16 January. As instructed, officials maintained a very low profile, but signed the eventual agreement. This provides for reasonable, but not excessively generous, rescheduling, over ten years, of Argentine debt to Western governments maturing up to the end of 1985. The terms are broadly comparable to those conceded by the banks, most of whom have now agreed to the parallel banking deal. Total banking exposure over the relevant period is roughly 10 times bigger than that of governments. Taken together with the IMF programme approved on 28 December, they constitute a package which resolves this phase of the Argentine debt problem.

3. We now have to decide how best to conduct the bilateral negotiations which will implement this framework agreement. These have to be completed before 30 June. In earlier Ministerial exchanges we accepted the need for this in principle, but left the details to be settled nearer the time. The Argentine side is now very anxious to make progress and their London banking agents are already pressing ECGD officials for the technical data necessary to prepare the deal. But these will be the first formal official contacts since the breakdown of the Berne talks, and both sides are aware of the sensitivities. Argentina broke the ice, by asking the French government if it would be prepared to organise a bilateral meeting on neutral ground, and were even anxious to do so last week while both sides were still in Paris. French Finance Ministry officials asked mine whether we could accept this. My officials replied that they would need Ministerial instructions, but were grateful for the French offer.

4. The Swiss government, as protecting power, had previously asked my officials if we wanted them to negotiate on our behalf or organise a similar meeting but were told, with thanks, that we were still considering our position. The Swiss Embassy here says there will be no embarrassment if we now prefer to accept the French offer instead.

5. I recommend, subject to the Foreign Secretary's views, that we accept the French offer. It would not be satisfactory to have the Swiss negotiate on our behalf a complicated technical document binding on both parties. It was recognised in Ministers' earlier decisions that at some stage we would need to engage in low-key bilateral technical talks of this kind. They will be a useful first step towards normalisation of commercial relations.

Agreed MT

6. There is one presentational problem. The UK is alone, among Paris Club members, in treating such bilateral agreements as treaties, requiring presentation to Parliament, publication in the Treaties series, and registration at the UN. Such formality is thought to give the agreements greater status and reduce the risk of further default. In fact this protection is illusory; several debtor countries have defaulted on these agreements and later renegotiated them. Other creditor countries are content to rely on less formal but nevertheless binding agreements. The treaty process is time-consuming, and officials were already considering whether to abandon it. In this case, I believe it would give undue prominence to this relatively minor step. If the Foreign Secretary and Lord Privy Seal agree, I recommend that, starting with the Argentine agreement, we do not regard these documents as international treaties.

Agreed MT

7. A decision is also needed on the question raised by the Minister for Trade in his minute of 14 December: how best to use the opportunity to lift the remaining trade restrictions in Argentina and in the UK. The Foreign Secretary's minute of 4 January indicates his agreement. We cannot make this an absolute precondition of a bilateral deal because the Paris Club framework agreement requires us to settle. But the talks provide a good opportunity to raise the matter. I suggest that officials pursue the various tactical options and do their best to achieve the objective proposed by the Minister for Trade.

Agreed MT

8. I am sending copies of this minute to the Foreign and Commonwealth Secretary, the Lord Privy Seal and the Secretary of State for Trade and Industry.

NL.

N.L.

22 January 1985

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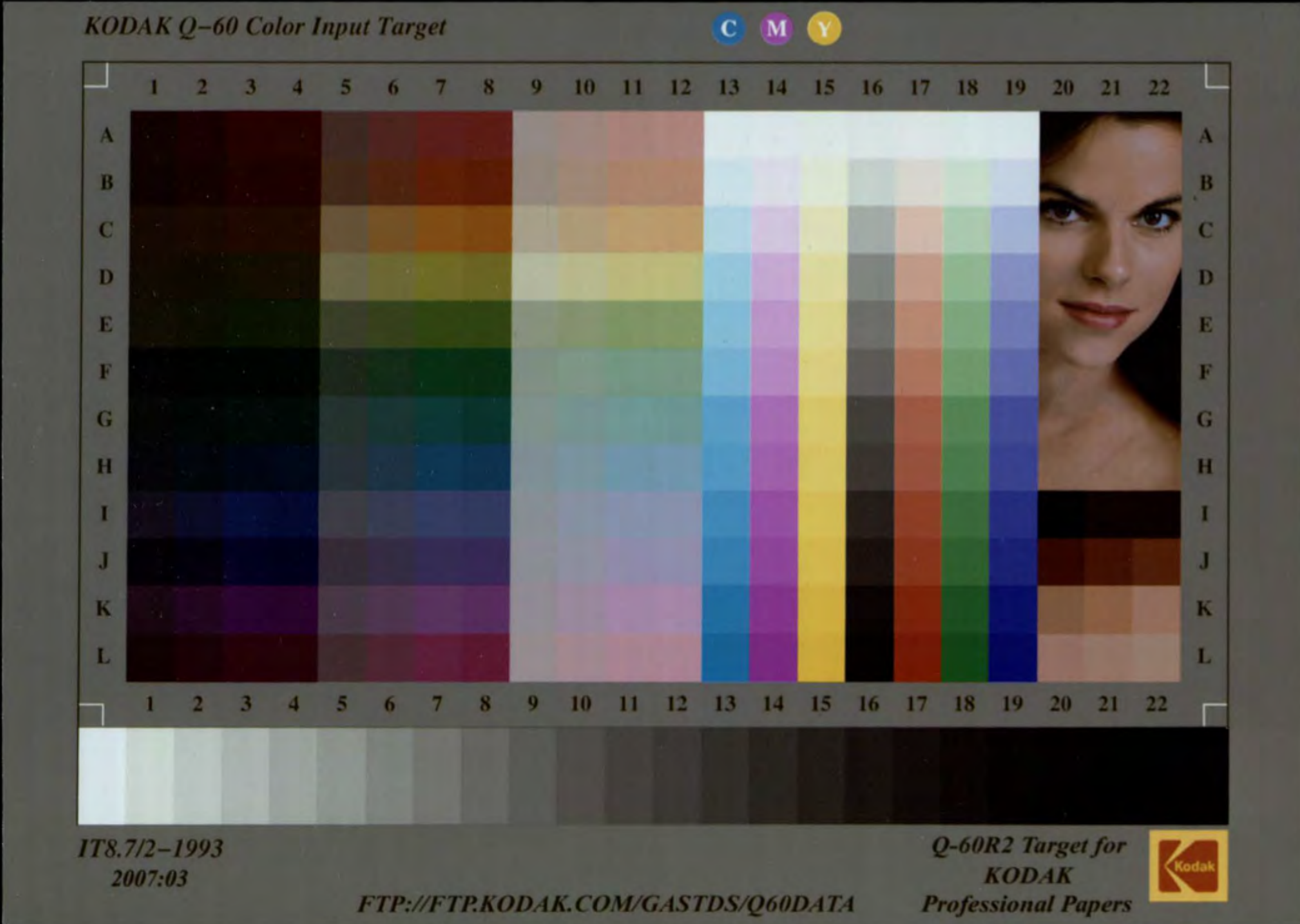
23 JAN 1985

PART 4 ends:-

DB to HMT 31.12.84

PART 5 begins:-

Ch/Ex to PM 22.1.85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