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PREM 19/2095

PART 6

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Confidential Filing

Indebtedness of various Countries and it's effect on the Western Banking system.

ECONOMIC POLICY

Pt 1: AUGUST 1982

Pt 6: MARCH 1986

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~20.3.86~~							
~~12.5.86~~							
~~27.6.86~~							
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~~31.7.87~~							
~~21.9.87~~							
22.10.87.							
PT 6 ENDS							

PREM 19/2095

PART 6 ends:-

FCS to CH EXCH (FCS/87/213) 22.10.87

PART 7 begins:-

HMT to CDP 9 11.87

FCS/87/213

CHANCELLOR OF THE EXCHEQUER

International Debt

1. You sent me a copy of your minute to the Prime Minister of 9 October. We made progress at CHOGM in obtaining an unqualified endorsement of your debt initiative, and in achieving language that stressed the importance of reaching early agreement to reduce interest rates on the rescheduled debts of the poorest and most indebted countries. The Canadians announced their full support early in the proceedings, and you might want to take a suitable opportunity to express our appreciation to Mr Wilson. The Australians said that they were in agreement with "95% of our proposals", and that they would not stand out against their endorsement. We (and Canada) were also singled out in the Communique for our willingness to contribute to the enlargement of the Structural Adjustment Facility. This is politically very helpful.

2. I agree with your analysis, and I believe that we should continue to press for agreement in the Paris Club on interest rate concessions. Like you, I doubt whether we shall make much progress before the end of the year. But it is important that when the OAU's debt conference takes place in December the more sensible African countries should be able to point to the initiatives under discussion - yours, Camdessus' and perhaps Mr Baker's proposal for an External Contingency Facility - as evidence that creditors and debtors can cooperate

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in efforts to reduce the burden of indebtedness and underpin adjustment policies. Otherwise the extremists may have it all their own way. So we should actively promote your initiative, while privately considering what other package might meet your essential objectives.

4. Your minute also mentioned Seaga's CARICOM initiative. The language of the relevant paragraph in the CHOGM Communique corresponds closely to the text agreed at Barbados. We told the Jamaicans that you had raised their problems with M. Camdessus, and they were duly grateful. Caribbean delegations gave your initiative useful support, although they knew that they would not benefit from it. Their own problem lies with what the communique describes as their "uncomfortably bunched" debts to the IMF and World Bank. Perhaps we can find ways of helping them without going so far as to urge the Fund - still less the Bank - to reschedule their debts.

5. I am copying this minute to the Prime Minister.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
22 October 1987

COMMONWEALTH: CHOGM PT 12

RJ8.50

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

21 September 1987

C Powell Esq
10 Downing Street
LONDON
SW1

Dear Charles

INTERNATIONAL FINANCIAL SCENE

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

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

In order to keep the focus clearly on sub-Saharan Africa, it will be necessary to ensure that the difficulties and problems of middle income debtors are not allowed to dominate the discussions. The UK line on middle income debtors will be, as it was at the April meetings, the continuation of the case by case strategy, emphasising the need for conditionality (additional creditor support linked to appropriate adjustment programmes) and for debtors and banks to work out market-related solutions.

The economic background as it affects the evolution of the debt problem has shown little change over the past two months. There is some improvement in the prospects for LDC exports,

together with a slight strengthening of non-food commodity prices, compared with the very low levels of last year. On ther other hand dollar interest rates have strengthened recently and further increases could well be needed if the US stands by the Louvre agreement to maintain the dollar at around present levels.

On individual countries, there are few bright spots. The performance of Mexico and some smaller Latin American debtors continues to be encouraging. On the other side Brazil remains the major problem. As the report notes the radical Brazilian proposal that one half of its commercial bank debt should be securitised (on terms which represented a significant discount on face value and would have led to wide spread write downs) was withdrawn following intervention by US Secretary Baker. He apparently said, in persuading the Brazilians to retreat, that new bank lending to cover interest arrears could become available without Brazil's acceptance of an IMF programme, although such a commitment would still be required for any rescheduling by Government creditors in the Paris Club and for any further "new money" from the banks next year. This, if true, would be an unwelcome weakening of the present strategy. It remains to be seen what the banks make of this. For the moment they (and the UK banks in particular) seem set on a harder line requiring a Fund programme for the arrears, and the Chancellor does not believe we should lean on the UK banks to soften whatever line they believe right to take, even though the US is likely to press us to do so. Brazil's intentions in relation to the Fund remain unclear. The Managing Director's summing up of the recent Article IV discussion of Brazil clearly amounted to a negative assessment of current economic measures but the latest indications are that Bresser Pereira has been persuaded to go for an IMF Standby. New formal debt proposals will be presented to the banks on 25 September.

Despite the signature of the commercial bank lending package in August, developments in Argentina have been adverse. The country is off tract on its new, weaker Fund programme and following the Peronist victories in the elections, a more confrontational aspect to debt issues seems to be emerging. On 9 September Alfonsin announced a decision to seek the "freezing of interest rates at historic levels". This appears to be a warning shot for the future rather than an immediate attempt to unpick the commercial bank package.

Elsewhere, there are a number of countries in Eastern Europe (Yugoslavia, Poland and Hungary) where an improvement in deteriorating economic performance depends on negotiations for a Fund programme. The Hungarians hope to negotiate a sizeable programme to reassure their creditors and to avoid rescheduling. Government creditors will make a new Fund

programme for Yugoslavia a precondition of further rescheduling. Such a programme remains a precondition for any long term approach to Polish debt problems, but is not an immediate prospect, so that an interim settlement is needed and now seems likely.

In Africa, the Nigerian position has deteriorated. The present programme is now effectively dead, although the Fund are formulating a new programme for next year. This could cause financing difficulties if it delays disbursement under the commercial bank package and negotiation of a further World Bank loan. Among Commonwealth countries in Africa there are a number (eg Tanzania, Ghana) who have Fund programmes and are therefore candidates for the Chancellor's sub-Saharan initiative. Others, like Malawi and Sierra Leone, could become so were they to reach an agreement with the Fund. Zambia, on the other hand, for the moment looks set to remain outside the fold.

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

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

Yours sincerely

Jonathan Taylor

J M G TAYLOR
Private Secretary

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CONFIDENTIAL

INTERNATIONAL FINANCIAL SCENE

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Further details on individual countries are given below.

Latin America and Caribbean

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

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

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

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

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

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

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

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

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

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

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

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

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

South and East Asia

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

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

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

Eastern Europe

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

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

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

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

Southern Europe

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

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

Sub-Saharan Africa

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

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

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

37 In Zimbabwe, the budget for 1987/88 fails to address major problems. The budget assumes no growth (in contrast, local Zimbabwean sources expect GDP to fall by 3%-4%) and aims for a virtually unchanged deficit (11% of GDP in 1986/87). Its measures fall well short of those envisaged by the IMF in the recent Article IV discussions as necessary for medium-term sustainable growth.

The economic recovery in South Africa is not continuing as strongly as first hoped. The Reserve Bank has said that GDP growth in 1987 is unlikely to reach the government's target of 3% - the third year in which growth targets have not been reached.

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

Middle East & North Africa

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

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INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

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

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

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

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

* Current estimate.

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INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

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

[4] Includes $30 bn from Arab countries.

[5] Excludes unguaranteed non-bank claims.

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OVERDUE FINANCIAL OBLIGATIONS TO THE FUND*

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

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

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

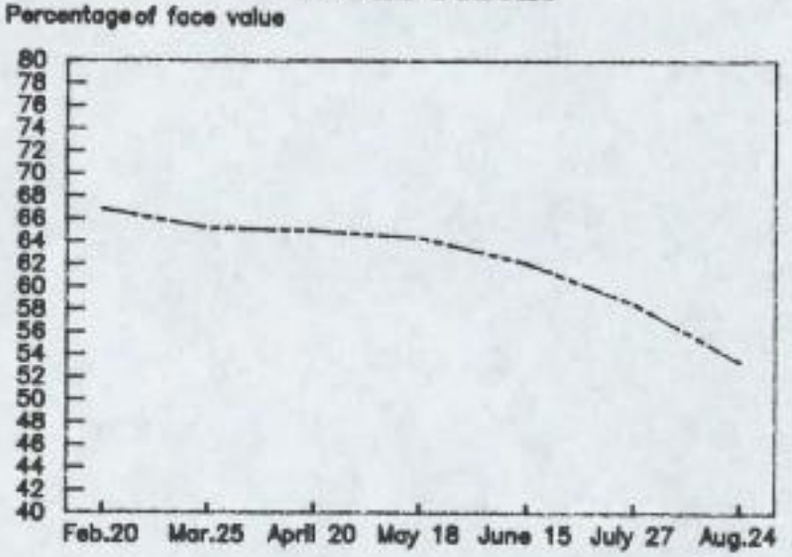
Guyana, Viet Nam, Sudan, Peru and Liberia are ineligible. Kampuchea is out of contact with the Fund. Zambia will be declared ineligible at end-September unless it has given firm indications of an intention to clear arrears in the interim.

CHART 1

SALOMONS SECONDARY MARKET PRICES

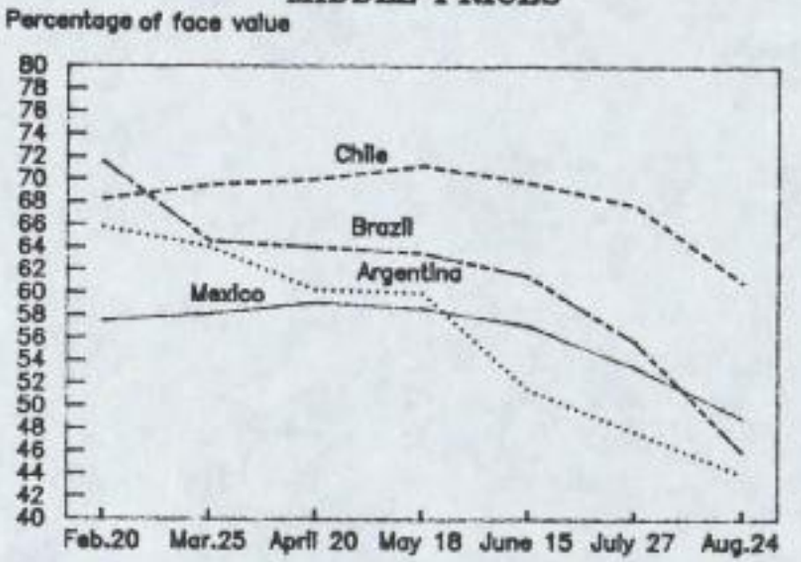
ALL IDR COUNTRIES (WEIGHTED AVERAGE)

MIDDLE PRICES

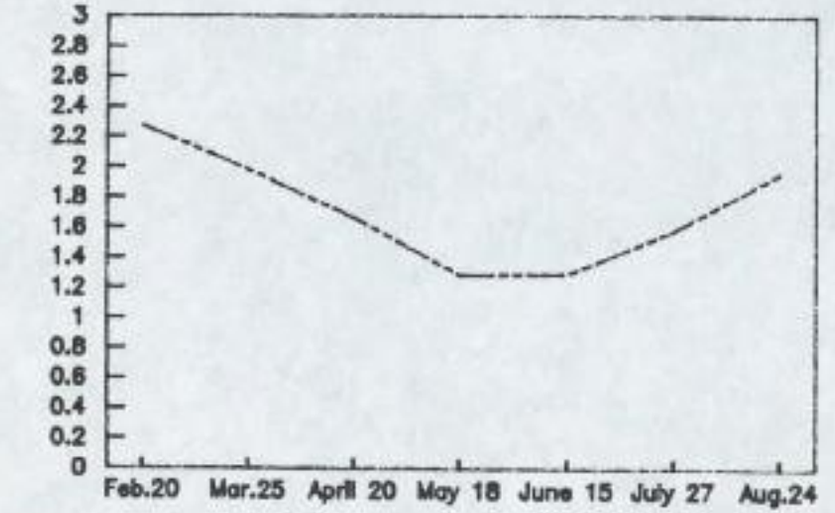


SELECTED MAJOR DEBTORS

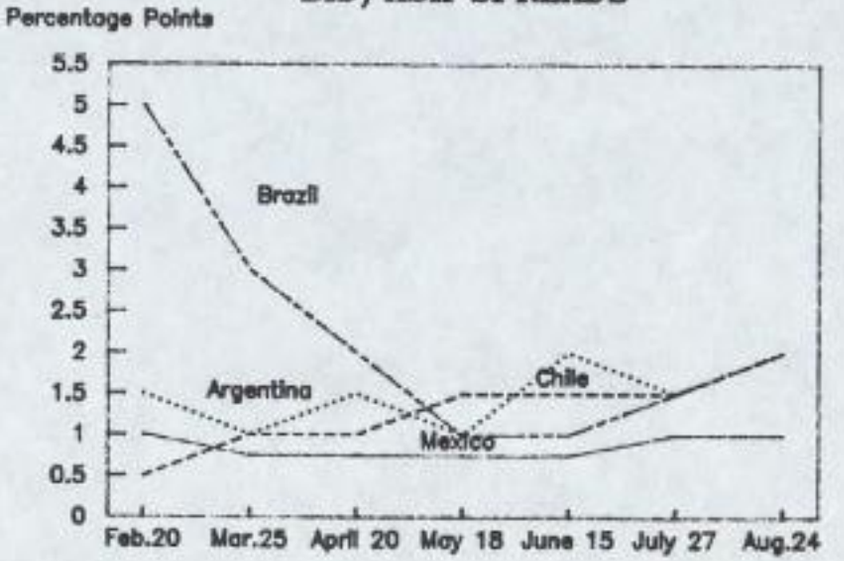
MIDDLE PRICES



BID/ASK SPREADS



BID/ASK SPREADS



C1/3

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cc PE (2)

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

Rose Austin
CDP
4/8.

C D Powell Esq
PS/Prime Minister
10 Downing Street
LONDON SW1

31 July 1987

Dear Charles

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INTERNATIONAL FINANCIAL SCENE

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

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

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

The other main development since our last report has been the continued move towards greater provisioning by the Commercial Banks against Third-World debt. The big four London clearing banks have now followed the lead of Citibank and other major American banks. This change of policy by the British banks is of course welcome, and in line with the greater realism which the Chancellor has urged for some time.

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

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

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

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

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

The Polish problem is as intractable as ever. The US has just changed its position, opening up the chance of a negotiation

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

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

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

Yours sincerely

Derek Taylor

J M G TAYLOR

MR 4/21

800

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

David Norgrove Esq
No.10 Downing Street
LONDON SW1

22 July 1987

1. CAB
2. NSBPM

Dear David,

CHANCELLOR'S SPEECH ON INTERNATIONAL DEBT, 22 JULY

... You may like to have the attached copy of the Chancellor's speech about International Debt, to the All Party Parliamentary Group on Overseas Development.

I am copying this letter to Tony Galsworthy (FCO), Paul Steeples (Department of Trade and Industry), Shirley Stagg (MAFF), and Martin Dinham (Overseas Development Administration).

Yours sincerely,

Andrew Hudson

A P HUDSON

CHANCELLOR OF THE EXCHEQUER'S SPEECH TO ALL PARTY PARLIAMENTARY GROUP ON OVERSEAS DEVELOPMENT, 22 JULY

The debt problem has been with us for almost five years now. While there is no magic solution, some useful progress has been made, and more is in prospect. Today, I want to look ahead at what the next steps should be, and what action should be taken by governments, by the commercial banks, and by the debtor countries themselves.

When the crisis broke in the autumn of 1982, the immediate need was to buy time, so that the banks could strengthen their capital base, and the debtor countries could begin the process of putting their economies on a better footing. This has been done successfully. Earlier fears about a systemic threat to the world banking system have receded. Many debtor countries have implemented long overdue reform policies. And the world economy generally is in better shape than it was five years ago.

With the worst of the crisis behind us, the job is to look forward to what needs to be done to enable the debtor countries, in time, to bring their debt burdens down to more manageable and sustainable levels. And, as I shall argue, the solution is not necessarily the same for the different groups of debtors.

Most of the discussion about the debt problem has understandably been focussed on the so-called middle income debtors, notably in Latin America. Certainly, these countries have the greatest overseas indebtedness - at the end of 1985, Brazil owed no less than $105 billion and Mexico $95 billion. But at the same time they are for the most part rich in natural resources, and have a fairly well developed industrial structure. In short, they are in a position to pull their economies round and to reduce their debt burdens, by their own actions.

The first requirement for these countries is therefore to put the right economic policies in place. This means, first and foremost, allowing markets to work more freely. It means, in many cases, cutting back a bloated State sector. And it means keeping interest

rates and the exchange rate at realistic levels - otherwise the capital flight which so damaged the debtor countries in the early 1980s will persist. It has been estimated that over $100 billion left the problem debtors between 1978 and 1985, equivalent to more than a third of the additional debt they incurred over that time. But Mexico has shown recently that it is possible to encourage significant capital inflow, provided sensible policies are pursued.

The overwhelming majority - some two thirds - of the debts owed by the middle income debtors are owed to the commercial banks. It is clearly the joint responsibility of the debtor countries and the commercial banks to manage these debts.

Throughout the past five years, a variety of schemes have been put forward under which the governments of the industrial countries would step in and take it upon themselves to "solve" the debt problem. People argue that the magnitude of the problem is such that it demands government action.

I am not attracted to any of these schemes. They all boil down, directly or indirectly, to the taxpayers bailing out the banks.

To do this would not only be a misuse of public money. It would also encourage bad banking.

The banks embarked on sovereign lending chiefly because it looked to be a profitable business. For some years, it was. But the banks knew all along that the returns were in no sense underwritten - by taxpayers or anybody else. They knew they were in the risk business. If they did not know that, they should have done. And there is certainly no case for taxpayers to pick up a disproportionate share of the bill for commercial misjudgements.

Thus the way forward for the banks is to treat sovereign debt as they would other types of debt. This has already meant a good deal of rescheduling of debts. And now, one by one, the major banks are announcing substantial increases in the specific provisions made against sovereign debt. In the immediate future, at least, this increase in provisioning is bound to mean a significant cost to the

taxpayer, since more tax relief will be due to the banks. This occurs under the normal rules for provisions against bad or doubtful debts. If any company's profits are cut back, the Exchequer is likely to get less revenue. That is wholly proper: indeed the only proper role for the taxpayer in this context.

Large though the tax cost is likely to be, I unhesitatingly commend the way the banks are now dealing with the debt problem on their books. By strengthening their balance sheets, and increasing provisioning, they are moving further down the road from involuntary lending back to lending based on proper commercial decisions, and from make-believe to realism.

They are also paving the way for a more market-orientated approach to the way in which the middle income debtors can in future meet their financial needs. So far, most funds have been provided through syndicated loans involving a number of banks. But other approaches have a role to play, particularly those involving a more explicit sharing of risk between lenders and borrowers. There needs to be more direct investment, both through new equity investment, and debt-for-equity swaps. This shift of emphasis will, however, require a more welcoming attitude from some of the debtor countries themselves, some of which are, for example, still resisting the idea of debt-equity swaps.

The debt problems of the middle income debtors will not be solved quickly. But the way forward is clear. The banks are adopting a more realistic approach towards provisioning. If the debtor countries themselves pursue sound policies, there is no reason why the middle income debtors should not, in time, make real progress towards full creditworthiness.

But the same cannot be said for the poorest countries of Sub-Saharan Africa.

The concentration on the middle income debtors has meant that, until recently, the plight of those in Sub-Saharan Africa has been neglected. But although the volume of debt there is not so great, their problems are even more acute.

These countries are very poor indeed: in 1985, their GNP per head was only about $280, less than one-fifth of that in the middle income debtor countries. And they are getting poorer. In many cases, their GNP per head is actually lower, in real terms, than it was twenty years ago.

Unlike the major debtors of Latin America, the poorest and most heavily indebted countries of Sub-Saharan Africa have no chance whatever of returning to viability by their own efforts. Although the amount of debt per head of population may be a good deal lower than in the middle income debtors, the ratio of debt to national income is much higher. And their problems are getting steadily worse. Sub-Saharan Africa's debt has risen by well over 70 per cent since 1980, while its exports are even lower now, in dollar terms, than they were then.

There is certainly a great deal of scope for the Sub-Saharan countries to start to improve the health of their own economies. And that they must do. But that by itself will not be enough to reduce their debt burden.

At the same time, in contrast to the middle-income debtors, two-thirds of the Sub-Saharan African countries' debt is owed to other governments and to international institutions, rather than to the commercial banks. Responsibility for tackling this side of the debt problem therefore lies fairly and squarely with governments. And just as I expect the banks to face up to their responsibilities for the middle income debtors, so governments must do the same for these very poor countries.

That is why I proposed, in Washington last April, a three point international plan to support those of the poorest and most heavily-indebted Sub-Saharan African countries which are pursuing satisfactory economic policies.

- First, the creditor nations should convert aid loans into outright grants.

- Second, longer repayment periods, with generous grace periods, should be allowed in rescheduling other official loans.

- And third, and of crucial importance, the creditor countries should reduce the interest rates payable on these debts to well below market levels.

Since this British initiative, there has been growing recognition - for example, at the Venice Summit - that the basic analysis is inescapable. And the reason for singling out the poorest countries of Sub-Saharan Africa for special treatment has been generally acknowledged. What is needed now is action.

The United Kingdom has in fact almost completed already the process of converting aid loans to grants for Sub-Saharan Africa. Denmark and the Netherlands have also made good progress on this front. I hope the other industrialised countries that have not yet done so will follow suit.

The industrialised countries generally, meeting together as the so-called Paris Club, have made useful progress in rescheduling debts on more generous terms. New arrangements have already been agreed for four African countries - Mozambique, Mauritania, Uganda and Zaire. Mozambique, for example, where new adjustment measures are just beginning to have their effect, was given twenty years to repay its rescheduled debts, instead of the conventional ten years. More such arrangements are in prospect.

However, there has not yet been sufficient support from other creditor countries for my proposal for an interest rate reduction on these debts. This is certainly a new departure in the handling of the debt crisis. But it is absolutely essential if we are to make any real progress in the case of Sub-Saharan Africa.

The plain fact is that, without some reduction of interest rates, the debt burden on the Sub-Saharan countries will continue to get worse, rather than better, as indeed has been happening since 1980. Many of these countries have no realistic prospect of meeting even

their full interest payments at present, let alone repaying capital. The interest is therefore capitalised and added to the total burden of the debt. As long as this process goes on, the debt burden will rise exponentially. The only way out of this vicious spiral is if the interest charges are reduced, so that the debtor countries can meet their current obligations and start to make inroads into the capital they have to repay.

Some creditor countries profess to be reluctant to incur the budgetary cost involved in the proposal. Clearly, this is not to be undertaken lightly. But since there is no realistic prospect of actually securing anything like full repayment if rates are not reduced, we have to regard the cost as one that has been incurred already. The question is how we face up to it. My proposal is that we should do so in an orderly way over a reasonable period of years.

Another concern that has been voiced is that debtor countries which accept such concessionary terms might be cutting themselves off from future commercial lending. Eventually, of course, the Sub-Saharan countries should indeed look to the market for the funds they need. But at present, and for some time to come, the brutal truth is that most of these countries are unbankable. For the foreseeable future, they will depend largely on concessional aid flows of various kinds. Lightening the burden of servicing the existing stock of debt will help, rather than hinder, a return to normal financing. It should also encourage more direct investment by the private sector.

I understand the concern that allowing interest rate relief would give the wrong signal to the countries in question. However, it has always been an integral part of my proposal that this facility should only be made available to countries which are implementing satisfactory economic reform policies. The Sub-Saharan countries should have no doubt of our determination on that score.

This is a specific measure designed to deal with the specific case of Sub-Saharan Africa. It is not a model for the debtor countries more generally. Nor, indeed, could it be. As I have said, the middle income countries owe their debts, predominantly to the

commercial banks, and it would be quite wrong for governments to dictate terms to the banks.

I have to say that I have little patience with the objections that have been raised to my proposal for concessional interest rates in these circumstances. The basic analysis has not been questioned, and it leads inexorably to the conclusion I have outlined. The job now is to take action, before the problem gets worse.

I therefore urge those countries which have so far been dragging their feet to join in this initiative, so that we can agree a timetable for action at the international meetings this autumn. We have a moral responsibility, as well as an economic one, to some of the poorest countries in the world.

I am glad to say that the IMF and the World Bank have now joined in recognising the need to tackle the problems in this area. The Managing Director of the Fund has proposed that more concessionary funds should be provided for low income countries, and this initiative was welcomed at the Venice Summit. Discussions are under way to decide how best to achieve the objective of providing more help from the Fund and Bank for the poorest countries. The UK is playing a full part in these discussions, and I hope to see us make parallel progress in this area, too.

The Wider Context

In the longer run, the aim for the Sub-Saharan countries must be the same as for the middle income debtors: that they should be able to play a full part in the world economy. They need to capitalise on those products in which they do have a comparative advantage - typically, agriculture and minerals.

This depends on two things. First, the African countries need to restructure their own economies, to shift the emphasis back towards agriculture, rather than bolstering an inefficient manufacturing industry - often supported by a highly protective trade regime - and a bloated public sector. Some of the poorer countries do not help themselves by overtaxing farmers, or not paying producers the world market price for their products, out of a misguided wish to

cushion the effects of world prices on the urban poor. But, second, the already overwhelming arguments for reform of agriculture in the developed countries are strengthened by the effects present policies are having on the developing countries.

The case for agricultural reform is by now well understood. The present system entails spending large sums of money on storing and disposing of surplus food. This imposes a direct burden on the rest of the economy. But the burden does not stop there. Consumers have to pay much more in the shops than if they were able to buy freely. And many of the poorer farmers are scarcely benefiting at all from a system which was originally designed to maintain farm incomes.

I have made these points repeatedly in international meetings. They underly our wholehearted opposition to increasing the EC Budget until the excesses of the Common Agricultural Policy are brought under control. The analysis of the problem is increasingly widely accepted. The question is how to tackle it. Earlier this month, the United States, which also subsidises its agriculture to a massive extent, as indeed does Japan, launched a radical proposal for the elimination of all subsidies over a ten year period, and this will be considered at the next GATT meeting. This is certainly an area where we must not be afraid of radical solutions. And we need to keep firmly in mind the damage which the present system is doing not only to our own economies but also to the very poorest countries in the world.

Of course, the need to make markets more, rather than less, free - and to give the poorer countries continued access to developed countries' markets - does not apply only to agriculture. It applies to trade of all kinds. That is why the Geneva talks in GATT need to be brought to a successful conclusion in other areas, such as services, too. But agriculture is of central and increasing importance in this context. We cannot preach free trade to the developing countries and practise something very different ourselves.

Conclusion

There are no panaceas for the debt problem. As in so many areas of economic policy, we have to put the right policies in place and pursue them with determination. And as in other areas, it is important for governments to concentrate on problems which are properly theirs.

In particular, this means that governments have to shoulder their share of responsibility for finding a solution to the problems of Sub-Saharan African debt, and act accordingly. We in this country have given a lead. I hope that others will follow.

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Prime Minister
CDP
22/6.

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

19 June 1987

Charles Powell Esq
No.10 Downing Street

Dear Charles

INTERNATIONAL FINANCIAL SCENE

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

2. Since the last such report, after the Washington Interim and Development Committee meetings, the Venice Summit has taken stock of the debt situation and generally endorsed the present strategy for handling it. The Summit communique recognised the particular problems of the poorest, most heavily indebted countries in Sub-Saharan Africa to which the Chancellor's initiative at the Washington meetings was directed. Although the communique fell short of endorsing our proposals on concessional interest rates, it is being interpreted as a clear signal to press on with the necessary work to provide the countries concerned with debt relief. The next step will be an informal meeting, jointly organised by the Bank and Fund in early July for G10 members, to discuss the various initiatives in this area, including the treatment of debt owed to the international financial institutions and M. Camdessus' proposal for a significant increase in the resources of the Structural Adjustment Facility. It will be followed by a further Paris Club meeting in late July. Although the communique only talks of a conclusion within the year, we shall be pressing for decisions by the time of the Autumn Bank/Fund meeting.

3. In the meantime, the discussions in Venice should be helpful in dealing with the debt issue at UNCTAD. They will also provide a basis on which we and others can reply to the now traditional pre-Summit letter from the Cartagena Group of countries.

4. On the general scene, there has been little change in the economic outlook, whether for debtors or for creditors, although the rise in dollar interest rates is clearly increasing debtor anxiety. The most important new development is the move by Citicorp followed by a number of other US banks to increase its loan loss reserves by $3 billion, equivalent to

providing against 25 per cent of its sovereign debt exposure. The scale of increased provisions by US banks has swiftly been overtaken by the decision announced earlier this week by Natwest to increase its provisions from 13 per cent to close on 30 per cent. These are long looked for moves in the direction of greater realism by the commercial banks, away from the orchestrated world of crisis management, and should be a healthy development for the longer term. The expectation of such decisions has been a central element in the debt strategy of buying time: the banks' moves have been welcomed in the market and reflected in strengthened share prices. It is possible that in the shorter term, say the next twelve to eighteen months, debt negotiations could be more difficult in some cases. Commercial banks may negotiate more toughly, be less prepared to make concessions or to provide new credit, and more prepared to risk defaults. Debtors could react by agreeing to quicker settlements, seeing little gain from holding out and risking breakdown: alternatively, some at least may see the balance tipped towards default. An increased risk of non-payment would also affect government creditors and export credit agencies.

5. Turning to individual countries, of the three major Latin American debtors, only Mexico is making satisfactory progress. Brazil remains the major problem; with political uncertainties compounding a poor economic outlook - very rapid inflation, lax fiscal policy and a trade balance only benefiting from recession. The new economic team have introduced an interim package of anti-inflation measures, including a further devaluation, a short-term wage and price freeze and cuts in public spending. A comprehensive macro-economic plan is still said to be in preparation. In the meantime, Brazil has asked the Paris Club for postponement of deadlines in the January rescheduling agreement. There will be difficult decisions about how far to go along with Brazilian requests for more time without a clearer idea of Brazilian intentions.

6. The situation in Argentina also gives cause for concern. Economic performance is moving away from the IMF programme on a number of fronts and the programme could be off track by the time the critical mass of commercial bank financing is secured.

7. Elsewhere further action is still needed in Nigeria before the first review of its IMF programme can be completed. In Zambia, President Kaunda has broken with the IMF and abandoned the IMF adjustment programme. Among Francophone countries, the Cote d'Ivoire, an earlier successful rescheduler, has suspended debt servicing. On the other side of the coin, following approval of Zaire's SBA, SAF and CFF despite reservations, the Paris Club agreed a rescheduling over 15

years - a partial implementation of one of the elements in our Sub-Saharan African initiative. Similar treatment may be offered to other African countries whose rescheduling requests come before the Paris Club this week.

8. Finally, problems over implementing the second stage of the Yugoslav MYRA seem to have been resolved. Doubts about whether the Yugoslavs are taking sufficient action remain but creditors, on the basis of a cautious assessment from the Fund Managing Director, seem likely to let Stage 2 go ahead and to focus on tightening conditionality for Stage 3.

9. I am copying this letter to Tony Galsworthy, Tim Walker and John Footman.

Yours ever,

Tony Kuczys

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INTERNATIONAL FINANCIAL SCENE

1 On 19 May Citicorp (with $11.6 bn exposure to Latin America the international bank most exposed to the region) announced that it intended to increase its loan loss reserves by $3 bn, leaving it with a net loss of $2.5 bn for 1987 Q2. Citicorp reported that the addition to its reserves meant that it had now provided against 25% of its sovereign debt exposure. To some extent this merely represented a continuation of the trend of the past couple of years towards banks making themselves less vulnerable to losses on their sovereign debt: in 1986 Citicorp itself had boosted its primary capital by 24% to $13 bn, and had increased its loan loss reserves by 37%. It may also have represented an attempt by Citicorp to improve its tax position in future quarters. Nevertheless, the magnitude of the increase in reserves was unprecedented, and created expectations that other heavily exposed banks would take similar action. On 27 May Chase Manhattan, the fourth most exposed bank to Latin America, and the second most exposed of the major US banks in relation to its equity capital, announced that it intended to increase its reserves by $1.6 bn in the second quarter, leaving it with a loss for the quarter of $1.4 bn. (Chase followed Citicorp in announcing that it would maintain its dividend for the quarter.) Some other banks, amongst them most notably Bank of America, the second most exposed bank and generally considered one of the weakest of the major banks, have also followed Citicorp in announcing large increases in their loan loss reserves. On 20 May the Bank of England issued a notice to the Press, reflecting discussions the Bank had held with the major British banks over the previous few months, declaring that the Bank expected to see British banks make sizeable increases in their provisioning against sovereign debt.

2 Market sentiment has been broadly in favour of Citicorp's move, and the bank's share price rose after the announcement, suggesting that the market had already largely discounted the fall in the underlying value of the sovereign debt, and was now regarding Citicorp's announcement in effect as a better recognition of reality. Citicorp's move was prompted in part by the moratorium on interest payments imposed by Brazil (claims on Brazil are a higher proportion of claims on problem debtors for Citicorp than for any other major international bank), but reflects also the increasing availability of secondary markets and of equity conversion schemes whereby a bank can dispose of, or transform, its existing

portfolio: Citicorp has indicated that it intends to remove $5 bn of LDC loans from its books using these activities. Whilst the strengthening of banks' positions is undoubtedly a step towards the resolution of the debt problem, it is also likely to lead to a hardening of banks' negotiating stances in future financing packages, making the completion of these packages rather more difficult. Citicorp itself was in recent months prepared to stand out for several weeks against the Advisory Group consensus over the Philippines and Chile, and further moves in this direction would provide a serious undermining of creditor cohesion. On the other hand, Citicorp (and latterly also Chase) have indicated that they intend to play their full role in continuing to handle problem sovereign debt; and, since the announcement of its increases in reserves, Citicorp has led the Advisory Committee (which includes Chase and Bank of America) in signing up for the financing package for Argentina. Nevertheless, the announcement of increased reserves may exacerbate debtors' reluctance to continue with the rescheduling process, thus perhaps increasing the risk of some form of default.

3 In addition to Argentina, progress has been made between debtors and the Advisory Groups over a number of other bank financing packages. The Advisory Groups have now agreed the documentation for the Venezuelan package, and have agreed to move on to the second stage of the Yugoslav MYRA. On the other hand, progress has been slow in getting full bank participation for packages agreed with Advisory Groups, for example for Chile, Morocco and Nigeria, and it remains to be seen how effective the incentive of the higher fee for early signature for the Argentina package will be. Nevertheless, at least as far as the major banks are concerned, most of the major financing packages have essentially been completed, in advance of expected negotiations with Brazil. These may begin by the end of June, and banks are likely to be asked for new money perhaps substantially in excess of the $4 bn that was earlier expected for this year.

4 Economic developments in debtor countries remain mixed. Adjustment measures in Indonesia and Malaysia seem to be proving sufficient to maintain the countries' creditworthiness in the markets despite the adverse economic shocks of last year. External economic performance continues to be strong in Mexico. Colombia and Venezuela are making tentative returns to market borrowing (although Colombia never rescheduled and Venezuela never had new money, so they may not necessarily provide pointers for the return of other debtors to the market). On the other hand, inflation seems to be rising dangerously, virtually throughout Latin America. The position in Brazil remains particularly worrying and uncertain: inflation in April

as over 20% and for May could have risen to 30% (an annual rate of over 2000%). Investment has reportedly come virtually to a halt. The Brazilian trade surplus, although in April at $500 mn well above the very low levels of the turn of the year, remains well below the level needed to meet the officially projected $8 bn surplus for the year as a whole. Meanwhile, Zambia has decided to break its links with the IMF after ten years of co-operation, and has abandoned economic reforms introduced over the last 18 months, revalued its currency and set a limit on its debt-servicing.

5 Spot commodity prices have been rising in recent weeks and the Economist index is now almost 3% higher in SDR terms (and in dollars) than five weeks ago. In SDR terms the index has returned to its mid-1986 levels, whilst in dollar terms it is back to its level of mid-1984. All of the Economist sub-indices strengthened during the past weeks. Food prices rose over 4%, largely because of lower estimates for this year's crops: vegetable oil seed prices were particularly buoyant (some rising almost 10%) although grain and coffee prices also strengthened. Among industrial raw materials, agricultural non-food prices picked up more strongly than metals (2.2% and 0.5% respectively in SDRs). Lead and zinc prices have led the metal recovery, with industrial action threatening supplies in the shorter term. With many users now maintaining lower stock levels, fears of even temporary supply shortfalls have produced sharp rallies in prices. The rise in agricultural raw material prices has been led by textiles where the recovery in demand from last year's very low levels has coincided with lower production estimates. Cotton prices rose over 15%. But it is much too early to say whether these rises represent a lasting reversal of the trend of the past few years. Most of the rises seem to stem from temporary factors - industrial action, crop shortfalls - and there is little evidence that there will be much of a shortage of supply at current real prices in the medium term. Nevertheless, the recent price rises will have brought at least a temporary respite to many commodity exporters.

6 Prospects for growth in the industrial world remain relatively gloomy, with growth expected to be no more than 2 1/4% this year and 2 1/2% in 1988. There are concerns about an economic slowdown in each of the G3 economies; apparently largely in response to external pressures, the Japanese have announced a programme of increased public expenditure which they claim will add almost 2% to the country's growth for the year, but some observers have questioned the size of the impact. Meanwhile, the dollar has been relatively stable: it rose by over 1% in effective terms during May, but remains 6% below its level at the beginning of the year, and roughly back at its level of 1980. However, efforts to restrain the fall in the dollar have contributed to a rise in dollar interest rates. US Prime now stands at

1/4%, compared with 7 1/2% last autumn, and the six-month eurodollar rate is now around 7 1/2% compared with about 6% around the beginning of the year. During the last period of sustained rises in interest rates, in 1985, debtor reaction was very strong, with heightened talk of interest capitalisation and limitations on debt servicing. The Argentine authorities have been quick to point out that the benefits of the lower spreads in their recent bank agreement have already been largely eroded because of the general rise in interest rates. The Presidents of Argentina, Brazil, and Uruguay met on May 27 to discuss possible responses to the rises in interest rates. Officials from the Cartegena Group of countries met at the end of May, and announced plans to hold a meeting of Finance Ministers, the first such meeting for over a year.

7 After the April 24 meeting of the Paris Club on the Chancellor's Sub-Saharan Africa initiative, lobbying has been taking place to enlist the support of those countries (especially the United States) which are not yet ready to accept all the proposals, in particular the call for concessional interest rates. The initiative is likely to be taken forward through a meeting to be called by the World Bank in the fringes of the July Paris Club meetings. In the meantime, one of the less controversial parts of the initiative - the lengthening of repayments periods on rescheduled debt - has been partially implemented by the Paris Club, which agreed to reschedule Zaire's debt over 15 years.

8 Developing country borrowers have since the middle of April raised just over $2 bn, three quarters of which was in the form of syndicated loans. China took the largest share of this with various government borrowings: the largest of these was a $200 mn floating rate note at 1/16 over 6 month LIBOR, substantially cheaper than recently arranged syndicated credits. India's National Aluminium Co arranged its third syndicated loan of this year, for $250 mn, but with a spread of about 1/4 over LIBOR, against LIBOR flat for the previous issues. There were several South Korean borrowings including $125 mn for Hyundai and $100 mn for Electric Power Co.

Further details on individual countries are given below.

Latin America and Caribbean

9 In Brazil there have been indications that the authorities may be moving closer to some kind of arrangement with the IMF, although the political obstacles to a formal agreement remain serious. The new Finance Minister, Bresser, held talks in

May with both the Article IV mission and a World Bank team, and has reportedly put a series of adjustment measures to the Cabinet. While no formal announcements have been made by either the Fund or the authorities, Bresser's statements on economic policy, the recent cruzado devaluation and the limit on price increases suggest that Brazil is moving towards a policy package which the IMF could endorse. Both the IMF and IBRD teams are planning to return to Brazil for further discussions. Any arrangement could be expected to facilitate discussions with commercial bank creditors, negotiations with whom might begin in late June if the economic plans outlined by the Finance Minister are introduced in time. It is, however, becoming clear that Brazil's financing requirements in 1987 will be substantially larger than the $4 bn originally mentioned, since the $8 bn trade surplus on which this figure was based does not seem likely to be achieved. The Brazilians claim that if their proposals on debt are accepted they would be ready to start paying interest on half their foreign bank debt (the rest to be refinanced) but would seek to refinance all the interest due on official debt.

10 Although the behaviour of the monetary aggregates and retail sales in Q1 reinforce reports that demand has been cooling, both retail prices and interest rates rose sharply in April, partly as a result of speculation in anticipation of a new price freeze. The CPI is reported to have risen 21% in April, bringing the rise since end-1986 to about 80%, while overnight interest rates have fluctuated wildly, rising to 45% a month in mid-May before falling back to 28% a month. The authorities announced on 15 May that retail price rises would be limited to 80% of the previous month's inflation, but there is still no indication that they are prepared to take action to control real wage increases or to eliminate the wage indexation trigger. After the 7.5% devaluation announced on 30 April the authorities are expected to continue with the current policy of crawling-peg depreciation, although Bresser himself appears willing to countenance implementing a larger devaluation if he is allowed to do so. The trade surplus for April was $520 mn, the highest level since September 1986, bringing the 1987 surplus so far to $1150 (cf $3750 mn in January-April 1986). Non-oil imports were the lowest this year, although still higher than the 1986 monthly average. Exports were the highest since September 1986, but still 23% below the April 1986 level. Prospects for external performance for the remainder of 1987 are at present therefore unclear, and the announcement in May that the 1986 trade surplus was only $8.4 bn, rather than the $9.5 bn earlier reported, indicates that any 1987 figures should be treated with caution. Creditor countries will shortly face difficult decisions over Brazil as the country is unlikely to meet its formal requirement to the Paris Club to be current on payments by 1 July. Meanwhile, President Sarney's authority has been badly affected by the economic crisis, the administration's inability to tackle it,

and the President's lack of a popular mandate. While pressure is mounting for early direct elections, possibly in 1988, Sarney has announced that his term will be five years - that is until early 1990 rather than the six years until 1991 stipulated under the present constitution - with elections in late 1989.

11 Signature of Mexico's bank financing package was completed in mid-April with commitments at $7.787 bn, compared with the $7.7 bn required and $8.5 bn requested. The first $3.5 bn tranche was drawn on 30 April and the $0.5 bn bridging loan was repaid simultaneously. The $0.5 bn growth contingency mechanism has been triggered as real GDP, which declined by 3.8% in 1986, seems to have been at best flat in 1987 Q1, but it is not certain that Mexico will make any drawings. Mexico met all the quantitative performance criteria for 1987 Q1 under its SBA, and targets for 1987 have been agreed. The external economy's performance, in particular, continues to be good. In 1987 Q1 a trade surplus of $2.2 bn was recorded: exports were $4.9 bn, reflecting continued growth of over 25% pa of non-oil exports, while imports were only $2.7 bn ($3.0 bn in Q1 1986), reflecting the continued recession in the domestic economy. The April trade surplus was $1.3 bn. Tourism earnings in Q1 were over $750 mn, up 36% on Q1 1986. Reserves rose to over $13 bn in early June, the highest level in the country's history. The major threat to the success of the programme continues to be inflation. Consumer prices rose by 44% during January-May, bringing the year-on-year rate to 125%; the programme target of 80% year-on-year at end-1987 seems increasingly unlikely to be met.

12 The terms sheet for Argentina's 1987-1989 financing package was sent out to creditor banks on 30 April and the roadshows took place during May. A critical mass of commitments to the package is being sought by 17 June, in accordance with the terms of the IMF SBA, with banks being offered higher fees if they commit before this date. The package also includes a scheme of exit bonds, allowing banks to exclude the first $5 mn of their Argentine debt from the base for new money, by accepting a bond paying 4% pa. The base has been reduced overall to $21.7 bn from the $25 bn level used in 1985; the new money package represents a 5% increase on the new base. The authorities also have obtained a rescheduling of Paris Club debts: the Paris Club agreed on 19-20 May to reschedule 100% of principal and interest due 1 May 1987 - 30 June 1988 and 100% of principal and interest on arrears as at 30 April 1987 over 10 years (5 grace). "Late interest" accrued as at

30 April 1987 is to be repaid in four equal half-yearly instalments between 31 July 1989 and 31 January 1991. The Argentine request for a rescheduling of previously rescheduled debt was refused. The deal is worth about $1.9 bn, and will be triggered by the entering into force of the SBA; a side letter to the agreement draws attention to new commercial guaranteed credits of $400 mn in 1987 which are included in the balance of payments projections in the SBA. The IMF programme on which the package is based would commit the authorities to a tighter fiscal policy in 1987, holding the PSBR to 2.5% of GDP (3.6% in 1986) and reducing year-on-year inflation to 42%. However, this programme seems seriously threatened by the continuing high rate of inflation (4.2% in May, bringing the year-on-year rate to 103%) and there are serious concerns about prospects for the economy. In order to combat inflation the authorities have allowed the exchange rate to become overvalued, which will in turn further damage the already weak trade balance. The trade surplus for January-April was only $325 mn, 70% below the 1986 level, largely because of weak exports. The authorities' projection for 1987 has been reduced from $2.5 bn to $1.7-$2.0 bn, and even this may prove optimistic.

13 The documentation for Venezuela's rescheduling agreement with the banks was finalised in late May. Following the Argentine agreement in April, which included a spread of 13/16% compared with the Venezuelans' 7/8%, the authorities indicated that they would not seek to reopen their own negotiations, provided that the Philippines were not also offered a lower spread and that Venezuela attained access to voluntary finance. Finance Minister Azpurua is reported to be talking to US banks about the possibility of new money: a medium term loan, reportedly for $100 mn, is being discussed with Morgan Guaranty. Reserves remain high, around $9.5 bn. However, inflation is rising: the CPI rose 6.2% in Q1 (2.8% in Q1 1986), bringing the year-on-year rate to 18.9% (15% at end 1986). The introduction at the beginning of May of "compensation bonuses" for private and public sector employees, can be expected to provide a further boost to inflationary pressures. The increasing lack of confidence has shown up in further speculation against the free-market bolivar, which has dropped by more than 15% against the dollar since the end of March despite the establishment in mid-April of an additional 200% excess reserve requirement for Venezuelan commercial banks.

14 Despite Chile's agreement with the Paris Club in early April, progress with its financing package with the commercial banks has been slow since the agreement in principle reached in February: by the beginning of May only 82% of banks (by exposure) had committed to the package, although signing is expected to begin in mid-June. Consumer prices rose by 7.9% in the first four months of the year

having a year-on-year increase at end-April of 18.8% (cf 17.4% at end-1986 and the IMF target of 13% for 1987). On the external side, the trade surplus for the first quarter of 1987 was $217 mn (cf $299 mn for the same period in 1986).

15 Colombia successfully syndicated an IDB complementary financing loan in London and New York at the end of April. Like the euromarket issue in March, the IDB loan carries a relatively high spread (1 1/8% over LIBOR for the first four years and 1 1/4% thereafter) although the risk to the banks to whom participations are sold is minimal because of the IDB guarantee. A further yen or eurodollar issue for the equivalent of $60-70 mn is reported to be planned for later in the year. On the domestic front the rate of inflation appears to have stabilised: prices rose 19.8% in the year to end-April, compared with 20.6% at end-1986. Nonetheless, the effect of weak coffee prices on fiscal revenue and on the trade balance may still jeopardise recovery, and, in the longer term, Colombia may need to seek more concerted external borrowing from 1988 onwards as the maturities fall due on the large commercial bank loans taken up in 1981-82. Uruguay is expected to seek enhanced surveillance after completion of the Article IV consultation on 29 June, and the World Bank Board will discuss a request for a SAL for $80 mn on 16 June. Exports, which prospered last year because of strong demand in Argentina and Brazil and because of the Uruguayans' competitive exchange rate, are beginning to fall.

16 Ecuador's economic decline has been exacerbated by domestic financial speculation following the earthquake in March. A contraction of GDP in 1987 of between 4-7% (cf an increase of 1.7% in 1986) is expected. Prices rose 4.7% in March, despite an attempted price freeze, bringing the year-on-year inflation rate to 29% (cf 26% in the year to end-February). Limited oil production has resumed following the opening of the Colombian pipeline link on 8 May, and it is hoped that production and transport through the main oil pipeline may restart in late July or August. The World Bank has provided $80 mn for the emergency petroleum reconstruction project. However, little progress has been made towards meeting the 1987 external financing requirement, now estimated to be $950 mn. Negotiations with commercial banks have been brief and superficial, and discussions with the IMF on a follow-on programme and emergency assistance are not yet completed.

17 Contacts may be resuming between Peru and the IMF. The Peruvian authorities have held a number of meetings with Fund Staff in Washington since February, and have indicated their willingness to have an Article IV mission in mid-year; the Fund Board hopes to conclude the consultation by 14 September. The Peruvians' change in attitude may have been triggered by the continuing fall in liquid reserves

to $850 mn at end-March), which has in turn caused an apparent tightening of the debt service policy to include restrictions on payments due to official creditors: as a result of the accumulation of $57 mn in arrears the World Bank suspended disbursements from 5 May. Debt to commercial banks has been unilaterally rolled over for another three months from 4 May. UK banks detected some softening in the authorities' stance with the announcement of the formation of a National Council for External Debt, but negotiations are unlikely to begin for some time. Meanwhile supply shortages have begun to slow the growth of output and to boost inflationary pressures, while the fall in reserves indicates that the external trade account has continued to deteriorate. From 21 April the authorities suspended foreign sales of silver by the state mineral company to try to boost the price on world markets.

18 Full commercial bank support for Bolivia's debt buy-back scheme was expected to be obtained by 22 May; two banks have yet to support the scheme, but are expected to do so shortly. The IMF has been asked but has yet to agree the nature of its involvement in the scheme. As a minimum the banks want the Fund to monitor the scheme to ensure that Bolivia uses only voluntary contributions from other governments to buy back debt, rather than deploying its own reserves; ideally, they would like the Fund to operate it. Costa Rica opened negotiations with the banks on 4 June. The country is seeking to reschedule all debt over 20 years (7 years' grace) and $100 mn new money or interest capitalisation for 1987. Discussion of the SBA is postponed until agreement is reached with the banks. Jamaica's 1987 commercial bank rescheduling agreement was signed on 5-6 May. Both the external account and the fiscal side performed better than expected in FY 1986/87, and economic recovery is expected to continue in FY 1987/88, when the authorities expect output to increase by 4.6%. There are indications that Cuba is seeking to normalise trading relations with western creditors. A rescheduling mission arrived in the UK on 25 May. The Paris Club Task Force originally due to visit Havana at the end of May has been postponed until late June.

19 Agreement on the IDB's Seventh Replenishment of Resources now looks unlikely before the autumn, although a Governors' meeting is planned for late June. The IDB's lending in 1987 will thus be financed entirely from resources left over from IDB-6. The US authorities have indicated that, if the regional borrowing members do not agree to the organisational changes the US is seeking, the appropriations which would have provided for a substantial increase in lending may be diverted to the IBRD while the IDB receives only a minimal replenishment with no new paid-in capital. Officials from the Cartagena group of eleven regional debtor nations met on 28-29 May at Guanajuato, Mexico. They are reported to be arranging a meeting of

their finance ministers, the first such meeting since February 1986. The Presidents of Argentina, Brazil and Uruguay met in Montevideo on 27 May and discussions focussed on debt: the possibility of a meeting of the Cartagena group at Presidential level before the end of the year is under consideration. The Organisation of American States has, at the instigation of Alva Castro, the Peruvian Finance Minister, invited major creditor banks to Latin America to meet in Washington on 29-30 June to discuss links between exports and the region's debt servicing.

South and East Asia

20 In the Philippines, increases in exports are helping to foster the economic recovery first detected in 1986 Q3, and an overall increase of 10% in export earnings appears likely for 1987. However, with imports forecast also to rise, there is likely to be an increased trade deficit. The official target of real GDP growth of between 6% and 7% appears optimistic, although a 4% increase is possible. The Government has signed an agreement with Japan's Exim Bank which will provide $300 mn in untied loans for development projects. Finance Minister Ongpin, who had earlier said that he intended to reopen his rescheduling package with the banks in the light of the better terms obtained by Argentina, appears now to be more reluctant to do so.

21 In Indonesia there was a sharp fall in the trade surplus, from $5.8 bn in 1985 to $1.8 bn last year. However, the authorities are confident that firmer oil and commodity prices, together with the present competitive exchange rate and increased receipts from tourism will significantly reduce the current account deficit in 1987. A CFF for SDR 462.9 mn was agreed at the beginning of May; the Indonesian authorities remain wary of a possible SBA on the grounds that it may discourage potential commercial lenders.

22 In Malaysia modest improvements in the prices and export volumes of palm oil, tin and rubber have coincided with a firming of the oil price to boost export earnings from the depressed levels of 1986. Overall, the trade surplus is expected to be in the region of $3.6 bn in 1987, an increase of $1 bn on the 1986 total. Official estimates for real GDP growth for 1987 are now 2%. However, domestic demand is still depressed, and doubts persist about the commitment to economic adjustment, following the almost successful challenge to Prime Minister Mahathir from within the ruling party and the dismissal of seven ministers who had supported the challenge. Meanwhile, a $60 mn Malaysia Fund is being launched on the New York

Stock Exchange: the International Finance Corporation will underwrite half the fund, with the remainder underwritten by Merrill Lynch Capital Markets, Morgan Stanley, and Arab-Malaysian Merchant Bank.

Eastern Europe

23 Little further progress has been made on reaching an agreement with Poland. The creditors' proposals for an interim agreement covering all arrears from 1986 and payments falling due in 1987 have been met with a counter-proposal expressing readiness to agree an interim settlement if the cut-off date is extended to end-March 1988; interest due under the 1981 agreement would be honoured only if bilateral reductions in the relevant interest rates were agreed. The Fund staff have completed work on the measures they would look for in the prospective SBA. In Frankfurt on 13-14 May the banks' steering committee confirmed the banks' unwillingness to re-reschedule beyond 1989 and to lower the margin below 1 3/8% (the Poles are seeking 0.6%); they were, though, open to the possibility of repayment terms beyond 10 years.

24 Yugoslavia's external performance so far this year has been better than expected. The trade deficit for 1987 Q1 was only $316 mn (43% down on 1986 Q1 and 45% below target) and the current account deficit only $27 mn (cf $366 mn in 1986 Q1 and a target of $260 mn). Nevertheless, there are serious doubts as to whether the Yugoslavs' targets for the year (including a current account surplus of $810 mn) can be achieved. Yugoslavia had been pressing hard for the automatic implementation of the second stage of its official MYRA (to end-March 1988) as provisionally agreed in Paris on 31 March. Major creditors, however, insisted on a formal discussion in the Paris Club on 20 May, and after great initial reluctance the Yugoslavs did provide letters setting out in more detail certain policy measures to be taken within the next year. Even on the basis of these letters the Club could not agree to implement the second stage: the correspondence was referred to the Fund MD for his personal assessment, at the insistence mainly of the US, who are anxious to strengthen the concept of enhanced monitoring given that it may soon be applied to Brazil. On the basis of the MD's cautious assessment, the US is now likely to let Stage 2 go ahead; the next stage will be to tighten conditionality for Stage 3. The banks had earlier granted the waivers necessary to allow the second stage of their MYRA to proceed on the revised date of 27 May.

25 Hungary met some market resistance to the terms it hoped to secure on the National Bank's latest syndicated euro-credit: it is now seeking $400 mn at a margin of 3/8% (compared to the $500 mn at +1/4% originally hoped for). It is also believed that the authorities are close to deciding to seek a new IMF Standby in the autumn; a final decision is expected to be taken in mid-June.

Southern Europe

26 In Greece first quarter data have confirmed the doubts, expressed by the EC Monetary Committee amongst others, about the likelihood of meeting the government's economic performance targets this year. Public finance, consumer price inflation and current account developments are all giving rise to concern, and the last will be adversely affected by the dismantling at end-April of the import deposit scheme, imposed in October 1985, and the reduction of export subsidies.

Sub-Saharan Africa

27 The Chancellor's proposed initiative to help the poorest and most indebted countries comprises the conversion of old aid loans into grants (Retrospective Terms Adjustment), the acceptance of longer repayment periods and grace periods when rescheduling other official loans, and the granting of concessional interest rates on rescheduled debt. All elements would have to be firmly linked to debtors' implementation of appropriate reform policies. The announcement of the initiative in Washington on 9 April was followed by an informal Paris Club session on 24 April. RTA presented no problems, and most creditors were ready to move immediately to rescheduling over 20 years with up to 10 years' grace for suitable cases. Progress was made over agreeing the list of countries standing to benefit from the initiative. However, it has become clear that intensive lobbying, aimed particularly at the US, will be needed to reach a consensus on softening interest rates; only Sweden was ready to follow the UK's lead on this particular part of the initiative. The initiative was discussed at the Venice summit, and is likely to be taken forward at a meeting to be convened by the World Bank in the fringes of the July meeting of the Paris Club with the aim of having definite proposals in place by the time of the Annual Meetings. The Fund MD wrote to the Chancellor, and to other participants at the Summit, asking for the political commitment to, at a minimum, triple SAF reserves to SDR 9 bn, with financial resources being committed commensurate to countries' resources and international responsibility. The Fund has been in intensive negotiations with the Japanese, who might contribute $3 bn.

28 On 1 May President Kaunda announced that Zambia had decided to break its links with the IMF and abandon its IMF-backed adjustment programme. The authorities are developing their own adjustment package, and a ceiling on external debt payments equivalent to about 5 per cent of export earnings has been imposed to free foreign exchange for investment. Most visible among the measures already announced is the decision to abandon the foreign exchange auction and fix the exchange rate at US$1=8 kwacha compared to the last auction rate of US$1=21 kwacha. The decision will inevitably lead western donors to reassess their policies towards the country. Already the World Bank has ceased disbursements because of mounting arrears. On 22 May the IMF Board agreed that Zambia would be declared ineligible at the end of July without further review unless there were clear signs in the meantime that the authorities were willing to re-open a meaningful dialogue with the Fund. At the end of May, Cote d'Ivoire announced that it was unable to meet its servicing obligations, because of the decline in prices of its commodity exports. Other countries in the region will be watching developments closely.

29 Zaire's SBA, SAF and CFF were approved by the Fund Board on 15 May. The UK, joined by Australia and the Nordics, abstained, and a number of others expressed serious reservations about the strength of the adjustment effort and the weak Fund programme. At the Paris Club creditors agreed on 18 May to reschedule all medium term maturities in arrears at 31 March 1987 or falling due between April 1987 and May 1988. Debt previously rescheduled at Zaire's first six Paris Clubs was further rescheduled, but not that falling under PC VII. The UK was prepared to reschedule over 20 years with 10 years' grace, but with other creditors not prepared to go as far a compromise of 15 years with 6 years' grace was agreed.

30 The latest IMF mission to Nigeria was encouraged by the evidence of the authorities' commitment to policy reform, but further action is still required before the first review can be successfully concluded. The reluctance of the Japanese banks to participate in the new money package remains the major stumbling block to the conclusion of the commercial bank agreement, and signature now seems unlikely before September at the earliest. Despite the issue of an additional $1.5 bn of promissory notes in early April and the expectation of a further modest issue shortly, the majority of uninsured creditors still have a large proportion of their debt unverified and are unlikely to consider rescheduling proposals until the verification process becomes more rapid. Despite optimistic reports from the authorities, Sudan is still some way from an agreement with the IMF on an adjustment programme. The main stumbling blocks remain the exchange rate and arrears to the Fund. A Fund team arrived in Khartoum on 10 May to continue negotiations, but was forced to postpone talks because of the dissolution of the cabinet on 13 May.

Middle East & North Africa

31 The Executive Board of the IMF approved Egypt's request for a SDR 250 mn Standby on 15 May with the Nordics and the Iranians abstaining. Many Executive Directors noted that the programme was weak and the risk of failure high; further adjustment measures were urgently required. The Egyptians have now promised to strengthen the programme (notably in the key areas of interest and exchange rates) before the first review is completed in November. Due to domestic political considerations, these promises have not been made public. In early May energy prices were increased (though remaining well below world levels) and the first stage of exchange reform was introduced. As expected, the Paris Club, meeting on 21-22 May, agreed to provide Egypt large-scale debt relief (over $7 bn) on generous terms. However, the present and prospective balance of payments position remains fragile; a deficit of $3.9 bn on the current account is expected in FY 1986/87 (ending June) and deficits of similar size are expected to persist into the 1990s.

32 Elsewhere, Algeria continues to experience domestic and external economic difficulties despite the more settled outlook in the oil market. Real GDP growth is unlikely to rise above last year's 2% level. Banks remain very cautious about lending to Algeria, and with amortisation payments of around $4 bn falling due and an expected current account deficit of $1 bn to be financed, payment arrears have arisen and more formal rescheduling requests cannot be ruled out. In Morocco, the authorities continue to be assisted in their adjustment efforts by favourable exogenous factors; the IMF programme is still on track (although a modification has been agreed). In addition, contingency measures have been prepared against expected revenue shortfalls to ensure that the key SBA target for the fiscal deficit is met. No firm date has yet been set for signing the rescheduling agreement with the banks but June/July now looks likely. Despite agreeing bilateral reschedulings with a number of countries, Iraq continues to experience payments difficulties. Negotiations with West Germany about guaranteed debt have stalled and new arrears to UK creditors are being reported.

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OVERDUE FINANCIAL OBLIGATIONS TO THE FUND*

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding as at 31. 5.87 (SDR mn)
Kampuchea	13 March 1975	29.9
Guyana	31 May 1983	56.5
Viet Nam	6 February 1984	72.1
Sudan	12 July 1984	425.7
Liberia	25 January 1985	144.7
Peru	9 September 1985	258.4
Zambia	30 April 1986	181.0
Sierra Leone	16 January 1987	5.8
		1,174.1

NB The above figures are derived from the Fund's latest six monthly Report on Overdue Financial Obligations.

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

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

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INDEBTEDNESS AND BRITISH EXPOSURE

	Total external debt $bn	British-owned banks' exposure[1]	$ billion ECGD amounts at risk	
	End-Dec 1986*	End-Dec 1986	End-March 1987 [2]	End-March 1987 [3]
Latin America				
Argentina	51	3.0(0.2)	0.2	0.2
Brazil	111	6.6(1.4)	1.0	1.9
Chile	19	1.3(0.1)	-	0.1
Colombia	15	0.6(0.1)	0.1	0.1
Costa Rica	5	0.1(-)		
Ecuador	8	0.5(0.1)	0.1	0.1
Jamaica	4	- (-)	-	-
Mexico	98	6.3(0.7)	0.7	1.3
Peru	15	0.3(-)	0.1	0.2
Uruguay	4	0.3(-)	-	-
Venezuela	36	2.1(0.1)	-	-
Far East				
Indonesia	42	0.8(0.3)	0.9	1.8
Malaysia	21	1.1(0.3)	0.1	0.1
Philippines	29	1.3(0.2)	0.1	0.2
Eastern Europe (convertible currency)				
Hungary	15	0.3(-)	-	0.1
Poland	34	0.6(-)	1.3	1.4
Romania	6	0.2(-)	0.3	0.4
Yugoslavia	19	0.8(0.1)	0.7	0.9
Southern Europe				
Greece	18	1.2(0.2)	0.1	0.3
Turkey	31	0.5(0.3)	0.2	0.6
Sub-Saharan Africa				
Cote d'Ivoire	9	0.3(-)	0.1	0.1
Nigeria	20	1.3(0.2)	2.5	3.5
South Africa	22	3.6(0.6)	0.9	2.5
Sudan	11	- (-)	0.2	0.2
Middle East and North Africa				
Algeria	27	0.4(0.1)	0.2	0.4
Egypt	45	0.2(0.2)	0.3	1.3
Iraq	55[4]	0.1(-)	0.6	1.6
Israel	31	0.4(0.1)	0.1	0.2
Morocco	17	0.2(-)	0.2	0.3
Oman	3	0.1(0.1)	0.7	1.9
Saudi Arabia	14	0.6(0.2)	0.2	0.3

[1] Defined as consolidated external claims including portfolio investments with a contractual repayment date, adjusted for certain inward and outward risk transfers in respect of guaranteed loans, plus any net claims on local residents in local currency. Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans. Other portfolio investments in these 31 countries amounted to $9 million at end-December 1986.

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

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

[4] Includes $30 bn from Arab countries.

* Current estimate.

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INDEBTEDNESS AND BRITISH EXPOSURE

	Total external debt $bn	British-owned banks' exposure[1]	$ billion ECGD amounts at risk	
	End-Dec 1986*	End-Dec 1986	End-March 1987 [2]	End-March 1987 [3]
Far East				
China	27	0.4(0.9)	0.2	3.0
India	38	1.0(0.4)	0.5	1.8
South Korea	46	2.4(1.0)	0.4	0.7
Thailand	17	0.2(0.1)	0.1	0.1
Eastern Europe				
Bulgaria	5	0.3(0.1)	0.0	0.1
GDR	17	0.5(0.1)	0.1	0.2
USSR	35	0.7(0.1)	0.6	0.8
Southern and Western Europe				
Denmark	36	2.1(0.5)	0.1	0.1
Finland	34	1.6(0.4)	0.1	0.1
Iceland	2	0.1(-)	-	-
Ireland	17	2.5(0.4)	0.2	0.3
Italy	62	7.5(1.5)	0.2	0.3
Norway	38	1.3(0.8)	0.5	1.2
Portugal	17	0.9(0.2)	0.2	0.2
Australasia				
Australia	72	6.2(1.9)	0.5	1.0
New Zealand	15	1.2(0.6)	0.2	0.3

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[1] Defined as consolidated external claims including portfolio investments with a contractual repayment date, adjusted for certain inward and outward risk transfers in respect of guaranteed loans, plus any net claims on local residents in local currency. Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans. Other portfolio investments in these 16 countries amounted to $113 million at end-December 1986.

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

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

* Current estimate.

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

26 May, 1987.

INTERNATIONAL DEBT

The Chief Whip had a word with me about David Norgrove's letter to you of 15 May. The Chief had an alternative form of words as a line to take, and I have had a further word with David on them. David and I agree that the safest formula to use is something on the following lines:

"The total debt of United States farms is as great as the debts of developing countries to American banks."

(M.E. Addison)

Murdo Maclean, Esq.
Chief Whip's Office.

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

15 May 1987

INTERNATIONAL DEBT

The Chief Whip mentioned the other day a report he had heard which suggested that farm debt in the United States now exceeded the debt of developing countries.

FCO estimates suggest that total farm debts in the U.S. amount to around $300 bn., whereas total developing country debt is put at around $1,000 bn. If defined more narrowly, total farm debts to U.S. commercial banks are put at around $50 bn. against total U.S. bank exposure to developing countries of around $250 bn. The statement runs only if farm debt to U.S. commercial banks is compared with total developing country debt.

The U.S Banks have as much indebtedness to their domestic farmers as they have to the whole of the developing world!

C. Mall (Duty Clerk)

pp David Norgrove

DN

Murdo Maclean, Esq.,
Chief Whip's Office.

Problems in agriculture debt arise only in the UK.
US farmers are ~~a~~ in debt to the tune of the total amount of third world assets held by American commercial banks.

The total debt of US farmers is an great a the debts of developing nations to American banks.

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Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

6 May 1987

Charles Powell Esq
10 Downing Street
LONDON
SW1

Dear Charles

INTERNATIONAL FINANCIAL SCENE

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

Since our last report at the end of March the Interim and Development Committee meetings have taken place in Washington. These meetings were dominated to a great extent by the problems of world growth, imbalances and exchange rates. The world economic prospect was generally judged to be less buoyant than assumed at the time of the annual meetings, with a greater chance of adverse developments than of improvements - eg upward pressure on US interest rates and slower than expected growth in Germany and Japan.

On debt, the meetings confirmed the growing perception of weaknesses in the present strategy.

As regards middle income debtors many speakers took refuge in ritual incantation of the need to strengthen the Baker strategy. However, the persistent nature of the debt problem is, if anything, leading to an expectation that in the next stage official creditors will be expected to take a more effective lead. This will need to be handled with considerable care.

Discussion of the low-income debtors was marked by the successful launch of the Chancellor's initiative on the debt of the poorest and most indebted countries in Sub-Saharan Africa. Since the Washington meeting, the Paris Club aspects have been taken further in a special meeting on 24 April. That meeting suggested a broad consistency of view about which countries were likely to qualify for any new facility and no serious problems about taking forward the idea of longer term reschedulings for qualifying countries. On the more difficult question of interest relief, the key will be to

get the US, who are worried about Congress, on board. If we can persuade them we would expect the French, Germans and Japanese all to participate. We shall need to keep up the pressure for action at forthcoming international meetings eg the OECD Ministerial meeting and the Venice Summit.

Turning to individual countries, the main focus of attention continues to be Brazil, where the replacement of Funaro as Finance Minister by Bresser Pereira (and Gros by Milliet as Central Bank President) looks a hopeful development against a very poor economic position. Bresser Pereira visited London last month, and made a good impression: not an ideologue like his predecessor and prepared to negotiate. Since taking office the new Finance Minister has announced a devaluation of the Cruzado of 8.49 per cent and outlined his intentions, including a lower short term growth rate (3 per cent to 3½ per cent rather than 7 per cent), early restoration of large trade surpluses, greater control over public expenditure and short term stabilisation of inflation (albeit at present high levels). Debt service is to remain suspended until the Government is able to introduce a non-recessive internal adjustment plan and Brazil is generating sufficient external surpluses to resume servicing the debt. The commercial banks see this appointment as encouraging and Bresser Pereira himself as someone they can negotiate with.

Recent news has been better on Mexico, Argentina and the Philippines. The commercial bank package for Mexico became effective - at last - on 30 April enabling the $500 million bridging loan to be repaid and $3.5 billion of new money to be disbursed. The Advisory Committees have reached agreement with Argentina and the Philippines, although there could well be delays before these packages secure sufficient participation to become effective. The Argentine package, however, includes incentives designed to streamline the negotiating process and avoid the delays which have dogged other recent packages.

Other small items worth noting have been the $50 million FRN signed by Colombia (the first Eurobond issued by a Latin American borrower since 1982) and Bolivia's debt buyback scheme, which remains under consideration by the banks. The news on Nigeria is also a little better. Following action by the government, the Fund programme seems to be back on track and the second tranche of the World Bank loan has been disbursed.

Despite these positive individual developments, the prospect remains in many respects as difficult as ever. For debtors whose packages are at any early stage of negotiation, the key issue, as the Chancellor made clear in his speech to the Interim Committee, will be to resist the weakening of IMF conditionality. On Egypt, and also Zaire, the programmes coming before the Fund Board do not contain nearly enough adjustment. In neither case is there any

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prospect of medium term balance of payments viability. On Egypt, the present position is that while none of the G7 creditors has been prepared to give commitments about filling the financing gap, the Managing Director now seems prepared to put the SBA to the Board on an assumption of "best endeavours" by creditors and of an as yet unspecified further strengthening of the programme in the Autumn. We will need to take a hard look at Camdessus' proposal and the programme before the Board discussion.

Elsewhere, Ecuador's position has deteriorated rapidly, in part reflecting the impact of the earthquake and other natural disasters. In Africa, Anglophone countries (Tanzania, Ghana, the Gambia) seem to have been doing better with their programmes than Francophone countries (problems with Cote d'Ivoire, Mali, Gabon among others). However, the latest news from Zambia is less good.

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

Yours ever,

Tony

A W KUCZYS

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INTERNATIONAL FINANCIAL SCENE

1 Following Brazil's declaration in February of a moratorium on interest payments on its medium and long term commercial debt, and of the freezing of its short term lines, and the consequent concerns that such moves may be followed by other countries, there have been a number of agreements over financing packages between middle-income debtors and the banks. Moreover, the Mexican package agreed last summer has finally become effective, following the signature of the British banks who had earlier held out for a larger contribution from the US. On the other hand, as regards the poorest, most indebted countries - largely those in Sub-Saharan Africa - with their clear inability in many cases to continue to service their debt within existing rescheduling constraints, British and French initiatives to offer debt relief were launched at the meetings of the Interim and Development Committees in Washington.

2 Amongst the middle income debtors, Mexico's financing package seemed in some jeopardy in early April. The Advisory Committee, anticipating that by no means all banks would agree to participate, had originally asked banks to contribute 12.9% of their 1982 exposure, although if all banks were to have participated only an 11.6% increase in exposure would have been necessary. The US banks' commitment to the target finance fell significantly short, with a number of regional banks and others refusing to participate or committing for a much smaller figure than asked for. The UK banks accordingly took the line that until the US bank contribution was substantially increased the UK banks would only commit at the 11.6% level. This move threatened to lead other banks also to reduce their level of participation, perhaps causing the entire package to unravel. In the event, after a token additional contribution from certain US banks, the British banks agreed to sign for the full 12.9% increase. The Mexican package finally became effective, and the $500 mn bridging loan was repaid and $3.5 bn of new money disbursed on 30 April.

3 The banks' Advisory Committees have reached agreement over financing packages for Argentina, Philippines and Venezuela, although difficulties and lengthy delays are likely to be encountered before these agreements obtain the participation of the banks as a whole, and there are reports that the Philippines already intend to reopen their agreement (having seen that they obtained less favourable terms than

Argentina). In an effort to induce banks to sign up quickly, the Argentine agreement provides higher fees to those banks agreeing to participate by 17 June. In contrast, as a result of the Brazilians' declaration of a moratorium, their refusal to accept any IMF programme, and the lack of any sign that they have any clear policy plan to remedy their poor economic position, the Advisory Committee for Brazil has been unwilling to countenance the longer term rescheduling which the Brazilians are seeking - although maturing short term lines seem to have been informally rolled over by most banks. For their part the Brazilians are also objecting to the fact that most creditor countries are still off cover for new export credit finance, claiming that the restoration of export credit was understood as part of the January Paris Club agreement: most creditors, however, have not accepted these claims. It remains to be seen to what extent the resignation of Finance Minister Funaro as of April 27, and of Central Bank Governor Gros on April 29, will lead to a change in policies.

4 Meanwhile, following the increasing inability of many of the poorest, most indebted - ie sub-Saharan African (SSA) - countries to fulfil their debt servicing obligations, and following some preparatory work at the Paris Club examining the effects of providing alternative forms of debt relief, the Chancellor of the Exchequer launched an initiative at the Interim/Development Committee meetings in Washington designed to provide debt relief for these countries. This relief may include creditors agreeing to retrospective terms adjustment (RTA - ie in effect converting aid loans to the poorest into grants - already largely undertaken by the UK, but not by a number of other creditors), extending the length of rescheduling of official debt, and the rescheduling of such debt at concessionary rates. The French launched a parallel initiative which advocates extended Paris Club rescheduling, a concessional CFF, and the use of an additional concessional World Bank facility to repay some existing official debt. Heads of delegation of the Paris Club met on April 24 to start working out the details of any proposed scheme: which countries should benefit, how conditionality should be enforced, what sorts of debt servicing concessions should be offered, and what comparability should be sought from other creditors (principally the IFIs and the banks). Progress was achieved on most of these issues, but some countries - notably the United States - still see difficulty in parts of the proposals, in particular on concessionary interest rates. Further work on these questions is also being undertaken by World Bank staff.

5 In the wider economic sphere, developments facing debtor countries continue to be mixed. Most debtors will have benefited from the continued decline of the dollar: by the end of April this had fallen over 7% since the beginning of the year

in effective terms, and had returned roughly to its average level of 1980. (On the other hand, the fall in the value of the dollar may lead to a reduction in the amounts available through World Bank programmes if no general capital increase can be agreed.) The authorities of the G7 countries have declared that they feel that exchange rates are now more consistent with fundamentals, and they restated in Washington the February Louvre agreement to co-operate to stabilise exchange rates at around current levels: but with the markets seeking to test this, especially following the announcement of US tariffs on certain Japanese electronic goods and of disappointing US trade figures for February, and with little clear evidence of remedial policies from the Japanese or the Germans, there are concerns that the US may have to raise interest rates to defend the dollar. Most euro-dollar interest rates have risen over half a percentage point in the last six weeks: the six-month rate is now over 7%, compared with 6% at the beginning of the year. And, whilst protectionist moves are at the moment principally directed at Japan, there are concerns that they may (especially in the United States) soon also affect some of the debtors. Meanwhile, forecasts for growth in the industrialised world continue to be shaded down: the IMF WEO discussed at the Washington meetings was somewhat less buoyant than the forecast presented at the Annual Meetings last autumn. And, more recently, the German economic institutes have revised down their forecast for German growth this year, from the 3% expected last autumn, to only 1%-2% now.

6 Spot commodity prices rose during March and April. In the seven weeks ending 21 April the Economist Index rose 2.3% in SDRs (up almost 5% in $), with rises in all of the sub indices. Food prices rose 1.7% and industrial raw materials almost 3% in SDR terms, with similar rises for both agricultural non-foods and metals. Stronger metal prices reflected short-term supply shortages in several markets. Overall, commodity prices are now roughly back to their level of the middle of last year. However, there remains considerable diversity in performance: coffee prices are still almost 20% below their 1986 low, whilst beef prices are 5% above their 1986 high.

7 Of the $1.6 bn borrowed on the international capital markets by developing country borrowers since the beginning of March, three quarters was raised in syndicated loans. Indian borrowers represented the highest proportion, with the equivalent of $344 mn through 9 loans (nearly half of which was in deutsche marks). China also borrowed over $300 mn. Colombia signed a $50 mn FRN, the first eurobond issued by a Latin American borrower since 1982. The only East Bloc borrowers in this period were from the USSR: Vneshtorgbank raised a $200 mn euro credit (and doubled its existing sterling bankers' acceptance facility to £200 mn), while the International Investment Bank borrowed $50 mn.

8 Banks and debtor countries continue to seek new ways in which financing needs can be met; both sides see advantages in offering options between which banks can choose how to participate in financing packages. The Interim Committee endorsed this "menu approach" to financing, and particularly commended local currency financing and debt equity conversions schemes. Chile, Argentina, Philippines and Brazil are amongst the countries operating, or expected shortly to be operating, such schemes; the Mexican scheme remains temporarily suspended, following an administrative backlog trying to clear earlier applications. Amongst other schemes to help particular debtor countries the possibility of using money provided for drug eradication as a vehicle for repurchasing Bolivia's debt at a discount is still being examined. The Japanese authorities have meanwhile announced that they will be granting $20-$30 bn of new loans, largely to Latin America, over the next three years. Details have yet to emerge, and it is not yet clear how much of this will actually be additional to earlier commitments.

Further details on individual countries are given below.

Latin America and Caribbean

9 The signing process for Mexico's bank financing package began on 20 March, when commitments had reached $7.6 bn (98.7% of the $7.7 bn required for the package, but only some 89% of the total commitments asked for from the banks because of the safety margin). The exercise was not smooth, particularly because of the reluctance of some US banks (mainly the regionals) to participate at the levels sought. The shortfall in the contribution from the US banks, which was only 82.3% of the amount sought, led the major British banks (and some Canadian banks) to make their signatures for the full amount dependent on conditions which in essence were designed to extract a higher US contribution. A token increase was eventually obtained from the US banks; the British banks concluded that no further contributions were likely and signed for the full amount on 13-14 April. The agreement has now become effective, and Mexico repaid the $500 mn bridging loan and received the first $3.5 bn disbursement of new money on 30 April. Meanwhile, on 1 April the EXIM Bank of Japan released $250 mn (part of a $1 bn loan package) for the Pacific Petroleum Project.

10 The Fund programme appears to be progressing satisfactorily, and targets for 1987 have been agreed. Mexico's external performance continues to be good: the trade account is benefitting from continued peso depreciation and the longer-than-expected recession. The January-February trade surplus was reported to

be $1.5 bn (up 109% on the same period in 1986), with oil exports of $1.35 bn (+6%), non-oil exports of $1.85 bn (+20%) and imports of $1.7 bn (-21%). However, domestic inflation is currently running above expectations, with the CPI rising by 8.1% and 7.2% in January and February respectively, giving a year-on-year increase of 110% in February: the target of 80% inflation for 1987 would require average monthly increases of 4.5% for the remainder of the year, and seems out of reach. Real GDP fell by 3.5% in 1986, and growth of only 2% is expected in 1987 (even this may prove optimistic). The Mexican debt-equity scheme has been suspended temporarily since March to clear the back-log of existing applications (it is reported that this move was also meant to pressurise banks into supporting the financing package). Nevertheless, Amex Bank has signed a deal to convert $100 mn of debt into equity for hotel development (it is the first US bank to have used the conversion mechanism entirely for its own account).

11 The rift between the Brazilian authorities and the banks' Advisory Committee has continued to widen since the authorities' suspension of interest payments on $68 bn of medium and long-term bank debt and the freezing of $15.5 bn of short-term trade and interbank lines in late February. The banks have been reluctant to enter into full-scale negotiations over the rescheduling of Brazilian debt at this stage; the Brazilians and the Advisory Committee met in the margins of the IDB Annual meetings in Miami (23-25 March), but failed to reach agreement on the "goodwill" interest payment sought by the banks as a prelude to negotiations. The Committee consequently refused to endorse the Brazilians' request, sent to creditor banks on 25 March, for a 60-day extension of short-term lines. Despite this, banks appear to have maintained their lines (initially for between 30 and 180 days), although the Brazilian authorities are believed to be unfreezing individual short-term lines if the banks concerned have threatened legal action. The Advisory Committee met a Brazilian delegation led by Central Bank President Gros on 10 April for discussions on interim arrangements for the maintenance of short-term lines and the rollover of medium and long-term debt. The Brazilians presented the banks with a copy of their general economic guidelines for 1987-91, but appear not to have made more specific financing requests, and no formal arrangements were reached. On 13 April the Brazilians sent telexes to creditor banks requesting a 3-month extension of the rollover of 1986 and 1987 Q1 medium term maturities which was due to expire on 15 April, and a rollover of maturities due between 16 April and 15 June. The Advisory Committee did not endorse the request.

12 The US Interagency Country Exposure Review Committee has reacted to the suspension of interest payments by downgrading loans to Brazil to "substandard" for regulatory purposes from 1 April. This in itself does not require US banks to take

any action regarding their loans; nonetheless, a number of the major banks have put medium and long-term loans to Brazil on a non-accrual basis in their end-quarter submissions to the US regulatory authorities (ie payments from Brazil are recorded on a cash rather than accruals basis for the previous quarter). This move is reported, for instance, to have reduced Chase Manhattan's net income in Q1 1987 by $36 mn (including $5 mn in respect of Ecuador) to $104 mn.

13 Whilst it is now widely believed that the Brazilian economy is moving into recession, there is little evidence of this in recent economic data. The trade surplus for March was only $156 mn, giving a 1987 Q1 total of $546 mn (cf $2465 in 1986 Q1). Overnight and 60-day interest rates remain at 400-500% pa, and the February rise in the CPI (13.9%) brought accumulated inflation in January-February to 33% (29% in January-February 1986). Finance Minister Funaro resigned as from 27 April, and was replaced by Luiz Bresser Pereira. This led to the resignation on 29 April of Central Bank President Gros who was replaced by Fernando Milliet D'Oliveira, an associate of Pereira. The new Finance Minister has already announced an 8.9% devaluation of the cruzado, and has reduced the projected rate of economic growth for this year from 7% to 3.5%: however, he has also warned that Brazil might have to suspend interest payments on official debt if the country cannot generate at least a $6 bn trade surplus.

14 Ecuador's earthquake on 5 March which destroyed the country's oil pipeline is estimated by the authorities to have increased 1987's external financing gap to $950 mn, from the $325 mn previously expected. Further recent disasters - a major landslide which destroyed a principal link to the Pan American Highway, a gold mine collapse, and flooding on the coastal plain - have doubtless increased the gap further. Ecuador's initial response to the earthquake involved austerity measures including 10% cuts in public expenditure, a price freeze on essential commodities and domestic petrol price increases of up to 80%; external debt service was also suspended. The public response was hostile, reflected in a general strike on 25 March. Arrangements have subsequently been made with Venezuela to borrow 12.5 mn barrels of oil until end-May, of which 40% will be for domestic consumption and 60% for export (such loans will be counted as Ecuadorean production by OPEC). A link to the Colombian oil pipeline should be completed by the middle of May and will enable movement of 50,000 bpd. Emergency assistance may be provided by the IMF and the World Bank, and loans from the IDB and Andean Development Corporation may provide about $100 mn. The IMF Board deferred discussion of Ecuador's Article IV, originally scheduled for 13 April, to allow for a fuller assessment of the impact of the earthquake. The review of the SBA has not yet been completed and the second and third tranches have not been drawn; there have been indications that

Ecuador no longer wishes to continue following its Fund programme. Meanwhile, the Ecuadoreans have indicated a desire to renegotiate their 1987-88 obligations under last year's Paris Club MYRA, to have them refinanced over 10 years (5 years' grace); they also wish to change the cut-off date from December 1982 to December 1984.

15 Peru's 8.5% economic growth in 1986 produced a deterioration in the external accounts for the year: the trade balance moved from a $1 bn surplus in 1985 to a $50 mn deficit, and liquid international reserves fell by $0.6 bn (to $1 bn, still nearly 5 months' imports) despite the continuing limitation on debt service. Nonetheless, the Garcia administration remains unwilling to employ tighter demand management. In a package announced on 3 April, the minimum wage was increased by 40% and some other wages by 27-30%, while the price of petrol, which provides a third of tax revenues, was increased only 20%. Instead, the authorities have announced that they may compensate for declining export and fiscal revenues by employing further restrictions on servicing the debt of preferential creditors. On the other hand, there are reports that the authorities may be moving towards a resumption of Article IV consultations.

16 Argentina has reached broad agreement with the banks' Advisory Committee following over two months of negotiations. The package includes $1.55 bn of new money for 1987, to be repaid over 12 years (5 years' grace) at a margin of 7/8% plus a 4-year $400 mn trade facility, which carries an interest spread of 13/16%. It also includes the rescheduling of around $25 bn of debt due to banks in 1986-96 over 19 years (7 years' grace) and the rescheduling of $4.2 bn of old 'new money' over 12 years (5 years' grace); the rescheduled debt also carries an interest margin of 13/16%. In order to try to avoid the lengthy delays which have characterised the finalisation of recent financing packages for other countries, the Argentine agreement provides for higher fees for those banks which agree to participate by 17 June. The banks have agreed to a scheme of exit bonds which the Argentinians proposed as a means of excluding those banks with small exposure to the country from future new money and rescheduling packages. The rollover of debt due between January 1986 and end-March 1987, which was agreed last August, expired on 31 March. Argentina requested that the rollover should also cover debt falling due in April, and that all the debt covered be rolled over for a further 180 days, giving a new expiry date of 31 October. Talks on a Paris Club rescheduling are tentatively due to take place on 19 May, although not all the bilaterals under the previous Paris Club agreement have yet been signed; the UK bilateral remains unsigned, largely because of a dispute over two ECGD claims. On the economic front, inflation continues to be a significant problem: the CPI rose by 8.2% in March (106% year-on-year).

17 The Venezuelan authorities' most recent forecast for the 1987 balance of payments indicates a current account deficit of $0.8 bn (cf $2.3 bn in 1986) and an overall balance of payments deficit of $1.2 bn (cf $4.5 bn in 1986). But although international reserves are projected to fall by over $1 bn this year, this would still leave them at around $8.6 bn at end-1987. Meanwhile, following the agreement in principle of amendments to Venezuela's public sector MYRA at end-February, a new term sheet which includes details of a debt-equity conversion scheme has been endorsed by the Advisory Committee and has been sent to the creditor banks. The Advisory Committee hopes to have the arrangements finalised quickly, but many banks have indicated that they will not sign the MYRA until some long-standing issues on the private sector debt repayment plan are settled. They are concerned that the government is still refusing to accept responsibility for certain private sector debts such as those of private banks which were intervened by the government. Nevertheless, the first major agreement under the private sector debt plan has just been signed: the finance company Inversiones Cremerca has agreed with international bank creditors to reschedule $58 mn. The Central Bank has meanwhile begun signing foreign exchange contracts with private sector debtors whereby the Central Bank will provide dollars at a preferential exchange rate on payment of a premium. This premium, it seems, is likely to prove excessively burdensome for a number of private sector debtors, particularly finance companies.

18 Chile's trade surplus in February, at $120 mn, was slightly above the level of a year ago ($105 mn). Consumer prices rose by 2% in January and by 1.7% in February bringing the year-on-year rate to 17.5% (against 17.4% in December and an IMF target for end-1987 of 13%). Following the agreement in principle of the commercial bank package, the Chilean authorities have renegotiated their Paris Club debts: 85% of principal due between 15 April 1987 and 31 December 1988 will be repaid over 7 years, including 3 years' grace. Of the remaining amounts, 5% of principal and 100% of contractual interest is to be repaid on original due dates, whilst the final 10% of principal will be repaid on 31 March 1989. The rescheduling will save approximately $150 mn in 1987 and 1988. As the consolidation period runs beyond the end of the existing Fund EFF, the Paris Club agreement has been backed by a specific commitment by Chile to seek a Fund agreement covering 16 August 1988 to 31 December 1988.

19 Colombia signed a $50 mn FRN in London on 6 April, the first eurobond issued by a Latin American borrower since 1982; it carries a spread of Libor +1 1/8% and has a term of 7 years (4 years' grace). Further use is expected to be made of the euromarkets to fulfil 1987's proposed $2 bn borrowing programme. The Colombian authorities are also expecting to receive $87 mn through an IDB complementary

financing to be marketed jointly in London and New York at end-April. Colombian export performance this year is likely to be weaker than last because of lower coffee prices, although export volumes will be higher as a result of the suspension of ICO quotas. Expectations are for a trade surplus of $200 mn and a current account deficit of $1-1.6 bn. In the domestic economy the government hopes to achieve GDP growth of 4-4.5%. Lower coffee revenues mean that the PSBR is expected to rise to 3% of GDP (0.8% in 1986). The inflation rate has remained fairly steady, with the CPI rising by 8.2% in Q1 (8.8% in Q1 1986) bringing year-on-year inflation to 20.4% (cf 20.6% at end-1986); the authorities' target for the year is 20%. Uruguay's SBA programme expired in March, and there are no indications that a follow-on programme will be sought. On 19 March Uruguay drew down the $45 mn which commercial banks had provided in a co-financing with the World Bank for a power sector rehabilitation project.

20 There has been little further progress recently on Bolivia's proposed debt buy-back scheme. Although the major US banks have apparently reacted quite favourably to the scheme, most other banks have not yet responded. Bank of America, which chairs the Advisory Committee, intends to revert to recalcitrant banks to obtain their support. The Advisory Committee is still working on the premise that funds for the buy-back will be available from foreign governmental sources; it has been rumoured that West Germany and Holland have agreed to provide $30 mn and $20 mn respectively. Costa Rica has reached a provisional agreement with the Fund, and a Letter of Intent has been accepted by management as the basis for a new SBA; a Fund Board discussion is expected by end-May/early June. The draft documentation for Jamaica's 1987 rescheduling agreement was sent to the 150 banks involved in early April, and signing has been tentatively scheduled for 29-30 April.

21 Final agreement on the IDB's Seventh Replenishment has yet to be reached. The IDB had hoped to announce the decision at the Annual Meeting in Miami on 23-25 March, but failure to agree on the US proposal for a change in the Executive Board's voting procedure prevented a final decision on the size of the lending programme and the amount of the Replenishment required. Agreement is not now expected before the next meeting of the Board of Governors in June. The gap between the US and the major Latin borrowing countries has widened, meaning that a smaller Replenishment now seems likely. This would result in the IDB's lending over 1987-90 being no greater than over 1983-86 ($13 bn).

South and East Asia

22 The Philippines finally reached agreement with the banks' Advisory Committee in New York on 27 March. The main elements in the $13.2 bn package included a rescheduling of previously unrestructured medium-term debt maturing between 1987 and 1992, amounting to $3.5 bn, over 17 years with 7 1/2 years' grace, a further rescheduling of previously rescheduled debt falling due between 1987 and 1992, amounting to $5.8 bn, also over 17 years with 7 1/2 years' grace, a rescheduling of private financial sector debt falling due between 1987 and 1992, amounting to $1 bn, over 16 years including 6 years' grace, and a four-year extension to the revolving short-term trade facility of just under $3 bn with a reduced margin of 3/4%. The banks conceded a 7/8% spread on the medium and long term debt, but only on condition that the Philippines make annual pre-payments of $37 mn in each of 1987, 1988 and 1989 of part of the $925 mn new money facility, amortisation on which was not otherwise due to begin until 1990; otherwise the spread would be raised to 1%. For the years after 1989 the lower spread would apply if the Philippines continued to meet their payment obligations under the new money facility and the rescheduling agreement. The Philippines expected to have no difficulty in meeting the prepayment conditions; prepayment was expected to be financed out of expected sales of $150 million a year of Philippines Investment Notes (PINs). Recent reports suggest, however, that the Philippines may now reopen negotiations with the banks, seeking to obtain instead similar terms to those agreed for Argentina. The Philippines are expected to achieve real growth of around 4% this year, after sharp declines in 1984 and 1985 and a virtually static performance last year.

23 Two syndicated loans for Indonesia, each for Y25 bn ($175 mn), and each for 10 years (5 years' grace) were signed by Japanese financial institutions on 10 April. Meanwhile, the first contract (worth £10.9 mn) under the UK-Indonesian £150 mn soft loan agreement has been signed. For the financial year ending March 1987 real GDP is estimated to have grown by 2.4%, with the central government deficit rising to 5.5% of GDP (cf 2.9% in 1985-6 and a surplus in 1984-5). The current account deficit rose to $4.2 bn (cf $2.0 bn in 1985-6), with a 6% increase in non-oil exports and a 13% cut in imports only partially offsetting a 45% fall in oil and LNG exports. For the coming financial year, projected 10% and 17% increases in energy and non-energy exports respectively, and a further 6% cut in imports, are expected to cut the current account deficit for the year to $2.3 bn. Indonesia's request for a CPT will come to the Fund Board on 4 May. Deflation last year in Malaysia, and the consequent fall in imports, meant that the visible trade surplus last year, at $3.2 bn, was virtually unchanged from 1985. The current account deficit narrowed to $0.5 bn, 1.8% of GNP (cf $0.7 bn, 2.5% of GNP in 1985). Latest figures

from Bank Negara Malaysia suggest that the economic downturn may have bottomed out. GDP growth in 1987 may be as high as 2%.

Eastern Europe

24 Both Poland and Yugoslavia attended the Paris Club in the week beginning 30 March. No agreement was reached with Poland whose arrears to the Paris Club now total around $4.5 bn. The Poles are seeking a long-term debt consolidation (covering up to 1989 at least), which official creditors are not prepared to contemplate until Poland has agreed an SBA with the IMF. In the meantime, creditors propose an interim agreement covering arrears outstanding and payments falling due in the rest of 1987 (although the US is unwilling to go beyond end-September or to support an IMF programme for Poland). Further discussions may take place at the May meeting of the Paris Club. At their meeting with the banks' steering committee on 10 April, the Poles submitted ambitious debt consolidation proposals encompassing all maturities due from 1988 onwards excluding those covered by the 1986-7 agreement. The banks are, however, only willing to discuss obligations due in 1988 and 1989; a further meeting is planned for mid-May. Meanwhile, Yugoslavia and the Paris Club reached provisional agreement on the implementation of the second stage of the country's official MYRA (covering the period 16 May 1987 to 31 March 1988). Despite the inadequacy of recent Yugoslav performance, the agreement was made subject only to consultations by Paris Club creditors on the basis of an IMF assessment of recent economic measures undertaken by the Yugoslavs on interest rates, the exchange rate, enterprise accounting, and public expenditure. The IMF assessment was debated in the Executive Board on 20 April, and the MD's summing up will be discussed by the Paris Club at their May meeting. For their part, the banks are unwilling to proceed until the Paris Club agreement is properly in place, and they have therefore rolled forward the implementation date of the second stage of their MYRA, initially to 27 May. The Yugoslav convertible-currency trade deficit in 1986 rose over 25% to $2.0 bn, but the deficit in the first quarter of 1987 ($245 mn) was less than half that of 1986 Q1, as exports stabilised and imports fell back sharply.

25 Romania has cleared its arrears to the IMF. In a meeting with the commercial banks to discuss a reduction in interest rate margins (from the 1 3/8% set in last year's re-rescheduling), the Romanians reported also that they had prepaid $300 mn of debt due to official creditors in the period 1987 to 1989. In a move aimed at reducing its budget deficit (which in 1986 was equivalent to 3.7% of GDP), Hungary announced significant price rises on a range of food and consumer products from 13 April.

Southern Europe

26 In Greece the government has indicated that the economic austerity programme adopted in October 1985 will continue in some form into 1988. However, the targetted reductions in the public sector and current account deficits this year appear ambitious in the light of less favourable external conditions and the imminent dismantling of the import deposit scheme. On the international capital markets, the Commercial Bank of Greece raised $75 mn through a commercial paper programme in March, and the Bank of Greece announced a $300 mn eight-year syndicated credit in April at slightly finer terms than on a similar loan last year (5/8% over LIBOR compared to 3/4%).

Sub-Saharan Africa

27 Nigeria has met the criteria for the release of the second tranche of its World Bank loan, and disbursement is expected to be imminent. The Fund Mission has returned to Lagos, and a successful completion of the first review is expected shortly. In the wake of the roadshow to Tokyo in early March, three more Japanese banks have agreed to contribute to the new money element of the commercial bank rescheduling agreement, bringing the overall Japanese bank commitment to 54%: the overall level of commitments has consequently risen to around 91.5%. However, progress recently made towards the rescheduling of uninsured trade arrears seems to have stalled. The Central Bank of Nigeria (CBN) issued a further $1.5 bn of new promissory notes on 7 April, but the majority of noteholders still have a large proportion of their debt unverified and are unlikely to consider any rescheduling proposals put to them by the CBN until the Nigerians have taken steps to speed up the verification process. In addition, creditor frustration has been heightened by the non-payment of interest due on notes on 6 April for which, as in January, there was no prior notification.

28 Cote d'Ivoire is in difficulties following the Fund's failure in March to complete the first review of the current 13-month SBA. Lower-than-expected prices for cocoa and coffee (on which the country relies for over half of its export earnings) mean that export earnings figures for 1987 have been revised downwards by around $1 3/4 bn (about 6% of 1986 GDP), resulting in a projected overall balance of payments deficit of $1.7 bn. The Fund has suggested that the authorities adopt a series of austerity measures worth about 2-3% GDP, leaving the remaining shortfall to be made up by faster IBRD lending, additional French funds and possibly new commercial bank money. However, the authorities have declined to countenance such cutbacks in their spending and, at present, the position is one of deadlock. If no

solution is found in the near future the position will worsen as, without a Fund programme, the Paris and London Club MYRAs only agreed last year will be void, and disbursement of the second tranche of a World Bank SAL worth $150 mn, due this summer, will be in jeopardy. Cote d'Ivoire may seek to reopen its MYRAs, under which it is due to pay some $1.3 bn in debt service in 1987; this would be strongly resisted by the Paris Club.

29 Following on from discussions with the 12-bank Technical Committee, the South African Standstill Co-ordinating Committee presented its proposals for a follow-on debt arrangement to the creditor banks on 24 March. The proposals are broadly as expected; they allow for $1.42 bn of blocked debt originally caught in the standstill to be released over three years. The option of converting blocked debt into long term loans has been retained. In Sudan, routine discussions with the IMF took place in mid-March. A further round of talks in May will examine budgetary proposals and possibly also the long delayed "Economic Salvation Programme". But although relations with the Fund are easing, the prospects of early agreement on a programme remain slim: fundamental differences on key issues such as devaluation and the removal of subsidies - both of which the Finance Minister refuses to contemplate - are still very much in evidence.

30 In Zimbabwe the authorities have now signed an export promotion loan - designed for the manufacturing, agricultural and mining sectors - with a group of commercial banks (£35 mn facilities have been signed with Barclays and Standard Chartered and £10 mn facilities are expected to be agreed with Grindlays and BCCI) to supplement the existing, fully drawn, IBRD Export Promotion Loan designed for the manufacturing sector only. The Zimbabwe authorities had hoped to negotiate the new facility with the IBRD, but were unable to agree to the conditions the IBRD proposed. The Barclays and Standard Chartered loans have a maturity of 6 years (2 1/2 years' grace) and carry an interest rate of LIBOR +1 1/4% for the first three years and LIBOR +1 3/8% thereafter. Zambia has reintroduced its foreign exchange auction, but with some alterations: some transactions (debt service, educational and medical supplies) will be conducted at an alternative official rate, and others (agriculture and small enterprises) at the marginal rather than bid rate. A new IMF programme could go to the Board by the end of May, but this depends on budgetary reforms which at present remain unsettled. It also assumes that arrears to the IMF (currently SDR 170 mn, rising to SDR 220-230 mn by end-May) can be repaid by bridging finance. Zaire has reached agreement with IMF staff over the details of a new programme (including SBA, SAF, CFF) which is expected to go to the Board around 15 May. It is also likely to seek a further Paris Club rescheduling in May; this would be too early for the country to benefit from the recent SSA initiatives.

Middle East & North Africa

31 Serious difficulties emerged in finalising the IMF Standby for Egypt, now scheduled for Executive Board approval on 15 May. After earlier encouragement to the staff to accept a Letter of Intent in February for an acknowledged weak programme, the attitude of major creditors hardened. On 2 April their EDs rejected Camdessus' unprecedented proposals for some form of guarantee that the IMF would be repaid. Subsequently, however, they have given sufficiently positive responses to alternative proposals on rescheduling terms (including subordinating Paris Club claims to those of the IMF) to enable Camdessus to issue the staff paper. Although Mubarak, whose party was successful in the parliamentary elections on 6 April, but who himself faces re-election in October, had been ruling out faster or more comprehensive adjustment at present, the Central Bank Governor gave written assurances to the Fund MD on 8 April that there would be some acceleration on exchange rates, interest rates, and pricing policy. Egypt has meanwhile benefited from recent substantial Gulf aid, and has also reached agreement with the USSR to reschedule $2 bn military debts over 25 years (with 6 years' grace and no interest payments). But Egypt has not yet formally accepted an earlier US offer to reschedule FMS debts of approximately $5 bn.

32 Elsewhere, Algeria continues to experience market resistance to its borrowings. A proposed 5 year bankers' acceptance facility organised by Lloyds Merchant Bank has recently been abandoned. Payments arrears persist. The first review of Morocco's SBA has been completed and the programme is back on track. No date has yet been set for the signing of the rescheduling agreement with the commercial banks. 37 banks (out of 304) have not responded to the proposals circulated by the Steering Committee some two months ago, and problems have arisen as regards the Belgian and Swedish banks, who are not allowed by their authorities to convert overdrafts into term loans as is being proposed. Iraq has largely eliminated arrears to UK creditors, but is only making a few, erratic repayments elsewhere and is involved in complex bilateral negotiations, with official and commercial creditors, to reschedule overdue and projected repayments of principal (amounting to some $71.25 mn) on a 1983 $500 mn syndicated Euroloan.

INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt End-Dec 1986*	British-owned banks' exposure[1] End-Dec 1986	ECGD amounts at risk End-December 1986 [2]	End-December 1986 [3]
Latin America				
Argentina	49[4]	3.0(0.2)	0.2	0.2
Brazil	104	6.6(1.4)	1.0	1.8
Chile	19	1.3(0.1)	-	0.1
Colombia	15	0.6(0.1)	0.1	0.1
Ecuador	8	0.5(0.1)	0.1	0.1
Jamaica	4	- (-)	-	-
Mexico	98	6.3(0.7)	0.6	1.2
Peru	15	0.3(-)	0.1	0.2
Uruguay	4	0.3(-)	-	-
Venezuela	35[4]	2.1(0.1)	-	-
Far East				
Indonesia	42	0.8(0.3)	0.8	1.6
Malaysia	21	1.1(0.3)	0.1	0.1
Philippines	28	1.3(0.2)	0.1	0.2
Eastern Europe (convertible currency)				
Hungary	15	0.3(-)	-	0.1
Poland	34	0.6(-)	1.2	1.3
Romania	6	0.2(-)	0.3	0.4
Yugoslavia	19	0.8(0.1)	0.7	0.9
Southern Europe				
Greece	18	1.2(0.2)	0.2	0.3
Turkey	29	0.5(0.3)	0.2	0.5
Sub-Saharan Africa				
Cote d'Ivoire	8	0.3(-)	0.1	0.1
Nigeria	23	1.3(0.2)	2.4	3.3
South Africa	22	3.6(0.6)	0.8	2.5
Sudan	10	- (-)	0.2	0.2
Middle East and North Africa				
Algeria	27	0.4(0.1)	0.2	0.4
Egypt	45	0.2(0.2)	0.3	1.2
Iraq	55[5]	0.1(-)	0.5	1.2
Israel	31	0.4(0.1)	0.1	0.2
Morocco	17	0.2(-)	0.2	0.3
Oman	3	0.1(0.1)	0.7	1.9
Saudi Arabia	14	0.6(0.2)	0.2	0.2

[1] Defined as consolidated external claims including portfolio investments with a contractual repayment date, adjusted for certain inward and outward risk transfers in respect of guaranteed loans, plus any net claims on local residents in local currency. Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans. Other portfolio investments in these 30 countries amounted to $9 million at end-December 1986.

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

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

[4] Medium and long-term debt only.

[5] Includes $30 bn from Arab countries.

* current estimate

40u

OVERDUE FINANCIAL OBLIGATIONS TO THE FUND*

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding (SDR mn)
Kampuchea	13 March 1975	28.9#
Guyana	31 May 1983	50.3#
Viet Nam	6 February 1984	60.1#
Sudan	12 July 1984	323.8#
Liberia	25 January 1985	97.5#
Peru	9 September 1985	210.9#
Zambia	30 April 1986	170.0
Somalia	20 November 1986	11.9
Sierra Leone	16 January 1987	5.3
Uganda		10.0
		968.7

NB The above figures are derived from Fund papers issued with respect to individual country complaints. There will have been further overdue obligations falling due subsequently, so the figures are not completely up-to-date. A Fund source indicates that total arrears were SDR 1044.5 mn as at 12.3.87 but this figure is not divided country by country.

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

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

R8.17

CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

25 March 1987

Charles Powell Esq
10 Downing Street
LONDON
SW1

Dear Charles

INTERNATIONAL FINANCIAL SCENE

I attach the regular report on developments in the international debt scene. This report sets out the background to the Interim and Development Committee meetings early next month in Washington, which will have debt issues on their agenda.

The meetings will take place against a growing perception amongst creditor governments, except the US Government, that the position of problem debtors is not yet improving despite the efforts made - on both sides - since 1982. The outlook on debt remains very difficult, although the systemic risks for the banks have clearly receded since the onset of the crisis and there has been some modest growth in schemes, such as debt/equity swaps, to value debt more realistically through the secondary markets.

The outlook for the world economy is for continued moderate growth. Most industrialised countries are implementing prudent macro-economic policies, and inflation has been reduced significantly. But the fall in oil prices has not boosted growth of output and trade as much as was hoped. There is therefore unlikely to be any major improvement in the external environment facing debtors (unless commodity prices recover sharply). There is also increasing recognition of the weaknesses in the implementation of the present strategy to which our earlier reports have drawn attention: uneven conditionality; differences between creditors; difficulty in assembling bank packages; more confrontational negotiations; and an increasingly intractable problem in sub-Saharan Africa.

Against this background, the Washington meetings seem likely to be dominated by the problems of individual countries. The meetings may see the start of attempts to reshape some aspects of the present strategy particularly in relation to sub-Saharan Africa.

Our last report noted that Brazil was likely to continue to dominate the scene. That has proved to be the case. The Brazilians announced, on 20 February, a moratorium on interest payments to commercial banks on medium and long term debt and an effective freezing of principal on short term debt. These measures follow a rapid deterioration in economic performance since summer last year, reflected in a much reduced trade surplus and accelerating inflation. There are as yet no signs that the Brazilians are prepared to contemplate the necessary corrective action. On the bank negotiations themselves, the position remains fluid and no formal proposals have been put forward. Funaro's attempt to politicise the negotiations, through visits to capitals, has largely misfired. The general message he received was that governments would not put pressure on the commercial banks and that policy improvements were necessary. In the main governments were unwilling to provide new export credits before Paris Club consideration of an IMF report in July.

The banks have had to accept the Brazilian measures as a fait accompli and are likely to have to roll over for a further period the payments under the existing rollover due on 31 March. In the wider context they have responded by a deliberate effort to speed up negotiations with a number of debtor countries, thus reducing the risk of contagion. Agreements have been reached with Chile and Venezuela in the past few weeks whilst faster progress has been made in the negotiations on the Argentine and Philippine packages.

Recent developments in Mexico have been relatively encouraging, although it is not yet clear whether signature of the long delayed commercial bank package is going ahead as planned. Economic developments have been generally favourable. The current account deficit was lower than expected in 1986 with the reduction in oil receipts offset in part by a 33 per cent rise in non-oil exports. However, the outlook remains uncertain and heavily dependent both on the oil price holding up and on adequate fiscal targets being agreed and implemented in a pre-Election period.

The current picture on Nigeria is less encouraging. The stand-by arrangement has run into trouble with the discovery that some 20 per cent of oil revenues have been dedicated to a number of major industrial projects thereby reducing the amount of foreign exchange available for debt service and imports. It is not yet clear whether the Government will take effective steps to dismantle these arrangements. In the meantime, ECGD are due to start their bilateral negotiations with a Nigerian team this week. Satisfactory completion of these is the key to activation of the promised export credit package.

CONFIDENTIAL

Still more discouraging is the outlook on Egypt. Although a formal letter of intent with the IMF has now been agreed, a financing gap remains even after very generous rescheduling. The medium term balance of payments prospect is so poor that the Fund Managing Director has asked Executive Directors to consider guaranteeing repayments by Egypt and offering concessional interest rates on rescheduling. We have very serious reservations about both these suggestions. Informal discussions are still going on in Washington and the subject will inevitably be discussed by Finance Ministers during the Spring meetings.

I am copying this letter to Tony Galsworthy (FCO), Tim Walker (DTI) and John Footman (Bank of England).

Yours ever,
Tony Kuczys

A W KUCZYS
Private Secretary

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COPY

(2)

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

10 February 1987

Charles Powell Esq
10 Downing Street
LONDON
SW1

Prime Minister

CDP
10/2

Dear Charles

INTERNATIONAL FINANCIAL SCENE

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

My letter of 22 December noted that the world economic outlook for 1987 was somewhat gloomier than it had seemed at the time of the Bank Fund meetings. The institutional response to this outlook combined with signs of both creditor and debtor fatigue has been to generate suggestions from various quarters for studies/new debt relief initiatives. The ECLAC Conference in Mexico was safely negotiated on this score but the underlying note was one of threat. Later this year, debt and development issues may take the centre stage in UNCTAD while there are proposals for studies of the debt problems of the poorest (mainly African States) from Ripert at the UN and Stern at the World Bank.

As foreshadowed in our December report, there is now evidence (eg the Mexican and Nigerian packages) of great reluctance by commercial banks to participate in packages involving the contribution of new money.

The easing of conditionality, in the shape of weak Fund programmes for Mexico, Egypt and Jamaica, has been given a new and worrying dimension by the Paris Club's breach, in the case of Brazil, of its previous refusal to reschedule without a Fund programme. As with the earlier Fund cases, the main responsibility for this weakening of conditionality lies with the US. The way in which the Brazilian negotiations were conducted with the 11th hour change of position by the US in response to Brazilian threats underlines the need for senior creditors to align their positions in advance. We shall be working on ways of improving procedures.

On individual countries, Brazil has dominated the scene and is likely to continue to do so. Although the Paris Club agreement last month broke unwelcome ground in allowing Brazil to reschedule without a Fund programme, the rescheduling of maturities in the first half of 1987 is conditional on a letter of support from the Managing Director on the basis of

an Article IV discussion. On present form it seems unlikely that such support will be forthcoming. The latest indications are that the Brazilian economy continues to deteriorate on both the domestic and external account; the effective collapse of the Cruzado Plan has confirmed our earlier caution. The default threatened by the Brazilian negotiators at the Paris Club negotiations may come about in any event if the Government fails to take necessary adjustment measures fast enough. Ministers will be consulted shortly about the question of ECGD cover in these very difficult circumstances. The attitude of the commercial banks remains unclear: they seem to be waiting for a Brazilian initiative. The rollover of 1986 maturities expires at the end of March and there are reports that the Brazilians may want new money and a bank MYRA.

The next major debtor in the queue is Argentina. An outline agreement has been reached between Argentina and the IMF for an SBA and a CFF drawing. A hopeful indication is that the SBA has been agreed without a Mexican-style trigger clause. We will need to look carefully at the programme and, more especially, the prospects for its implementation. In the meantime the new Fund Managing Director has asked Executive Directors to participate in a $700 million bridging loan. The UK has refused to take part and it is not clear that sufficient support can in fact be secured from other countries.

On a brighter note, the Chilean, Colombian and Uruguayan economies have generally been performing well. A number of oil exporters, such as Algeria and Indonesia, have also taken significant adjustment measures to try to maintain their creditworthiness.

I am copying this letter to Tony Galsworthy (FCO), Tim Walker (DTI) and John Footman (BOE).

Yours ever,

Tony Kuczys

A W KUCZYS
Private Secretary

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Enclosure to PS/Ch/Ex to CDP 10.2.87

INTERNATIONAL FINANCIAL SCENE

1 Heightened concern over the prospects for handling international debt derives from three interrelated factors: the increasing difficulties in maintaining a co-operative approach amongst banks and other creditors, the apparent easing of conditionality in some IMF programmes and Paris Club reschedulings, and the deterioration in economic performance in some debtor countries.

2 Regarding the first of these factors, there has been little progress in recent weeks in securing the remaining commitments to the Mexican new money package. Whilst around 95% of the required new money has so far been committed, well over 100 banks have to date not agreed to participate. It remains to be seen whether Chairman Volcker's appeal to the recalcitrant US regionals earlier this week has any significant effect. The fact that such an appeal has been delayed so long may well serve to blunt its efficacy. For the Nigerian package, critical mass on the agreement was not achieved in time for the IMF's revised completion date of 26 January; most Japanese banks, in particular, have been very reluctant to participate, especially on the new money element. Whilst these two packages may well yet be successfully put together (the Nigerian SBA was in the event made effective on 30 January on the existing level of commitments), the unprecedented difficulties involved - and the hostility of the banks more generally now to new money packages - suggest that Advisory Groups and debtors will be reluctant in the future to devise agreements which include significant conventional new money elements. At a time when several important debtors are about to begin discussions with banks in which a need for new money has been identified - Argentina, for example, is expected to seek $1-$1.5 bn in its prospective negotiations - this reluctance is likely to cause particular difficulty, and can only serve to undermine the credibility of the Baker Plan.

3 Partly because of the severity of the economic conditions facing some debtors, but partly because of political pressures, the Fund has in a number of recent cases endorsed strategies which imply a significant weakening of its conditionality.

nd staff have been instructed by the Board to work on a programme for Egypt which is expected to leave the country's current account position at the end of the programme as weak as at present; and Fund staff have backed away from insistence on an immediate devaluation for Jamaica. In response to pressure from the US, the Paris Club has in the case of Brazil broken from its practice of requiring an IMF Standby to be in place before it will reschedule official debt: on 21 January it agreed to reschedule 1985-86 arrears and principal of 1987 H1 maturities; Brazil at this stage is committed only to "enhanced contacts" and to a favourable outcome from Article IV Consultations with the Fund.

4 Meanwhile, for the first time since 1983, there are no clear "success cases" amongst the major debtors. Brazil's economic position, in particular, deteriorated rapidly in the last months of 1986; although the authorities have taken measures to reverse the weakening on the external account, it seems that the anti-inflationary benefits of the Cruzado Plan have been dissipated and will be difficult to recover. In Mexico the authorities continue to struggle with the 60% reduction in export revenue in 1986 as a result of the oil price fall, although recent economic data suggest that the picture may well not be as gloomy as had earlier been expected. In Argentina the current account deficit more than doubled last year (to $2.7 bn), and the country continues to suffer from the decline in the prices of its commodity exports. Amongst other major debtors, the problems of Egypt look intractable. A number of fora, including the Paris Club, have started considering new ways of handling the debt of the poorest countries.

5 Against these trends, there have been positive developments in some countries. After considerable delays, Morocco completed a rescheduling agreement with the banks and agreed an SBA with the Fund in mid-December. (Even so, there are already indications that a performance criterion on external arrears has not been met.) The Chilean, Colombian and Uruguayan economies have generally been performing well. A number of oil exporters, such as Algeria and Indonesia, have taken significant adjustment measures to try to maintain their creditworthiness in the markets. And, despite some rhetoric in individual countries about imposing limits on their debt-servicing payments, there has been little indication of any concerted attempt by debtors at an alternative strategy for handling debt problems.

6 The spot price of oil has risen from under $15 pb at the end of November to approaching $18 pb now, largely as a result of the December OPEC agreement. Meanwhile, non-oil commodity prices have continued to decline. In the eight weeks ending 27 January, the Economist all items index fell about 2% in SDR terms

(although it rose 2% in $), so that prices are now 14% below their level at the end of 1985. Once again, the heaviest falls in the most recent period were in food prices (-4.7%), with industrial raw material prices stable. Major falls included coffee (-15%), maize (-16%) and beef (-12%). Coffee prices are now almost 50% below their level at the end of 1985, and close to their 1985 trough. Sugar prices rose 16%, because of lower estimates for output this year, after initial falls following the announcement that the US would cut its preferential import quotas for 1987 by 41%: these cuts will mainly affect Caribbean and Philippine producers.

7 In the wider economic sphere, developments have been mixed. Eurodollar interest rates fell slightly in early January, but have since recovered (six-month eurodollar rates are around 6 1/4%). Most debtors benefit from the continued decline of the dollar: in effective terms the dollar had by February 5 fallen over 5% since the beginning of December, leaving it 17% below its level at the start of 1986, and around its level of early 1981. However, the beneficial effects on the US trade account are slow in coming through: although on preliminary estimates the trade deficit for December fell to $10 bn (cf $19.2 bn in November), there are no clear signs yet of a sustained improvement in the trade deficit. Without such a reduction, protectionist pressures are unlikely to abate: whilst these pressures are at the moment directed principally at the EC, at Japan, and at some East Asian NICs, the threat to the LDC debtors remains real. Prospects for growth in the major industrialised economies are becoming slightly more gloomy, with forecasts edging down below 3% for the coming year - the West German official forecast has been revised down from 3% to 2 1/2%, and there are fears that activity could be weak in the US in the current quarter.

8 Since the beginning of December, there have been 11 market borrowings, totalling $682 mn, for LDCs: within this, China borrowed a total of $188 mn, whilst India borrowed $125 mn. Jordan has arranged a syndicated credit for $150 mn. Hungary was the only East Bloc borrower active in this period. The National Bank raised a $200 mn syndicated credit and the Central European International Bank arranged a $40 mn uncommitted NIF.

Further details on individual countries are given below.

Latin America and Caribbean

9 Little progress has been made with Mexico's financing package since the critical mass was achieved in November: commitments are only just over 95% and many small banks have yet to participate. Furthermore, a number of banks have committed on a

sis smaller than that requested by the Advisory Committee. It is thus unclear when disbursements will begin: the banks were originally expected to disburse $3.5 bn by end-1986. The Advisory Committee met Mexican Finance Ministry representatives on 13 January to review the status of responses and, in a subsequent telex to the banking community, stressed the importance of full support from all banks and urged the recalcitrant banks to commit to the package. Against this background, economic performance continues to improve. All end-September performance criteria were met, releasing SDR 225 mn from the SBA in mid-November, and it seems that the end-December criteria will also have been met. The current account deficit during January-September was $1.7 bn (cf $2.7 bn expected in the Fund programme). The end-year trade surplus was $3.9 bn, with oil exports down 63%, but non-oil exports up 33%; imports fell by 12%. (Non-oil exports exceeded oil exports for the first time for a decade.) Gross reserves fell $1.3 bn in the nine months to September, but Finance Minister Petricioli indicated that at end-1986 gross reserves were slightly higher than at end-1985, largely because of private capital inflows of $1.5 bn during the year. Consumer prices rose by 106% in the year to December (cf 115% forecast in the SBA), the highest on record. Nevertheless, the government is continuing its policy of raising public sector tariffs and prices to realistic levels and has undertaken to depreciate the peso in line with inflation: for a short period during December the controlled market rate was actually above the free market rate. Minimum wages were raised by 23% on 1 January.

10 Mexico has been repaying its official bridging loan on schedule; the whole of the first tranche ($750 mn) has been repaid, and the remaining $248 mn is to be repaid by 13 February. However, a request to defer repayment of the banks' bridging loan from 30 January until 30 April has been granted. The IMF have held discussions with Mexico to establish detailed performance criteria for 1987; their report will be scheduled for Board discussion before the end of March. Meanwhile, the IDB Board approved a loan of $100 mn for tourism development on 2 December and the World Bank Board approved a $250 mn second Export Development Project loan on 20 January.

11 The overheated Brazilian economy (which experienced real GDP growth of more than 8% in 1986) has run into serious liquidity difficulties. Concern about external performance has led the authorities to seek a rescheduling of Paris Club maturities, and they are now reported to be looking also for up to $4 bn in new money in 1987 (including $1.3 bn from IFIs) and possibly a commercial bank MYRA. At its meeting on 17-18 December the Paris Club agreed to discuss terms for a short-term

rescheduling of Brazil's $3.2 bn 1985-86 payments arrears, provided 1987 payments were kept current. However, on 6 January, the Brazilians made a counter-proposal for rescheduling of the arrears plus 100% of 1987 principal and interest over 10 years (5 grace). After lengthy discussions at the Paris Club on 19-21 January - which included threats of default from the Brazilians and considerable pressure to reach agreement from the US - the Paris Club agreed to reschedule 1985-86 arrears over 6 years (3 grace), for moratorium interest to be repaid in three semi-annual instalments from June 1988, and (if a letter of support is received from the Managing Director of the IMF by 15 July on the basis of an Article IV discussion) for the principal on 1987 H1 maturities to be rescheduled also over 6 years, with 3 years' grace. The commercial banks have given no clear reaction to the Paris Club agreement, with its weak conditionality. Some reports suggest that discussions on a 6-month extension of the rollover of 1986 maturities to end-March will begin shortly, but that the banks will be unwilling to grant new money in the absence of a full IMF programme. UK banks appear fairly content with the Paris Club rescheduling of 1985-86 maturities, and take some comfort from their view that official creditors have kept a relatively tight rein on Brazil over 1987 maturities.

12 The Brazilian authorities remain under domestic pressure to avoid a Fund programme, but their room for manoeuvre has been curtailed by continuing poor trade figures and lack of liquidity. Commentators have suggested that the Brazilians would impose a temporary moratorium in the first instance if liquidity is exhausted, rather than go to the Fund immediately. The trade surplus in Q4 1986 was $460 mn (cf $3.4 bn Q4 1985), bringing the yearly figure to $9.6 bn (cf $12.8 bn in 1985), and unconfirmed reports suggest that there was a trade deficit in January. However, the authorities have indicated that they expect the trade surplus to recover to its Q1-Q3 1986 monthly average level of $1 bn in the second half of 1987. The current account is reported to have recorded a deficit of $2.8 bn (1.5% of GDP) in 1986, and the authorities forecast a $1.7 bn deficit in 1987. Gross international reserves were estimated by the Central Bank to have fallen to $5.3 bn at end-1986, although other estimates have put the level considerably lower, and the likely further drawdown since then suggests cash reserves may now be no more than $2 bn (2 months' imports). On the domestic side, the Sarney administration, still feeling the after-effects of the unfavourable reception given to Cruzado II, has relaxed the price freeze by approving rises in a range of items in the face of continuing supply shortages and labour disputes. As a result the narrow official inflation rate rose to 15% in January, and the authorities expect a rate of 17% in February. The position of Finance Minister Funaro looks insecure.

13 Outline agreement has been reached between Argentina and the IMF on a 15-month SBA for SDR 1.1 bn and a CFF drawing of SDR 390 mn. Board approval is likely by end-February. Contrary to earlier reports, and in spite of strong Argentine pressure, the IMF has not agreed to a Mexican-style 'trigger clause'; however, the outline agreement provides that the country's growth performance and terms of trade will be 'taken into account' in setting future performance criteria under the programme. It also provides that Argentina may draw more under the CFF if its terms of trade deteriorate further and other normal CFF conditions are met. The programme is based on a projected real GDP growth rate of 4% in 1987 (cf growth of 5 1/2% last year); in addition, Argentina hopes to reduce inflation to an annual rate of about 40% in 1987 (cf 82% in 1986). Having already reduced the PSBR from 6.3% of GDP in 1985 to 3.6% last year, the authorities are aiming at a further reduction to 2.5% of GDP in 1987. They also intend to relax progressively the existing wage and price controls as and when conditions allow. It remains to be seen whether the government can carry through its adjustment programme in the face of opposition from the Peronist - dominated trade union movement, and in view of the gubernatorial elections due to be held in November. Doubts about the administration's policies were reflected in the increase in the parallel exchange rate premium to nearly 45% in early January.

14 Argentina continues to be seriously affected by the fall in commodity prices and the loss of the Soviet grain market. Exports for the first eight months of 1986 were $4.9 bn, down 18% from the same period in 1985, whilst imports were $3 bn (up 11%). It now seems that the 1986 current account deficit could be as high as $2.7 bn (cf $1.3 bn in 1985). The capital account surplus could be about $700 mn, after allowing for the repayment of $1.2 bn of arrears to external creditors during the year (which has reduced the total outstanding to $500 mn). For 1987 the Fund Staff has identified a $3.25 bn financing gap. They have suggested that $1.2 bn of this could be met by a Paris Club rescheduling of 1986 and 1987 maturities, with an additional $200-300 mn in the form of additional export credits, mainly from Japan. The commercial banks will probably be asked to supply the balance of $1.85 bn. Argentina's liquid reserves fell to about $1.5 bn (4 months' imports) at end-1986 and, with a $300-400 mn bond repayment falling due shortly, could fall by a further $1 bn in 1987 Q1. Because negotiations with bank and official creditors are progressing only slowly, the IMF MD has canvassed support for an official bridging loan to be arranged under the auspices of the BIS. The UK does not propose to participate (the UK did not take part in two earlier bridge loans for Argentina), but will not stand in the way of its arrangement.

15 The Advisory Committee failed to reach agreement with the Venezuelans by the end of 1986 over the proposed amendments to the MYRA covering $21.2 bn of public sector debt. Instead, the banks granted a 90-day deferral on all payments due in Q1 1987, in order to allow more time to reach a satisfactory agreement; but the Advisory Committee insists that agreement must be reached by end-March. The Venezuelans have requested a one year grace period (1987) on their MYRA repayments, and much reduced payments in 1988 and 1989; they have also requested a reduction in the interest rate spread from 1 1/8% to 3/8% above Libor. The banks have yet to reach agreement amongst themselves how to respond, but the $750 mn downpayment necessary to activate the MYRA has been made. Meanwhile, although the private sector debt scheme has now become law, many banks still feel that some of the issues have not been settled satisfactorily. Talks are continuing between the Central Bank and Advisory Committee representatives, but the banks are likely to have to accept the scheme as it stands. The Venezuelan authorities announced that real GDP growth was a rather surprising 3.1% in 1986, following the IMF projection (in June) of nil economic growth and their own forecast (made in November) of 0.8%. Inflation in 1986 was 11.5% (cf the IMF target of 11.9%). Oil export revenues fell by $5.5 bn to $7.2 bn in 1986; non-oil export revenues were up 13% on the previous year. A current account deficit of $2.3 bn was recorded in 1986 compared with a surplus of $2.9 bn the year before. Gross reserves fell to $9.85 bn at end-1986 (cf $13.75 bn at end-1985), of which $4.3 bn are regarded as operating reserves. Even with the proposed amendments to the MYRA, the Venezuelans are forecasting overall balance of payments deficits of $3.6 bn in 1987 and $1.5 bn in 1988; allowing for a reduction in reserves, they are forecasting a financing requirement of $3.5 - $4 bn for the 1987-88 period.

16 There still appears to be a stalemate between Peru and the banks' Advisory Committee. The Committee remains unwilling to negotiate until the authorities make a payment equivalent to 10% of outstanding interest arrears (some $650 mn at end-1986), and has discussed cutting short-term trade and working capital lines ($320 mn, on which Peru has remained current) to put further pressure on the authorities. The latter have reiterated their policy of limiting debt service payments on medium- and long-term debt to 10% of export revenue, but are seeking to reach agreements whereby up to an additional $240 mn would be repaid in goods this year. Most creditors have shown little interest, although four agreements have been reached with Soviet bloc countries. On the domestic front, a surge in domestic demand boosted real GDP growth in 1986 by 8% (1.5% in 1985) and the PSBR remained between 4-5% of GDP, excluding arrears. Higher domestic demand and the over-valued exchange rate have, however, weakened the trade balance, which may

register a deficit for 1986, and gross international reserves were a reported $2.2 bn at end-November (11 months' imports, cf $2.5 bn at end-1985). There were no new IDB loans to Peru in the year and the IBRD is reported not to be planning any new lending at the moment.

17 No significant progress has been made in Cuba's negotiations with external creditors. On 26 December, the government announced an austerity package aimed at improving the country's hard currency position in 1987. The main measure was a sharp increase in fuel prices to reduce domestic consumption. Ecuador will be having discussions with the banks about easing the repayment schedule on the banks' $4.7 bn MYRA (signed in December 1985). The country's official MYRA is also off-track, and at some stage the Ecuadoreans will have to renegotiate. Meanwhile, the country is close to agreement with the IMF to extend the SBA to the end of 1987. However, recent events (the kidnapping of President Febres Cordero and its consequences) underline the weakening position of the government. This raises considerable doubt about the future effectiveness of economic management and will render debt negotiations much more difficult. The Guyanese authorities have been continuing talks with the Fund about an SBA. However, before the Board can approve an adjustment programme, Guyana will have to eliminate its SDR 50 mn of arrears to the Fund; the Fund will also need to be satisfied that the overall financing gap (estimated by the IBRD at $157 mn in 1987 and $100 mn per annum in 1988-90, after rescheduling) can be met from external sources.

18 Negotiations continue between Chile and the commercial banks about covering $650 mn of the $1.2 bn financing gap: the banks have suggested that they provide only $450 mn with the Paris Club providing $150-$200 mn. The Paris Club has expressed its unwillingness to agree a second rescheduling, given its exceptional undertaking to maintain cover in its previous rescheduling agreement with Chile in July 1985. However, the Chilean authorities have indicated that they will have to approach the Paris Club again. The IBRD is reportedly considering various co-financing mechanisms to try to break the deadlock. All IMF targets for 1986 are likely to have been achieved. Real GDP growth in 1986 was 5% (cf an IMF target of 3-5%), whilst the public sector deficit was on target at 2.2% of GDP (cf 2.6% in 1985). The trade surplus may exceed the target of $1 bn (it was $946 mn up to mid-October). Inflationary pressure has been increasing, and the year-on-year rate in December was 17.4% (but still just within the IMF target range of 15-18% for 1986 as a whole). On 2 December the IDB approved a $319 mn loan for Chile for a hydro-electric project.

Jamaica and the IMF have reached agreement on a new 15-month SBA for an estimated SDR 110 mn. Targets under the agreement include the reduction of inflation from a projected 12% in FY 1986-87 to 7% in FY 1987-88; the reduction of the central government borrowing requirement from 6.4% of GDP in FY 1986-87 to 3.3% in FY 1987-88; and a 10% ceiling on annual wage rises. The programme does not include a devaluation (which had previously been urged by the Fund and had been a major stumbling block) at this stage, but the government has introduced a tax rebate scheme to encourage exporters. The Fund Staff hope to bring the SBA (together with a CFF request) to the Board in late February. Meanwhile, Jamaica cleared its SDR 50 mn of outstanding arrears to the Fund on 13 January from the proceeds of forward sales of bauxite. Agreement with the Fund on a new SBA will enable Jamaica to draw on recently-agreed IBRD loans totalling $60 mn.

20 The Colombian economy performed well in 1986. Real GDP grew by an estimated 5%, whilst inflation fell to 21% (cf 22.5% in 1985). The PSBR fell from 3.7% in 1985 to 1.7% of GDP in 1986. Shortly before Christmas, the Colombians drew $318 mn of the final $361 mn tranche of the $1 bn commercial bank loan. The IMF "enhanced monitoring" arrangement expired at end-1986 and will not be renewed. The Uruguayan economy also generally performed well, achieving a 1986 trade surplus of $234 mn, with exports of $1,056 mn (up 25% on 1985) and imports of $822 mn (+15%). Foreign exchange reserves grew strongly and GDP growth was about 5%. The Advisory Committee met the Bolivians early in January to discuss the possible repurchase by Bolivia of its commercial bank debt; they are shortly to telex all banks requesting their approval of an amendment to the original loan agreements to allow repurchases. The source of finance for the repurchases has yet to be resolved.

21 The December meeting of IDB Governors to discuss the 7th Replenishment agreed that the lending programme would be between $20-25 bn, up to 25% of which would be allocated to sector lending. The precise size of the Replenishment and the voting structure within the Board of Governors are expected to be decided at the next meeting (in Washington on 17-20 February). Loan approvals in 1986 amounted to only $3 bn, the lowest annual level since 1982, bringing the total under IDB-6 (1983-86) to $12.7 bn.

South and East Asia

22 The negotiations between the Philippines Government and its major commercial creditors scheduled for 6 January were postponed at the last minute. Both sides seemed to accept that another meeting would prove futile at that time since there

was no apparent compromise available. The banks, however, agreed to another 90-day standstill on repayment of debts maturing from 1 January 1987, and to extend the $4 bn trade facility for another 6 months. The banks also ruled that a prospective agreement would be retroactive to 1 January 1987. With the constitutional Plebiscite now out of the way, a meeting is being arranged for later this month. Meanwhile on 22 January, the Paris Club agreed to reschedule 100% of principal and 70% of interest on $870 mn of Philippine debt over 10 years with 5 years' grace. During this period, the Government has been adopting an aggressive stance on debt. Finance Minister Ongpin has intimated that legal sanctions may be applied against Citibank in retaliation to its stand at the abortive negotiations in November, and stated that the Philippines would discuss joint action on debt with Brazil and Argentina. Real GDP is estimated to have grown by 0.1% in 1986, following the sharp falls in the previous two years, and the Government is aiming for a growth rate of around 6% in 1987. However, a level of 3-4% (roughly in line with the IIF's recent forecast) seems more likely.

23 Malaysia's latest figures show a trade surplus of US $2.3 bn in the first ten months of 1986 (cf US$3.4 bn for 1985 as a whole). However, the outlook for 1987 appears relatively gloomy, despite the recent recovery in oil and tin prices. Real GDP is set to increase by no more than 2%, following only 0.5% growth in 1986. In Indonesia the 1987 Budget was presented on 6 January. Real government expenditure was cut by an estimated 4% in rupiah terms, although the decrease was nearer 17% in US dollar terms. On the assumption of an oil price of US$15 pb, the budget deficit is expected to widen to Rp 5.5 bn (6.9% of GDP), compared with Rp 3.6 bn (4.5% of GDP) in 1986. The budget is regarded by bankers to be as austere as is politically possible. Nevertheless, concern is mounting about the debt-service ratio, now variously estimated at between 35% and 40%. A US$350 mn syndicated loan was agreed before Christmas with an 8-year maturity, a 5-year grace period and a 5/8% spread for the first 6 years and 3/4% for the remaining two. An initially lukewarm response put paid to suggestions that the authorities would seek to raise the amount to US$400 mn.

24 In marked contrast, a US$300 mn syndicated loan for Thailand, proved so popular that the amount was increased to $350 mn. Meanwhile a new US$30 mn "Thailand Fund" has been launched to channel foreign investment into the Thai Stock Exchange. This comes shortly after Merrill Lynch doubled the size of its Bangkok Fund to US$30 mn. GDP growth is set to increase to 5 1/2% in 1987 following the 4 1/2% recorded in 1986. South Korea's prospects continue to appear very promising. The current account surplus of US$4.5 bn in 1986 enabled Korea to achieve a cut in its

foreign debt, from US$46.8 bn in December 1985 to just under US$46 bn at the end of last year. Assuming that Korea achieves a projected US$5 bn current account surplus in 1987, the Finance Ministry expects external debt to fall to US$42.3 bn by the end of the year. GNP growth is forecast at 7.5% in 1987 after an exceptional 12.2% in 1986.

Eastern Europe

25 The Poles met official creditors in Paris on 23 January but failed to reach agreement. The Poles indicated that they expected to have around $325 mn available for official creditors in 1987 as a whole, compared with the Paris Club's expectations of around $550 mn in the first half of the year. At the end they were handed a letter setting out the Paris Club's proposals for consolidating arrears and payments due under various arrangements, but requiring the Poles to implement in full the 1981 agreement. A visit to Warsaw by Whittome (IMF) earlier in the week had revealed sharp differences over the timescale of economic adjustments the Poles were to make. Nevertheless, the IMF will return to Warsaw in the Spring to begin exploratory discussions on a Standby. Hungary's performance in 1986 was dismal, with a convertible currency current account deficit expected to be well in excess of $1 bn (4% of GDP). Banks (which may not be aware of the size of the deficit) still do not seem very concerned; however, although the $200 mn 8-year credit currently being arranged has been fully underwritten, the general syndication may prove more difficult because of the aggressive terms (Libor +1/4%). Yugoslavia's poor economic performance in 1986 gives cause for serious concern; the surplus on the convertible currency current account is unlikely to have reached $400 mn. Despite earlier reports that the financing gap appeared to have been closed with the aid of substantial unidentified capital inflows, and no reports of any arrears, new balance of payments and national accounts data show substantial revisions; these indicate a much less favourable picture than seemed likely even at the time of the Fund Article IV mission in December. The Article IV report will have to be rewritten, and Fund discussion postponed. This casts doubts over the implementation by governments and banks of the next stages of their respective rescheduling packages. The outlook for 1987 is not good, with the Fund projecting a financing gap of around $0.8 bn.

26 Romania on the other hand appears to have ended the year relatively well. The current account surplus appears to have exceeded the target of $1.2 bn, enabling the clearing of arrears with both the IMF and IBRD (reports of new arrears with the IMF in January probably only reflect normal Romanian practice of late payment) and some

recovery in reserves. Following rejection of their earlier request to official creditors to reduce interest margins, the Romanians have informed them that they want to prepay the remaining balances under the 1982 and 1983 rescheduling agreements (around $340 mn, of which some $150 mn is due this year). If the Romanians proceed along these lines it will imply a very tight liquidity position throughout 1987. The move would be very unpopular with the banks, who would be bound to see the relief given by their agreement of last September to re-reschedule $750 mn as having been used to pay out the official side, and the banks could be expected to be correspondingly reluctant to lend further support should the Romanians seek it in the future.

Southern Europe

27 In Greece the current account deficit last year was reduced to $1.8 bn (4.6% of GDP) from $3.3 bn (10% of GDP) in 1985, but the near-achievement of the $1.7 bn target was only as a result of weaker oil prices and increased transfers from the EC. The import deposit scheme is to be completely removed by end-April, and export subsidies are to be phased out gradually by means of a substantial reduction this year and further annual steps to complete removal by the beginning of 1990. Following the EC Finance Ministers' agreement in December, the second half of the ECU 1.75 bn Community Loan is expected to be disbursed in March or early April, but the progress of the Greek economy is to be monitored on a quarterly basis by the Monetary Committee.

Sub-Saharan Africa

28 Nigeria's 1987 budget, announced on 2 January, maintains the tight fiscal policies required under its structural adjustment programme. The government's announcement of its intention to limit debt service to 30% of export earnings is thought to be only for domestic political consumption. Meanwhile, the authorities have reduced the amount of foreign exchange available at the weekly auction, and the rate is moving towards N4=US$1 (having earlier rebounded to N3=US$1). However, the country failed to secure critical mass (now defined as 90%) of commitments from the banks within the 30 days given by the approval in principle of the SBA. A two week extension was agreed to 26 January, but responses have been slow. A particular difficulty has been the reluctance of the Japanese banks to participate in the new money element of the package. The SBA was nevertheless made effective by the IMF Board on 30 January on the basis of commitments received (about 87%), but there are likely to be further difficulties over Nigeria's failure to make the payment of

interest (about $30 mn) due on 5 January to holders of promissory notes under the scheme to reschedule uninsured trade arrears; discussions of detailed proposals of a revised payments schedule are expected to begin shortly.

29 The South African Standstill Co-ordinating Committee has been touring Europe and the US to see the major creditor banks. The commercial banks in the Technical Committee see advantage for themselves and South Africa in starting negotiations for the next roll-over of commercial bank debt ahead of the scheduled meeting in April (which could clash with the planned general election for the White electorate). The SCC has yet to give its response to the idea. However, some banks appear to have been irritated by the SCC's tactics of trying to play off the banks against each other. Despite further consultations in November between Fund staff and the Sudanese authorities, there is no sign that the two sides are any nearer to reaching agreement on a Fund-backed adjustment programme. The Article IV discussion revealed little progress.

30 Zambia continues to face serious financing difficulties. The Zambians are actively seeking bridging finance to cover IMF arrears (which currently stand at SDR 130 mn), so that either their Fund programme can be re-instated or a new programme can be negotiated. Commercial bank bridging finance to clear the arrears may be obtainable, but only if the banks can be assured that a viable Fund programme can be put in place. For their part, Fund staff have drawn up a scenario for 1987 which - even assuming disbursements from the Fund and World Bank as well as generous Paris and London Club reschedulings - still leaves a financing gap of SDR 57 mn. Zaire has recently improved its relations with the IMF and IBRD, despite the announcement last October of a debt servicing ceiling. The engineered depreciation of the zaire by 11.6% in January appears central to this improvement, and negotiations on a new IMF programme are expected to begin soon. On the IBRD side, the first tranche of an industrial Sector Adjustment Loan, agreed last June, now been disbursed.

Middle East & North Africa

31 Following the informal meetings of the Paris Club and of IMF Executive Directors to discuss Egypt, on 17 and 22 December respectively, official creditors and the Fund have embarked on a course which they privately acknowledge has little prospect of success in the medium term. A Fund Mission arrived in Cairo on 15 January with instructions to agree a Letter of Intent, despite the authorities' continuing reluctance to accept Staff recommendations for early corrective action on exchange

rates, energy prices and, in particular, interest rates. An exceptionally generous Paris Club-style rescheduling is expected which, for political reasons, is likely to be dealt with outside the Club. A meeting of a consultative group of donors, probably to be chaired by the IBRD, is also envisaged to ensure that the prospective external financing gap will be closed for at least the period of the initial eighteen-month Standby.

32 Consequent upon the banks' signing of an agreement on 15 December with Morocco, to reschedule their 1985-88 debt, the IMF approved a 16-month SDR 230 mn Standby arrangement the next day. The first review under the Standby, which is scheduled for mid-February, seems likely to reveal that the Moroccans failed to meet the stipulation that external arrears should be reduced to a maximum of SDR 375 mn by end-December 1986. Syndication of Algeria's latest loan (progressively scaled down to $250 mn) arranged by BNP, proved difficult, but the deal was eventually signed on 19 December. The authorities are reported to be seeking further borrowings via a £75 mn bankers' acceptance facility for the state oil company and a $100 mn credit for the state-owned commercial bank. Against the background of growing external difficulties, the authorities continue to demonstrate the will to adjust: they have announced a budget for 1987 which envisages a deficit of some $2.5 bn (5% of GDP), $500 mn less than the revised figure for last year, and a further 17% reduction in imports.

33 Iraq's payments problems continue, with latest reports indicating that the vast majority of letters of credit remain unpaid, including a number payable through Rafidain's London branch. A recent report has estimated that Iraq's total indebtedness was (mid-1986) at least $55 bn, and, more importantly, that debt other than that to the Gulf Co-operation Council may be $26 bn (including $19.4 bn of trade credits).

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INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1986*	End-June 1986	End-September 1986 [2]	End-September 1986 [3]
Latin America				
Argentina	51	2.8(0.2)	0.2	0.2
Brazil	104	6.3(1.4)	1.0	1.8
Chile	19	1.4(0.1)	-	0.1
Colombia	15	0.5(0.1)	0.1	0.1
Ecuador	9	0.5(0.1)	0.1	0.1
Jamaica	4	- (-)	-	-
Mexico	103	6.2(0.5)	0.6	1.2
Peru	14	0.3(-)	0.1	0.2
Uruguay	4	0.3(-)	-	-
Venezuela	35	2.1(0.1)	-	-
Far East				
Indonesia	42	0.7(0.3)	0.8	1.6
Malaysia	21	1.2(0.3)	0.1	0.1
Philippines	27	1.4(0.1)	0.1	0.2
Thailand	18	0.3(0.2)	0.1	0.1
Eastern Europe (convertible currency)				
Hungary	14	0.4(-)	-	0.1
Poland	34	0.5(-)	1.2	1.3
Romania	6	0.2(-)	0.3	0.4
Yugoslavia	19	0.9(0.1)	0.7	0.9
Southern Europe				
Greece	18	1.3(0.1)	0.2	0.3
Turkey	27	0.5(0.2)	0.2	0.5
Sub-Saharan Africa				
Cote d'Ivoire	8	0.2(-)	-	0.1
Nigeria	21	1.1(0.1)	2.2	3.1
South Africa	20	3.6(0.4)	0.8	2.5
Sudan	10	- (-)	0.2	0.2
Middle East and North Africa				
Algeria	23	0.3(0.1)	0.2	0.4
Egypt	45	0.2(0.2)	0.3	1.2
Israel	30	0.4(0.1)	0.1	0.2
Morocco	17	0.2(-)	0.2	0.3
Oman	3	0.1(-)	0.7	1.9
Saudi Arabia	n/a	0.6(0.4)	0.2	0.3

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[1] Defined as consolidated external claims including portfolio investments with a contractual repayment date, adjusted for certain inward and outward risk transfers in respect of guaranteed loans, plus any net claims on local residents in local currency. Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans. Other portfolio investments in these 29 countries amounted to $21 million at end-June 1986.

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

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

* current estimate

2099k 28.1.87

OVERDUE FINANCIAL OBLIGATIONS TO THE FUND*

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding (SDR mn)
Kampuchea	13 March 1975	28.9#
Guyana	31 May 1983	50.3#
Viet Nam	6 February 1984	60.1#
Sudan	12 July 1984	323.8#
Liberia	25 January 1985	97.5#
Peru	9 September 1985	131.9#
Zambia	30 April 1986	140.0
Somalia	29 October 1986	3.2
Romania	6 January 1987	34.0
		869.7

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 972.1 mn as at 12.1.87 but this figure is not divided country by country.

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

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

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INDEBTEDNESS

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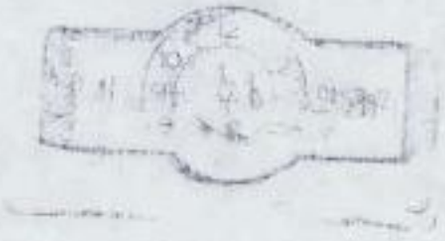

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Prime Minister
CDP
23/12

Charles Powell Esq
10 Downing Street

22 December 1986

Dear Charles

INTERNATIONAL FINANCIAL SCENE

I attach the regular report on developments in the international debt scene. The timing of this report offers a useful opportunity to take stock of the past 12 months and to try to identify the likely problems for 1987.

World economic developments in 1986 were dominated by the fall in oil prices. Its benefits came through more slowly than anticipated while its negative impact on the major oil producing debtors (Mexico, Nigeria and Egypt) was felt immediately. Growth rates in aggregate were adequate, while other positive factors were the fall in interest rates and dollar depreciation.

Looking ahead to 1987, the overall world economic outlook is a little gloomier than it was at the time of the Bank and Fund meetings in September. There has been some firming of oil prices but a number of negative features seem likely to continue, in particular poor terms of trade for developing countries as a result of low commodity prices and uncertainties over future developments in the US economy. Debtors, particularly those in Latin America, could be harmed either by a reduction in the US trade deficit or by increasing protectionism - in which context a new US Trade Bill seems increasingly likely.

On the narrower debt front, the main anxieties of 1986 were oil related. This resulted in a heavy concentration during the year by banks, governments and international financial institutions on those debtors hardest hit by the fall in prices: Mexico, Nigeria and Egypt. However, by the end of 1986, both Mexico and Nigeria had come into the fold with agreed IMF programmes, Paris Club and commercial bank reschedulings. Next year, Brazil, which during 1986 was pushed backstage by the problems of others and, until recently, by its own good external position, seems likely to come to the fore again as a major problem.

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Apart from individual country problems, in particular Brazil, Egypt and the Philippines, three broad issues seem likely to dominate the debt scene next year. First, what impact will absorption of the lessons of the Mexican negotiations have on perceptions of the overall debt situation and its handling. Our last report suggested that the banks would not want a repetition of the bruising they felt they had suffered in that exercise, while government creditors would be likely to want the exceptional features of the Mexico package trimmed back. In current negotiations debtors and creditors variously assert that the Mexican package either is or is not a precedent. Although there have been public indications of a shift in commercial bank attitudes, we will not know how far these attitudes, whether to the provision of finance or towards IMF leadership in such packages, have changed in practice until we come to the crunch in new negotiations.

Second, has the Fund lost direction? In a number of current discussions, particularly on Egypt and Brazil, but also in relation to Mexico and Jamaica, there are signs of the Fund Board accepting weak programmes. It is not yet clear whether this is a temporary feature attributable to a lame duck managing director or, as seems to be the case with Egypt and Brazil, to a shift in approach on the part of some major G5 countries. The departure of the Fund's managing director, de Larosière, will not help in this context.

Third, there are the problems of Sub-Saharan Africa where in many cases there is little chance of their becoming creditworthy or attracting spontaneous flows of new investment capital. The debt issue here is not a systemic one but the possible need for a different approach to these problems is already surfacing on the international agenda. We shall be giving it more thought.

Finally, 1986 saw little by way of political confrontation between debtors and creditors. In 1987 there may be greater politicisation with pressure not only from the developing countries in UNCTAD and elsewhere but possibly also within the G5/G7 where Mitterand, with Italian encouragement, may try to relaunch his recent North/South ideas at the Economic Summit.

All in all a heavy burden for the new Managing Director.

On individual countries, the following points are worth noting. Brazil's Paris Club debts were discussed last week in the light of the qualified "certificate of approval" given by the Managing Director following the recent Article

IV review and the latest (Cruzado II) economic measures. The creditors agreed to negotiate next month a limited short term rescheduling of 1985 and 1986 arrears but made it clear to the Brazilians that any longer term debt settlement covering 1987 or beyond must be based on a proper SBA or a closer (albeit ill-defined) relationship with the IMF. This partial approach reflects a shared concern among all government creditors about the prospects for the Brazilian economy and in particular the adequacy of the Cruzado II measures and the political constraints on any necessary further policy measures. This was evidenced by the Brazilian reluctance to promise now that they would remain current throughout 1987 when they face considerable cash-flow problems.

The Paris Club also reached a comprehensive agreement with Nigeria, broadly in terms of the original Nigerian requests but after a very difficult meeting. The deal includes rescheduling of 100% of principal and interest payable up to 31 December 1987 over 10 years with 5 years grace, 100% rescheduling of short term debt accrued in 1983 over 8 years including 3 years grace and 90% of short term debt accrued since 1983 over 4 years including 1 year's grace. The outcome on the 1983 short term debt will effectively set the pattern for renegotiating the promissory notes and claims of the uninsured creditors. At a late stage in the negotiations new figures were put forward for the size of the financing gap. Once the IMF have got to the bottom of this we shall need to consider urgently the proposals already discussed for new cover.

The very difficult position we face on Egypt was set out in the Chancellor's minute of 15 December to the Foreign Secretary. The next stage here is the informal Fund Board meeting today to discuss ways of meeting the 1987 financing gap. The Paris Club agreed a common approach recognising the Egyptians' need for rescheduling over a number of years once agreement was reached with the Fund.

Finally, among the recent developments covered in the report below, it may be worth noting the worsening of the economic position in Indonesia in recent months and the consequent deterioration in sentiment towards that country, which is now the world's fourth or fifth largest debtor.

I am copying this letter to Tony Galsworthy (FCO), Tim Walker (DTI) and John Footman (Bank of England).

Yours ever,
Tony Kuczys

A W KUCZYS

INTERNATIONAL FINANCIAL SCENE

1 Commercial bank commitments to their agreement with Mexico reached the "critical mass" (90%) on 19 November. This, together with the subsequent IMF Board approval of Mexico's SBA, has permitted disbursements of various elements of the Mexican financial package. Disbursement of the banks' new money, however, still requires the commitment of a large number of smaller banks that have so far been reluctant to participate.

2 Meanwhile, a number of the concessions and innovations which have been required in order to put the package together - in particular the reductions in spreads, the growth contingency facility and the oil price contingency facility - are themselves causing difficulties in other debt negotiations. A number of debtor countries - including the Philippines and Argentina - have indicated that they regard the Mexican agreements as a precedent, and that they intend to secure equal - or better - terms for themselves in the face of insistence from the commercial banks that the Mexican agreements were an unrepeatable special case. At the same time, the IMF has, in the last couple of weeks, modified its earlier insistence on particular adjustment measures in a number of countries: the Fund MD has indicated his willingness to consider a programme for Jamaica that does not require an immediate devaluation of the currency, and Fund Management have been urged by Directors to put together a programme for Egypt despite there being considerable doubts over whether it will be possible to fill future financing gaps.

3 Whilst debtors see Mexico as a precedent, many banks are resentful at what they feel they have been forced to concede for Mexico. This is likely to manifest itself in widespread reluctance to participate in any further significant "involuntary" new money packages. There is particular resentment among the banks at what they perceive as the IMF endorsement, without prior consultation with them, of concessional terms proposed by debtors. This could affect banks' willingness to accept IMF leadership in future debt negotiations. As noted above, even participation in the Mexican package itself is to date far from universal: although 93% of the required new money has so far been committed (including a similar figure for the UK share), under 300 of the total of almost 500 banks involved have so far agreed. With banks now better capitalised than earlier, and having made substantial provisions against problem country debt, many feel less constrained in

their negotiations with debtor countries. With markets in secondary debt apparently now growing in significance, many banks are seeking to pass on their problem debts. The withdrawal of banks from the rescheduling process raises questions about the principle of burden sharing which has characterised debt negotiations to date; on the other hand, this reallocation of debt portfolios has a number of important benefits, and has been widely seen as providing a significant route for ameliorating debt problems.

4 Whilst some of these developments had been largely foreseen, concern over their implications had been to a certain extent mitigated by perceptions that the position in other major debtor countries was relatively favourable, so that no further financing packages of the scale of that arranged for Mexico were in immediate prospect. In particular, the Austral Plan in Argentina and Cruzado Plan in Brazil have been widely interpreted, despite some misgivings, as indicating that the authorities in those countries were committed to tackling their countries' economic difficulties, which would reduce further financing packages. The recent deterioration in economic performance in those countries is therefore all the more worrying. Argentina's monthly inflation rate rose to an average of over 6% per month between September and November. The current account has deteriorated this year, with the deficit expected to be $1.6 bn (cf $1.3 bn in 1985). Latest estimates suggest that the country may have to seek well over $1 bn in commercial bank new money in 1987. In Brazil too inflation is causing some concerns (1.9% in October after 1.7% in September). More striking, however, is the sudden deterioration in the country's external position. After seeming until recently to be on track for achieving the earlier forecast of a $12.3 bn trade surplus for the year, Brazil's surplus for October fell to only $210 mn, and first reports put the November figure no higher than $200 mn. The IMF forecast for the year has been revised down to $10.5 bn. Clearly, any indication that the Brazilians are in serious difficulties would, especially given the attitude of creditors after the Mexican package, be extremely serious. On the positive side, it seems that the Brazilians are aware of the dangers they face: on 21 November, immediately after the Congressional and Gubernatorial elections, the authorities introduced a wide-ranging austerity package designed, inter alia, to cut 3 1/2% of GDP from the fiscal deficit in 1987, and including the introduction of crawling-peg devaluations, intended as a step towards restoring the country's competitive position. However, the public reaction to the new measures has been extremely hostile.

5 Elsewhere, attention has concentrated on a number of other oil exporters. Having achieved agreement on their official bridging loan, which was repaid on December 10, and on a term sheet with the commercial banks, the Nigerians conducted

a short roadshow at the beginning of December. The Nigerian SBA was approved in principle by the Fund Board on 12 December despite some concerns over the operation of the second-tier foreign exchange market. Meanwhile Egypt's new administration presented a package to Fund management which falls well short of the measures recommended by the IMF staff, and it has seemed increasingly unlikely that a financially viable programme could be devised which the Egyptians would find politically acceptable. But because of the risks arising from a breakdown of negotiations, creditor governments, including the G5 except for the UK, have given Fund Management some encouragement to reach agreement with the Egyptians on a softer programme than that recommended by the staff, despite the wider ramifications for the Fund. Even the staff's tougher programme would still leave the current account deficit as high (in absolute terms) in 1992 as in 1985. Venezuela has continued to irritate the banks with its unco-operative stance, particularly in negotiations over private sector debt, although it has now passed legislation on private sector debt which is likely to be accepted. And there is increasing concern over Indonesia's economic situation. Whilst the authorities' firm response to the collapse in oil prices was initially reassuring, the underlying deterioration in the country's economic position is now becoming more apparent. The current account deficit may exceed $5 bn this year and is unlikely to improve significantly in 1987; the debt service ratio is expected to rise to 35% this year (cf 26% in 1985). The authorities may have to consider an IMF Standby; the Fund has apparently persuaded them not to use the fall in oil prices as the basis for seeking a CFF, despite the precedent for Ecuador, because of the opposition this would encounter in the Board.

6 Amongst other oil-importing debtors, the picture has been mixed. Morocco has reached agreement on a MYRA with the banks covering maturities of 1985-88. On the other hand, Zambia is facing serious difficulties in obtaining bridging finance to clear its growing arrears to the Fund. After serious food riots, the country has had to rescind measures to eliminate subsidies, thereby throwing its Fund programme into further doubt.

7 The wider economic environment shows little change overall in the last six weeks. The cut in the Japanese discount rate in October was not followed by other major industrialised countries; 6-month eurodollar interest rates remained slightly over 6% for most of the period, and have risen a little in the last few days. Indicators of activity in the United States are mixed, but are on the disappointing side. Growth in the fourth quarter is projected at about 3% pa or slightly less. The US trade deficit for October, initially estimated at $12.1 bn, was somewhat better than expected; these figures are particularly prone to revision, but if they are unchanged they may indicate the beginning of some feed-through from past dollar

depreciation. If sustained, this could help dampen the rise in protectionist pressures in the US, although political factors point the other way. The dollar has weakened slightly since the end of October: on 17 December it was 11% below its level at the beginning of the year in effective terms; this leaves it some 30% below its February 1985 peak in effective terms, and roughly at its level of mid-1981.

8 Having risen in October, non-oil spot commodity prices resumed their downward trend in the five weeks to 9 December. The earlier rises seem largely to have arisen from temporary supply shortages, and did not reflect the underlying position in most commodity markets. Overall, the Economist index rose almost 5% in SDR terms (3% in $) in October, but lost 3% in SDR terms in the following five weeks, to stand 12.4% below its level of the end of last year. There were dramatic movements over the nine weeks in some food prices with higher vegetable oil seed, maize and sugar prices (coconut oil rose 38.2%, palm oil 20.7%, maize 32.4%, sugar 27.5%) offset by lower tropical beverage prices (coffee prices fell 21.9%, cocoa -6.8%). Overall, the food index ended 21% below its level of the end of last year. Agricultural raw materials are 1.4% higher, whilst metals are almost 10% below end-1985 levels.

9 There is in general increasing interest in innovative approaches to handling debt, with the debt equity conversion schemes introduced by a number of debtor countries attracting particular attention. The Paris Club too has been considering moving beyond its conventional refinancings for the poorer debtors. And the series of conferences on international economic issues organised by Congressman Kemp and Senator Bradley (who has proposed a limited write-down of debts) seems to be gaining recognition in some quarters. At the latest conference on December 4 and 5, Bradley proposed a limited trial of debt relief in parallel with the Baker initiative, although Baker and several bankers pointed out that debt relief and new money sat together very uneasily. The discussions on debt at the UN General Assembly produced no major confrontation, and a consensus resolution, reaffirming the Baker strategy and recognising the importance of the debt issue, was adopted. A Ministerial conference on Latin America's economic problems will be held in Mexico City, between 19-23 January, under the auspices of ECLAC, and will focus on national and international strategies and policies for promoting economic recovery and development.

10 In the period since mid-October two borrowings by East Bloc countries, totalling $355 mn, have been announced. Vneshtorgbank of the USSR is seeking a syndicated loan of $300 mn at Libor + 1/8% to 1/4%, slightly finer terms than on its two

borrowings earlier this year; there has however been some market resistance, reportedly because of the fine spreads. During this period the National Bank of Hungary issued fixed rate bonds to the value of $55 mn. Non-OPEC LDCs borrowed $770 mn in fourteen loans, whilst OPEC members raised a further $850 mn. Algeria's borrowing spreads in the syndicated credit market have widened to 5/8% from 3/8% earlier in the year, and a recent loan had to be reduced from $500 mn to $250 mn because of market resistance. Indonesia has raised $350 mn at LIBOR +5/8% to 3/4% although the drawdown period of the loan has been reduced from the four years sought by Indonesia to 18 months.

Further details on individual countries are given below.

Latin America and Caribbean

11 Commercial banks achieved the "critical mass" (90%) for Mexico's financing package on 19 November, having missed the 31 October deadline. The Fund Board subsequently gave the SBA final approval, immediately releasing SDR 225 mn. In anticipation of the critical mass, on 18 November the World Bank had approved disbursement of the first tranche ($300 mn) from the $500 mn Trade Policy loan, and the second tranche was approved on 5 December. Achievement of the critical mass made Mexico eligible for funds from various elements of the whole financing package - namely, further drawings from the bridging loans ($750 mn) and export credits ($1 bn) from Japan - and the Paris Club agreement of 17 September is now effective. However, the banks' Advisory Committee still need commitments from a large number of smaller banks and broad agreement on other matters before disbursement of the new money can occur.

12 Finance Minister Petricioli presented the draft 1987 Budget on 19 November; this was accompanied by a tax reform bill which should raise government revenue by 1.3% of GDP; the PSBR is projected to be 13.8% of GDP (cf 16.9% forecast for 1986). Amongst the Budget's underlying assumptions for 1987 are growth of only 2-3% (cf 3.5% forecast in the SBA) and inflation of 70-80%. Inflation continues to rise, reaching 104% year-on-year in November (the government now forecast 110% by end-year). Depreciation of the controlled market exchange rate continues, though at a slower rate than previously, and the differential with the free rate remains narrow (at 2%). However, the slower rate of depreciation seems to have discouraged public interest in Pagafes (dollar-linked peso securities introduced in August). The first auction gave a dollar yield of 4.3%; in response to weak demand, the yield rose subsequently to peak at 14.9% on 23 October, but auctions were suspended thereafter. External performance is better than expected; the current account for

January-August showed a $1.6 bn deficit (cf a forecast of $3.5 bn for the full year) and the Fund report that net international reserves at end-September were $1.2 bn better than expected. The January-August trade surplus ($3.4 bn) was 63% lower than in the same period last year; oil exports were down 59%, but non-oil exports were up 30%, while imports were down 9%. A Fund team was in Mexico in early December as part of the first review under the country's SBA. Early indications are that its report will be mildly optimistic.

13 Argentina's "Austral Plan" seems to be faltering as inflation continues to rise, reaching a year-on-year rate of 79.2% in November (cf 74.2% in October). The government, however, argues that price rises are under control; banking reforms introduced in October should strengthen the formal banking sector and permit tighter control over credit expansion. The real economy is recovering, and industrial production rose by 24% between 1985 Q3 and 1986 Q3, returning to peak mid-1984 levels. It seems that the revised PSBR target of 3.5% of GDP for 1986 will be missed because of expenditure overruns earlier in the year. The current account deficit for the year is now expected to be around $1.6 bn (cf $1.3 bn in 1985), and a further deterioration is expected for 1987.

14 Although Argentina is seeking an SBA (possibly for SDR 1-1.5 bn) to replace that which expired at end-June, the IMF and the Argentines are not close to agreement on a programme, and negotiations with the IBRD are also proving difficult. Argentina also is expected to need well over $1 bn from the banks in 1987; the Argentines met banks at the beginning of December, but some bankers are sceptical about the feasibility of a new money package. Meanwhile, Argentina has proposed a revision to Paris Club procedures for negotiating bilateral agreements which would involve them in launching a capital market issue (at a competitive market interest rate), guaranteed by creditor governments, instead of negotiating interest rates bilaterally.

15 The Fund Board discussed Brazil's Article IV on 10 December. The MD's summary expressed some concern on the country's economic programme. Meanwhile, there are increasing worries about Brazil's economic situation, including, for the first time since 1984, concern about its external performance. The external accounts have deteriorated sharply. The October trade surplus ($210 mn) was by far the lowest this year, and November is expected to be no higher. The IMF has revised down its 1986 trade surplus forecast from $12.3 bn to $10.5 bn. Cash reserves are understood to have fallen from $6.9 bn in July (6 months' imports) to between $4.5 bn and $6 bn in October (4-5 months' imports) and may have fallen to $4 bn at the end of November. Following its decisive victory in the November Congressional

and Gubernatorial elections, the government introduced a package of sweeping economic measures designed to dampen consumer demand, reduce the PSBR, and halt the recent rise of inflationary pressures (inflation in October was 1.9% compared with 1.7% in September). The package substantially increased the taxes on a wide range of products, and raised public service tariffs; in addition, the immediate closure or merger of 15 state enterprises was announced, with a further 32 closures in the coming months. Wage indexation provisions have also been revised so that only those who have received no increase since February will benefit from an automatic rise when the CPI rises by 20%. The package is expected to raise around Cz 120 bn in 1987 (3 1/2% of GDP) and is expected to eliminate the operational PSBR in 1987. However, the package has been poorly received in Brazil, although a general strike on 12 December against the measures failed to gain much support. Attention will now focus on Brazil's attempts to obtain a rescheduling agreement of $3.1 bn Paris Club arrears (1985-86 maturities) without an IMF programme.

16 Venezuela's proposed arrangements for handling its private sector debt were made law on 6 December, and now seem likely to be accepted by the banks, thus clearing the way for negotiations over amending the public sector MYRA. The Venezuelans are making the downpayment of $750 mn needed to activate the MYRA: $600 mn was paid in November, the remainder will be paid during December-January. Repayments under the MYRA should begin in January 1987, but the Venezuelans are seeking a longer grace period. The economy is generally performing poorly: real GDP is now expected to grow by only 0.8% in 1986, against earlier expectations of 3%, and gross international reserves declined by $0.8 bn from mid-September to mid-October (cf a $2 bn decline in the previous 9 months) to stand at $10.9 bn. On December 6, the government announced a 48% devaluation of the bolivar. The government has presented its draft 1987 Budget, which envisages a deficit of 2.3% of GDP. This seems to have anticipated an alteration to the terms of the public sector MYRA as it contains no provision for 1987 amortisation payments.

17 The meeting between Peru and the banks' Advisory Committee, and a token ($60 mn) interest payment, did not occur - as stipulated - by 25 November. In response, the banks have not disbanded the Advisory Committee, but are refusing to send an economic sub-committee to Lima, and a stalemate seems to have been reached. Meanwhile, the Peruvians have announced a further unilateral 3-month rollover (to 4 February 1987) of maturing public sector principal. President Garcia's APRA party strengthened its position in November's municipal elections. Garcia subsequently stated that debt service would continue to be only 10% of exports, that price controls would be maintained, and the exchange rate would not be changed before end-year. He also asked the business sector to co-operate with the

government in economic management. In 1987 the authorities are to employ monthly devaluations to depreciate the exchange rates by 30% over the year and have promised tax incentives to stimulate investment. The limit on debt service has boosted domestic economic growth, which is now officially forecast to be 8% in 1986 (cf 1.9% in 1985) - the highest rate for over 20 years. The government also expected to meet its inflation target of 66% for 1986 (cf 158% in 1985): year-on-year inflation in November is reported to be 60%. The end-1986 PSBR is expected to be 5.2% of GDP, hardly changed from 1985. Cuba and the banks' Steering Group have reportedly reached outline agreement on a deal to reschedule 1986 maturities and outstanding short-term deposits, although full details are not yet available. The banks have, however, rejected Cuba's request for $300 mn in new money to meet an estimated financing gap for 1986 of $600 mn. The Paris Club Task Force met the Cuban authorities on 18 November and made clear that the Club will not consider 1987 rescheduling needs until all non-rescheduled payments due under the 1986 agreement have been brought current. Ecuador is failing to achieve performance criteria under its current Fund programme. Relations between President Febres Cordero and the opposition-controlled Congress continue to be poor: Alberto Dahik, who had to resign as Finance Minister following impeachment by Congress after only three months in office as Finance Minister, has become the President's economic adviser. Meanwhile, it seems that lower oil prices will halve oil export revenues and reduce fiscal revenue by one-third. Ecuador's OPEC quota was raised by about 21%, to 221,000 bpd following October's OPEC Ministerial meeting, but this will involve significant cutbacks as Ecuador was producing an average of 286,000 bpd earlier this year.

18 Jamaica now seems rather nearer to reaching agreement with the IMF on a new SBA to replace that which was cancelled in July. The Fund have apparently made major concessions on the devaluation issue, agreeing that Jamaica need not devalue for 18 months, providing that targets for inflation and reserves are met. Jamaica is paying off its arrears to the Fund, and may be current by Christmas; its new SBA and proposed CFF could then come to the Board by late January/early February. It remains to be seen how long the new programme will stay on track, and how Jamaica's prospective 1987 financing gap will be filled. The IBRD Board met on 25 November to discuss Bolivia's medium-term economic strategy. This was discussed further in an IBRD Consultative Group meeting on 3-4 December, when the Bolivians also presented proposals for an anti-narcotics programme in the hope of attracting industrial countries' financial support. The Fund board discussed the SBA review and the CFF request on 15 December. Meanwhile, commercial bank creditors are awaiting an offer from Bolivia to repurchase its entire bank debt ($680 mn). Funding the repurchase may be a problem: Bolivia has told the banks that donor

governments will provide the finance, but it seems that no government has actually made such an offer. The Guyanese authorities have now formally approached the IMF and IBRD for their support in designing an adjustment programme. The IMF may make its support contingent upon the willingness of Guyana's other creditors to participate in a debt restructuring and financing exercise. In any event it is difficult to identify the source of the bridging finance which would be needed to pay off IMF arrears.

19 The Chilean economy is generally performing well: the January-September trade surplus was $0.9 bn, 50% higher than the same period last year, while industrial production in the nine months to September was 7.4% higher than in the same period last year. Chile's SAL2 loan ($250 mn) was approved by the World Bank Board on 20 November: the US abstained on human rights grounds, whilst the UK voted in favour, on technical grounds. The first tranche ($150 mn) will be disbursed by end-year, and the loan's approval means that the last tranche ($50 mn) of the $1.1 bn bank loan can be disbursed. On 2 December the IBRD approved a $400 mn project loan. Meanwhile, negotiations are under way with the banks regarding 1987-88 financing needs, forecast by the Chileans at $1.2 bn, with $650 mn expected from banks. The banks, for their part, have urged Chile to approach the Paris Club to cover about $200 mn and reduce their own provision of finance to some $450 mn. Some banks are also concerned at the Chilean proposal that interest should in future be paid only annually in arrears, fearing that this might be the first step towards capitalisation. Colombia's economy is performing well. The Fund Board considered the 1986 Article IV and Review of the 1986 Economic Programme on 1 December: all performance criteria to end-September had been met and the end-December criteria were likely to be met. The "enhanced monitoring" arrangement lapses at end-year, and may not be renewed. Real GDP is expected to rise by 5%, against 2.8% last year; while inflation of 20% is forecast for 1986, against 22.5% last year. The PSBR is likely to be 1.6% of GDP this year, against 3.7% in 1985. High coffee prices have helped the external accounts and coffee exports for 1986 are forecast to be $2.9 bn (cf $1.7 bn in 1985), producing a much increased trade surplus of $1.7 bn (cf $0.1 bn in 1985). The current account is now projected to show a $0.4 bn surplus against a $0.3 bn deficit originally forecast. On 9 October, Colombia eventually made a first drawing ($639 mn) from the $1 bn bank loan arranged last year; there is no clear indication when the remainder will be drawn, though the existing termination date is end-1986. Uruguay's economy is also performing well: all SBA performance criteria for the first 3 quarter have been met; and real GDP in H1 was 5.8% above H1 1985, against a forecast of 3-4% growth for 1986. However, inflation is still a problem, and was 78.5% in the twelve months to October (cf an IMF target of 45% for 1986).

South and East Asia

20 The Philippine commercial bank debt rescheduling negotiations collapsed on 7 November. The major stumbling block was the Mexican precedent, with the banks determined that it should not become the norm for all future reschedulings and the Filipinos equally determined that it should in their case. Effectively the Philippines wanted to put almost all their debt onto a 20-year maturity with seven years' grace, at a margin of LIBOR +5/8%, together with an undefined "growth facility" to achieve 6.5% pa. economic growth. The Advisory Committee's counter proposals of a much more limited rescheduling at a spread of 1 3/8% were dismissed by the Philippine delegation, and further discussions within the Advisory Committee failed to persuade Citibank and Bank of Montreal to come down from 1 3/8% to 1 1/8% as a final offer. However, it appears that the banks are now prepared to make an offer of 1 1/8% and wish to reopen negotiations. The next meeting may take place in the first week of January. Economic Planning Minister, Mrs Monsod, has suggested that the government should toughen its stance by declaring a "partial moratorium" on interest payments, but it is not clear how much support she commands within the government. The new agreement with the IMF was approved on 24 October, and the Philippines is to be considered by the Paris Club at its January meeting.

21 Various indicators point to a marked deterioration of the economic position in Indonesia in recent months. In particular, earnings from oil and gas are expected to be about half their level in 1985, a drop of some $6 bn. The current account deficit may exceed $5 bn this year, and the debt service ratio is forecast to jump from 26% last year to 35% this. In the absence of a sustained increase in oil prices it may prove impossible to reduce the current account deficit significantly in 1987. September's devaluation has now been followed up with a series of measures designed to boost investment and non-oil exports, but only a small stimulus can be expected next year. The authorities may have to consider an IMF standby, despite their sensitivity to outside monitoring and the still healthy reserves position. Apparently Fund Management has argued successfully against a CFF.

22 In Malaysia the budget for 1987 was less tough than had been generally expected. Although development spending is to be slashed by 25% and overall Federal Government spending by 11%, an "operational" deficit will emerge for the first time and the consolidated public sector deficit will not be cut significantly from the 19% of GNP expected in 1986. Official projections indicate an 11% drop in per capita income in 1986, so that further measures would be bound to exacerbate the country's social and political difficulties. However, Malaysia is still well regarded in the international markets, where a $500 mn syndicated loan was arranged in early October on fine terms.

23 Thailand's impressive economic recovery this year has been sustained, with growth now projected to exceed 5%, inflation steady at only 2% and a small current account surplus likely for the first time. The debt service ratio is forecast to fall from 27.4% in 1985 to 26% this year. Immediate prospects look encouraging.

Eastern Europe

24 Poland's external performance continues to give cause for concern, and the financing gap this year may exceed $1 bn despite reschedulings by both bank and official creditors earlier in the year. In response to the Chairman's statement at the October Paris Club, the Poles are thought likely to pay some $130 mn towards meeting arrears and have come up with new proposals for a future debt consolidation, but no further meeting is planned before January. Talks with the banks continued in December but the banks are against offering new money and official creditors will no doubt be expected to bear the brunt of the prospective financing gap of $2-2.5 bn in 1987. An IMF SBA is unlikely to be agreed before end-1987.

25 Yugoslavia has now revised further downwards its 1986 convertible currency current account projection to $462 mn, increasing official creditors' doubts as to how the financing gap will be closed. The Finance Minister's reply to the Paris Club Secretariat's letter seeking an explanation of policies was considered vague and unhelpful, but official creditors seem resigned to awaiting the next Fund enhanced monitoring report (probably to appear in mid-February) before taking further concerted action. The Fund Mission arrived in Belgrade on 1 December.

26 Elsewhere in Eastern Europe, Hungary's continued weak performance, and its failure to take necessary remedial action, give cause for increasing concern. The convertible currency trade deficit widened to $624 mn in the first nine months and a current account deficit in the order of $0.9 bn this year seems inevitable. However, the recent IMF Mission, due to report in January, appears rather sanguine about Hungary's ability to cope with its financing needs in 1987. Bulgaria's convertible currency trade balance deteriorated sharply in 1986 H1 (largely because of the country's dependence upon re-exporting oil, and on Middle Eastern markets) to a deficit of $697 mn, and in the year to last June its position with BIS area reporting banks has shifted from a net exposure of only $0.2 bn to $2.1 bn. One bright spot - Romania has cleared all its remaining arrears with the IMF (SDR 39 mn) and prepaid its December obligations, and has settled $76 mn out of $103 mn arrears to the IBRD.

Southern Europe

27 In Greece the overshoot of the $1.7 bn target for the current account deficit is now expected to be limited to around $100 mn, because of oil price weakness. Non-oil imports have continued to rise, however, and the stabilization policy appears to have led to little structural reform so far. Despite indications that several of the performance targets for 1986 attached to the granting of the second half of the ECU 1.75 bn Community Loan have been missed, EC Finance Ministers have agreed to its release, following indications from the Greeks of further progress in dismantling export subsidies and import deposits and assurances that further expenditure and monetary policy measures would be taken if necessary.

Sub-Saharan Africa

28 Following the agreement of a term sheet with the commercial banks, the Nigerians embarked on a short roadshow in the first few days of December. The Fund Board approved Nigeria's SBA in principle on 12 December for 30 days. The Nigerians were commended on their adjustment programme, although some concern was expressed at the recent operation of the second tier foreign exchange market. The Paris Club agreed a rescheduling of $7-7.5 bn of official debt on 16 December.

29 The upsurge in disinvestment by foreign companies from South Africa is causing concern in the country, although in many cases links are not being totally severed. The decision of Barclays to sell its remaining 40.4% stake in Barnat has created fears that further widespread UK disinvestment is likely. On the domestic front, the authorities expect growth of only 1% in 1986; their priority in 1987 is to achieve growth of between 3% and 4%. Despite the favourable balance of payments outlook, the South Africans may seek to limit resources available for the 1987 debt negotiations so as to allow for higher growth. A possible linkage between the amount on offer and the gold price has been mooted.

30 On 29 October, Zaire announced that it intended to restrict its debt service payments to 10% of export earnings or 20% of the domestic budget. It is unclear whether this policy stance is negotiable, but it is understood that discussions with the Fund are continuing over the old 22-month Standby, seven months of which have been completed. Zambia's external position has now become critical. The latest figures indicate that at least SDR 270 mn is required in new aid pledges to close the combined 1986 and 1987 financing gaps. A Paris Consultative Group is scheduled to meet on 16 and 17 December, but this may well be too early unless donors can focus very quickly on the problem. Bridging finance to clear Fund arrears

(currently SDR 104 mn and rising to SDR 135 mn at end-December 1986) is unlikely to be available until prospects for closing the financing gaps have substantially improved. Fund management is at present considering whether to revive the current programme or negotiate an entirely new one. Both options carry substantial risks, but negotiating a new programme would allow the current level of non-Fund arrears to be reduced over time; revival of the present SBA would involve these arrears being paid off. Moreover, after recent food riots the authorities have rescended measures designed to reduce subsidies, thereby increasing the country's financing problems. Sudan continues to face intractable problems. Mahdi's government has, so far, been unable to resolve the damaging civil war or take firm action on the economy. Sudan remains ineligible to draw from the IMF and arrears continue to mount.

Middle East & North Africa

31 In Egypt, negotiations with a visiting IMF mission on a Standby arrangement were first delayed by President Mubarak's dismissal of Prime Minister Lutfi's administration (and the resignation of Central Bank Governor Negm) and then concluded at end-November without agreement on a Letter of Intent. It remains uncertain whether a viable programme can be put in place even with considerable exceptional assistance. The programme proposed by Fund staff, which assumed such assistance and further large accumulation of debt, conceded that the balance of payments would almost certainly not be viable over the medium-term; but the proposals were not acceptable to the Egyptians, who put forward their own much more gradual adjustment package. In an informal meeting on 4 December, Fund Executive Directors - including those from the G5 apart from the UK - encouraged the staff to adopt a softer approach, despite the wider ramifications for the Fund. In Iraq, the problems of Rafidain Bank remain unresolved. Some progress has, however, been made in bilateral rescheduling talks and some letter of credit payments are now reportedly being made. Iran is now facing an increasingly serious foreign exchange shortage, following Iraqi strikes on oil export facilities at Kharg Island and Larak which have significantly reduced Iran's oil exports (in October to around half the July level). The strains in the domestic economy, notably manufacturing industry, have become more severe.

32 In Morocco, the authorities have agreed a draft Letter of Intent with the IMF for a new SDR 230 mn Standby, but one precondition was an agreement in principle with banks on rescheduling 1985-7 maturities and closing the 1987 financing gap. In the event the banks agreed on 15 December to reschedule 1985-88 maturities over

10 years with 4 years' grace at LIBOR +1 3/16, and to re-reschedule also previously rescheduled 1987 and 1988 maturities. Outstanding bankers' acceptances and trade arrears are also being rescheduled. The Steering Committee have telexed the IMF, saying that the 1987 financing gap should now be closed. In Algeria, the external position is under growing strain - despite prompt adjustment - because of the low prices for oil and gas exports. Algeria's latest approaches to the market have been poorly received, and heavy amortisation payments are due in 1987. Increasing payment delays have been reported. The Omani economy has moved into recession with recovery unlikely before 1989. Sizeable fiscal and external deficits are in prospect this year and next; and further market borrowing may be sought to smooth difficult adjustment decisions.

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INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1986*	End-June 1986	End-September 1986 [2]	End-September 1986 [3]
Latin America				
Argentina	51	2.8(0.2)	0.2	0.2
Brazil	104	6.3(1.4)	1.0	1.8
Chile	19	1.4(0.1)	-	0.1
Colombia	15	0.5(0.1)	0.1	0.1
Ecuador	9	0.5(0.1)	0.1	0.1
Jamaica	4	- (-)	-	-
Mexico	103	6.2(0.5)	0.6	1.2
Peru	14	0.3(-)	0.1	0.2
Uruguay	4	0.3(-)	-	-
Venezuela	35	2.1(0.1)	-	-
Far East				
Indonesia	42	0.7(0.3)	0.8	1.6
Malaysia	21	1.2(0.3)	0.1	0.1
Philippines	27	1.4(0.1)	0.1	0.2
Thailand	18	0.3(0.2)	0.1	0.1
Eastern Europe (convertible currency)				
Hungary	14	0.4(-)	-	0.1
Poland	34	0.5(-)	1.2	1.3
Romania	6	0.2(-)	0.3	0.4
Yugoslavia	19	0.9(0.1)	0.7	0.9
Southern Europe				
Greece	18	1.3(0.1)	0.2	0.3
Turkey	27	0.5(0.2)	0.2	0.5
Sub-Saharan Africa				
Cote d'Ivoire	8	0.2(-)	-	0.1
Nigeria	21	1.1(0.1)	2.2	3.1
South Africa	20	3.6(0.4)	0.8	2.5
Sudan	10	- (-)	0.2	0.2
Middle East and North Africa				
Algeria	23	0.3(0.1)	0.2	0.4
Egypt	45	0.2(0.2)	0.3	1.2
Israel	30	0.4(0.1)	0.1	0.2
Morocco	17	0.2(-)	0.2	0.3
Saudi Arabia	n/a	0.6(0.4)	0.2	0.3

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[1] Defined as consolidated external claims including portfolio investments with a contractual repayment date, adjusted for certain inward and outward risk transfers in respect of guaranteed loans, plus any net claims on local residents in local currency. Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans. Other portfolio investments in these 29 countries amounted to $21 million at end-June 1986.

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

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

* current estimate

2099k

3.12.86

OVERDUE FINANCIAL OBLIGATIONS TO THE FUND*

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding (SDR mn)
Kampuchea	13 March 1975	28.9#
Guyana	31 May 1983	46.3#
Viet Nam	6 February 1984	60.1#
Sudan	12 July 1984	323.8#
Liberia	25 January 1985	97.5#
Peru	9 September 1985	131.9#
Jamaica	15 April 1986	61.5
Zambia	30 April 1986	104.0
		854.0

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 886.4 mn as at 17.11.86 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, Viet Nam, Sudan, Peru and Liberia are ineligible. Kampuchea is out of contact with the Fund.

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UNCLASSIFIED
PP CANBE
PP ATHEN
PP ROMEE
PP TOKYO
PP WELLI
PP ANKAR
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FM FCO
TO PRIORITY WASHINGTON
TELNO 2210
OF 191500Z DECEMBER 86
AND TO PRIORITY CANBERRA, VIENNA, BRUSSELS, OTTAWA, COPENHAGEN
AND TO PRIORITY HELSINKI, PARIS, BONN, ATHENS, REYKJAVIK, DUBLIN
AND TO PRIORITY ROME, TOKYO, LUXEMBOURG, AMSTERDAM, WELLINGTON
AND TO PRIORITY OSLO, LISBON, MADRID, STOCKHOLM, BERNE, ANKARA
AND TO PRIORITY BIS NEW YORK, UKDEL OECD
AND TO PRIORITY UKMIS GENEVA, UKREP BRUSSELS

OECD ECONOMIC OUTLOOK

1. THE LATEST EDITION OF THE SIX-MONTHLY OECD ECONOMIC OUTLOOK WAS PUBLISHED ON 18 DECEMBER. THE GENERAL THRUST OF THE REPORT IS THAT COUNTRIES SHOULD PROMOTE THE CORRECTION OF INTERNATIONAL IMBALANCES WHILE MAINTAINING LOW INFLATION AND STRENGTHENING OUTPUT AND EMPLOYMENT GROWTH. SPECIFIC RECOMMENDATIONS INCLUDE
(A) A LARGE AND SUSTAINED REDUCTION IN THE US BUDGET DEFICIT
(B) DOMESTIC DEMAND IN JAPAN TO GROW FASTER THAN PRODUCTIVE POTENTIAL
(C) INCREASED EFFORTS TO REDUCE STRUCTURAL RIGIDITIES IN EUROPE.
2. THE REPORT'S MORE PESSIMISTIC FORECASTS ON UK ECONOMIC

PERFORMANCE, AND ITS CLAIM TO SEE A SHIFT TOWARDS EXPANSION IN UK FISCAL AND MONETARY POLICY, HAVE BEEN PROMINENTLY REPORTED BY TODAY'S (19 DECEMBER) UK PRESS: THE FINANCIAL TIMES HIGHLIGHTS THE OECD MEDIUM-TERM FORECAST OF A WORSENING UK TRADE POSITION AND STEADILY RISING INFLATION.

LINE TO TAKE

3. THE OECD ASSESSMENT SUPPORTS OUR VIEW THAT SUSTAINABLE WORLD GROWTH OF AROUND 3 PER CENT SHOULD BE ACHIEVED IN 1987 WITHOUT INFLATION PICKING UP FROM PRESENT LOW LEVEL. WE AGREE WITH THE OECD'S SPECIFIC RECOMMENDATIONS ON THE WORLD ECONOMY, AND WE WELCOME CONTINUED OECD SUPPORT FOR PRUDENT FISCAL AND MONETARY POLICIES, AND FOR EFFORTS TO REDUCE STRUCTURAL RIGIDITIES.

ADDITIONAL POINTS ON UK ECONOMY (IF ASKED)

4. OECD FORECASTS CORRECT OF CURRENT ACCOUNT DEFICIT OF POUNDS 3 AND HALF BILLION FOR 1987, POUNDS 3 BILLION FOR FIRST HALF OF 1988?

DIFFERING FORECASTS ARE THE RESULT OF DIFFERING VIEWS ON TERMS OF TRADE. BUT OECD FORECAST FOR 1987 CLOSE TO INDUSTRY ACT FORECAST FOR INVISIBLES AND FOR IMPORT AND EXPORT VOLUME GROWTH.

5. INFLATION ACCELERATING?

MAY RISE IN MIDDLE OF NEXT YEAR BUT WILL ASSUME DOWNWARD PATH TOWARDS END OF 1987. UNDERLYING INFLATION (EXCLUDING MORTGAGE INTEREST COMPONENT) UNLIKELY TO BE VERY DIFFERENT IN 1987 Q4 FROM WHAT IT IS NOW.

6. CHANGE IN EMPHASIS IN MONETARY POLICY?

NO CHANGE IN VIEW THAT MONETARY POLICY IS KEY TO CONTROLLING INFLATION AND THAT INTEREST RATES ARE THE ESSENTIAL INSTRUMENT OF THAT POLICY. SOME CHANGE IN BEGIN UNDERLINING IMPLEMENTATION CEASE UNDERLINING OF POLICY OVER TIME.

7. OVERALL STANCE OF FISCAL POLICY EASING?

NO. CHANCELLOR HAS REAFFIRMED THAT PSBR FOR 1987-88 WILL BE HELD TO ONE AND THREE QUARTERS PER CENT GDP AS IN 1986 MEDIUM TERM FINANCIAL STRATEGY, DESPITE IMPACT OF OIL PRICE FALL ON NORTH SEA REVENUE.

8. STATUS OF REPORT?

OECD AN INDEPENDENT BODY, CARRYING OUT ITS OWN FORECASTS AND

ANALYSIS.

HOWE

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CONFIDENTIAL

Prime Minister

CDP 10/xi

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

7 November 1986

Charles Powell Esq
10 Downing Street
LONDON SW1

Dear Charles,

INTERNATIONAL FINANCIAL SCENE

I attach the regular report on developments on the international debt scene. This covers the period since the annual meetings of the Bank and Fund in Washington. The keynote of the report lies in the words used to describe discussion of the debt situation at those meetings: no significant confrontation or new initiative. Indeed, the main focus for those concerned with debt matters at the Annual Meetings was general world economic prospects and particular cases eg Mexico.

The world economic environment is currently mildly favourable. Short term dollar interest rates have been stable, the dollar has continued to weaken, oil prices have been relatively steady and there has been some stabilisation in non-oil commodity prices. However the longer term outlook is less good, in particular protectionist pressures in the US continue strong and there is no real sign of any underlying change in the downward trend of commodity prices. Against this background individual debt cases do not fall into a clear pattern except for the oil exporters.

Similarly there has been no clear focus for debtor demands. The Cartagena Group has been quiet. But there is no shortage of opportunities for discussion which could become political and confrontational. The United Nations will be discussing the debt situation in November, and there will be a Special ECLAC Conference in Mexico in January. UNCTAD will provide yet another opportunity.

Among individual debtors, attention has continued to be focused on Mexico. The deadlines of 29 September and later 31 October for the banks to obtain a critical mass for the financing package have slipped. In the meantime Fund reapproval of the SBA has had to be postponed. Progress has been slower than anticipated.

Most of the UK banks have yet to sign, though for technical reasons. The US banks are also lagging. For the moment we do not think these difficulties give cause for serious concern, although the Managing Director has urged rapid agreement to keep the programme on track.

On Nigeria considerable progress has been made. The Nigerians signed the Letter of Intent with the Fund in early September although they do not intend a drawing. The Nigerian Government have expressed great satisfaction with the role played by HMG and the Bank in putting together an official $250 million bridging loan which secures adequate funding for the introduction of the second tier foreign exchange market pending disbursements under a World Bank Trade Policy Loan. The second tier market has brought about a reduction in the naira exchange rate of some 63 per cent. Negotiations with the commercial banks are in progress with broad agreement being reached on a rescheduling package. Paris Club discussion is now likely to slip until December.

Once these two major packages have been fully settled there is likely to be a pause while the lessons of those operations - both handling and novel elements - are assimilated. The banks will not want a repetition of the bruising they feel they have suffered, while creditors are likely to want the exceptional features trimmed back to more conventional dimensions.

The other oil debtor - Egypt - continues to give serious cause for concern. Although exchange rate and tariff reforms have been introduced, many in the Fund Board feel that the pace of reform should be stepped up. This has not been well received by the Egyptians and discussions on a Standby involving further adjustment measures eg devaluation, exchange rate unification, high interest rates and the removal of subsidies, are unlikely to proceed smoothly or quickly.

[Mr. Amtji has been sacked]

The Brazilian economy continues to perform strongly, although the longer term outlook is uncertain. Further major fiscal and monetary measures are likely to be announced after the elections in mid November. In the meantime, the Brazilians continue to refuse to seek a formal IMF programme and their relations with government creditors are deteriorating as a result of extensive and growing arrears.

Finally, it is worth noting, as a "first", that China has approached the IMF for a first credit tranche drawing (SDR598 million) under a 12 month SBA.

I am copying this letter to Tony Galsworthy (FCO), Tim Walker (DTI) and John Footman (BoE).

Yours Alex,

A C S ALLAN
Private Secretary

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INTERNATIONAL FINANCIAL SCENE

1 Discussions of the debt situation at the Annual Meetings of the IMF and IBRD at the end of September brought no significant confrontation or new initiative. The focus for those concerned with debt matters was largely on issues affecting general world economic prospects and on the continuing Mexican negotiations with the banks. Although these negotiations were not completed by the 29 September deadline set by the IMF Board for achieving the support of a "critical mass" of banks, they progressed more smoothly than many had expected, and broad agreement with the Advisory Committee was announced on 30 September. Two further weeks of negotiations were needed to finalise the details. Whilst the agreement has not included some of the Mexicans' more radical original proposals (such as the elimination of spreads and the linking of debt service payments to an ability-to-pay formula), it does involve a number of novel features, including a growth contingency facility and a contingent investment support facility, and the Mexicans have achieved a reduction in spreads from the levels negotiated in last year's MYRA.

2 As already indicated in previous Reports, the outcome of the Mexican negotiations is likely to have a major impact on perceptions of the overall debt situation for some time to come. The drawing back of Mexico from its earlier threatened confrontational stance, and the achievement of the agreement, will have brought considerable reassurance. However, the reductions of spreads on existing debts, and the inclusion of contingent facilities, are being seen as precedents by other debtors. The Philippines' Finance Minister, for instance, has already said that the Mexican agreement "opens up new horizons", and that the Philippines will seek terms better than those the Mexicans obtained. Moreover, the Mexican agreement still has to obtain the support of the "critical mass" of creditor banks: indications are that many of the smaller banks, particularly the US regionals, will be very reluctant to go along with it. This may force the authorities, particularly in the US, to consider how far to encourage their banks to participate in the agreement, and may force the larger banks to re-consider how far they should be willing themselves to absorb the share of the contributions due from the smaller banks. Both the IMF itself and the larger banks have used up a considerable part of their store of goodwill and credibility in putting together the Mexican agreements; whilst this has been seen as appropriate because of the significance of Mexico, there will be substantial pressure not to permit similar agreements in the future. In particular, it has been suggested that the process of agreeing significant amounts of "involuntary" new money may now virtually have run its course.

3 One particular issue arising from the Mexican agreement concerns its currency conversion clauses. Under the draft term sheet, banks will be able to convert into home currency 100% of the 1983 and 1984 new money facilities and up to 100% of their restructured debt (conversion to be effected on one interest payment date under each credit agreement for the new money and 24 months for the rescheduled debt). Preliminary estimates suggest that UK-registered banks may have about $5 bn eligible for switching (currency switching involves corresponding sales of the home currency if mismatched positions are to be avoided). The Bank of England has asked banks for a statement of their present intentions on switching, and to be informed of any change in intentions. If substantial sales occur on the specified dates, this could lead to downward pressure on the exchange rate.

4 The UK authorities continued to be in the lead in putting together an official bridging loan for Nigeria. The size of the bridge was scaled down to $250 mn (of which the UK share is $70 mn), and disbursements delayed beyond the original target by the process of negotiation which was intense and difficult. Full agreement was finally achieved on October 30, with actual disbursements starting on October 31. With the second tier foreign exchange market now already in operation, the contribution of the bridge to Nigeria's cash flow is probably less important than the symbolism of support from the governments of the industrialised countries; this is believed to have helped both, politically, for Nigeria to maintain the momentum of adjustment and, commercially, with the negotiations on banking debt. The goodwill amongst the Nigerians towards the UK generated by the operation has been worth the very considerable efforts of both HM Government and the Bank of England. Reports from Nigeria suggest that UK may gain considerable benefits from the success of this exercise.

5 Apart from Nigeria, some other previously recalcitrant debtors have been reaching agreement with the Fund: the Fund has, for instance, approved a follow-up Standby for Morocco, after the previous programme collapsed shortly after it began. The Fund has also approved a growth-oriented SBA and a CFF for the Philippines. But on the other side, although Peru remains isolated in carrying out unilateral restrictions of debt-service payments, Jamaica's negotiations still seem far from resolution, Brazil continues to insist that it will not subject itself to a formal Fund programme and Argentina has so far not begun substantive discussion on its follow-on programme. Moreover, whilst Egypt had earlier appeared to be moving towards agreement with the Fund, it is now showing itself very resistant to introducing the additional measures which the Fund still considers essential. Little has been heard of the Cartagena Group recently, but representatives of 25 Latin American and Caribbean countries met in Lima on 16 October to examine new

approaches to the problems of debt servicing. The meeting, held under the auspices of SELA (Latin American Economic System) was intended to work out a common approach to present to the United Nations, which will discuss the debt situation in November, and to prepare for the ECLAC Special Conference in Mexico City from 19-23 January. These discussions, and others scheduled over the coming months in a number of international fora, may bring renewed attention on those seeking to pursue a confrontational stance.

6 Economic performance amongst debtor countries continues to diverge. Whilst oil-exporters are generally facing increased austerity, there is now significant growth in a number of countries - including Brazil, Argentina, Chile and Peru - albeit in some cases from a much lower level of activity than they enjoyed earlier in the decade. Other countries previously thought vulnerable - such as South Korea and Thailand - expect this year to be growing rapidly, running current account surpluses, and reducing their indebtedness. However, rapid growth is in some cases being accompanied by a resurgence of inflation: in Argentina prices rose 7.2% in September, bringing the year-on-year rate to 67.4%, its highest level since the introduction of the Austral Plan. And in Brazil, the continuing rapid expansion has led to a (modest) cut in projections for this year's trade surplus.

7 The world economic environment has continued to be mildly favourable for most debtors, although prospects for the longer term may have deteriorated. Short term dollar interest rates have remained fairly stable - three and six month eurodollar rates are around 6% - but fears about a resurgence of inflation, and about the dollar exchange rate, have caused interest rates to rise at the longer end. The dollar has continued to weaken for most of this period; although it revived somewhat the end of the month, it was still 15% below its level at the beginning of the year in effective terms, and almost 25% below its level at the time of the Plaza Agreement. Whilst the fall in the dollar brings relief to most debtors, the longer term implications of the weak US external position seem more worrying: the absence of any turnaround as yet on the trade deficit is expected to lead to continued heavy protectionist pressures for some time to come. On 21 October the US introduced a fee of 0.22% on all imports except those from least developed countries and those in the Caribbean Basin programme (in order to help reduce the budget deficit); Mexico has already filed a formal protest. Meanwhile, Congress is moving to cut US contributions to the World Bank and the other international institutions; it is too early as yet to assess the significance of these moves.

8 Oil prices have remained relatively steady since August, with markets awaiting the outcome of the OPEC discussions on production restraints beyond October. Reports of an agreement on 22 October on a marginal increase in output quotas for

the remainder of the year have led to a slight firming in prices. Non-oil commodity prices too have been stable recently (the Economist Index rose by 4.1% in the two months since the end of August) bringing at least a temporary halt to five months of continuous declines. Nevertheless, the all-items index remains (in SDR terms) more than 14% below its level of the first quarter of this year and over 18% below its level at the beginning of 1985. The more recent stability has derived partly from a supply squeeze on vegetable oil supplies in Malaysia reversing the steep price falls earlier this year (palm oil prices have risen by 80% to reach their highest level since the beginning of the year, and coconut oil prices have more than doubled, returning to their level of last June), from strikes in Canadian mines (zinc rose 4%), and from some rebound after earlier major price falls in cotton (prices rose by almost 40% over the last two months, but are still at historically low levels). Nevertheless, these developments do not yet seem to suggest any underlying change for commodity prices from their continuing long term downward trend.

9 Since the beginning of September there has been a further $100 mn eurocredit for the National Bank of Hungary; the Soviet Foreign Trade bank is currently negotiating an 8 year $300 mn credit, at LIBOR +1/8% for the first five years and +1/4% for the last three. Among developing countries there were seven borrowings, totalling $1.2 bn; India's Oil and Natural Gas Commission, with a three tranche loan, accounted for $500 mn of this. (Two of the three tranches were arranged under tax sparing agreements with Japan, the UK and Belgium.) South Korean borrowers were totally absent in this period, a reflection of their improving economic condition and their current account surplus.

Further details on individual countries are given below.

Latin America and Caribbean

10 Mexico concluded its negotiations with the banks' Advisory Committee on 14 October, after five weeks in continuous session. The package includes a $5 bn new money loan, repayable over 12 years (5 years' grace), plus a $1 bn co-financing of transport sector projects with the World Bank ($500 mn guaranteed by the World Bank) to be repaid over 15 years (9 years' grace); re-rescheduling of "old debt" under last year's MYRA of $43.7 bn over 20 years (7 years' grace); and no change in the overall term of the 1983 and 1984 new money loans, totalling $8.6 bn. The spread on all elements will be 13/16% over LIBOR or cost of funds (ie the Prime option has been removed), the reduced margin on existing debt producing annual savings of some $300 mn. The package also includes a "growth contingency" facility

for $500 mn (over 12 years, including 7 years' grace, and with $250 mn guaranteed by the World Bank) to be triggered by a review of economic activity in Mexico at end-Q1 1987, and a contingent "public sector investment maintenance" facility of $1.2 bn (over 8 years with 4 years' grace) to be activated if the IMF certifies there has been a shortfall in the Mexican public sector's external receipts. Other broad elements have reportedly now also been agreed: $11.6 bn of private sector debt will be rescheduled; interbank deposits (about $6 bn now, minimum required level $5.2 bn), due to expire at end-1986, will be rolled over to 30 June 1989; and the $950 mn repayment, due in October and November, is to be rescheduled over 1989-94.

11 The Fund had set a deadline of 29 September, when the approval in principle of the SBA would lapse, for the banks to obtain a critical mass for the financing package, but the Advisory Committee did not even agree the broad terms with Mexico until 30 September. The details of the package subsequently also proved difficult to resolve, and a term sheet was not issued until 16 October. The critical mass (about 90%) of commitments was to be sought by 31 October; there is some slippage beyond that date, but this is not expected to be serious. Although the Fund Board has not reconvened, approval of the SBA will run in effect until early-November when a Board meeting will probably be held - as soon as the critical mass is achieved - to consider the impact of recent events on the programme.

12 In efforts to secure further financing for 1986/7, Finance Minister Petricioli visited Japan in late September to agree loans, totalling $1 bn, from the Ex-Im Bank of Japan. The US's Commodity Credit Corporation has approved credit guarantees of $745 mn for delivery of agricultural commodities during US FY 1987 and the Paris Club agreed on 17 September to $1.5 bn of rescheduling of official debt. The Mexicans made a first repayment ($270 mn) of the official bridge on 30 September, as required. No more bridging finance may be drawn until the banks have achieved a critical mass for the financing package.

13 General economic developments in Mexico continue to be mixed. The current account recorded a deficit of $1.57 bn during January-July, better than expected given the weakness of oil prices during the period, and suggesting that the Fund estimate of a deficit of $3.5 bn for the year may be too high. Industrial production in the twelve months to June fell by 4%. Average oil exports in Q3 were 1.35 mbd (cf 1.35 mbd in Q2 and 1.1 mbd in Q1). Meanwhile, with inflation continuing to rise (the CPI in the twelve months to September rose by 95%), and in response to union calls for the introduction of monthly wage rises, the government has conceded an unprecedented third increase in minimum wages within a 12-month period, of 21.2%,, bringing minimum wage rises for the year to 100%. However, the possibility of introducing an "Aztec Plan", involving a wage freeze, seems not yet to have been ruled out.

14 Brazil's economy has continued to perform strongly, but there are concerns that the fiscal targets set under the Cruzado Plan will be exceeded, and further major economic measures to tighten fiscal and monetary policies are likely to be announced after the Senate and State elections on 15 November. Meanwhile, whilst the CPI rose by 1.7% in September, the highest rise since the Cruzado Plan was introduced in February, bringing the cumulative rise in prices since then to 8.2%, the consumer boom has contributed to a fall in the official unemployment rate, to 3.5% at end-August (cf 5% in August 1985). However, on the external side, the authorities have revised their 1986 balance of payments forecast and now expect an overall deficit of $150 mn (cf an original forecast of a $800 mn surplus). The 1986 trade surplus target has been revised down $0.5 bn, to $12.3 bn. Following the IMF/IBRD meetings, Finance Minister Funaro reiterated that Brazil was unwilling to seek a formal IMF programme to facilitate its expected debt rescheduling negotiations with the commercial banks and the Paris Club. There have been reports that the banks may be willing to accept joint IMF-IBRD monitoring; but negotiations with the Paris Club continue to be hindered by the Brazilians' refusal to settle arrears 21 October. The IBRD has approved loans to Brazil totalling $371 mn.

15 In Argentina the CPI rose by 7.2% in September (cf 8.8% in August), bringing the year-on-year rate to 67.4% (cf 59.2% in August). Despite the pick-up in inflation and a deterioration in the external outlook, the domestic economy appears to be recovering strongly from last year's recession, with real GDP growth officially forecast at 5% for 1986 (against 4% forecast earlier). An SBA is being sought from the Fund to replace that which expired at end-June: prior to the IMF/IBRD Annual meetings, a Fund mission visited Argentina to gather economic information, and a negotiating mission is scheduled to be sent shortly. The authorities are also reported to want to approach the commercial banks and the IBRD for new finance, but no substantive negotiations have yet taken place with either set of creditors. In the meantime, the authorities have announced changes in banking regulations, including a substantial reduction in the reserve requirements on deposits in Argentine banks. By encouraging a shift of business from the parallel to the regulated sector, the changes should allow the Central Bank to keep tighter control of credit expansion and the money supply. Meanwhile, the integrity of the financial system has been called into question by several recent fraud cases which may involve the previous President of the Central Bank, Alfredo Concepcion, and other senior officials.

16 The IBRD Board is due to discuss a second IBRD SAL for Chile in late November, despite efforts by the US to delay the talks. Under domestic legislation the US may have to oppose the loan on political grounds, because of human rights abuses.

UK policy remains that IFIs' loans should be judged solely on their technical merits. The Chileans are also seeking to fill half their forecast financing gap of $1.2 bn for 1987-88 from the banks; however, negotiations could be adversely affected by any delay in signing the SAL. Within the domestic economy, inflation continues to decline; the CPI for the twelve months to August rose 17% (cf 36% to August 1985). The trade surplus for January-August was $806 mn (cf $555 mn during January-August 1985 and an IMF target of $955 mn for 1986). Real GDP in H1 was 5.8% above H1 1985 (cf an IMF target of 3-5% growth for 1986 as a whole).

17 Colombia made a first drawing ($639 mn) from its $1 bn voluntary bank loan on 9 October; there is no clear indication when the remainder will be drawn, although the loan's existing termination date is end-1986. Meanwhile, it seems likely that the "enhanced monitoring" arrangement with the IMF, which lapses at end-1986, will not be renewed. (This will not bring the bank loan into default as there are provisions for the continuation of the required flow of economic information to the banks in the absence of Fund monitoring.)

18 In Ecuador, Finance Minister Dahik resigned on 26 September (after only 3 months in office), having been impeached by the opposition-controlled Congress and found guilty of introducing policies against the national interest. The Congressional opposition also proposed in September to limit debt service to 25% of petroleum export revenue. However, the Presidential approval needed to make the proposal law is unlikely to be obtained. Export receipts during January-July were $1.25 bn, 22% less than in the same period last year, despite an 18% increase in non-petroleum export values.

19 Continuing difficulties in Venezuela's negotiations with the banks' Advisory Committee over the country's private sector debt have held up progress on modifying the MYRA covering $21.2 bn of public sector debt. In a meeting with banks in September, the Venezuelans proposed several changes to the MYRA, including lower spreads, a longer grace period and debt repayments linked to oil revenues and international interest rates. The banks rejected the last proposal outright and will probably not agree to any significant change in the existing repayment schedule. The Venezuelans have agreed to make the $750 mn downpayment required to activate the MYRA, between November and January. In the external accounts, total export revenue for January-August was $7.1 bn (of which oil accounted for 77%), while total imports were $4.2 bn. Reserves were $11.7 bn at mid-September (cf $13.7 bn at end-1985). The CPI rose by 0.7% in September, bringing the year-on-year inflation rate to 11.4% (cf 10.8% in the year to August and an IMF target of 11.9% for the year as a whole).

20 The Peruvian authorities and the banks' Advisory Committee held talks on 26 September. No formal proposals were made, but the banks stipulated that the Peruvians make a token interest payment ($60 mn has been reported) as a precondition for further talks (due to take place within 60 days). The Advisory Committee has told the Peruvians that if payment is not made individual banks will decide how to proceed - in effect, the banks will decide whether to disband the Advisory Committee. Meanwhile, the banks have agreed to send a team of economists to Peru to examine recent data and the country's economic programme. The authorities' current projections are for real GDP growth of 5% in 1986, inflation of 66% (cf 57% year-on-year at end-August), a public sector deficit of 5.2% of GDP (excluding interest arrears of 1.3% of GDP), a $200 mn trade surplus and a current account deficit of $232 mn. Finance Minister Alva Castro argued at the IMF/IBRD meetings that Peru's ability to service its external debt could be further reduced in 1987 as a consequence of deteriorating terms of trade and restrictive practices in the main international markets; he expected these factors to reduce the trade surplus to $50 mn for the year.

21 Among other debtors, Uruguay signed a 12-year $90 mn energy sector loan on 2 October ($45 mn from the World Bank and $45 mn voluntary bank co-financing). All IMF performance criteria for the first three quarters of 1986 have been met, although the end-year inflation target may be missed. The January-July trade surplus was $129 mn (cf $45 mn in January-July 1985), with export and import values respectively 31% and 18% higher than in the same period in 1985. GDP growth of 3-4% is now forecast for this year. Bolivia met all end-June performance criteria under the 12-month SBA except for the ceiling on external arrears. Since the Bolivians could demonstrate that remedial action was being taken, the Fund agreed to a waiver to enable a drawdown in September of the second tranche (SDR 8.65 mn) due originally on 15 August. The US has agreed to provide a $100 mn short-term credit line, to be repaid by 14 November, while negotiations on assistance from IFIs continue.

22 At a meeting with the banks' Advisory Committee on 24 September, Costa Rica advised the banks that it would not be able to maintain debt service beyond that due up to 30 June. At a further meeting on 23 October, the Costa Ricans requested a rescheduling of their debt over 25 years (7 years' grace) at concessional rates. This was rejected by the banks who have urged the Costa Ricans to agree a programme with the Fund. Cuba has continued to build up arrears; there are reports that the country may have taken the decision to default on its debt. The joint IBRD/IMF Article IV mission which visited Guyana in late September found little fundamental

change since last year. Jamaica is reportedly negotiating an 18-month SBA with the IMF to replace the one cancelled recently: Seaga's announcement that he would stand down as party leader in November and as Prime Minister next August may have been intended to strengthen his negotiating position. Jamaica has paid SDR 30 mn of its arrears to the Fund, but SDR 61 mn of arrears remain. The country has indicated a need to reschedule debts due to the Paris Club in 1986/7 and has ceased payments on debts which may be eligible for rescheduling.

23 Some progress was made over the Inter-American Development Bank Seventh Replenishment (1987-1990) negotiations at the meeting of Executive Directors held in Washington at end-September. Agreement was reported to be close on a $24 bn replenishment, with 2.5% paid-in, allowing a lending programme of $20 bn, with any additional lending coming from unused Sixth Replenishment contributions. However, prospects for this - as well as for the MIGA and the IFC - are unclear following Congressional moves to cut US contributions to the World Bank and the IADB for 1987.

South and East Asia

24 China has approached the IMF for an SDR 598 mn (25% of quota) SBA, to be considered by the Board with the Article IV Consultation on November 7. The Chinese propose moderate tightening of domestic credit expansion and money supply, but their proposed reduction in external borrowing (based on much higher earnings from non-oil exports) may be more difficult to meet. In 1985 China had a trade deficit of US $14.9 bn, and a current account deficit of US $11.4 bn; despite the introduction of import restrictions, the trade deficit in the first nine months of 1986 amounted to US $8.9 bn. Although China's reserves fell sharply in 1985, from about $20.5 bn to $12.7 bn, they have been fairly stable this year, and now stand at $11.4 bn. There has however been substantial borrowing in 1986 - about $2.5 bn of concessional debt alone - pushing gross debt (including short term) to about US $25 bn. The medium term debt-service ratio remains comfortable at about 7%.

25 The Philippine government's efforts to secure further debt relief from commercial and official creditors appear to be on course. The IMF has approved an 18-month growth-orientated SBA (SDR 190 mn) and a CFF (SDR 224 mn) which will trigger $350 mn of undrawn commercial bank money as well as $300 mn in loans from the IBRD. On 27 October the Advisory Committee began discussing proposals for the rescheduling of $3.6 bn of maturities due from 1987-91. The authorities also wish to discuss the terms of the 1983-5 rescheduling. No "new money" is being sought for 1987. Finance Minister Ongpin has indicated that he regards the Mexican

agreement as having "opened a new horizon", and that he hopes to negotiate better terms than Mexico achieved. Meanwhile, the US Senate has finally passed an additional aid package of US $200 mn for 1987. On the economic side, real GNP declined by 2.3% in H1, but latest estimates by the Fund suggest an increase of 1.5% for 1986 as a whole, and GNP is expected to rise by between 6% and 7% in 1987. Consumer price inflation fell to zero in H1 1986, but is projected to accelerate to 5% by end 1986. The current account is forecast to show a small surplus of US$0.3 bn (0.9% of GNP) in 1986, reverting to a deficit of US$0.4 bn (1.2% of GNP) next year. The Philippines' draft constitution is expected to go to plebiscite in January.

26 Malaysia's real GDP fell by 1% last year, and a further fall can be expected in 1986. Per capita income is expected to fall by over 10% this year. The 1987 budget, which was announced on 24 October, whilst undoubtedly restrictive, was not as severe as had been expected. Although expenditure is to be cut by 11% (comprising a 6% cut in operations expenditure and 25% in development expenditure: initial recommendations to the cabinet were for development expenditure to be cut by 30%) the budget deficit for 1987 is projected at 16% of GNP (cf 11% in 1985 and 19% in 1986). Rumours of a devaluation (to follow that in Indonesia) have been denied, and Bank Negara has been using reserves to defend the currency. The financial sector remains dogged by scandal and poor results.

27 In contrast the Indonesian government appears determined to respond to events decisively. The government has stuck by the August OPEC agreement and hopes to see oil prices rise to $17-19 pb. It is also preparing a series of follow-up measures to the 31% devaluation in September. There have been rumours that it intends to introduce exchange controls and a freeze on time deposits, but these have been firmly denied; however, some banks have suffered withdrawals as a result. Meanwhile, the position of the economy remains precarious. Foreign investment is down yet again and the external account has deteriorated significantly: the current account deficit may widen to around $5 bn this year from $2.1 bn in 1985. Total reserves have fallen slightly this year, from $10.7 bn, but are still a healthy $10 bn.

28 Elsewhere, in Thailand economic growth may reach 5% this year, whilst a small current account surplus now looks likely, the first in the country's history. On the other hand, the authorities in India have revised upwards the trade deficit for the year ending March 1986 to US $6.9 bn (4% of GDP). This implies a current account deficit of $4.6 bn (2.5% GDP), double last year's level.

Eastern Europe

29 Against a background of a financing gap of around $800 mn this year and, on current weak export performance, around $2 bn in 1987, Poland held an unproductive meeting with official creditors in Paris on 24 October. There were no formal proposals: Poland would like to reach an agreement covering 1986 and 1987 maturities (including the phasing of arrears under the 1981 and 1985 agreements) but no progress was made and no date set for a further meeting. The Poles intend to start negotiations with other creditors and are to meet the banks in London on 4 November. At the IMF Article IV discussion on 15 October, Directors generally welcomed the proposed package of measures announced by the Polish representative, although concern was expressed that the envisaged pace of their implementation was too slow. The Finance Minister has indicated that Poland will seek an early borrowing from the Fund, but it is likely to take some time before a programme can be agreed.

30 Yugoslavia shows few signs of getting to grips with its problems. Although the National Bank's most recent forecast of a full-year current account surplus of $0.6 bn is more optimistic than earlier indications, it still falls well short of the original official forecast of $0.9 bn. Substantial financing gaps seem in prospect for both 1986 and 1987, although at present there is no evidence of Yugoslav anxiety on this score. Prime Minister Mikulic is apparently having difficulty reaching a consensus at republic level, and the long-promised "autumn package" may now prove little more than a series of proposals for debate that will not be implemented before 1987. At the September meeting of the Paris Club the Secretariat was instructed to write to the Yugoslavs seeking an explanation of policies. Intensive lobbying by the Yugoslav representatives at the Washington meetings failed to impress and both Fund and World Bank staff have expressed concern. The banks seemed more optimistic than the official side following the Manufacturers Hanover mission to Belgrade on behalf of the banks in September, but more recent indications from IMF/IBRD staff suggest that some end of September performance criteria may have been missed. It will be for the banks to decide what action if any to take in relation to the next stage of their MIGA.

31 The first half of 1986 witnessed a further deterioration in Hungary's convertible-currency current account with a deficit of $845 mn being registered ($434 mn deficit in H1 1985) against a planned surplus of some $100 mn for the year as a whole. In order to stimulate export performance the forint was devalued by 8%

against its currency basket on 23 September. The USSR recorded a hard currency deficit (excluding arms sales) of $3.7 bn in the first half of the year compared with a deficit of $4.3 bn in H1 1985. Romania has cleared a large part of its arrears to the Fund and IBRD.

Southern Europe

32 In Greece the current account deficit amounted to $1.21 bn in the period January-August, compared with a target of $1.7 bn for the year as a whole. Non-oil imports have continued to rise, despite the import deposit scheme introduced as part of last October's austerity package; under the conditions attached to the EC loan granted last November, this scheme must begin to be dismantled next month. The Bank of Greece has raised two small syndicated credits since July, totalling $100 mn, on less favourable terms than for a similar loan at the beginning of the year.

Sub-Saharan Africa

33 After lengthy discussions Nigeria signed a Letter of Intent on 3 September which would entitle it to draw up to SDR 650 million under an SBA. The authorities continue to stress, however, that they do not intend to avail themselves of these funds. Central to the adjustment package was the introduction of the second tier foreign exchange market (SFEM) designed to ensure a more competitive rate for the naira, whilst avoiding the possible political difficulties associated with a formal devaluation. At the first auction on 25 September the naira depreciated by 66 per cent against the dollar. A further modest depreciation resulted at the subsequent weekly auction, but at the 9 October session the naira rebounded sharply, reflecting a change in the method of arranging the bids and an extra $25 million put through the auction. The naira exchange rate currently reflects a depreciation of 63% compared to the pre-auction rate. In order to ensure adequate funding for the SFEM, an official $250 mn bridging loan, to be repaid from drawings under a World Bank Trade Policy Loan, has been successfully completed as a result of intensive activity by the UK authorities. Meanwhile, following a meeting between the Nigerian authorities and the commercial banks' steering committee on 8-10 October, broad agreement was reached on a rescheduling package, including some $320 million of new money for the Nigerians. The outline agreement is notable for not being made conditional on an IMF borrowing. A term sheet was agreed by the banks and put to the Nigerians on October 30; the Nigerians are expected to conduct a short 'roadshow' in the week beginning November 10.

34 The September review of the Interim Agreement between South Africa and the creditor banks passed largely uneventfully. Although planned as a purely economic review, the banks clearly felt that the South Africans had the capacity to repay more debt than originally scheduled. The South African team made it clear, however, that they had no mandate to offer additional payments; the banks did not press the point. Zaire has announced that it intends to restrict its debt-servicing to 10% of exports. Amongst other African countries, Zambia's domestic and external position has further deteriorated, and prospects for retrieving the present Fund programme are rapidly dwindling. The fiscal deficit is again above the original target, and a sizeable bridging loan would be required to close the 1986 financing gap and clear arrears to the Fund - currently SDR 74 mn. Moreover, a large financing gap is projected for 1987, even after assuming generous rescheduling and the minimum viable level of imports.

Middle East & North Africa

35 During the Executive Board's discussion of Egypt's recent Article IV Consultation on 6 October, US and European Directors (including the UK's) welcomed the exchange rate and tariff reforms introduced during July and August, but urged that the pace of reform should be stepped up. This was not well received by the Egyptians. It therefore seems likely that the current Fund Standby mission to Cario will meet continuing resistance for further measures including devaluation, exchange rate unification, higher interest rates, and the removal of subsidies. Agreement on a programme is unlikely to be reached this year.

36 Following additional budgetary measures undertaken in July-August, the Algerian government has sounded out commercial banks about the terms for fresh medium-term borrowing, expected to total about $300 mn. There are reports that the response was disappointing. Algeria has already borrowed nearly $1 bn this year and also drawn down reserves to finance an expected current account deficit of around $2 bn, brought about by sharply reduced hydrocarbon export revenues. In Morocco real growth is expected to reach 4.7% this year (cf 4.3% in 1985) and inflation continues to decline. However, expansionary monetary and fiscal policies have caused a smaller than programmed reduction in the current account deficit, and external arrears have continued to accumulate. Following lengthy negotiations, agreement has been reached with Fund staff on a Letter of Intent covering a new Standby of SDR 230 mn which will run until March 1988. As a pre-condition, however, Morocco must first reach agreement in principle with commercial banks on the rescheduling of 1985/86 maturities and a new money package of $200 mn. The banks' steering committee begun discussing terms on 30 October, and it is hoped that the IMF programme will be discussed by the Board early in December.

37 Iraq's acute shortage of foreign exchange has continued, leading to increasing arrears on letters of credit opened by Rafidain Bank. Officials of Rafidain Bank have recently been visiting banks in London to seek a loan, but were unsuccessful. Iraq has also failed to meet a repayment due at end-September under a 1983 international bank loan (although interest on the loan reportedly is being paid). It is reported that the Iraq authorities have requested a formal rescheduling of the $500 mn loan. In Sudan the new civilian coalition government has so far failed to make progress in resolving the escalating civil war or to take firm action on the economy. The recently announced budget seems based on unrealistic revenue and aid forecasts.

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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 1986	End-June 1986 [2]	End-June 1986 [3]
Latin America				
Argentina	50	2.8(0.2)	0.2	0.2
Brazil	102	6.3(1.4)	1.0	1.9
Chile	19	1.4(0.1)	-	0.1
Colombia	14	0.5(0.1)	0.1	0.2
Ecuador	8	0.5(0.1)	0.1	0.1
Jamaica	3	- (-)	-	-
Mexico	97	6.2(0.5)	0.6	1.3
Peru	14	0.3(-)	0.1	0.2
Uruguay	4	0.3(-)	-	-
Venezuela	37	2.1(0.1)	-	-
Far East				
Indonesia	35	0.7(0.3)	0.8	1.7
Malaysia	19	1.2(0.3)	0.1	0.1
Philippines	28	1.4(0.1)	0.2	0.2
South Korea	45	2.5(0.7)	0.4	0.8
Thailand	17	0.3(0.2)	0.1	0.1
Eastern Europe (convertible currency)				
Hungary	12	0.4(-)	-	0.1
Poland	30	0.5(-)	1.3	1.4
Romania	7	0.2(-)	0.3	0.5
Yugoslavia	19	0.9(0.1)	0.7	1.0
Southern Europe				
Greece	17	1.3(0.1)	0.2	0.4
Portugal	16	1.1(0.1)	0.2	0.2
Turkey	25	0.5(0.2)	0.2	0.6
Sub-Saharan Africa				
Cote d'Ivoire	8	0.2(-)	-	0.1
Nigeria	21	1.1(0.1)	2.2	3.3
South Africa	23	3.6(0.4)	0.8	2.6
Sudan	10	- (-)	0.2	0.2
Middle East and North Africa				
Algeria	20	0.3(0.1)	0.2	0.5
Egypt	40	0.2(0.2)	0.2	1.0
Israel	30	0.4(0.1)	0.1	0.2
Morocco	14	0.2(-)	0.2	0.3
Saudi Arabia	13	0.6(0.4)	0.2	0.3

[1] This column now shows exposure defined as consolidated external claims including portfolio investments with a contractual repayment date, adjusted for certain inward and outward risk transfers in respect of guaranteed loans, plus any net claims on local residents in local currency.
Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans.
[2] Defined as ECGD-guaranteed loans disbursed, plus political claims paid and claims under examination.
[3] Defined as ECGD-guaranteed loans (disbursed and undisbursed) and contractual interest, plus political claims paid and claims under examination.
* current estimate

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INDEBTEDNESS AND BRITISH EXPOSURE

	Total external debt	British-owned banks' exposure [1]	$ billion ECCD amounts at risk	
	End-Dec 1985*	End-June 1986	End-March 1986 [2]	End-March 1986 [3]
Latin America				
Costa Rica	3	0.1 (-)	-	-
South & East Asia				
Pakistan	13ø	0.3 (0.1)	0.1	0.1
Eastern Europe				
USSR	30	0.7 (0.1)	0.7	1.0
Southern & Western Europe				
Iceland	2	0.2 (-)	-	-
Sub-Saharan Africa				
Kenya	4	0.1 (-)	0.2	0.4
Zambia	5	0.3 (-)	0.1	0.2
Zimbabwe	2	0.2 (0.2)	0.2	0.4
Middle East & North Africa				
Iraq	20ƒ	0.1 (-)	0.4	1.0

ø Mid-1985 estimate
ƒ Mid-1986 estimate

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Prime Minister

CDP

22/9.

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

22 September 1986

Charles Powell Esq
10 Downing Street
LONDON
SW1

Dear Charles,

INTERNATIONAL FINANCIAL SCENE

This edition of our regular report on developments in the international debt scene is intended as background for the forthcoming international meetings.

On the world economy, the level of activity in the industrial countries will be a major topic at the Bank/Fund Annual Meetings in Washington. In broad terms (eg the latest IMF World Economic Outlook forecasts) the overall outlook is just about satisfactory from the "debt" perspective and the paper notes some helpful developments eg the decline in interest rates (6 month dollar LIBOR now about 6 per cent, compared with 8¼ per cent at the time of Plaza and 12½ per cent at its mid 1984 peak) and the slight hardening in the oil price. But the situation remains fragile. The outlook for developing countries is not good with continuing very weak commodity prices. This too will surface in the Annual Meetings and will link with discussions of trade and protectionism and the burgeoning agricultural debate.

As we noted in August, economic developments over the past year, particularly the fall in oil prices, have increased the heterogeneity of the debt problem. But this has always been taken into account and there are no obvious bonuses in terms of its handling to come from the Annual Meetings, though the IDA8 replenishment should be settled and positive progress will be reported on IBRD lending and co-ordination of export credit. Shortly after the Annual meetings, however, there will be a bunching of difficult issues involving the oil exporting countries - Mexico, Nigeria and Egypt - which may bring debt management issues more sharply into focus. Another cloud on the horizon is the indication in the paper of a pick up in inflation especially in Latin America.

On individual countries, the current focus remains Mexico and the commercial bank package. The Paris Club have now agreed to reschedule Mexican public sector debt on fairly generous terms (100 per cent of principal to 31 March 1988 and 60 per

cent of interest to 31 December 1987 over 10 years including 5 years grace). The agreement will be operative only when the IMF standby comes into force ie when the banking negotiations are complete. The commercial bank element of the agreed bridge finance similarly cannot be drawn until the banking package is agreed. The bank negotiations are unlikely to be concluded rapidly. Some extension of the 21 days allowed by the Fund looks inevitable. The latest news is that the Mexicans have toned down some of the novel features in their original proposals eg the elimination of spreads and that both sides are moving towards common ground, though agreement is still by no means in the bag.

In the case of Nigeria, the important development is the signing of the Letter of Intent to the Fund, although the ~~Nigerians remain totally opposed to~~ any Fund drawing. The Bank of England are currently involved in discussions of a BIS briding loan of some $250 million. This could be agreed in principle in the next week or so depending on the attitude of the Bundesbank (who have doubts about participating which we are seeking to allay and the timing of decisions on the IBRD trade policy loan and commercial bank support for Nigeria.

Finally, the news on the third big oil debtor - Egypt - is mildly positive. A recent Fund Mission noted encouraging developments in the field of tariff reform and pricing policy together with a rather smaller budget deficit than initially estimated. Much remains to be done on energy prices, the exchange rate and interest rates and negotiations with the Fund remain at a preliminary stage. There will be an opportunity at the Article IV discussion in early October for our Executive Director to reinforce the line which the Chancellor and the Prime Minister recently took with the Egyptian Prime Minister of sympathetic encouragement for Egyptian adjustment efforts. In the meantime the Chancellor is writing to the President of the EC Commission rejecting the idea of an EC initiative at this stage to assist Egypt resolve its current financial difficulties. There is likely to be continuing political pressure as discussions are carried forward.

Elsewhere, it is worth noting the very special position of Brazil with strong economic growth and large surpluses on its external accounts, at the same time as continuing arrears to Government creditors and refusal to seek endorsement of the IMF to its economic policies to facilitate Paris Club and tougher term bank rescheduling. Finally, Peru having made only a token payment towards its arrears to the IMF, was on 15 August declared ineligible to use IMF resources. Contacts however continue in the hope of encouraging a more orthodox approach to debt obligations.

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I am copying this letter to Tony Galsworthy (FCO), Tim Walker (DTI) and John Footman (BOE).

Yours
Alex

A C S ALLAN
Principal Private Secretary

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Prime Minister

CDP

1/8.

Treasury Chambers, Parliament Street, SW1P 3AG
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Charles Powell Esq
No 10 Downing Street
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1 August 1986

Dear Charles,

INTERNATIONAL FINANCIAL SCENE

I enclose the pre-holiday edition of our regular report on developments in the international debt scene. The most important concern Mexico, which our last report identified as likely to set the tone for other debt negotiations.

The outcome and timing of current negotiations on a package of financial assistance for Mexico, worth some $12 billion, remain uncertain. Our assumption is that the Managing Director will want to seek Board endorsement of the IMF Standby Agreement in early September before the Fund/Bank meetings and will want assurances of support from the commercial banks before then. It remains to be seen whether support will be forthcoming on the scale demanded. The signature of the Letter of Intent by the Mexican Government has been greeted with relief though there are considerable doubts in at least two areas about the nature of the agreement. It is too early (in advance of the IMF Staff appraisal) to reach firm conclusions about the measures proposed by Mexico. Despite the US Government's public enthusiasm some aspects seem weak. Indeed, its long term viability is in doubt except on the assumption of an increase in the oil price to at least $14-15 a barrel. Second, the agreement contains some novel features, in particular the provision for additional financing if oil prices fall (and conversely reduced financing if they rise) and access to further loans for capital expenditure if growth falls below 3-4% per annum in 1987. Even if the conditionality - which looks distinctly generous - attached to these proposals is acceptable in the case of Mexico, it seems inevitable that the precendent will be seized on by other countries eg Nigeria and Egypt in the hope of avoiding or deferring unpalatable adjustment.

As far as the general outlook is concerned, the Mexican Letter of Intent is undoubtedly a favourable factor (despite the doubts

expressed above) in terms of handling the debt problem and isolating those, like Peru, who are taking a confrontational path. This needs to be seen against a slightly worse outlook on the economic front. Both the Treasury and Bank summer reviews of debtor countries' economies emphasise that recent developments, in particular the fall in oil prices, have increased the heterogeneity of the debt problem and complicated its handlng. It is doubtful whether the gains to oil importers will reduce their borrowing as much as the losses to oil exporters increase theirs. In the last few weeks oil prices have continued to fall whilst other commodity prices have also fallen heavily (almost 9% in SDR terms with large falls for food prices); the fall in interest rates has been limited and growth in industrialised countries sluggish. The Bank's report picks up the issue of agricultural subsidies and protection emphasised in the IBRD World Development Report.

On other individual countries, the political log jam in Nigeria appears to be moving in the right direction. The picture should become clearer when an IMF mission returns at the end of next week, provided that the question of South Africa does not intrude. In Latin America Brazil has continued to perform strongly on the external front but the Government has announced two sets of measures in June and July in response to an acceleration in the rate of inflation. Peru seems unlikely to clear its arrears to the IMF by the 15 August deadline but the resulting declaration of ineligibility by the Fund seems unlikely to provoke any dramatic response from other lenders eg the commercial banks. In Eastern Europe there are signs that Yugoslav commitment to adjustment is weakening, possibly leading to a breach of the targets built into the enhanced surveillance underlying the debt rescheduling arrangements.

The next report will come forward in mid-September and will provide an opportunity for a considered look at the debt scene and individual countries in advance of the autumn IMF and IBRD annual meetings.

I am copying this letter to Tony Galsworthy (FCO), Tim Walker (DTI) and John Footman (BOE).

Yours
Alex

A C S ALLAN
Principal Private Secretary

TO be Attached to HMT to CDP 1.8.86
International Financial Scene
(Letter in Box 1.8.86 but CDP
didn't want this to go in)

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INTERNATIONAL FINANCIAL SCENE

1 On 22 July Mexico signed an agreement with the IMF, designed to be the first stage in the country's attempts to put together a financing package of some $12 bn over the next 18 months. With the outcome of the Mexican negotiations likely to dominate perceptions of the overall debt situation for some time to come, news of the agreement will have provided a measure of reassurance, although some doubts remain about the nature of the agreement. With Mexico's financial position deteriorating rapidly - the trade surplus for the first four months of the year was less than $1 bn, compared with over $3 bn and $5 bn for the corresponding months of 1985 and 1984 respectively, and with interest payments of $600 mn falling due each month - rapid conclusion of the negotiations was essential. The Fund agreement includes some novel features, including the provision that if oil prices fall below $9 pb Mexico will receive additional financing from the Fund and other creditors; conversely, if prices rise above $14 pb, external financing will be reduced. Emphasis on linkage with IBRD loans, and on providing for growth in Mexico from 1987, maintains the thrust of the Baker Initiative, and should facilitate presentation of the agreement domestically in Mexico.

2 With some time to go before Fund money is likely to be disbursed, Mexico's immediate financing needs may be covered by a $1.5 bn bridging loan probably involving the US authorities, the BIS, other central banks and the commercial banks. In response to a request from de Larosiere, the Bank of England has agreed to participate in the bridging loan (HMT would give the Bank an indemnity). But a major outstanding uncertainty over all these arrangements is how the 500 commercial banks involved will react: at a meeting with the Advisory Committee in New York on July 23 and 24, banks were asked to provide around $6 bn of new money over the next 18 months, and some were asked to participate in the bridging loan. So far they have expressed a cautious welcome for the Fund agreement, but have indicated a number of reservations over the proposed bridging loan. At the Advisory Committee meetings a Working Party under Sam Cross of the Fed was established to resolve the bridging finance issues. Negotiations may well be difficult.

3 Whilst Mexico has been working towards agreement with the Fund, Venezuela has incensed commercial banks by its unilateral restructuring of $6.9 bn of private sector debt. Law 33506, passed by the Venezuelan Congress on 5 July, provides for the swap of private sector debt into 15-year dollar bonds with a 5% coupon; if

implemented, this law would effectively halve the value of affected debt. Bankers are deeply concerned that the Venezuelans would seek to extend such a restructuring also to the public sector, and that other countries might follow Venezuela's unilateral example. Some US banks are variously reportedly as threatening, in retaliation, to call all Venezuelan debt into default, to cut all lines to the country, or to institute proceedings to seize Venezuelan assets; the Fed is reported as intending to classify all loans, public and private sector, to Venezuela. However, after intensive representations, Finance Minister Azpurua has now said that he will try to have the law amended. The Venezuelan Congress will meet in special session in August to review changes in the plan, but the outcome remains uncertain.

4 The economic background to the Mexican and Venezuelan developments has been one of continued deterioration in oil-exporters' prospects, although for a number of other debtor countries prospects have been significantly improving. The renewed slide in oil prices in mid-July to below $10 pb, and the diminished prospect of an early OPEC agreement which could lead to a significant rebound in prices, worsened the already bleak economic prospects facing many oil exporting debtor countries. A number of other commodity exporters - such as Argentina and the Philippines - also face some deterioration in prospects: in the six weeks to mid-July commodity prices fell heavily (by 8.9% in SDR terms, 6% in $); within this, food prices fell over 10%, with falls of almost 30% in sugar prices and around 20% in wheat and maize prices, resulting in part from expectations of record world grain harvests. Food prices are now overall about 17% below their 1985 Q4 levels in SDR terms (10% in $); with non-food commodities having fallen by about 10% in SDR terms over this period, prices overall (as measured by the Economist all-items index) are 13% in SDR terms (6% in $) below their level at the end of last year.

5 Benefits to output in industrialised countries from the falls in oil (and other commodity) prices are coming through more slowly than expected. In the United States industrial output fell by 0.5% in June following a fall of 0.4% in May. GNP growth in Q2 is put at 1.1% ar (although the first quarter rate has been revised up to 3.8%). The Federal Reserve has revised down to 2 1/2%-3% its expected growth rate for the US economy for the year. GNP fell in Japan and Germany in Q1, although more recent indicators suggest performance now is more buoyant.

6 The continued fall in the dollar has been providing at least a partial palliative to many debtors: it fell by over 5% between the beginning of June and 29 July, to stand 10% (in effective terms) below its level at the beginning of the year and almost 20% below its level at the time of the Plaza agreement. Moreover,

as a result of relatively depressed economic performance, and no apparent immediate resurgence in inflation, interest rates have resumed their downward movement. The Fed discount rate was cut from 6.5% to 6.0% from 11 July (although this was not followed by moves in Germany and Japan), and three-month eurodollar rates are again near their lowest levels of the year, slightly above 6 1/2%. However, taken in conjunction with falling prices for their exports, and expectations of little revival of prices in the near future, real interest rates for many debtors continue extremely high.

7 Of renewed concern to debtor countries is the recent identification in industrial countries, particularly in the United States, of increased agricultural export volumes from LDCs (often as part of IMF or IBRD programmes) with depressed prices, and financial problems, for domestic farmers. With increasing US questioning of support for bilateral and multilateral loans to promote agricultural activity in debtor countries, the risk of increased protection against agricultural products from these countries is rising. The IBRD's World Development Report, published at the end of June, emphasised the need for LDCs to introduce measures to support agricultural development (as well as for industrialised countries to reduce costly subsidies); but falling world prices, and protectionism in industrial countries, will make LDCs' adjustment more difficult to achieve.

8 Leaving aside Mexico and Venezuela, developments regarding other oil exporters remain mixed. On 11 July the Fund Board discussed Nigeria's adjustment programme, which includes proposals for the introduction of a two-tier exchange rate in October, as a means to facilitate a naira devaluation. Although the Nigerians requested Colombian-style monitoring at the Board discussions, they seem to be moving towards accepting a "classical SBA" (ie SBA without necessarily making any drawings). Ecuador has now asked the Fund for a CFF, in addition to its SBA, in order to compensate for its oil export shortfall, and it seems likely that this will be approved next month. Although Ecuador's good relations with the Fund over the past few years are being emphasised as a justification for granting the CFF, this CFF may set a precedent for other oil exporters (Indonesia has already expressed some interest). On the other hand, whilst Egypt has declared itself prepared to begin serious negotiations on a Fund programme, it is far from certain that the country is willing or able to undertake the kind of drastic adjustment which the Fund is likely to require. Peru has now extended for a further year its restriction of debt-servicing payments to 10% of its exports, and has further tightened this policy by including $2 bn of private sector debt within this limit for the first time, and by introducing curbs on remittances of profits and royalties.

9 Amongst the oil importers, external prospects for Korea and Brazil continue to improve - although doubts are emerging over the success of the Cruzado plan in breaking Brazilian inflation in the longer term. In response, the Brazilian authorities have introduced further measures to reduce consumer spending and raise fiscal revenues, and are also taking steps to control the spending of the parastatals; in the meantime the June trade surplus - at $1.08 bn - was a record for the month, and last year's total surplus of $12.4 bn now looks likely to be exceeded.

10 The declaration of the state of emergency, and the increase in social unrest, have further depressed economic prospects for South Africa. With the imposition of measures of some sort against South Africa looking increasingly likely, there is clearly some possibility that the South Africans will at some stage undertake some retaliatory action on servicing their debt. However, it seems unlikely that this would lead to similar behaviour by other significant debtors.

11 Since the beginning of June, borrowing in the international markets by developing countries (apart from Hong Kong) has been very limited, totalling only $335 mn. South Korean borrowers raised only $40 mn, after raising $800 mn in the previous six weeks (and after withdrawing from a proposed $500 mn loan when they decided to reduce their new borrowings and to seek finer terms). Banco Itau of Brazil has arranged a euronote/commercial paper facility for $50 mn; its spread of only 1/4% above LIBOR resulted from the backing of the issue by a letter of credit from Fuji Bank. For East Bloc countries only the UK based Moscow Narodny bank was active in the markets in this period. Its $100 mn facility with euronote, revolving credit and multicurrency advance options, is the first such for a Soviet name. Among East Bloc borrowers only Hungary has previously used euronotes. Algeria was the only Arab oil producer to borrow in the international markets in this period, with a DM 200 mn ($90.7 mn) fixed rate bond.

Further details on individual countries are given below.

Latin America

12 Mexico signed a Letter of Intent to the IMF on 22 July, thus opening the way to an SBA involving SDR 1.4 bn over 18 months. The programme has several exceptional features: it envisages "moderate" growth in 1987, with a trigger mechanism for additional external finance if by Q1 1987 manufacturing production has not grown at a predetermined rate; it accepts the operational deficit (ie the fiscal deficit

with the nominal component of interest payments taken out) as a performance criterion alongside the fiscal deficit as conventionally defined; and it introduces a formula whereby programme targets will be adjusted in response to any changes in the oil price from pre-determined levels, and more (less) external finance will be sought if the price falls below $9 pb (rises above $14 pb). If the price falls to $5 pb, Mexico could be eligible for an additional $2.5 bn under this formula, half from the Fund, and half (it is hoped) from the banks. Mexico has proposed measures to reduce its fiscal deficit by 3% of GDP over 1986-1987 and will continue policies of rationalising parastatal enterprises and further trade liberalisation, and will improve procedures for approving foreign investment. The Fund finance is part of a total 18-month financing requirement of $12 bn, which will include World Bank loans (perhaps $2 bn) related to trade policy reform and industrial reorganisation, financial support from foreign governments, and (it is hoped) $6 bn of financial assistance from commercial banks. Mexico met the bank Advisory Committee plus other key banking representatives in New York on 23 and 24 July when an initial outline of its financing proposal was presented. It is likely that negotiations with the banks will be difficult, as there are indications that certain groups of banks are reluctant to participate in new lending to the country. For its part, the World Bank Executive Board approved loans to Mexico totalling $700 mn on 29 July (release will be subject to assurances that an adequate financing package will be obtained for 1986). De Larosiere told G10 Fund Directors on 28 July that Mexico needed a Paris Club rescheduling by September and needed a positive response from major creditors to continuation/resumption of cover after the rescheduling. He suggested that the SBA might come to the Board for approval (in principle) in the week beginning 8 September. In the interim period, while the financing package is being developed, de Larosiere had already proposed that a bridging loan be provided (of at least $1.5 bn), probably by the US authorities, central banks (including some Latin Americans) and commercial banks. However, the Mexican Finance Ministry's alternatives of incurring interest arrears or creating interest deposits in pesos cannot yet be entirely ruled out. Net reserves have fallen sharply in recent months, and reports suggest that the Mexicans are unwilling to see them decline much further; monthly interest payments are believed to be some $600 mn.

13 By contrast, the situation in Argentina has been relatively quiet since the Fund approved the request for a waiver on 23 June. The waiver opened the way for the final SDR 236.5 mn tranche of the SBA to be drawn on 27 June and this was followed on 30 June by the banks releasing the remaining $600 mn from last year's new money package. The next step will be to complete negotiations for a new SBA. But, with Argentina already having agreed targets for certain key indicators in the second

half of 1986, in order to obtain the waiver, the discussions over the new SBA appear to be progressing at a somewhat leisurely pace, perhaps as participants await the resolution of the Mexican situation. As a condition of the waiver conditionality, the Argentinians also agreed to pay off arrears to the Paris Club. Once this has been completed, and outstanding bilaterals (including the UK's) are signed, the way would then be open for a resumption of Paris Club discussions; September is the earliest date such talks are likely to begin, although October or November seem more realistic.

14 On the economic side, inflation in Argentina remains relatively high, at around 4 1/2% per month. Whilst the authorities have been re-iterating that their target for the year remains under 30%, achievement of this figure would require a considerable reduction in the average monthly rate - to around 1 3/4% - for the remainder of this year from the levels attained since the Austral Plan was introduced a year ago. With the initial wage/price freeze now being relaxed, this seems most optimistic. Recent trends in economic growth have been favourable: real GDP showed a small rise in Q1 1986 (after a buoyant Q4) and industrial output in June 1986 is put at around 13% higher than when the Austral Plan was introduced. However, recent renewed falls in grain prices may have damaged external prospects.

15 Brazil has continued to perform strongly on the external front. Its trade surplus in June was a record for the month. The surplus in the first half of the year was $6.15 bn, over $0.6 bn up on a year earlier, and last year's total surplus of $12.4 bn seems likely to be exceeded. Nevertheless, some doubts are emerging about the durability of the Cruzado Plan. In May the inflation rate was 1.4%, about one percentage point higher than the government forecast, and this was followed in June by a rate of 1.3%. The acceleration in inflation since the trough levels earlier in the year has been largely attributed to the recent consumer boom, which has led to shortages of many commodities. In response, the government announced a set of measures at the end of June intended to cut total consumer credit by about Cz 9 bn ($654 mn). Nonetheless, the Central Bank has suggested that the 1986 PSBR may be as high as 8.6% of GDP, compared with last year's 3.2% and an original forecast for this year of 0.5% (although this is still unverified by the government). In a further move to dampen demand and increase fiscal revenue, President Sarney announced on 23 July a package of measures designed to raise up to Cz 350 bn ($25 bn), largely through compulsory loans from consumers. The revenue will also contribute towards the financing of a three-year development plan reportedly aimed at raising per capita GDP to $2000 in 1990 ($1634 in 1985). The package is, however, likely to incur opposition from a number of quarters.

Signature of the $31 bn 1985-86 rescheduling agreement took place on schedule on 25 July, but there are no details as yet about the number of banks signing. Meanwhile, the Finance Minister, Dilson Funaro, has announced that Brazil will be seeking new money or refinancing packages in 1987-1988 so as to limit the country's net payment of interest on external debt to 2-2.5% of GDP in each year. It seems that this represents an opening negotiating stance for the discussions with the banks which are due to begin in the autumn, rather than any threat of unilateral action. Meanwhile, Banco Itau has announced that it has arranged a $50 mn euronote/commercial paper facility, backed by a letter of credit from Fuji bank, which will enable it to issue paper in both the US and Europe. The financing is the first of its kind involving a Brazilian bank since mid-1982 and is designed to extend the maturity of its existing interbank lines from the current one year to three years.

16 The signature date for the 1985/86 rescheduling was brought forward from 15 August to 25 July in an effort to encourage recalcitrant banks to agree to the terms of the deal. A number of banks are expected to hold back because of the failure to settle the dispute relating to Resolution 63 loans of three banks which failed last year. A creditors' committee has been negotiating with the failed banks' controlling shareholders but, before proposals can be put to the creditor banks, an audit appraisal of the assets of the banks in liquidation must be completed. The Central Bank has advised the creditor banks that it will make every effort to achieve a solution in the shortest possible time.

17 On 17 July, perhaps in response to criticisms in the recent IMF Article IV paper, the Venezuelan authorities announced a 21 point austerity plan - including the abolition of the preferential exchange rate for private debt repayments - aimed at compensating for the loss of 30-40% of fiscal revenue this year resulting from the weakness of oil prices. The authorities have, however, angered the commercial banks by passing legislation at the beginning of July intended unilaterally to re-reschedule payments on $6.9 bn of private debt (already rescheduled over 7 years at Libor +1.25%). Under this legislation the current foreign exchange contracts between debtors and the Central Bank would be replaced by Central Bank bonds, with a minimum term of 15 years and a maximum interest rate of 5%, issued directly to creditors. The banks, while willing to concede some ground on private debt repayments, have refused to accept the new scheme and some (mainly US) banks have suspended credit lines to the country. Following meetings between the Advisory Committee banks and the authorities, it has been announced that the Venezuelan Congress will meet in special session in August to review changes in the plan. Although the outcome is uncertain, the legislation has been unhelpful both

for banks' negotiations with Venezuela and for the precedent it may be seen to set for other debtor countries. Negotiations with the commercial banks over the possible rescheduling of the MYRA - the $750 mn down payment on which has yet to be made - have not yet begun.

18 Elsewhere in the region, Peru has extended for another year its limit of 10% of exports for servicing medium and long term public sector debt, and is now including also $2 bn of private sector debt within this policy; remittances of profits and royalties are also being curbed. It is looking increasingly unlikely that the country will clear its arrears to the IMF by the 15 August deadline; Foreign Minister Allan Wagner said recently they would not be eliminated even by the end of the year. A further partial payment is likely to be the best the Peruvians offer; if so, a declaration of ineligibility by the Fund looks unavoidable. Moreover, as its conditionality is being breached, the IBRD is already delaying disbursements on some of its loans. Yet the government's own perception of the economic outlook remains favourable. Recent official forecasts put the growth in industrial production (which accounts for around one quarter of GDP) at 12% for this year - which would be the highest for a decade. Growth in the first five months was said to have almost achieved that rate. Inflation has fallen over the past year from 200% to 70%. Meanwhile, the political background continues to deteriorate. The recent escalating confrontation with the terrorists increased speculation about the possibility of a military coup, but Garcia appears to have averted this threat - at least for the time being.

19 By contrast, several other countries are making good progress in their negotiations. For Bolivia the IMF Board meeting on 19 June approved a 1-year SBA for SDR 50 mn (55% of quota); this was followed by agreement in principle being reached with the Paris Club on 24 June to reschedule $430 mn of arrears and all debt service due to mid-1987: $190 mn of principal and interest in arrears at 30 June 1986 were extended over 10 years (4 grace) and $224 mn of debt service due July 1986 to June 1987 were rescheduled over 10 years (6 years grace). Bolivia is expected to seek similar terms on commercial bank debt ($900 mn plus about $200 mn interest arrears) in negotiations next month. The possiblity of a CFF seems to have receded. In Chile all the economic indicators - domestic and external - are on track. On the basis of the recent Article IV Mission the Fund are confident that growth of 4-4 1/2% for the year is a realistic expectation; and annual inflation is now down to 20%. On the debt front, the debt/equity scheme continues to prove attractive (it is said to have reduced outstanding debt by some $500 mn). However, the political situation continues to give grounds for concern, with attention focussing increasingly on the country's political future after the 1989 elections.

20 Colombia has still not drawn the first tranche of its $1 bn new money loan, despite having stated that a drawing would occur by end-June. The external situation clearly remains strong and reserves rose by $0.6 bn in the first half of the year. Ecuador's request for an SBA (SDR 75 mn) is set to be discussed in the Fund Board on 4 August, along with the country's request for a CFF. If granted, the CFF will be the first such loan largely to cover a shortfall in oil earnings, and might be seen as a precedent by other oil exporters - although the justification for granting Ecuador the CFF rests heavily on Ecuador's good relations with the Fund over the past few years. Activation of the Paris Club MYRA continues to be deferred, pending the approval of the new SBA, but progress continues on syndicating the bankers acceptance facility (estimated at between $150-$200 mn). The authorities have indicated that they may request a waiver on Ecuadorean counterpart funding for bilateral aid projects (including those with the UK) to help meet the balance of payments shortfall. In Uruguay the authorities signed the contracts for rescheduling $1.7 bn of bank debt due 1985-9 on 10 July.

21 In Costa Rica, an IMF team has prepared a draft Letter of Intent for consideration. The World Bank, for their part, are satisfied with recent measures to reduce subsidies and import surcharges, and have released $40 mn from the SAL thus allowing USAID to release an equal sum. Although some interest arrears to banks have been cleared, Costa Rica remains technically in default on its debt to the banks. Cuba imposed a moratorium on medium and long term debt service obligations from 1 July. However, the Cubans provided the Paris Club with revised projections of the 1986 balance of payments which show a reduced new money requirement, and met the Paris Club on 15 July, when agreement on a rescheduling package was reached. However, no agreement was reached with the banks at the meeting with the Steering Committee on 18 July; a further meeting will be held in early August. Unconfirmed reports suggest that the moratorium on debt service has been extended to cover short term debts from mid-July. Jamaica's relations with the Fund continue to deteriorate. Fund Staff visited Jamaica in mid-July and will probably suggest suspension of the current SBA and the negotiation of a new programme. Meanwhile, the question of arrears to the IMF (which have risen to SDR 49 mn) was considered under the Fund's complaints procedure on 23 July. Given that arrears on Nicaraguan debt were more than two years overdue on 1 June, the World Bank agreed on 24 June to make provisions (in the accounts for the year ended June 1986) against 20% of the total loans outstanding to the country - the first time such provisions have been made. Nicaragua has since promised to pay the amounts overdue beyond two years ($1.9 mn), but with no indication of timing. If this payment is forthcoming before the Bank's accounts are audited in late July, the provision will be eliminated; it now seems, however, that no payment will in fact be made.

22 Discussions in the Inter American Development Bank on the Seventh Replenishment of Resources, which will finance lending over 1987-1990, are making some, albeit rather slow, progress. The Board of Governors met in Paris from 16-18 July to continue negotiation on the size of the Seventh Replenishment and the details of proposed organisational changes; a further meeting is due in September.

South and East Asia

23 An IMF team is in the Philippines to discuss a new Standby programme. The government is pressing for some relaxation in targets, particularly on the monetary front, as previous targets are seen to have contributed greatly to two years of GDP decline and loss of business confidence. On the fiscal side, following pre-election spending by the Marcos administration, the deficit in 1986 is in any case running well above the original IMF target. Whilst it is generally thought that the IMF will be prepared to agree to some relaxation, they are also likely to press for a reform of the tax system. The authorities have already announced a series of import liberalisation measures with which the IMF team is reported to be satisfied. A letter of intent is expected to be signed shortly. Once a new programme is in place, the government is likely also to attempt to renegotiate and extend the terms of its debt rescheduling agreement with the banks. The Economic Planning Minister periodically talks of selective debt repudiation but it seems that this concept does not receive widespread support within the Cabinet.

24 In Indonesia the latest trade figures indicate that the full impact of the oil price fall has yet to be felt. In the first quarter there was actually an improvement in the merchandise trade account, with a surplus of $3.4 bn ($2.8 bn in Q1 1985); export receipts fell marginally to $4.7 bn ($4.4 bn) whilst import payments were cut more dramatically, to $1.3 bn ($1.6 bn). The South Korean economy continues to expand strongly; real GDP growth this year is now expected to be in the range of 9-10%, with the trade account moving into a surplus of $1.4 bn, following a deficit of $30 mn in 1985. The government is consequently considering reducing its external borrowing programme this year, by at least $500-600 mn, from an original $5.7 bn. Meanwhile, in their report on the 1986 Article IV consultation with Malaysia, IMF staff have suggested that the size of the public sector deficit (17% of GDP) and the weak balance of payments outlook for 1986 and the medium term were most disquieting, and noted that they viewed with concern the prospective increase in the country's external debt burden which could ensue; they therefore urged the Malaysians to persevere with intensified fiscal adjustment and more active use of exchange rate policy to bring about a depreciation of the

ringgit. Prime Minister Mahathir has called a general election for August 3; when this is out of the way, there may be less pressure to delay taking the suggested remedial actions.

25 India recorded a particularly weak trade performance in FY 1985/86 (ended March). The trade deficit increased to $6.8 bn from $3.8 bn in the previous year, with exports registering a 10% fall in value terms and imports an 11% rise. If exports fail to pick up soon, Rajiv Gandhi's drive toward greater industrial deregulation and import liberalisation may be called into question, particularly if (as seems inevitable next year) the debt service ratio breaches the 20% ceiling which the government sees as a maximum safe level.

Eastern Europe

26 At the meeting between the Paris Club and Poland on 17 July, set up for the Poles to explain why arrears had been building up on payments due since January, the Poles requested a re-opening of the rescheduling agreement initialled in March, to give further relief of $500 mn, and also requested new credits. The Poles claimed this was necessary as their forecast trade surplus for 1986 had been revised down by $200 mn, and the banks had refused to provide new credit, while IMF loans would not be available until mid-1987 (at the earliest). Although the Poles appear to have made most payments due in January, creditor governments expressed disappointment at the Poles' request, and refused to re-open the March agreement. The Poles were expected to seek further relief from other creditors, including the banks, but the possibility of another Paris Club meeting later in the year was kept open. Subsequently, the Chairman of the Paris Club met the co-Chairmen of the banks' Working Party to discuss burden sharing; however, it seems unlikely that the banks will be willing to do anything further this year at least.

27 On the other hand, following discussions with the banks in London on 7-8 July, the Romanians have reached an agreement which should effectively relieve their current liquidity crisis and permit some recovery in reserves (although much will depend upon the settlement of arrears with the IBRD, and continued disbursement of official credits and renewed supplier credits). The banks agreed to reschedule 100% of 1986 maturities under the 1982 agreement ($354 mn) and 85% of 1987 maturities arising from the 1982 and 1983 agreements ($456 mn relief). Each payment due under the original agreement will be made in two instalments on a rolling maturity basis beginning May 1989. The margin has been reduced to Libor +1 3/8% compared with Libor +1 3/4% under the earlier agreements. The banks showed some flexibility in concluding these arrangements without insisting on parallel

action by the Paris Club or on an IMF programme (which could have created an impasse, given the Romanians' past and prospective lack of cooperation with the Fund).

28 Economic results in Hungary for the first five months of the year indicate a further deterioration in the country's external economic performance. The hard-currency deficit increased to the equivalent of $430 mn, compared with $183 mn in the corresponding period last year year, following increases in imports of 14.5% and of exports of only 1.1%. Industrial production has risen only 1.2% (cf a target for the year of 2 to 2 1/2%). With no sign of any reversal in these trends, there are growing prospects that the country may be forced to seek IMF assistance. On present trends the convertible-currency current-account deficit this year may be in the region of $1 bn, which could seriously undermine market confidence. Meanwhile, there is some concern about extent of the new Yugoslav Government's commitment to policies introduced during IMF programmes, and there are increasing doubts about the country's underlying cash-flow position: even assuming a recovery in the current account surplus to $0.9 bn, and the raising of $0.8 bn supplier credits, there is still a prospective financing gap in 1986 of close to $0.5 bn, after allowing for the implementation of the bank and official reschedulings. If the banks, who have yet to be approached, decline spontaneous financing, it seems likely that additional rescheduling - of already rescheduled and/or of hitherto privileged debt or interest - and/or a new round of export credit pledges will have to be sought before the end of the year.

Southern Europe

29 Although the austerity programme introduced last October has begun to have an impact on performance in Greece, with falling inflation and public expenditure restraint, the current account deficit reached $1.2 bn in the first four months of 1986 against a $1.7 bn annual target. The most recent borrowing on the international capital markets - a small $43 mn ten-year syndicated loan for Olympic Airways at LIBOR +3/4% - saw a worsening of terms compared with earlier loans.

30 Partly as a result of lower oil prices, the Portuguese authorities have increased their 1986 projected current account surplus to $0.7 bn (3.6% of GDP); this compares with a surplus of $0.4 bn (2% of GDP) in 1985. In response to the continuing fall in inflation (year-on-year 11.7% in June) interest rates were again reduced in June: the key 6-12 month deposit rate (the 'Pivot Rate') was cut by 3 percentage points to 15 1/2%. The authorities have also been able to reduce the monthly crawling peg depreciation of the escudo, from 0.9% to 0.7% with effect from July.

Africa

31 The Nigerian Article IV consultation was completed by a Board discussion on 11 July. The external position is very weak, with a projected cumulative financing gap of $10.5 bn in 1986-87. Debt service ratios before rescheduling are projected at 130% in 1986 and 82% in 1987. In a public address on 26 June President Babangida had announced the introduction of a wide ranging Structural Adjustment Programme, the key elements of which have been designed with the assistance of the World Bank. This aims to reduce the budget deficit to less than 3% of GDP, substantially liberalises the domestic economy and, crucially, establishes a temporary two-tier exchange rate system to facilitate a devaluation. The second tier, which will be a market-determined rate, will cater for all transactions except debt service and payments to international organisations; it is expected to be introduced in early October, but its financing is as yet uncertain. An IMF mission left for Lagos on 19 July with the solution of this problem as a main aim. The mission will be in London on 8 August, and will brief Bank and HMT officials. The banks have tentatively agreed to meet the Nigerians in the second half of August. Progress on rescheduling their debts awaits the calculation of Nigeria's financing gap and the country's agreement of an IMF Letter of Intent. The banks' willingness to include new money in a debt relief package is likely to be influenced by Nigeria's treatment of arrears of letters of credit accumulated since end-1983: since early this year there has been no further issue of promissory notes under the scheme to reschedule pre-1984 uninsured trade arrears.

32 The Paris Club MYRA agreed for Cote d'Ivoire on 26/27 June is the first for an African country (and the second overall). It is to cover 3 years' maturities with a goodwill clause for a fourth year. Principal only is rescheduled, on a declining basis (80% in 1986, 70% in 1987, 60% in 1988, 50% in 1989), repayment is over 9 1/2 years with 4 1/2 years' grace. The London Club has agreed in principle on similar terms covering the same percentages of principal over a 4 year period. Elsewhere, Tanzania and Sierra Leone seem poised to clear their arrears to the IMF and agree new programmes, but programmes in Zambia and Zaire are proving difficult to keep on track. There is concern that increased Government interference with the auction system in Zambia will negate much of its value.

33 The debate on the imposition of sanctions against South Africa continues, both within the EC and the Commonwealth. In the UK, the South African Ambassador's remark that, in the event of extensive sanctions being applied, South Africa could consider not repaying its international loans and that this might have repercussions on other debtors (later contradicted by the South African Minister of Finance) has

not helped business and financial confidence in South Africa. The statement on 3 July (subsequently denied) that Dr Leutwiler had resigned as mediator between South Africa and its creditor banks added to the air of uncertainty. The banks' economic sub-committee has recently returned from South Africa to refine its balance of payments statistics. But with the imposition of the State of Emergency and the continued political turmoil, prospects for any revival of confidence in the country remain very distant.

Middle East & North Africa

34 A team of Egyptian ministers visited Washington in late June to discuss military debt and a planned economic reform programme with US government officials, the IMF and World Bank. President Mubarak has recently visited a number of European countries in an effort to enlist support in the forthcoming IMF negotiations. He appears to have been listened to sympathetically, but little more. The problem of arrears on servicing US military debt has been temporarily eased by the release of $110 mn in grant aid by the Reagan government. But the package of reforms designed to cut the budget deficit and strengthen the balance of payments - due to be introduced in stages before the end of August - made an inauspicious start when the new tariff system, in the pipeline for a year and due to come into force on 1 July, was delayed again. This inspires little confidence that Egypt is ready to implement the more radical policy measures certain to be required by the IMF for a Standby, nothwithstanding Egyptian protestations that they are now ready to agree a programme. In its most recent attempt to regain markets for its oil exports, Egypt has cut the price of its oil to between $6 and $7 pb.

35 The latest falls in oil prices have put further heavy pressure on other oil producers in the region. Iraq's acute foreign exchange shortage has steadily worsened in recent weeks, even though oil production has been running at 2.0 mbd (compared with its OPEC quota of 1.2 mbd). Banks reportedly are not confirming letters of credit for Rafidain Bank, the country's only commercial bank, and major delays on payments have become commonplace. Iraq is continuing to service large syndicated credits, including its recent $500 mn borrowing, but payments are often up to 2 weeks late. Iraqi officials have been visiting creditor countries, seeking to reschedule debt, including short-term bank lines, and offering oil in lieu of cash repayments.

36 Following the break-down of Morocco's IMF programme, Finance Minister Berrada is reported to have said that he wants nothing more to do with the Fund, claiming that it is politically impossible to comply with Fund pressure to reduce the budget

deficit, either by increasing revenue or cutting expenditure. Berrada argued that he saw no alternative to rescheduling capital repayments and ceasing to pay interest altogether. Discussion with the banks on rescheduling 1985-87 maturities and possible new money has been stalled since March, pending a reactivation of the Standby or its replacement. The new civilian government in Sudan has resumed contacts with the IMF and IBRD but agreed to receive a Fund mission only to collect economic data and highlight areas where policy changes were needed. The mission's findings, reported to the Finance Minister on 26 June, showed a continuing economic decline in 1985-86, with inflation running at 50-60%, government expenditure rising by 35%, exports the lowest for several years, and little debt repayment other than to key creditors (IBRD and USAID). With the main budget (due in June) having been postponed, a stop-gap financing budget was approved on 30 June to run for 3 months, by which time the committee charged with devising a new economic policy should have reported. There is no indication that the authorities have taken on board any of the IMF's concerns. The Tunisian authorities have appealed to western governments for urgent financial aid to cover an acute shortage of foreign exchange. Although a syndicated commercial bank loan worth $120 mn was signed on 30 May, additional funds are necessary to tide over the period until October-November when an IMF programme and World Bank facilities are expected to become operational.

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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-Dec 1985	End-March 1986 [2]	End-March 1986 [3]
Latin America				
Argentina	50	2.8(0.1)	0.2	0.2
Brazil	102	6.3(1.0)	0.9	1.9
Chile	19	1.3(0.1)	-	0.1
Colombia	14	0.6(0.1)	0.1	0.2
Ecuador	8	0.5(-)	0.1	0.1
Mexico	97	6.3(0.3)	0.6	1.3
Peru	14	0.3(-)	0.1	0.2
Venezuela	37	2.1(-)	-	-
Far East				
Indonesia	35	0.7(0.3)	0.8	1.7
Philippines	27	1.3(0.1)	0.2	0.2
South Korea	45	2.3(0.4)	0.4	0.8
Eastern Europe (convertible currency)				
Hungary	12	0.4(-)	-	0.1
Poland	30	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	17	1.3(0.2)	0.2	0.3
Portugal	16	1.1(0.2)	0.2	0.2
Turkey	25	0.4(0.2)	0.2	0.5
Africa				
Egypt	40	0.3(0.3)	0.4	1.0
Morocco	15	0.1(-)	0.1	0.3
Nigeria	19	1.1(0.1)	2.1	3.2
South Africa	22	3.9(0.8)	0.8	2.6
Sudan	10	0.0(-)	0.3	0.3
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 ECGD-guaranteed loans disbursed, plus political claims paid and claims under examination.
[3] Defined as ECGD-guaranteed loans (disbursed and undisbursed) and contractual interest, plus political claims paid and claims under examination.
* current estimate

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10 DOWNING STREET

From the Principal Private Secretary

23 July 1986

Dear Rachel,

MEXICAN DEBT

I have shown the Prime Minister your letter of 22 July about the arrangements put together by the Managing Director of the IMF in support of the Mexican IMF programme.

The Prime Minister has noted these arrangements. She is content for the Chancellor of Exchequer to authorise the Bank of England to take part in the operation, and to give the Bank an indemnity on the lines similar to that given in 1982.

I am copying this letter to Joan MacNaughton (Lord President's Office), Tony Galsworthy (Foreign and Commonwealth Office), Alison Smith (Lord Privy Seal's Office), Murdo Maclean (Chief Whip's Office), David Beamish (Lord Denham's Office), and John Footman (Bank of England).

Yours ever,

Nigel Wicks

N. L. Wicks

Mrs. Rachel Lomax,
H. M. Treasury.

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NW

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

David Norgrove Esq
10 Downing Street
London
SW1

22 July 1986

Prime Minister
Content with X?
N.L.W.
22.7

Dear David

MEXICAN DEBT

As part of the arrangements which are being put together to support a Mexican IMF programme, the Managing Director of the Fund has asked Central Banks in certain member states to take part in a three-month bridging loan, to carry Mexico through the period until it can make a drawing from the IMF. It will be announced in Washington on Wednesday that Mexico has signed a Letter of Intent, which can be expected to lead to a Stand-By Agreement with the Fund in September, and an early drawing thereafter, from which the bridging loan would be repaid.

The bridging loan would amount to $1.5 billion, and would be in three parts: one-third from the US Authorities (Fed and Treasury); one-third from the commercial banks who are exposed to Mexico; and one-third from central banks who are members of the BIS. The UK share of the Central Bank tranche could be up to $85 million.

There is a precedent for this operation: a very similar loan was made in 1982 for Mexico (and somewhat similar operations were also carried out for Brazil and Yugoslavia).

X The Chancellor proposes to authorise the Bank of England to take part in the operation, and to give them an indemnity on lines similar to that given in 1982.

Unlike 1982, there are now statutory powers for such an indemnity (International Monetary Arrangements Act 1983) and the Act requires us 'immediately after giving any undertaking under this section, to lay a statement of the undertaking before each House of Parliament'.

... The Chancellor proposes to do this on Thursday. I attach a draft. I should be grateful for confirmation that the Prime Minister sees no objection.

The Chancellor does not think it will be necessary to make a separate announcement, by way of arranged Question or otherwise. But the announcement will have been made in Washington on Wednesday so we shall let you have suitable briefing for the Prime Minister's use at Question Time on Thursday, and will provide speaking notes for the Adjournment Debates in both Houses in case the points are raised then. However, our expectation is that the operation is on balance unlikely to provoke any comment in Parliament.

The FCO has arranged to send an appropriate briefing to Mexico City and other foreign posts. Our Press Office and the FCO Press Office have question and answer briefing.

As a matter of courtesy, we will be notifying the Public Accounts Committee and the Treasury and Civil Service Select Committee.

I am copying this letter to Joan MacNaughton (Lord President's Office), Tony Galsworthy (FCO), Alison Smith (Lord Privy Seal's Office), Murdo Maclean (Chief Whip's Office), David Beamish (Lord Denham's Office), John Footman (Bank of England) and Bernard Ingham (No 10).

Yours ever,

Tony

A W KUCZYS

DRAFT 21.7.86

INDEMNITY TO THE BANK OF ENGLAND COVERING THEIR COMMITMENT TO THE BANK FOR INTERNATIONAL SETTLEMENTS IN RESPECT OF A LOAN TO MEXICO

Section 2(i) of the International Monetary Arrangements Act 1983 empowers the Treasury to undertake to indemnify the Bank of England in respect of financial assistance given by the Bank to the monetary authorities of a foreign country, in co-operation with the Bank for International Settlements or any other central banks or monetary authorities. The Act requires the Treasury to lay a statement of the undertaking before both Houses of Parliament immediately after giving the undertaking. This paper fulfils that requirement.

International assistance to Mexico

2. Financial support for Mexico is being provided or sought through an application by the Mexican Government to the International Monetary Fund for a Standby Agreement; an application to the International Bank for Reconstruction and Development for a series of loans; by assistance in various forms by the United States authorities; through discussions with the commercial banks of many countries which have provided loans to Mexico; and by a loan from the Bank for International Settlements supported by the central banks of a number of countries. The BIS loan to the Bank of Mexico is part of total central bank facilities of $1.5 billion being made available to Mexico and is for a period of three months. The BIS will finance the loan from its own resources, but with a right of recourse to participating member central banks. The Bank of England's contingent liability under this arrangement is [$85] million and the Treasury has agreed to

give the Bank an indemnity in respect of this commitment.

3. The Government's decision to support the BIS operation and to give the indemnity took into account that the Mexican Government had applied for assistance to the International Monetary Fund and the International Bank for Reconstruction and Development, and that the BIS loan was essentially of a bridging character. A more general consideration was the Government's view of the importance of facilitating Mexico's economic adjustment and the contribution that a bridging facility would make towards safeguarding the health of the international financial system.

4. A similar undertaking was given to the Bank of England in August 1982 in respect of a similar bridging operation. In the event the loan was repaid on time and the indemnity was not required. The present undertaking is given under statutory powers which were not available in 1982.

CF / for you I think!

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and return please

DLS

(to CF)

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WEP(86) 2
27 June 1986

HER MAJESTY'S TREASURY

WORKING PARTY ON
WORLD ECONOMIC PROSPECTS

I attach a report on the Summer WEP exercise. Detailed background tables can be obtained from Mr Hennebry on 233 3829.

Stephen Matthews

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WORLD ECONOMIC PROSPECTS

JUNE 1986 REPORT

Contents

	Paragraph Numbers
Summary	1-3
Fiscal policy	4-7
Monetary policy	8-10
Activity in major countries	11-22
Inflation and commodity prices	23-26
World trade	27-28
Current balances and exchange rates	29-30
The oil market, oil prices and OPEC	31-34
Non-oil developing countries	35-37

WORLD ECONOMIC PROSPECTS: SUMMER 1986

SUMMARY

1. The forecast covers the period to 1989, but the numbers beyond 1987 are particularly speculative. The main features are summarised below.

(a) Growth in world output and trade volumes has been disappointingly slow over the past six months, but we expect low oil prices to give a significant boost to activity over the next two years.

(b) Real GNP in the major industrialised countries grows at an average annual rate of 3 per cent over the rest of the decade, rather faster in 1987 and 1988.

(c) Trade volumes are expected to rise by only 4-5 per cent per annum because of depressed levels of imports into oil-producing countries.

(d) Inflation in the major seven OECD economies is already down to 2 per cent and should remain low throughout next year. After the once-and-for-all benefits of low oil prices, inflation may rise to 3 per cent in 1988, and further if inflationary fears in the US are realised.

(e) We assume that world oil prices average $15 from now until the end of 1987, the same assumption that was used in the FSBR.

(f) Non-oil commodity prices have continued to weaken in real terms. We expect some recovery from current extremely depressed levels as world activity grows strongly in 1987 and 1988.

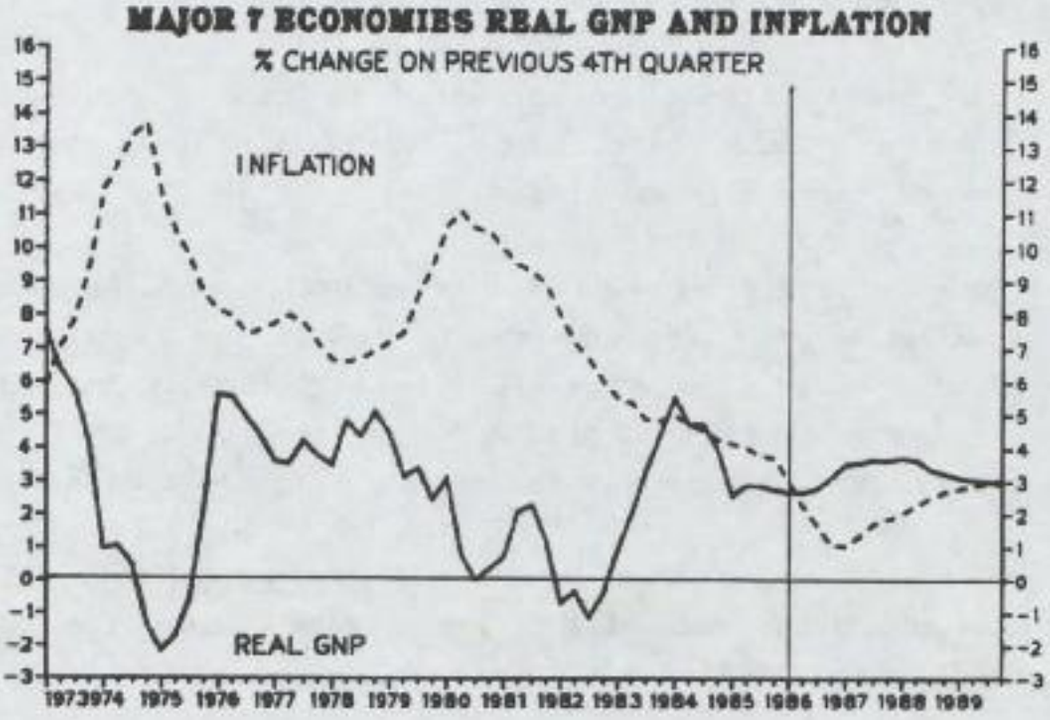
(g) Despite the depreciation of the dollar the US continues to run large current account deficits, albeit falling slightly as a proportion of GNP. Little reduction in the Japanese surplus is expected.

Table 1: Output, inflation and trade

Percentage change on year earlier	1984	1985	1986*	1987*	1988
Major 7 real GNP	4½	3	3 (3½)	3½ (4)	3½
Major 7 consumer's expenditure deflator	4½	3½	2 (2½)	1½ (1½)	2
UK export markets (manufactures)	8½	5	3 (5)	4½ (5)	5

* Figures in brackets were those in FSBR; for 1987 they are for first half only.

Chart 1:

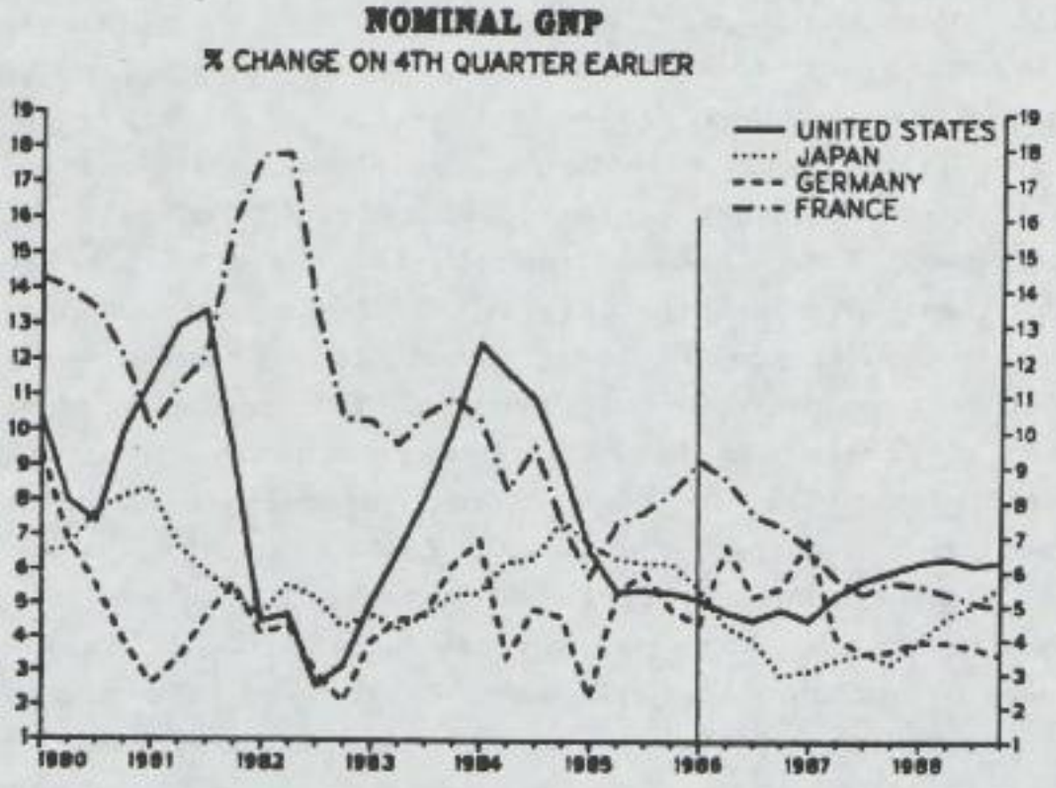


2. This report focuses on a "central" case only. A major source of uncertainty is the reaction of the world economy to the unprecedented fall in oil prices. Experience of the increases in oil prices in 1973 and 1979 indicates that such shocks can create conditions under which major forecasting errors may be made, e.g. the strength of inflationary forces in 1974 and the

depth of the recession in 1975 were underestimated. Moreover the response to a fall in oil prices may not mirror the effects of the rises of 1973 and 1979, e.g. because the propensity of OPEC to consume its revenues has increased. While there is some consensus between forecasters on the short-run effects on output, there has been little discussion of the supply-side mechanisms and the factors which may increase the long-run growth rates of productive potential.

3. Another source of uncertainty is the ability of the equations in our model to handle the response to the dramatic fall in the dollar's foreign exchange value over the past fifteen months. The conjunction of this and the oil price fall means that our forecasts of trade volumes and trade prices necessarily rely more on our own judgement, and less on the equations, than usual.

Chart 2:



FISCAL POLICY

Table 2: General Government Deficits

General Government Financial Balances as % of GNP	1968-73	1974-79	1980-84	1985	1986	1987	1988
US	-½	-1¼	-2½	-3½	-3	-2	-1½
Japan	1	-3½	-3½	-1⅜	-1¼	-1	-½
Germany	0	-3	-2½	-1	-¾	-½	-¾
France	½	-1	-2	-2½	-2½	-2½	-2¼
Italy	-5	-9	-11½	-14	-13	-12¾	-12¼
Canada	1	-1½	-4½	-6	-6¼	-6	-5½
Major 7	-½	-2½	-3½	-3½	-3	-2¼	-2

4. Although the Supreme Court in the United States may find the role of the Comptroller-General under the Gramm-Rudman Balanced Budget Act unconstitutional, the mood of Congress is such that there is likely to be a significant deficit reduction in the 1987 fiscal year. The House, the Senate and the President have, all produced budget proposals which yield Federal deficits in the range $137 to $144 billion (on the basis of some fairly optimistic economic assumptions). The House and Senate have now gone to conference on their proposals. It remains to be seen whether the package they produce will persuade President Reagan to compromise on his desire to avoid tax increases and to prevent deep cuts in real defence spending. Nevertheless we expect that, helped by recent falls in interest rates, optimistic assumptions on real GNP growth, the added bonus of a likely $10 billion extra tax revenue because of the tax reform bill (see paragraph 14), and some fudging on the proportion of defence budget authority actually spent, a FY1987 budget broadly consistent with the Gramm-Rudman deficit ceiling of $144 billion will eventually be agreed. The out-turn, though, is likely to turn out somewhat higher at around $160 billion.

5. For FY1988 and beyond, the probable modification of the Gramm-Rudman procedures from their present stringent form will

make further cuts in the deficit more difficult. Furthermore the gaps between the Gramm-Rudman target and expected outturn deficits are likely to be viewed as insurmountable (especially with rising interest rates) if tax increases are ruled out. We are therefore forecasting Federal deficits to remain around $150 billion in each of fiscal years 1988 and 1989. This is sufficient to stabilise the debt-GNP ratio at around 43½ per cent.

Table 3: US Federal Budget Deficit

Fiscal Year	CBO baseline (Feb 86) ($bn)	Gramm-Rudman targets ($bn)	WEP ($bn)	WEP (% of Nominal GNP)	WEP Ratio of Federal debt to GNP (%)
1985	210	-	212	5½	38
1986	208	172	210	5	41
1987	181	144	160	3½	42½
1988	165	108	150	3	43½
1989	144	72	150	3	43½
1990	120	36			
1991	104	0			

6. In Japan and Germany, fiscal policy remains tight despite pressure from other countries, notably the US, for easing in the face of negligible inflation rates and falling export growth. In Japan the forecast assumes further small reductions in the central government deficit as a percentage of GDP. The German government continues to show its determination to restrict the budget deficit this year to its target of 1.2 per cent of GNP and there would seem to be little difficulty in continuing fiscal "consolidation", despite the introduction of tax reforms.

7. In France (despite its new government) and Italy the authorities are assumed to have their usual difficulties in reducing their deficits. They will be assisted by the beneficial effects of falling oil prices, but this is not expected to result in major reductions in their structural deficits. Italy, however,

is using the fall in oil prices to reduce government borrowing by raising petrol taxes. Lack of consensus on the deficit problem in Canada is limiting attempts to curb their federal budget deficit, but the markets have shown that they will react unfavourably if no action is taken.

MONETARY POLICY

8. Falling oil prices and currency appreciations outside the US have permitted sharp falls in nominal interest rates in many countries. However these factors create a difficult background for interpreting developments in monetary growth and for setting interest rates. Real interest rates (as measured by nominal rates less the current rate of inflation) have not fallen (perhaps because some of the fall in inflation due to lower oil prices is expected to be reversed), but money supply has been growing above target in several countries. Low nominal interest rates should persist over the next year or so, but rising real demand and the unwinding of the oil price effect on inflation may put upward pressure on interest rates by 1988.

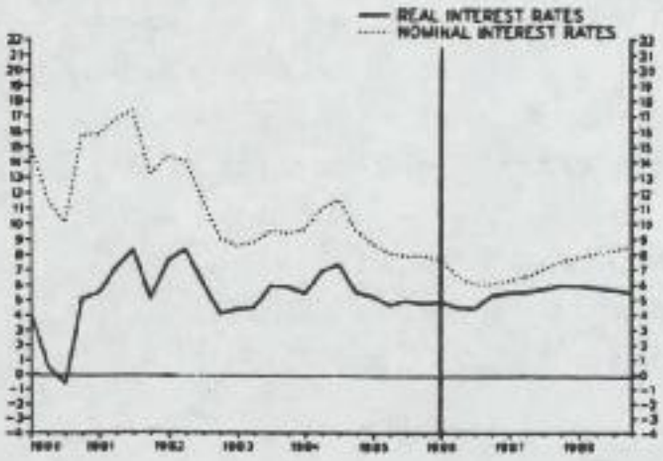
9. In the United States interest rates have fallen considerably over the past 18 months and the yield curve has become almost flat. The declines reflect good news on inflation, largely thanks to oil, and market perceptions of improved prospects for cutbacks in Federal borrowing. In the short-term there could be further interest rate cuts if growth in the second quarter is weak. Thereafter, stronger activity in the second half of the year, accompanied by concern over continued depreciation of the dollar could produce a period of gradually rising rates. There does not however seem much concern at present about the monetary aggregates, which are growing strongly, with M1 and the credit aggregate well above the top of their target ranges.

10. Japan and Germany are both facing international demands for the easing of monetary as well as fiscal policy, reinforced in the Japanese case by home pressures to ease the transition from export to domestic demand-led growth. In Japan, three

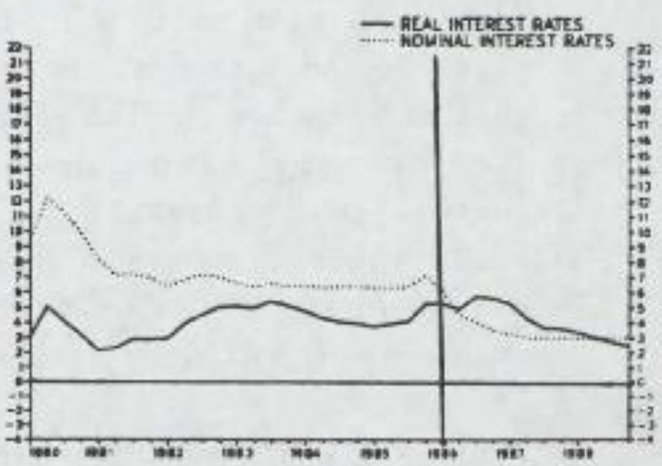
REAL AND NOMINAL 3-MONTH INTEREST RATES

CHART 3:

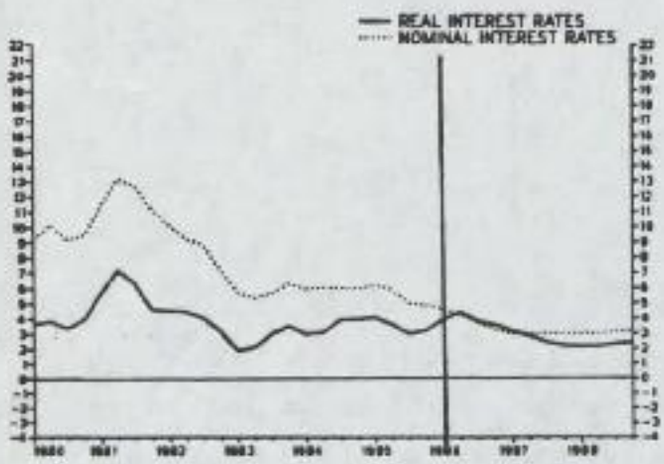
UNITED STATES



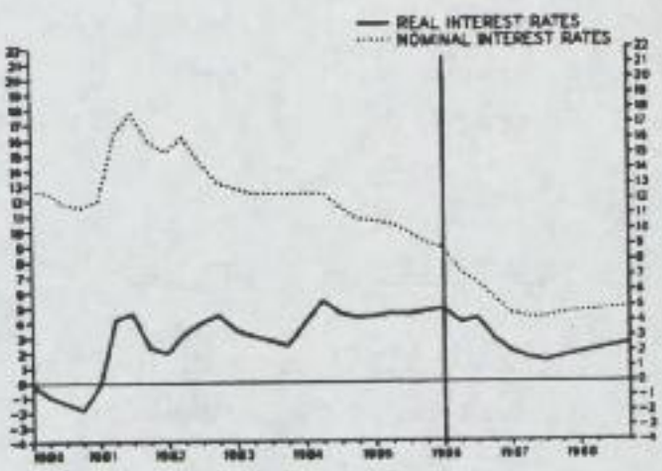
JAPAN



GERMANY



FRANCE



½ per cent cuts in the discount rate so far this year have brought most short-term interest rates down to levels last experienced in 1978. The monitored monetary aggregate, M2 + CDs, is growing at around 8½ per cent per annum, but further cuts in interest rates are thought likely later in the year. Short-term market rates in Germany have stayed at about 4½ per cent since January, despite a half point cut in the official discount rate in early March. The authorities have been reluctant to reduce rates further because of the weakness of the deutschemark in the EMS and the above target growth in CBM (Central Bank Money) in the early months of 1986. With stable prices there should be scope for further reductions in German interest rates in due course, but here, as in Japan, floors to nominal rates could limit the magnitude of falls in real interest rates in 1987 and 1988.

Table 4: Real Short-Term Interest Rates

Average annual three-month interest rates less annual change in consumer's expenditure deflator.

	1969-73 (ave)	1974-79 (ave)	1980-84 (ave)	1985	1986	1987
US	2	¼	6¼	5	4¾	5½
Japan	-½	-1	4¼	4½	5½	4¼
Germany	2¾	1	4¼	3½	4	2¾
France	1½	-1	2½	4½	4	1¾
Italy	1½	-4½	2½	6¼	7	6½

ACTIVITY

11. Activity in the major industrialised countries has been disappointingly weak in the past six months. There is no single explanation for this slowdown, but a number of factors could have contributed -

(a) cutbacks in oil exploration and investment;

(b) a pause as the major countries alter the balance of domestic and external demand in their economies in

Chart 5:

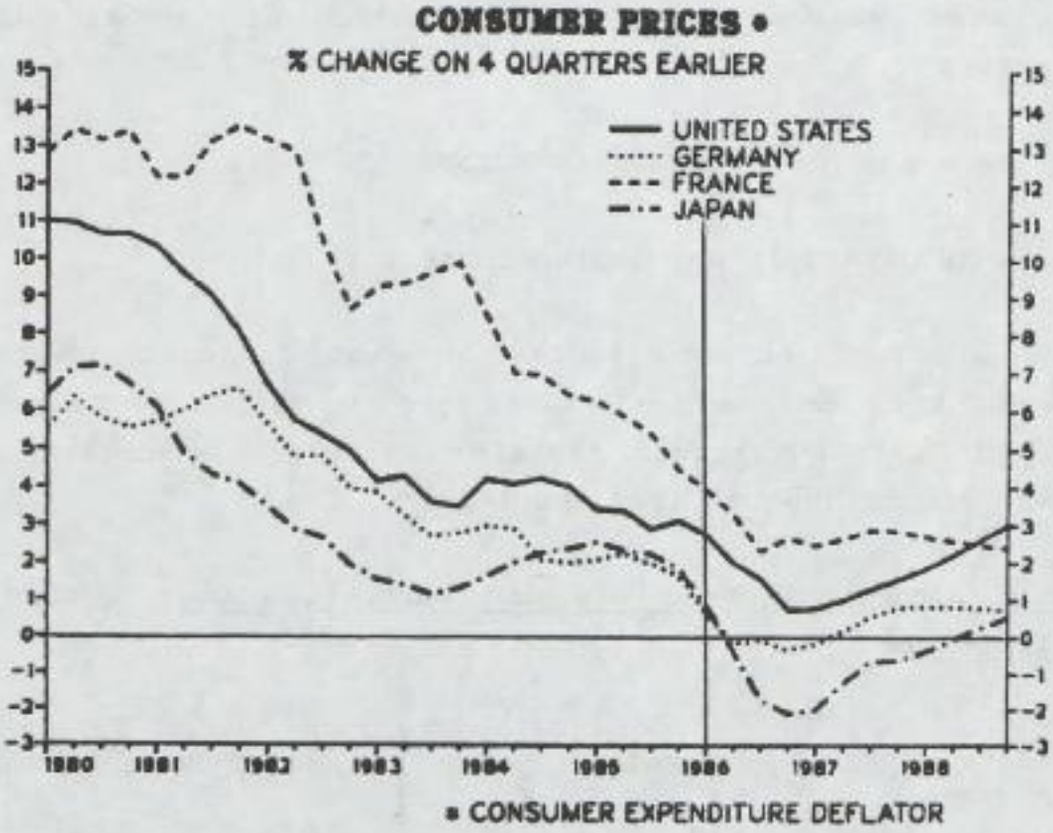


Table 7: Consumer price inflation in the Major 7 countries

% change in the consumers expenditure deflator on a year earlier	1985	1986	1987
US	3	2	1
Canada	4	3½	2½
Japan	2	-1	1
Germany	2	0	½
France	5½	3	2½
Italy	9	6	4½
Major 7	3½	2	1½

response to a lower dollar and low oil prices;

(c) some destocking in the expectation of further falls in prices;

(d) severe winter weather in Europe;

(e) weak demand in developing countries.

The present poor output figures are not forecast to persist as the fall in oil prices should give a significant boost to activity. Real GNP should therefore accelerate markedly later this year and throughout 1987 and 1988.

Table 5: Growth of Real GNP and Percentage Contribution from Domestic Demand

	GDP/GNP			Domestic Demand		
	1985	1986	1987	1985	1986	1987
US	2.2	2.6	4.1	2.9	3.0	4.0
Japan	4.6	3.2	3.6	3.6	3.9	4.6
Germany	2.4	3.0	3.5	1.4	3.9	4.9
France	1.3	2.7	2.6	1.9	3.4	3.3
Major 7	2.8	2.8	3.6	2.8	3.5	4.5

13. In the United States real GNP grew by an estimated 2.9 per cent (seasonally adjusted at an annual rate) between the fourth quarter of 1985 and the first quarter of 1986. This figure, boosted by strong growth in business inventories (especially cars) and government purchases, looks to be artificially high in relation to other current activity indicators; in particular, industrial production in May was 1 per cent lower than in December, and retail sales have been stagnant over the same period. Oil and gas drilling activity has been cut back, the former to a post-war low, and commercial property development is depressed. The principal bright spot comes from housing starts, with four months of strong figures fuelled by lower mortgage rates.

13. Beyond the very short term, the prospect is for some recovery in domestic demand growth although non-residential investment seems to be slowing (fulfilling the gloomy investment intentions figures). Housing investment looks likely to be strong over the next twelve months. The fall in oil prices is already showing up in lower inflation and higher real incomes and, although the initial effect may appear as higher savings, when consumers adjust their behaviour this will be translated into increased consumption expenditure. The saving ratio has risen from its recent low of 3½ per cent in September 1985 to about 4¼ per cent in April, but we continue to expect that a combination of factors (demographic trends, wealth effects from strong bond and equity prices, and low inflation and interest rates) will restrict the saving ratio to an average 5 per cent by the end of 1987 and through 1988, somewhat below its average level over the past 20 years.

14. Development of the US economy in 1987 is further complicated by the likelihood that agreement will be reached on a tax reform package which is acceptable to both Congress and the President. The package assumed in our forecast would transfer $100-140 billion from businesses to consumers over a period of five years. The net effect on activity may be slightly positive in 1987, with the cut in income tax further boosting consumers' expenditure to grow by nearly 4 per cent.

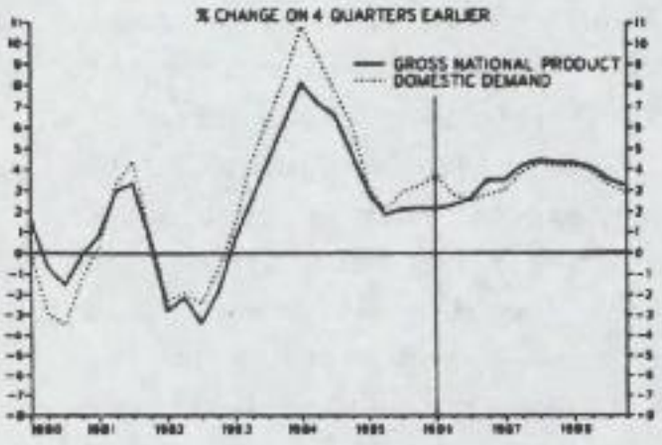
15. The volume of US exports has started to respond to the depreciation of the dollar. The scope for Japanese and other importers to maintain market share by squeezing profit margins must now be fairly limited, but strong domestic demand growth in the US will stimulate imports and limit the extent of the turnaround in trade volumes.

16. Our forecast therefore shows real GNP growth of 2½ per cent in 1986, and 4 per cent in 1987. This is in line with the latest "Blue Chip" consensus forecasts for the current year, but we are more optimistic in 1987. It should be noted however that projections for real GNP growth in 1987 show a wide

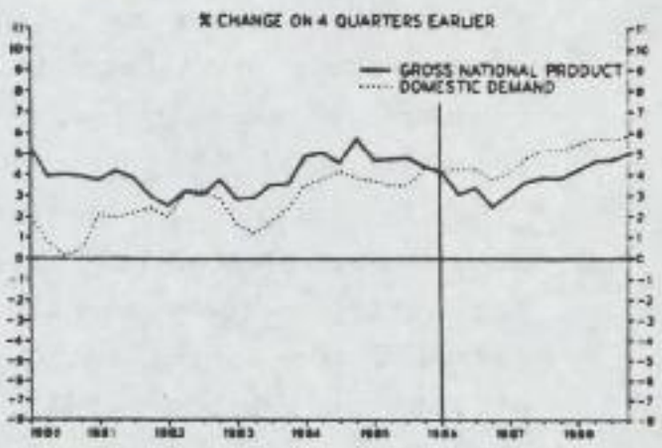
REAL GNP AND DOMESTIC DEMAND

CHART 4:

UNITED STATES



JAPAN



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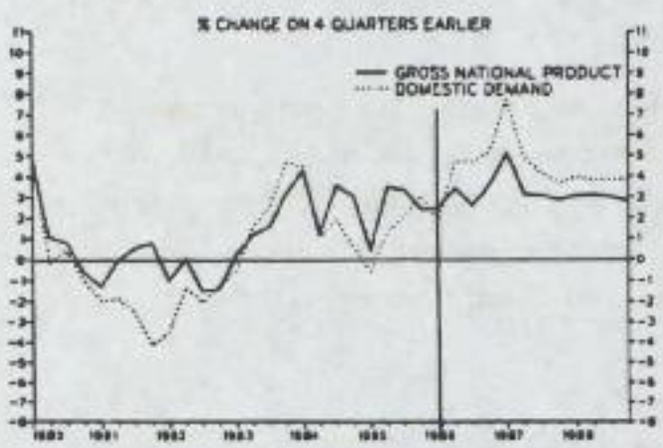
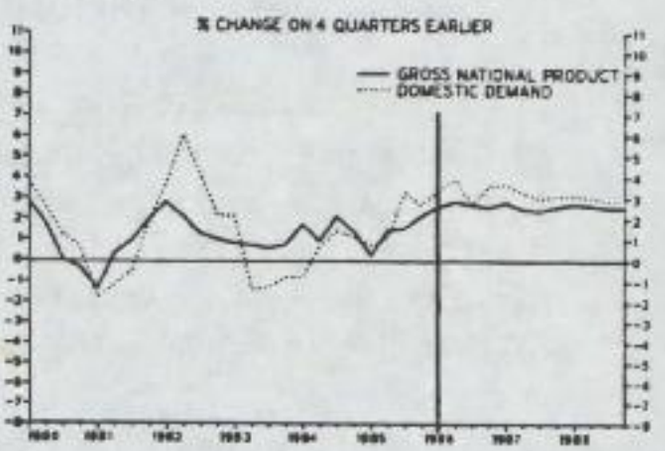


FRANCE



dispersion - several forecasters are expecting growth in the 2 - 3 per cent range while at the opposite extreme there are a few who predict 5½ per cent growth.

17. In Japan real GNP growth in the fourth quarter of 1985 was surprisingly high at 1.8 per cent. All forms of investment grew strongly and there was a 0.3 per cent contribution to growth from external demand. GNP in 1985 was 4½ per cent higher than in 1984, with external demand contributing 1 per cent of the growth.

18. Prospects for the early part of 1986 look much less favourable; figures released subsequent to completion of our forecast show a fall in real GNP in the first quarter of ½ per cent - the first fall in eleven years. In April industrial production was at the same level as in September 1985 and domestic machinery orders were only marginally higher than one year previously. Consumers expenditure continues to grow at a modest rate. Consequently, domestic demand growth is expected to be particularly weak - by Japanese standards - in the first half of 1986, before picking up as a result of increased consumers' expenditure in the latter part of this year and stronger growth of business investment in 1987. Government investment is expected to make a positive contribution to growth in 1986 for the first time since 1981 and housing investment is expected to grow modestly.

19. Provisional figures suggest that the volume of Japanese exports fell by 5 per cent in the first quarter of 1986, reflecting the first effects of the appreciation of the yen and the determination on the part of the Chinese authorities to reduce their trade deficit with Japan. The strength of the yen is expected to keep export growth below the growth of export markets over the next few years.

20. GNP in Germany fell by over 1% in 1986 Q1. The construction industry was once again badly hit by the weather and exports were weak, but consumers' expenditure was relatively buoyant. We expect domestic demand to be strong in 1986; in particular, consumption is expected to increase by nearly 4½%. Wage

settlements next year may be a little lower than in 1986 and no tax cuts have been assumed, but the saving ratio is forecast to decline as consumers adjust to slower inflation and lower interest rates. With a high degree of company profitability and a relatively good outlook, business investment is also forecast to grow rapidly over the forecast period. German exports have fallen in recent months and, with the loss of competitiveness resulting from the appreciation of the DM, exports are likely to remain weak.

21. According to preliminary French GNP data the slight slowdown in growth seen in the fourth quarter of 1985 continued into the first quarter of 1986. Both consumption and fixed investment remained strong, but there was substantial destocking (particularly of energy products) and a negative contribution from trade. With the exception of the destocking, which is likely to prove temporary and may be reversed, this broad pattern characterises our forecast for the year as a whole. Consumption will be boosted by the end-1985 tax cuts and by falling inflation, although the saving ratio may fall less sharply than it did in 1985. Business investment is likely to grow steadily through the year under the influence of increased profitability, while residential investment may start to level off after several years of decline. A similar pattern of growth is forecast for 1987.

Table 6: Unemployment*

%	1974-84 Average	1985	1986	1987
US	7½	7	7	6½
Japan	2¼	2½	2¾	2¾
Germany	4½	8½	8¼	8
France	6	10	10	10

* OECD standardised rates

22. Unemployment is forecast to remain high in most developed countries despite the sustained output growth in the forecast. Growth rates well above potential would be needed to make substantial inroads into unemployment.

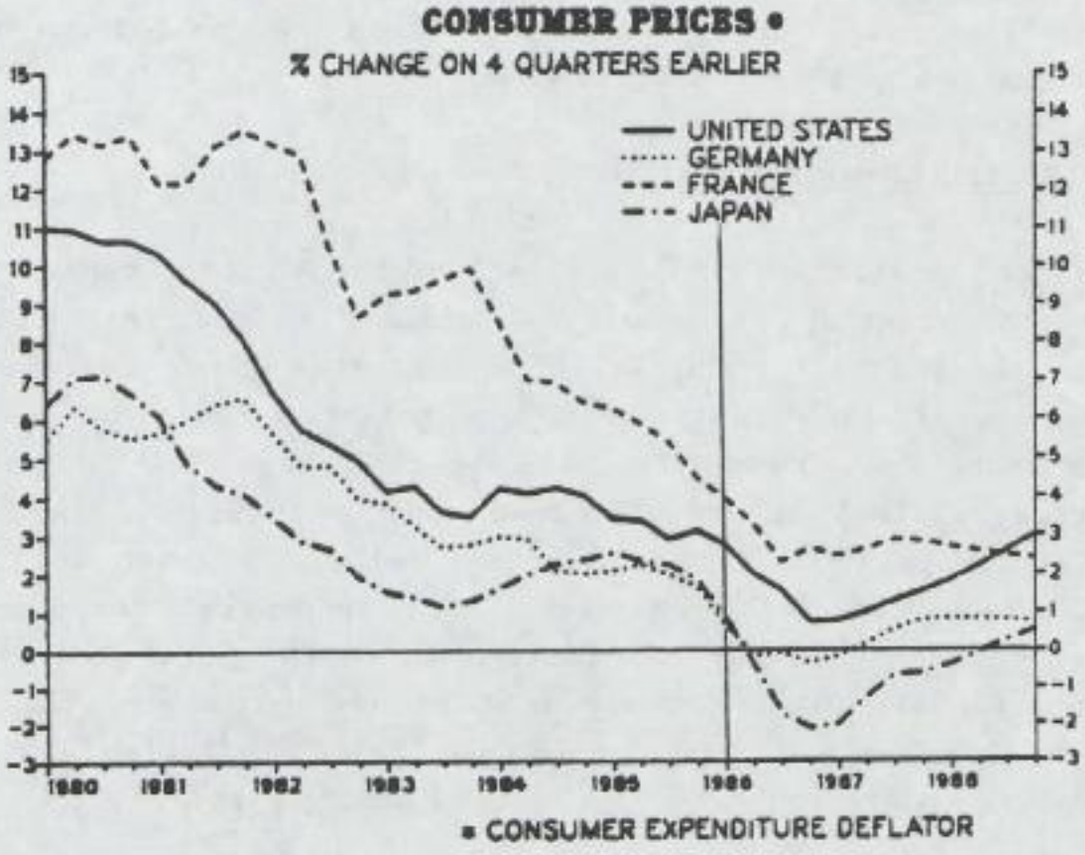
INFLATION AND COMMODITY PRICES

23. Recent indicators on price inflation have been better than we were forecasting in January. Consumer prices in April in the major seven OECD countries were less than 2 per cent higher than in April 1985 (only half the inflation rate of a year earlier) and have been virtually static since last December. In Germany prices are actually lower than they were a year ago. Already the fall in oil prices is leading to lower fuel and petrol prices and as these feed into industrial costs there should be further falls in inflation later this year. However, the once-for-all nature of the fall in oil prices and the oil-induced boost to activity will push price inflation back up towards its underlying rate of 2 - 3 per cent by 1988.

24. In Europe and Japan, the forecast continues to show a combination of factors (rising exchange rates, weak oil and other commodity prices, persistently high unemployment and firm monetary policies) which should perpetuate low rates of inflation. We do not expect price levels in Japan and Germany to change very much over the next four years, and French inflation is forecast to settle at around 3 per cent, having been around 12 per cent at the beginning of 1983.

25. The position is rather different in the US. Although consumer prices have fallen in each of the three months to April, there is a marked divergence between the energy and non-energy components - the latter were still rising at an annual rate of nearly 4 per cent in April. There are a number of reasons why the underlying rate of inflation may increase - the fall in the dollar, high rates of monetary growth, and overheating in regional labour markets bidding up real earnings - and the prospect of a significant inflationary spiral in the late 1980s cannot be ruled out.

Chart 5:



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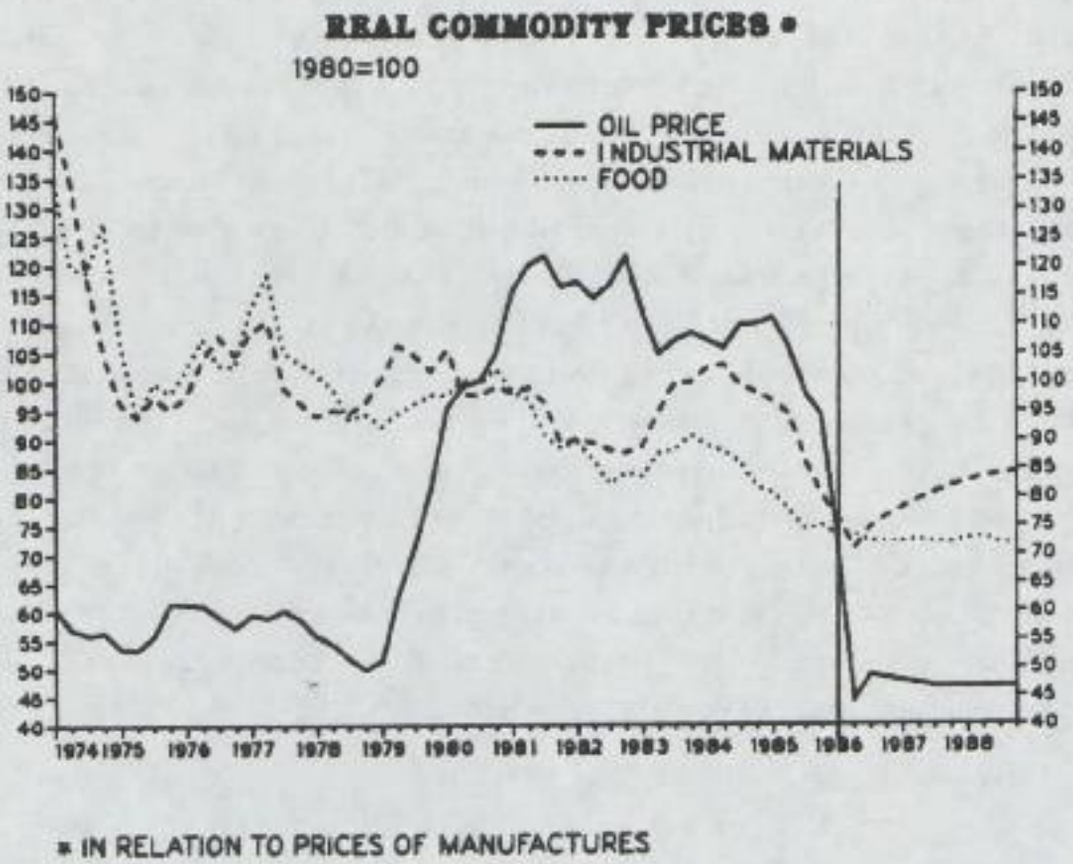
Germany	2	0	½
France	5½	3	2½
Italy	9	6	4½
Major 7	3½	2	1½

26. Once again commodity prices in recent months have turned out weaker than expected; industrial materials prices are at record low levels in real terms. Abundant supply and healthy world stocks continue to dominate most commodity markets. Nevertheless, we are forecasting some gains in real commodity prices as world activity responds to lower oil prices. Food prices are always liable to be pushed up by bad harvests and extreme weather conditions. This has caused coffee prices to firm considerably since last autumn and our expectation is that they could remain high until early 1987. In general, however, the abundant supply position generated by technological improvements in agriculture and government subsidies should continue to keep world food prices at very low levels.

Chart 6:



* IN RELATION TO PRICES OF MANUFACTURES

WORLD TRADE

27. Along with activity in the major countries, world trade slowed down in 1985 from its exceptional growth of nearly 10 per cent in 1984. Strong growth of imports into North America helped maintain moderate underlying growth of world imports through 1985, offsetting the depressing effect of an estimated fall of nearly 15 per cent in OPEC import volumes. Figures for the first quarter of 1986 are patchy but the indications are that trade may have fallen slightly. The US has recorded a small fall in the volume of imported goods, while exports from most of the major countries (apart from the US) seem to have been weak; in particular there was a large fall in Japanese exports.

28. Expansion of trade may be only moderate for the remainder of this year, reflecting a pause in world activity and the transition of Japan and Germany to greater domestic demand orientation (and the US vice versa) as well as economic difficulties in Australia and South Africa. Once lower oil prices start to stimulate world demand, the growth of import volumes can be expected to pick up. A 20 per cent cut in OPEC imports in each of 1986 and 1987, as well as relatively weak developing country imports, will reduce world import growth relative to real GNP growth in the major OECD countries as compared to the 1970s experience. (See chart 7). Within total world trade growth, trade in oil will grow relatively faster and imports of manufactures more slowly. The UK's relative dependence on OPEC markets, although declining, will depress UK-weighted measures of trade growth. The forecasts assume no major changes in levels of protection.

Chart 7:

MAJOR 9 REAL GNP AND WORLD IMPORTS
1980=100

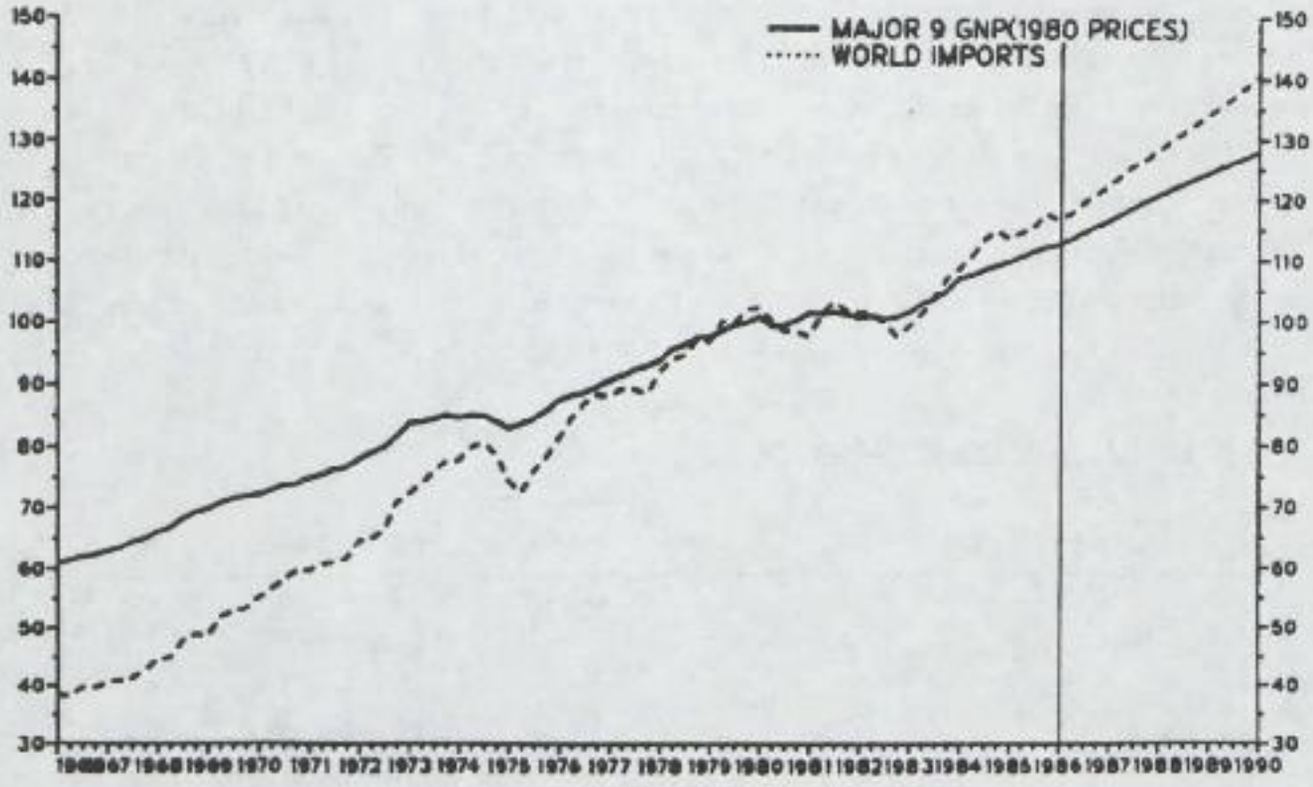


Table 8: World Import Growth

% change on previous year	1984	1985	1986	1987	1988
US	24	4	7	4	3
Japan	11	0	5	9	8
Europe+	6	5	4	8	6
Total Developed* Economies	12	5	6	6	5
OPEC	- 10	- 14	- 20	- 20	- 3
NODCS	8	3	1	6	5
Total	10	3½	3½	5	4½
UK export markets in manufactures	8½	5	3	4½	5

+Germany, France, UK, Italy, Netherlands, Belgium

*OECD + South Africa.

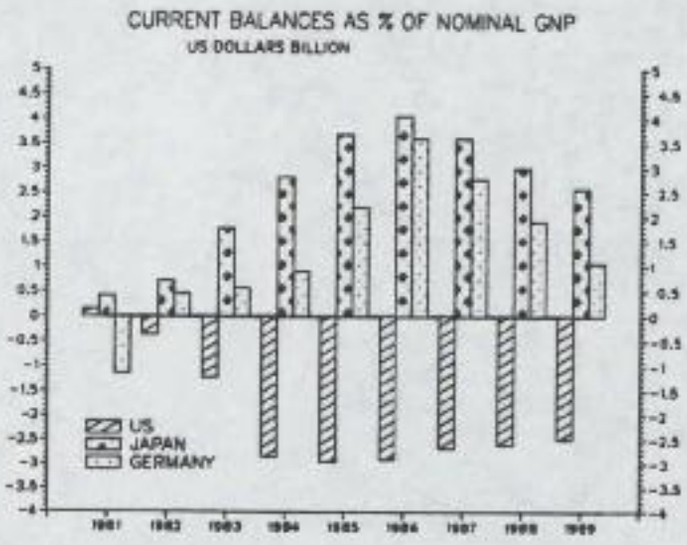
CURRENT BALANCES AND EXCHANGE RATES

29. Table 11 shows continued large current account imbalances. The US deficit is expected to fall only slowly in response to the depreciation of the dollar. Although trade volumes react to the gain in competitiveness, the sheer size of the initial deficit increases the importance of the continuing J-curve effects. In addition, the succession of deficits reduces the net stock of US assets held overseas and entails increasing net interest payments. Nevertheless the US current account deficit, and the Japanese and German surpluses, show some falls in relation to nominal GNP in 1987 and 1988.

Table 9: Current balances

$ billion	1982	1983	1984	1985	1986	1987	1988
US	-11	-42	-107	-118	-121	-118	-122
Japan	8	21	35	49	79	81	77
Germany	3	4	6	14	31	27	21
NODCs	-61	-29	-13	-27	-6	-10	-13
OPEC	-16	-17	-9	-5	-54	-30	-16
World Imbalance	-114	-66	-85	-85	-75	-58	-67
as % of GNP							
US	-½	-1	-3	-3	-3	-2½	-2½
Japan	½	2	3	3½	4	3½	3
Germany	½	½	1	2	3½	3	2

Chart 8:



30. The dollar seems likely to depreciate further in response to continued US current account deficits and, in the medium term, its relatively high inflation. We have assumed that expectations of continued high real interest rates and confidence in the general strength of the US economy will prevent a further dramatic dollar collapse, and that Japan continues to show a strong desire to build up its external assets by direct and portfolio investment in the US and elsewhere. Even so we are forecasting further appreciation of the Yen by about 6 - 7 per cent per annum. Similarly the Deutschemark is expected to appreciate further against the dollar reflecting Germany's stable price level and large current account surplus. The EMS realignment in April has restored some of the competitiveness which other European economies had lost to Germany over the past three years. Over the forecast period we expect the French Franc and the Italian Lire to depreciate against the DM broadly in line with relative changes in prices.

Chart 9:

THE OIL MARKET, OIL PRICES AND OPEC

TABLE 10: THE OIL MARKET

Millions of barrels per day	1983	1984	1985	1986	1987	1988
Demand (including stockbuilding) in OECD, OPEC and developing countries.	44.6	45.7	45.4	47.6	49.3	51.3
Production						
OPEC	18.4	18.5	17.2	19.3	20.4	21.9
Non-OPEC	26.1	27.2	28.2	28.3	28.9	29.4
Oil Price[1] ($ per barrel)	29.0	28.1	26.9	16.2	15.0	15.7
Real (1980=100) price (relative to world manufactured export prices)	108.2	108.2	102.3	53.2	47.1	46.8

1 average price of oil imported into OECD countries (f.o.b.)

31. Spot oil prices fell dramatically from $26-27 per barrel in December to a low of $10 at the beginning of April and have since fluctuated between $10 and $15 per barrel. The prospects for the oil market in the short-term remain very uncertain. We have retained the assumption made for the FSBR forecast that world oil prices remain at $15 per barrel until late 1987, while recognising that prices could be quite volatile in practice; this assumption has also been adopted by the IMF, EC and OECD staff in their latest projections. After 1987 rising demand and further depreciation of the dollar should allow nominal (and perhaps some real) price increases.

32. World oil demand (outside the Communist area) has fallen steadily since 1979 in response to the two oil price increases in the 1970s, and has only shown signs of flattening off in the last two years with a pick-up in world activity. The Department of Energy's latest assessment, on which our forecast is based, shows OECD energy demand in 1986 and 1987 growing a little faster

than OECD real GNP, with oil's share, nearly 49 per cent in 1980, stabilising at around 42½ per cent of all energy consumption. This is a sharper turnaround in energy demand than other forecasters are expecting, but there is no previous experience by which to assess the effect of a halving of oil prices.

33. The response of oil production is also difficult to forecast. There has been little effect on oil supply in the US or the North Sea. A number of countries, including Mexico, Egypt and Norway, have said that they would be prepared to cooperate with OPEC in restraining production, but only if the OPEC members themselves come up with a realistic and viable agreement. There is, however, no consensus within OPEC on how to share out the production between members. The cartel is clearly in a weak position at present, but the longer prices stay low the stronger the pressure on OPEC to cooperate. Given the Saudis' wish to restore some stability to the market, the likelihood of their reaching an agreement, which would initially stabilise prices and then increase OPEC's market share, will increase over time.

34. Continuing low oil prices pose severe financial difficulties for OPEC and other countries highly dependent on oil exports. Further substantial reductions in import volumes are inevitable. Even Saudi Arabia can only finance two or three years of payments deficits of current magnitude without exhausting its limited reserves of liquid overseas assets and countries like Nigeria, with no foreign exchange reserves and no access to financial markets, are even harder hit.

NON-OIL DEVELOPING COUNTRIES

35. NODC export volumes are estimated to have grown by 4% in 1985, reflecting slower growth in export markets, particularly in the US. Export markets are likely to grow by only 3 per cent in 1986, but to grow faster thereafter as activity in the industrialised countries picks up. The currencies of developing countries have on average depreciated in effective terms, as some are linked to the dollar and others have adopted more realistic exchange rate policies. As a result NODCs should continue to make gains in market share, assuming no increase in protectionist measures by the industrialised countries.

Table 11: NODCs Current Account

	1984	1985	1986	1987	1988
Export volume growth (%)	14½	4	4½	6	6
Export market growth (%)	10	2½	3	5	5
Import volume growth (%)	8	3	1	6	5
Terms of Trade (% change)	½	-3	+1	-1	-1
Current Account ($bn)	-13	-27	-6	-10	-13
of which:					
trade[1]	13	5	19	17	19
invisibles	-26	-31	-25	-27	-33
MEMO ITEMS					
Change in reserves ($bn)	11	-10	14	12	12
Reserve/Import Ratio (%)	27	23	27	25	28
Capital Flows ($bn)	27	16	20	22	25

36. The sharp fall in oil prices will, of course, have different implications for the prospects of individual developing countries; but, on balance, it is unlikely to affect the overall terms of trade greatly. With coffee a temporary exception to generally weak commodity prices, the terms of trade improve marginally in 1986, but deteriorate thereafter. Import volumes appear to have fallen sharply in the second half of 1985 and this probably continued into the early part of 1986. Thus, despite a substantial recovery in the course of the year import volumes are forecast to be only slightly higher than in 1985. Chinese imports, in particular, are expected to fall from their very high 1985 levels. Given our assumptions about capital flows, NODCs should be able to increase import volumes by 5-6% a year from 1987.

Table 12: NODC Debt Indicators

	1977-84 average	1985	1986	1987	1988
Growth in Gross Debt Stock: (% change)					
Nominal	16	6	6	6	6
Real	10	4½	-8	3	1
Gross Debt/Export Ratio	1.2	1.6	1.6	1.5	1.5
Net Debt/Export Ratio	0.9	1.2	1.2	1.2	1.1
Gross Interest Service Ratio	0.10	0.14	0.12	0.12	0.12
Net Interest Service Ratio	0.06	0.10	0.09	0.08	0.08

37. Capital flows in 1985 appear to have been rather weak, although latest figures show that borrowing from banks picked up in the course of the year. There was also an increase in borrowing in the form of bonds, but this was concentrated on a small number of Asian countries. The forecast assumes a slight recovery in capital flows in 1986. IBRD lending is expected to increase in response to the Baker initiative, but commercial bank lending is likely to continue at low levels. Given the adverse effects of the oil price fall on the position of countries like Mexico, the commercial banks will be wary of lending any more to them than is absolutely necessary. Much will depend on the continuing negotiations between Mexico and the IMF.

Table 13: NODC Capital Account

	1984	1985	1986	1987	1988
Current balance	-13	-27	-6	-10	-13
ODA	13	14	16	17	18
Other Official Lending	13	9	11	12	14
o/w IBRD	9	9	10	11	13
Direct Investment	8	8	8	9	10
Bank Borrowing	10	9	9	10	11
Bonds	3	6	5	5	5
Other Capital Flows	-25	-29	-28	-28	-28
Capital Account	22	15	20	25	29
IMF Credit	5	1	0	-3	-4
Change in Reserves	11	-10	14	12	12

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CONFIDENTIAL

CC PM (2)

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

Prime Minister

CDP 23/6.

Charles Powell
10 Downing Street
London SW1

23 June 1986

Dear Charles

INTERNATIONAL FINANCIAL SCENE

I enclose the regular report on developments in the international debt scene. Though generally quiet, the unexpected resignation of Silva Herzog as Mexican Finance Minister has added a new and unwelcome element of uncertainty to the already difficult outlook for Mexican debt negotiations. The outcome of these will determine the tone for other debt negotiations.

As the paper notes there are no new trends on the economic or political front. There has been some dampening of the euphoria that immediately succeeded the oil price falls as the benefits are inevitably taking time to come through. The estimates of debtor countries' financing requirements made when the Baker initiative was launched are now generally obsolete and the countries concerned are now in a period of reassessment. Over the next few weeks the Treasury and Bank of England too will be finalising their regular summer reviews of debtor countries' economies. On the political front, the UN special session on Africa was carried off without too much difficulty and the Cartagena Group have been quiet.

As for individual countries, the key (as already indicated) is Mexico. The economic situation here continues to deteriorate with persistent rumours of suspension of interest payments. The likelihood of an orthodox solution, with a Fund programme and formal rescheduling, appeared to improve after Volcker's visit to President de la Madrid earlier this month. It remains unclear what the impact of Herzog's resignation will be. We have been watching developments closely and considering what we might do to help accelerate a solution - or, alternatively, what action we might take in the event of further deterioration.

Among the other major Latin American debtors, problems are emerging in Argentina where inflation is rising again and targets under the current standby arrangement missed. Against this background the talks now beginning with the Fund (on a new SBA) and with the IBRD could be difficult. Brazil's external performance continues to be strong, with no sign of any approach to the Fund. In view of this Paris Club Governments have rejected a Brazilian request for a formal rescheduling but will accept payments to export credit agencies designed to reduce arrears.

Elsewhere, the rescheduling discussions between the banks and Poland, mentioned in the last report, have now been concluded on the basis of rescheduling 95% of 1986 and 1987 maturities: Poland rejoined the IMF on 12 June. The outlook for Nigeria remains uncertain. There has still been no formal progress in agreeing a Fund programme. But we continue to get indications that the Nigerians are at last prepared to take the measures that will enable them to conclude a "classical" standby arrangement (ie an agreement without drawings). Recent political developments in South Africa have had no immediate impact on the debt situation, although further damage to confidence would inevitably reduce South Africa's capacity to pay its debts.

Finally, the report draws attention to the marked deterioration in the outlook for Middle East and North African countries as a result of the oil price fall. This has brought to a head underlying domestic financial problems. Commercial banks are now recognising this, and in some cases looking to reduce their exposure. ECGD too are reassessing their considerable exposure in these markets. This brings a wide range of countries into the net of those giving cause for concern.

I am copying this letter to Tony Galsworthy (FCO), John Mogg (DTI) and John Footman (Bank of England).

Yours ever

Rachel

RACHEL LOMAX

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INTERNATIONAL FINANCIAL SCENE

1 The international debt problem has, at least until the last few days, been perhaps less in the news headlines over the past few weeks than at almost any time since 1982. In part this has been because attention shifted, at least temporarily, to the specific problems of Africa, and focussed on the UN special session dealing with the problems of that continent. But in addition the broader debt situation has been relatively quiet as debtors and creditors revise their financing projections in response to the drastic external changes - on oil prices, interest rates, and exchange rates - which took place earlier in the year. With Mexico evidently the most adversely affected amongst the largest debtors, sentiment about the debt situation in general is likely to be very heavily determined over the next few months by the outcome of Mexico's current debt negotiations and its impact on the attitude of other debtors. There are conflicting signals as to how these negotiations are progressing, but the apparent rapid deterioration in Mexico's economic position means that early resolution of this uncertainty is required. Failure of the IMF and/or the banks to reach agreement with Mexico in the near future would cast a serious shadow over debt prospects more widely.

2 Meanwhile, after the major shocks earlier in the year, there have in recent weeks been no very clear trends in oil prices, interest rates, and exchange rates. Oil prices rose in early May from their trough levels, to reach about $17 pb in mid-month, but subsequently fell back to around $12 pb. Little real progress has been made within OPEC towards a workable production accord, and the chances of one emerging from the end-June Ministerial Meeting remain slim, although most observers expect some agreement eventually, perhaps by end-year. Three month eurodollar rates have also rebounded slightly from their trough levels, and are now slightly above 7%. The cut in the US discount rate to 6 1/2% in April was widely expected to be the last cut for some time. Meanwhile, the dollar too has rebounded slightly. In effective terms it rose 5% during May, but it still remains 8% below its level at the beginning of the year and 18% below its level at the time of the Plaza Agreement.

3 In contrast, commodity prices, which earlier in the year had stabilised, seem to have resumed their downward trend. At the beginning of June the Economist

commodity index was, in SDR terms, almost 6% below its level of two months earlier. Food prices fell most heavily - almost 10% - with the greatest falls in coffee (25%) and sugar (18%). The four largest producers of sugar (Australia, Brazil, Cuba and the EEC) met to discuss prospects for an international agreement which would include price stabilisation measures. Falls in the prices of timber and cotton (13% each) dominated the downward movement in agricultural non-food prices. Metal prices were little changed.

4 There has recently been some dampening of the euphoria that immediately succeeded the oil price falls about prospects for world economic growth. It is now clear that the world economy is performing more sluggishly than earlier expected, and that the output benefits of the oil price fall will take some time to work through. Although US GNP growth in 1986 Q1 has been unexpectedly revised upwards to 3.7% (ar), this rise was due to a large increase in stocks, and prospects are for much slower growth in the second quarter. The US current account deficit is now projected not to decline significantly this year, despite the fall of the dollar, but this is increasing pressure for further protection. Elsewhere too, growth does not seem yet to have picked up - within Europe, for instance, GNP in France grew by only 1.2% (ar) in Q1, whilst GNP in Germany is estimated to have fallen by 1.0%.

5 The falls in oil prices, interest rates and the dollar this year have had a major impact on the economic prospects and financing requirements of the debtor countries. Estimates of financing requirements made at the time the Baker initiative was launched are now generally obsolete. Full assessment of the new situation is likely to take some time, especially given present uncertainties over whether the new prices and rates will be sustained. Clearly, the oil exporters have been most adversely affected by these changes. Quantitatively, the effect has been greatest on Mexico. Its economic position was deteriorating rapidly even before the recent oil price falls, and the country faces major difficulties in filling its financing gaps. Mexico is aiming to reach agreement with the Fund on a new programme and will then begin discussions with the banks. Mexican officials have stated that a Fund agreement may be close, but others are much more pessimistic. Serious differences remain with the Fund, especially over the appropriate size (and measure) of the fiscal deficit. Concerns over the Mexican debt situation, and the possibility of a declaration of a moratorium on interest payments, contributed to a 25% fall in the value of the free market peso against the dollar in the early part of June. Within the Mexican government, there seems to be increasing divergence between those who favour the continuation of the present strategy and those who consider that the present strategy has run its course. If agreement cannot be reached with the Fund, this is bound to strengthen the hand of

those favouring a unilateral, unorthodox strategy. In any case, without an agreement, the country's financial position does not seem to be sustainable for very long: there are repeated stories that, without some debt agreement, Mexico will not be able to maintain interest payments beyond the summer. If, however, agreement can be reached, it is generally felt that the overall debt situation will be very significantly improved, and prospects will brighten over negotiations covering also other debtor countries. The likelihood of agreement was reportedly increased as a result of a visit by Volcker to President de la Madrid on June 9. The implications of the resignation of Finance Minister Silva Herzog on 17 June, however, are not yet clear; he has been replaced by Gustavo Petricioli, previously head of Nacional Financiera, who is believed to support Silva Herzog's orthodox line.

6 The Fund is likely to have to determine rapidly how it will respond to the problems affecting oil exporters, following Ecuador's probable request for a CFF. Of the other oil exporters, Venezuela has irritated its creditors by seeking to have its MYRA reopened at a time when it is not yet even operational and when the country retains a very substantial buffer of reserves. Nigeria has reached agreement in principle with the IMF and IBRD on outstanding issues, in particular the introduction and operation of the two-tier foreign exchange market, but the form of an eventual agreement has not yet been clarified. The Nigerians appear willing to accept the terms of a "classical Standby" (ie a Standby agreement with no drawings) but, for domestic political reasons, do not want to present it as such. In the Middle East and North Africa a number of oil exporters (such as Saudi Arabia) are giving cause for heightened concern in the future, whilst even countries (such as Oman) which have not previously given any serious cause for concern are now being reassessed. In some countries (such as Egypt) already identified as having major difficulties, prospects for containing their debt positions seem increasingly desperate.

7 Meanwhile, most oil importers continue to benefit from recent developments. For a number of smaller countries - such as Yugoslavia and Chile - the external position has improved (although difficulties remain), and agreements with creditors have recently been achieved and/or seem likely to be achieved shortly. In the major debtor oil importer, Brazil, the economy continues to perform strongly, particularly on the external side; the authorities' continued refusal to negotiate with the IMF, and to repay more than token amounts to the Paris Club, is likely to leave creditors in some difficulty over how to handle the situation. In Argentina (now almost self-sufficient in oil) there are signs of a possible resurgence of inflation, the handling of the fiscal deficit remains problematic, and opposition is mounting to the deflationary impact of the Austral Plan.

8 But contrary to earlier fears, there has recently been no serious concertation between debtors over alternatives to maintaining the present strategy. The beneficiaries of the oil price falls seem unwilling to risk their gains through a confrontation with creditors at this juncture. Peru remains very largely isolated, and little has been heard recently from the Cartagena Group. Mexico's reported attempts to seek support from Brazil and Argentina in the event it imposes a moratorium on interest payments have apparently been rebuffed, at least by Brazil. But, as already noted, opposition to further austerity continues to grow in Mexico, and could become much more serious if the country fails soon to reach agreement with the Fund and the commercial creditors. And in Ecuador, hitherto identified as a paradigm of the orthodox approach, the government party was heavily defeated in Congressional elections on 1 June: there is now considerable uncertainty over how the President will deal with the new opposition-dominated Congress.

9 The period since the middle of April has seen further borrowings for the USSR and Czechoslovakia. Vneshtorgbank of the USSR raised two syndicated credits, totalling approximately $500 mn; both were over eight years and had spreads of 1/4% over LIBOR, this being much in line with other recent East Bloc credits. Czechoslovakia is raising a $100 mn credit to finance foreign trade on even finer terms. IIB, the CMEA investment bank, has also returned to the market, for $250 mn over ten years at a spead of 1/4%. In the same period there was a revival of borrowings by LDCs: nearly 80% of the $1 bn total went to South Korean borrowers, including a two tranche syndicated credit of $500 mn, and a DM 100 mn fixed rate bond, for the Korean Development Bank. The terms of these borrowings are slightly improved compared with similar issues earlier in the year. Finally, Banco Mexicano Somex issued an FRN for $50 mn at 0.75% over LIBOR for 5 years, designed to repackage some existing interbank lines.

Further details on individual countries are given below.

10 Latin America

Problems seem to be developing with Argentina's Austral Plan. Inflation has picked up quite sharply, with consumer prices rising by 4% or more in each of the three months to May. Moreover, labour unrest continues, despite a series of measures designed gradually to relax the initial wages/price freeze; the first anniversary of the Austral Plan, in mid-June, has been greeted with another 24 hour protest stoppage. At the end of April the Economy Ministry revealed that some Q1 performance targets under the SBA had been missed, with the fiscal deficit well in excess of its target of 4% of GDP. The Fund granted a further one-month extension

to the SBA (already extended once to end-May from its original end-March expiry date) in the hope that the Argentine authorities would agree to implement appropriate remedial policies, so as to permit the Fund to grant Argentina a waiver, and to allow the final tranche (of SDR 236.5 mn) of the SBA and the final tranche ($600 mn) of the commercial banks' new money to be drawn. De Laroisiere agreed to recommend to the Board on 23 June the release of the final tranche of the SBA. This was too late to secure the parallel disbursement of the bank loan, so the Advisory Committee has had to seek a waiver from the banks before the final tranche of the banks' money can be drawn.

11 Against this background, the discussions for a follow-on SBA (a Fund mission spent three weeks in Argentina in May), and for further IBRD policy-based lending, could prove difficult. Talks with the banks on future new money requirements, and with the Paris Club on a possible further rescheduling, are unlikely to begin in earnest until a new Fund programme is in place. As an interim measure the banks have agreed to extend for 180 days their original roll-over (granted in January for maturities to end-April), to refinance over $6 bn of debt maturing in the first three quarters of this year.

12 By contrast the Cruzado Plan in Brazil appears reasonably well on course. The country continues to perform particularly well on its external account; exports grew by some 10% (to $10.3 bn) in the first five months of this year compared with a year earlier, pushing the trade surplus up to a record $5.0 bn, 8.6% above last year's level. Against this strong performance a further round of talks was held with the Paris Club on 15 May. The Brazilians put forward proposals for dealing with $2.4 bn of arrears, $100 mn in overdue interest on arrears, and $748 mn of interest due between May 1986 and June 1987. However, their proposals were unacceptable to the Paris Club and the meeting ended without substantive agreement. The Paris Club reiterated that any rescheduling must be dependent on Brazil reaching some kind of agreement with the IMF, and that Brazil should make every effort to reduce its arrears in the meantime. Meanwhile, the World Bank has approved two loans, totalling $149 mn, for rural development and irrigation projects.

13 The economic situation in Mexico continues to deteriorate, with the Banco de Mexico now projecting a 4% decline in real GDP this year. As discussed above, much attention has focussed on the negotiations with the IMF for a new SBA. Claims from the Mexican authorities that these discussions could be successfully concluded in a matter of weeks have been discounted as optimistic by most other sources. Considerable differences remain, in particular over the projected public sector

deficit, and negotiations may be further complicated by the change of Finance Minister. Moreover, until a new SBA is agreed, there is little prospect of a new agreement with the banks and, without new money, reserves will continue to decline (and/or arrears will be run up), following the apparent cessation of the capital reflows which resulted earlier in the year from the credit squeeze. The Mexicans are likely to demand lower spreads on existing bank debt, and have floated various additional proposals to tackle the debt problem on a longer term basis.

14 In Venezuela, the weakness of the oil market has begun to undermine the previously relatively comfortable economic position: the current account is now expected to be in deficit this year (cf earlier projections of a $3 bn plus surplus). The authorities have yet to announce their intended policy response, although they have declared their intention to invoke the renegotiation clause in their MYRA - which is unlikely to become effective for another two or three months. The banks have already expressed discontent at the invoking of the clause at this stage, particularly given the sizeable cushion of foreign currency reserves which the Venezuelans have available. A meeting with the banks, due on 5 June, has been delayed at the Venezuelans' request. Nor are relations with Paris Club proceeding smoothly, since payments of private debt approved by RECADI are being delayed; the Paris Club is pressing for remedial action.

15 For Chile the improvement in the outlook for the balance of payments because of the lower oil prices should counterbalance the prospect of lower copper prices. Despite internal political disturbances, the country continues to make progress with its external financing arrangements. IMF targets for the first quarter of this year under the EFF were met, enabling a draw-down at the end of May. Discussions with the World Bank on an SAL are under way, and disbursements could begin before the end of the year. The completion of the $6 bn MYRA is expected this month. The authorities have recently indicated that they will be seeking $500 mn new bank money for 1987-88 and, in addition, a further 3-year MYRA covering debt due 1988-90.

16 Colombia continues to show a steady improvement. With the country having met its 1985 targets comfortably, the Fund have endorsed the 1986 economic programme. Political changes resulting from the Presidential election on 25 May are unlikely to mark any significant shift in policy stance when Barco succeeds Betancur in August: indeed, if anything Barco is thought likely to adopt an even more positive approach to relations with the IMF.

17 Ecuador is continuing discussions on several fronts on its financing needs in response to the lower oil prices. The US agreed in May to provide a bridging facility of $150 mn, to be taken out by a bankers' acceptance facility for between $175 mn and $200 mn to prefinance oil exports. But there has been some slippage in the signature of the bank MYRA (due to have been completed by end-May) because negotiations on a new one year SDR 75 mn Fund SBA have been delayed and are now unlikely to be completed before late July. A CFF of some SDR 55 mn is also being requested. In Congressional elections on 1 June the government party was heavily defeated; there is considerable uncertainty over how the President will deal with the new opposition-dominated Congress.

18 · Peru finally agreed at the IMF Board on 6 May to clear all outstanding arrears (over SDR 100 mn) by mid-August, and so avoided (for the time being) being declared ineligible; but there are some grounds for doubting the country's intention of honouring its undertaking. There are no other signs of a softening in Peru's approach to debt issues, and negotiations with the banks and official creditors tentatively scheduled for June are unlikely to make significant progress .

19 Amongst the smaller countries, Bolivia has made progress in securing IDA and IDB credits. On 19 June the IMF Board is expected to discuss a request for an SDR 50 mn SBA, and an SDR 50 mn CFF; there is also a possibility of a payment from the Structural Adjustment Facility. A Paris Club meeting, at which the Bolivians will request a rescheduling of $250 mn on exceptionally generous terms, is scheduled for 24 June. Although an IMF Mission arrived at the end of May in Costa Rica to discuss a possible 18 month SBA, the country's external position continues to look grim. Having failed to pay $19 mn due to banks on 28 April, Costa Rica incurred a major payments default, and is reported to have withdrawn about $200 mn from banks in major centres, in order to avoid retaliatory action, and has placed the funds in offshore banks. The report from the Paris Club task force visit to Cuba was considered on 14 May. In anticipation of that meeting, the Cubans announced on 5 May that their debt-service moratorium would be suspended for one month. The Paris Club regarded this gesture as inadequate and agreed to adopt a tough stance: it stated that without an indication of corrective measures to reduce the external financing requirements there could be no prospect of rescheduling 1986 maturities. The banks' Steering Group met on 22 May, and despatched a reply to Cuba's rescheduling request: a further meeting will be considered after they have responded. The banks' intention is to liaise closely with official agencies.

20 Relations between the IMF and Jamaica remain notably troublesome. Although Seaga has stated he does not want Jamaica to break relations with the Fund, there

seems little prospect of drawings under the SBA resuming, particularly since arrears (of some SDR 30 mn) have recurred. While Uruguay made good progress in 1985 towards economic adjustment under its SBA, its high rate of inflation - 70% year-on-year in February, compared with a target of 60% in the year to June and 45% for 1986 as a whole - could jeopardise its ability to meet fiscal targets for June 1986. The $2 bn bank MYRA has still not been signed (now scheduled for later this month); and completion of a $45 mn co-financing deal has also been deferred, to June or even July. Meanwhile, Paraguay (one of only two Latin American countries so far not forced to reschedule its debts) is running into serious problems following five years of balance of payments deficits. Banking sources believe that the Central Bank could exhaust liquid currency reserves by end-1986. Arrears are accumulating increasingly rapidly, and currently stand at some $250 mn. Total registered debt is put at $1.85 bn.

21 South and East Asia

In the Philippines the economy grew by 0.8% (ar) in the first quarter of this year, following declines of 5.5% and 3.9% in 1984 and 1985 respectively. However, the new administration appears to be having some difficulty in establishing a clear set of economic policies. The new Standby Arrangement - to supersede the one arranged by the previous government - which the authorities had hoped to negotiate quickly has consequently been delayed, but is nevertheless expected to be in place later in the year. The new Standby is generally expected to be less restrictive than its predecessor.

22 Elsewhere, the position of Malaysia has deteriorated since the beginning of the year. Adjustment in 1985 was much greater than had been envisaged, but both the budget and current account deficits look set to widen substantially this year, reflecting the weakness of oil and other commodity prices as well as greater debt servicing costs in local currency terms as a result of yen appreciation. Business confidence is very low, and the stock market has fallen in the wake of the Pan Electric affair. With a general election due to be called before April 1987, it seems that a full policy response to the deterioration in the economic situation may be delayed until after the election. However, latest projections in the Bank indicate that the debt service ratio will not reach 20% before 1990; provided bank confidence is maintained, therefore, the country's position should remain sustainable.

23 Thailand failed to meet its IMF target for the central government deficit in FY 1984/85 (ending September), as a result of which the programme has had to be

renegotiated. The revised programme, which was approved by the IMF Board on 6 June, takes a fairly soft approach this year, but seeks to strengthen adjustment in FY 1986/7 as the economy picks up. Lower oil prices improve prospects for the country, and economic growth may now increase to 5% in 1986 from 4.1% last year. A general election has been called for 27 July. South Korea continues to perform well this year, and economic growth may exceed 9%. Meanwhile, Indonesia is likely to experience negative growth this year, but adjustment measures already taken - together with a high level of foreign exchange reserves and commitments from banks, IBRD, and aid donors - are helping the country to cope with the loss of export and budget revenues that will result from the fall in oil prices. Nevertheless, further measures may still be required.

24 Eastern Europe

On 27 May Poland's membership of the IMF was approved. The US, as expected, abstained on the vote, on the grounds that it was not certain that Poland would be able to meet the economic criteria required by Congress. The IBRD membership poll is to be completed by 20 June. It is now expected that Poland will formally join at the Annual Meetings in September after paying in its IMF quota (SDR 680 mn) and complying with other procedural requirements. The UK announced on 9 June that, subject to certain conclusions, it would be resuming limited export cover to the country. The banks' steering committee reached agreement with the Poles in Vienna on 12 June on the deferral of 95% of maturities falling due in 1986 and 1987 (totalling around $2 bn) under the 1981 and 1982 rescheduling agreements. In addition, a lower interest rate margin has been agreed. It is hoped that this agreement will enable the Poles to sign the multilateral agreement on 1986 official maturities which was initialled in Paris on 7 March. On 13 May Yugoslavia and its official creditors signed the three-stage rescheduling agreement initialled in Paris in April, following Fund Board endorsement of the principles of enhanced monitoring. Romania's request for assistance with its liquidity problems on 21 May in London met with little sympathy from the banks' steering commitee. The banks' economic sub-committee is to report within the next few weeks. Meanwhile, the banks have rolled over maturities of some $175 mn for a month, and the authorities have renewed their informal approach to the Fund about a CFF; they are also talking about approaching Paris Club creditor governments. The further deterioration in Hungary's convertible-currency trade, and the absence of concrete measures to correct the situation, give some concern about the medium-term position of the country.

Southern Europe

25 In Greece the external position has begun to respond to the economic austerity package (and especially the import deposit scheme) introduced last October. The Bank of Greece has commented that the authorities' current account and inflation targets are achievable on condition that policy is not relaxed. Doubts remain, however, about whether the authorities will meet the PSBR target set under the terms of the Community Loan last November. On the international capital markets the most recent syndicated credit, announced in March for the Bank of Greece, has been increased following initial oversubscription. Portugal is reportedly now expected to achieve a current account surplus of $800 mn this year, contrary to earlier estimates of a deficit of this size. Oil price falls will save the country $500 mn, prospects for a good harvest suggest a saving of $200 mn in food imports, and exports are performing better than expected The 1986 budget projects a public sector deficit of 11% of GDP, slightly less than last year's 13%. International capital markets continue to take a positive view of economic prospects.

26 Africa

The Commonwealth Eminent Persons Group have concluded that it is not possible to make any further progress in their mission to promote dialogue in South Africa. Their report published on 12 June was highly critical of the South African government. This, along with the reimposition of the state of emergency, has prompted further widespread international calls for economic sanctions to be imposed against the country. On 18 June the financial rand stood at 25 US cents (as against a rate of 45 US cents for the rand early last August). The authorities have projected growth of around 3% for this year, but this seems optimistic. Measures designed to stimulate the economy were announced on 17 June. There remains the possibility that the heightened political tension will further damage confidence in the economy, thereby reducing South Africa's capacity to pay its debt. Work is being undertaken separately on considering policy options for the UK.

27 Latest estimates suggest that Nigeria's export earnings will fall by about $2 bn to $8.5 bn this year, having already fallen by $3 bn in the last two years. Following the banks' agreement to a 90 day moratorium on principal payments beginning 1 April, Nigerian officials have drawn up, with the aid of a World Bank team, a medium term adjustment package which, they hope, will form the basis for a rescheduling of official and commercial debt. At talks with Fund and IBRD staff in Washington on 11 June, agreement in principle was reached on three outstanding issues: introduction within 90 days of a two-tier exchange market; unification of the two markets within twelve months; and the phasing out of existing capital controls thereafter. But the form of an agreement with the Fund remains

problematic. The Nigerians appear willing to accept the terms of a "classical Standby" but for domestic political reasons do not wish to present it as such. A meeting with Paris Club creditors will be sought, possibly for October. A commercial bank economic team visited Lagos in the week beginning 12 May, and presented its report to a meeting of the banks' steering committee in New York on 12 June. At the meeting the banks stressed the linkage between a London Club and Paris Club rescheduling. In the meantime, the Nigerians have suspended until 30 June the issue of further promissory notes under the scheme to reschedule trade arrears, so as to facilitate cross-checking of claims.

28 Elsewhere in sub-Saharan Africa there has been encouraging progress towards new IMF agreements for Tanzania and Gambia, but difficulties have emerged (probably transitory) in the implementation of IMF programmes for Zambia, Zaire and Somalia. This underlies the fragility of recovery programmes in much of sub-Sahara Africa.

29 Middle East & North Africa

The position and outlook for the Middle East/North Africa region as a whole has changed markedly for the worse in recent months. The sharp fall in oil prices, and the prospect of continuing volatility, has put growing pressure on the fiscal and external accounts of oil-producers and non-producers alike. In the Gulf States, budgetary cutbacks have been imposed across the board (even in Kuwait), payments delays and/or arrears have emerged on a large scale (notably in Saudi Arabia) and expatriate workers from neighbouring countries are being sent home. Private sector activity is depressed, particularly in construction, with a number of well-publicised bankruptcies, and several foreign firms have pulled out. The banks face the growing problem of non-performing loans with recovery complicated by Islamic law, especially in the UAE. Although supervisory authorities have moved, in some cases, to support the banks and tighten up provisions (as in Kuwait), several foreign banks, including in particular US banks, are looking to reduce their presence and their exposure in the area.

30 Among oil-producers, Saudi Arabia's oil export earnings have fallen by over 80% since 1981 and are likely to fall further this year despite the higher volume of its oil exports. The postponement of the FY 1986-7 budget, the devaluation of the riyal, and the rapid erosion of usable official foreign assets are indicative of the Kingdom's mounting difficulties. Useable foreign assets could be exhausted in 2-3 years. Oman has also devalued, suspending the new 5 year Plan (and deferring purchases of Tornado aircraft), and has stepped up foreign borrowing with a $500 mn

loan signed last month. Both Iraq and Iran face serious foreign exchange shortages at a time when the Gulf War has escalated. Iraq is close to bankruptcy, with Gulf aid now less certain, and is seeking to reschedule large amounts of official debt (some previously rescheduled) with all its major creditors. Even the suggested reduction of non-military imports by 30-50% may be inadequate to offset losses from the oil price fall.

31 Egypt, already in difficulties before the oil price fall, has failed, for much of the year, to market its oil. Foreign exchange earnings from remittances and tourism will also fall sharply in FY 1986-7. Agreement on an IMF programme is not yet close to being reached, and there are few signs, as yet, of the government's commitment to the necessary reforms (including devaluation). Algeria has reacted swiftly to falling oil and gas prices with sizeable expenditure cutbacks, notably for imports, and the postponement of major projects. Even so the current account deficit could rise to around $2 bn this year and, although foreign exchange reserves are comfortable, Algeria has already come to the markets this year for $600 mn. Further borrowing is likely to be sought in the coming months, but banks are reportedly becoming more cautious. Tunisia also faces a widening current account deficit and a rising debt-service burden (over 20% of budgeted expenditure in 1986). The government has recently raised $120 mn from the markets, less than the $175 mn originally sought. (The tax-spared element had to be dropped following legal difficulties concerning Tunisia's eligibility under the 1982 double taxation treaty with the UK.)

32 Among non-oil countries, Morocco's external prospects have improved somewhat as a result of the fall in oil prices, lower international interest rates and a good harvest. But the budget deficit remains high and the external financing gap has increased to $500 mn this year. The current IMF programme is now inoperative and the Fund are looking for new adjustment measures before opening discussions on a new programme. Agreement with the banks on rescheduling 1985-7 maturities and possible new money remains distant. Sudan has achieved a peaceful transition to civilian rule, but the civil war has since escalated and the economic and financial position has deteriorated further. The new government has good intentions, but there is no prospect for immediate or decisive action on the economy. Sudan is still ineligible to draw from the IMF, and its IMF arrears have now reached $300 mn. Initial contact has been made with the World Bank and the Fund, but agreement on a programme will be difficult given the widespread hostility to the IMF in the country. Jordan's economic prospects have worsened considerably with the Gulf recession which has jeopardised the principal sources of foreign exchange. Syria (still a net oil importer) is also in severe financial difficulties. Foreign

exchange reserves have reportedly been run down to the equivalent of two weeks' imports, and arrears on official payments and on the part of Syrian banks are now substantial.

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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-Dec 1985	End-March 1986 [2]	End-March 1986 [3]
Latin America				
Argentina	50	2.8(0.1)	0.2	0.2
Brazil	102	6.3(1.0)	0.9	1.9
Chile	19	1.3(0.1)	-	0.1
Colombia	14	0.6(0.1)	0.1	0.2
Ecuador	8	0.5(-)	0.1	0.1
Mexico	97	6.3(0.3)	0.6	1.3
Peru	14	0.3(-)	0.1	0.2
Venezuela	37	2.1(-)	-	-
Far East				
Indonesia	35	0.7(0.3)	0.8	1.7
Philippines	27	1.3(0.1)	0.2	0.2
South Korea	45	2.2(0.5)	0.4	0.8
Eastern Europe (convertible currency)				
Hungary	12	0.4(-)	-	0.1
Poland	30	0.5(-)	1.2	1.3
Romania	7	0.2(-)	0.3	0.5
Yugoslavia	19	0.9(-)	0.7	1.0
Southern Europe				
Greece	17	1.3(0.2)	0.2	0.3
Portugal	16	1.1(0.2)	0.2	0.2
Turkey	25	0.3(0.2)	0.2	0.5
Africa				
Egypt	40	0.3(0.3)	0.4	1.0
Morocco	15	0.1(-)	0.1	0.3
Nigeria	19	1.0(0.1)	2.1	3.2
South Africa	22	3.9(0.8)	0.8	2.6
Sudan	10	0.0(-)	0.3	0.3
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 ECGD-guaranteed loans disbursed, plus political claims paid and claims under examination.
[3] Defined as ECGD-guaranteed loans (disbursed and undisbursed) and contractual interest, plus political claims paid and claims under examination.
* current estimate

LR2.23

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CCPC (2)

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

12 May 1986

Charles Powell Esq
10 Downing Street
LONDON SW1

Prime Minister
CDP 12/5

Dear Charles,

INTERNATIONAL FINANCIAL SCENE

I enclose the regular report on developments in the international debt scene which was prepared just before the Summit meetings. As usual the paper provides considerable detail on the individual countries now regarded as problems.

On the outlook, our judgement - confirmed in discussions at the Summit - remains that the position overall is reasonably satisfactory. Movements in both interest and exchange rates have been positive. However the oil price collapse has created acute difficulties in relation to major oil exporting debtors such as Nigeria and Mexico.

On individual countries, many of the smaller Latin American countries are making progress, in particular Colombia, Chile, Ecuador, Uruguay and even Bolivia. Mexico's negotiations with the Fund are still proceeding, although differences over the appropriate size of the public sector deficit remain to be resolved.

Brazil's position remains very difficult. She has paid no principal or interest on official debt since end-1984 and continuing buoyancy on her trde account is reinforcing her unwillingness to negotiate with the Fund. Given this, a rescheduling demand has recently been rejected by the Paris Club, although there are signs that Brazil wants to continue these discussions. Some recent indications suggest that the Brazilians themselves are aware that the present situation cannot last but in the short term creditor leverage is limited. The UK is however supporting a US attempt to use the provision of new export credit as a lever.

Why?

Cuba has now imposed a unilateral moratorium on debt payments. In financial terms, this is not significant but could provide an unwelcome example. On the other hand, Peru, threatened with immediate ineligibility unless she undertook to clear all arrears to the Fund by mid-August, has given an undertaking to do this.

Elsewhere, there are some recent developments worth noting in Eastern Europe. The 1986 Paris Club agreement with Poland remains unsigned but the banks have improved their rescheduling offer and are now offering to reschedule 95 per cent of 1986 maturities and 90 per cent of 1987 maturities. Yugoslavia initialled a three-stage agreement with official creditors last month covering the period mid-1986 to 1988. This is the first Paris Club agreement without a formal IMF programme. In its place the agreement incorporates very tough provisions for Fund monitoring of economic performance. Hungary's external performance is now giving rise to concern and we shall be keeping a close eye on developments there: in the meantime we are taking a very cautious line on new credit.

Finally, on Nigeria, there are some positive indications to report in the form of an apparent willingness to seek an IMF programme (without drawing or standby) which has impressed some key IBRD staff. This would certainly be progress but we should continue to be sceptical about the speed and extent of any new measures until the IMF satisfy themselves and the measures themselves are implemented.

I am copying this letter to Tony Galsworthy (FCO), John Mogg (DTI) and John Footman (Bank of England).

Yours ever
Rachel

RACHEL LOMAX
Principal Private Secretary

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INTERNATIONAL FINANCIAL SCENE

1 Interest rates have recently been falling dramatically. With significant cuts in domestic interest rates in all the major financial centres, three month eurodollar rates fell almost to 6 1/2%, down from around 8% at the beginning of the year, 9% early last year, and 12% about two years ago (although there has been a slight reversal in recent days, and rates are now around 6 3/4%). Most debtors have also been helped significantly by the continued fall in the US dollar, which by 30 April had depreciated by 19% in effective terms since the Plaza agreement last September and 28% from its peak level of February 1985.

2 As noted in earlier Reports, the impact on debtor countries of the continued fall in oil prices is more mixed. The Baker 15 countries are in aggregate oil exporters, and some of the countries most heavily dependent on oil exports - in particular Mexico and Nigeria - were in extremely serious financial difficulty even before the oil price began its recent decline. Despite the increase in political tension in the Middle East, with the continuing absence of full agreement on output restrictions amongst OPEC members, there seems little immediate prospect of a rapid revival of oil prices from their present depressed levels - though the advantages to OPEC of collective production restraint remain. Prices are now in SDR terms over 65% below their peak levels of last autumn.

3 Contrary to some earlier expectations, the substantial deterioration in the financial prospects of oil-exporting debtors has so far not led to a clear radicalisation of the debtors' stance. In particular, the Cartagena Group meeting at Punta del Este at the end of February, whilst expressing support for any country wishing to take unilateral action, did not itself press a more radical line. With economic prospects for the majority of Cartagena Group countries appearing to improve, these countries seem unwilling to take the risks inherent in overturning the current case-by-case strategy. For their part, the banks have been seeking to underpin the resolution of such countries, by completing rescheduling agreements with a number of countries, thereby in effect isolating Mexico, which has been seen as the most serious threat to the current debt strategy. Mexico itself seems to be standing back for the moment from earlier proposals that interest rates on its loans should be cut to below commercial levels; but the country still says that it will

accept only $4 bn increase in debt towards its projected $6 bn financing gap this year, although it has so far not offered specific proposals to bridge the difference.

4 In the event, discussion of debt problems at the Interim and Development Committee meetings on 9-11 April passed relatively uneventfully. General optimism (at least amongst creditor countries) about the world economic environment, plus the absence of any feeling of imminent crisis about any of the major debtors, meant that debt problems did not dominate the meetings in the way that they had done in many recent international financial fora. Amongst debt-related matters covered at the meetings, the Interim Committee's clarification of the possibility of going to the maximum in access limits, and perhaps beyond in 'exceptional circumstances', will have been helpful. Moreover, there seems now to be agreement among all donors except the US that $12 bn should be the goal for IDA 8. The meetings noted agreement by the IMF Board to the establishment of the Structural Adjustment Facility which will help mainly the poorer African debtors pursuing adjustment programmes. Several countries including the UK used the opportunity to sign the MIGA Convention. On the other hand, continued US opposition to agreeing a timetable for a World Bank capital increase was, if not unexpected, disappointing, although some progress was achieved in securing a firmer commitment from the US for an eventual increase. The possibility of an oil facility, suggested earlier in the year to compensate (non-OPEC) oil exporters, now seems dead.

5 Discussion of the Baker initiative appears to have receded marginally from the limelight. It is generally accepted that the initiative should be viewed more as an overall approach to handling the debt situation rather than as specific proposals for particular amounts of money to identified debtors. No clear recipient of "Baker" funds seems likely to be forthcoming - or, indeed, willing to be identified - in the near future. However, one result of the Baker initiative seems to be the higher profile of the IBRD in a number of countries, and the increased role for it in providing structural or sectoral financing for problem debtors. A package of $465 mn for Mexico was approved in March, and a further $500 mn loan for that country is being negotiated; in April $250 mn was approved for Colombia and $350 mn has recently been agreed for Argentina.

6 Nevertheless, serious concerns do remain. As already noted, the falls in oil prices exacerbate the difficulties of a number of debtors, and the falls in the dollar and in interest rates will provide only partial relief for them. Some banks are likely to be hit by oil-related problems more widely, and will be particularly reluctant to increase their involvement with oil-dependent debtor countries.

Moreover, internal developments in a number of debtor countries are not reassuring: Brazil has re-introduced partial indexation of wages; the Argentine authorities face continued domestic opposition to their economic programme and have exceeded their IMF fiscal target for the first quarter; Mexico still has significant differences with the Fund over the size of its prospective fiscal deficit for this year; uncertainty surrounds the prospective economic policies of the Philippine authorities; Egypt remains unwilling to countenance serious economic adjustment although its economic condition continues to deteriorate; Peru continues its policy of virtual non-co-operation with the banks, although it has made token payments to the banks (of $18 mn) and to the US ($16), as well as SDR 30 mn to the Fund to reduce its arrears; and, although the Nigerian authorities are now giving more positive signals about their willingness to reach agreement with the Fund, there are still considerable doubts about the firmness of their commitment on this issue.

7 Furthermore, the world economic environment is not entirely bright. The recent interest rate reductions have been a response in part, especially in the US, to slower than expected economic growth. US growth in 1985 Q4 has been revised downwards to 0.7% (ar), and whilst Q1 figures for 1986 suggest 3.2% growth, largely because of improved exports and stockbuilding, prospects for the year remain mixed. With the US trade deficit likely to rise this year (because of J curve effects), and industrial production indicators in February and March showing their largest two-month decline (1.2%) since late 1984, increased protection remains a serious threat. Treasury Secretary Baker has suggested that further dollar depreciation and/or faster growth in other industrial countries will be necessary if protectionist pressures are not to increase; however, other countries, in particular Japan, now seem to be resisting further dollar depreciation.

8 Since the beginning of the year, there has been some reversal in the downward trend in commodity prices, and the aggregate Economist Index rose by 4% in SDR terms (8.6% in dollars) in the first quarter. During March, agricultural raw material prices rose relatively strongly (by 6.3% in SDRs), and food prices also continued to rise (+5.5% in SDRs), with most commodities moving upwards. Metal prices overall were roughly unchanged, with heavy falls in the price of tin offsetting rises in other metals. More recently, there has been some downward movement in prices, but this may have been only a transitory development.

9 East Bloc borrowers have continued to borrow heavily on the capital markets, raising nearly $1 bn in March and April. The USSR has arranged a further non-dollar denominated loan, for DM 1 bn ($450 mn). Hungary arranged a $275 mn

credit on improved terms, comparable with many OECD countries; and a $250 mn FRN continues the country's sophisticated use of the market which may not yet have fully caught up with the underlying deterioration in the country's economic prospects. There has been little LDC borrowing since February, with only $350 mn raised in March and April, including a $175 mn credit for Tunisia (taking advantage of a tax-sparing agreement concluded with the UK in 1985).

Further details on individual countries are given below.

10 Latin America

Following the emphasis of the Austral Plan on cutting inflation in Argentina, pressure on the authorities to introduce measures to stimulate economic (and export) growth has been mounting. A 3 1/2% devaluation of the currency, announced in early April, and an additional 1.2%, announced on 24 April, may be insufficient to restore the country's competitive position, although further adjustments are said to be under consideration if required. Despite the announcement of permissible wage increases for the rest of the year of between 18-25% in the private sector (18-21% public sector), labour unrest continues. Plans for a general strike on 24-25 April were postponed after the major unions agreed to talks with Labour Minister Barrionuevo, but the agricultural sector strike on 20-21 April went ahead and attracted widespread support. Efforts to promote more dynamic growth in agricultural output and exports are being underpinned by a recently approved IBRD agricultural sector loan of $350 mn. However, export prospects for this year are likely to be badly hit by continued low grain prices.

11 On the financing side, the March Fund drawing under the extended SBA which expires at end-May paved the way for disbursement during the week ended 18 April of the penultimate $600 mn tranche of the commercial bank facility. One final drawing remains to be made. A possible $1.4 bn follow-on SBA is now under consideration by a Fund mission, and negotiations have begun with commercial banks on the financing needs for 1986, which banking sources put at around $500-700 mn (although Argentina will probably ask for much more). However, the Ministry of Economics has recently stated that the IMF target for the Q1 fiscal deficit was exceeded; this may complicate the final purchase from the IMF under the current SBA and the final drawdown of the commercial bank facility. It may also complicate the current negotiations with the Fund and the banks for 1986-7.

12 Brazil continues to perform very strongly on its external account. The first quarter trade surplus stood at $2.6 bn, compared with $1.9 bn in the same period

last year. Exports increased by 16% to $5.8 bn (cf $5.0 bn), non-oil imports rose 30.6% to $2.2 bn (cf $1.7 bn), whilst oil imports fell by 26% to $1.0 bn (cf $1.4 bn). The impact of the government's tough anti-inflationary measures ('the Cruzado Plan') led to a fall in consumer prices in March of 0.9%, the first fall since September 1957. Other preliminary signs of the Plan's impact are encouraging: the gap between the official and parallel exchange rate has narrowed, and the stock exchange indices in the major cities have reached record levels. However, there is some concern that the effectiveness of the Plan may be weakened by the government's recent decision to reintroduce partial indexation of wages and salaries, a move designed to placate trade union opposition to the reforms. In addition to the automatic upward adjustment when inflation reaches 20%, there will now also be an automatic end-year adjustment to compensate for 60% of the annual inflation rate. This decision has received a mixed response in Brazil.

13 Brazil re-opened talks with the Paris Club on 15 April to discuss rescheduling about $2.4 bn of official debt falling due in 1985 and 1986. The discussions were heated, with the Brazilians proposing that current arrears be repaid over seven years (for principal) and four years (for interest) with an initial payment of 15% of arrears due between October 1985 and end-April 1986. They also proposed a moratorium on maturities falling due between May 1986 and June 1987. These demands were rejected and the US responded by announcing that it had decided to withdraw medium-term export credit cover. Brazil has paid no principal or interest on official debt since end-1984, and remains adamant in its refusal to negotiate with the Fund; the Brazilians are temporising over the date of the forthcoming Article IV mission.

14 Mexico was slow to adjust its oil price this year, and has substantially lost market share. Exports in March were only 1.1 mbd, compared with 1.5 mbd in March 1985. The economy seems to have slowed dramatically after its reported 2.7% growth last year; and inflation in accelerating slightly, with prices rising by 19% in the first quarter of this year. Although discussions with creditors continue, Mexico has yet to propose formally its 1986 financing plan. The authorities continue to estimate their overall financing requirement to be $6 bn, but stress that external borrowing will be limited to $4 bn. An Institute of International Finance analysis suggests that, on certain (favourable) assumptions, the financing gap might be only $2 1/2 bn, and banks have suggested that this might be filled without need for any new bank money. Some progress has been made in Mexico's negotiations with the IMF; however, the public sector deficit continues to cause difficulties, although the authorities are now taking measures which should reduce the deficit by the

equivalent of $2 bn, bringing it to about 9% of GDP for this year, through both increased tax revenues and reduced subsidies. In the absence of a provisional agreement with the Fund, no meeting with the banks' Advisory Committee has yet been called. Mexico's external financing for this year has been assisted by the approval in late March of a package of IBRD loans totalling $465 mn (including $400 mn for earthquake rehabilitation), and an IBRD trade policy loan of $500 mn is currently being negotiated. Silva Herzog has been in Japan and is reported to have requested $1 bn from the Japanese to finance three projects covering oil, steel, and export promotion. On 17 March a major export promotion package was introduced which is expected to boost non-oil revenues by $1 bn in 1986. Meanwhile, the reserves seem to be holding up well (about $6 bn at end-March), and have been aided by the faster depreciation of the controlled peso rate against the dollar. (The free rate has been broadly stable since end-1985: it is now only 2% above the controlled rate, against 25% at the start of the year.) Although it had been suggested that by the beginning of this month the Mexicans might need to consider limiting debt service payments to protect the reserves (there have been suggestions that a 90-day suspension of interest payments is being contemplated) it now seems that they can get by at least until July without needing to take action. At end-March the banks agreed to a further 6-month rollover of $950 mn due in April and previously rolled over last October.

15 On 23 April the Venezuelan authorities sent telexes to their creditors confirming that the country would invoke the contingency clause in the $21.2 bn MYRA, which was signed at end-February, and seek a resumption of discussions with the banks. (Under the MYRA, Venezuela was able to request talks on further restructuring within one month of signature if the uncertainties in the oil market continued.) Although the Venezuelans are still expected to make the $750 mn down payment due under the MYRA this year, there are reports that they may seek to defer the $2 bn principal due in 1987-88. Banks are likely to resist reopening discussions at this stage, especially as the Venezuelans still have reserves of almost $14 bn. Meanwhile, oil exports in Q1 1986 averaged 1.35 mbd at $18 pb, bringing revenue of $2.2 bn, down 30% from the comparable period last year. The authorities have again ruled out voluntary cuts in production, preferring to defend market share rather than price.

16 Of the smaller countries, Peru's stance remains problematic. Relations with the commercial banks have deteriorated even further. At a meeting with the banks' Advisory Committee on 12 March, Central Bank President Figueroa restated an earlier promise by the Peruvian government to make a token payment to reduce interest

arrears on bank debt, and on 28 April a payment of $18 mn was made. (The Peruvians also made a payment of $16 mn to the US.) However, given that arrears currently stand at about $400 mn, the banks remain unhappy at what they see as Peru's repeated prevarication in debt negotiations.

17 Following Peru's payment of SDR 30 mn to the Fund to reduce arrears, which currently stand at about SDR 97 mn, the IMF Board decided at its meeting on 14 April against an immediate declaration of ineligibility. After much discussion, and against the wishes of de Larosiere (who wanted a review in two months), a narrow majority, which included the US, UK, Germany and Japan, voted to adjourn the meeting only to 5 May, at which time they will vote for immediate ineligibility unless Peru has given an assurance that it will clear all arrears by mid-August.

18 Prospects for Colombia continue to look good. The report of the IMF Staff mission's visit in January/February has now been published. It confirms that the end-1985 targets under the enhanced surveillance agreement were amply met. Enhanced surveillance is to continue this year, and the Fund Board will discuss a staff report on Colombia's 1986 programme on 23 May. The second tranche ($150 mn) of the World Bank's trade policy and export diversification loan was released on 27 March, thus enabling release of part of the $1 bn commercial banks' loan. Signing of the banks' loan was completed on 5 April, and drawing of at least a part ($350 mn) of the first tranche ($515 mn) is expected in late May (after ratification of the loan by the Council of State); Colombia has indicated that it may not wish to draw the second tranche. On 15 April, the IBRD approved a $250 mn trade and agricultural policy loan.

19 Bolivia is making slow and unsteady progress towards reaching agreement with the IMF on an adjustment programme. A second IMF Letter of Intent was signed at the end of March following a Fund mission to La Paz to investigate policy slippages since the previous Letter of Intent was signed in January. Bolivia's request for an SBA, reportedly of SDR 50 mn, is now scheduled to be discussed by the IMF Board at the end of May or in early June, with discussions with the Paris Club likely to follow some time in June. However, this timetable is dependent on the Paz administration succeeding in passing a tax reform package through Congress. The collapse of tin prices to less than half their pre-suspension levels is expected to reduce 1986 export revenue to no more than $300 mn (compared with $550 mn in 1985).

20 Chile's economic prospects for 1986 have been improved by the fall in oil prices. On 14 March there was a drawing of SDR 62.5 mn from the SDR 750 mn EFF,

followed by a $150 mn drawing on the $1,085 mn commercial bank loan on 27 March. The first contract of the multi-year rescheduling agreement was signed on 11 April, covering $2.6 bn of the $6 bn of public and private sector debt due 1985-89, to be rescheduled over 12 years, with 3 years' grace, at Libor + 1 3/8%. It is hoped to complete the MYRA by mid-June. Both the release of the third tranche of the bank loan and the next IMF disbursement, which should occur late May or June, are conditional upon the MYRA.

21 In Ecuador a commercial bank MYRA covering public and private sector debt due 1985-9 was to have been completed in February. The first part of the agreement, covering $2.5 bn of public sector debt was signed in December, but agreement on the second part of the package, covering $1.5 bn of private sector money, has been delayed; the Advisory Committee are now pressing for signature by end-May. The economic outlook has been very badly affected by the fall in oil prices; if prices remain around current levels, this could result in oil export revenue ($1.9 bn in 1985, 64% of exports) falling by $1/2 bn this year. The fiscal impact of lower oil prices has so far been minimised by greatly improved tax administration, as a result of which the collection of certain taxes doubled in January-February 1986 compared with a year earlier. Until recently the authorities maintained that the loss of oil income would not lead them to seek fresh finance; however, they now hope to receive $600 mn in soft loans from foreign agencies and governments. Banks are meanwhile considering whether they could stretch their existing oil facility, and whether more money might be put up with the World Bank. A new SBA reported to be about SDR 130 mn is expected to be signed shortly, following on from the one-year SBA for SDR 105 mn which ended in March. The new programme was to be initialled by the Fund MD by 30 April; otherwise, the existing trade facility would formally expire and require a waiver.

22 In Uruguay the economy may be pulling out of its long recession. Following an upswing in late 1985, the authorities are seemingly on track for their 2% target growth for the year to end-June 1986. A $45 mn IBRD co-financing loan for an energy project is expected to be signed soon with an IBRD guarantee for repayment of half the loan. Uruguay's bank MYRA, covering $2 bn of debt due 1985-89, is also expected to be signed soon; debt is to be rescheduled over 12 years, with 3 years' grace, at Libor + 1 3/8%.

23 A Paris Club Task Force visited Cuba from 22-26 April. The Cubans indicated that 1985's foreign exchange deficit was about $150 mn ($110 mn more than indicated at the previous rescheduling last July), due partly to lower oil prices and sugar

prices. The deficit for 1986 is projected at about $450-500 mn. To meet their financing needs the Cubans have told western creditors they require a rescheduling over 12 years of all principal and interest due on loans contracted before August 1982, plus either new money of around $450-500 mn or additional reschedulings and a smaller new money loan. The Cubans have declared a moratorium on principal and interest payments (excluding short-term commercial debts and unguaranteed supplier credits) from 5 May, pending a satisfactory conclusion to negotiations within a 90-day period. The Paris Club is due to discuss the proposals at its next meeting, from 12-16 May, and discussions with banks may begin after that meeting. However, it is unlikely that either the Paris Club or the banks will respond favourably to the proposals; they are likely to insist on evidence that Cuba is ready to take action to cut its financing requirements or to obtain some assistance from its socialist allies. Meanwhile, the "new look" mission's draft report on Jamaica has been to the IMF, IBRD and US AID for comment, and the final version was taken by the mission to Jamaica on 17 April. The report apparently calls for "comprehensive economic adjustment measures" but is not specific about what these should involve. Assuming that the report is quickly agreed by the government, an operational summary will be prepared for despatch to donors in May, and will form the basis of discussions during May and June.

24 South and East Asia

Following significant breaches of performance criteria of the Philippines' existing IMF Standby (negotiated by the previous adminstration), the programme has now been abandoned. Instead, a new programme will be negotiated, which, when in place (perhaps by June), is then expected to release the remaining $350 mn of new commercial bank lending, provided that the creditor banks agree to an extension of the drawdown period. At a meeting of the Advisory Committee on 15 April, Finance Minister Ongpin indicated that he, personally, did not support a selective repudiation of external debt, although parts of the Cabinet were in favour - as reported recently in the press. Ongpin also mentioned that some $600-700 mn of aid may be forthcoming this year, and a further approach to the Paris Club to restructure maturities falling due after June 1986 can be expected.

25 Some banks now appear to be re-appraising Malaysia's credit rating, and an unfortunate comment reportedly made by Prime Minister Mahathir, that the country would be seeking to reschedule its debt next year, will not have not helped. The prospect of a rescheduling has subsequently been firmly denied, and Mahathir may have been referring to normal market refinancing. On the economic side, knock-on

effects from the weak commodity prices, especially for oil and palm-oil, could lead to negative growth this year, while the current account deficit may widen from $1 bn last year to at least $3 bn. The ringgit has depreciated by over 20% over the last six months. Nevertheless, the debt service ratio is only 14% at present and, despite increasing amortisation payments, should remain under 20% in the next few years. The position should therefore be sustainable, as long as confidence in the country is maintained. Indonesia has responded to the lower oil price by seeking to reduce public expenditure, but the authorities are still avoiding an outright devaluation of the rupiah. South Korea, by contrast, looks set for an excellent year. Growth of at least 8% is expected, and a current account surplus of around $1 bn may be achieved. Both net external debt and the debt service ratio should fall.

26 Eastern Europe

Following the absence of significant progress in the talks between Poland and the banks' committee in Warsaw on 8 April, when the banks improved their rescheduling offer from 75% to 80%, the banks conceded further ground at a meeting in London on 28-29 April. They have offered to reschedule 95% of 1986 maturities over 4 years, to recommend a rescheduling of 90% of 1987 maturities also over 4 years (75% by rescheduling and the remaining 15% to be covered by an increase in the revolving trade facilities), and to extend the 1983 revolving trade credits by a further two years in order to take the Poles beyond the 1987 debt hump. While continuing to emphasise that there is no possibility of new money, the banks estimate total relief offered over the two years at $2 bn. No further meeting is scheduled, but the banks have asked the Poles to respond before 10 June, the due date of their next major repayment. Meanwhile, the IMF Executive Board have endorsed the Membership Committee's recomendations (the US quietly abstained), and the draft resolution has been passed to the Board of Governors. Voting will close on 27 May, and it is intended that Poland should be admitted to the Fund in early June.

27 Yugoslavia initialled a three-stage agreement with official creditors in Paris on 17 April covering debt maturing between mid-May 1986 and end-1988. For the first stage, creditors have agreed to reschedule 85% of principal falling due between mid-May 1986 and mid-May 1987 over 9 years including 4 years' grace. There will be no formal IMF programme, but Fund staff will monitor economic developments and creditor governments will be able to require Yugoslavia to seek a Standby programme if performance deviates from planned targets. For the second stage, covering maturities from mid-May 1987 to end-March 1988, official creditors have

agreed to reschedule a smaller percentage of principal, the precise level to be decided at a later date. For the third stage, maturities until end-1988 are covered by a goodwill clause. The liquidity crisis in Romania remains serious: ECGD now report delays in payments, and arrears with the IBRD are accumulating fast. Romanian officials are currently in London for discussions with the banks, presumably about the country's financing gap ahead of the large payments due in mid-year. A $275 mn credit for Hungary has been oversubscribed and may be increased. There is, however, some concern about Hungary's continued weak external performance, and a number of banks may be reluctant to increase their exposure to the country, particularly given the present low margins (Libor + 1/4%, rising to +3/8% after two years). The USSR is adjusting to the lower oil price through planning to reduce imports by up to a third, so as to restrict the amount of new borrowing it would otherwise require.

28 Southern Europe

In Greece the effects of the tight economic policy initiated last October are beginning to be felt, with a substantial fall in imports listed under the import deposit scheme, and a slight fall in the rate of inflation (to 24.4% in February). Following two small public sector loans in March, the Bank of Greece announced a $300 mn 6-year syndicated credit in early April at a spread higher than that on a similar loan last year. The authorities remain confident that a reduction in the current account deficit from $3.3 bn in 1985 to the target of $1.7 bn this year will be met, as a result of the benefits from the oil price fall, higher revenues from the EC and an easing of pressure on the drachma.

29 Although the Portuguese government's programme of 'controlled expansion' is likely to result in a deterioration of the current account this year, lower oil prices are expected to limit the current account deficit to below $300 mn. The continuing decline in the rate of inflation (year-on-year rate of 12.2% in March) recently prompted the authorities to reduce the discount rate by 1 1/2 percentage points to 17 1/2%. The 1986 budget, due to come into effect on 1 May, projects a decline in the budget deficit from 13% to slightly over 11% of GDP.

30 Africa

On 27 March a Nigerian delegation led by Finance Minister Okongwu met in London with a Steering Committee (co-chaired by Barclays, Banque Nationale de Paris and Citibank) representing commercial bank creditors. The Nigerians were seeking to

reschedule principal maturities covering 1986-89 over 10 years with five years' grace. This first meeting turned out to be largely a ground-clearing exercise and in the event the Nigerians requested and were granted a 90-day standstill on principal repayments of public debt with an original maturity of over 12 months. The Nigerians made it clear, however, that they would be seeking a formal rescheduling of both commercial and official debts (the latter to cover interest as well as principal). At a meeting on 17 April between the Nigerians and a Paris Club Contact Group, creditor countries refused to agree to a standstill on repayments of official debt, and continued to stress the need for the prompt conclusion of a Standby arrangement with the Fund as a pre-condition for rescheduling. Such an arrangement now looks more likely following Okongwu's statement at the Paris Club in which he indicated that the Nigerian authorities were ready to talk to the Fund, and that they were prepared to move on the crucial question of the exchange rate. This came as a surprise to creditor governments (and to some members of the Nigerian party). The World Bank, which seems to have taken the lead in drawing up an adjustment programme, gave a strong measure of support at the Paris meeting for Nigeria's commitment to adjustment. It seems, however, that any agreement with the Fund would take the form of an "empty programme", whereby a letter of intent would be signed but no money would actually be drawn, in order to assuage opposition within Nigeria to the use of Fund resources. A further meeting between the Nigerians and the banks' Steering Committee took place on 23 April, at which the banks continued to stress the importance they attached to linkage with the Paris Club and thus with the IMF. The Steering Committee also appointed an economic sub-committee which is due to visit Lagos shortly. Their report is likely to form the basis of the next full meeting due to be held on 11-12 June in New York, at which the IMF and the World Bank will be present.

31 Although economic prospects have improved somewhat, mainly as a result of lower oil prices, Morocco has encountered further difficulties in its negotiations both with commercial bank creditors and the IMF. Significant differences have emerged over the terms of a 1985-7 rescheduling package with the banks, notably over Morocco's request for new money, and a further meeting between the Moroccans and the banks' steering committee is not envisaged until the end of May at the earliest. An IMF mission in early April was once again unable to complete the first review of the current Standby, and substantial arrears to the Paris Club remain. But a further IMF mission is planned in early May, with the aim of agreeing a programme for 1986 for possible submission to the Executive Board in June. After originally seeking a loan of $500 mn, Algeria succeeded in concluding a borrowing of $300 mn on

fine terms (LIBOR + 3/8% over 10 years), but very largely with only Japanese banks participating. The Algerian State Bank for Agriculture and Rural Development is now seeking a further borrowing of $300 mn, of shorter maturity (eight years) and on terms less favourable for Algeria (LIBOR + 1/2% for the first 5 years falling to 3/8% thereafter). The Planning Minister has said that Algeria will seek substantial borrowing over the next three years rather than drastically cut its development plan. At the same time, a series of austerity measures is to be introduced, which is expected to include cuts of 11% and 26% in the 1986 current and investment budgets respectively and some, as yet unspecified, reductions in import quotas, commodity subsidies and travel allowances. Greater flexibility is being shown in respect of the renegotiation of maturing long-term export contracts for natural gas, which will reflect market prices rather more closely.

32 In Egypt the outlook for foreign exchange earnings, already bleak in the wake of falling oil prices, has deteriorated further following Iraq's recent decision to restrict emigrants' remittances (hitherto a valuable source of hard currency). The Egyptian government has continued to introduce minor economic measures in a piecemeal fashion, but has yet to embark upon the major reforms sought by the IMF. Although there have been several IMF missions to Cairo, and the Governor of the Central Bank of Egypt has had talks in Washington about a possible Standby, agreement on an appropriate programme now seems unlikely before the end of the year. Routine Article IV discussions were due to begin at the end of April. The Egyptians are now lobbying G7 countries, in advance of the Tokyo Summit, to support - and help finance - the establishment of a $25-30 bn Middle East Development Fund (originally proposed by Israel and since taken forward by the US). The Egyptians regard this as a response to the problems caused by falling oil prices and a way of alleviating their debt repayment difficulties. It is however far from certain whether the proposed fund will get off the ground.

33 After extensive discussions with the banks' technical committee, South Africa's debt rescheduling has now been agreed in principle, and the proposals have been circulated to all creditor banks; so far, only about one third of the banks have accepted them. There have been reports that some banks (possibly Swiss and Italian) are prepared to accept an option of a rollover of released funds: as a result, it seems likely that rather less than the estimated $420 mn due on 15 April under the 5% down-payment will actually have been paid. Following the recent elections in Sudan a moderate coalition government will assume office on 6 May, but the rebellion in the South continues. In the recent IMF Article IV discussions, emphasis was once again placed on the urgent need for Sudan to adopt an effective

set of adjustment measures and eliminate arrears to the IMF (to which it is the largest single debtor). But the prospects for early or decisive action are remote. At a critical stage in the country's adjustment process President Kaunda has appointed a completely new economic team in Zambia, including the replacement of the widely respected Finance Minister Mwananskiku. The former team had won the confidence of western donors, and its replacement has been greeted with suspicion by the banks. The government has stated that there will be no change of policy, but this remains to be seen.

34 Middle East

Although Iraq's oil production has continued at a level well above its OPEC quota, revenues have been depressed by the low oil price. Rescheduling talks with official credit agencies in both India and West Germany have recently broken down. The authorities have introduced new austerity measures, including even tighter restrictions on emigrant remittances; and 720 day credit is being sought on a range of imports.

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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-Dec 1985	End-Dec 1985 [2]	End-Dec 1985 [3]
Latin America				
Argentina	51	2.5(0.1)	0.2	0.2
Brazil	100	5.8(0.9)	0.9	1.8
Chile	20	1.2(0.1)	-	0.1
Colombia	14	0.5(0.1)	-	0.2
Ecuador	8	0.5(-)	0.1	0.1
Mexico	98	5.7(0.3)	0.6	1.3
Peru	14	0.3(-)	0.1	0.1
Venezuela	38	1.9(-)	-	-
Far East				
Indonesia	36	0.7(0.2)	0.8	1.6
Philippines	27	1.2(0.1)	0.2	0.2
South Korea	46	2.1(0.4)	0.4	0.8
Eastern Europe (convertible currency)				
Hungary	11	0.4(-)	-	0.1
Poland	30	0.5(-)	1.2	1.3
Romania	6	0.2(-)	0.3	0.8
Yugoslavia	18	0.9(0.1)	0.7	1.0
Southern Europe				
Greece	16	1.2(0.2)	0.2	0.3
Portugal	16	1.0(0.2)	0.2	0.3
Turkey	22	0.3(0.2)	0.2	0.6
Africa				
Egypt	40	0.3(0.3)	0.4	0.9
Morocco	14	0.1(-)	0.1	0.2
Nigeria	19	1.0(0.1)	2.0	3.2
South Africa	22	3.6(0.7)[4]	0.9	2.7
Sudan	9	0.0(-)	0.3	0.3
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] Because of deconsolidation of subsidiaries which are no longer majority owned, the data shown from end-June 1985 is not compatible with those previously shown.

* current estimate

RP6.4

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Prime Minister

CDP 20/3

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

20 March 1986

Charles Powell Esq
10 Downing Street
LONDON
SW1

Dear Charles,

INTERNATIONAL FINANCIAL SCENE

... I enclose the latest in the regular series of reports on developments on the international debt scene. On this occasion the report provides background material for the forthcoming international economic meetings, including the OECD Ministerial Meeting, the Spring Meetings of the Interim and Development Committees and the Economic Summit.

Our judgement is that the debt strategy and international institutional framework which supports it, looks valid - though challenging - provided the oil price stabilises within limits of about $12-20 a barrel. This is somewhat more optimistic than our last report, reflecting more detailed assessments of the impact of the oil price change and the moderate response so far from those major debtor countries most affected. However, recent IBRD calculations for the Development Committee Meetings suggest a need for total additional capital inflows to major debtors of between $14 billion and $21 billion a year. This is a more challenging target than that implied by the figures in the Baker package. It assumes a need, in political terms, to maintain an acceptable level of per capita consumption growth. This may lead to pressure at the Spring Meetings for greater financial flows from the commercial banks. Combined with demands for further adjustment as a precondition for new money, this will inevitably lead to some politically difficult negotiations. Mexico will be in a key position here.

In addition to the generally benign impact of the oil price fall on the world economic outlook, other developments, including interest and exchange rate movements, are pointing

in the right direction. Agreement on the Preparatory Committee for a GATT round is a further positive factor. There has been some criticism of the lack of progress in implementing Baker but this under-estimates both the political difficulties of the adjustment measures required by the IFIs and commercial banks and the effort which is now being put into working out policy reform loans for key debtors, in particular by the IBRD.

On individual countries Mexico, despite its difficulties, is taking a non-confrontational path and has reduced her estimate of new money required in 1986. She is embarking on an intensive round of dicussions with the IBRD, IMF, IADB and perhaps the Paris Club as well as with the commercial banks. The latter will not be easy. The Mexicans are looking for a concession on interest rates which would not only improve their external account but, even more important, would reduce the size of their fiscal deficit now running at some 10 per cent of GDP. The Fund see this as more of a problem than the external financing gap which is judged to be coverable.

Since our last report Brazil has reached agreement with its commercial bank creditors on a holding operation under which, despite the absence of an IMF programme, 1985 arrears have been rescheduled whilst 1986 maturities, including short term trade credit, have been rolled forward for a further year. Government creditors remain unwilling to reschedule in the absence of an IMF programme. Within the last two weeks Brazil has introduced a new package of monetary measures to control inflation: prices are frozen for a year, the economy is largely de-indexed and a new currency, the cruzado, has been introduced. This is a step in the right direction but doubts remain about whether the fiscal and monetary package goes far enough or will be adequately carried through.

On non-Latin American debtors, the Paris Club has reached agreement with Poland on a generous 1986 debt relief package. Official creditors have conceded about 60 per cent of total debt relief sought from the West, in line with official creditors' share of original stock of debt. The commercial banks and other creditors will now need to give equivalent relief. But even if they do, the Poles may well run out of money later in the year. However, the problem is sufficiently sui generis not to be contagious.

On the Philippines, the outlook remains uncertain following the replacement of the Marcos Government. Radical statements on debt made by President Aquino during the election campaign have not been formally repeated since she took office although

there have been suggestions that some categories of debt should not be paid.

Over Egypt there is increasing concern. The already poor outlook has been seriously damaged by the oil price fall. Egypt must now be judged a very risky market on which there is an unwelcome overhang of UK arms sales and other commitments.

Finally, the banks have now agreed in principle to the proposals for South African rescheduling put forward and the details are being considered in a technical group.

I am copying this 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

1 The continued fall in oil prices since the last Report has brought expectations of lower inflation and higher growth in the world as a whole, but is greatly exacerbating the problems facing a number of oil-exporting debtors. At the moment it seems that some of these countries will be unable, or unwilling, to offset the shortfall in their prospective export earnings fully through domestic adjustment, and that they will therefore be seeking increased inflows or reductions in their debt payments. With the likelihood that little visible progress will have been achieved in putting together Baker money by the time of the Interim Committee meetings in April, there is a danger that some debtors might seek alternatives to the existing framework for handling their debt problems. The steering committee of the Cartagena Group has already held a special meeting to discuss the implications of the oil price fall. Although the meeting stopped short of unilaterally setting lower interest rates on commercial debt, it declared that "substantial modifications to existing debt agreements could no longer be postponed, in particular with regard to current interest rate levels". On the banks' side, the projected growth in their balance sheets - and likely further strengthening of their capital ratios - means that the 2-3% increase in total exposure called for under the Baker initiative in fact represents a decline in proportionate exposure to the debtor countries; therefore - assuming the other legs of the Baker initiative are in place, in particular the stipulation that debtor countries take measures to improve the structures of their economies - it may well seem prudent for banks to increase their exposure along the lines envisaged by Baker.

2 Spot oil prices have continued to fall over the past few weeks, and are now 50% in dollar terms below the peak levels of last autumn. Taking all LDCs together, it seems that the initial effect of the price falls on the aggregate trade balance of this group of countries is roughly neutral, with gains to importers roughly offsetting losses to exporters, although the effect is clearly negative if one looks only at the Baker 15. But the fall in oil prices should stimulate economic activity in the industrial countries, and the second-round beneficial effects from this might eventually outweigh the initial adverse effects of the price falls for some of the smaller oil exporters. But in any case, the overall effect on the debt situation cannot be evaluated simply by aggregating the trade balance effects on all the individual countries. The fall in oil prices may, for instance, benefit

countries not currently needing new money anyway (eg Brazil) whilst adding substantially to the burden of some countries already in difficulty. In any case, rapid changes in prices tend to intensify problems, as countries become unable to adjust to the new circumstances with the necessary speed.

3 Evaluation of the prospects for oil-exporting debtors is greatly hampered by the absence of any firm expectations on where the oil price is heading. But it is clear that, even with some rebound from current price levels, Mexico will face financing needs on a scale substantially greater than those envisaged a few months ago and, arguably, greater than those which would be consistent with the flows specified in the Baker initiative. Although the Mexican authorities last week revised downwards their expected financing gap for 1986 to about $6 bn from earlier estimates of $9 bn, and reportedly agreed with the US Treasury that this amount could be generated from existing sources, they will undoubtedly face considerable difficulty over the coming months in pulling their required financing together. And, in any case, serious questions have been asked - both inside and outside Mexico - whether the country should accept so much additional finance, since it would add to an interest burden that the country already finds insupportable.

4 Other countries being seriously affected by the oil price falls include Nigeria, Egypt and Venezuela. Even if the price rebounds somewhat from current levels, Nigeria and Egypt will have major difficulty in meeting their financing requirements. Venezuela, on the other hand, is likely to be protected by its sizeable reserves unless the oil price continues to fall. And if the oil price does fall further, other countries not yet in difficulty, such as Indonesia, may not find it possible to continue obtaining their financing requirements at fine spreads in the market. Exporters with more diversified economies such as Malaysia are less likely to be seriously affected. Some additional countries may be affected by knock-on effects from oil prices on to prices of complementary and competing products. Coal prices are particularly likely to be affected, with major exporters of coal including Poland and Colombia. Most countries, however, will expect to gain from the fall in the oil price. For a country such as Jamaica, which is in a critical debt situation, which relies heavily on oil imports and on exports of a commodity (bauxite) whose usage is heavily energy-intensive, the fall in oil prices could bring substantial relief.

5 A major general concern is how the fall in oil prices will affect countries' attitudes to handling their debt. Some optimists have suggested that the fall in oil prices might actually help resolve Nigeria's debt situation, since the country will now be under increased pressure to recognise that it cannot get by without a

Fund programme. However, recent weeks have seen more worrying developments, with the meetings of the Mexican and Venezuelan Presidents, and the repeated calls - now endorsed by the steering committee of the Cartagena Group - for lower interest rates on existing debt. The US authorities have apparently been working on a deadline of providing the first Baker money before the Interim Committee meetings in April. Whilst some recent arrangements (Ecuador, Uruguay) could arguably be said to derive from the Baker initiative (even though negotiations began before the Seoul meetings), there is as yet no clear example of a country being a recipient of Baker funds. Argentina, Mexico, Chile and the Philippines have all been mentioned as early candidates. Insofar as the Baker inititiative may have raised expectations amongst debtors, this may increase the likelihood of some reaction, perhaps along the lines of the Peruvian example, as these expectations are disappointed. For the poorer debtors, the first round discussions on both the IMF Trust Fund and IDA 8 were held, and further rounds are due in late March/early April.

6 Against these developments, prospects for the world economy have in general improved, with expectations of higher activity and lower inflation as a result of the falls in the oil price. A fall of $10 pb in the oil price is estimated to raise output in the major industrialised countries by a total of 2-3% over three or four years, and to lower the price level by 3% over this period. Partly in anticipation of lower inflation, interest rates - both short-term and long-term - have been falling in recent weeks. Three-month eurodollar rates are now below 7 1/2%, over one and a half percentage point below the level of early last year, and four and a half percentage points below the level of two years ago. Certain aspects of the Gramm Rudman legislation were declared unconstitutional in a District Court but it remains in force, pending appeal.

7 Debtor countries are also likely to be helped by the continued fall in the US dollar, which in effective terms is now 18% below its level at the time of the Plaza Agreement and 25% below its February 1985 peak. The US economy is now estimated to have grown by only 1.2% in the final quarter of 1985, but this slowdown was largely due to a higher than expected trade deficit and official growth forecasts for this year remain unchanged. Nevertheless, with the non-oil trade deficit likely to grow for much of this year as a result of J-curve effects (January saw another record US trade deficit), there is a possibility that protectionist pressures, which seem to have receded for the moment, may revive.

8 Commodity prices have been fairly stable recently: in the first two months of the year the Economist index fell just 1.8% in SDR terms. Of the sub-indices, food prices fell almost 3%, largely as a result of lower vegetable oil seed prices;

these have fallen rapidly as a result of the glut in palm oil supplies following record Malaysian output. Coffee prices have risen very slightly overall since the beginning of the year, although they have behaved erratically, and remain well above levels prevailing before the recent drought scare; cocoa prices have fallen, adding to the difficulties of some of the West African countries.

9 Looking at developments in individual countries, the future of the Philippines' economic policy is at present uncertain following the recent change of administration; the rise in the stock market, and the reported increase in reserves and improvement in the currency, suggest however that the conclusion of the earlier political chaos has brought some reassurance. Brazil seems finally to be trying to come to grips with its accelerating inflation. On 28 February the authorities announced a package apparently modelled on the Argentine austral plan of last summer: prices are frozen for a year, the economy is largely de-indexed, a new currency (the cruzado) has been introduced, and the 'crawling peg' depreciation against the dollar suspended. First reports suggest a popular welcome for these measures. There are, however, some doubts about whether these measures will fully achieve their objectives, because no further action has been taken to reduce the fiscal deficit.

10 Uncertainty over the South African debt situation has receded for the moment, following acceptance by major creditor banks and the South Africans of revised proposals from Leutwiler, the mediator, which ensures higher spreads, a 5% repayment of maturing debt to the banks this year and the maintenance of other lines until March 1987. Banks seem now to be less reluctant than earlier to be seen to be negotiating with the South Africans, and a small technical group has been formed to consider the details of the agreement.

11 Following the clearance of its arrears to the Fund, Zambia's SBA and CFF were approved on 21 February. Other countries, however, remain in difficulty over Fund arrears: Sudan has now been declared ineligible to use Fund resources, and Peru will be declared ineligible on 14 April if it has not paid a minimum of SDR 70 mn towards clearing its arrears by that date.

12 East bloc borrowers have raised just under $700 mn on the capital markets so far this year, with both USSR and Hungary coming to the markets in each of the first two months. Hungary is still the only East bloc country to step outside the syndicated credit market, with the National Bank issuing a floating rate note of $100 mn and a DM fixed rate bond equivalent to US$62 mn. Indian and South Korean borrowers were the most active among LDC borrowers in the first two months of the

year, taking nearly two thirds of the $1.75 bn total raised. The South Koreans used all areas of the euro capital markets in borrowing $500 mn; Indian borrowers too made use of bond and syndicated credit markets for their total of just over $500 mn. A small deal for Siderca SAIC, of Argentina, marked the first appearance by a borrower from that country for four years.

Further details on individual regions and countries are given below.

13 Latin America

At the beginning of February the Presidents of Argentina, Brazil, Mexico and Venezuela called for an emergency meeting of the Cartagena Group to discuss the outlook for their countries in view of the weakening oil market and falling commodity prices, and on 22 February the President of Mexico asserted that the international financial community should play its part in assisting the regional debtor countries. Subsequently, on 27-28 February, Foreign and Finance Ministers of the steering committee of the Cartagena Group met in Punta del Este, Uruguay. Argentina reportedly hoped that the meeting would lead to agreement to press for preferential below-market interest rates for debt already contracted; a figure of 2.5% below LIBOR was to be suggested, with the aim of providing an interest saving of $10 - 15 bn pa for the region. However, whilst the steering committee declared that "substantial modifications to existing debt agreements could no longer be postponed, in particular with regard to current interest rate levels", the meeting drew back from unilaterally setting a specific level of interest rates. Mexico in particular was apparently concerned that such a move could jeopardise its own negotiations with banks and official creditors.

14 Turning to events in individual countries, Argentina continues to hold the support of the international financial institutions for its implementation of the austral plan announced last June. Following agreement with the Argentine authorities on revised fiscal targets for the first quarter of 1986, the IMF Board on 10 March approved a decision enabling Argentina to make the scheduled third purchase of SDR 236.5 mn under the current SBA. However, because of the earlier lack of agreement on end-1985 targets, the scheduled second purchase of SDR 236.5 mn was cancelled and the SBA has been reduced accordingly from SDR 1.42 bn to SDR 1.18 bn. The programme itself will be extended from end-March to end-May. Agreement with the Fund is expected, in turn, to trigger drawdown of the third, and penultimate, tranche of the commercial bank $4.2 bn new money loan. Discussions are continuing on a follow-on Fund programme of at least a year. In early February Argentina announced that it was also seeking a rescheduling of some of the Paris Club debt falling due in 1986, and declared a moratorium on payments of both

principal and interest of Paris Club debt pending negotiations; the Paris Club has expressed a willingness to discuss such a rescheduling, once agreement has been reached on the new IMF programme, but has informed the Argentinians that the moratorium is not acceptable. Negotiations with commercial banks were put to one side while discussions with the Fund were taking place, but contact was resumed in the first week of March. Meanwhile, the introduction of the 1986 budget - the 'second stage' of the austral plan - in early February shows the authorities' determination to continue with the present economic strategy. The overall emphasis remains firmly on controlling inflation, and the authorities have so far shown the political will to continue the strategy despite a certain amount of popular opposition: a General Strike on 24 January was well supported, but government/union talks on the 'social pact' may help to defuse the situation. January inflation was 3% (cf 30% in June, before the austral plan), and the monthly inflation target of 2% (28% over 12 months) looks within reach.

15 Brazil continues to perform strongly on the external account. The trade surplus in February was $719 mn (cf $545 mn February 1985). The authorities have estimated that the country will receive an additional $700 mn in export earnings this year, as a direct result (paradoxically) of higher world coffee prices in the aftermath of the Brazilian crop failure. In addition the country will gain $1.2 bn this year from the recent fall in oil prices, if there is an average price of $18 per barrel, and is again likely to surpass its trade surplus target ($12.5 bn). On the domestic front, however, inflation has continued to be the major problem. The inflation rate for February was 14.4%, bringing the year-on-year rate to 255% (cf 234% at end-1985). In response, the government introduced a package of radical economic measures on 28 February (the "cruzado" plan), modelled on the Argentine austral plan: the main elements are (i) the introduction of a new currency, the cruzado (equivalent to 1,000 old cruzeiros) which will be pegged to the US dollar (ii) a 12-month freeze on consumer prices and measures designed to ensure wage restraint and (iii) a virtual de-indexation of the economy. The plan has received a generally favourable response in Brazil, although difficulties are already emerging. Whilst it certainly represents a welcome attempt to tackle the problem of spiralling inflation, doubts persist about the capacity of the authorities to carry the plan through. The apparent lack of supporting fiscal measures is a particular area of concern.

16 Negotiations between the banks and the Brazilian authorities on the details of a debt package covering 1985-86 medium-term maturities and short-term credit lines resumed in the week beginning 10 February, and agreement was reached on 2 March. Some $6 bn of 1985 debt has been rescheduled for seven years with repayments

starting in 1991, and a further $9 bn of 1986 debt is to be rolled forward until next March. Interest margins on 1985 and 1986 maturities have been cut to 1 1/8% from 2%. The agreeement has been described by the negotiators as "a bridge to a future multi-year rescheduling package". Informal discussions also took place between the Central Bank President, Bracher, and French officials at the weekend of 22 February on the rescheduling of Brazil's Paris Club debt. The Paris Club, however, is unwilling to agree to a rescheduling if Brazil continues to by-pass the IMF in its negotiations with the banks; for its part, Brazil remains unwilling to make interest payments to Paris Club creditors in the absence of a rescheduling.

17 Mexico is heavily affected by the weakening oil market. Average Mexican oil prices have been reduced by some $9-10 pb since the start of the year; moreover, the volume of exports in January was only 1.1 mbpd, against a target of 1.5 mbpd (at which volume each dollar's drop in the price reduces export revenue by over $500 mn). While oil export revenue will be substantially less than the $12.25 bn originally forecast by the Mexicans late last year (based on a price of $22.5 and volume of 1.5 mbpd), the ultimate impact on the external financing requirement - originally put at $4 bn - will depend also on the extent to which the Mexicans undertake further domestic adjustment. Perhaps as worryingly, the loss of oil revenue will have a major adverse impact on the country's domestic fiscal position. President de la Madrid announced on 21 February that Mexico would be unable to meet its external financing requirements, and called on the international community to play its part in assisting the country; however, no formal request for new money was made when the Mexicans met the banks' Advisory Committee in early February. The Mexicans are thinking of withdrawing an earlier request to the Paris Club for a multi-year rescheduling of official credits with retention of export credit cover, because they wish to consider further the problem that much of the relief they might gain from rescheduling could be offset if some countries withdrew cover. The Paris Club remains willing to consider a request if and when it is forthcoming. The UK line will be that, while the Paris Club may offer a MYRA in principle, no details can be discussed at this stage and any agreement has to be dependent on the Mexicans reaching agreement with the IMF. Meanwhile, the UK will be prepared to continue cover. The latest indication is that Mexico will require altogther about $6 bn this year, which may be made up of new bank money ($2.5 bn), interest relief from banks ($1 bn), which banks will be reluctant to concede because of the precedent it would set for others, inflows from IFIs, ($1.5 bn) and Paris Club financing ($1 bn).

18 Although Venezuela is cushioned from the immediate effects of weakened oil prices by international reserves amounting to $14 bn, the Advisory Committee agreed in the second week of February to reschedule $923 mn of payments due in 1985-1986

under the MYRA which was signed at the end of the month. The Advisory Committee have also agreed that the Venezuelans may reassess their position within a month of signing in the light of continuing uncertainties in the oil market. These concessions by the banks are being seen as reflections of their desire to tie up their agreement with Venezuela before the oil market worsens further. Like Mexico, Venezuela has lost market share, with export volume in January being only about 1 mbpd, against the authorities' target of 1.4 mbpd. But, as part of a more aggressive marketing strategy, the state oil company PDVSA has now announced that it will negotiate prices individually with foreign buyers rather than set an official price for its oil. Early indications are that this more aggressive marketing is bringing Venezuelan market share back up near to previous levels.

19 Most of the smaller countries continue to make progress in their external financing arrangements, the major exception still being Peru. Bolivia's external situation also remains precarious, and has been exacerbated by the tin crisis. Following reports of policy slippages in December after the IMF Letter of Intent was signed, another Staff Mission was sent to La Paz on 14 February to investigate recent developments and the implementation of proposed reforms. Bolivia's request for an SBA, reportedly of SDR 50 mn, and for a CFF of SDR 55 mn, is thus unlikely to be discussed by the Fund Board before the end of April. The World Bank is apparently discussing a rehabilitation package of about $40 mn, of which $20 mn might be through the IDA. Negotiations are unlikely to proceed with the Paris Club and the commercial banks until agreement has been reached with the Fund. Chile signed its $1,085 mn new money agreement in December, and agreed in principle a MYRA covering about $4.5 bn due 1985-87. It is hoped that model contracts now being discussed under the bank MYRA will be signed by end-June. All bilaterals have now been completed for the Paris Club rescheduling of 65% of principal due July 1985 - December 1986. Since oil accounts for about 11% of imports, the benefit to the balance of payments of the fall in oil prices will help to offset a likely shortfall in copper revenue.

20 Following the signing of the $1 bn new money agreement in December, an IMF Staff Mission visited Colombia in January to conduct an appraisal under the enhanced surveillance agreement to which drawings under the loan are subject. If, as expected, the Fund gives its approval to Colombia's performance against end-year targets, this would trigger drawdown this quarter of the first $515 mn tranche of bank money. Colombia's economic position continues overall to strengthen, with the country well-placed to take advantage of the suspension of coffee export quotas by the International Coffee Organisation on 19 February, although it may find some difficulty in maintaining its coal exports in the present environment. Oil plays a relatively small part in the trade balance, although Colombia should become a (small) net oil-exporter this year.

21 Ecuador may be seriously affected by the oil price decline. A public sector commercial bank MYRA ($2.5 bn due 1985-89) was signed in December, and a private sector MYRA ($1.4 - 1.5 bn, also 1985-89) is expected to be signed shortly. However, the weakening oil market has impaired prospects for successful6implementation of the country's IMF adjustment programme. The authorities have claimed that they would be able to meet external obligations if the price stabilised at $19 pb, but at current price levels the position is likely to be much more difficult. International reserves (at about five months' imports) provide only a limited cushion. However, the authorities are reportedly putting together a package of import and monetary measures to ease the impact of the latest oil price falls. In Jamaica, the 'new look' mission, comprising the IMF, the World Bank and USAID, has made little progress in persuading the Prime Minister that present policies are unsustainable. A report is expected at the end of March. Meanwhile, the IMF Board approved a review and modification of the SBA - in abeyance since last September - which entails maintenance of the existing exchange rate with tighter monetary and fiscal measures: as a result, a drawing of SDR 26.6 mn has been approved.

22 Peru's relations with its official creditors remain poor. Arrears to the IMF currently stand at about SDR 85 mn. Following a meeting on 10 February, the IMF has given Peru until 14 April to pay a minimum of SDR 70 mn ($75 mn) to avoid being declared ineligible to draw on Fund resources; President Garcia has said he will announce on 13 April whether or not Peru will pay. The country has now built up reserves to about $1.5 bn. A Staff Mission was due to visit the country shortly to carry out the delayed 1985 Article IV consultation, but the Peruvians have now postponed this visit indefinitely. In a further ominous move Peru has moved gold held abroad back to Lima, allegedly to avoid risk of seizure by creditors. On the commercial bank side the Peruvians failed to make the payment requested by the banks by 12 February to reduce arrears by 90 days. Garcia has warned the country that foreign banks may in retaliation now begin to seize Peruvian assets held abroad. The authorities are continuing their expansionary domestic economic strategy, but so far with limited success. Meanwhile Uruguay has agreed in principle a commercial bank MYRA, covering $1.6 -2 bn of debt due 1985-1989. All end-year targets were met under the 18-month IMF SBA, approved in September, and the authorities' battle against inflation will be helped by the fall in the price of petroleum products, which accounted for 30% of imports in 1984.

23 South and East Asia

After a period of political chaos following the disputed presidential election in the Philippines, the recent change of administration will provide some

reassurance. However, the new administration will need some time before it can get to grips with the country's difficult economic situation, although the retention of Central Bank Governor Fernandez provides some continuity. Meanwhile pre-election spending seems set to bring about a breach of the IMF's existing monetary target at end-March. President Aquino intends to review the terms of the Programme, and says that she will seek new, and better, terms, similar to those given to Argentina. A Fund team arrived in Manila on 11 March.

24 Balance of payments projections for Indonesia indicate a sustainable scenario, should oil prices return to an average of $20 per barrel in 1986, although further severe retrenchment will be necessary. Problems become increasingly pressing as oil prices remain below this level. At present the Indonesians are compensating for falling oil prices by increasing production, but they are also prepared to cut spending further. A Yen 100 bn credit has recently been arranged. Although Malaysia too is adversely affected by the fall in oil and other commodity prices, its position seems sustainable even if prices fall below current levels.

25 By contrast, falling oil prices will have a beneficial effect on South Korea, which may now achieve its 1986 target of 8% real growth (up from 7% originally), balanced current account and inflation of 3% or less. External targets will also be helped by the strength of the yen. In Thailand the authorities seem to be persevering with their austerity programme despite some domestic opposition.

26 Eastern Europe

At the end of January the Poles sought debt relief of some $1.1 bn this year (100% rescheduling of principal and $250 mn in new credits) from the banks, in conformity with the official creditors' position on burden sharing. After considering the request, however, the banks' Steering Group offered only 75% rescheduling of principal ($600 mn) at a meeting in Frankfurt on 25 February. The banks seem to be losing patience with the Poles, and may be moving towards countenancing default. A further meeting is scheduled for 17 March. On 7 March Paris Club creditors intialled an agreement rescheduling $1.9 bn of debt due in 1986; the $550 mn moratorium interest over-due from end-1985 is now to be paid in 1986 in two tranches. It is hoped this early agreement will put pressure on other creditors to offer comparable relief. The IMF membership committee has decided to recommend a quota of SDR 680 mn.

27 Under concerted pressure from Fund Staff and creditors Yugoslavia has abandoned its earlier opposition to positive real interest rates; rates were raised to 68% in

accordance with the SBA formula on 1 February (one month late) and will be raised to at least 73% at the next review on 1 April. The IMF Board was to consider interest rate and other missed performance criteria on 12 March; this is the day Yugoslavia is scheduled to prepay some $258 mn of the $600 mn 1983 new bank money in advance of the first loans, due to be disbursed on 25 March, under its refinancing agreement. The timing for the bank MYRA is therefore tight. The authorities have now requested a meeting with creditor governments to discuss an official MYRA in Geneva on 14 April. Romania failed to make two principal repayments in January, and requested the banks to spread them monthly from March to December. Faced with a heavy repayment schedule in 1986 - particularly mid-year - the likelihood of new cash flow problems and further ad hoc reschedulings must remain a high probability. (Nevertheless, Romania's external debt has been reduced from $7.1 bn at end 1984 to $6.1 bn at end 1985.) The USSR, with over half of its convertible currency earnings deriving from energy exports in 1984, will be seriously affected by the falls in the oil price.

28 Southern Europe

In Greece, economic policy remains tight, with the announcement of a reduced target for the PSBR in 1986 of 11.2% of GDP. Inflation continues to rise as a result of the October devaluation and increases in administered prices. All four tranches of the first half of the ECU 1.75 bn Community loan have now been raised by the EC.

29 Portugal is estimated to have moved into current account surplus ($150 mn) last year, for the first time since 1973. Despite concern that 'controlled expansion' would boost the volume of imports, the government now expects that lower oil and other commodity prices will restrict the deficit in 1986 to around $200 mn. The introduction of VAT this year is likely to undermine efforts at reducing inflation, although the authorities still project a modest decline to 14%. The recent election of Dr Mario Soares (the former Socialist Prime Minister) as President may create difficulties for the centre-right Social Democrat government and hinder the implementation of its economic policy.

30 Africa

Even before the recent fall in the oil price Nigeria was facing severe balance of payments difficulties in 1986. And as a result of the likely loss of revenue this year (oil contributed 95% of foreign exchange earnings), the country will require generous debt relief as well as substantial sums of new money if it is to avoid the accumulation of arrears and maintain sustainable import levels. Paris Club

creditors remain insistent on an accommodation with the IMF before agreeing to a rescheduling, and hope that the Article IV mission which recently arrived in Lagos will allow negotiations to begin, although probably on a confidential basis given continued political opposition to an IMF agreement. Meanwhile, commercial bank creditors have been frustrated by the absence of an initiative from the Nigerians. However, the Nigerian Ministry of Finance has now asked Barclays to co-ordinate a meeting of creditor banks, which is scheduled to take place in London on 27 March. The banks too require a link with the IMF before agreeing a rescheduling, although some banks may be prepared to accept something less than a formal programme: however, it is unlikely that new money would be made available without a SBA. Progress on the reconciliation of short term trade arrears continues to be slow.

31 There has been some speculation in the press that Algeria may find it necessary to reschedule some of its foreign currency debt, which is estimated to have reached over $18 bn. The government recently sought to raise a further $500 mn 10 year market loan, but had to settle for $300 mn, as the markets appeared to start questioning the fine terms on which Algeria has been borrowing. The IMF has advised Egypt that, until economic reforms are implemented and an effort is made to close the country's 1986-87 external financing gap, it can do no more than lay the groundwork for a Programme. A parallel approach to the Paris Club seems inevitable. Recent unrest in the country is certain to depress tourist revenue still further, thus intensifying the country's economic difficulties.

32 Morocco has made some modest progress with rescheduling its commercial bank debt (but has widespread arrears to the Paris Club). The agreement covering 1983-84 maturities became effective on 21 February, and this has cleared the way for discussions on 13-14 March on restructuring 1985-86 maturities and for an IMF mission to return to Morocco to complete the first review of the current Standby arrangement. On 20 February, under the chairmanship of Dr Leutwiler, South Africa and a group of major creditor banks reached a "broad consensus" on proposals for the repayment of some of the $14 bn of debt covered by the current standstill. The outcome was described not as a rescheduling but rather as a short-term interim arrangement that will allow the country time to return to a more normal financial situation. Final details of the arrangement are being clarified by a small technical group of major creditor banks.

33 Sudan was declared ineligible to use IMF resources on 3 February. An Article IV discussion is scheduled for 12 March, but it is unlikely that progress can be made towards putting a new programme in place until after the elections in April. Zambia's SBA and CFF (for SDR 229.8 mn and SDR 68.7 mn respectively) were approved

on 21 February even though the recent accumulation of some US $40 mn arrears on Zambia's commercial oil facility technically breached the Fund's approval criteria. The restoration of Zambia's access to IMF resources was vital to resolving the immediate financial crisis and as a prelude to comprehensive debt relief; a successful Paris Club meeting was held on 4 March and a request to the London Club is expected shortly.

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INDEBTEDNESS AND BRITISH EXPOSURE

	Total external debt	British-owned banks' exposure[1]	$ billion ECGD amounts at risk	
	End-Dec 1985*	End-Dec 1985	End-Dec 1985 [2]	End-Dec 1985 [3]
Latin America				
Argentina	51	2.5	0.2	0.2
Brazil	100	6.7(0.6)	0.9	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)	0.6	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	0.8
Yugoslavia	18	0.9(0.1)	0.7	1.0
Southern Europe				
Greece	16	1.3(0.2)	0.2	0.3
Portugal	16	1.2(0.1)	0.2	0.3
Turkey	22	0.4	0.2	0.6
Africa				
Egypt	40	0.4(0.3)	0.2	0.9
Morocco	14	0.2	0.1	0.2
Nigeria	19	1.3(0.1)	2.0	3.2
South Africa	22	4.0(0.5)[4]	0.9	2.7
Sudan	9	0.0	0.3	0.3
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.

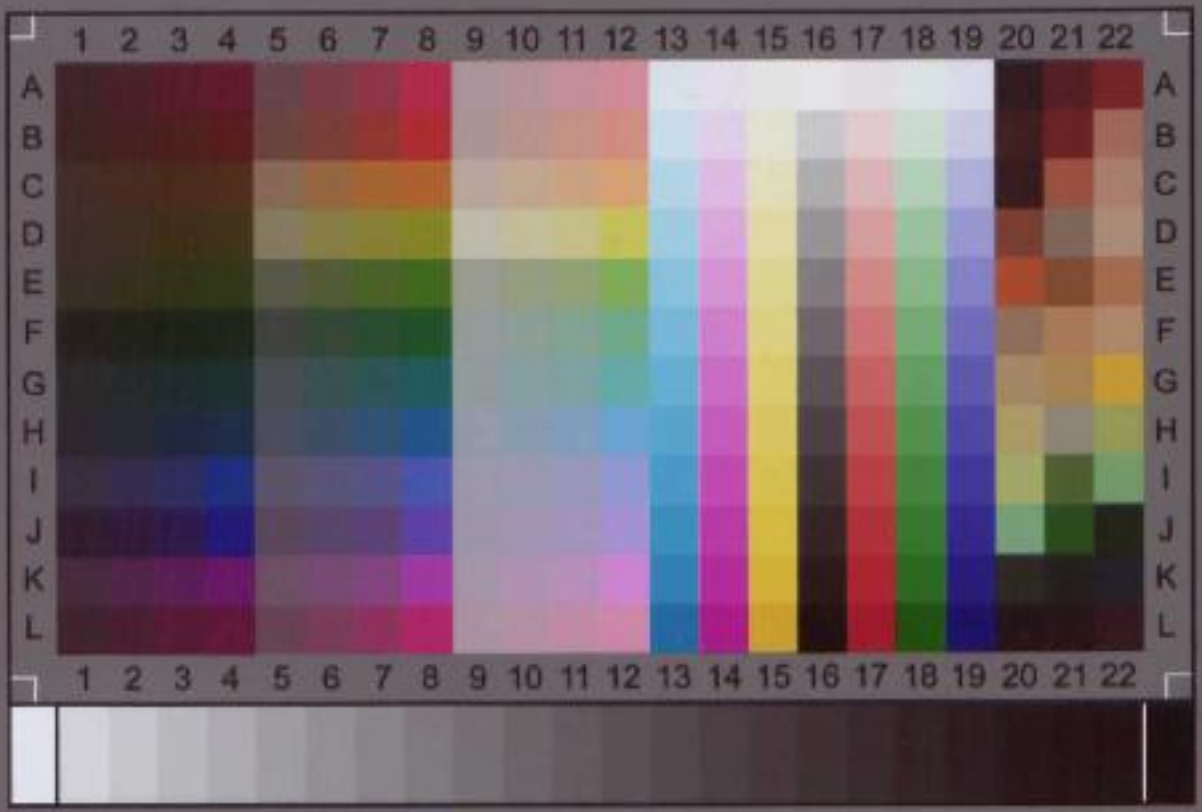
* current estimate

PART 5 ends:-

HMT to CDP 5.2.86

PART 6 begins:-

HMT to CDP



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