PREM 19/2629

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PART 7

29.57

CONFIDENTIAL FILING

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

ECONOMIC POLICY

PT1: August 1982

PT7: November 1987

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~9.11.87~~		PART CLOSED					
~~29.12.87~~							
~~8.2.88~~							
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PREM 19/2629

PART 7 ends:-

Luisi to CDP 19/5/89

PART 8 begins:-

International Debt Group Report

July 89

INTER-AMERICAN DEVELOPMENT BANK
REPRESENTATION IN THE UNITED KINGDOM
MORGAN HOUSE, 1 ANGEL COURT,
LONDON EC2R 7HJ

R20-5

REPRESENTATIVE

19 May 1989

CDP 19/5

Dear Mr. Powell,

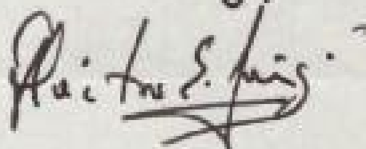
Just to thank you very much indeed for being instrumental in arranging the meeting between the Prime Minister and the President of the Bank yesterday.

Mr. Iglesias was delighted to have met Mrs. Thatcher and was very pleased to have had the opportunity to exchange views with her on Latin America.

I thought the meeting went extremely well and I know that Mr. Iglesias was most satisfied with it.

Once again, many thanks.

Yours sincerely,



Héctor E. Luisi

Mr. Charles Powell

(2)

INTER-AMERICAN DEVELOPMENT BANK
WASHINGTON, D.C. 20577

PRESIDENT

CABLE ADDRESS
INTAMBANC

Prime Minister
CDP 19/5

18 May 1989

The Rt. Hon. Margaret Thatcher, MP
Prime Minister and First Lord of the Treasury
10 Downing Street
London, SW1A 2AA

Dear Prime Minister

I was very pleased to meet you earlier today and I welcomed the opportunity to exchange views with you on Latin America's current situation and its outlook for the future. The problems facing the region are certainly serious, but not unsurmountable. However, I feel that the efforts which will be required to overcome the difficulties will be even greater than the considerable ones made so far. I greatly appreciated your thoughtful remarks and your many insights.

I am grateful for the continued support given by Her Majesty's Government to the Bank's activities. The role played by British officials in the recent negotiations leading to the successful agreement of the IDB's seventh capital increase was most constructive and deserves to be highlighted.

I look forward to another opportunity of meeting with you.

With all good wishes.

Yours sincerely

Enrique V. Iglesias

File
to
cc PG

SUBJECT CC MASTER

10 DOWNING STREET

From the Private Secretary

18 May, 1989.

Dear Bob,

PRIME MINISTER'S MEETING WITH THE PRESIDENT OF THE INTER-AMERICAN BANK

The Prime Minister had a good talk this morning with Senor Iglesias, whom she thought rather good news.

Sr. Iglesias was cheerfully pessimistic about the prospects in Latin America. The past decade had been very difficult: the outlook was not much better. There were some bright spots: Chile, his own country Uruguay, and Bolivia - not long ago a joke country but now applying Thatcherite policies. He also mentioned with approval new legislation on private investment in Mexico, which represented an important breakthrough. The problems of Latin America were poor public administration, together with economic and social fatigue. Sr. Iglesias and the Prime Minister vyed with each other in gloomy predictions about Argentina.

Turning to the affairs of the Inter-American Development Bank, Sr. Iglesias said that he was not so much running a bank as a hospital. He saw his role as helping countries to change their policies and modernise their ideas. He was also keen to develop lending to support environmental policies. The Prime Minister expressed sympathy for Sr. Iglesias' problems. He had to deal with countries who wanted to borrow money but did not want to repay it or pay interest on it.

The Prime Minister asked Sr. Iglesias' views on the debt situation. Sr. Iglesias said that he was trying to discourage Latin American governments from being fixated on debt. There was a tendency to believe that solving the debt problem would solve all problems, which was simply not true. Look at Peru, which had failed to pay anything on its debt for five years, but was in worse shape than ever. The essential step towards overcoming debt problems was the adoption of sound domestic economic policies. Among other things, this would help attract

capital back into the country, a crucial factor in a country like Venezuela, where capital held by Venezuelans outside the country was twice the amount of overseas debt. He was also a believer in the step by step approach. The Prime Minister cautioned against trying to transfer the burden of commercial debt onto the taxpayers' shoulders.

I am copying of this letter to Alex Allan (HM Treasury), Neil Thornton (Department of Trade and Industry) and Myles Wickstead (Overseas Development Administration).

Yours sincerely,
Charles Powell

C.D. POWELL

R.N. Peirce, Esq.,
Foreign and Commonwealth Office.

RESTRICTED

From : J L F Buist

Date : 15 May 1989

c PS/Minister (w/out encs)

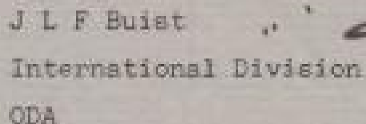
Private Secretary to the Prime Minister

PRIME MINISTER'S MEETING WITH PRESIDENT OF THE INTER-AMERICAN DEVELOPMENT BANK, 18 MAY 1989

I attach briefing for the meeting at 12.30. The briefing has been seen by Mr Patten who observed that Mr Iglesias is a good interlocutor and he hoped that the Prime Minister would draw him out on regional issues - debt, environment, politics - and not concentrate on the IADB.

2. As the relevant Under-Secretary and UK Alternate Governor for the Bank I shall attend as required.

3. The Foreign Secretary has also agreed to see Senor Iglesias at 3pm on 19 May and has been given similar briefing.



J L F Buist

International Division

ODA

STEERING BRIEF FOR PRIME MINISTER'S MEETING WITH PRESIDENT OF THE INTER-AMERICAN DEVELOPMENT BANK (IADB) SENOR ENRIQUE IGLESIAS - LONDON - 12.30 PM, 18 MAY 1989

We joined IADB for commercial, political and development reasons. It is not an ideal institution: it has been regularly bedevilled by disputes between the main Latin shareholders and the US, and by 17 years' poor management by the previous President. But under Iglesias' forceful and informal style it has a chance of becoming an important economic instrument in the 1990s, together with the World Bank, to help get Latin America back to growth and deal with its debt problems. It is also very well placed to set the Latin countries thinking more positively about environmental issues. We have led the 17 non-regional members (all very small shareholders), in working to overcome obstacles to agreement just before Easter on a $26bn (77%) increase in the Bank's resources, and in supporting the President's drive to overhaul the Bank and make it more efficient.

2. Iglesias is good value, and we want to encourage him to continue to push for sensible economic policies, open markets, and better environmental management. Unlike some non-regional countries (eg Japan, Germany, France) we have no wish to increase the non-American stake in the Bank, an idea with which he has toyed but which would require difficult Charter amendments.

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PERSONALITY NOTE

SENOR ENRIQUE V IGLESIAS

Born 1930 in Spain but grew up in Uruguay. Graduate in economic and business administration. Studied in the United States and France. He has held distinguished posts in Uruguayan Government and various agencies within the inter-American system, but is debarred by his birthplace from standing for Presidency of his country.

From 1972 to 1985 he was Executive Secretary of the UN Economic Commission for Latin America and the Caribbean. He also occupied leading UN posts on renewable sources of energy.

From 1985 to 1 April 1988 he was Minister of Foreign Affairs for Uruguay. He chaired the meeting of Ministers which launched the Uruguay Round of GATT negotiations. He has also been generally helpful to Britain over the Falklands, as far as the opportunity arose.

On 1 April 1988 he became President of IADB for a five-year term.

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BRIEFING FOR PRIME MINISTER'S MEETING WITH PRESIDENT OF THE INTER-AMERICAN DEVELOPMENT BANK (IADB) - SENOR ENRIQUE IGLESIAS, LONDON - 12.30 PM, 18 MAY 1989

Our Objectives

To underline our interest in the region and our support for the Bank's role in relieving poverty and helping its borrowing countries to cope with environmental and debt problems.

Senor Iglesias' Objectives

To bring the Bank and the problems of the region to the attention of the Prime Minister.

Points to Make

(a) Bank's role

1. Congratulations on at last getting your capital replenishment agreed, though I understand it was a cliffhanger. Glad Britain was able to help.

2. Understand you will work alongside World Bank in giving fast-spending loans to debtor countries following sound adjustment plans. Can your Bank also do more to improve the environment for private investment, and get more commercial bank co-financing?

3. Are you thinking of a role for your Bank in debt reduction? We believe debt reduction by commercial banks will help return to long term growth. But the Brady Plan causes some problems - we are opposed to transfer of commercial risk to taxpayers - and its impact won't be so great as debtors seem to expect.

4. What more can your Bank do to get Latin America more interested in protecting its own environment? Brazil in particular: we have received over 7,000 letters on proposed World Bank loan for power (now shelved)

(b) Regional issues

5. Argentina: Your views on outcome of elections on 14 May? Welcome continuation of democratic process. Hope transition period will be peaceful. We've tried repeatedly to move towards more normal relations. But Argentina response disappointing; persist in pointless trade discrimination against UK, and insist on linking any normalisation of relations to discussion of sovereignty.

6. Brazil: Economic and political prospects? Likely outcome of Brazilian election?

7. Central America: Peace process an essential first step towards economic development. But countries must look at their own economic policies too. Nicaragua the worst example of economic mismanagement. Others (Honduras, Costa Rica) could also improve performances with more realistic policies - as has Mexico. Panama: a special case. No prospects for normalisation of US/Panama economic relations while Noriega remains.

BRIEFING FOR PRIME MINISTER'S MEETING WITH PRESIDENT OF THE INTER-AMERICAN DEVELOPMENT BANK (IADB) - SENOR ENRIQUE IGLESIAS, LONDON - 12.30 PM, 18 MAY 1989

Essential Facts

1. The Bank: Set up in 1959, it lends, and gives technical cooperation, to all Latin American countries except Cuba and to five Commonwealth Caribbean countries (Bahamas, Barbados, Guyana, Jamaica and Trinidad). The UK and other non-regional countries joined in 1976. No non-regional has more than about 1% of the voting power: the US has over 34% and Canada over 4%. Total capital at 31 December 1988 was US$34 billion. There is a small Special Fund providing low cost loans to the poorest countries, including Guyana.

2. The last President resigned in early 1988 after two years' wrangling over a new capital increase and the accompanying institutional and policy changes demanded chiefly by the US. Iglesias has worked very hard since he took over a year ago and in March 1989 a capital increase of US$26 billion and an increase in the Fund of US$200 million were finally agreed. As a result the Bank will lend about US$22½ bn over the next four years.

3. The 17 non-regional members are divided into two Groups corresponding to who holds their two Directors' chairs. Britain currently chairs one Group, but effectively led all 17 in the last phase of the negotiations in a constructive role as honest brokers.

4. So far the IADB has not mooted plans to lend for commercial debt reduction, but part of the agreement negotiated will allow the Bank to give fast-spending policy-based loans to countries following adjustment programmes. The IADB, with no previous experience, will work only in tandem with the World Bank for at least two years. But the IADB may also be able to secure more private commercial bank financing, which has almost dried up since the debt crisis began, by revising its arrangements for co-financing. Its voice in favour of economic liberalisation may also be very important as the tide of Latin American populism returns.

5. On appointment Iglesias decided on a major programme of renewal and reorganisation for the Bank which had become inefficient, overstaffed and inflexible through many years of atrophy. This is still under way.

6. Debt: Since 1982 Latin America's serious debt-servicing difficulties have been dealt with almost entirely by creditors deferring payments due and providing new money conditional on debtors undertaking adjustment programmes to improve their long-term debt-servicing capacity. This strategy was confirmed in the Baker Plan in 1985. However, by 1988 this approach was encountering increasing difficulties.

7. Last March, the new US Treasury Secretary, Brady, proposed a new approach. This involved financing from the IMF and IBRD, (most, but not all, of which would have been lent to the affected countries anyway), conditional on debtors observing adjustment programmes agreed by the IMF. Under the plan, IMF/IBRD would lend

a) for debtors to buy back their debt for cash at a discount;

b) to provide collateral or guarantees on bonds which could be exchanged for existing debt, again at a discount; and

c) to provide partial interest support for restructuring existing debts at face value, but with a reduced interest rate.

8. The Brady Initiative has generated very high expectations among debtors, which could not be satisfied even if it were implemented in full. The banks have been generally lukewarm, and strongly opposed to general waivers. We ourselves oppose the transfer of risk from commercial banks to governments, and have concerns about its impact on IMF and IBRD finances, and about some specific proposals (eg guarantees). However, the general outlines of the proposals were broadly approved at the IMF and World Bank's Spring Meetings in April, and discussions are now proceeding in their Executive Boards.

9. Environment. While our bilateral aid goes mostly to the poorest countries, public concern over destruction of the Amazonian forests has focussed on mistaken past projects by the World Bank and IADB. Iglesias is doing his best to repair fences with environmental critics, but has to cope with strong resistance by Brazil (a major shareholder) and others. Brazil opposes debt for nature swaps.

10. The "Declaration of Brasilia", issued by Latin American and Caribbean Environment Ministers on 31 March, reaffirmed the principles "that each state has the sovereign right to freely manage its natural resources" but emphasised the need for international cooperation at all levels. The Brazilians got into the Declaration a strong emphasis on the restrictive effect of foreign debt on effective environment planning and management.

11. The best way forward - which we are trying ourselves on a small scale - must be to persuade borrowers to ask for direct lending for environmental improvement. This could include help to attack the CFC problem as well as to conserve forest diversity. IADB environmental procedures have improved, particularly since Iglesias' appointment.

12. Argentina. In the Presidential elections on 14 May Mr Carlos Menem of the Peronist Party obtained a majority sufficient to ensure his nomination as President of the electoral college. The new President is scheduled to take office on 10 December. We are concerned by his threats to expropriate British property: we hope they will remain pre-election rhetoric. We have noted statements on the Falklands that blood might need to be shed to regain the Islands. Mr Menem has also stated that he would advance Argentina's "claim" by diplomatic means alone.

13. Brazil. Inflation in 1988 was almost 1000%. The government's efforts to bring this under control (the "Summer Plan") have not really worked; prices rose by only 3.6% in February but inflation is now increasing again. President Sarney appears content to let the economy muddle through until Presidential elections in November. The main right-of-centre candidate for the Presidency-Ulysses Guimaraes - is no match for either of the two left-wing candidates, Leonei Brizola (ex-governor of Rio de Janeiro) and the radical trade Unionist Lula. The bast candidate is probably Fernando Collor de Mello, who is committed to reforming the public service.

14. <u>Central America</u>. We are coming under increasing pressure to back our moral support for the Central American Peace Process with financial support. But we have little or no leeway for increased aid to the region, and in any case have reservations about some aspects of the aid sought. Apart from our unwillingness to support the Sandinista regime in Nicaragua, we should also not wish to assist in the sort of debt relief schemes being sought by the Central Americans.

15. <u>Panama</u>. Situation remains fluid following annulment of 7 May Presidential elections. Noriega shows no sign of standing down. Diplomatic initiatives by Latin American "Rio" Group and the Organisation of American States appear to offer the best hope of resolving the problems.

International Financial Institutions Department
O D A
May 1989

JD3AFF

PRIME MINISTER

MEETING WITH THE PRESIDENT OF INTER-AMERICAN DEVELOPMENT BANK

You have agreed to see the President of the Inter-American Development Bank briefly on Thursday. Senor Iglesias is a former Foreign Minister of Uruguay and highly regarded. He chaired the meetings which led to the Council of the Uruguay Round of GATT negotiations. He was also helpful to us over the Falklands.

I don't see any need for you to spend time discussing the Inter-American Development Bank. Rather, you might use the opportunity to talk about some general Latin American issues, notably:

- Argentina. The implications of Menem's victory and the economic prospects.

- Brazil. Prospects for the Brazilian economy, where there are elections in November.

- Central America. Developments in Nicaragua and Panama.

- Latin American Debt, in particular his views on the Brady plan for debt reduction.

- Environmental issues. The Brazilians remain strongly opposed to debt for nature swaps. The best way to proceed is probably to persuade borrowers to seek loans for environmental improvement - e.g., measures to conserve forests as well as tackle CFCs.

There is a fuller background note about the Inter-American Development Bank in the folder. Sr. Iglesias has been in charge since last year, and has started to spruce up its operations and has reached agreement on a capital replenishment.

CDP

CDP

15 May, 1989.

Prime Minister 2

PRIME MINISTER

PRCG 21/4

21 April 1989

Fascinating MS

THE INTERNATIONAL DEBT PROBLEM

The attached "International Briefing" from the Heritage Foundation in Washington offers a fascinating insight into the problems of Peru.

Forty per cent of Peru's GDP is generated in a Black Market created by all embracing State regulation and corruption; more than half of the people live off this "informal sector". The Briefing gives some very interesting examples of its vigour and ingenuity (more than half of the electricity produced in Peru is unaccounted for!)

Peru is deep in debt; as the price of their assistance, the IMF and World Bank want to bring about structural change which would free the markets and remove the distortions and inefficiencies which have stunted economic growth. Yet their aid is channelled through a regime which shows that it has no interest whatever in giving its people real legal rights to own property and trade freely.

The conclusion is that only when the creative energies of people like the Peruvian Black Marketeers are "legitimised" in a free market society will the problems of poverty be tackled.

Howell Harris Hughes

HOWELL HARRIS HUGHES

The Heritage Foundation International Briefing

No 18 | The Heritage Foundation • 214 Massachusetts Ave., N.E. • Washington, D.C. 20002 • (202) 546-4400

March 1, 1989

THE LESSONS FOR U.S. POLICY MAKERS OF PERU'S GRASS ROOTS FREE MARKET REVOLUTION

by
Hernando De Soto*

INTRODUCTION

The debt crisis and continuing economic stagnation in Latin America raise major concerns for United States policy makers. Millions of Latin American families suffer declining living standards or abject poverty, disturbing most Americans and undermining political stability. Some radical politicians in Latin American countries threaten to pursue anti-Western policies. Debt defaults threaten many U.S. creditor banks. And U.S. exporters find their traditional customers in the region unable to purchase their products, adding to the U.S. trade deficit.

The Reagan Administration, the International Monetary Fund, and the World Bank, among others, over many years have tried to deal with the crisis through new loans and economic assistance, accompanied by advice on economic reforms. In most cases, reforms have not come and countries have been left even poorer.

Ignoring the "Informal Sector." Some critics blame the problem on Latin American culture. They argue that Latins simply are "not suited" for a free market system or that they have a "slower" lifestyle — in other words, that they are lazy. Yet most Western policy makers concerned with the less developed world ignore the most important and revealing economic phenomenon in the Third World today: a vibrant grass roots free market revolution against oppressive state control of economic activities.

*Hernando De Soto, the President of the *Instituto Libertad y Democracia* (ILD), was asked by The Heritage Foundation for his observations about the Peruvian economic situation and its relevance to development policy. De Soto responded with the following comments.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

The *Instituto Libertad y Democracia* (ILD) in Lima, Peru, has conducted an extensive empirical study of the "black market" or "informal sector" activities in that country. These economic activities consist of the pursuit of legal ends, such as manufacturing, housing construction and retailing. The only thing that makes them "black" is that they evade government regulations and taxes. The results of the ILD study are startling. Among them:

◆◆ Informal sector activity equals nearly 40 percent of Peru's Gross Domestic Product.

◆◆ Over half of Peruvians survive through informal sector activities.

◆◆ Almost seven out of every ten new dwellings are constructed "illegally."

◆◆ Of the large retail markets in Lima, 274 were built by so-called "informals," while only 57 were constructed by the state.

◆◆ Nearly 95 percent of Lima's public transportation is run by informals.

Peruvians are driven into the black market by their government's harsh control of the economy. Example: the ILD has found that securing a license to open a small manufacturing operation in Lima takes 289 days and costs 32 times the monthly minimum wage. To obtain legally a tract of abandoned government land and permission to construct a house would take 6 years, 11 months.

Limiting Economic Growth. Most Peruvians find informal sector activities necessary for their survival. The system, moreover, is all that keeps the country economically afloat. The trouble is that this system is extremely wasteful and limits economic growth. The informals, for instance, receive no protection of law. Therefore the risk of entering long-term business agreements with firms or individuals other than friends and family members is too great for most informal entrepreneurs. Thus they often are forced to agree to less efficient arrangements.

Similarly, the lack of legal titles means that entrepreneurs cannot use their businesses or land as collateral to secure credit; they must rely on expensive forms of credit or else their businesses grow only as fast as their own savings permit. In addition, it is usually impossible for informals to secure insurance, adding to the risks of doing business. And because authorities can act against informals at any time, there is a great disincentive to invest in business expansion.

Hamstrung by the Elites. The obstacles facing informal entrepreneurs stem from the fact that Peru has never had a true free market tradition. Various political factions and interest groups always have sought economic advantage through redistribution of wealth achieved by political power and influence. Interest groups use laws not to protect legitimate activity, but simply as a means to gain wealth from others. Ruling elites of the left and right never have favored economic freedom — the right of each individual to earn a living through free economic transactions and to be secure in his property against infringements by the state.

What is missing in Peru and many other less developed countries is economic freedom, including the protection of the private property of every individual by the laws and governments. There is, moreover, virtually no way for the people to influence the enactment of laws and regulations that adversely affect them. The political system is closed. Yet the existence of vast informal sectors proves that the Peruvian people are hardworking and entrepreneurial. Black markets also demonstrate that government control is the major cause of poverty and destitution.

THE KEY ROLE OF THE INFORMAL SECTOR

World history since the Middle Ages is dominated by the spectacular economic rise of Western Europe, North America, and Japan to remarkable levels of prosperity. Since the end of World War II, a number of Asian countries have joined the ranks of the prosperous. By contrast, Latin American countries have progressed only in fits and starts. Indeed, since the debt crisis began in 1982, most Latin American countries have suffered serious economic setbacks.

Some policy makers have suggested that more money for these countries is the answer. Others, including several prominent Latin American politicians, advocate debt forgiveness. Peruvian President Alan Garcia, for example, in 1985 unilaterally announced that his country would devote only 10 percent of foreign currency earnings to debt payments; this, in effect, is a debt default. Despite the popularity of that move in his nation, Peru's economic decline has since accelerated, with inflation now reaching 1500 percent.

Myths About Latins. Some observers contend that the economic situation in the region is bad because Latin Americans are not suited for the sort of activities demanded by a modern free market system. Business and entrepreneurial skill are said to be lacking in Latin peoples. Others blame the problem on the Roman Catholic religion, maintaining that it makes its adherents "passive" and "docile." Still others suggest that the lifestyle of Latin Americans is simply "slower" than in rich, industrialized countries. This is a tactful way of saying that Latins are lazy.

None of these explanations holds up under study.

The *Instituto Libertad y Democracia* (ILD), a Peruvian research organization, has conducted an extensive empirical investigation of the problems of Peru's economy. The results reveal a vast underground economy or informal sector in Peru. Activities include the construction of houses and commercial buildings, manufacturing of clothing, shoes and furniture, and retailing of all kinds. None of these ventures meets government requirements and regulations or pays most taxes or other legal costs. The ends are legitimate, while the means are not. This distinguishes informal sector activities from activities that are illegal under any circumstances, such as embezzlement, robbery, and drug dealing.

The ILD study finds that 48 percent of the economically active population in Peru and 61.2 percent of total hours worked are in the informal sector. Informal sector activities are equal to about 38.9 percent of the Gross Domestic Product of Peru. The ILD estimates that if current trends continue, the black market will be valued at 60 percent of legal economy. Most Peruvians operate in part in the informal sector and in part in the formal sector, which is in compliance with government regulations. Thus operators of informal bus lines usually agree to charge fares mandated by the government in exchange for government acquiescence to their informal activities. But the informals still might avoid taxes, licenses, and safety and insurance requirements.

The ILD studied in detail the extent of informal sector activities in several major sectors.

Housing

The influx of peasants from the Peruvian countryside, combined with government policies, has led to serious housing shortages, especially in the capital city of Lima. The result has been an explosion of informal housing constructed without proper government authorization, usually after what are called "invasions," the illegal occupation of government land. The ILD estimates that by 1982, some 42.6 percent of the housing in Lima was the result of informal sector activities. In 1985, the research group estimates, 69 percent of all new houses built were in the informal sector. The value of all informal housing investments between around 1960 and 1984 was some $8.3 billion, compared with state-sponsored housing valued at only $176.6 million, a mere 2.1 percent of the informal amount.

Some informal sector housing results from gradual encroachments on private land. Farm workers with the right to live on the owner's property, for example, are joined by relatives and friends. The result is small settlements or even towns. The property owner with no plans to utilize such land might not consider it worthwhile to evict these squatters; then it becomes physically impossible to do so.

Holiday Invasions. Far more common are large-scale invasions, usually of unoccupied government land. Such invasions typically are not violent, but they are organized, swiftly executed, and carefully prepared to meet counter-moves by authorities. Usually a deserted piece of land is chosen for its proximity to other settlements, and easy access to electrical wires that can be tapped for power, and for its defensibility against authorities. Planners enlist enough invaders for a critical mass, making organization and development possible while making it difficult for authorities to evict the squatters.

The invasion usually occurs on a national holiday, when government forces are less prepared to respond, and squatters erect straw mat huts on assigned lots, only gradually replacing them with more permanent structures. Committees are established to supervise construction, defense, provision of

food, and care for children. Agents are even employed to begin negotiations with the government for legal recognition of the settlement. Later, settlement leaders might negotiate with informal bus lines for service.

Over the years, as squatters become more affluent, usually through informal economic activities, straw mat roofs and walls are replaced by tin or bricks. Building is gradual, as savings are accumulated, and roads and other facilities are financed by neighboring "homeowners." The result is communities in a permanent state of construction.

Informal Trade

Most retail sales in Peru are conducted by roaming vendors, in informal street stands or "pitches," or in large, permanent, yet still informal markets. The ILD study finds that in Lima in 1986 there were 91,455 vendors in the streets, occupying some 79,020 pitches. The city in 1985 had 274 large, informal markets, distinct from street vendors. These were located away from public thoroughfares and consist of buildings with permanent stalls, refrigerated storage, and electricity. A favorite location for vendor pitches is on the outskirts of informal markets. Only 57 markets existed that had been built by the state, a mere 20 percent of the informal amount. In the 239 informal markets surveyed there were 38,897 Peruvians working in 29,693 stalls. ILD estimates that 125,000 individuals were directly dependent on these markets for employment.

Informal merchants often begin as street vendors. Such vendors usually aim at establishing a more permanent stand or pitch on the street, so that they can keep larger supplies, sell more products, and develop a regular clientele. When a number of vendors congregate on a street, a minimarket can develop. Some 60 percent of pitches sell, and sometimes prepare, foodstuffs. Around 17.5 percent sell personal accessories and 13.7 percent provide services. In some pitches small scale manufacturing of such goods as shoes, clothing, and furniture occurs.

Vendors' Rights. Since the rights of street vendors are not fully protected by the state, an extra-legal system has arisen to regulate such retail activity. A vendor who remains in one location develops an informal "special right of ownership" recognized by fellow vendors and conferring certain privileges. Thus another vendor attempting to occupy an established pitch would meet strong opposition from the informal right holder as well as from other vendors. A vendor with a special right in many cases can even "sell" his pitch or place on the street to another vendor. The ILD has found that pitches cost an average of about $700. Yet because it is a place on a public thoroughfare, the informal special right sometimes is tenuous. Increased traffic congestion or complaints from neighbors can lead to the eviction of vendors by authorities.

In an attempt to secure some legal protection, many vendors conscientiously pay an excise tax, averaging about five cents per day, which the municipal authorities require for the right to sell anything in the city.

Though this tax could be evaded, and though it does not confer state recognition of the right to sell from a particular pitch, both residents and authorities see it as a gesture to comply with the legal system, and officials are apt to look with greater favor on such tax-paying vendors.

The vendors have organized themselves into self-defense groups. Associations or alliances of small businessmen, usually operate in one area or neighborhood. A federation of these groups covers a number of neighborhoods. At each level of organization, these groups attempt to protect vendors against attacks by state authorities, formal businesses, or other vendors.

Public Transportation

Public transportation is another major sector in Peru dominated by informal activity. The ILD has found that 91 percent of the 16,228 vehicles, from station wagons to large buses, providing transport services in Lima are informal. If taxis are included, the informal portion rises to 95 percent. The replacement value of vehicles in 1984 is estimated at $620 million, with an additional $400 million invested in such infrastructure as informal gas pumps, repair shops, and storage facilities. Since these carriers operate in part or entirely outside the law, they cannot obtain insurance, credit, or legal protection of contracts.

An individual with a vehicle might simply run his vehicle along a certain route, stopping at different locations to pick up customers. But individual owner-operators usually join a group, so that interconnecting, potentially more profitable routes might be established and coordinated, with designated stops. Drivers and vehicle owners, moreover, tend to establish committees to advance their interests. The leaders of committees are elected democratically by the members. Funds contributed to the committee are used to purchase such items as fuel in larger, less expensive quantities, provide credit to members, and buy limited self-insurance against damage to vehicles. Even more important, committees deal with the authorities — or bribe officials — to protect their routes. These committees often ally with larger unions or federations to deal with the central government authorities. Transport operators, for instance, often charge fares mandated by government in return for low official gasoline prices or other benefits.

THE COSTS OF FORMALITY

The massive informal sector activity in Peru raises the obvious question: why do entrepreneurs choose to bypass the legal system, sacrificing the protection of the law and possibly incurring penalties or direct physical assaults by government officials? The main reason, according to ILD research, is that official regulations, red tape, and corruption are so oppressive that it is extremely costly to gain access to the legal, formal sector, or to remain there once established.

Examples:

Retailing. ILD researchers in 1983 tested the system by taking all the steps needed to open a street kiosk. This required 43 days of dealing with bureaucrats and $590 in costs and lost wages, an amount equal to 15 times the monthly minimum wage in Peru at that time. In the U.S., such permission can be secured in a few hours.

Manufacturing. An attempt to meet all legal requirements for establishing a small textile manufacturing facility was even more costly and time consuming. ILD researchers decided that bribes, which are usually solicited by government officials, would not be paid unless absolutely necessary to continue the process, because poor Peruvians seeking to establish a legal business normally cannot afford such payments. Ten bribes were solicited but only two had to be paid. The results: 289 days of full-time effort were required to secure eleven permits, at a cost of $1,231, or 32 times the monthly minimum living wage.

Housing. The time necessary for a group of prospective settlers legally to secure an abandoned tract of government land and win approval for plans to construct a dwelling was too long for a direct test. Thus ILD investigators instead consulted records of actual cases to determine the average requirements for each step. The figure: 6 years and 11 months.

THE ECONOMIC COSTS OF INFORMALITY

While the costs of entering and remaining in the formal sector is high, remaining in the informal sector also is costly. The most direct and obvious burdens are borne by the entrepreneurs themselves. But this also translates into an enormous and avoidable drag on the economy.

Costs Borne by Entrepreneurs

Informality means freedom from red tape, but it also imposes costs on the informals.

First, informal sector participants pay a high cost to avoid punishment or state action against their operations. Much time and energy must be expended to organize self-defense with other informals. The ILD estimates that informals must pay 10 percent to 15 percent of their gross incomes in bribes to public officials for what limited and uncertain protection they can secure.

Second, informals transfer a great deal of funds to the government without receiving in exchange the protection of the law. For example, informals do not pay or collect sales taxes in their dealings with the public or with one another. Yet when informals purchase supplies from the formal sector they do pay such taxes. The ILD estimates that in 1985 informals paid $813 million in cash taxes, equal to 5.7 percent of the official Gross Domestic Product.

Third, inflation of the currency is a means by which governments extract purchasing power from people. Because they do not have access to credit, advanced techniques for transactions, and interest-bearing accounts, informals tend to hold more currency. The ILD estimates that inflation cost Peruvians $554 million in purchasing power in 1985, an amount equal to 3.8 percent of GDP. This loss falls disproportionately on informal sector participants.

The Costs to the Economy

The need of citizens to engage in black market activities is not just costly to the informals themselves. The whole economy suffers. In particular, the absence of good laws to protect private property undermines economic growth and helps keep Peru impoverished. For instance, the lack of clear, legally protected titles to property, whether to a piece of land or to a retail outlet, reduces incentives and opportunities for productive enterprise. The less secure that property is, the more reluctant informals are to expand business operations or to invest in better housing. Thus informal businesses tend to be under-capitalized and not as productive as they could be, slowing down economic growth.

The lack of a property title also makes it extremely difficult for informal firms to secure insurance or to borrow money. An illegal enterprise or occupied piece of land cannot be used as collateral for a loan. Thus Peruvian capital formation is well below the level possible if all entrepreneurs had access to an evenhanded system of laws.

Staggering Property Values. The aggregate impact of the lack of property rights cannot be determined, but the enormous cost to the country is hinted at in differences in the value of formal and informal land holdings. To investigate this, the ILD examined two settlements, built adjacent to one another, at approximately the same time, by individuals from the same socio-economic group and region of the country. One settlement was classified by the government as permanent, giving it the benefits of legal property rights, while the other as temporary and lacked these rights. Property values in the permanent settlement were a staggering 41 times higher than those in the temporary settlement. Using a sample of 37 settlements around Lima, the ILD has found property values averaged nine times higher in settlements where occupants possessed land titles than in less secure settlements.

Because the state drives Peruvians to resort to informal sector activities, state tax coffers suffer. Since informals do not pay all the taxes to which they are subject, the country's tax base shrinks. This means that the state must invest more time and effort to collect taxes. It also means higher taxes on those who remain in the formal sector, further eroding productivity and discouraging growth.

Informality pushes up the costs of formal businesses in other ways. For example, nearly half the electricity and water used in Peru is unaccounted for,

as informals regularly tap into state electrical lines and water supplies. The result is higher rates for legal consumers of utilities. In turn, formal businesses and other users demand government subsidies to offset high utility costs and this requires greater government expenditure and higher taxes, discouraging economic activity.

WHY PERU PERSISTS IN SUFFOCATING ENTERPRISE

Peru pursues policies that stunt economic growth because, as in many other Latin American countries, it has not had a political tradition of fostering free markets. Policy makers in these countries tend to view laws as a means by which to redistribute wealth from one interest group to another rather than as a way to create a secure environment for the production of wealth.

This means that laws in Peru command the respect of few if any citizens; they are seen simply as vehicles by which interest groups — usually elite businessmen, union leaders, landholders, government employees, and other powerful individuals — can redistribute wealth from one faction to another. The result is that the society has become so completely politicized that short-term political and economic advantages are the only concern of most individuals and groups.

Closing Out Citizens. The outcome is political and legal anarchy. Laws and legal procedures are contradictory and make little sense, and the sheer volume of laws, rules and regulations make the system incomprehensible. In 1985, for example, the government of Peru issued 17,498 new laws and decrees. The system is anything but democratic; only 420 of these laws were issued by the Peruvian legislature, the body elected by the people. The other 17,078, or 98.6 percent of the total, were issued by the executive branch with no accountability to the people and little if any coordination between the issuing bureaucrats. The rule-making process goes on behind closed doors. The government is not required to publish proposed new rules and hold public hearings. Information on such matters is legally forbidden to the public. Thus there is little chance for citizens to oppose adverse new government dictates.

The situation in Peru is strikingly like Europe's mercantilist system of the 16th, 17th, and 18th centuries. With mercantilism, the state controlled economic activities in the interest of "national" power and at the expense of other nations. The government would distribute monopoly rights to produce certain products, import and export certain goods, and distribute products and goods in the domestic market. The elite prospered through the manipulation of political power and police actions against those who did not respect their monopolies. There were few opportunities for new entrepreneurs to profit through their own efforts and abilities to provide goods and services to customers at competitive prices.

This is Peru today. As in mercantilist Europe, intervention by Peru's government on the side of one private interest against another is considered

justified, while the sale of government favors for personal gain is widespread. And just as in the Europe of the past, black markets, smuggling and the informal sector in Peru have arisen to make up for the deficiencies of the system.

Consider the example of the informal sector public transport carriers, which provide 95 percent of the service in Peru. To obtain some acquiescence from the government, operators have tended to charge government-mandated fares. But because of an annual inflation rate of over 1000 percent, these fares do not cover the costs of carriers. Because of this, 350,000 Peruvian transport workers went on strike last September. But rather than demanding higher fares, at the suggestion of the ILD, which acted as a mediator, the workers demanded instead that the government allow them to cut their costs through trade liberalization. At that time, import restrictions and the absence of foreign currency meant it was nearly impossible to secure spare parts for existing buses, much less new vehicles, and most of the public transportation fleet was falling apart.

Threatening Manufacturers' Rights. The government agreed to liberalize trade in auto parts and vehicles to reduce the operating costs of vehicle owners. In effect, free market principles were being forced on the state by the informal sector entrepreneurs. Efforts to carry out this agreement are still under way. One explicit effort, however, was made to derail the pact. It came from tire manufacturers in Peru, who maintained that liberal trade would reduce tire prices and endanger jobs. Tire companies in Peru employ 1,254 workers. These manufacturers also argued that their own costs were high due to government regulations. The ILD suggested that the settlement include deregulation of this manufacturing sector. The manufacturers have so far refused the offer. With special privileges removed, tire companies in Peru no longer would enjoy a mercantilist monopoly, captive customers, and guaranteed profits. They would be subject to free market competition.

CONCLUSION

In Europe, mercantilism's economic inefficiencies led to mercantilism's demise. Countries such as Britain, which moved in the 18th century to an economic system based on private property rights, free enterprise, limited government power and rule of law, prospered as a result. The growth of political democracy, and the consequent increase in political power of the entrepreneurial class, eventually destroyed the European mercantilist system. What is needed in Peru and other neo-mercantilist Third World countries today is a similar revolution.

U.S. Secretary of State James Baker has maintained correctly that less developed countries must restructure their economies along free market lines if they wish to prosper. The World Bank has loaned billions of dollars to these countries for structural adjustments. The results of these international pressures and assistance programs, however, generally have been disappointing. Yet in Peru, as the settlement of the transport strike indicates,

structural adjustment can be being forced on the government by the informal sector entrepreneurs.

Will of the People. The policies of the Reagan Administration, the International Monetary Fund, and the World Bank have sought to promote structural reforms by lending money to the government elites in less developed countries that are responsible for the current economic mess. The results have been disappointing. Too often, policy makers in industrialized countries believe that Third World leaders always speak for their people. Unfortunately, this is the equivalent of believing that King George III of Britain spoke for the thirteen colonies during the period leading up to the American Revolution. The Boston Tea Party, then, like the informals in less developed countries today, is probably more representative of the will of the people.

The informal sector in Peru demonstrates that Latin Americans are hard working and entrepreneurial. It also makes clear that the main things holding them back are governments and ruling elites whose survival and prosperity are based on their ability to control most aspects of economic life.

In Peru, like so many other less developed countries, the law is used not to protect the rights of people but to gain wealth for one interest group at the expense of others. Only when the freedom of each individual to own property and trade freely is protected by the law will the creative energies of Third World peoples be unleashed and the problems of world poverty and debt be eliminated.

All Heritage Foundation papers are now available electronically to subscribers of the "NEXIS" on-line data retrieval service. The Heritage Foundation's Reports (HFRPTS) can be found in the OMNI, CURRNT, NWLTRS, and GVT group files of the NEXIS library and in the GOVT and OMNI group files of the GOVNWS library.

INTER-AMERICAN DEVELOPMENT BANK
REPRESENTATION IN THE UNITED KINGDOM
MORGAN HOUSE, 1 ANGEL COURT,
LONDON EC2R 7HJ

REPRESENTATIVE

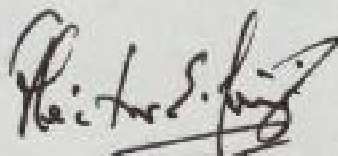
19 April 1989

Dear Mr. Powell,

Many thanks for your kind letter of 10 April regarding the upcoming visit to London of Mr. Enrique Iglesias.

Mr. Iglesias is delighted that the Prime Minister has agreed to see him and he is very much looking forward to seeing her on Thursday 18 May at 12.30 o'clock.

Yours sincerely,



Héctor E. Luisi

Mr. Charles Powell

10 DOWNING STREET

Charles, Yes.

re: your letter of 10/4/89 (top of file).

Jeff Crabtree (ODA) rang to say:

a) the lead dept is IFID ODA + they will be preparing the brief.

b) ODA Under Sec Ian Buist will be the attending

Under Secretary, and

c) they plan to let us have the briefing by close of play Monday 15th May

For your information

[signature]

15/4.

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary 10 April 1989

INTER-AMERICAN DEVELOPMENT BANK

The Prime Minister has agreed to see Mr. Enrique Iglesias, President of the Inter-American Development Bank, on 18 May. I should be grateful for a short brief in time for the meeting.

I am copying this letter to Bob Peirce (Foreign and Commonwealth Office) and Myles Wickstead (Overseas Development Administration).

(C. D. POWELL)

Alex Allan, Esq.,
HM Treasury.

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary 10 April 1989

Thank you for your letter of 7 April about the forthcoming visit of Mr. Iglesias. The Prime Minister would be able to see Mr. Iglesias at 1230 on 18 May. I hope this is convenient.

(C. D. POWELL)

Mr. Hector E. Luisi

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10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary 10 April 1989

INTERNATIONAL DEBT

The Prime Minister was grateful for the Chancellor's minute of 7 April. She shares the Chancellor's concerns and is distressed by the approach which the Americans and others wish to adopt. She has commented that Brady's proposals are totally wrong. They will encourage third world countries' spending with a view to non-payment of their debts; the proposals will reward the profligate at the expense of the honest.

I am copying this letter to Stephen Wall (Foreign and Commonwealth Office) and to John Footman (Bank of England).

Paul Gray

Alex Allan, Esq.,
H.M. Treasury.

R819

INTER-AMERICAN DEVELOPMENT BANK
REPRESENTATION IN THE UNITED KINGDOM
MORGAN HOUSE, 1 ANGEL COURT,
LONDON, EC2R 7HJ

REPRESENTATIVE

TELEPHONE: 01-726 4389
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CABLE: INTAMBANC-LONDON EC2

7 April 1989

Dear Mr. Powell,

You were kind enough to write to me on 23 February regarding when the President of the Inter-American Development Bank, Mr. Enrique Iglesias, might next be in London, in order to see whether it would be possible to arrange for a meeting with the Prime Minister.

Mr. Iglesias has in principle accepted an invitation to take part in a Ditchley Conference on the problems and prospects of Latin America, which will be held at Ditchley Park on 19-21 May. Should the Prime Minister be able to see him, Mr. Iglesias would of course be prepared to come to London one day earlier, on the 18th, or leave one day later, on the 22nd. He is not expected at Ditchley Park until late in the afternoon of the 19th.

Yours sincerely,

Héctor E. Luisi

Mr. Charles Powell

EAMARM

CONFIDENTIAL

PRIME MINISTER

THE BRADY INTERNATIONAL DEBT PLAN

The Chancellor's minute at Flag A reports more fully on the outcome of the internationl debt discussions at G7 and the Interim Committee.

The Chancellor underlines the dangers involved in the path that the Americans now want to go down. Together with the Germans, he does seem to have been able to resist the worst aspects of the proposals last weekend. But it is clearly going to be an uphill fight. And I suspect the truth is that the damage has already been done - whatever final details are thrashed out, the debtor countries have already taken the message from last weekend's events that governments are prepared to dip further into their taxpayers' pockets.

You may also like to see the note from Alan Walters at Flag B, in which he underlines his serious worries about Brady's proposals. Alan was able to talk to the Chancellor about this when he was last here, and the two of them are in close agreement.

Content that I should minute out indicating your endorsement of the Chancellor's worries about the Brady approach and urging him to continue to seek to co-operate with the Germans in trying to turn the package round?

PRCG

PAUL GRAY

7 April 1989

Yes — Brady's proposals are totally wrong. They will encourage 3rd world spending with no need to [illegible] non-payment. It is rewarding the profligate at the expense of the honest. MT

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

PRIME MINISTER

INTERNATIONAL DEBT

As I briefly reported to Cabinet yesterday, the main topic at the G7 and Interim Committee meetings in Washington last weekend was the Brady proposals for dealing with the Latin American debt problem. I thought it might be helpful if I were to let you have a fuller note.

It has been clear for some time that the commercial banks who had made these massive loans to Latin American Governments during the '70s were most unlikely to ever be repaid in full. This is reflected in the bad debt provisions they have already made (and on which, at least in the UK, they enjoy tax relief) and in the heavy discounts at which this debt now stands in the secondary market.

But we have always taken the view - as, under Reagan, did the Americans - that this was a matter which would have to be resolved by negotiation between the banks and the debtor nations; and we have consistently rejected various plans for a solution via the injection of tax payers money.

What has now happened is that the Americans - or at least the US Treasury under Brady: there are some signs that some other parts of the administration are less than wholly enthusiastic about it - have done a U-turn. With riots in Venezuela, and growing political instability elsewhere in Latin America, they feel they can no longer wait for the matter to be resolved between the banks and their Sovereign clients. But because straightforward US financial assistance would be an added burden on their budget, and

might well incur opposition in congress (US tax payers' money bailing out the banks), they have decided to achieve the same objective via the IMF and the World Bank (which also means, of course, that the burden is shared with the rest of the world's tax payers).

They have proposed two main ways of doing this. The first is for the International Financial Institutions (IFIs) to lend 25% of their money to Latin American Governments (provided they are undertaking appropriate adjustment policies) for the specific purpose of buying back their debt at a discount. The second is for the IFIs to provide funds to "support" - perhaps by guarantees - the payment of interest by these Governments to the commercial banks, in return for which the banks would agree to a lower rate of interest. Nonsense

The dangers in this approach are all too clear. It has aroused massive expectations among the debtor countries, beyond even what I believe the Americans have in mind. It has removed the pressure on them to take the necessary economic measures and on the banks to take the "hit" they can now well afford. Now that the principle of the risk being transferred from the private sector to the public sector has in effect been conceded, the demands for the IFIs to do more and more, and for Governments to take an increasingly interventionist role in negotiating with the banks and the Latin American Governments, will steadily grow.

Within the G7, the Americans had already sewn up the Japanese in advance (in return for US support for Japan to move up in the IMF hierarchy), while Brady had no difficulty getting the French on board, claiming that his proposals were in the spirit of the Mitterrand debt plan (about which we shall hear a great deal more at the Paris Economic Summit in July).

It was left to Stoltenberg, the German Finance Minister, and myself to resist the gadarene rush. At the end of a very long and at times heated meeting, we agreed a compromise. No agreement on

any extra money for the IFIs to lend; agreement that "a portion" of existing lending could be set aside to finance the buy-back of debt, but only on the basis of strong conditionality and with no agreement on the size of the portion; and agreement to examine the interest support idea. The matter was then discussed again in the Interim Committee, where we managed to get a communique that, while broadly endorsing the G7 compromise formula, was somewhat tougher in one or two respects.

So there is still a great deal to play for. But although there may be no vital UK interest at stake in all this, I must say I view with the greatest apprehension the apparent American determination to set the world off on the slippery slope towards the complete takeover by Governments (via IFIs), and thus by tax payers, of the Latin American debt problem, and the provision of unlimited public funds to "save democracy" in the sub-continent.

I am copying this minute to the Foreign Secretary and to the Governor of the Bank of England.

ACS Allan

pp [NL]
7 April 1989

[approved by the Chancellor and signed in his absence]

PERSONAL AND CONFIDENTIAL

file V6

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

5 April 1989

THIRD WORLD DEBT PROPOSALS

As I mentioned to you, Alan Walters has been anxious to express his doubts about the Brady plan. The note he promised me has at last arrived this afternoon. It does not I think include any major new points, but the Chancellor may wish to be aware of it and I am therefore enclosing a copy with this letter.

PAUL GRAY

Alex Allan, Esq.,
H.M. Treasury.

PERSONAL AND CONFIDENTIAL

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(2)

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

Prime Minister
CDP 2/4.

31 March 1989

Charles Powell Esq
10 Downing Street
LONDON
SW1

Dear Charles,

INTERNATIONAL FINANCIAL SCENE

I attach our quarterly report on developments in international debt. This one will form the basis of briefing for the IMF/IBRD Spring meetings in Washington next month.

The main heavily indebted developing countries which improved their external performance on average in 1988, face renewed difficulties this year in many cases. The prospects for the world economy are for further substantial growth, but rising interest rates threaten to increase debt-servicing burdens. Domestic policies have deteriorated in a number of important debtors - partly reflecting electoral pressures. Against this difficult background, the US Treasury Secretary Mr Nicholas Brady's proposals to shift the debt strategy's emphasis towards debt reduction have had a mixed reaction from other creditors and from debtors. Finance Ministers will be discussing the issues at the IMF Interim Committee in early April. The US proposals, however, have injected an element of uncertainty about the future of the debt strategy which could complicate negotiations with some of the main debtors over the coming months.

The rapid growth of major industrial countries' output by more than 4 per cent in 1988 was accompanied by a rise of 8½ per cent in the volume of world trade which helped heavily indebted countries to increase their exports sharply on average. This, together with the strength of commodity prices (except oil), led to a fall in the share of export earnings taken in debt service and a modest fall in the current balance of payments deficit of the Baker 15 countries.

The growth of world trade seems likely to be substantial again in 1989, though less rapid than in 1988, and world interest rates are about 2½ per cent higher than a year ago when they were affected by reaction to the stock market crash. Commodity prices in

general have levelled off or fallen slightly from their peaks in mid-1988, although oil prices are stronger. On balance, the main heavily indebted developing countries seem likely to have to devote an increased share of their exports to paying interest on their external debts.

Debtor countries failed to take full advantage of strong world growth last year because of continued poor domestic policies. Brazil, Mexico, Venezuela and Argentina all suffered from domestic policy failures. On average GDP growth in the Baker 15 countries fell short of the rise in population, and real incomes per head fell by about 1 per cent. Debt issues featured strongly in the Mexican and Venezuelan elections and are to the fore in the current Argentine and Brazilian presidential campaigns.

President Bush's announcement that his new Administration would review the debt strategy aroused expectations but Mr Brady's proposals given in a speech on 10 March were short of details and were endorsed by Mr Bush only belatedly. The main features of the Brady plan are:

a. Debtors should continue strong economic adjustment policies - in particular to encourage new investment, higher domestic savings and the return of flight capital - with the support of the IMF and World Bank.

b. Commercial banks should provide a broader range of alternatives for financial support including a reduction in debt and debt service as well as a resumption in new credits.

c. The IMF and World Bank should help finance debt reductions by commercial banks. Some of this finance would be additional to existing commitments, and could take the form of: lending to debtors for the purposes of debt buybacks or for providing security for debt conversions; lines of credit; or guarantees.

d. Creditor governments are expected to continue to reschedule debts in the Paris Club, as well as provide new credits.

The Chancellor will be discussing these issues in Washington in early April with Mr Brady and other finance Ministers. The UK objectives in the debt strategy are to ensure as full as possible servicing of all official debt, to encourage the debtors to strengthen their economies and regain creditworthiness, and to halt the transfer of risk that has been going on from the private to the public sector.

Some of the elements of the Brady plan are helpful. These include: the recognition that debtors must give a higher priority to private sector investment, and remaining barriers to inward investment; the need for the banks to reduce debt, but without being lent on by governments; and the potential usefulness of bilateral loans where creditor governments find their own political/strategic interests are most clearly involved.

The Chancellor will seek to alter other elements of the plan, especially the proposals for substantial additional resources for the IMF and the World Bank, and for guarantees - both of which would be a potential claim on the UK taxpayer. He will also seek to attach firm conditions to IMF and World Bank investment, so as not to undermine these institutions and their ability to look after other countries - such as India - who need help but who have managed to remain creditworthy.

Other G7 governments have so far reacted cautiously to the Brady plan. Most are waiting for details. The Japanese who are ready to provide additional resources to the IMF in return for greater influence, were consulted in advance by the US and have been most positive. The French chairman of the Paris Club, however, has spoken out against any need for a reduction in official creditors' claims although this does not seem to be part of Brady's plan. The Dutch chairman of the IMF Interim Committee has questioned especially the provision of guarantees by the Fund or the World Bank. Among debtor countries, the Brady proposals have generally been welcomed as necessary but not sufficient.

Commercial bankers in the UK and elsewhere have reacted cautiously. Several leading bankers have drawn attention to the difficulty of achieving both debt reduction and new credits at the same time. Most are waiting to see the details of the extent of both debt reduction and any official support.

Mexico is likely to provide the first test for any new approach to debt relief. A deterioration in trade performance last year as a result of lower oil prices (which have since recovered), an unrealistic exchange rate and soaring imports was made worse by capital flight so that reserves fell sharply. The new Salinas government's Pact for Economic Stabilisation and Growth provides for price and wage agreements to curb inflation and a gradual devaluation of the peso. Inflationary pressures, however, are already leading the monthly rate of price increase to edge upwards. Mexico is seeking a new IMF standby arrangement, substantial loans from the World Bank, a generous Paris Club rescheduling and new credits from commercial banks. The Finance Minister told the Chancellor when he visited London in February that Mexico did not want to declare a moratorium but if a financial package was not agreed, the accounts would simply not add up.

In Venezuela, the new government of President Peres has agreed a programme with the IMF to reduce the budget deficit and create a more flexible exchange rate system. Food shortages and higher petrol prices, however, triggered unrest which was suppressed with considerable loss of life, and the government has responded by bringing forward wage increases. The Venezuelans are seeking new money from banks. They have not approached the Paris Club but the US and the Spaniards are reported to have offered bridging finance.

Brazil achieved a very substantial external trade surplus last year but the IMF programme has gone badly off track as a result of

the failure of domestic policies which saw inflation approach 1000 per cent by December. A new heterodox 'Summer Plan' was introduced in January to check the fiscal deficit and freeze partially wages and prices. Congress, however, has weakened substantially the fiscal measures, the monthly inflation rate is again edging upwards and the parallel exchange rate has fallen steeply. The Chancellor encouraged the Finance Minister Mailson da Nobrega to persevere with his reform efforts when he saw him on 23 March - but the Brazilian government's room for manoeuvre is likely to be highly circumscribed ahead of November's elections.

The imminence of elections in Argentina has totally paralysed policy there. The government has been unable to agree fiscal targets with the IMF, and the World Bank has suspended drawings on the policy loans agreed last October in the face of reasoned UK opposition. Interest payments to commercial banks are effectively halted and arrears are mounting. There may be a continued policy hiatus even after the elections in May, since the new government will not take office until the autumn.

Outside Latin America, the main development has been the IMF Executive Board's approval of a programme for Nigeria. This was made possible by the successful donors' meeting in London in January chaired by the IBRD and hosted by the UK, which is providing $100 million. This was followed by the rescheduling of Nigeria's Paris Club debt in late-February. The cost to Nigeria of making good arrears to a number of creditors has worsened the financial prospects for both 1989 and 1990. The recent rise in oil prices, however, if sustained, should benefit export earnings and budgetary receipts. The IMF expects to review the programme in April.

Among other large countries, the main concerns focus on Egypt which has still not agreed an IMF programme, Yugoslavia where lack of a government has impeded negotiations with the Fund and Poland where no major progress with creditors seems likely until the US are ready to allow the IMF to try to negotiate a programme.

Among the smaller countries, Jordan has approached the IMF for a programme to be followed by debt rescheduling. Some seven countries, including Uganda and Tanzania, have now benefited from concessional terms on Paris Club rescheduling following implementation last autumn of the Chancellor's initiative on Sub-Saharan Africa.

I am copying this letter and enclosures to Robert Culshaw (FCO), Jeremy Godfrey (DTI) and John Footman (Bank of England).

Yours sincerely,

Duncan Sparkes

p.p. J M G TAYLOR

0277u

COVERING CONFIDENTIAL

(Based on information as at 17. 3.89)

INTERDEPARTMENTAL DEBT REPORT: MARCH 1989

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INTERNATIONAL DEBT GROUP REPORT: MARCH 1989

Main points

- Secretary Brady has announced a revision to the Baker Plan which includes IFI financing of debt reduction, and the option of interest forgiveness in return for official guarantees to the banks. The new arrangements would only be available to debtors willing to implement adjustment programmes. There is also a suggestion that the IMF might begin to lend in support of a programme before full external financing was in place. Initial reactions from UK banks have been generally supportive if cautious in the absence of further detail.

- Despite higher interest rates and, overall, a further deterioration in their terms of trade, the Baker 15 countries' current account deficit narrowed a little last year. Both export and import volumes were up sharply. But with domestic demand weak, per capita incomes fell by 1%, and the IMF expects both a larger current deficit and a further decline in real per capita GDP this year.

- Secondary market prices have fallen sharply reflecting a loss of confidence in policies, the suspension of debt:equity programmes and talk of moratoria.

- With elections due in Brazil and Argentina, the prospects of an effective policy response to rising inflationary pressures is remote. Confidence in current heterodox "plans" is waning.

- Mexico is seeking a comprehensive, multi-year restructuring of its debt with both official and bank creditors. It has allowed the US offer of bridging finance to lapse.

- Venezuela, which is requesting $5 bn of new money, has signed a Letter of Intent with the IMF. A package of measures sparked off a wave of unrest, which was suppressed with many casualties.

- The Paris Club has agreed a comprehensive rescheduling with Nigeria.

- Jordan's payments difficulties have worsened and a rescheduling will be sought.

International Financial Scene

Growing fears of inflation have led to a further tightening of monetary policy in the industrial countries. Since the beginning of the year, 6 month Eurodollar rates have risen about 150 basis points and now stand 3 1/2 percentage points above their post-crash trough (Chart 1). As a rule of thumb, a one percentage point increase in rates increases debt servicing costs of the Baker 15 countries by about 2.3% of exports of goods and services (or roughly $3.8 bn). Non-oil commodity prices have weakened a little since their peak in the middle of last year as earlier disruptions to supply have eased, although oil prices have recovered sharply with signs of greater OPEC cohesion (Chart 2).

The Brady Scheme

On 10 March US Treasury Secretary Brady announced the conclusion of the long-awaited review of the Baker Plan. His speech to the Bretton Woods Committee focused on the heightened role of debt reduction first mooted at the Berlin Annual Meetings and subsequently developed by Mulford in meetings of the G7. Its timing appears to have been prompted by concerns over Mexico and the recent Venezuelan riots. Brady put forward the following methods by which debt reduction might be achieved:

(i) Debtors should be permitted to use foreign exchange reserves for debt buybacks; IMF/World Bank funding would replenish these reserves.

(ii) Debt could be defeased (ie exchanged for new forms of debt) at a substantial discount with IFI funds used to provide collateral.

(iii) The IMF and the World Bank could provide "additional financial support" to collateralise a portion of interest payments on debt due to commercial banks; in return the banks would offer debt reduction.

In order to facilitate an agreement to reduce the debt burden, banks should agree to waive the "sharing" and "negative pledge" clauses in loan documentation for a period of up to three years. Also creditor governments should reassess any regulatory, tax and accounting systems which may impede debt reduction.

Brady suggested that debt reduction should be "encouraged and supported but not managed by the IFIs". The IMF might, in certain circumstances waive the present requirement that financing gaps be filled before its funds are disbursed. The debtor would have to give evidence of pursuing an effective adjustment programme before benefiting from any relief arising from the above measures. It would also be required to encourage the return of flight capital and prevent any further outflows by adopting appropriate policies.

Publicly, Brady has provided little detail on his suggested measures; it is not clear how they might be implemented. Japan has endorsed the proposals but other G7 members and, indeed, the US Fed has been more cautious. Key members of Congress, however, have signalled their support. Latin American countries have generally welcomed the plan but regretted its lack of immediacy.

Initial reactions from UK banks have been generally supportive, but cautious in the absence of more detail. A number of banks has suggested that it would be useful to make a quick start with a test case of a country with a strong adjustment record. The banks have welcomed IFI involvement in debt reduction. On the proposal for general waivers, the banks prefer a case-by-case approach to individual schemes for debt relief.

<u>Latest IMF WEO</u> (Table 1)

The unexpected strength of world trade in the latter part of last year is evident in revisions to the IMF's latest WEO and its estimates of the Baker 15 countries' balance of payments. Despite a fall (overall) in the terms of trade (reflecting the weakness of oil and beverage prices) their combined surplus on goods and non-factor services rose $4 bn to $23.4 bn. This outward resource transfer represented about 2.2% of GDP. Export volumes rose over 11% (in the Autumn WEO projected growth in 1988 was less than 5%). Import volumes rose 7.6% - the first significant rise since the early 80s - despite weak domestic demand. The increase probably reflected a combination of liberalisation and real exchange rate appreciation, notably in Mexico. On average, Eurodollar rates, at 8.1%, were 3/4 of a percentage point higher than in 1987, but despite a higher interest burden there was a small decline in the Baker 15 combined current account deficit.

CHART 1

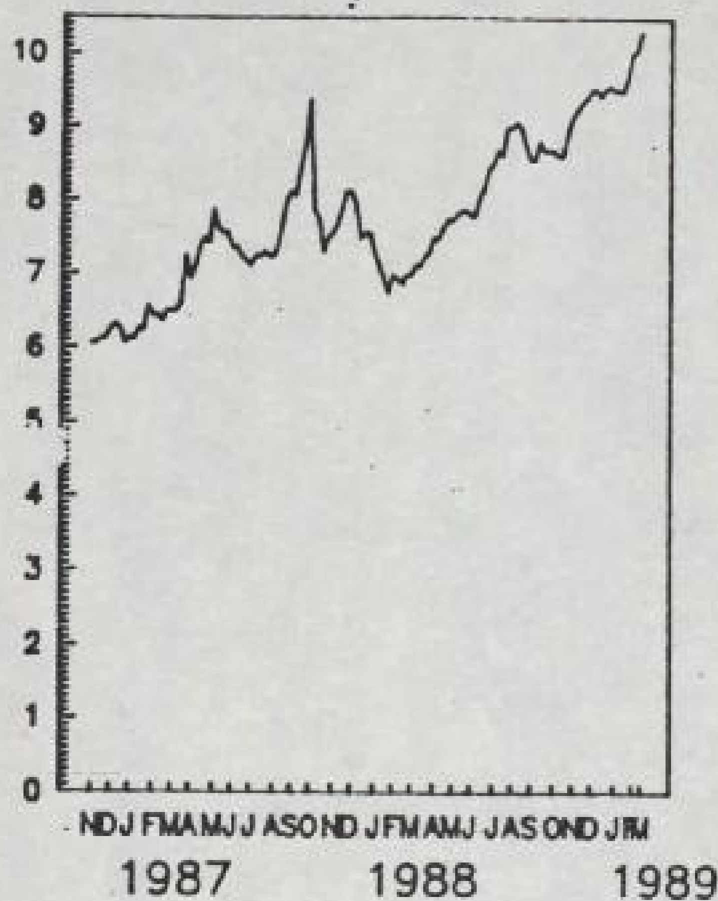

CHART 2

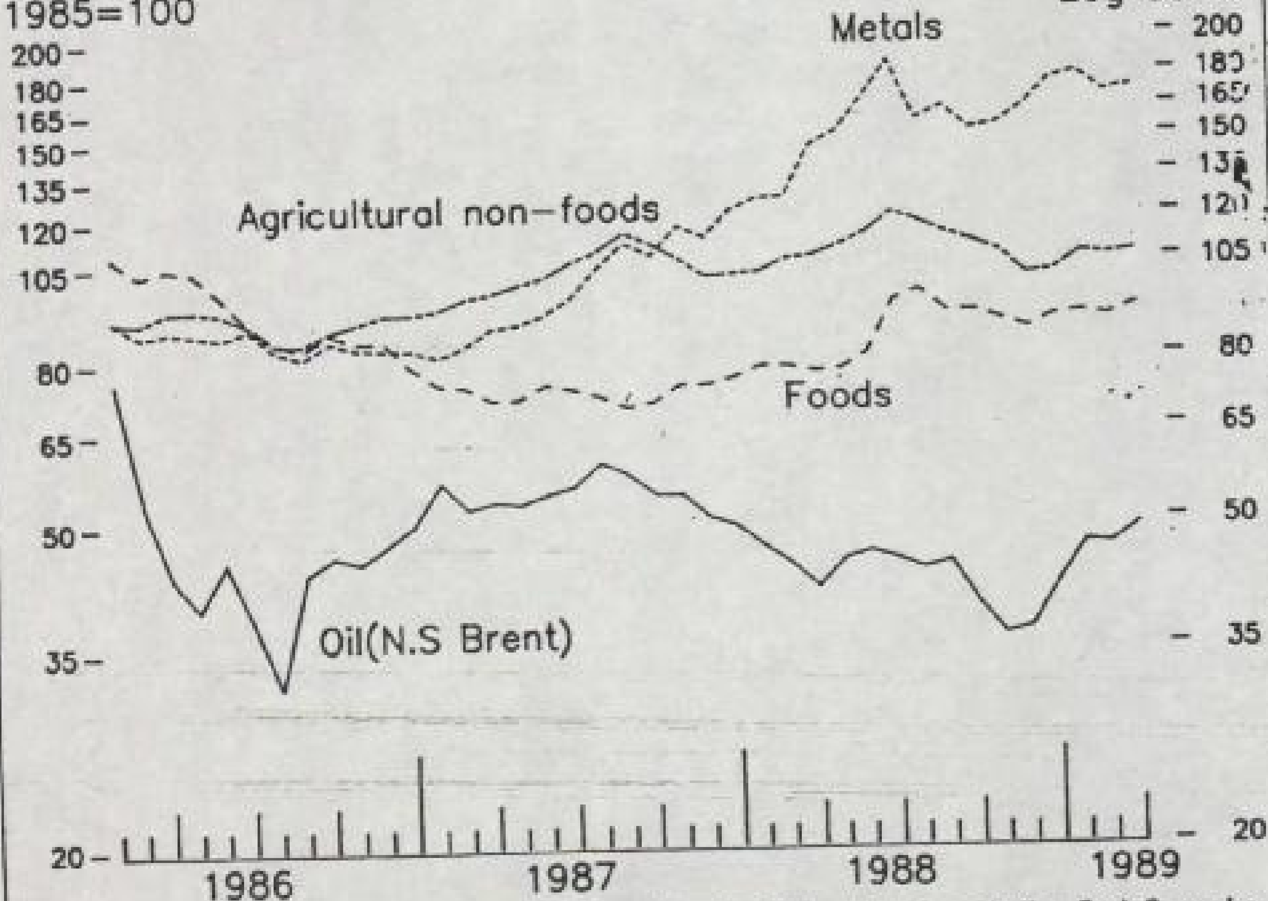

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TABLE 2: IMF SPRING WEO

% change on previous period

	1986	1987	1988	1989	1990
Industrial countries					
real domestic demand	3.7	3.7	4.3	3.4	3.1
import volume	8.1	6.9	9.1	6.2	5.5
GNP deflator	3.4	2.9	3.1	3.7	3.4
$ world prices					
manufactures	17.7	12.0	5.5	4.5	3.8
oil	-50.1	29.0	-20.8	-0.9	8.3
non-oil	-1.2	3.4	18.2	1.6	-5.8
6-month $ LIBOR (level)	6.8	7.3	8.1	9.2	8.8
15 heavily indebted countries					
terms of trade	-15.9	-1.2	-2.4	-3.0	-1.1
export volume	-2.5	5.5	11.2	2.7	4.7
import volume	-1.0	0.5	7.6	1.8	7.8
current balance ($ bns)	-16.0	-9.4	-8.7	-11.1	-15.2
Real per capita GDP	1.8	-	-0.9	-1.3	1.1
Ratio of debt to exports G&S (level)	348.8	338.2	299.6	296.3	285.4
Interest payments due as % of exports G&S (level)	31.0	26.8	26.6	27.3	25.6
Debt service paid as % of exports G&S (level)	45.2	35.5	39.8	40.5	39.8
Sub-Saharan Africa					
Terms of trade	-17.1	-8.3	-2.2	-1.9	1.3
Export volume	8.7	2.4	-0.5	5.6	5.3
Import volume	-1.9	-1.2	3.1	2.0	2.9
Current balance ($ bns)	-5.9	-6.7	-8.2	-7.6	-8.0
per capita GDP	0.6	-1.0	-1.6	-0.6	0.9
Ratio of debt to exports G&S (level)	300.6	328.1	332.3	337.7	344.0
Interest payments due as % of exports G&S (level)	16.2	17.4	19.1	18.8	18.4
Debt service paid % of exports G&S (level)	26.1	23.4	23.4	22.8	25.1

Notes: The interest service ratios have been calculated on the basis of accruals including sums due on portfolio investment. The overall debt service ratios are shown on an actual payments rather than an accruals basis (and so will be affected inter alia, by changes in outstanding arrears).

Table 2

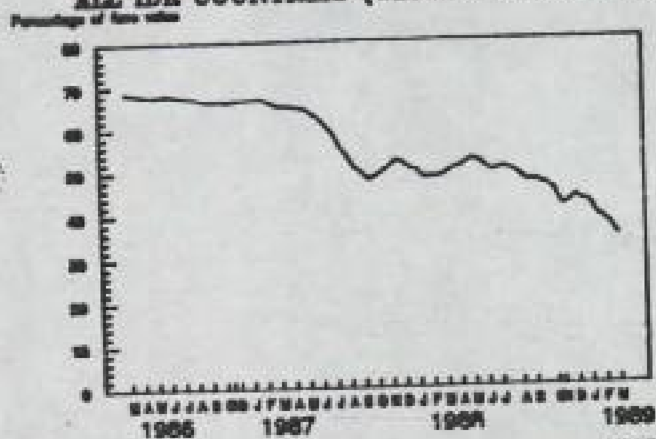
Baker 15 Countries plus Poland
Recent changes in secondary market prices

	Bank debt end-1987 $bns	22/12/88 % face value	2/3/89 % face value	% change
Mexico	56.[illegible]	43.13	33.38	-22.6
Brazil	53.[illegible]	[illegible]0.37	[illegible]7.13	-32.8
Argentina	39.7	21.50	17.63	-18.0
Venezuela	23.6	41.25	27.63	-33.0
Poland	12.3	34.00	32.13	-5.5
Nigeria	11.5	24.00	21.50	-10.4
Chile	11.5	57.50	55.63	-3.3
Philippines	11.3	49.50	36.50	-26.3
Yugoslavia	7.6	45.50	43.75	-3.8
Ecuador	5.5	13.00	12.50	-3.8
Colombia	4.9	58.00	50.50	-12.9
Morocco	4.7	48.50	44.50	-8.2
Peru	4.5	5.50	4.75	-13.6
Cote d'Ivoire	3.5	25.00	16.00	-36.0
Uruguay	2.4	60.00	57.50	-4.[illegible]
Bolivia	1.0	10.50	9.50	-9.5
Total/Wtd av.	274.[illegible]	37.85	29.45	-22.[illegible]

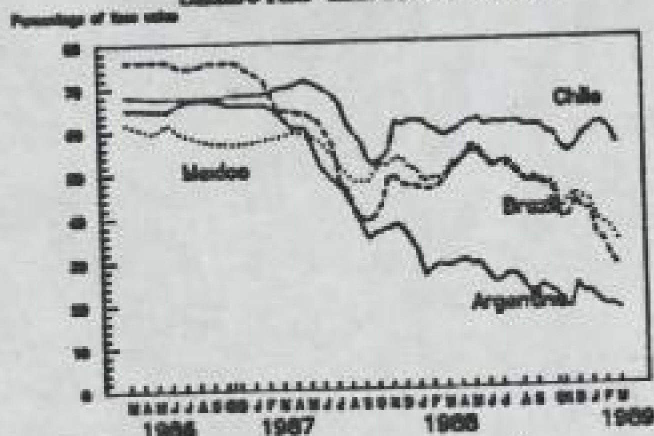
CHART 3

INDICATIVE SECONDARY MARKET PRICES(1)

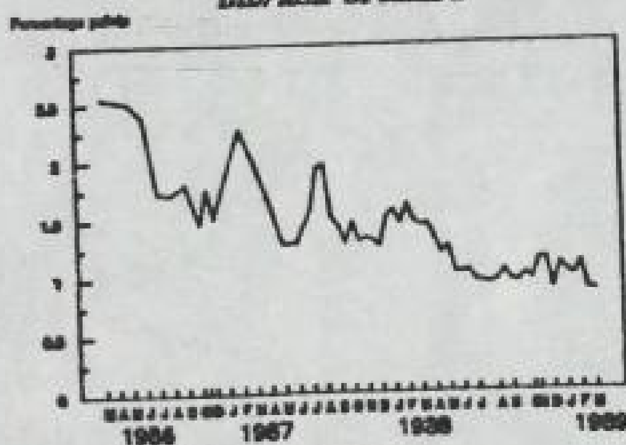
ALL IDR COUNTRIES (WEIGHTED AVERAGE)



SELECTED MAJOR DEBTORS



BID/ASK SPREADS



(1) Source : Salomons, mid-point of bid-ask spread

Net lending to the Baker 15 by official creditors fell from $16 bn in 1987 to $5.4 bn and the borrowers also drew heavily on their reserves (down $7 bn). Net repayments to the banks totalled nearly $12 bn (although within the total are about $4 bn of debt:equity swaps). The stock of Baker 15 debt (measured in dollar terms), which rose sharply in 1987 largely because of exchange rate movements, declined slightly last year and the debt:export ratio fell below 300%. The ratio of debt service paid to exports rose a little reflecting the clearance of interest arrears by Brazil.

The IMF's forecast for 1989-90 paints rather a bleak picture. With OECD activity slowing somewhat (although still higher than projected in earlier forecasts) export market growth for the Baker 15 declines and real commodity prices fall. Annual average interest rates rise just over 1% between 1988 and 1989 before falling back slightly. The current account widens and real per capita GDP declines further this year with only a partial recovery in 1990. The projected improvement in debt ratios is only small. The share of official claims in total long term Baker 15 debt continues to rise throughout the forecast and by the end of 1990 represents just under a third of the total as against a quarter at end-1986.

Secondary Market Prices

The steady fall in the average price of ldc debt since the late spring of last year has steepened over the last two months. The accelerated fall probably reflects a general loss of confidence in adjustment efforts, higher interest rates and growing talk of debt reduction. Chart 3 and Table 2 show, however, quite a wide disparity in recent price movements about the general trend. Prices of the better performing debtors (eg Chile and Uruguay) have declined least, while those for Brazil, Venezuela and Cote d'Ivoire have fallen particularly sharply. In Brazil's case the suspension of debt conversions and talk of a moratorium have had a depressing effect. The price (together with that of some of the other major Latins) is also likely to have been depressed by the decision of US regulators to unload the ldc claims of rescued Texan banks. Following the disturbances, the price of Venezuelan debt has dropped precipitously. Cote d'Ivoire has made no payments to the banks since mid-1987

"International Insider" estimates that turnover in the market (most of it in the form of swaps rather than outright cash sales) doubled last year to $40-50 bn. 80% of trading was in Latin American debt. Of an estimated $15 bn of debt retired last year, Brazil accounted for $6-7 bn (and about $15 bn of total turnover). The suspension of its debt:equity programme and the fact that many of the smaller banks have sold out their ldc portfolios could lead to a lower volume of activity this year. On the other hand at very low prices the market could become more attractive to speculators. A steady contraction of spreads is indicative of the growing competitive pressures on the intermediary banks who provide broking services.

Japanese banks have been allowed to sell some $600 mn of their claims on Brazil to their Cayman Islands factoring company in order to crystallise tax losses. (Only 1% of the banks' provisions are directly tax deductible.) The transfer price was 35% of face value.

The Latin American G8

Finance Ministers (except Panama) met in Rio in December and proposed measures for dealing with the region's debt problems: these involve debt forgiveness, IFI guarantees on new debt and the establishment of a new multilateral agency to buy and re-sell existing debts. The proposals were approved by the respective Presidents when they met in Caracas in January. The promised joint proposal to the main industrialised countries has yet to be sent.

Assessment

There has been little progress over the last 3 months in the workout of Latin American debt. Despite tinkering, policies remain inadequate in Brazil and Argentina with little prospect of change ahead of forthcoming elections. Stronger oil prices have eased the position somewhat in Mexico but last year's decline has left Venezuela with an acute liquidity shortage. Mexico has refused to tie itself to the conditions attached to bridging finance offered by the US and is seeking a substantial new financing package. Venezuela, in the wings for some months has come back on stage. Price rises, introduced as part of an adjustment package, aggravated discontent already bred by growing shortages of basic goods. It has not been difficult for the authorities to deflect responsibility for their difficulties from

root cause - falling oil prices and their own gross mismanagement of the economy - to external creditors, particularly as the banks have received substantial repayments of principal since 1982 and have never provided new money.

Elsewhere there have been some successes. That all the pieces of a complicated Nigerian jigsaw eventually fell into place with the approval of an SBA and a successful (ie not overly concessional) Paris Club rescheduling, is a tribute to the growing realism shown by the Nigerian authorities, the skill of the Paris Club Secretariat, and, it has to be said, the diplomatic effort mounted by UK ministers and officials. The agreement is however only a small step down a very long road and the programme could fall apart. Solidarity within the Paris Club also seems to have persuaded Poland to abandon its attempt to squeeze concessional interest rates from official creditors. A new government in Yugoslavia offers some prospect of better economic management. There has been little progress to report as regards Egypt. Jordan is likely to reschedule soon and Morocco's relations with the banks appear to have deteriorated.

1988 was a year of distinctly mixed fortunes for the major middle income debtors taken as a group. To a large extent the beneficial effects of very strong import growth in the OECD, only a modest rise in the general inflation, but a sharp recovery in non-oil commodity prices, were spoilt by the weakness of oil prices and higher interest rates. In general, commitment to sound policies has ebbed. The strength of export volume and the slow growth of debt led to quite a significant improvement in debt:export ratios and a stable interest service ratio. Nevertheless, this improvement was bought at the cost of a further stagnation or fall of real incomes. Many debtor governments face elections in the year ahead and will be unwilling to adopt unpopular measures. Signs of growing disenchantment with debt:equity schemes, on-lending and similar innovations in the "menu" is also a discouraging sign.

Scepticism as to the sustainability of the current strategy has if anything been reinforced by the US decision to review the Baker Plan. It is unfortunate that such a time elapsed between the announcement that a review was to take place and of the revised plan itself. The likelihood of any new plan including elements of debt reduction and regulatory/tax changes has made both debtors and their bank creditors reluctant to move. It may well have generated expectations that substantial debt forgiveness is on the horizon, a possibility that appears to have been anticipated by the market as evidenced by the sharp fall in prices.

If, as seems inevitable, debt reduction becomes an increasingly important element of the strategy, creditors face a number of challenges. Weaker countries who qualify for debt reduction will have to incur some penalty if the stronger or more willing debtors are not to be discouraged from pressing on. The latter are going to have to be offered carrots in terms of new financing, initially in the form of concerted lending but with some real prospect of market re-entry. Amongst the Baker 15 countries there is no simple relationship between levels of indebtedness and willingness to pay; the importance of adhering to the case-by-case principle is, if anything, more important when debt reduction becomes as a significant element of the strategy.

Equal burden sharing between official and private creditors - a principle which in any case has not been endorsed by the banks - will become more difficult to assess. In practice can some equivalence between debt reduction and new financing be established? The range of possible instruments and the uncertainties of the returns on them make comparisons technically difficult. Pressure on the official sector to provide guarantees or other forms of credit enhancement on the new forms of debt to be exchanged for old are likely to grow. As the IMF Staff has recently argued, the widespread use of official guarantees would only act to postpone market re-entry since the debt reduction process would be seen largely as a way of increasing debtors' dependence on official sources of finance. If substantial progress is to be made, the new instruments created in the process of debt reduction or new financing are going to have to carry enhancements of one kind or other which lead to their greater marketability. Both bank and official creditors who are in for the long term will have to accept the implicit subordination of their existing claims that this implies.

Further details on individual countries are given below.

LATIN AMERICA AND CARIBBEAN

Brazil

Brazil has been caught in a vicious circle of rapidly rising inflation and a ballooning fiscal deficit (largely reflecting the indexation of debt interest) financed by the banking system. With household incomes and business confidence depressed by a 12-month inflation rate approaching 1000% by December last year, domestic demand declined and real GDP stagnated (cf growth of 3% in 1987). The

[illegible]ession, coupled with a sharp improvement in the terms of trade, led to a trade surplus of $19 bn (6% of GDP) with the value of exports up nearly 30% while imports were unchanged. Despite higher interest payments, there was a current account surplus of $4.6 bn (1.3% of GDP) following a $0.8 bn deficit in 1987.

In January a new heterodox anti-inflation package (the Summer Plan) was promulgated by Sarney. The main elements include a partial wage and price freeze, a pledge that the federal Treasury would only spend what it received, the sacking of 60,000 federal employees and the closure of 5 ministries, plus a 15% devaluation and the creation of the 'new cruzado' trading at par to the US$. The fiscal proposals have been emasculated by the Congress and the major unions plan to hold a General Strike in mid-March. In response to the likely failure of the Plan, the parallel dollar premium has returned to its pre-Plan level of 75% to the official rate, even though monetary conditions have been considerably tightened since the Plan was introduced.

The SBA is badly off-track. The first review has been deferred until March at the earliest. It is expected that by 17 March a sufficient number of banks will have agreed to de-link the $600 mn second tranche from the IBRD's Power Sector II loan and re-link it to a series of projects that have already been approved. It has been reported that the IBRD has proposed that the Power Loan be replaced with a series of project loans, but details remain unclear. Political sensitivities have led to a shelving of the debt-equity scheme.

Prospects for 1989 seem bleak. The Plan may lead to a temporary drop in inflation (prices rose "only" 3.6% in February), but fiscal inaction has undermined the credibility of current policies; thus hyper-inflationary pressures have not been effectively addressed and with elections pending the government has its hands tied. These uncertainties and rumours of a new moratorium, have led to a sharp drop in the secondary market price of Brazilian debt.

Mexico

Although the Economic Solidarity Pact expired after a year in December, it has been replaced by a "Pact for Economic Stabilisation and Growth", which will run until July. Its main aim is to reduce inflation to 18% by end-year. It involves a small rise in the minimum wage, increases in some public sector prices and a daily one -

peso depreciation of the exchange rate. The austerity of the original pact led to a decline in inflation - 52% in the 12 months to December (cf 159% in December 1987). (CPI rose only 1.4% in February after 2.4% in January, raising hopes of achieving the 18% goal.) GDP growth slowed to 0.4% and real wages declined further. The government's primary surplus improved from nearly 5% to 8% of GDP as spending cuts and privatisations took effect, although the PSBR remained large at about 11% of GDP, reflecting high interest payments on domestic debt. In 1989 the government hopes to achieve GDP growth of 1.5%. The PSBR is expected to fall to about 6.4% of GDP.

The current account showed a $3 bn deficit in 1988, following a $4 bn surplus in 1987. The swing reflects the sharp decline in the trade surplus from over $8 bn in 1987 to just over $1 bn. Imports rose by 50% in both value and volume terms, partly reflecting liberalisation measures, while export values stagnated, mainly on account of lower oil prices (though non-oil exports rose 17%). Oil exports will be reduced by 5% in Q2 1989 as part of non-OPEC oil countries' effort to raise prices. The sharp real appreciation of the exchange rate and political uncertainty led to large-scale capital outflows in 1988 H2. Much of this, however, has been reversed since the introduction of the new pact.

The Mexicans are pressing for a multi-year debt renegotiation to cut servicing from 6% to 1.7% of GDP and to provide net additional funds of $7 bn annually for the next few years. This year's financing need is put at about $7 bn (but on an assumed oil price of only $10 a barrel). The World Bank may approve loans for $1.3 bn. An SBA for $1.4 bn will probably be sought in order to secure a new agreement with the banks; a CCFF for up to $0.6 bn may also be negotiated to compensate for lower oil prices. A Paris Club MYRA is also being sought with partial interest capitalisation and a change in the cut-off date from 1985 to 1988 (the latter step would kill any chance of new official credits). The banks will be asked to reschedule $12.5 bn of principal due 1989-94 and provide new money or equivalent interest capitalisation or accept a debt reduction scheme. Mexico may well press for some official credit enhancement in order to obtain the banks' participation. The $3.5 bn bridge offered by the US in October has been allowed to lapse: the tough conditionality attached was unacceptable. Slower than desired progress on debt negotiations has led to renewed calls for moratorium among the opposition.

Salinas has moved quickly to assert his authority in an anti-corruption drive, his broad sweep of targets including the leader of the oil workers' union and prominent members of the stock exchange.

A[illegible]ntina

Argentina saw a sharp improvement in its trade balance in 1988 reflecting a combination of higher commodity prices and depressed domestic demand. Real GDP grew only 0.7% (2% in 1987). Exports rose 36% in dollar terms (including a 23% increase in industrial goods - admittedly from a low base) while imports fell 5%. The trade surplus rose from $0.5 bn to $3.1 bn (4.0% of GDP). Despite an increase in interest payments due (arrears have risen sharply) the current deficit fell from $4.2 bn to $2.3 bn. Agricultural output and exports this year will be reduced as a result of the Government's exchange rate policies and a severe drought which has also seriously affected hydroelectric power production.

The introduction of the Primavera Plan in August led to a fall in the monthly inflation rate (nevertheless, the 12-month rate was 343% in December) but confidence in the Plan - now extended to June - is waning as underlying inflationary pressures and inertia have not been tackled. The government's commitment to keep monthly inflation to single figures, not least through soaring interest rates, looks set to fail before the May elections. Shortage of external liquidity (despite the build-up of arrears to the banks and some reflows of flight capital in the second half of last year attracted by higher real interest rates) has accelerated the process of devaluation and exchange rate unification. Central bank intervention in the free market has been suspended and a new multi-tiered system for exports and imports implies an effective devaluation.

To cover 1988-89 financing requirements, Argentina has requested $3.5 bn new money from the banks and a Brazil-style menu. There is strong resistance to new money within the banks' Advisory Committee, which is in any case reluctant to negotiate with a lame-duck government. (The Peronists, who are favourites to win May's election, have threatened a "negotiated moratorium".) Failure to agree fiscal targets with the IMF has stymied progress towards an SBA. Because of the inadequate stance of policies, the IBRD management have decided not to release further tranches of the second Trade Policy Loan or the Banking Sector Loan, controversially approved last October. However, IBRD is to disburse $420 mn in April, partly for housing and development purposes and partly to offset some of the effects of the drought. This amount may include part of the disbursement due for release in 1990. President Alfonisin has acknowledged a de facto halt to debt interest payments, making renewed payment conditional on the granting of fresh credits.

Venezuela

Economic growth was a buoyant 4.2% in 1988, though shortages of basic products have become serious. 12-month inflation fell to 35% in December, but since mid-1988 monthly increases in the index have been rising despite the maintenance of a restrictive monetary policy. The fiscal deficit is estimated to have been 6% of GDP last year, compared with a Fund forecast of 5.6%. The external position has deteriorated sharply. During 1988 total reserves fell $2.8 bn and operating reserves were reported to be only $2 bn at end-year and even lower in January: below $2 bn the banks may call the MYRA in default. The reserve draw-down, short-term borrowing from the BIS, drawing the reserve tranche from the IMF and running up arrears on letters of credit helped cover a BoP gap of over $4 bn. The trade surplus fell to $0.5 bn, (cf $1.7 bn in 1987). The $ value of exports was 3% lower while imports were up 19%.

The new President, Carlos Andres Perez, announced new policy measures in February aiming to rid the economy of distortions, reduce the fiscal deficit and promote an externally oriented development policy. The measures include the planned establishment of a single, flexible exchange rate, higher interest rates, tariff reform, reduction of the fiscal deficit by raising revenues and lowering spending (including a freeze on appointments and higher petrol prices), tax reform and privatisations. To alleviate the impact on the poor, minimum wages and pay scales will be raised, direct subsidies on certain basic foods and a welfare package will also be introduced (financed by the higher petrol prices). The measures may result in a slowdown in activity in 1989-90 and, at least in the short term, an increase in inflationary pressures. A Fund programme is being sought (a request for an SBA and CCFF is likely) and a Letter of Intent is reported to have been signed. The increase in petrol prices and shortages triggered unrest which was suppressed with considerable loss of life, and the government has responded by bringing forward planned wage increases.

A floating unified exchange rate was introduced on 13 March; the free market rate closed at about BS40 = $1 on 10 March. Letters of credit bought after 31 October 1988 will be paid at the free market rate. New money and a rescheduling are being sought. Principal payments on public sector debt were suspended in January (although with the banks' endorsement) while negotiations take place. A grace period of at least 7 years is reportedly being sought as is a reduction in interest

payments to reflect the secondary market discounts. On top of this $5 bn of new money is being requested, with $2 bn from the banks and the rest from IFIs. The possible $0.6 bn loan from banks backed by oil receivables has been turned down; but a $0.6 bn loan backed by future gold sales is also under discussion. In the near-term, bridging finance may have to be provided by banks and some governments to tide Venezuela over: in early March the US Treasury agreed in principle to provide a $450 mn bridging loan and Spain is reportedly ready to provide a further $250 mn. Signs of a toughening stance towards creditors (perhaps to deflect local opinion from the root cause of domestic economic difficulties) have become evident recently with the beginning of a build-up of interest arrears to the banks; a ban on the use of foreign exchange for the servicing of debt owed by private borrowers (some $7 1/2 bn of total long-term debt of $32.7 bn at end-87) also took effect from the beginning of March.

Chile

Real GDP rose nearly 7% last year. Although 12 month inflation fell to 13% in December (cf 22% a year earlier), signs of overheating have prompted a tightening of monetary policy. A fiscal surplus is expected for 1988, reflecting the benefit of higher copper prices and privatisation receipts, but there is the risk of some relaxation ahead of December's elections.

While the dollar value of imports rose 20% last year, exports rose by a third with the trade surplus increasing to $2.2 bn (nearly 11% of GDP). The current account deficit narrowed to $0.2 bn. Debt conversions totalled $2.6 bn but are likely to fall to $1 bn in 1989. The trade surplus narrowed in January to $128.7 mn compared to $195.7 mn in December, despite strengthening of exports from $522.3 mn to $610.9 mn. Political uncertainties ahead of the elections may put a brake on the economy or translate excess liquidity into capital flight (the opposition has threatened to reverse some privatisations). Nevertheless, moderate candidates are likely to be fielded by both right and left.

Colombia

Real GDP rose 4.2% last year (cf 5.4% in 1987). Inflation, at 28%, was up slightly from 1987, reflecting looser monetary policy and tight food supplies. The fiscal deficit was 2.5% of GDP. Total exports were unchanged in $ terms (though oil exports fell 20%, partly through guerrilla attacks), while imports grew by 18% as

t[illegible]e liberalisation and strong industrial growth sucked in intermediate and capital goods. This produced a trade surplus of only $0.3 bn, against $1 bn in 1987. Consequently, the current account recorded a deficit of $1 bn against $0.4 bn in 1987. For 1989 the authorities hope to achieve GDP growth of 4.5%, a fiscal deficit of 2.7% of GDP, reduce inflation to 24% and maintain a current account deficit of $0.6 bn. The process of finalising the $1.7bn 'Challenger' loan has gone somewhat better than expected and commitments for $1.64 bn had been received by 16 March.

Ecuador

The economy grew by 5.6% in 1988, mainly reflecting the recovery of oil production and exports from the low, earthquake-affected levels of 1987. Last August's adjustment programme has still to show any sign of reducing inflation, which rose to 86% in the twelve months to December. The government's aim of a 12-month rate of 30% by August seems unattainable, requiring monthly increases of less than 1% during 1989. The fiscal deficit has been contained, however, and was 9% of GDP in 1988 after running at some 16% at mid-year. The drop reflected the ending of earthquake-related capital expenditure, higher revenues from oil, and the benefit of higher taxes and utility prices. There was a trade surplus of $0.7 bn, against 1987's deficit of $0.1 bn, with a 16% increase in exports and a 25% reduction in imports. Discussions with creditors have made little progress although those with the banks are due to resume soon. The financing gap has been put at $2 bn, with interest arrears of $1 bn, and is expected to be covered by rescheduling and new money in equal amounts. President Borja has stated that no IMF programme is needed as $1 bn will be received from the IADB, but a Fund agreement may be insisted upon by the banks. In December Ecuador's debt was downgraded to "value impaired" by US regulators.

Peru

Real GDP fell 9% last year while 12 month inflation rose to 1700% in December. The government belatedly announced two packages of economic measures in January. The first included a 29% devaluation, a cut in exports taxes, higher prices for petrol and certain foods and a rise in the minimum wage. The second included a further 24% devaluation, the abolition of 6% export tax and more prices and wage increases. The aim is to reduce the fiscal deficit to 2% of GDP in 1989, from 12.4% in 1988. Forward-looking indexation has been introduced until May: no target for inflation

(currently running around 45% per month) has been set but there are guidelines for minimum wages, petrol prices and the exchange rate. Companies are already taking advantage of the limited scope of price controls to raise profit margins and consumers' hoarding has produced severe shortages. Tougher measures continue to be vetoed by Garcia and inflationary expectations have not been dampened.

During 1988 the current account deficit narrowed to $1.6 bn as the trade deficit fell to only $37 mn. Exports rose 2% (strikes offset most of the potential benefits from higher metal prices) and imports fell 12%. The debt service limit of 10% of exports has recently been reconfirmed. Total arrears rose $2.6 bn to nearly $10 bn. The banks' Advisory Committee is reported to be due to meet soon for the first time since 1986. Press reports suggest that Peru is seeking a $1 bn bridging loan from governments. Failure to make a $10.5 mn payment on 6 February pushed Peru's arrears to IADB to over 180 days, so it is ineligible for further loans. Economy Minister Rivas claims, however, that IADB will help arrange a bridging loan of perhaps $100 mn, to be financed by Spain and various Latin American lending agencies, and that Iglesias plans to re-open credit for Peru before the IADB annual meeting.

Italy is to provide $100 mn loan for Lima Electric Train project, repayable at 1.5% over 20 years with 10 years grace. Italy will also provide a grant of $22 mn.

Uruguay

The adjustment process lost momentum in 1988: most of the targets included in the economic programme (monitored by the Fund under an enhanced surveillance arrangement) were missed. GDP growth slowed to 1%, from 5% in 1987 and nearly 7% in 1986. Both labour disputes and capacity constraints were responsible. Inflation increased to 69%, reflecting the impact of drought and a rising public sector deficit. The fiscal deficit rose slightly to 4.5% of GDP, monetary policy was loosened and there was some appreciation of the real exchange rate. Nevertheless, the trade surplus rose to $0.25 bn, from approximate balance in 1987: and the current account was in surplus. Discussions with the World Bank for a SAL of $140 mn are in progress. The authorities also hope to place a yen-denominated bond in the Japanese market.

Bolivia

GDP in 1988 grew by 2.5%, much the same as in 1987. End-year inflation reached 21.5%, almost twice the target. There was a trade surplus of $100 mn, an improvement on 1987's deficit of $190 mn. Imports remained static while exports rose by 17% in dollar terms reflecting higher metal (especially tin and zinc) prices. A current account deficit of around $400 mn-$500 mn (about 11-12% of GNP) is projected for 1988, about the same as in 1987. Although Paris Club debts were negotiated in November, Boliva will remain heavily dependent on rescheduling into the foreseeable future. Following last year's buyback, talks on the remaining bank debt remain stalled.

Costa Rica

Real GDP rose by 4% in 1988, broadly the same as in 1987. The central government recorded a small surplus. The trade deficit for 1988 was about the same as in 1987 ($130 mn). However, inflation has risen rapidly, to 25% in the year to December against 16% in 1987. The government's expectations for 1989 are for growth of 4-5%, a small central government deficit and inflation of only 12%. Discussions with the banks have made little progress since the summer: various debt-reduction options are under consideration, including a debt buy-back. Although the Fund programme was off-track and still had an unfilled financing gap, the World Bank approved a $100 mn SAL2 in December.

Jamaica

Between January and November 1988 Jamaica recorded a current account surplus of $10 mn (compared with a deficit of $123 mn during the same period in 1987) reflecting insurance settlements and other hurricane-related transfers. Exports increased by 6% to $701 mn and imports by 15% to $1290 mn. In February the Fund Board approved a modification to last September's SBA, to take account of the impact of the hurricane; it also granted emergency assistance of SDR 36 mn. Michael Manley's left of centre social democratic party (PNP) won a convincing victory in the General Election held on 9 February, gaining 44 seats to the out-going (conservative) JLP's 16. He has indicated that Q1 performance criteria on public spending might have been breached and that a waiver may be needed. Manley has been making conciliatory approaches to the US administration and the IFIs; he visited Washington from 14-16 March to call on Secretary of State Baker, the IFIs and the banks. Speculation continues in Jamaica on the possibility of a devaluation of the Jamaican dollar.

Panama

In December US regulators declared loans to Panama "value-impaired". US sanctions continue to hamper the economy and GDP declined 20% in 1988. Spin-offs from money laundering may have averted a complete economic collapse.

SUB-SAHARAN AFRICA

Nigeria

Nigeria's request for a 15-month SBA was approved by the IMF Board - but only after the UK took the lead in providing concessional finance and in co-ordinating support from other official creditors.

The programme is designed to encourage the implementation of macroeconomic reforms, including those announced on 1 January in the 1989 Budget. The fiscal deficit for 1989 is now targeted at 8.3% of GDP with domestic financing reduced to about 1.0% of GDP. Net domestic credit is programmed to rise by 9.3% in 1989 (against 27.2% in 1988). Broad money growth is projected to be 11% in 1989 (against 33% in 1988). As regards exchange rate policy, the 1989 Budget introduced a single rate, reflecting market forces, to replace the dual auction and interbank rates. Consequently, the naira has depreciated considerably, but doubts have emerged about whether the new arrangements are consistent with those agreed by the Fund. There have been rumours of Central Bank manipulation and a widening margin between the official and black market rates.

To help close the financing gap (estimated at $9.4 bn for 1989 assuming an average oil price of $14.50) official creditors agreed to a generous rescheduling despite difficult negotiations. This should provide debt relief of about $4.5 bn up to end-April 1990. Signature of the draft agreement between Nigeria and the commerical banks is expected on 22 March following reconciliation of minor difficulties over documentation, and Nigeria's agreement to clear US$60 mn-US$80 mn in interest arrears prior to effectiveness. The potential total debt relief resulting from commercial bank and official sector rescheduling could amount to $8.3 bn in 1989. On top of this, the IMF agreement has opened the way for disbursement of $500 mn from the World Bank. The remaining gap of $600 mn will be filled from a number of official sources including $100 mn from the UK and $200 mn of Japanese co-financing

of the World Bank's Trade and Investment Loan. Latest estimates put the total of firm financing commitments at $542 mn. The balance is likely to be found now that the SBA has been approved, though the Nigerians continue to resist a Fund drawing.

Cote d'Ivoire

Payments to official creditors continue although nothing has been paid to the banks since May 1987. The sale of 400,000 tonnes of cocoa to a French cocoa dealer has brought in vital revenue, although the world market remains depressed. Preliminary figures following routine Article IV consultations suggest a worse position than expected. On 5 March 1989 President Houphouet Boigny issued a written invitation to the IMF to send a team to Cote d'Ivoire to resume talks on Ivorian economic problems, including both completion of Article IV consultations and negotiations on a structural adjustment programme. It is, however, understood that the Ivorians continue to resist any consideration of a reduction in the cocoa producer prices or cuts in public sector salaries as part of a structural adjustment programme. The IMF has not so far indicated when a mission will visit Cote d'Ivorie but it is thought unlikely that this will take place before mid-April at the earliest.

Kenya

Large aid flows and postponed government outlays are likely to have kept the current IMF programmes on track. Two problems prevented agreement on the coversion of the SAF to an ESAF during the end-February Mission. However, the problems are expected to be resolved shortly and the ESAF should come to the Fund board in late April/early May. Monetary policy has been tightened but success in reducing inflation - 12.9% in the year to November (cf a programme target of 7%) - remains uncertain. The parallel exchange rate is currently at a 50-60% discount on the official rate, reflecting large capital outflows.

South Africa

Tighter monetary policy had brought the economy more into equilibrium by 1988 Q4, with the current account surplus running at an annualised rate of some $2 bn, and domestic demand growth moderating somewhat. More recently, however, confidence has been dented by a series of poor economic statistics, including a sharply lower trade surplus for January, a rise in the inflation rate and faster monetary growth. Bank rate was raised by 1 1/2 points to 16%, effective 23 February. Based on preliminary reports the 1989/90 budget, announced on 15 March, was cautious. Government spending is forecast to remain flat in real terms, resulting in a slight reduction in the deficit before borrowing to 4.1% of GDP (cf 4.4% in 1988/89).

Sudan

Economic conditions remain grim following the floods, with both external and fiscal accounts expected to deteriorate in FY 88/89; the current account and fiscal deficits are projected to be $0.9 bn and Sud £3.88 bn respectively. In addition, against a background of increasing political turmoil - an alleged coup attempt and a national strike which prompted the government to repeal recently imposed price rises - major donors have been discussing the possibility of suspending aid to Sudan pending a definitive peace agreement with the rebels in the South. Latest reports indicate that Prime Minister Sadiq el Mahdi is threatening to resign unless the threat of army participation is removed.

Zambia

A greater sense of economic realism may be emerging with an acceptance that go-it-alone policies have not worked. A recent Fund mission has returned moderately encouraged. But enormous problems remain not least that of arrears to the IMF which now amount to over SDR 600 mn.

Zimbabwe

The 1988 budget revealed no fundamental reforms, postponing the policy decisions needed to tackle Zimbabwe's economic problems. However, debate on the economy's direction continues; the "liberals" seem to have gained some ground, and changes in this year's budget should not be ruled out. An IMF programme still seems remote, but the necessary injection of foreign investment, needed to sustain the government's 5% growth target may be realised via a World Bank programme focussed on liberalisation of the considerable battery of controls. The Government are also expected to announce a new investment code this year.

SOUTH AND EAST ASIA

India

India's external position continues to warrant close attention. The trade deficit has widened and the current account deficit in the year to end-March is likely to be significantly greater than the $4.6% (1.8% of GDP) recorded in 1987/88. Foreign exchange reserves fell by over $1.2 bn in the first 10 months of the current fiscal

[illegible]r and (excluding gold) now amount to just over 3 months worth of imports. Unless the trade position shows signs of improvement in the near future, the authorities could decide further to tighten import controls, which could have an adverse impact on growth and inflation. The 1987/8 GDP growth rate has just been revised up again to 3.6% and growth in excess of 9% is forecast for the current fiscal year. The budget in February 1989 attempted to tackle the financial imbalances through record tax increases, administered price rises and no increase in the defence budget.

Indonesia

The latest five year plan envisages average real GDP growth of 5% p/a, a doubling of non-oil export receipts and a decline in the DSR from 36% to 25%. The latest budget is expansionary, being partly predicated on a 50% rise in aid disbursements.

Pakistan

The new administration under Prime Minister Bhutto is to back the IMF programmes agreed in principle last November with the interim government. There are, however, growing doubts that the programme's performance criteria will be met. Remittances (at least those transmitted through offical channels) are down sharply, imports are sharply up in both volume and value, while exports are up in volume but not in value. It seems unlikely that the narrowing of the current account deficit to 3.3% of GDP in FY88/89 (cf 4% in FY87/88) envisaged in the SAF programme will be achieved and the DSR is unlikely to show much improvement on the present level of 30% current account receipts. According to February figures, there has been a further serious fall in reserves.

Philippines

The trade deficit is expected to have widened to around $1.2 bn last year (cf $1 bn in 1987). Talks with the IMF recommenced in January. Agreement on a $1.3 bn EFF and CFF appears to have been reached. President Aquino has approved a letter of intent, but has said that some details are still to be settled. Board approval is being sought in May. The IBRD is to co-ordinate the "mini-Marshall plan" or Philippines Assistance Programme (PAP) with $5-10 bn in aid expected to be pledged.

EASTERN AND SOUTHERN EUROPE

Yugoslavia

Chaos in the domestic economy has yet to spill over into the trade accounts. With inflation soaring way ahead of target, and the resignation of the Mikulic government at the turn of the year, the SBA agreed last June is in abeyance. Fund staff have concluded that consultations on revisions to the SBA cannot be completed until the new government has put together a coherent programme for 1989; both the third and the fourth tranches of the SBA (scheduled for end-November and mid-February) remain undrawn. Although the new Prime Minister Markovic may prove to be more competent and more of a free marketeer than his predeccessor, the Federal government, faced with continuing opposition from the republics, seems as likely to have the same problems as its predecessors in trying to implement the projected reform programme. Foreign debt, though, continues to be serviced fully, and the UK bilateral covering the 15-month Paris Club rescheduling agreement of last June was signed in January.

Poland

Since the start of 1989 arrears of principal and interest to official creditors have begun to accrue and a de facto moratorium is in effect (though payments under the banks' MYRA continue to be honoured regularly). The Paris Club is refusing to consider negotiations on 1989 maturities until the Poles sign the bilaterals due under the multilateral agreement to reschedule 1988 maturities and arrears. Until recently the Poles were pressing (in vain) for further concessions on 1988 debt and new money but they have now signalled that they will sign with the UK in April. Although the new Rakowski government appears to be trying to push ahead more strongly with the faltering reform programme (and "round-table" talks with all interested parties - including Solidarity have led to the promise of democratic constitutional reform) - the Fund SBA sought by the Poles still seems a long way off.

Hungary

Although the SBA remains broadly on track, there have been some slippages in respect of both the current account and, more seriously, the budget deficit; a waiver had therefore to be sought for the latter before the fourth drawing on the SBA could become available in mid-February. Despite Hungary's obvious commitment to reform,

international financial markets still remain cautious: a new National Bank $150 mn loan facility carries a proposed margin of 5/8% throughout, compared to a split 1/2-5/8% last summer.

Romania

Romania continues to reduce its foreign debt apace. In 1988 it repaid or pre-paid an estimated $3.5 bn, leaving only $2.2 bn outstanding at the year-end, thanks to a an apparent convertible currency trade surplus of $4 bn. Payments under the agreement reached with the commercial banks creditor group, whereby all outstanding medium and long-term debt was to be paid off by end-June 1989, have been accelerated, and the debt was all cleared by end-February. Once the pre-payments under the agreement with the IBRD have been completed by (or possibly before) end-June, gross debt should be well under $1 bn.

Bulgaria

Bulgaria is becoming of increasing concern. Gross debt has tripled over the last four years to an estimated $6.8 bn, which is uncomfortably high for a country whose annual visible exports to the West amount to only around $2 bn, or less than 20% of total exports. At the same time reserves have fallen to their lowest level since 1980. Although there are as yet no obvious debt servicing problems, the situation is reminiscent of the late 1970s, when Bulgaria ran into serious difficulties and had to be "bailed out" by the Soviet Union; margins on bank credit lines are known to be hardening.

Greece

The current account deficit in 1988 fell slightly to $1.0 bn (2% of GDP) thanks to higher receipts from tourism which offset a worsening trade deficit. The latter is, however, forecast to widen further this year. At present net non-debt capital inflows remain strong enough to finance the deficit without recourse to new external borrowing. A relaxation of fiscal policy in advance of this year's elections now jeopardises recent progress in reducing inflation.

MIDDLE EAST & NORTH AFRICA

Egypt

GDP growth was estimated at only 2% last year and prospects for 1989 look even bleaker. Inflation, up to 30% in 1988, is set to remain high. Problems with fiscal control persist and the IMF doubt that proposed budgetary measures can reverse the upward trend in the deficit for FY 1988/89. Talks with the IMF remain deadlocked. A Fund mission visited Egypt in January but no agreement is in sight as fundamental differences persist in key policy areas. Talks may resume in March around the time that President Mubarak is expected to tour western capitals lobbying for support for a softening of IMF demands. With the external position continuing to deteriorate, in part because of rising prices of imported food, arrears on official debt repayments due after June 1988 are now mounting, though the amount vulnerable to the Brooke amendment (the triggering of which could terminate Egyptian access to massive amounts of US aid) is relatively modest.

Jordan

Government measures in the face of serious economic problems have been insufficient to resolve the foreign debt problem. ECGD has suspended further cover for Jordan and UK banks are refusing further claims on existing lines of credit. International confidence evaporated, as evidenced by three separate runs on the dinar in recent months and by the withdrawal on 2 February of a planned $150 mn euroloan syndication, in spite of inducements in the form of substantial front-end fees and generous margins. The decision to withdraw became inevitable following the government's request for a 3-month deferment on payments due on an earlier euroloan. In addition, Jordan has missed a Fund repurchase (for a CFF) due in January. The Prime Minister has stated that a rescheduling is necessary and despite official reluctance to approach the IMF, a telex to creditor banks from the Ministry of Finance states that they are now conducting talks with the IMF and World Bank to agree a solution to the debt problem in the context of an IMF/World Bank programme. Jordanians intend not to default on private sector debt.

Against this background, the prospects for completion of the Tornado deal without the provision of additional government guarantees have been seriously undermined. The UK banks lead-managing the unguaranteed UK portion (Lloyds and Morgan Grenfell) feel unable to launch syndication in the current climate and there is concern about the continued official commitment of the Germans and Italians.

Iraq

With oil prices still weak, the proceeds of Neutral Zone production (worth around $1.5 bn pa at current prices) no longer available, and a repayment hump in 1989/90, Iraq faces a significant financing gap this year. Western banks are beginning to make it clear that they are unwilling to provide medium and long-term credits for reconstruction. However, the Iraqis seem to be meeting with some success in efforts to raise a $500 mn Club loan from relationship banks in Europe. Nevertheless, Iraq is likely to remain dependent upon trade credits and bilateral rescheduling, together with support from the Arab world (there are suggestions that Kuwait might finance a facility to buy out Arab trade creditors whose claims may amount to nearly $7 bn). ECAs remain wary of the market, and many are willing to provide new cover only in return for payments on debt outstanding.

Algeria

Latest data issued by the OECD put external debt at $26.7 bn at end 1987 (possibly excluding military debt of around $3 bn). Debt service obligations continue to represent a burden on the economy; interest payments are projected to increase to $1.7 bn in 1989 and total debt service to an estimated $5.9 bn, reflecting the maturing of medium-term debt. Unless a substantial recovery in oil/gas prices occurs, the debt service ratio is also likely to rise (from a reported 64% last year). The recent elections have provided President Chadli with a positive mandate for political reforms although some doubt exists as to whether these can be adequate compensation for existing austerity and new measures which may need to be introduced. Although no formal approach has been made, the authorities have made technical enquiries about IMF credit facilities and further discussions are expected to take place with the Article IV mission currently in Algiers.

Morocco

The SBA is in trouble with drawings having been suspended. There had been doubts over the authorities' ability to achieve a target for the fiscal deficit of 3.2% of GDP. The Moroccans have demanded a comprehensive rescheduling of 1989-92 maturities of commercial bank claims over 20 years with 10 grace at a fixed interest rate of 6%. Such terms were turned down flat and in response a suspension of interest payments was threatened. Nevertheless, interest payments due on 9 March were paid. Although the authorities have not yet approached the Banks' Steering Committee to re-open negotiations on the reschedulings, they are expected to do so.

Om[illegible]

The recently announced budget for 1989 projects a large rise in the fiscal deficit from [OR 252 mn ($654.5 mn) to OR 409 mn ($1062 mn)] reflecting a fall in expected revenues. The budget is, however, conservatively based on an oil price of $12.50 pb (around $2 pb below the current levels). The authorities remain confident that they will be able to finance the deficit through drawings on reserves (perhaps including the State General Reserve Fund, whose avowed purpose was to build up capital to provide income when oil revenues declined) and borrowing in the international markets (there are reports of a $500 mn loan being sought.)

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RECENT SOVEREIGN BORROWING BY LDCS

Date Announced	Borrower	Amount (mn)	Maturity/ Grace (years)	Spread or Fixed rate (%)
BANK BORROWING				
Africa				
10/2	Algeria - Air Algerie	$27	5/1	3/4
	Algeria - Air Algerie	$56	12	3/4
26/10	Tanzania - National Bank of Commerce	$40	1	1 3/8
25/11	Zimbabwe - Agricultural Marketing Authority	$45	1	7/8
Asia				
22/10	India - Bharat Heavy Industries	$50	10/5	0
		$50	10/3.5	1/4
19/11	India - IFCI	Y20	7	1/4
21/11	India - Air India	$115	12	0
4/2	India - Air India	$250	15/1.5	0
29/10	Indonesia	Yen 40	8/5	1/2
		Yen 40	8/5	5/8
19/11	Korea	$169	3.5	0
	Korea - Korean Airlines	$56.9	7.5/0.5	0
13/1	Taiwan - Bank of Communications	$2/1	5	1/2
Latin America				
10/2	Colombia	$175	8/5	1 1/2
Communist				
2/12	Bulgaria - Foreign Trade Bank	Sch 500	7	3/8
	China - Peoples Construction Bank	$128	10	0
5/1	China - Bank of China	$28.6	13.5/3.5	5/8
9/1	China - Bank of China	DM 200.1	15	6 3/4
		DM 107.9	15	6 3/4
		$23	10	0.062
		DM 54.3	10	0.062
6/1	China - Hainan Province	$24	10	3/4
		$24	10	1
25/2	Hungary - National Bank	$150	8/5	5/8
28/1	Poland - Lot Airlines	$160	12	1
Middle East				
25/11	Egypt - Airline	$600	10	1 1/8

Date Announced	Borrower	Amount (mn)	Maturity/ Grace (years)	Spread or Fixed rate (%)
BONDS				
Africa				
8/10	Algeria - Banque Exterieure d'Algerie	Yen 10	5	6 3/5
30/11	South Africa	SFR 55	3	7
17/1	South Africa	SFR 70	3	7
Asia				
5/11	India - Oil and Natural Gas Commission	$125	5	9 3/4
8/10	Indonesia	DM 300	5	6 3/8
Latin America				
17/12	Venezuela	$166	6	1 1/8
		$167	10	1 1/8
		$167	15	1 1/8
10/1	Venezuela	$262.7	6	1 1/4
Communist				
14/1	Hungary - National Bank	DM 200	7	6 5/8

OVERDUE OBLIGATIONS TO THE FUND (1) AS AT 27. 2.89

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding (SDR mn)	Forthcoming Obligations (to 1999)
KAMPUCHEA	13 March 1975	33.2	16.7
GUYANA	31 May 1983	88.7	29.9
VIET NAM	6 February 1984	101.3	70.5
SUDAN	12 July 1984	733.5	182.9
LIBERIA	14 March 1985	249.6	74.6
PERU	9 December 1985	537.6	303.2
ZAMBIA	6 June 1986	608.6	326.4
SIERRA LEONE	13 February 1987	55.0	55.9
SOMALIA	2 July 1987	61.9	97.1
PANAMA	28 December 1987	103.5	213.5
ZAIRE	29 June 1988	100.2	619.1
HAITI	28 October 1988	6.7	43.2
HONDURAS	14 November 1988	3.8	31.7*
		2,683.6	2,064.7

(1) Includes both overdue repurchases and charges of members with at least one obligation overdue for more than one month.

NB The above figures are from Fund papers issued with respect to individual country complaints and the six-monthly, "Overdue Financial Obligations" report. There will have been further obligations falling due subsequently, so the figures are not entirely up-to-date.

* Honduran forthcoming obligations are only assessed to 1993.

International Development Association

Summary of Overdue Service Payments as of 3/03/89

($US Millions)

	Days Overdue 30-60	61-75	76-90	91-180	Over 180	Total
Total of which	6.7	1.4	0.3	2.2	13.1	23.7
A : Countries with Overdue Service Payments	6.5	1.3	0.1	0.2	0.0	8.1
AFGHANISTAN	0.0	0.0	0.1	0.0	0.0	0.1
BENIN	0.2	0.0	0.0	0.0	0.0	0.2
BURKINA FASO	0.1	0.0	0.0	0.0	0.0	0.1
COMOROS	0.1	0.0	0.0	0.0	0.0	0.1
GAMBIA, THE	0.1	0.0	0.0	0.0	0.0	0.1
GUINEA	0.0	0.0	0.0	0.1	0.0	0.1
HAITI	0.1	0.0	0.0	0.0	0.0	0.1
* HONDURAS	0.0	0.0	0.0	0.1	0.0	0.1
JORDAN	0.1	0.0	0.0	0.0	0.0	0.1
KENYA	0.1	0.0	0.0	0.0	0.0	0.1
NIGER	0.8	0.0	0.0	0.0	0.0	0.8
SENEGAL	0.8	0.2	0.0	0.0	0.0	1.0
SOMALIA	0.1	0.0	0.0	0.0	0.0	0.1
SUDAN	1.9	0.6	0.0	0.0	0.0	2.5
TANZANIA	0.8	0.0	0.0	0.0	0.0	0.8
TURKEY	0.5	0.0	0.0	0.0	0.0	0.5
UGANDA	0.5	0.0	0.0	0.0	0.0	0.5
VIET NAM	0.0	0.5	0.0	0.0	0.0	0.5
ZAIRE	0.3	0.0	0.0	0.0	0.0	0.3
B : Countries in IDA Non-Accrual Status	0.2	0.1	0.2	2.0	13.1	15.6
* LIBERIA	0.0	0.1	0.1	0.4	2.2	2.8
* NICARAGUA	0.0	0.0	0.0	0.3	3.3	3.6
* SIERRA LEONE	0.0	0.0	0.0	0.4	1.8	2.2
* SYRIAN ARAB REPUBLIC	0.1	0.0	0.0	0.4	2.1	2.6
* ZAMBIA	0.1	0.0	0.1	0.5	3.7	4.4

*: Disbursements suspended

Cashier's Department

International Bank for Reconstruction and Development

Summary of Overdue Service Payments as of 3/03/89

($US Millions)

	Days Overdue					
	30-60	61-75	76-90	91-180	Over 180	Total
Total	165.7	41.8	18.6	121.7	909.9	1257.7
of which						
A : Countries with Overdue Service Payments	120.3	15.1	1.0	20.7	0.0	157.1
BOLIVIA	1.0	0.0	0.0	0.0	0.0	1.0
BRAZIL	13.2	0.0	0.0	0.0	0.0	13.2
CAMEROON	2.8	0.0	0.0	0.0	0.0	2.8
COSTA RICA	2.7	0.0	0.0	0.0	0.0	2.7
DOMINICAN REPUBLIC	6.6	1.9	0.0	0.0	0.0	8.5
EGYPT, ARAB REPUBLIC OF	1.2	0.0	0.0	0.0	0.0	1.2
EL SALVADOR	2.6	0.0	0.0	0.0	0.0	2.6
* HONDURAS	7.6	4.9	0.5	20.7	0.0	33.7
JAMAICA	11.7	0.0	0.0	0.0	0.0	11.7
JORDAN	4.6	3.6	0.0	0.0	0.0	8.2
KENYA	2.2	0.8	0.0	0.0	0.0	3.0
NIGERIA	36.2	0.0	0.0	0.0	0.0	36.2
PARAGUAY	2.2	0.0	0.0	0.0	0.0	2.2
SENEGAL	2.0	0.0	0.0	0.0	0.0	2.0
SUDAN	0.7	2.2	0.0	0.0	0.0	2.9
TANZANIA	6.4	1.4	0.0	0.0	0.0	7.8
TURKEY	8.2	0.0	0.0	0.0	0.0	8.2
YUGOSLAVIA	5.6	0.0	0.0	0.0	0.0	5.6
B : Countries in IBRD Non-Accrual Status	45.4	26.7	17.6	101.0	909.9	1100.6
* GUYANA	0.3	0.0	1.5	5.0	29.3	36.1
* LIBERIA	1.1	1.7	3.3	3.9	44.3	54.3
* NICARAGUA	2.6	0.0	1.1	11.0	126.1	141.8
* PANAMA	0.1	2.0	1.6	21.6	75.3	100.6
* PERU	19.8	9.5	8.0	39.9	367.8	445.0
* SIERRA LEONE	0.0	0.0	0.0	0.3	3.9	4.2
* SYRIAN ARAB REPUBLIC	5.1	13.0	0.0	5.7	143.4	167.2
* ZAMBIA	16.4	0.5	2.1	13.6	119.8	152.4

*: Disbursements suspended

Cashier's Department

INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1987	End-June 1988	End-March 1987 [2]	End-March 1987 [3]
Latin America				
Argentina	58	3.4(0.1)	0.2	0.2
Brazil	121	6.2(0.7)	1.0	1.9
Chile	20	1.0(0.0)	-	0.1
Colombia	17	0.5(0.1)	0.1	0.1
Costa Rica	4	0.1(0.0)	-	-
Ecuador	10	0.6(0.0)	0.1	0.1
Jamaica	4	0.2(0.0)	-	-
Mexico	107	6.0(0.1)	0.7	1.3
Peru	17	0.3(0.0)	0.1	0.2
Uruguay	5	0.3(0.0)	-	-
Venezuela	35	2.1(0.1)	-	-
Far East and Australasia				
Indonesia	46	0.6(0.3)	0.9	1.8
Pakistan	19	0.2(0.1)	0.1	0.1
Philippines	29	1.3(0.0)	0.1	0.2
Eastern Europe (convertible currency)				
Bulgaria	6	0.2(0.1)	-	0.1
Hungary	18	0.3(0.0)	-	0.1
Poland	39	0.7(0.0)	1.3	1.4
Romania	6	0.1(0.0)	0.3	0.4
Yugoslavia	20	0.8(0.1)	0.7	0.9

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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 countries amounted to $56 mn at end-June 1988.

[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.

INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1987	End-June 1988	End-March 1987 [2]	End-March 1987 [3]
Europe				
Greece	21	1.3(0.4)	0.1	0.3
Turkey	38	0.4(0.1)	0.2	0.6
Sub-Saharan Africa				
Cote d'Ivoire	12	0.3(0.0)	0.1	0.1
Kenya	6	0.1(0.0)	0.2	0.5
Nigeria	28	1.3(0.1)	2.5	3.5
South Africa	23	3.7(0.6)	0.9	2.5
Sudan	12	0.0(0.0)	0.2	0.2
Zambia	6	0.2(0.1)	0.2	0.2
Zimbabwe	3	0.3(0.2)	0.2	0.3
Middle East and North Africa				
Algeria	27	0.4(0.1)	0.2	0.4
Egypt	50	0.2(0.1)	0.3	1.3
Iraq	65[4]	0.1(0.1)	0.6	1.6
Jordan	5[5]	0.2(0.0)	0.1	0.7
Morocco	21	0.2(0.0)	0.2	0.3
Oman	4	0.1(0.1)	0.7	1.9
Saudi Arabia	18[6]	0.7(0.2)	0.2	0.3

[4] Includes $30 bn from Arab countries.

[5] End-December 1986 estimate which excludes sizeable military debt. More recent estimates put the figure at $6.5 bn (again probably excluding military debt).

[6] External bank and guaranteed trade debt at end-December 1987.

BILATERAL NEGOTIATIONS \ AGREEMENTS CURRENT POSITION AS AT 1 MARCH 1989

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
ANGOLA I	Not applicable		17.11.87	04.12.87 (London)	04.12.87		Final version of the Portuguese translation of the text returned to Luanda by FCO 24\2.
ARGENTINA I	16.01.85	30.06.85	23.04.85	15.05.85 + 29\31.01.86+ 25.10.88	28.08.87	16.02.89	Exchange of Notes concluded.
ARGENTINA II	20.05.87	31.12.87	19.10.88 + 23.12.88	25.10.88 (Paris)			FCO and our solicitor have commented on Argentine proposed amendments to text. Reply to Argentina sent 2\3. Four countries, including UK, have yet to initial Agreements.
BOLIVIA II	14.11.88	30.04.89	03.02.89	16.03.89 (provisional)			Draft texts and Debt List sent to La Paz 3\2. We have proposed conclusion by correspondence with 16&17\3 set aside for meeting if needed.
BRAZIL III	29.07.88	31.03.89	27.10.88	20.03.89. (Brasilia)			Negotiations arranged for w\c 20\3 in Brasilia.
C.A.R. IV	14.12.88	31.05.89		By correspondence			Draft text now cleared. Telex reply sent to Caisse Autonome 10\2 suggesting negotiations be concluded by correspondence.
JAMAICA IV	24.10.88	30.04.89	11.01.89	By correspondence			Draft text forwarded to Jamaica 11\1. We have proposed concluding by correspondence. Post chased 1\3.
MADAGASCAR VI	28.10.88	31.08.89		To be arranged			Draft text cleared. Awaiting CDA input to cater for interest rate subvention.
MALAWI III	22.04.88	31.12.88	11.07.88	By correspondence	07.12.88		Agreement initialled. Formal Exchange of Notes despatched by Bag 20\12.
MALI I	27.10.88	31.07.89	16.01.89 + 26.01.89	17.01.89			Telex sent to Caisse Autonome 16\2 explaining that an extra clause will need to be added to to the text to account for CDA involvement.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
MAURITANIA II	16.05.86	31.12.86	14.07.86	28.11.86 (London)	28.11.86		Cabled Post 18\11 asking them to explain that telex received from Mauritanians does not constitute signature.
MAURITANIA III	15.06.87	29.02.88	08.01.88	By correspondence	03.03.88		FCO despatched Exchange of Notes 4\5. Cable to Dakar 18\11 also asks to chase progress of this Agreement.No positive development since.
MOROCCO IV	26.10.88	31.08.89	24.02.89	To be arranged			Draft text despatched to Rabat 24\2. We have suggested conclusion by correspondence.
MOZAMBIQUE II	16.06.87	30.09.88 (originally 30.06.88)	31.12.87	11.01.88 + 19.04.88 (London)			Cable from Post 17\2 suggests that MoF is now prepared to accept a moratorium interest rate of Libor + 0.5%.
NIGER VI	16.12.88	30.06.89		By correspondence			Draft text with FCO for clearance 27\2.Our telex to MoF 24\2 suggests conclusion by correspondence.
NIGERIA II	03.03.89	30.09.89					Draft text being prepared.
POLAND IV	16.12.87	31.05.88	04.02.88	9\10.03.88 (Warsaw)+ 6\7.04.89 (London)			Offer left with Poles after earlier negotiations was rejected by them. Nevertheless they now seem keen to reopen talks. Cable 3\3 from Warsaw suggests dates of 6&7\4 in London . Bilaterals initialled 2 out of 17.
SENEGAL VI	24.01.89	30.06.89		By correspondence			Draft text sent to FCO and our lawyer for clearance 2\3.
SIERRA LEONE IV	19.11.86	30.04.87	23.03.87	26.03.87 (London)	26.03.87		Despite numerous reminders from the High Commission there has been no progress at all in reaching a formal signature. FCO last contacted Post 17\1.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
SUDAN IV	03.05.84	28.02.85	24.07.85	08.08.85 (London)	08.08.85		Formal signature still outstanding. Li[illegible] action taken to pursue due to increasing arrears under previous Agreements and Sudan's position in relation to IMF.FCO have promised to ask Post to find out whether there is any possibility of this Agreement being signed 16\2.
TANZANIA II	13.12.88	31.05.89		To be arranged			Draft text with FCO for clearance 27\2.
TOGO VI	22.03.88	31.10.88	08.07.88	9\10.08.88 +18.10.88 (London)	18.10.88		Exchange of Notes forwarded to Post 14\11. FCO sent reminder 19\1.Cummins (FCO) to raise the need for formal signature during his visit to the Post.
TRINIDAD I	25.01.89	31.07.89					Draft text sent to FCO and our lawyer for clearance 2\3.
UGANDA IV	26.01.89	30.09.89		To be arranged			Draft text sent to FCO and our lawyer for clearance 2\3.
ZAIRE VII	15.05.86	31.12.86	16.06.86	07.07.86 (London)	07.07.86		Delays on part of Zaire to arrange conclusion of Agreement. See below.
ZAIRE VIII	18.05.87	31.12.87	30.09.87	06.10.87 (London)	07.10.87		Need for formal signature raised with Kathima bin Ramazini,Secretary General of the National Party, by Mrs. Chalker in London 15\12. He promised to look into the matter and on his return the Post presented a dossier to him on this. No progress has been made despite a further chaser by the Post 23\2.

BILATPS.RET

222 8141

Confidential

Mr. Gray,

Brady's Proposals for Third World Debt

Brady's plan for the third world debt is becoming clear in principle if not yet specific in terms of burdens and benefits. In essence, it converts LDC government debt to Western commerical banks into debt guaranteed by Western governments with either lower interest or forgiveness of principal or some combination of the two. The sharing of the burden of forgiveness has yet to be settled, but undoubtedly the banks will be required to shoulder much of the loss while the remainder is loaded onto the Western taxpayers.

At a stroke this will nationalise most international capital movements, with contingent burdens on governments, or their surrogates in the IMF and World Bank. It is most unlikely that any commercial bank or any other major lender will supply any new money at market rates except in so far as he receives a government underwriting of both interest and principal. The borrowers will claim that (a) they need and can usefully employ new money (they can), and (b) the banks will supply it at reasonable interest rates only if they get government (IMF or Bank) guarantees (true). I believe that then we are only one step away from Harold Lever's grand scheme for government control of all capital movements.

This is a shame. The Baker "plan", for all its vagueness and wishful thinking, was working. Debt as a fraction of GNP has declined in many countries and the marketing of debt, together with debt/equity swops, was easing the situation for both lenders and borrowers. Some countries which had adopted appropriate policies (e.g. Korea and Chile) have reduced the dollar value of their debt and are out of the wood. Others (Argentina is the most obvious culprit) have continued business as usual, firm in the belief that they would be relieved by the commercial banks and taxpayers. The Brady plan will clearly discourage government taking the hard decisions of reform.

The political problem is contained in the various threats, as in Venuzuela recently and simering always in Mexico, of social unrest and political turmoil. It may well be considered wise politically to give Mexico and Venuzuela some financial relief. But it would be much better to do this with straightforward cash subsidies, honestly recorded by the western governments as public expenditures, rather than the Brady measures which will distort and discourage capital markets for a long time ahead, and will contain contigent liabilities on Western taxpayers of unknown extent and timing.

I do not know how far we ar committed to Brady's (really Mulford's) plan. When I talked to the Chancellor just after the budget, I did sketch out some of my fears. As more of Brady is revealed, however, these fears have been confirmed and heightened.

AAW Washington 27 March 1989

ECON POL Indebtedness Pt 7

CONFIDENTIAL

SUBJECT
cc MASTER

FILE

MR MARKS

cc BS

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

13 March 1989

PRIME MINISTER'S MEETING WITH MR. ALAN GREENSPAN

The Prime Minister entertained Mr. Alan Greenspan to lunch at Chequers on Saturday 11 March. Also present were the Governor, Sir Peter Middleton, Mr. Nigel Wicks and Professor Brian Griffiths.

Discussion over lunch was in fairly general terms. After lunch there was about one and a half hours discussion, ranging over six main issues.

Data Problems

The Prime Minister commented on the difficulties for the conduct of UK economic policy arising from the large uncertainties and residual errors in our current statistics. She wondered whether similar difficulties were being encountered in the United States.

Mr. Greenspan responded that there were some difficulties of this sort, although he thought they were not as serious as in the United Kingdom. Problems in the National Income statistics arose from the common phenomenon in both countries of substantial equity withdrawals by houseowners. This has been a major factor behind the observed reduction in the personal savings ratio.

There were also shared difficulties in the two countries in the measurement of balance of payments flows. Indeed this was a universal problem given that when the estimated figures for all countries were put together, the implication was of a large world balance of payments deficit. Greenspan speculated that a substantial element of the flows not captured by the statistics related to US investment income.

CONFIDENTIAL

United States Budget Deficit

Greenspan said that, as long as overseas investors continued to have confidence in the US economy, it was difficult to argue publicly that the US deficit constituted a serious problem. But it was essential to tackle the deficit, because if no efforts were made to reduce it the likelihood was that it would grow; this would arise, for example, from a similar percentage growth in expenditure and revenue. It was also important to avoid complacency on the grounds that the states were running large surpluses; this resulted from essentially private pension funds which were not properly scored in assessing the budget deficit position.

Greenspan expressed cautious confidence that action would be taken to reduce the deficit. He was encouraged by the fact that Darman was keen to proceed on a multi-year planning process, with analysis of fiscal year 1991 getting under way quickly after completion of the exercise for fiscal year 1990. It was important however for efforts to settle the budget by agreement to succeed because of weaknesses in the Gramm-Rudman-Hollings (GRH) procedure; a key point was that the GRH process was triggered by forecast figures rather than outturns. The Prime Minister commented that another reason for seeking to avoid the GRH process was that the sequestration arrangements were likely to lead to the defence programme being sacrificed for the welfare programme.

Greenspan said that proceeding along the GRH path also gave difficulties to Congress. Congress was required by the GRH rules to come up with its own budget proposals in the Spring. But they faced a dilemma; Congress had hitherto being arguing that the economic assumptions in the OMB proposals were too optimistic, but if they now came forward with less optimistic assumptions that would make it more difficult still to produce acceptable budget figures. It was probably in Congress's interests not to confront this problem, which led Greenspan to conclude there was a reasonable chance of an early budget agreement. But he would not rate the chances on this at higher than 55 per cent. Whether or not an agreement was achieved, the key thing for the Administration was to keep tight control over the variable that could be controlled, namely public spending. The most dangerous trap was to seek to square the books by a reliance on over-optimistic forecasts of revenue. He was also cautiously optimistic that Congress would not try to escape from the dilemma by raising the GRH baseline; such an action would be perceived as unacceptably anti-inflationary.

Savings and Loans Associations

The Prime Minister said that she had been concerned by reports of the off balance sheet proposals for dealing with the Savings and Loans crisis. This seemed to carry a serious danger of perpetuating arrangements where, because

all deposits were guaranteed, those responsible for managing [illegible]m had no incentive to conduct business prudently.

Greenspan said the position was not as bad as it seemed. The fact was that there was a major problem to deal with, and the correct solution was to find some means of writing off the whole of the problem now and funding it. Doing this in the budget in a straight forward way had been contemplated but it had been ruled out because the necessary derogation from GRH would have meant that whole process was undermined. That danger had been avoided. The off-budget solution adopted was unorthodox, but had been constructed in a way that it could not be adopted in any other case; to put it crudely it was a ring fenced fiddle. At the same time he thought the whole process had been enough of a shock to avoid giving an incentive to every Savings and Loans to be irresponsible. And a further part of the solution was to carry out a full scale review of the whole system. The aim in that process should be to rule out the possibility of "reverse incentives"; new legislation might be introduced, for example requiring more long term borrowing on Savings and Loans balance sheets.

German and Japanese Structural Surpluses

There was lengthy discussion of the problems presented for the world economy by the German, and particularly the Japanese, large structural balance of payments surpluses. It was suggested that a distinction needed to be drawn between protectionist tendencies that were directly government initiated and those that arose from inbuilt cultural effects. The major need was to tackle the latter, but this was a particular intractable problem. The upshot of the discussion was an agreement that everyone recognised the scale of the problem and the need to tackle it; but that no satisfactory solution, or set of solutions, had yet emerged.

Third World Debt

Greenspan was asked whether the statement the previous day by Treasury Secretary Brady should be interpreted as a significant change in the Administration's approach to the Third World debt problem. Greenspan responded that there had been no radical change, but that what Brady was seeking to describe was the process of evolution in US thinking. This started from the premise that there would be no debt problem if the debtor countries were in a position to adopt "reasonable" or "appropriate" economic policies. But it was not politically realistic to expect these countries to have real interest rates and budget surpluses at the level necessary to attract inflows of capital automatically to correct their problems. Against that background it was necessary for the creditor countries to recognise the need for some form of support programme; the aim should be a mechanism that was temporary and weaned the governments back to orderly debt payments. Such support was necessary notwithstanding the fact that the number of US commercial banks who were seriously exposed to Third World debt

problems had come down from about twenty in 1982 to four [illegible].

In discussion it was suggested that the process that Brady had been describing would be dangerous if it led the debtor countries to perceive that their problems could be solved politically in the United States. It would be pointless to have a system of help for the debtor countries if this had the effect of encouraging them to behave just as they have had in the past. Greenspan acknowledged these problems, but said there was no simple way to resolve the fundamental dilemma. It was also suggested that the difficulty was exacerbated by the reluctance of governments in various of the key debtor countries to give up public control over their para-statal industries.

United States Domestic Economy

Greenspan suggested that the course of the US domestic economy was progressing as well as could be expected. Growth was staying surprisingly stable, and there had been only very limited involuntary inventory accumulations; interest rate increases had so far had only a limited impact in slowing the economy down. Although interest rates could have a powerful macro-economic effect, this was less strong in the United States than the United Kingdom because much less of the United States domestic mortgage borrowing was on variable interest rate terms.

Greenspan said that the Fed had been doing some research on the recent trend of monetary relationships. They had been encouraged by the discovery of a more stable M2 velocity relationship in the recent past. The implication was to increase confidence that a tight monetary policy would succeed in bringing down inflation. At the same time Greenspan said there were difficulties in focussing on M0 as a monetary indicator, given that roughly a half of the currency measured in M0 was held overseas.

I am copying this letter to Alex Allan (HM Treasury).

PAUL GRAY

J. Footman, Esq.,
Bank of England

PA Prime Minister
You may like to draw on this for tomorrow's lunch discussion.
PRG 10/3

PRIME MINISTER

10 March 1989

LUNCH WITH ALAN GREENSPAN

I enclose Twenty Questions for Alan Greenspan as well as an article by Rimmer de Viries which is excellent.

Brian Griffiths

BRIAN GRIFFITHS

PRIME MINISTER 10 March 1989

MEETING WITH ALAN GREENSPAN

TWENTY QUESTIONS

Budget Deficit

1 The Administration predicts growth for next year of 3-3½%: the Fed between 2-2½%. Why the difference in growth rates?

2 How much is the 1990/91 deficit likely to be in excess of the Gramm-Rudman targets?

3 If the overshoot next year is substantial, how much will be reduced by:

(a) cutting expenditure

(b) raising taxes

(c) raising the Gramm-Rudman-Hollings baseline itself?

4 President Bush has said he will not cut defence in real terms this year and allow it to grow a little in future years. If he wished to cut welfare expenditure, how could the idea of a "kinder, gentler society" continue to have credibility?

5 A number of economists/commentators in the US seem to believe the deficit is no longer a problem. How widely shared is this view?

6 What is the gearing (debt/equity rates) of the USA as a whole? Despite the high budget deficit and trade deficit,

this may still be very conservative (below 20%)? and would, therefore, account for why people still regard the dollar as secure.

Monetary Policy

7 Higher interest rates are necessary to control monetary growth and inflation. But with US rates at present levels is there a risk of recession?

8 How much pressure will the Adminstration bring on the Fed to take risks with inflation?

Exchange Rates and the Trade Deficit

9 In the UK we are presently paying the price for massive intervention in the foreign exchange markets in 1987-1988. Is it likely that the Administration will again actively canvass greater exchange rate intervention?

10 Can there be a significant reduction in the trade deficit without a further significant devaluation of the dollar?

11 What is most likely to put the dollar under pressure in the next year?

12 What factors are likely to trigger protectionism in the US?

13 Inward investment into the US has been strong, particularly from the UK. Will this confidence be sustained?

Savings & Loans Crisis

14 What is the dimension of the problem?

15 How serious is it for public expenditure?

16 How much does it complicate monetary policy?

17 Are there likely to be knock-on effects in the way the US regulate financial institutions?

Third World Debt

18 What is the assessment of the debt problem? Most of the financing is falling on governments (through international institutions) and the countries themselves are not sticking to IMF guidelines. (Venezuela - recent troubles with 300-500 dead, Brazil election of centre left/left President etc).

Where is the debt problem likely to go from here?

19 How would he assess the strength of US banks' balance sheets?

20 What are the possibilities for linking conservation of third world forests to debt forgiveness?

Brian Griffiths

BRIAN GRIFFITHS

One of the questions the international financial community is asking is: "What economic policy is beginning to emerge under the Bush Administration?" Specifically, "What is the outlook for budget, monetary and foreign exchange policies?" Obviously, judgments and perceptions still have to be very tentative at this stage. Nevertheless, while there is a lot of talk about the necessity of reducing the budget and trade deficits, the Bush Administration does not have a comprehensive program to deal forcefully, head-on with these deficits. Based on what we know to date, the deficits will be reduced only gradually, on a trend-like basis. Another conclusion is that the new government does not favor cutting the trade deficit through a significant change in the value of the dollar along the lines of the recommendations of many Harvard and MIT professors, such as Martin Feldstein and Rudiger Dornbusch, but rather gradually through a variety of policies. It remains an open question whether the realities of the financial markets will force in due course the authorities to adopt a tougher approach to narrow the deficits.

President Bush's economic policy is wrapped up mainly in his budget policy. The Bush economic team regards budget reduction as the Number 1 economic priority. It sees reduction as a means to an end of which increased investment in productivity and competitiveness and the rising standard of living is the goal. It is thoroughly convinced that the national savings rate has to be raised and that the best way to do this is by cutting the budget deficit by slowing the growth in government spending. Its budget policy is based on the concept of a "flexible freeze." According to this concept the budget deficit--which has been around $150 billion--can be eliminated over time without a tax increase and without reducing social security by holding the growth in the non-interest, non-social security portions of the budget to the rate of inflation. This portion of the budget includes defense, international programs (foreign affairs, aid, etc.), all entitlement programs other than social security (e.g., medicare, which is a rapidly growing health insurance program for all elderly persons) and hundreds of domestic programs, many of which subsidize significantly various industries. In order to keep the growth of total expenditures to the rate

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Bush Economic Policies: Rendez-vous with reality?

Article by

Rimmer de Vries

Chief Economist
Morgan Guaranty Trust Company

in
Nihon Keizai Shimbun
(Japan Economic Journal)

February 15, 1989

of inflation, some programs could grow at rates higher than inflation, as long as the growth in other programs are held below the inflation rate.

Tax increases are rejected because the current federal tax level is about 19 1/2% of GNP and is not low by historical standards. In fact, since World War II the level has been above this only during 1969 (the Vietnam war), 1981 (when taxes were widely felt to be too high and in the process of being reduced), and 1982 (recession). Despite the Reagan marginal tax rate cuts, the average tax burden has not fallen. It has merely stabilized and would have gone up significantly in the absence of the Reagan tax cuts. Tax increases generally lead to higher spending. Thus, there is no widespread bipartisan support for raising taxes and if they have to be raised at all, it will be for reasons other than to eliminate the budget deficit (e.g., the gasoline tax may have to be raised to conserve fuel, rebuild highways and bridges, or improve mass transportation).

Government expenditures are divided in three major categories: social security, interest and all other payments . Social security poses no problem for the rest of the century as social security tax revenues are rising significantly faster than payments, partly because of demographic reasons. As a result, the social security surplus is growing strongly each year contributing to overall deficit reduction. The same is true for other trust funds. All these funds together now have an annual surplus of about $130 billion. Therefore, the speed with which the government's budget strategy succeeds depends on the real rate of economic growth, the course of interest rates, and whether all other expenditures combined will be frozen in real terms. Simple arithmetic shows that if the economy grows 2%-3% per year in real terms, interest rates decline from their present rather high levels, the social security surplus keeps rising and all other expenditures are frozen in real terms, the budget deficit will shrink and be wiped out in a matter of a few years.

As regards government spending for 1990, the Bush Administration has released only a few details. Importantly, it proposes to freeze defense spending in real terms next

year but the President has indicated he still favors small real defense increases in later years. The President has increased spending modestly here and there, mostly for research and development, education and some urgent social programs. The growth in all other programs therefore has to be trimmed in real terms. However, the President has left it to the Congress to decide in its negotiations with his Budget Director how these real cuts (which still could amount to nominal increases) have to be spread over the various programs.

This is a very shrewd and clever procedure. It underscores the current political realities of a divided government whereby both parties, each controlling one branch of government, have just about equal power over the budget process. President Bush in this way has given the Congress a great deal of initiative to shape the spending details from the very beginning. The Congress could not declare the budget as "dead on arrival," since only the broad parameters have been set by the President and the Congress has been given the freedom to determine many of the spending details. Of course, the Congress does not like to be put on the spot and determine the needed, unpopular "cuts," while the President has only announced his proposed spending increases. Nevertheless, the negotiating process should start immediately. All this reflects the Bush Administration's pragmatic, skillful realism and much more cooperative attitude toward the Congress than that of President Reagan. This is not to say the negotiations will be easy and, accordingly, the Budget Director has stressed his willingness to use the stick of the sequestration procedures of the Gramm-Rudman-Hollings (GRH) law. The Reagan Administration never favored using this stick, but this administration is willing, if necessary, to cut across-the-board defense and non-defense expenditures alike if negotiations break down.

It is very important to recognize the limitations of the GRH law and that it does not assure that the budget deficit will indeed be wiped out over the next few years. The GRH law mandates that based on revenue projections, which in turn are based on GNP and interest rate projections held as realistic in mid-July 1989 by the Budget Director (not the

Congress or some independent body), a certain maximum amount of expenditures will have to be agreed on to reach the $100 billion target in fiscal 1990. Then, on August 25, 1989 the Budget Director has to issue his first GRH sequester report for fiscal 1990. On October 15, the Director issues his final sequester report based on spending agreements as of that date but still using his mid-July economic projections. If the projected deficit exceeds $110 billion, a sequester is triggered. A sequester would cut spending by the amount needed to reduce the projected deficit to $100 billion. When, during 1990, revenue and spending produce an actual deficit that exceeds the projected deficit, there is no penalty or procedure during 1990 to achieve the $100 billion target. Indeed, the original GRH law required the 1989 deficit to be no higher than $72 billion. When that was felt to be unrealistically low, it was raised to $136 billion, not far below the current adjusted estimates.

The budget outcome, as noted, depends also importantly on the course of the economy and interest rates. The architects of the "flexible freeze" policy believe that the U.S. economy can sustain more than 3% real growth without causing inflation. If growth falls below that rate, as is projected for fiscal 1990, interest rates should fall. Moreover, they believe that the market will reinforce this trend toward lower interest rates if it is convinced of steady and significant deficit reduction. These views are not shared by everyone. The U.S. economy indeed has grown at about 3% rate without accelerating inflation in recent years, but several special, temporary factors kept inflationary pressures down (e.g.,low oil prices, strong import competition, excess capacity). Prices and wages are more likely to rise to the 5%-6% range, about one percentage point higher than in 1988. The economy has become somewhat more competitive and productive, but full employment and capacity constraints still operate to lift inflation. Short and long term interest rates should rise at least an additional 50 basis points from current levels and should not begin to drop until well after GNP growth slows down to about 2%-2 1/2%. Based on current economic projections about $15-$20 billion of spending cuts have to be negotiated to reach

the GRH targets for 1990. The target for fiscal 1991 will be much more difficult to reach, as the deficit target for that year is $64 billion while the realized deficit for fiscal 1990 is probably to be well above the $100 billion target. This means that the budget reduction process probably will be slowed down again and spread out over more years than is targeted by the present GRH law, unless new policy initiatives emerge in the spending or revenue areas.

In this respect there are two possibilities. First, as indicated, the Bush Government has adopted a little more flexibility in the defense area. It has already proposed to keep defense spending flat in real terms for 1990 while President Reagan had proposed a 2% increase. While President Bush will tread carefully and slowly in scaling down defense expenditures, there are nevertheless great opportunities over the next four years to review critically defense spending, the amount of troops needed abroad, conventional weapons, the priority of nuclear weapons systems, the possibility of more equitable burden sharing with our allies, etc. Secretary of State James Baker, known for making important surprise "initiatives" in his previous position as Secretary of the Treasury, is bound to generate another initiative and negotiate hard and effectively with the Russians, Europeans, Japanese, Koreans, and others, so as to pare U.S. defense spending over the long run.

In the revenue area, while President Bush should not be expected to deviate lightly from his "no new tax" policy, the imposition of some important fees should not be excluded. Probably the most prominent example of a "fee" would be an import fee not only on oil but also on non-oil imports. U.S. imports now total $450 billion per year or ten times the level in 1971, when the U.S. last imposed a temporary import surcharge. A 10%-20% import surcharge would yield considerable revenues even if some products and Canada would be exempted. Importantly, an import surcharge would be imposed for trade balance purposes and not be regarded as a tax, but it could nevertheless be a very large revenue raiser and narrow both deficits significantly and quickly.

The new administration, as already indicated, is probably going to be disappointed with the course of monetary policy. President Bush in his first week in office already uttered his disagreement with the Federal Reserve about the assessment of inflationary pressures. He repeated his differing views again in mid-February. The Federal Reserve remains unconvinced that non-inflationary GNP growth exceeds 2 1/2% over the long run, although it acknowledges that some competitive improvement may have occurred in recent years. It is also concerned that the economy may have become less sensitive to the rise in interest rates. Several factors may be responsible for this. Industrial companies have improved greatly their inventory control, having adopted Japanese company methods. The housing market has not been hurt, partly because long term interest rates have not risen much. And, the rising importance of exports and imports may represent a shift toward a type of economic activity that is less sensitive to interest rates than domestic spending. Although there still are a great deal of uncertainties surrounding this complicated interest rate sensitivity issue, it could leave interest rates higher than welcomed by the flexible freeze proponents. Of course, the economy also would be stronger, generating larger tax revenues. The bottom line is that budget deficit reduction will be a slow process but that in terms of GNP it will steadily fall.

Trade deficit reduction, which is likely to be very modest this year, is clearly put on the back burner. The budget deficit, not the trade deficit, is at the center of current policy attention. The level of the dollar is felt to be broadly correct as U.S. industry remains competitive and U.S. exports are expected to continue their expansion. To lower the dollar now would invite inflation as the economy is fully employed and no budget agreement has yet been reached. The administration seems willing to wait for significant trade deficit reduction till next year when the economy has slowed down and the dollar may weaken in response to lower short term interest rates.

The new administration appears to be somewhat "agnostic" about the value of the dollar. It is not clear what the equilibrium value of the dollar is in a world of liberal,

integrated capital markets. It appears this administration wants to accomplish long run trade deficit reduction by: reducing the budget deficit and thus raising the national savings rate; calling for high growth of domestic demand in surplus countries; pursuing an aggressive trade policy in agriculture and services; putting considerable pressure on Korea, Taiwan, and similar countries to open up their markets, to adjust their exchange rates and their domestic policies; and favor foreign direct investment in plant and equipment. In fact, for the purpose of correcting trade balances it is far more effective if surplus countries such as Japan export their surplus capital in the form of direct investment (in plant and equipment) than in portfolio investment (e.g., government bonds). The latter tend to keep interest rates down, and relieve pressures on the government to mend its budget deficit. Foreign direct investment, especially "transplants," tend to transfer technology, replace imports and create exports. In fact, the rapid changes in trade imbalances, which have become a common feature among industrial countries, should be countered by faster changes in technology transfers and foreign direct investment. This sets in motion the correct adjustment process. History has shown clearly that easy financing in the form of foreign loans or bond purchases delays economic and balance-of-payments adjustment.

Rimmer de Vries

February 14, 1989

R311

INTER-AMERICAN DEVELOPMENT BANK
REPRESENTATION IN THE UNITED KINGDOM
MORGAN HOUSE, 1 ANGEL COURT,
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REPRESENTATIVE

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28 February 1989

CDP
1/3

Dear Mr. Powell,

Thank you very much indeed for your letter of 23 February 1989 regarding the visit to London on 13 March of the President of the Inter-American Development Bank, Mr. Enrique Iglesias, and the possibility of his meeting the Prime Minister.

On behalf of Mr. Iglesias, I would be grateful if you could convey to the Prime Minister how much he regrets that she will be unable to see him, but that he perfectly understands the constraints which her busy schedule must impose on her.

I will not fail to let you know, as you so kindly suggest I do, when Mr. Iglesias shall next be in London.

I am personally most grateful to you for having taken the time to look at this matter and for having discussed it with the Prime Minister.

Yours sincerely,

Héctor E. Luisi

Héctor E. Luisi

Mr. Charles Powell

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

23 February 1989

Thank you for your letter of 9 February about the visit to London of Mr Enrique Iglesias on 13 March and the possibility of his meeting the Prime Minister.

I have looked at this very carefully and discussed it with the Prime Minister. Most unfortunately, she simply cannot manage a meeting that day. But I hope you will let me know when Mr Iglesias is next going to be in London because I am sure that the Prime Minister would find it valuable to talk to him on a future occasion.

CHARLES POWELL

Mr Hector E Luisi

R22/2

Foreign and Commonwealth Office

London SW1A 2AH

22 February 1989

Dear Charles

Thank you for your letter of 10 February seeking advice about the further request by the IADB London representative for the President of the Bank, Sr Iglesias, to see the Prime Minister in mid-March.

You may recall that the Bank put forward a similar request direct to you last September, but the Prime Minister was unable to see him on that occasion because of other commitments. In the event he saw Professor Griffiths, and I understand that they had an hour's useful talk. During the same visit he saw the Foreign Secretary and other Ministers. The Foreign Secretary found him very worthwhile. Sr Iglesias is an impressive interlocutor and has emerged as one of the leading advocates of new economic thinking in Latin America about the role of the State.

We have normally advised the Prime Minister to reject such requests from the Presidents of regional banks for precedent reasons. However the Prime Minister may wish to make an exception on this occasion, particularly if she is keeping open the possibility of a visit to the region in 1990. We think she would find a talk with Sr Iglesias lively and interesting.

Yours ever

Bob Peirce

(R N Peirce)
Private Secretary

C D Powell Esq
10 Downing Street

SW2ARC

PRIME MINISTER

POSSIBLE MEETING WITH ALAN GREENSPAN

Brian Griffiths mentioned to you last week that Alan Greenspan had suggested coming to see you when he is in London in early March. You were keen to fit this in if the diary permitted.

I have now discussed this with the Governor's office, who are organising the schedule. Greenspan will be arriving on the morning of Thursday 9 March, and will not be here on Wednesday 8 March which is your only relatively easy day in that week. Given the usual Thursday morning business and your trip to the north-east on the Thursday afternoon/Friday, I see no possibility of your meeting Greenspan on those two days.

However, he will still be in the London area on Saturday 11 March. The present plan is for him to go down to the Governor's house in Kent during the Saturday morning, have an informal lunch with the Governor and his wife, and then have a more formal evening dinner at which outside guests would be invited. On that Saturday you have a session with June Mendoza from 1000-1200, but nothing organised thereafter.

So the one possibility would be for you to invite Alan Greenspan to lunch at Chequers on Saturday 11, with him then going to the Governor's house in Kent during the afternoon. I gather from the Governor's office that he would be perfectly relaxed about that.

Do you want to invite Alan Greenspan to Chequers for Saturday lunch?

If so who else would you want to invite?
Possibilities might be:

- the Governor,
  the Chancellor,
  Brian Griffiths,
  any others?

PRG.

(PAUL GRAY)

14 February 1989

FILE

10 DOWNING STREET
LONDON SW1A 2AA

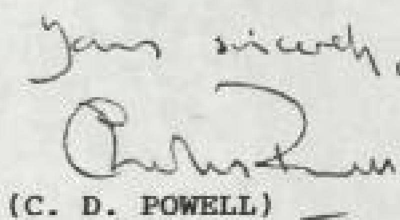
From the Private Secretary 13 February 1989

Dear Alex,

VOLUNTARY DEBT REDUCTION

I enclose a copy of a note which Dennis Weatherstone, President of J.P. Morgan, recently gave the Prime Minister containing proposals for voluntary, market-based debt reduction. You may find it of interest if you have not already received it from elsewhere.

I am copying this letter and enclosure to John Footman (Bank of England) and Stephen Wall (Foreign and Commonwealth Office).



Yours sincerely,

(C. D. POWELL)

Alex Allan, Esq.,
HM Treasury.

Hector LUISI
24/2

c.c. MA

10 DOWNING STREET
LONDON SW1A 2AA

No Ack

From the Private Secretary 10 February 1989

I enclose a letter from the representative from the Inter-American Development Bank in London regarding a request for the Prime Minister to see the President of the Bank, Mr. Iglesias when he passes through London on 13 March. I should be grateful for advice.

I am copying this letter and enclosure to Jonathan Taylor (H M Treasury).

C D POWELL

R. N. Peirce, Esq.,
Foreign and Commonwealth Office

Scc AT PG

JPMorgan

Morgan Guaranty
Trust Company of
New York

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Tel: 01-600 2300

VOLUNTARY DEBT REDUCTION

Voluntary market-based debt reduction constitutes a viable and effective mechanism for reducing, on a case by case basis, the external debt costs of LDC debtors who are adhering to sound economic policies. The first significant transaction of this type was announced by Mexico and J.P. Morgan on December 29, 1987.

The Mexican Debt-for-Bonds Exchange

Mexico offered to its bank creditors a voluntary exchange under which lenders tendered in an auction, at a discount from face value, their existing loans to the public sector for newly issued 20-year bonds whose principal was secured by 20-year obligations of the U.S. Treasury. Mexico purchased the U.S. Treasury obligations used as collateral directly from the U.S. government using its international reserves.

The bonds have a single final maturity 20 years after the date of issuance and bear interest at a floating rate equal to the London Interbank Offered Rate (LIBOR) plus 1 5/8%. The payment of principal of the bonds at maturity is secured by U.S. Treasury zero-coupon bonds having a face amount equal to, and maturing on the same date as bonds issued by Mexico. This means that the repayment of the Mexican bonds in the year 2008 will come from the proceeds of the maturing U.S. Treasury zero-coupon bonds whose purchase price in 1988 was about $19 per $100 of face value.

The transaction provided banks with an opportunity to improve the quality of the Mexican public sector debt in their portfolio by receiving a better asset with the following characteristics:

1. Principal repayment of the bonds is assured.

2. The bonds carry a higher interest rate than existing bank loans.

3. The bonds are likely to be more marketable than bank debt.

4. They will not be rescheduled.

5. Holders of the bonds will not be asked by Mexico to participate in any future involuntary new money programmes, as regards those obligations.

In exchange for these benefits, banks were asked to tender their existing loans at a price below face value, thereby incurring a loss.

For Mexico, the transaction resulted in a reduction of the level of its bank debt and debt service, and at the same time assured repayment in the year 2008 of the principal amount of the new securities issued.

The U.S. government did not incur any costs in connection with its provision of U.S. Treasury obligations as these were sold to Mexico at prices slightly above market levels.

Mexico received bids totalling $6.7 billion from 139 banks in 18 countries. Bids for $3.7 billion were accepted, at an average bid price of 69.77 cents per dollar. Banks incurred losses averaging 30% of the face value of the old debt tendered. Mexico issued $2.6 billion of new bonds to banks whose bids were accepted. As a result, the transaction reduced Mexico's outstanding debt by $1.1 billion and will save Mexico about $1.5 billion in interest payments over the life of the bonds.

While the transaction achieved some of Mexico's goals and introduced a new technique that can be used to address the debt problems of developing countries, the size of the transaction was not as large as Mexico would have liked. A number of factors influenced adversely the willingness of banks in different countries to participate, including complex and varying regulatory and accounting issues. However, the principal drawback expressed by bank lenders was the lack of security on interest payments of the new bonds, which continued to be 100% Mexican risk.

Full or partial security on interest payments would have lowered the Mexican risk component of the new asset, thereby making it more valuable to banks. A more attractive asset would yield more positive results in terms of eliciting a greater volume of debt tendered as well as a larger discount from face value than that attained in this first effort.

The Way Forward

Enhancement of interest payments would make this type of transaction more effective in reducing the debt burden of LDC debtors carrying out sound economic policies. One way to provide interest security is for the LDC debtor to purchase additional collateral, for example in the form of U.S. Treasury securities, to back the interest payment flows. By and large however, collateralization of this type is not feasible since even LDC debtors with good performance face a foreign exchange constraint. Accordingly, the size of the transactions that could be carried out on this basis would be small, and consequently, yield little benefits in debt reduction, unless loans from multinational organizations could be used to supplement collateral purchases.

Third-party guarantees on the interest flows of the new securities offer the most promising alternative for enhancement. Guarantees can be constituted at a fraction of the cost of purchasing collateral, and can be priced in line with the risk characteristics of individual countries. Moreover, the guarantees need not cover 100% of the interest payments over the life of the new security but could be structured

on a rolling basis. An initial three-year rolling guarantee, for example, could move forward to cover interest in years 2 through 4 after the initial year's interest payments have been made, and extended in this fashion throughout the life of the security unless or until the guarantee is exercised. The guarantor's total liability would be limited to three-years' worth of interest payments.

The most obvious sources for the provision of these guarantees or the financing of collateral purchases would be the multilateral organizations such as the World Bank and the IMF, and to a lesser extent, their regional counterparts such as the Inter-American Development Bank and the Asian Development Bank. These institutions enjoy the financial backing of all member governments, they are knowledgeable about the LDC's economic performance, they have a mandate to promote balance of payments stability and economic development, and they recognise that voluntary debt reduction of commercial bank debt can contribute to those objectives, and improve the quality of their own loans to these countries.

The claims that voluntary debt reduction with interest security could put on the capital structure of these entities could be controlled in a number of ways. Firstly, by earmarking a specific portion, say 5 - 10%, for such transactions. Secondly, access to guarantees or financing for collateral would be managed through conditions to access which required prior demonstrated economic performance, rather than the announcement of an economic program, even if backed by these institutions. Thirdly, the provision of guarantees or of financing for collateral would carry financing costs in line with those currently in place in these entities. Finally, the participation of these entities in support of these type of transactions will not require additional financial contributions or budgetary allocations from member governments.

Mexico as a Test Case

The LDC debt problem is long-term in nature owing to the need for these countries to effect consistent, sound fiscal and monetary policies, as well as major structural changes in areas like trade incentives, the tax system and the pricing structure.

Such changes require sustained effort and can have a major impact on society albeit putting great demands upon the political system. Each country has different natural and human resources. Each has different social and political structures. Each has its own vulnerability to external factors. As a result each requires solutions tailored to its specific circumstances.

Mexico has made significant progress over the last several years. It has moved aggressively to open up the domestic market to international competition, has stimulated non-oil exports to record levels, has taken important privatization initiatives and is currently embarked on an ambitious program to bring inflation down to less than 20% per annum.

Mexico's recent performance and the prospects for continuity under President Salinas' administration stand in stark contrast to those of the other two major LDC debtor countries - Brazil and Argentina. In these countries, the promise of substantial resource endowments have been negated by lack of policy consistency and a recurrent failure to address fundamental economic distortions.

Depending on the level of interest security and the amount of collateral financing available, Mexico could reduce its bank debt by as much as 35%. Mexico, thus, represents a significant opportunity to utilize the debt exchange mechanism with interest security to achieve a meaningful reduction in its debt level, as well as to provide a strong stimulus to other LDC debtors to adopt and sustain sound economic policies.

REPRESENTATIVE

INTER-AMERICAN DEVELOPMENT BANK
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R10/2

9 February 1989

Dear Mr. Powell,

Once again I am taking the liberty of writing to you to request an interview with the Prime Minister for the President of the Inter-American Development Bank and former Foreign Minister of Uruguay, Mr. Enrique Iglesias.

Mr. Iglesias will be passing through London on Monday 13 March, on his way to Amsterdam for the Annual Meeting of the Board of Governors of the Bank and he would very much welcome the opportunity to exchange views with the Prime Minister on the current situation in Latin America and its outlook.

You may be interested to know that President Mitterand has invited Mr. Iglesias, along with the Latin American Governors of the Bank, to meet with him at the Elysée Palace in Paris immediately after the Amsterdam meeting.

It might perhaps be useful if we could briefly discuss this matter. May I give you a ring sometime next week?

With all good wishes.

Yours sincerely,

Héctor E. Luisi

Héctor E. Luisi

Mr. Charles Powell

10 DOWNING STREET

Prime Minister

The zero coupon bonds are issued by the US. Treasury as part of its funding of the ~~[illegible]~~ budget deficit.

AT 9/2

PRIME MINISTER

DEBT REDUCTION

You might like a worked (stylised) example of the Mexican debt transaction.

(i) Mexico has bank debts of $1,000 million paying LIBOR of say 10 per cent.

(ii) It holds a reverse auction and buys in the debt for $700 million, i.e. a discount of 30 per cent.

(iii) It issues bonds for $840 million using

(a) $700 million to buy in the debt;

(b) $140 million to buy zero coupon bonds with a value on maturity of $700 million but a value on issue of 20 per cent of the face value.

(iv) The interest burden is now LIBOR + $1^5/_8$ per cent, i.e. $11^5/_8$ on $700 million rather than 10 per cent on $1,000 million, i.e. $81 million rather than $100 million a year.

Thus Mexico reduces its debt by $300 million and its interest burden by $19 million. The banks get a fully marketable security rather than a partially marketable bank loan, and with a higher interest rate.

AT

Thankyou - much clearer than their explanation

ANDREW TURNBULL

8 February 1989

EL3DHX

But Where does the U.S Treasury not come in?

JPMorgan

Morgan Guaranty
Trust Company of
New York

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Tel: 01-600 2300

VOLUNTARY DEBT REDUCTION

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In exchange for these benefits, banks were asked to tender their existing loans at a price below face value, thereby incurring a loss.

For Mexico, the transaction resulted in a reduction of the level of its bank debt and debt service, and at the same time assured repayment in the year 2008 of the principal amount of the new securities issued.

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While the transaction achieved some of Mexico's goals and introduced a new technique that can be used to address the debt problems of developing countries, the size of the transaction was not as large as Mexico would have liked. A number of factors influenced adversely the willingness of banks in different countries to participate, including complex and varying regulatory and accounting issues. However, the principal drawback expressed by bank lenders was the lack of security on interest payments of the new bonds, which continued to be 100% Mexican risk.

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Depending on the level of interest security and the amount of collateral financing available, Mexico could reduce its bank debt by as much as 35%. Mexico, thus, represents a significant opportunity to utilize the debt exchange mechanism with interest security to achieve a meaningful reduction in its debt level, as well as to provide a strong stimulus to other LDC debtors to adopt and sustain sound economic policies.

May I have a word with your
PRE 2/2 Paul.

(2)

JPMorgan

Morgan Guaranty
Trust Company of
New York

PO Box 161
1 Angel Court
London EC2R 7AE
Tel: 01-600 2300

Prime Minister

This is a note from Mr. Weatherstone 2 Feb. 1989 spelling out JP Morgan's ideas on debt reduction in rather greater detail. It is undoubtedly ingenious. CDP. 2/2

Dear Charles,

Enclosed is a memo describing the possible Mexican debt "solution". It's probably a little too long but nevertheless sets it all out reasonably clearly, I hope!

Obviously there is a "potential" cost to the tax payer as the Prime Minister correctly pointed out – even so we believe it would represent progress on the problem.

Enjoyed the lunch very much.

Regards

Dennis

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Ref 90065

chex.md/aa/120 CONFIDENTIAL

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

Prime Minister
CDP 23/12.

22 December 1988

Charles Powell Esq
PS/Prime Minister
No.10 Downing Street
London SW1

Dear Charles,

INTERNATIONAL FINANCIAL SCENE

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

Developments in the world economy have been rather more favourable than expected this year with real output in major industrial countries likely to have risen by over 4 per cent and the volume of world trade by a rapid 8½-9 per cent. Commodity prices are currently some 20 per cent higher in SDR terms than at this time last year, although oil prices have fallen. In spite of this generally very helpful background, however, debtor countries have made less progress than might have been hoped.

Most major debtors' exports have grown and this has helped to ease the burden of debt interest payments - except in the case of oil producers. Domestic policies, however, have remained inadequate in a number of countries which have had difficulty agreeing IMF programmes and obtaining external finance. Lax budgetary policies have been accompanied by chronic inflationary problems and disappointing growth.

The prospect next year is for continued substantial increases in world output and trade, though at a somewhat slower pace, together with probably higher average interest rates and some flattening of commodity prices. This will provide a more difficult background for debtors. Political considerations in advance of or in the wake of elections could also strain the debt strategy in the major Latin American countries.

The trend for official creditors to bear an increasing share of the burden of financing major debtors has continued. Banks have remained reluctant to provide new money packages commensurate with their share of exposure, although they have continued to show interest in debt reduction options. Finance Ministers at the IMF/IBRD annual meetings in Berlin in late-September agreed that the menu approach to financing packages should be broadened to

increase financial flows and reduce debt through voluntary market-based schemes without transferring risk from private to official creditors. The Bank of England is preparing a paper on the various methods of debt reduction.

Official creditors have had continued difficulty in securing adequate conditionality from debtors. The IBRD's approval of major policy loans for Argentina, on the basis of macro-economic targets which fell short of those sought by the IMF, threatened to undermine the Fund's role. The UK, however, has supported firmly the IMF's primacy. G10 Finance Ministers are to discuss a report on the roles of the IMF and IBRD at their April meetings in Washington.

In the Paris Club, the first concessional reschedulings for the poorest sub-Saharan African countries have been agreed on the lines of the proposals endorsed by Summit leaders at Toronto. Tanzania was the first Commonwealth country to benefit in early December. Others have been Mali, Madagascar, the Central African Republic and Niger. Creditors failed to agree on Senegal which some (though not the UK) felt was too rich to benefit. The majority of creditors, in common with the UK, has chosen to reduce interest rates.

The attitude of major debtors has shown some signs of hardening. In late-October the presidents of the G8 Latin American countries issued a 'Declaration of Uruguay' calling among other things for urgent talks on debt with the new US Administration. Their finance ministers meeting in Rio de Janeiro in early December reaffirmed their interest in reducing their debts. The new Mexican president has said that growth must not be sacrificed to debt service and has spoken of re-opening negotiations with creditors. Venezuela's new leader is also advocating a tougher stance. Argentina and Brazil both face elections in 1989. These may not only paralyse economic policy-making for an important period but will also provide an opportunity for critical debate on debt issues.

The attitude of the new US Administration to the debt strategy is not yet clear. President-elect Bush has announced a major review. The move of Mr James Baker from the US Treasury to the State Department, however, suggests that hemispheric political considerations will continue to play an important role in US thinking. The continued fragility of parts of the US financial system will also be a factor, although American banks have generally strengthened their position.

Argentina is the country where lack of agreement with the IMF and mounting interest arrears to commercial banks threaten to cause strains in the coming weeks. The government's Primavera Plan has had some success in reducing inflation but its reliance on administrative controls without the necessary underpinning of firm

fiscal and monetary policies means that it is likely to be short-lived. The IBRD's disbursement of further tranches of the policy loans agreed in October depends at least partly on satisfactory macro-economic policies; but Argentina's 1989 budget seems likely to exceed even the IBRD's targets let alone the IMF's more stringent demands. Lack of an IMF agreement is likely to hamper Argentina's negotiations with commercial banks which have already rejected a $3½ billion new money request. It is difficult to envisage how President Alfonsin can take the necessary measures before May's elections, particularly in view of the recent army mutiny.

Mexico's external payments situation has worsened sharply as lower oil exports and the liberalisation of imports have led to an unexpectedly large current deficit. Expectations of a peso devaluation immediately before or after the presidential election were accompanied by substantial capital flight and a sharp drain on reserves. In these circumstances, the US has offered a $3.5 billion bridge loan. Last week's announcement of a new wage and price pact, together with a one peso per day devaluation from 1 January, seem unlikely to reverse the trend. The external financing gap for 1989, therefore, looks particularly large and is likely to lead to calls on all creditors. The new Salinas Administration, however, will not find it easy to agree a policy package with the IMF. The World Bank is actively considering possible loans for Mexico, but it will be important that the IBRD does not again go ahead of the Fund - even if the US lobbies for exceptionally favourable treatment.

Brazil's strong trade performance has been overshadowed by continued domestic budgetary problems which have brought the country to the brink of hyperinflation as monthly price increases have approached 2,000 per cent a year. Further measures seem likely to be required if the Standby Arrangement with the IMF is to be kept on track. The Finance Minister Mailson da Nobrega has suggested a tax package to reduce the budget deficit with President Sarney's hesitant support - but opposition from other Ministers is strong.

The Prime Minister is familiar with the efforts made in recent weeks to secure an agreement between Nigeria and the IMF backed by adequate financial support from creditors. The Nigerian government has agreed at the second attempt a package of measures to reverse this year's soaring budget deficit and unify the naira exchange market. A programme is expected to be brought to the IMF Executive Board in January. The IBRD is prepared to offer new policy loans and a generous Paris Club rescheduling will be needed. Commercial banks have settled the outline of an agreement without any new money. The UK has taken the lead in trying to put together a donor package to fill the remaining financing gap, offering $100 million conditional on others providing at least

$150 million, which so far they have proved reluctant to do. Nigeria's unwillingness to draw Fund money is one factor weakening other creditors' support and also makes the programme more vulnerable to a fall in oil prices.

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I am copying this letter and enclosures to Bob Pierce (FCO), Jeremy Godfrey (DTI) and John Footman (Bank of England).

Yours,

Moira Wallace

MOIRA WALLACE
Private Secretary

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MDADAN 0339

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OECD WP 3 MEETING 8-9 DECEMBER:

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GRAY

YYYY

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MR MATTHEWS TRSY
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cc PO

CDP 18/11

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

18 November 1989

Lyn Parker Esq
PS/Secretary of State
Foreign and Commonwealth Office
King Charles Street
LONDON
SW1

Dear Lyn

CALL BY MR ENRIQUE IGLESIAS

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Mr Iglesias touched on recent developments in relation to the debt of Latin American countries. Although some countries were still experiencing major problems, the adjustment process was well under way. Argentina and Mexico were doing better; Chile had done exceptionally well. Generally, there was more understanding of the nature of the problem within the various countries. He welcomed the "menu" approach to the problem of middle income debt. Did the Chancellor expect further options to be added to the "menu"?

The Chancellor said that, for countries which were prepared to take equity capital on reasonable terms, the prospects were good. There were already a lot of options on the "menu", and it was up to the countries themselves to choose the most appropriate. The experience of Chile, with its use of debt/equity swaps, had shown what could be done. Other countries had assets that were just as valuable, and should, similarly, take advantage of the secondary markets. At Toronto, the Summit countries had agreed a solution to the problem of the poorest, most heavily indebted countries. For the middle income debtors, they had reaffirmed their existing strategy. The Japanese had put a new option on the table. This was complicated and unclear, but appeared possibly to involve a transfer of risk from the private sector to the public sector in

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The Chancellor agreed with Iglesias' analysis of the problem. Its solution required political leadership of a considerable order. Perhaps this could be helped if the IADB were to publicise the success stories (eg Chile) including the amount of debt reduction that had been achieved so far. Iglesias said this was an excellent idea.

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MR MATTHEWS TRSY
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MR JOHNSON DTI VIC ST
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MR SIMMONDS MAFF
MR WICKS NO 10
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Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

18 November 1989

Lyn Parker Esq
PS/Secretary of State
Foreign and Commonwealth Office
King Charles Street
LONDON
SW1

Dear Lyn

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I am copying this letter to Charles Powell (No.10) and John Footman (Bank).

Yours ever

Jonathan

J M G TAYLOR
Private Secretary

10 DOWNING STREET

LONDON SW1A 2AA

26th October, 1988

Dear Tim

You wrote to me earlier this month to ask whether the Prime Minister might see Mr Enrique Iglesias during his forthcoming visit to London in November.

I have made enquiries here, and I understand that the Prime Minister has reluctantly had to decline because of her many other commitments. But I understand that Mr Iglesias has other meetings planned with various Ministers during his time here.

I am sorry to send you a disappointing reply.

Yours ever

Mark

MARK LENNOX-BOYD
Parliamentary Private Secretary

The Rt Hon Timothy Raison MP

R6/10

INTER-AMERICAN DEVELOPMENT BANK
REPRESENTATION IN THE UNITED KINGDOM
MORGAN HOUSE, 1 ANGEL COURT,
LONDON EC2R 7HJ

REPRESENTATIVE

TELEPHONE: 01-726 4389
TELEX: 268543 INTAMB G
CABLE: INTAMBANC-LONDON EC2

5 October 1988

Mr. Charles D. Powell
10 Downing Street
London, SW1A 2AA

CDP
4x.

Dear Mr. Powell,

Thank you for your letter of 30 September. We are very sorry indeed that other commitments prevent the Prime Minister from seeing Mr. Iglesias.

Mr. Iglesias is grateful for the Prime Minister's good wishes and he is very much looking forward to an enjoyable and profitable first visit to London in his official capacity as President of the Inter-American Development Bank.

I am personally grateful for the attention you have given to this matter.

Yours sincerely,

Héctor E. Luisi

8 / w

cc FCO.

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary 30 September 1988

Thank you for your letter of 15 September suggesting a call by the President of the Inter American Development Bank on the Prime Minister in mid-November.

I regret that other commitments prevent the Prime Minister from seeing Sr. Iglesias. But she would be grateful if you could convey to him her best wishes for an enjoyable and profitable visit to London. I understand that Sir Geoffrey Howe is hoping to see him, and that he will also meet Chris Patten and Tim Eggar and, I believe, a Treasury Minister during his stay in London.

(C. D. POWELL)

Mr. Hector E. Luisi

10

R 29/9

Foreign and Commonwealth Office

London SW1A 2AH

29 September 1988

Dear Charles,

Thank you for your letter of 15 September covering a letter requesting a call on the Prime Minister by the newly-elected President of the Inter American Development Bank.

I note that the Prime Minster will not be able to see him. This is a pity. Sr Iglesias is a particularly impressive figure (he was, until recently, Foreign Minister of Uruguay and remains a leading figure on the Latin American scene). It has been a long time since the Prime Minister last received a South American visitor. However we have arranged for him to see the Foreign Secretary as well as Mr Patten and Mr Eggar, and possibly a Treasury Minister, during his visit in November.

/ I attach a draft reply to Dr Luisi.

Yours ever,

Lyn Parker

(L Parker)
Private Secretary

DSR 1 (Revised Sept 85)

DRAFT: minute/letter/teleletter/despatch/note

TYPE: Draft/Final 1 +

FROM: C D Powell

Reference

DEPARTMENT: TEL. NO:

Your Reference

BUILDING: ROOM NO:

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.... In Confidence

CAVEAT ....

TO:

Hector E Luisi
Inter American Development Bank
Morgan House
1 Angel Court
London EC2R 7HJ

Copies to:

SUBJECT:

Thank you for your letter of 15 September suggesting a call by the President of the Inter American Development Bank on the Prime Minister in mid-November.

I regret that other commitments prevent the Prime Minister from seeing Sr Igelsias. But she would be grateful if you could convey to him her best wishes for an enjoyable and profitable visit to London. I understand that Sir Geoffrey Howe is hopeing to see him, and that he will also meet Chris Patten and Tim Eggar and, I believe, a Treasury Minister during his stay in London.

CDP

Enclosures flag(s) ....

HOUSE OF COMMONS
LONDON SW1A 0AA

ALL PARTY PARLIAMENTARY GROUP ON OVERSEAS DEVELOPMENT

Chairman: Lord Oram   Deputy Chairman: Jim Lester MP   Joint Secretaries: Andrew Smith MP   Bowen Wells MP   Treasurer: Tom Clarke MP
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Timothy Raison MP
House of Commons
LONDON
SW1A 0AA

19 September 1988

26 SEP 1988

Dear Mr Raison

I have just learned that Enrique Iglesias, newly ensconced as President of the Inter-American Development Bank, will be in London on an official visit from 16-18 November. I hope to be getting him for an APGOOD meeting - at present he is a little reluctant to do a full presentation with questions - but I am writing today to ask if you could make your best efforts to ensure he sees the Prime Minister during his visit. Perhaps a word to Charles Powell? It seems he will be seeing heads of government at other stopovers on the same tour.

Mr Iglesias is clearly in the big league - a past and arguably future contender for the UN Secretary-General job. He was previously Uruguay's Foreign Minister and is a member of the currently sitting <u>South Commission</u>.

Yours sincerely

pp

Adrian P Hewitt

cc: Bowen Wells MP
Jim Lester MP

Research Adviser: Adrian Hewitt
Overseas Development Institute, Regent's College,
Inner Circle, London NW1 4NS 01-487 7413

Hector LUISI File
29/9

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

Ack'd

15 September 1988

I enclose a copy of a letter asking the Prime Minister to receive the newly elected President of the Inter-American Development Bank in mid-November. The Prime Minister will not be able to do this, but you will no doubt wish to consider whether the Foreign Secretary or the Minister for Overseas Development should see him. I should be grateful for a draft reply.

C. D. Powell

R. N. Peirce, Esq.,
Foreign and Commonwealth Office.

R15/9

INTER-AMERICAN DEVELOPMENT BANK
REPRESENTATION IN THE UNITED KINGDOM
MORGAN HOUSE, 1 ANGEL COURT,
LONDON EC2R 7HJ

REPRESENTATIVE

TELEPHONE: 01-726 4309
TELEX: 268543 INTAMB G
CABLE: INTAMBANC-LONDON EC2

15 September 1988

Charles Powell, Esq.
10 Downing Street
London, SW1A 2AA

Dear Mr. Powell,

The newly elected President of the Inter-American Development Bank, Mr. Enrique V. Iglesias, former Minister of Foreign Affairs of Uruguay, will be visiting the United Kingdom on 15, 16 and 17 November. This shall be his first visit to Britain in his official capacity as President of the Bank and he would be honoured if the Prime Minister would agree to see him sometime during his visit.

Since he assumed office on 1 April 1988, Mr. Iglesias has been making a special effort to visit not only the governments of the Latin American countries which are members of the Bank, but also the governments of member countries outside the Latin American region. With regards to the latter, he has so far called upon the Japanese and Swiss governments and he will call upon the French and Spanish governments next month. In Japan he called upon Prime Minister Takeshita and other Cabinet Ministers; in Switzerland he met Federal Councillors Delamuraz and Felber and several Secretaries of State; in France he is scheduled to meet with President Mitterand and Prime Minister Rocard, as well as with other Cabinet Ministers, and in Spain he will meet with His Majesty King Juan Carlos and with Prime Minister Gonzãlez.

Should the Prime Minister be kind enough to see Mr. Iglesias, he would very much welcome the opportunity to exchange views with her on Latin America's current situation and outlook, with special emphasis on the external debt problem and matters relating to trade. I believe that the Prime Minister would be interested in Mr. Iglesias's views, particularly in light of his previous experience as Uruguayan Foreign Minister, Executive Secretary of the United Nations Commission for Latin America and the Caribbean, and Chairman of the GATT Uruguay Round.

.../

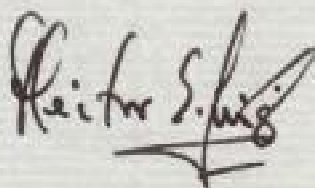
Charles Powell, Esq.
15 September 1988

/...

Over the past few years, Mr. Iglesias has had the great pleasure to develop a most cordial relation with your Foreign Secretary; he was also very pleased to welcome several members of Her Majesty's Government to Uruguay. He particularly remembers your Trade and Industry Secretary's visit to Punta del Este on the occasion of the GATT Ministerial Meeting, which resulted in the setting up of the Uruguay Round and which Mr. Iglesias chaired until quite recently.

Mr. Iglesias would obviously be very happy indeed to arrange his schedule during his visit to London in order to accommodate that of the Prime Minister, should she have the kindness to agree to see him.

Yours sincerely,



Héctor E. Luisi

chex.nh/jt/2 CONFIDENTIAL

12 September 1988

Charles Powell Esq
Private Secretary
10 Downing Street
LONDON SW1

Dear Charles

INTERNATIONAL DEBT SCENE

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

The World economic background

This year's strong growth in the world economy is providing some benefit to debtor countries. Output in major industrial economies appears to have risen by about 4 per cent and world trade by 8-9 per cent. Commodity prices have fallen from the peak reached earlier this year but are still about a third higher than a year ago. These factors have helped to boost many debtors' export earnings - although individual countries have been affected adversely by weak coffee and cocoa prices and the decline in oil prices has reduced oil exporters' earnings, while all debtors face somewhat higher world interest rates. Against this on balance helpful background, progress by the major debtors is disappointing.

The international environment should continue to be reasonable next year, although rather less helpful to debtors with both industrial countries' output and world trade growing more slowly, and the risk of further falls in oil prices. Interest rates, at least in the United States, may rise further.

Sub-Saharan Africa

The Paris Club has met twice to discuss how the Toronto summit agreement on debt relief for the very poorest countries will be implemented. A substantial measure of agreement has been reached on the technical issue of how the different creditor options may be regarded as fairly comparable. This calls for those creditors

who do not reduce their claims by writing down principal or lowering interest rates to reschedule over 25 years. The United States has so far refused to reschedule over longer than 20 years, which merely reaffirms current Paris Club practice for the poorest countries. This attitude is frustrating attempts to reach a consensus before the Annual Meetings and is encouraging some other countries including Germany and Australia to obstruct the process of implementing the Toronto agreement.

Middle income debtors

Prospects for the major Latin American countries and Nigeria give cause for concern. Brazil has agreed a programme with the IMF but inflation has accelerated to an annual rate of 1,000 per cent and electoral pressures next year may hinder implementation of the tough measures necessary to sustain the programme. Argentina is still trying to negotiate a Fund programme and secure finance from banks but also faces elections next year. Mexico's trade performance has deteriorated, and the present rigid policies are probably unsustainable; but the ruling PRI's reduced credibility following the recent elections may make changes more difficult. Venezuela is suffering from lower oil prices and is seeking new finance from banks. The risks of simultaneous, although not concerted, moratoria, in Latin America have thus increased. Nigeria, which also faces lower oil earnings, is now discussing a Fund programme but the scale of adjustment, the size of financing needs and the burden placed on creditors all suggest that agreement may be extremely difficult to achieve.

The role of creditors

Among creditors, the toughened attitude of commercial banks to middle income debtors is putting increased demands on official creditors. The banks' improved capital base and higher provisioning has brought a welcome strengthening in their financial position. But with the market continuing to value debt at only about half its face value, there is understandable reluctance to provide net new money to some debtors. In the absence of a further tightening of debt countries' policies this has led to calls for increased official finance both from the international institutions and from export credit agencies - particularly through generous Paris Club rescheduling. Banks' share of total claims on major debts has fallen while that of official creditors has risen - placing governments and their taxpayers at increased risk.

IMF/IBRD meetings

The Chancellor will be seeking to reinforce the existing debt strategy when he meets other Finance Ministers at the IMF/IBRD annual meetings in Berlin at the end of this month. He will want to ensure that the international financial institutions have

adequate resources but also that conditionality is strengthened so that the IMF and the World Bank, which face growing arrears, are repaid and that other creditors' support for debtors is justified. He will be concerned in particular that the interests of official creditors are taken fully into account in the design of IMF agreements with debtor countries. The handling of banks' claims is for negotiation between banks and debtors but the Chancellor will be ready to welcome extensions of the menu approach which transforms and reduce debt.

Individual countries

Nigeria is close to agreement with commercial banks on the rescheduling of debt but the banks' refusal to provide new money has increased the scale of policy adjustment needed from Nigeria and the burden on other creditors. This is making agreement on a Fund programme difficult. President Babangida now seems ready to support public spending cuts to check the rising budget deficit and inflation which resulted from Nigeria's abandonment of last year's IMF programme, but the external situation is critical with oil revenues reduced, reserves exhausted and payments to official creditors in arrears. The Nigerians are likely to seek exceptionally generous treatment from Paris Club creditors, but in view of the country's poor past performance and present doubts about the government's ability to sustain reform, other official creditors may be reluctant to support this. We shall probably have to take some difficult decisions in the coming weeks.

Argentina's trade surplus has benefited from this year's rise in world wheat prices but the domestic budget deficit has been higher than predicted and prices were rising at a monthly rate of 25 per cent in July. In August, the government announced policy changes to reduce the budget deficit, restrain private sector prices, and devalue the austral but lower than expected capital inflows and increased capital flight have undermined the external financial position. Argentina has been running significant payments arrears to banks. The IMF is discussing a new programme with the Argentinians who are expected to approach the banks for new money. In the meantime, the US is seeking to organise a $500 million bridging loan with other central banks (excluding the UK) until disbursements of World Bank trade and banking sector loans are available. A decision by the World Bank to renegotiate the banking loan and reduce the trade loan disbursements in 1988, however, has put the viability of this bridging operation into doubt. We are also concerned that the World Bank loans should not go ahead without a Fund programme being agreed and that despite liberalisation required under the trade loan Argentina is still discriminating against the UK. On the present timetable, the World Bank loans would come up for decision before the Fund programme.

Brazil's new IMF programme went into effect at the end of August when commercial banks' commitments to a new financing package reached 95 per cent. Completion of the programme also required bridging finance from industrial countries' central banks and an exceptionally large call on the Paris Club which after tough negotiations agreed reluctantly to reschedule not only all principal due until March 1990 but also 70 per cent of interest. The Fund programme, regrettably, contains detailed targets only for the rest of the present year. In view of the current annualised inflation rate of 1200 per cent and the sustained fiscal adjustment needed to curb it, we shall be looking carefully at the 1989 budget due soon and the Fund's review of the programme early next year.

I am copying this letter and enclosure to Bob Pierce (FCO), Jeremy Godfrey (DTI) and John Footman (Bank).

Yours sincerely

J M G TAYLOR
Private Secretary

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COVERING CONFIDENTIAL

(Based on information as at 8.9.88)

INTERDEPARTMENTAL DEBT REPORT: SEPTEMBER 1988

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MAIN REPORT

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2 Overdue Financial Obligations to the IMF

3 Indebtedness and British Exposure

4 UK Paris Club Bilaterals - Current Position

INTERNATIONAL DEBT GROUP REPORT: SEPTEMBER 1988

Main points

- latest IMF projections for the world economy suggest that the most heavily indebted countries have enjoyed rather limited benefits from the strength of the world economy this year. Nevertheless, despite projections of higher interest rates and slower growth in 1989 debt exports ratios of the middle-income countries should continue to decline.

- Brazil's agreement with the banks was quick to achieve critical mass. However, with monthly inflation now at an annual rate of around 1000%, domestic credit and fiscal performance criteria set under the SBA could well be missed.

- Argentina's trade position has recovered somewhat but arrears have built up to the banks. The US is attempting to put together a further bridging loan. The latest package of fiscal measures seems unlikely to have much impact.

- Mexico's oil and non-oil trade surplus has been sharply reduced and uncertainties surrounding policy following the unexpectedly close Presidential election have grown.

- weak oil prices and an overvalued exchange rate have led to a deterioration in Venezuela's external position and a hardening of attitudes to debt service.

- the chances of an agreement between Nigeria and the Fund appear to have improved, but the banks remain reluctant to provide new money.

- the economic implications of the ceasefire in the Gulf War are as yet unclear. As a group, the Baker 15 countries are net oil exporters so a further weakening of oil prices as a result of higher output by Iraq and Iran would on balance aggravate their debt servicing problems. The already dismal prospects for Sudan have been worsened with the Nile floods and the threat of locust swarms.

- the Paris Club has made some progress in developing a menu of debt relief options for SSA countries although some major creditors are still holding back. The IMF Board seems to support UK proposals to allow retroactive access to the ESAF as part of the solution to clearing arrears to the Fund.

CHART 1

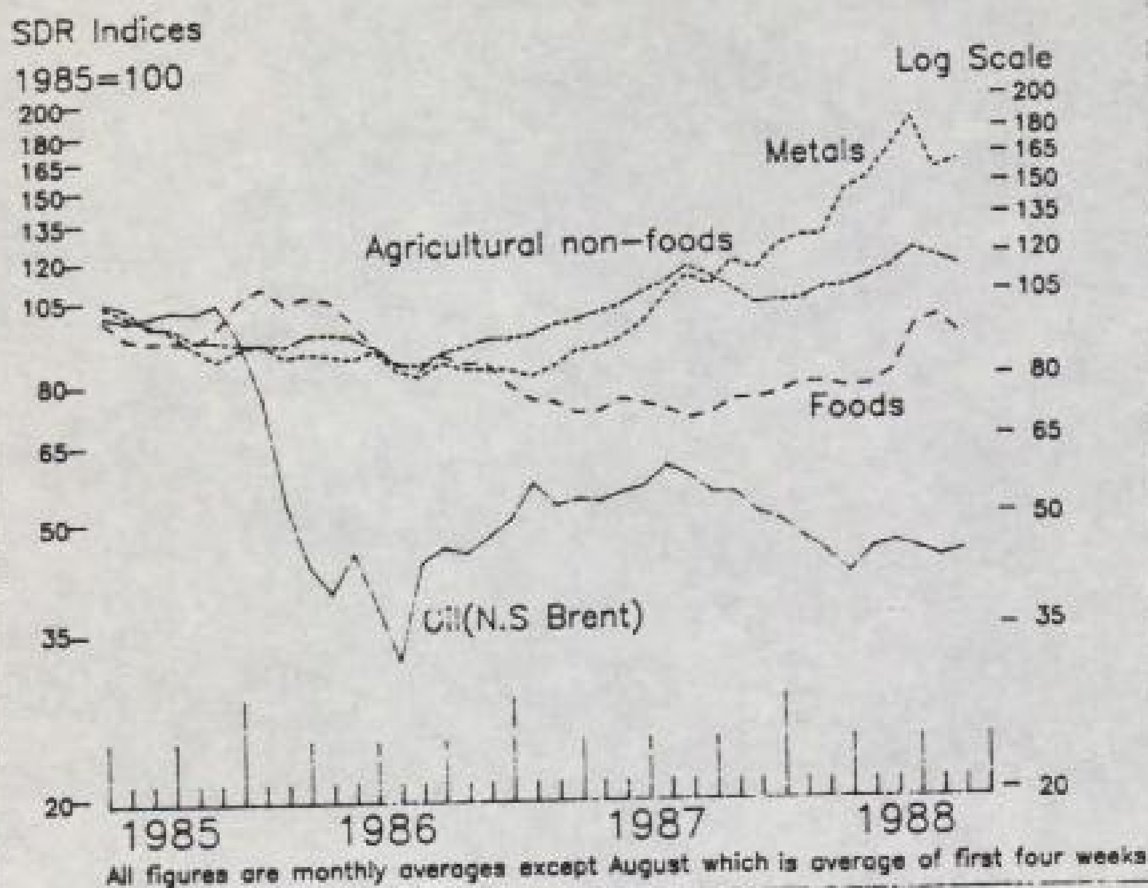
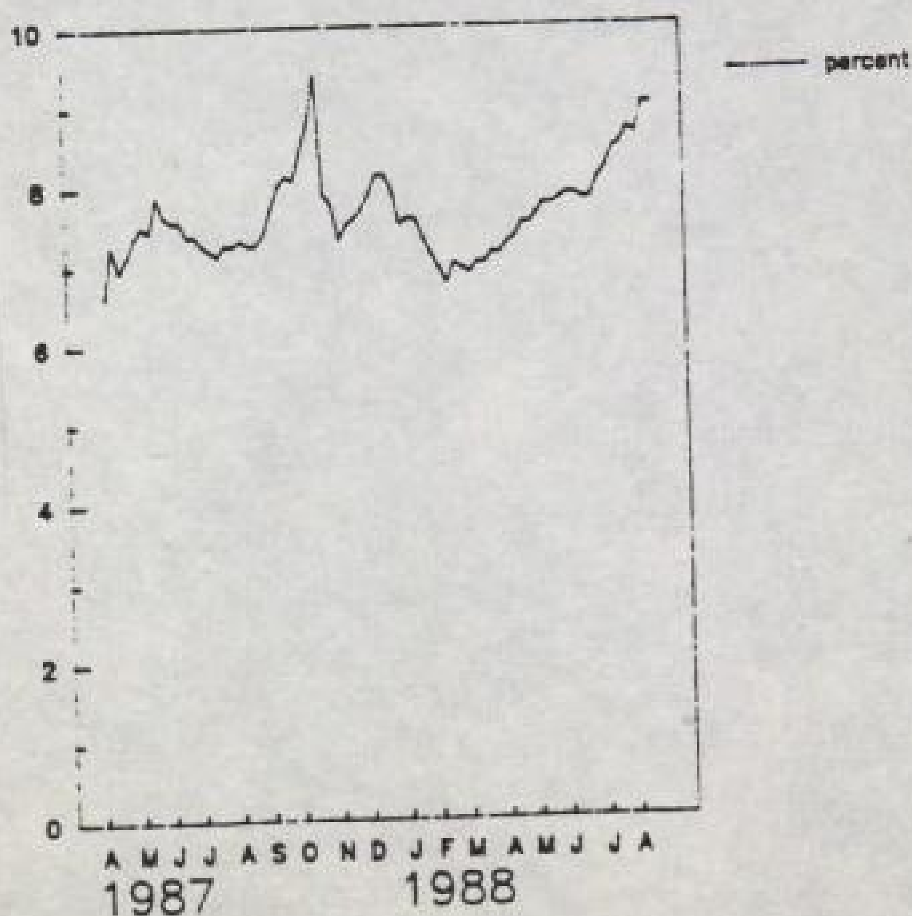


CHART 2



Latest IMF projections

The IMF's latest draft World Economic Outlook (WEO) (Table 1) suggests that, overall, developing countries' export markets and most non-oil commodity prices are likely to be stronger this year than expected in the spring. Although some slowdown in industrial countries' domestic demand is foreseen in 1989, growth is still expected to exceed earlier projections. A forecast decline in non-oil commodity prices (which have weakened recently - Chart 1) is partly in reaction to special factors (including strikes and the North American drought) that led to exceptional rises this year. Interest rates are expected to rise and given recent trends (Chart 2) the forecast may be on the low side.

With a stronger than expected performance of the world economy so far this year it is perhaps surprising that the most heavily indebted middle income countries and the poorest ldcs have not enjoyed a stronger recovery. Despite the unexpected strength of many non-oil commodity prices, the terms of trade of both groups are still projected to deteriorate this year, although not by as much as previously forecast. This is no doubt a reflection of the weakness of prices of oil and tropical beverages which form an important part of the exports of many of these countries. Although export volume growth is still expected to be above trend in 1988-1989, the Fund has lowered its forecasts for growth this year. The relatively modest rise projected for US imports is probably dampening the demand for exports from some of the larger Latin American debtors and their limited ability to respond to more buoyant market growth elsewhere may also reflect inappropriate domestic policies and the cumulative impact of low rates of investment since the onset of debt difficulties. Although earlier estimates for GDP growth in 1985-1987 for the Baker 15 have been revised up, growth is expected to be more sluggish this year than projected earlier and imports to rise only slowly. Overall, the combined trade surplus of the Baker 15 is expected to improve this year, broadly matching a heavier burden of interest payments.

Next year the Fund see scope for raising import volumes significantly in the Baker 15, providing external financing is sufficient to allow the current account balance to be broadly unchanged. However, these projections rest on an assumed $15 per barrel oil price and an average eurodollar interest rate at around current levels. Oil prices could clearly be much lower. As a group the Baker 15 are net oil exporters: although some countries will benefit from lower oil prices, Mexico, Venezuela and Nigeria among others will suffer (Table 2). Although recent

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TABLE 1: IMF AUTUMN WEO

% change on previous period

	1985	1986	1987	1988	1989
Industrial countries					
real domestic demand	3.4	3.8	3.6	3.9	2.9
import volume	4.8	8.7	6.8	7.5	5.0
GNP deflator	3.7	3.4	2.9	2.8	3.2
$ world prices					
manufactures	1.1	17.9	12.3	8.4	3.7
oil	-5.0	-50.2	28.4	-11.3	4.7
non-oil	-12.9	-1.2	3.4	17.5	-3.2
6-month $ LIBOR (level)	8.6	6.6	7.3	8.0	8.5
15 heavily indebted countries					
terms of trade	-2.4	-18.2	0.1	-1.4	0.7
export volume	2.1	0.3	4.1	4.9	3.1
import volume	0.6	-1.4	0.8	1.8	6.1
current balance ($ bns)	-0.3	-15.3	-8.7	-8.8	-8.7
Per capita GDP	1.7	1.5	0.1	-0.4	0.9
Ratio of debt to exports G&S (level)	288.8	346.7	335.5	311.5	297.1
Interest payments due as % of exports G&S (level)	30.2	30.9	26.3	27.0	25.3
Debt service paid as % of exports G&S (level)	38.7	43.2	36.7	41.0	38.7
Sub-Saharan Africa					
Terms of trade	-1.6	-16.3	-6.0	-1.5	-2.9
Export volume	-0.3	7.5	0.1	1.9	6.2
Import volume	0.1	-3.2	-1.2	3.3	2.2
Current balance ($ bns)	-3.0	-5.1	-6.4	-7.0	-6.1
Per capita GDP	0.3	0.6	-0.6	0.7	0.5
Ratio of debt to exports G&S (level)	269.8	296.6	324.3	323.1	323.7
Interest payments due as % of exports G&S (level)	14.2	15.5	16.1	16.2	16.0
Debt service paid % of exports G&S (level)	27.4	25.4	22.1	24.6	31.4

Notes: The interest service ratios have been calculated on the basis of accruals including sums due on portfolio investment. The overall debt service ratios are shown on an actual payments rather than an accruals basis (and so will be affected inter alia, by changes in outstanding arrears).

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TABLE 2: BAKER 15: TRADE IN OIL

	Net oil exports* 1987
Bolivia	.51
Colombia	.21
Ecuador	.33
Mexico	.32
Nigeria	.94
Peru	.08
Venezuela	.80
Brazil	-.12
Chile	-.08
Morocco	-.15
Philippines	-.15
Yugoslavia	-.20
Baker 15	.15

Source: IIF

* Measured as a share of total exports of goods and services.

increases in interest rates have, in themselves, raised the debt servicing burden, they have to be seen against the unexpected strong growth in the world economy. Moreover, the general tightening of monetary policies in the OECD this summer as an early response to incipient inflationary pressures, is intended to engineer a "soft landing" in terms of OECD activity. Inter alia, this reduces the risk of abrupt swings in market growth and a sharper rise in interest rates which would be particularly destabilising for heavily indebted ldcs.

The main debt ratios (after allowing for distortions arising from the build-up and subsequent settling of arrears) are forecast to continue to decline for the Baker 15. However, for the SSA countries no underlying improvement seems in prospect in the absence of exceptional relief measures such as those under discussion in the Paris Club (see below).

Secondary Market Prices

Prices for ldc debt in the secondary market have drifted down recently (Chart 3) and on average are little changed from the floor reached last autumn. The continuing decline of bid-ask spreads suggests that trading activity is continuing to expand, although non-bank investor interest (discouraged by potential new money obligations) remains minimal. Citicorp recently announced that in the year to June 1988 it had disposed of $2bn of ldc loans at an average discount of only 18%. How it achieved this remains something of a mystery but it may partly reflect the valuation of assets acquired in exchange and trading profits in ldc debt may also have provided an offset. Some of the debt was swapped for equity and other local currency claims so the bank's overall exposure did not decline as much. The price of Iraq's debt is reported to have risen from 10c to 60c on the announcement of the ceasefire.

Recent market borrowing

Since June, Algeria and Pakistan have raised money from foreign banks. A US$ bond issue has been made by Venezuela (but targeted at domestic institutions). Issues have also been made by India, Taiwan and Thailand.

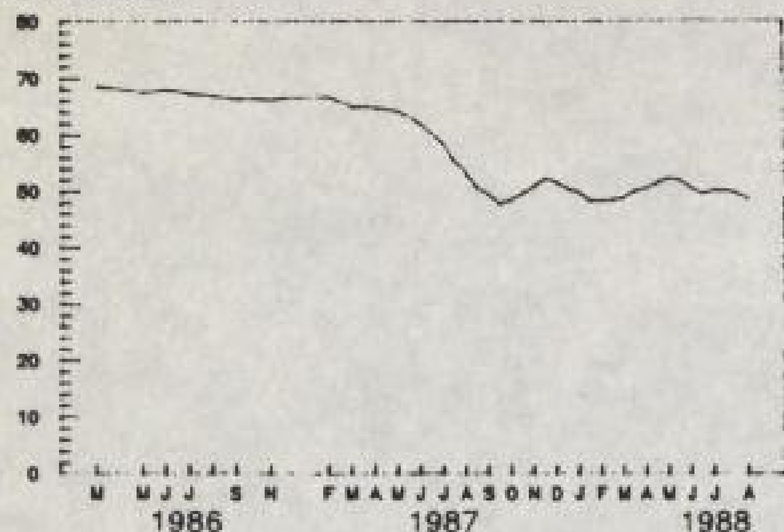
The Baker Plan in Retrospect

IIF estimates of the external financing of the Baker 15 over the three years 1986-1988 are set out in Table 3. They suggest that the banks have provided a

CHART 3

INDICATIVE SECONDARY MARKET PRICES(1)

ALL IDR COUNTRIES (WEIGHTED AVERAGE)



SELECTED MAJOR DEBTORS

BID/ASK SPREADS

(1) Source : Salomons, mid-point of bid-ask spread

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TABLE 3: BAKER 15: EXTERNAL FINANCING 1986-88

$ bns

	1986	1987(p)	1988(f)
Current account	-15.7	-9.4	-9.6
Non-debt creating flows	4.4	6.7	5.8
Official lending			
Bilateral	1.8	5.1	4.1
Multilateral	4.9	2.3	3.9
Sub-total	6.7	7.4	8.0
Private lending			
Commercial banks			
Net financing	0.3	5.6	3.3
Debt conversions	-1.2	-3.4	-2.8
Total commercial banks	-1.0	2.2	0.6
Other private	-1.0	-1.2	-2.2
Sub-total	-2.0	1.0	-1.6
Resident net lending	-2.5	-2.2	-2.7
Errors and omissions	2.0	-1.1	-
Change in reserves	7.2	-2.5	0.2

Source: Institute of International Finance, May 1988 - figures for the combined current account in 1988-89 differ slightly from the later IMF estimates shown in Table 1.

little under a half of the $20bn in new net lending proposed. However, debt conversions, which have a counterpart inflow included in the item "non debt creating flows" and which therefore lead to no net outflow, have also played a part in bringing about a better mix of debt and equity liabilities in debtors' external balance sheets. Net credit extended to Baker countries other than the 4 largest Latin American debtors has been fairly stable over the past three years, in the range $0.7-$0.9 bn pa. Within the latter group Brazil and Argentina have received the lion's share, a net $4bn and $3.6bn respectively over the period. Net borrowing by Mexico has been more modest ($1.4bn) while Venezuela has made net repayments in each year. Other private creditors have been steadily reducing their exposure. Resident outflows have been relatively stable.

While gross disbursements by multilaterals have also not met the levels envisaged under the Plan, the growing contribution of official creditors to the overall financing requirement is only too apparent. Greater reliance on non-debt creating inflows and official development finance is generally seen to be a desirable development. Although the banks are keen to quit the business of general balance of payments lending, there remains the question as to how much new money they should continue to provide in order to protect the value of their existing exposure. Official creditors are understandably reluctant to refinance existing bank debt which may prove to be too large in relation to feasible servicing capacity, whose limits remain so uncertain.

Sub-Saharan African Debt

Following the Toronto summit, the Paris Club has made some progress in formulating a creditor menu. As regards export credits at market rates a consensus on the terms of the two most concessionary elements - now formulated as forgiveness of 1/3 of principal or alternatively interest rate reductions of 3 1/2 percentage points, with the debt in each case being rescheduled over 14 years 8 grace - appears to have been reached. There has also been broad agreement on eligibility criteria. There remain two sticking points. First, the proposed 25 years/14 grace terms for the third, "longer rescheduling" option, which, while not providing relief in NPV terms, might be held to expose creditors to greater (or at least more prolonged) risks , are unacceptable to the US. Second, Japan and Germany (which, unlike other Paris Club creditors, still have significant low interest aid loans to SSA countries) are seeking special formulae that would give recognition to recent and prospective steps to alleviate the burden of these. Trichet, the Paris Club chairman, has circulated

a plea for compromise and reactions to this will be discussed later this month. Although the summit communique set an end-year deadline, there are still reasonable hopes of resolving remaining differences in time for the Berlin meetings.

IMF Arrears

Arrears to the Fund now total SDR2.2bn, or 8% of IMF credit outstanding. The Board have given a general endorsement to a Staff proposal whereby officials from creditor and donor agencies should meet in "support groups" and that corresponding Fund EDs should form a "task force" to assist a country which has expressed a willingness to undertake the necessary adjustment to draw up a "shadow" programme. The support group would take the lead in fostering support for the financing that would enable the country to clear its arrears and so restore its access to Fund money. There was also widespread support for the Chancellor's proposal that countries in arrears but pursuing successful shadow programmes should be allowed retroactive access to the ESAF (although the amounts available under the facility would only refinance part of the money that might be raised from other sources to clear the arrears). The banks are reluctant to provide new money which would have the effect of clearing arrears to the IMF as long as the latter's global net lending flow to heavily indebted countries remains negative. A progress report will be submitted to the Interim Committee this month.

Assessment

Although the remarkably quick achievement of critical mass for the Brazil agreement and the completion of a number of commercial and Paris Club reschedulings in recent months may have alleviated concerns that the current strategy had become bogged down, it has to be said that such progress has been made at the cost of a weakening of earlier standards of IFI conditionality. As an account of the domestic policy stance the following regional summary section makes grim reading in all but a few cases. In particular, three of the four largest Latin American debtors (Mexico perhaps excepted) are currently facing severe economic difficulties primarily attributable to lax fiscal policies. In all four sluggish growth is tending to hide, or until recently has hidden, the disequilibrium in their external accounts. Nevertheless, there have been some encouraging developments elsewhere. The Nigerian authorities now seem more amenable to a Fund programme although there may still be difficulty in closing the financing gap. The success of Chile's economic

policies has enabled it to negotiate a reduction in spreads, to obtain agreement from the banks to use assets to repurchase part of their debt, and to obtain an extension to its EFF.

An initial reaction to the implications of the ceasefire in the Iran/Iraq war is given later in the report. Welcome as the peace is from the humanitarian standpoint, higher oil production by the two former adversaries could lead to a further drop in oil prices intensifying the problems of Mexico, Venezuela and Nigeria among other indebted ldcs.

The strategy of dealing with each of the four main Latin American debtors singly to reduce the chances of collusion and a strengthening of their bargaining position has become even more apparent in the run up to the US elections in November. The US authorities seem anxious to avoid any upset on the international debt front which would exacerbate the problems of parts of the US financial sector. Over the past year the almost indecent haste with which bridging loans and World Bank money have been lined up for Argentina and the willingness to accept weak IMF programmes for Argentina and Brazil may also reflect growing US concerns over political and economic trends in Mexico. Should Dukakis win in November, US Administration attitudes to global debt relief may soften. For the present, the US is taking a hard line on global debt relief even in the Paris Club discussions on SSA countries, perhaps fearing contagion first to Nigeria and Egypt and then to Latin America. In contrast it appears to be adopting an even softer line towards its own clients.

As the share of troubled ldc debt in the banks' balance sheets has fallen (Table 4) so, inevitably, has their resistance to providing new money increased - particularly to second rank debtors. As the improvement has not been uniform, opportunities to compete at the expense of weaker banks still encumbered by a heavy portfolio of ldc loans have grown. The development of alternative financing options has undoubtedly kept the rescheduling process alive - the breadth of the Brazil package contributing to its rapid acceptance and the absence of a good menu delaying new money for Ecuador and Colombia. Sales of debt in the secondary market may also have cleared some small exposures. Nevertheless, the free rider problem has not been resolved: exit bonds remain an unproven instrument (although the take-up of those offered under the Brazil package appears to be going reasonably well) and the "novation" procedure proposed in the Cote d'Ivoire restructuring is in limbo. Proposals to use the IMF's powers under Article VIII to approve arrears to recalcitrant banks as an allowable exchange restrictions, which would have had far wider and undesirable

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TABLE 4

DEVELOPMENTS IN COMMERCIAL BANK LDC EXPOSURE

A British Banks' exposure to problem debtors

	Loans outstanding to Mexico and Brazil as percentage of capital*		Loans outstanding to all problem debtors end-1987	
	1984	1987	£ bns	Percent of capital*
Lloyds	78.8	53.2	3.9	111.3
Midland	134.9	59.8	4.1	111.5
NatWest	40.1	15.6	2.5	39.9
Barclays	43.0	17.2	2.8	50.7
Stan Chart≠	38.4	31.3	2.5	121.4

* Equity and undated loan capital and general provisions
≠ 1985 figure

Source: Annual reports

B Selected US banks' exposure to 4 largest Latin American Debtors ≠

	end 1982		end 1988 Q1	
	Amount ($ bns)	% of capital	Amount ($ bns)	% of capital
Citicorp	9.9	178	8.8	53
Bank of America	7.3	140	7.7	94
Manu Hanover	6.6	224	6.6	110
Chase Manhatten	6.0	157	6.5	82
J P Morgan	4.8	144	4.2	57

Memo: US banks' claims on all developing countries as a % of capital*

1982	1987 H1
209.2	94.8

≠ Source Merrill Lynch. US primary capital definition
* Source IMF

implications, have been headed off. Nevertheless, despite their reluctance to provide new money to countries such as Nigeria, Colombia and Ecuador, the banks have been showing some flexibility in their approach to special cases such as Costa Rica, Bolivia and Sudan where there is little alternative to relief. Whether techniques such as interest caps and other debt reducing techniques will in time spread to the large debtors is an open question.

Further details on individual countries are given below.

LATIN AMERICA AND CARIBBEAN

Brazil

On 26 July the Fund Board approved in principle a 19-month SBA for SDR1096mn (75% of quota). The programme became effective on 23 August following the Advisory Committee's confirmation that 95% of commitments to the new money package had been secured. The SBA sets ceilings of 36.6% of GDP for the PSBR and of 4% of GDP for the operational deficit this year. Unspecified policy measures for 1989 are to reduce the operational deficit to at most 2% of GDP (cf a Budget sent to Congress at end-August envisaging a deficit of 2.3%). The programme was criticised for its substantial front-loading of disbursements and lack of specific policy measures; nevertheless, it was approved unanimously. ECGD resumed medium-term cover for Brazil immediately the SBA became effective.

The favourable response to the new money package partly stems from an attractive range of options offered to the banks. Over 90% of requested commitments were received by 5 August (the cut-off date for the 3/8% "early bird" fee) and on 7 September reached 99.9%. A reduced fee of 1/8% was available for those committing by 2 September. Over 70 banks have taken up the exit bonds, involving $800 mn of debt. Activation of the agreement will enable Brazil to clear 1987's interest arrears. 1988 interest is current.

On 28-29 July the Paris Club agreed (subject to the SBA becoming effective) to reschedule, over 10 years/5 grace, 100% of principal due February 1987-March 1990 (about $5bn) and 70% of interest due August 1988-March 1990. The remaining 30% of interest will be repaid in two instalments on 1 April 1990 and 1 April 1991. Brazil had remained current on Paris Club interest payments since the moratorium was declared in February 1987.

Brazilian officials have expressed surprise at the ease with which apparently difficult steps, such as agreeing a Fund programme, have been accepted in Brazil. Nevertheless, Finance Minister Nobrega has been under greater domestic pressure over his attempts to tackle inflation and the fiscal deficit. He has resisted pressure for unsustainable quick fixes but his inability to prevent substantial wage increases for some public sector workers is undermining his position.

There is already talk of some of the key September IMF performance criteria being likely to be missed. Inflation has accelerated with prices rising at an annual rate of 600% in H1 (about 18% a month); the monthly rise was 24% in July and 21% in August. While the operational deficit for H1 was moderately encouraging at 1.1% of GDP (against 1.8% for H1 1987) further progress may be hampered by federal employees' increasing challenges to the April-May pay freeze. A slowdown in economic activity is attributed to a combination of accelerating inflation with retrospective wage indexation which is reducing real wages and demand: the Fund programme forecasts an increase in real GDP of only 2% as against 2.9% in 1987.

Weak domestic demand and improved terms of trade have produced an improvement in the trade surplus: for the first seven months of 1988 the surplus was $10.5bn, more than double that of the corresponding period last year. IMF forecasts of only a slight improvement in the full-year surplus to $13bn seem cautious, even allowing for the likely impact in H2 of trade liberalisation.

The new constitution completed in the week beginning 29 August includes a cap of 12% on annual real interest rates (including lending changes and commissions), and the banning of foreign majority share holdings in mining (including exploration and mineral refining) subject to a 5-year grace period.

Mexico

Carlos Salinas de Gortari, the presidential candidate of the ruling party (PRI), was declared the winner of the elections on 6 July, although with a much lower than expected majority and share of the vote.

The Mexicans may attempt another debt reduction scheme before December, perhaps including a partial guarantee of interest payments. Prepayments of private sector debt have been substantial, facilitated by generous terms offered by creditors, and the outstanding balance held under the FICORCA scheme has fallen to only $4bn

(against $9.4bn in March 1987). However, the proposed sale of the Cananea copper mine, which would have involved a reduction in public foreign debt of some $0.9bn, has been withdrawn because of the unwillingness of banks to participate. Debt equity swaps remain suspended and will not be resumed during the remainder of the current administration.

The Economic Solidarity Pact has been renewed for a further three months, to 30 November. The freeze on wages, public sector prices and the exchange rate has been extended (though some depreciation of the exchange rate had been expected) clearly signalling that reducing inflation remains the government's main priority. Inflation continues to fall: July's monthly rate of 1.7% was the lowest since mid-1981 and brought the 12-month rate down to 122%. Industrial activity during January-April was 4.9% above the same period last year. Deteriorating competitiveness, the recovery in domestic activity, import liberalisation and weaker oil prices have predictably led to a sharp fall in the trade surplus ($2.4 bn in H1 as against $4.8 bn in 1987 H1). Non-oil imports in H1 were up more than 50% on a year earlier. Despite receipts from the final tranche of the banks' financing package and higher inflows of foreign direct investment, official reserves fell sharply between March and July. Prepayments of private sector debt were a factor earlier in the year but more recently capital flight may have accounted for a significant part of the outflow. The reserves rose in August perhaps indicating a slowdown in prepayments or a partial reversal of other recent outflows.

The Fund staff do not expect a further programme or enhanced surveillance to be agreed until December or later.

Argentina

While foreign trade performance has recovered significantly this year, lower than expected capital inflows and capital flight have led to a severe cash shortage resulting in mounting interest arrears. No formal new money request has been made to the banks, who are anxious to see the arrears cleared before discussing a new financing package. However, informal talks have been held with the Advisory Committee and the Argentines are expected to seek about $2bn. The US Administration has been the force behind a proposed $0.5bn bridging loan (which would only partly alleviate the immediate cash flow problem). The US Treasury would provide $265 mn and, under the auspices of the BIS, ten European central banks (excluding the Bank of England) and the German state-owned KFW (significantly, not the Bundesbank) would

provide the remainder. Disbursement would be linked to effectiveness of the IBRD's Second Trade Policy Loan (TPL2) and a revised Banking sector loan now due to be presented in October. Drawings under the IBRD loans would not, however, be completed until end-February implying a four month bridge. Moreover, conditionality is weak: there is no direct linkage to a Fund programme; instead the World Bank's President would merely have to endorse macro-economic policies. There is an obvious change that the Bank will have to compromise its conditionality to ensure full disbursement of its loans in order to take out the bridge.

The fiscal position continues to deteriorate: real tax revenues fell in H1 and are expected to decline further in H2. The 1988 Budget, presented to Congress in mid-July assumes GDP growth of 1.5%, inflation of 284% and a fiscal deficit of 4.9% of GDP. (This may seem low by the standards of some other debtors but reflects the small share of (indexed) domestic currency debt in the total.) Inflation continues to accelerate: the CPI rose 25.6% in July (the highest monthly rate since the Austral Plan was announced in mid-1985) giving a 12-month increase of 322%. Upward pressure on prices seems set to continue in H2. Higher inflation resulted in the failure to meet all nominal targets for end-June under the SBA, and the programme will consequently expire with the remaining two tranches (SDR 331 mn) undrawn. Discussions on a new SBA started in August and Board consideration is expected around December.

In early August the government announced measures to curb inflation. The package includes higher public sector tariffs followed by a freeze until October, a pact with industry to restrain private sector price increases until September, and a 10.5% devaluation of the commercial exchange rate (frozen until September). Significantly, 50% of industrial exports and all imports excluding oil products were switched to the free market rate, and from April 1989 the government will begin unification of the exchange rates. Government expectations that the measures will ensure that the fiscal deficit target for 1988 is achieved seem optimistic. Domestic reactions to the package have been mixed, although Camdessus welcomed the measures as a serious effort to tackle imbalances.

The Peronist primaries, held in July, resulted in the stridently nationalist Carlos Menem being chosen as next May's Presidential candidate. He has recently proposed a negotiated five year moratorium on debt repayments.

Venezuela

While lower oil export revenues are only being partly offset by higher non-oil exports, the latter's growth continues to be hampered by an overvalued exchange rate. Any devaluation is likely to be postponed until after the Presidential elections in December. The deteriorating balance of payments outlook for 1988 has forced the Venezuelans to seek substantial new funds. In an Article IV report seriously critical of present policies, the Fund forecasts a financing gap of $2bn even after a $1.8 bn drawdown of reserves. The gap may be filled by bond issues of $0.5bn, sales of gold (up to $400 mn) and short-term operations with the BIS and other central banks ($1bn). As part of the programme of bond issues, Midland Montagu lead-managed a $100mn 5-year FRN which was launched on 22 August: the issue is, however, largely intended to meet the legal requirement that a proportion of some Venezuelan companies' assets be maintained in $-denominated assets. At end-June the BIS extended a $500 mn loan for a further 6 months to end-1988. Attitudes to debt servicing seems to have hardened recently. President Lusinchi has denied rumours of a moratorium but indicated that substantial assistance would be required from creditors if Venezuela were to meet its obligations. However, recent missions to US and Europe met a cool response from the banks. The two main candidates for President have intimated that another rescheduling will have to be negotiatied once the new government takes office in February 1989.

While the Venezuelan authorities have projected real GDP growth of 3.3% for 1988, against 3% in 1987, the Fund foresee growth of only 2%. The lower oil prices have weakened the fiscal position. Consumer prices began to rise more strongly in Q2 following a fall in inflation in Q1, and in June the 12-month rate was 25%.

Chile

Despite a strong rise in domestic demand, the trade surplus in H1 was $1.2bn, more than double that of a year earlier mainly, reflecting higher copper prices. Debt-equity swaps during January-May were $1.1bn, bringing total conversions to over $4bn, and investor enthusiasm seems unaffected by the impending plebiscite. Other direct investment inflows were $0.4bn during January-July, twice the level for the same period in 1987. In August the Fund approved an increase and a year's extension to the EFF. This is the first lengthening of an EFF and was facilitated by Chile's sustained adjustment effort. In early August the banks signed amendments to the term sheet which reduce from 1990 the spread on rescheduled debt from 1% to

13/16% and that on old new money from 1 1/8% to 7/8% providing Chile does not request concerted new money next year. The amendments also facilitate future voluntary new money and debt-for-debt swaps; Chile may also use up to $0.5bn from the Copper Reserve Fund to buy back debt.

Inflation continues to decline, aided by real effective exchange rate appreciation, some agricultural price reductions and lower VAT rates. It fell to an annual rate of 13.7% in July and is expected to be 10-12% by end-year. Real GDP is expected to rise by over 6% in 1988 and a fiscal surplus of 1.1% of GDP is expected in 1988 (cf a deficit of 0.8% in 1987).

The plebiscite (when Chileans vote for or against the official Presidential candidate Pinochet) will be held in October. Voting could be close: if there is a "no" vote Pinochet's government will remain in office until March 1990, with open Presidential and Parliamentary elections in January 1990. The opposition will however press for an immediate change of government if there is a 'no' vote.

Ecuador

The new government took office on 10 August. So far its attitude on debt has been conciliatory. The outgoing government had suspended debt negotiations with the banks in July with a new money agreement for $330mn left uncompleted. Preliminary talks have been held with the banks but detailed discussions have not been scheduled. President Borja has stated that Ecuador cannot pay interest in the present circumstances (arrears were some $0.7bn in June). The Ecuadoreans have indicated their intention to approach the Fund but wish to develop their own programme first (the SBA approved in December is off-track and is effectively dead). A package of emergency measures was introduced at end-August. Inflation continues to rise and reached an annual rate of 56% in July, the highest for five years. The trade surplus in H1 was $0.5bn, in line with the Fund's forecast of $0.8bn for the year. Real GDP is expected to rise by over 6% in 1988, after a fall of 5% in 1987.

Peru

Peru's acute economic problems have worsened, with monthly inflation reaching a record 30.9% in July (the 12-month rate rising to over 300%) and usable reserves effectively nil. The July inflation rate reflected a package of price and wage

rises in June and July, which were part of an 18-month gradualist adjustment programme. This has now been replaced (as has Finance Minister Robles) and a more drastic 120-day anti-inflationary plan announced. The measures announced by the new Finance Minister Salinas (former energy minister) on 7 September include devaluation of the Inti by 47.5% and unification of the exchange rate at I250 = $1 (the rate to be frozen until 1 December when it will be adjusted according to the previous month's inflation); raising of the minimum wage from $20 per month to $45 per month; and raising of petrol prices by nearly 400% (other reports say 200-250%).

Arrears to IFIs are still growing. Even interest payments on working capital loans from international banks have been suspended. Midland's debt-for-goods deal is not progressing well and Midland is now seeking a more co-operative local banking partner to allow a three-month extension of the contract to end-September. Peru intends to negotiate a rescheduling with banks (although relations with the Advisory Committee are virtually non-existent). However, Salinas' announcement on 7 September reportedly included an admission that Peru's economy had been unable to grow sufficiently in the past 2 1/2 years without help from the international financial community.

Colombia

Colombia has been seeking a $1.85 bn "voluntary" loan from the banks to offset amortisations due in 1989-90. Preliminary discussions have been held, but in the absence of a menu of options and with the request following so soon after Colombia's previous loan (approved in January only after difficulty) the banks are reluctant to participate for the full amount. This may push the Colombians into seeking a formal rescheduling for the first time - indeed rumours that they have already decided to have intensified. Continuing political uncertainties, violence and guerrilla activity cast a cloud.

Inflation this year is now expected to be higher and growth somewhat lower than earlier predicted. Despite a strong rise in imports and the loss of oil exports due to guerrilla activity, the current deficit has narrowed, partly reflecting higher transfer payments.

Uruguay

The trade balance has improved this year. Exports have been boosted by higher wool prices and volumes, while a fall in imports reflects a downturn in economic activity, attributable to the deepening recessions in Argentina and Brazil, rising interest rates and some overvaluation of the peso. Inflation in the 12-months to July was 62%, well above the Fund target, and attempts to restrain wage settlements are being met with increasing labour unrest. Higher government expenditure has also resulted in a widening of the budget deficit. On the debt front, Uruguay may ask the World Bank for a reduction in the guarantee fee on a $45mn co-financing loan.

Costa Rica

There had been signs of progress in discussions with the banks' Steering Committee when radical proposals (developed with the help of Fund and World Bank staff) were tabled by the chair bank (Bank of America). These include consolidating and restructuring the outstanding principal and overdue interest over 20 years, collateralisation of the new stock of principal, interest rates related to "ability to pay", establishment of an interest maintenance fund, plus exit mechanisms and debt-equity options. In response the authorities established an escrow account at the BIS into which full payment of interest due to the banks will be made from July, minus the $5mn a month paid to the banks directly. However, with the Advisory Committee considering possible alternatives no progress has been made on the terms sheet. A preliminary meeting was held with the chairman of the Paris Club in late June and a Paris Club rescheduling is likely in September. The second review of the SBA (approved controversially without full financing assurances last October) has been completed - although some performance targets have been missed, waivers were not sought and no drawings have been made.

Panama

In June, the IMF suspended Panama's right to draw. Arrears to both the IMF and the World Bank have grown. Preliminary information indicates that government revenues are sharply down and that real GDP will decline substantially this year. Most of the banks appear to have continued to roll over debt due as advised by the lead bank, Bank of America, although there is no formal agreement between the Panamanians and the Advisory Committee. An increase in bank deposits since May enabled banking restrictions on current accounts to be eased significantly during July. However, restrictions on all types of savings and deposit accounts remain unchanged.

Bolivia

The IMF Board approved the second Extended Structural Adjustment Facility for a three-year period, worth SDR 136 mn; an SDR 45 mn CFF was also approved. During the IBRD Consultative Group meetings in July, donor governments pledged to provide assistance totalling some $900 mn in 1988-1990. Following the completion of the buy-back of nearly half of Bolivian's external commercial bank debt in August, Bank of America confirmed the government was keen to repurchase the remainder of its bank debt, again at 11c in the $. However, although donor government support has reportedly been forthcoming, it is thought unlikely that the banks which did not participate in the first round would offer their debt for repurchase now at the old price.

Jamaica

An SDR 82 mn 14-month SBA will go to the Fund Board soon. If approved this will facilitate a Paris Club rescheduling later in the year. The economy continues to grow strongly while inflation remains relatively low. A widening of the trade deficit reflects the buoyancy of the economy but receipts from tourism have been maintained.

Other regional developments

In June the Andean Reserve Fund was expanded to become the Latin American Reserve Fund: it will have an initial capital of $0.5bn, provided by the Andean Group founder members and the remaining six members of the Latin American Integration Association (ALADI) (Argentina, Brazil, Chile, Mexico, Paraguay and Uruguay) will be able to apply for membership. The objectives of the new fund are BoP and reserves support through credits and loan guarantees, the harmonisation of exchange and monetary policies, and the facilitating of operations by members in international financial markets. A sound economic programme will be a condition for assistance.

There are indications that of the $4 bn earmarked for Latin America under the $20 bn Nakasone Plan between $0.9-1.5bn had been committed by mid-1988. Most loans have been small but significant amounts have been made available to Venezuela ($500 mn), Colombia ($345 mn) and Argentina ($370 mn). Brazil has not been a major beneficiary so far because of its lack of progress with creditors, though it has requested assistance of $5.5bn from Japan for 19 major projects and programmes.

SOUTH AND EAST ASIA

Philippines

A current account deficit of $234 mn was recorded in H1 1988, compared with a deficit of $212 mn in H1 1987. Little emerged from a meeting of the banks' Advisory Committee in July which appears to have been arranged for domestic political consumption in the Philippines. A new IMF programme (possibly an EFF) is expected to come into effect before the end of the year.

Malaysia

Real GDP growth has been strong and forecasts for this year revised up from 5-5.5% to 7-7.5%. The recovery reflects higher commodity prices and exports of manufactured goods. The current account surplus is now forecast to exceed $2.7 bn (8.2% of GDP) in 1988 compared with $2 bn (6.3% of GDP) in 1987. The constitutional crisis has taken another twist following the dismissal of Malaysia's most senior judge. It is unclear whether the judiciary can now maintain its traditional independence. The Supreme Court has ruled in favour of Dr Mahathir in the protracted dispute for control of Malaysia's dominant political party UMNO.

Indonesia

At its annual meeting in The Hague in June, the Inter-Governmental Group on Indonesia (IGGI) pledged $4.01 bn in aid commitments, compared with the $3.6 bn recommended by the World Bank and the $3.15 bn agreed in 1987. Indonesia will also receive a further $1 bn in special aid, the majority of which will come from Japan which announced a $900 mn soft loan over and above its IGGI commitment. The scale of the IGGI pledges once again demonstrates international confidence in Indonesia's economic management.

Thailand

The July General election resulted in a majority for the outgoing four-party coalition government. However, against all expectations, General Prem resigned as Prime Minister and was succeeded by Chatichai Choonhavan, leader of the Chart Thai Party, the largest component in the new six-party coalition. No fundamental

changes to economic policy are expected and forecasts for real GDP growth in 1988 range from 7.5% to 10% compared with 7.1% in 1987, whilst the current account deficit is likely to be less than the 1.7% of GDP recorded in 1987.

Pakistan

The death of President Zia ul-Haq has come at a particularly awkward time for Pakistan. Although growth in the last fiscal year 1987/88 was put at a respectable 5.8%, fiscal and monetary laxity and the loss of two thirds of the reserves during June and July give cause for concern. With no obvious successor to Zia, there is a distinct possibility that tough economic decisions will be avoided.

Burma

After his resigantion, Ne Win remains the most influential figure behind the scenes. Burma is, however, paralysed and without an effective government. There is no united opposition yet, but a wave of public unrest is sweeping the country with calls for multi-party democracy. This may provoke the army to intervene directly, leading to further bloodshed. The economic situation is perilous, and a general collapse of the country, with a civil war, cannot be ruled out.

EASTERN AND SOUTHERN EUROPE

Poland

The two-stage MYRA agreed with the commercial banks in July 1987 - which virtually reschedules all of Poland's debt to the commercial banks (some $8 bn) and provides for rising repayments of restructured maturities over 15 years - was finally signed in July 1988. The Poles won a further reduction in the margin to Libor +13/16% (cf Libor +15/16% under the initial terms of the agreement). Poland's repayment obligations on all medium and long-term debt rise from around $1 bn in 1988 to over $3 bn in 1990. Although the Poles hope to discuss the possibility of a Fund programme, early agreement is unlikely, given differences that still remain particularly on the pace of current account adjustment. Further concessions following the latest wave of industrial unrest are likely to compound the problem. Another interim agreement with the Paris Club will probably be sought, following on from that struck in October 1987 covering the period to end-1988. The $0.8 bn build-up in reserves in 1987 should give the Poles a sufficient cushion to meet

their 1988 payment obligations of $1.7 bn non-rescheduled interest and $1 bn non-rescheduled principal, despite some expected deterioration in the current account.

Yugoslavia

The agreement with the commercial banks on an 18-year rescheduling (6 years' grace) of all arrears accumulated since June 1987 and all principal falling due up to end-September 1996 will be signed later this month. An SDR 306 mn SBA was approved in principle on 1 June, following a 24% devaluation of the dinar and the liberalisation of the foreign exchange, imports and price regime. The IMF identified a $1.2 bn residual financing requirement: $0.5 bn to be provided by official creditors, $0.4 bn from international agencies and $0.3 bn new money, in the form of a trade and deposit facility from the commercial banks. Critical mass on this last element was reached in mid-June, enabling the SBA to become operative. A $200 mn bridge facility with the BIS (to which the Bank of England, with an HMT indemnity, contributed $30 mn) and a $50 mn parallel facility from the US was made available in three tranches linked broadly to the first three drawings of the SBA. Official creditors agreed on 13 July to reschedule 100% of principal and interest (including previously rescheduled debt but excluding that covered by the 1983 Berne Agreement) falling due between 1 April 1988 and 30 June 1989 over 10 years with 6 grace.

Although Yugoslavia's trade account appears to be in a relatively healthy position at present, there have been delays in import liberalisation and evidence of suppressed inflation, and the situation may deteriorate. IMF targets on reserves and inflation seem likely to be missed.

Hungary

Hungary is approaching the mid-term review of its SDR 265 mn one-year SBA concluded with the IMF on 16 May. The report, scheduled for discussion on 16 September, is positive in its overall assessment of Hungary's H1 performance - the current account deficit has fallen to $480 mn (cf $813 mn in H1 1987) largely as a result of a 20% rise in export receipts and small decline in the value of imports over the same period 1987. The Fund appear confident that barring adverse exogenous developments, Hungary will meet the SBA performance criteria for the year. Following the approval of the SBA, Hungary obtained two IBRD loans totalling $250 mn.

Romania

Further talks with the banks, intended to reduce the margin on Romania's remaining debt, are being sought.

Turkey

In H1 the trade deficit widened but high invisible earnings are expected to lead to some reduction of the current account this year.

Greece

The H1 current account deficit was only marginally higher than last year's figure of $1.45 bn and with non-debt capital inflows remaining buoyant the official objective of zero net new external borrowing this year should be met. Following the expiry of the government's "Stabilisation Programme" the prospects for stronger GDP growth this year remain good but the target of a single figure inflation rate is unlikely to be met. A sharply higher fiscal deficit is probable.

SUB-SAHARAN AFRICA

Nigeria

Prospects for a new IMF agreement by the end of this year now look brighter. The IMF mission which left Lagos at the beginning of August reported 'substantial progress' on aspects of monetary policy and on the budgetary adjustment for 1988. A fiscal correction of 5% of GDP has been agreed, through an extensive across-the-board reduction in recurrent expenditure and selective cuts in capital expenditure. The foreign exchange auction is to be discussed at a further meeting between the IMF and the Nigerians in Washington, on 6 September, and indications are that a free interbank market will emerge. Closure of the financing gap, which will form a major part of the September discussions, continues to present difficulties. The IMF's current projection for 1988/89 assumes further import compression, and new money from the World Bank and Japanese cofinancing. Fund staff are also looking to a generous Paris Club rescheduling (ideally Toronto terms, but certainly rescheduling of moratorium interest, and long repayment periods); the restoration of export credit cover; and a donors' conference, hopefully in November under World Bank Chairmanship, at which the UK would be expected to play a major role. The Nigerians

also appear more open to the possibility of drawing under a Fund programme, though recent reports have been conflicting. Nigerian negotiations with the London Club have achieved a broad agreement on rescheduling terms. However, the banks adamantly refuse to provide new money. The agreement (which in the absence of new money will result in a small net reduction of the banks' exposure over the next 18 months) provoked adverse reactions from the IMF and IBRD, both of which had originally assumed some London Club new money. The banks argue that the rescheduling terms represent a significant easing of the Nigerian cash flow, and compensate for the lack of new money. The Nigerians have taken a similar view, surprisingly favouring further import compression if necessary, though they are also mindful of other creditors' burden-sharing concerns. The IMF has subsequently accepted that no more can be got from the banks; the IBRD's position remains uncertain. A clearer picture of Nigeria's financing needs (especially in view of the further weakening of the oil price), and a more considered response from the multilaterals, should emerge during the September negotiations in Washington, when the Nigerians and the banks are also due to meet to finalise the rescheduling details.

South Africa

In the face of a rapidly deteriorating balance of payments position the South African authorities have introduced a package of import control measures, which reportedly could cut about $0.6 bn off the annual import bill (about 5% of 1987 import levels).

Cote d'Ivoire

The London Club agreement remains inactive. The Ivorians are struggling to find money to pay interest due to the banks, and the IMF is unwilling to lend unless cocoa producer prices are adjusted towards world levels and public sector wage increases are restrained. The process of "novation" whereby the Ivorians will deny payment of interest arrears to those banks unwilling to put up new money, may come to nought.

Kenya

Inflation in the year to May reached 10.6%, much higher than programmed for 1988 as a whole (at 7%). Coffee prices have recently reached seven year lows, adding to

the uncertainty over Kenya's medium-term outlook. Favourable commodity prices and substantial aid flows will be needed in the coming year if Kenya's longer term performance under the programme is to be satisfactory.

Malawi

In July the IMF approved a three-year ESAF. Malawi is the first Fund member to benefit from the new facility which will supercede the current 18-month SBA. In advance of the SBA the authorities lifted the debt moratorium and concluded reschedulings at both the London and Paris Clubs. A Consultative Group of donors pledged $555 mn over three years, to support the programme.

Sudan

The already dismal prospects for the Sudanese economy have worsened further with the recent floods and the prospect of locust swarms. Prime agricultural areas have been swamped and cotton crop estimates have been halved. As a consequence the FY 88/89 financing gap, assuming non-clearance of arrears, is likely to be wider than the projected $325 mn. Expenditure on flood relief is likely to push up the fiscal deficit and largely negate any benefits of higher revenues, even if these could be achieved by broadening the tax base. Discussions with the IMF on a new shadow programme and PFP have collapsed after failure to agree key economic reforms, particularly devaluation. Although talks continue, and technical assistance is still on offer, there appears to be little chance of a Consultative Group meeting being called before the end of the year. The stability of the government, already threatened by mis-handling of Sudan's other problems, may be further undermined if it fails to cope adequately with the latest crisis.

At end-June the Fund Deputy Managing Director presented a draft paper on an external financing framework for medium-term BoP viability envisaging substantial aid, exceptional rescheduling terms and a commercial bank debt-buy back scheme at deep discount. However, the proposal preceded the floods and the magnitude of the assistance now required suggests that, even if implemented, the programme would have a financing gap unfilled.

Zaire

Zaire is at an impasse with the IFIs over policy measures since its last SBA broke down in late 1987. Since then arrears have accumulated. The Fund are said to be looking for a commitment to reduce the budget deficit and for action on price reform.

Zambia

Presidential elections are due this year and this will cramp the government's ability to take any radical action in the near future. A Fund program seems unlikely as the Finance Minister has repeated the government's determination to pursue policies independently of the IMF. Promises of donor support, he said, would not tempt the authorities away from this course. At mid-1988 arrears to the Fund amounted to SDR 496.6 mn.

Zimbabwe

The Fund are confident that a programme can be agreed in 1989. The Zimbabweans favour an EFF but the Fund is determined to have at least one year's adjustment under an SBA or a shadow programme (as proof of commitment to adjustment) before launching into a full blooded EFF. However there is nothing in the recent budget proposals to suggest that Zimbabwe intends to confront deep-seated structural rigidities.

MIDDLE EAST & NORTH AFRICA

Gulf

Following the August ceasefire the major priority for Iran and Iraq will be reconstruction - and the re-equipping of their armed forces. However, it is questionable whether financial assistance from the Gulf States will be forthcoming, certainly on the scale ($50 bn or more) canvassed in some quarters. Gulf donors are likely to be reluctant to strengthen the two countries they continue to fear, and their ability to provide finance is also limited. Saudi Arabia continues to experience large budgetary and external deficits and oil market uncertainties, as well as heavy commitments under the Tornado deals, are likely to preclude any significant increase in assistance beyond what currently goes to Iraq (except perhaps by writing off past "loans" to this country).

OPEC also faces a testing time. Iran and Iraq may try to boost oil production in an attempt to maximise revenues and prices could collapse, though this might then restore some discipline to the organisation.

The broader implications of the end of the war for the Gulf economies are not yet clear. Although reconstruction may have positive benefits for the region, eg in providing work for the depressed Gulf construction industries and employment for skilled workers, some countries will suffer if the oil market is destablised further and expatriate workers are replaced by returning soldiers in Iraq.

Iran

Iranian promises to adhere to its OPEC quota may reflect production difficulties (caused by over-exploitation during the War). Oil revenues may also be depressed by falling prices - the probable result if Iraq were to raise its own production. Iran is unlikely to receive reparations from Iraq and multilateral reconstruction aid is not likely to be large because of potential donors' financial constraints and Iran's poor political relations, especially with the US and Saudi Arabia. Despite its low level of indebtedness and good payment record, Iran seems unlikely to be able to secure long-term commercial loans on the scale needed, even if its religious sensibilities allowed it to seek them. Hence foreign exchange is likely to remain in short supply preventing the rapid reconstruction of the industrial sector.

Iraq

If the cease-fire holds Iraq's priorities are likely to be military and civilian reconstruction and military restocking (given the fear of future Iranian aggression and the continued action against the Kurds), with debt service a residual. Additionally, the Shatt al-Arab Waterway will have to be cleared, or alternative port facilities constructed. The satisfaction of pent-up consumer demand may also be needed to secure Saddam Hussein's political position.

Financing these requirements from the three major sources of revenue (oil, aid and borrowing) may present serious problems. Given Iraq's territorial claims on Kuwait and Saudi Arabia's budgetary problems, significant amounts of Gulf aid (above the present estimated level of $2-3 bn pa) is unlikely to be forthcoming. Oil revenues are also unlikely to rise as higher production would probably weaken prices. Iraq's ability to borrow will be hampered by its current level of indebtedness and its poor payment record. (In a wafer-thin secondary market Iraqi debt was quoted at 10% of face value before the ceasefire and 60% after). At present only the US and UK ECAs are providing significant amounts of cover. There is no sign that the

Iraqis are prepared to regularise their position with the IMF or Paris Club. A UK-Iraqi Joint Commission is scheduled for November at which the Iraqis can be expected to press ECGD to offer greater credit facilities.

Egypt

Negotiations with the Fund on a new programme remain stalled over exchange rate, interest rate, pricing and fiscal policy. The Fund believes that this year's budget deficit could be at least 15% of GDP - poor budgetary control persists and the authorities continue to resist the reduction of subsidies. Refusal to accept such reforms is holding up a series of proposed World Bank structural adjustment loans. Despite the recent floods in Sudan, the level of the Nile may fail to improve sufficiently to obviate the need for several gas-fired power stations (with their associated imports). In the financial sector, although laws to regulate the hitherto unregulated Islamic Investment Houses have been passed, several are effectively insolvent and the threat of a financial crisis has not yet passed.

Arrears look set to grow as Egypt continues to resist IMF and World Bank reform programmes. The failure to reach agreement with the IMF precludes a Paris Club rescheduling of repayments falling due after July 1988.

Jordan

With growth slowing the Jordanian authorities are having to review the 1986-90 Development Plan. Fiscal weaknesses remain and it is questionable whether the projected improvement in the fiscal deficit in 1988 can be realised, despite the recent withdrawal from the West Bank. IMF projections, for rough balance in the overall BoP position for the period 1989-92 are highly dependent on remittances and foreign aid, which may not materialise. In addition, the government eased its protectionist stance in July. Jordan hopes to benefit from an end to the Gulf War through the employment of Jordanian construction engineers etc. On the other hand, the ceasefire is eventually likely to reduce revenue from road transportation through Jordan used by Iraq. Trade problems with Iraq have now been resolved, however, with Iraq agreeing in principle to extend the 1988 protocol to cover $100 mn of extra Jordanian exports and to attempt to repay its US$500 mn trade debts to Jordan within 2 years. (These difficulties had led to a slump in the dinar, but the Central Bank, after borrowing to strengthen depleted reserves, now has better control of the currency.) Jordan is reportedly seeking a $150-200 mn Euroloan to

cover its financing gap. Even if successful, the spread is likely to reflect the perceived diminution of Jordan's creditworthiness. However, the proposed Tornado deal is likely to preempt much or all of any remaining country limits in the banks and ECAs.

Algeria

Foreign exchange shortages persist and austerity measures remain in place. The external position is unlikely to improve significantly while the prospects for hydrocarbon exports remain uncertain. Recently introduced liberalisation measures will take time to work through and produce higher non-hydrocarbon exports. Despite projected current account balance in 1988, Algeria faces a large financing gap as a result of amortisation payments in the region of $4 bn. As part of the Japanese recycling, approximately $700 mn has already been provided by EXIM Bank credits and through private placements. The DM and eurodollar markets have also been tapped (however, the 7/8% spread on Algeria's recent $100 mn eurodollar loan represents a significant hike from last year's 5/8% margin). Some banks appear willing to lend cautiously but only at higher spreads as borrowing remains heavy, county limits are being approached, and arrears to non-banks persist. Concern about the debt servicing burden has also stemmed from Algeria's exposure to currency risk on the debt, resulting from a currency mis-match between Algeria's largely dollar denominated income and its mostly non-dollar debt.

Morocco

The IMF approved a new SBA for Morocco at the end of August, a pre-condition for the second phase of the commercial bank rescheduling and a new Paris Club deal (already requested by the Moroccans). Although arrears to commercial banks were cleared as part of the rescheduling in January, trade arrears persist but the authorities aim to eliminate these during 1988. A bumper harvest (and the prospect of an end to the war with the Polisario) should improve bop prospects but the accompanying increase in producer subsidies could weaken the fiscal position.

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RECENT SOVEREIGN BORROWING BY LDCS

Date Announced	Borrower	Amount (mn)	Maturity/ Grace (years)	Spread or Fixed rate (%)
BANK BORROWING				
Africa				
16/7	Algeria - Banque Exterieure d'Algerie	$100	7/4	7/8
19/7	Madagascar - Banque Centrale de la Republique Malgache	$7	1	1 1/4
Asia				
27/5	India - Air India	$150	10/4	3/16-1/4
13/5	Pakistan - International Airlines	$63	7	-
16/7	Pakistan - Rice Export Credit Corp	$50	1	5/8
17/6	Thailand - Thai Airways International	$72.5	16	-
South America				
15/5	Venezuela - Super Octanos	$70	11/3	5/8
Communist				
22/6	China - Air China	$58	-	-
Middle East				
6/5	Iraq	£17.7	5	7/8
South Europe				
27/5	Greece - Athens Urban Transport Authority	$50	7	5/8
27/5	Greece - Bank of Greece	DM 278	6/5	1/2-5/8
30/6	Greece - Public Power Corporation	$150	8/5	-
Pacific				
13/8	Papua New Guinea - Electricity Commission	$17	7/3	3/4

Date Announced	Borrower	Amount (mn)	Maturity/ Grace (years)	Spread or Fixed rate (%)
BONDS				
Asia				
9/7	India - ICICI	SFR 80	7	5 1/4
20/8	India - Industrial Development Bank of India	DM 250	7	5 5/8
28/5	India of State Bank of India	Yen 15 bn	5	5 1/4
11/6	Malaysia	SFR 100	10	5 1/4
28/5	Taiwan - Bank of Communications	HKD 200	5	5 3/100
23/7	Taiwan - Bank of Communications	$100	5	9 3/8
18/6	Thailand	SFR 200	7	4 5/8
9/7	Thailand	DM 200	5	5 3/4
Caribbean				
14/5	Barbados	Yen 5 bn	10	6 4/5
Communist				
14/5	Czechoslovakia	Yen 10 bn	10	5 1/2
18/6	Hungary - National Bank of Hungary	DM 200	6	6 1/4
Pacific				
14/5	Nauru	Yen 4 bn	7	6 1/2
South America				
20/8	Venezuela	$100	5	1 7/8
South Europe				
27/8	Greece - Bank of Greece	Yen 20 bn	10	5 9/10

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OVERDUE OBLIGATIONS TO THE FUND(1) (SDRmn)

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding (SDR mn)	Forthcoming Obligations (to 1999)
KAMPUCHEA	13 March 1975	32.2	13.7
GUYANA	31 May 1983	78.2	34.7
VIET NAM	6 February 1984	90.8	66.4
SUDAN	12 July 1984	642.9	239.2
LIBERIA	14 March 1985	221.9	81.5*
PERU	9 December 1985	446.8	320.6**
ZAMBIA	6 June 1986	496.6	372.6**
SIERRA LEONE	13 February 1987	43.3	61.5
SOMALIA	2 July 1987	34.9	119.4
PANAMA	28 December 1987	67.3	230.6#
HONDURAS	15 January 1988	13.5	41.2*
HAITI	6 May 1988	4.7	41.0**
		2,173.1	1622.4

(1) Includes both overdue repurchases and charges of members with at least one obligation overdue for more than one month.

NB The above figures are from Fund papers issued with respect to individual country complaints. There will have been further obligations falling due subsequently, so the figures are not entirely up-to-date. A Fund source indicates that total arrears were SDR 2,160.4 mn as at 28.7.88 but this figure is not broken down by country.

* Honduras, Liberia only to 1992.
** Haiti, Peru and Zambia only to 1993.
\# Panama only to 1994.

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INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1987*	End-December 1987	End-March 1987 [2]	End-March 1987 [3]
Latin America				
Argentina	57	3.3(1.1)	0.2	0.2
Brazil	121	6.7(4.9)	1.0	1.9
Chile	20	1.2(1.0)	-	0.1
Colombia	15	0.5(0.9)	0.1	0.1
Costa Rica	4	0.1(-)	-	-
Ecuador	10	0.6(0.5)	0.1	0.1
Jamaica	4	0.1(0.1)	-	-
Mexico	104	6.3(2.6)	0.7	1.3
Peru	18	0.3(0.3)	0.1	0.2
Uruguay	5	0.3(0.3)	-	-
Venezuela	35	2.1(0.8)	-	-
Far East and Australasia				
Indonesia	46	0.6(3.6)	0.9	1.8
Pakistan	16	0.2(0.1)	0.1	0.1
Philippines	29	1.4(0.1)	0.1	0.2
Eastern Europe (convertible currency)				
Bulgaria	6	0.2(0.3)	-	0.1
Hungary	18	0.4(0.3)	-	0.1
Poland	39	0.7(0.4)	1.3	1.4
Romania	6	0.2(-)	0.3	0.4
Yugoslavia	20	0.8(0.8)	0.7	0.9

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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 countries amounted to $11 mn at end-December 1987.

[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 1987*	End-December 1987	End-March 1987 [2]	End-March 1987 [3]
Europe				
Greece	21	1.4(1.9)	0.1	0.3
Turkey	38	0.5(1.7)	0.2	0.6
Sub-Saharan Africa				
Cote d'Ivoire	12	0.3(0.1)	0.1	0.1
Kenya	4	0.1(0.1)	0.2	0.5
Nigeria	26	1.4(1.2)	2.5	3.5
South Africa	23	3.7(5.6)	0.9	2.5
Sudan	12	0.1(0.1)	0.2	0.2
Zambia	6	0.3(0.1)	0.2	0.2
Zimbabwe	3	0.1(0.3)	0.2	0.3
Middle East and North Africa				
Algeria	24	0.4(0.8)	0.2	0.4
Egypt	50	0.3(1.8)	0.3	1.3
Iraq	65[4]	0.1(0.8)	0.6	1.6
Jordan	5	0.2(0.1)	0.1	0.7
Morocco	20	0.2(0.2)	0.2	0.3
Oman	3	0.1(0.4)	0.7	1.9
Saudi Arabia	18[5]	0.7(1.9)	0.2	0.3

[4] Includes $30 bn from Arab countries.

[5] External bank and guaranteed trade debt at end-December 1987.

* Current estimate.

BILATERAL AGREEMENTS - CURRENT POSITION AT 1 SEPTEMBER 1988

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
ANGOLA I	-	-	17.11.87	04.12.87 (London)	04.12.87		FCO has now received the Portuguese translation and will arrange for conclusion of Exchange of Notes as soon as possible - 28/7.
ARGENTINA I	16.01.85	30.06.85	23.04.85	15.05.85 + 29-31.01.86 (Paris)	28.08.87		English and Spanish texts agreed. FCO arranging Exchange of Notes through "Protecting Powers" -Switzerland and Brazil. Swiss passed bilateral documents to Argentinians 12/1. Reminders sent to Berne 8/3 and 23/6. Bilaterals signed 15 out of 16
ARGENTINA II	20.05.87	31.12.87		To be arranged			Draft text prepared; awaiting signature of Agreement No 1 before sending to Argentinians. Debt list sent 17/12. Bilaterals signed 9 out of 14
BRAZIL III	29.07.88	31.03.89		To be arranged			Draft text prepared. We await outcome of TMD discussions on refinancing possibility, however before further progress.
COTE D'IVOIRE III	27.06.86	31.01.87	08.10.86	24.10.86 (Paris)	24.10.86	28.06.88	Exchange of Notes concluded.
COTE D'IVOIRE IV	18.12.87	31.05.88	08.04.88	13.04.88 (Paris)	13.04.88	14.07.88	Exchange of Notes concluded.
ECUADOR III	20.01.88	31.08.88	07.04.88	26/28.04.88 (Quito)	28.04.88	09.08.88	Exchange of Notes concluded.
GABON II	21.03.88	31.10.88	10.06.88	27.06.88 (London)	27.06.88		Bilateral negotiations concluded, text despatched by F.C.O on 7/7.
GUINEA REP I	18.04.86	31.12.86	16.09.86	29.10.86 (London)	29.10.86		Documents have been submitted to Guinea but no response as yet. We wrote to FCO 26/8 asking them to explain to Guineans the need to sign the agreement.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
JAMAICA III	05.03.87	30.09.87	20.05.87	09.06.87 (London)	09.06.87	16.03.88	Exchange of Notes concluded. Amendment needed, however, to reflect extended Consolidation Period -fresh Exchange sent out 19/8.
MALAWI III	22.04.88	31.12.88	11.07.88	To be arranged			Text passed to Min. Fin. on 18/7 by Post. We have suggested conclusion by correspondence. Post chased 25/8.
MAURITANIA II	16.05.86	31.12.86	14.07.86	28.11.86 (London)	28.11.86		Documents passed to British Embassy in Paris 14/1. FCO chased 29/2. No response from Mauritanians.
MAURITANIA III	15.06.87	29.02.88	08.01.88	By correspondence	03.03.88		FCO despatched Exchange of Notes on 4/5. Contacted FCO on 28/7 they are monitoring the situation but there are difficulties because there is not an embassy in Mauritania.
MOROCCO III	06.03.87	30.09.87	29.07.87	19/20.10.87 (London)	20.10.87		FCO chased 5/7 -it now appears that the situation has improved and that there is a possibility of signature quite soon.
MOZAMBIQUE II	16.06.87	30.06.88	31.12.87	To be arranged			Preliminary discussions held with MoF in London on 11 January; commercial rate of interest unacceptable to Mozambicans. A further visit was made by a Bank of Mozambique Official who accepted the text of the Agreement but no further progress was made on the interest rate(19/4). Bilaterals initialled 2 out of 14
NIGER V	21.04.88	30.09.88	23.05.88	26.05.88 (London)	26.05.88		FCO despatched Exchange of Notes 9/6.
PHILIPPINES II	22.01.87	31.03.88	13.07.87	17/18.11.87 (Manila) and 01.03.88 (London)	01.03.88	24.03.88	Exchange of Notes concluded. However minor amendment necessary -fresh exchange sent out 15/8.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
POLAND IV	16.12.87	31.05.88	04.02.88	9/10.03.88 (Warsaw) and w/c 03.10.88 (London)			Offer put to Poles in negotiations rejected on 30/3. We have reaffirmed our position but left way clear for another meeting which has been arranged for w/c 3/10. Bilaterals initialled 2 out of 17
SIERRA LEONE IV	19.11.86	30.04.87	23.03.87	26.03.87 (London)	26.03.87		High Commissioner in Freetown sent note to MoF 22/5. Despite numerous "chasers" the High Commission feels there is little prospect of making any progress-1/8.
SOMALIA II	22.07.87	31.12.87	27.11.87	8/9.12.87 (London)	09.12.87		Agreement initialled.Documents sent to Mogadishu on 7/1, FCO chased formally 17/3. The Head of Chancery is currently on leave and whilst here there was an informal meeting at which concern was expressed at the length of time that completion was taking-1/8.
SUDAN IV	03.05.84	28.02.85	24.07.85	08.08.85	08.08.85		Formal signature still outstanding. No action taken to pursue due to increasing arrears under previous agreements and Sudan's position in relation to IMF.
TOGO VI	22.03.88	31.10.88	08.07.88	9/10.08.88 (London)			Negotiations held 9-10/8. These proved inconclusive - Togolese unwilling to accept either Libor + 1/2 or fixed rate of 10.625%.
YUGOSLAVIA IV	13.07.88	31.12.88	15.08.88	02.11.88 (London)			Draft bilateral text sent out 15/8. Negotiations to take place in London commencing 2/11.
ZAIRE VII	15.05.86	31.12.86	16.06.86	07.07.86 (London)	07.07.86		Delays on part of Zaire to arrange conclusion of agreement. FCO chased 26/7.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
ZAIRE VIII	18.05.87	31.12.87	30.09.87	06.10.87 (London)	07.10.87		Documents sent to Kinshasa on 26/1.Embassy has requested details for a formal signing ceremony for both VII and VIII.Cable from Post 28/7 indicates that Zairoise are awaiting conclusion of IPPA loan negotiations beforehand - FCO have since explained that these have no connection with signature of bilateral.

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PARIS CLUB FORWARD PROGRAMME

Country	Extant bilateral agreements (rescheduling/ refinancing)	Possible timing of next Paris Club restructuring	Non-consolidated arrears at 30 June 1988	Non-consolidated forward exposure 1 July 1988 - 31 December 1989	Expiry date of last bilateral
Bolivia	1 (1/0)	Oct 1988	GBP 0.16m	GBP 1.21m	30.06.87
C.A.R	1 (1/0)	Oct 1988	GBP 0.00m	GBP 0.00m	31.12.81
Colombia	0 (0/0)	1989	TBA	TBA	
Congo	1 (1/0)	Nov 1988	GBP 3.30m	GBP 18.63m	31.03.88
Costa Rica	2 (2/0)	Sept 1988	GBP 2.25m	GBP 0.56m	31.03.86
Cuba	4 (4/0)	Dec 1988	GBP 4.87m	GBP 2.69m	31.12.86
Guyana	0 (0/0)	Dec 1988	GBP 53.36m	GBP 3.96m	N/A
Jamaica	3 (3/0)	Oct 1988	GBP 1.68m	GBP 8.54m	31.05.88
Madagascar	5 (5/0)	Oct 1988	GBP 0.66m	GBP 1.26m	31.03.88
Mauritania	3 (3/0)	Jan 1989	GBP 0.00m	GBP 1.13m	31.05.88
Mali	0 (0/0)	Sept 1988	GBP 7.06m	GBP 2.02m	N/A
Morocco	3 (3/0)	Sept 1988	GBP 0.00m	GBP 27.21m	30.06.88
Nigeria	1 (1/0)	1988	GBP 272.46m	GBP 782.96m	31.12.87
Philippines	2 (1/1)	1988	GBP 0.00m	GBP 6.32m	30.6.88
Tanzania	1 (1/0)	Oct 1988	GBP 1.40m	GBP 3.74m	30.09.87
Uganda	3 (3/0)	Oct 1988	GBP 0.00m	GBP 0.00m	30.06.88
Zaire	8 (8/0)	Nov 1988	GBP 0.00m	GBP 0.00m	14.05.88

All figures based on latest P.C declaration forms

RFO

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

21 July 1988

Paul Gray Esq
10 Downing Street
LONDON SW1

Dear Paul,

"CREDIT-WORTHINESS RATIOS"

The Chancellor thought the Prime Minister might be interested to see the attached table from an OECD WP3 Report on "The Financing of International Imbalances", which shows various measures of net external assets etc. for OECD countries. It shows the UK top of the G7 and second in the OECD to Switzerland on these calculations of credit-worthiness.

Yours
Alex

A C S ALLAN
Principal Private Secretary

Table 3. "Credit-worthiness ratios" for selected countries

Countries	Net external position (1) as % of GNP/GDP	Net external position (1) as % of exports (2)	Net interest payments/receipts as % of exports (2)
United States (1986)	-6.5	-96.9	7.3
Other G-7 (1986)			
United Kingdom	30.0	114.4	5.2
Germany	12.0	39.1	1.2
Japan	9.2	77.8	4.1
France	0.3	1.5	-0.3
Italy	-5.7	-27.7	-5.1
Canada	-39.9	-144.4	-12.2
OECD non-G-7 (1986)			
Switzerland	75.9	203.2	16.9
Netherlands	18.7	35.5	-
Belgium-Luxembourg	6.1	8.9	0.1
Spain	-11.0	-56.5	-4.5
Finland	-14.8	-55.7	-7.3
Sweden	-22.0	-64.4	-5.6
Portugal (4)	-34.5	-101.0	-10.3
Australia	-40.4	-254.1	-20.5
Denmark	-44.2	-131.2	-12.5
Ireland	-82.2	-145.1	-20.6
Turkey	..	..	-16.2
Non-OECD countries (1986) (5)			
Brazil	-42.4	-432.6	-33.9
Korea	-53.7	-121.7	-9.9
Argentina	-70.5	-593.1	-37.2
Mexico	-86.9	-437.5	-37.2
United States (2000) (3)	-18.3	-161.3	-10.6

1. Excluding monetary gold.
2. Exports of goods and non-factor services.
3. Assuming the scenarios developed in Table 1.
4. Excluding foreign direct investment and portfolio investment.
5. For the non-OECD countries, the debt numerator is defined as total gross debt minus gross official reserves, on the assumption that private foreign assets (largely the counterpart of "capital flight") are not available - either as principal or as revenue flow - to service debt.

psC2/59 CONFIDENTIAL

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

29 June 1988

Charles Powell Esq
10 Downing Street
LONDON SW1

Prime Minister
The picture for Nigeria is particularly worrying.
CDP 29/6

Dear Charles

INTERNATIONAL FINANCIAL SCENE

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

The world economic outlook as it affects debtor countries in the current year has improved recently in some respects. Output in major industrial economies seems likely to grow by 4 per cent, world trade is increasing by 8-9 per cent and commodity prices in SDR terms are more than 30 per cent higher than the depressed levels of a year ago. These factors should boost many non-oil developing countries' export earnings and help to offset the adverse impact on their current balance of payments of the upward trend in world interest rates. Oil prices, however, remain well below last year's average and continue to limit oil producers' earnings. Over the slightly longer time horizon, the prospects for debtor countries depend at least partly on the ability of the US and other major economies to sustain growth without a renewed surge in inflation which might trigger a tightening of policies.

Summit leaders discussed debt prospects in Toronto last week. They agreed that official creditors should ease the debt burden of the poorest countries through concessional interest rates, longer repayment periods, partial write-offs, or a combination of these options. Details are to be worked out in the Paris Club. We expect negotiations to be tough and we shall try to combine with the French to persuade the US to ensure comparable burdens between creditors.

The Summit reaffirmed the case by case approach to middle income debtors and noted commercial banks' increasing use of innovative, market-orientated financing techniques. A Japanese proposal aimed at improving the prospects for the refinancing of bank

loans - under IMF management but without IMF money - was not discussed. Summit leaders, however, did reiterate the role of the IMF and World Bank in the debt strategy, and this is to be the subject of a G10 study commissioned by Finance Ministers at their April meetings in Washington.

Neither debtors' or creditors' attitudes have changed significantly in recent months. The major Latin American debtors seem likely to become increasingly keen to capture some of the secondary market discount on their loans. We should expect further initiatives from the Mexicans after July's elections. President Alfonsin is also seeking interest rate concessions for Argentina. Latin American leaders, however, decided not to approach Summit leaders for global relief. An important issue will be the need to ring-fence the proposals for relief to the poorest countries. Nigeria, Yugoslavia and Poland have already asked tentatively for similar consideration.

Among creditors, the attitude of commercial banks to middle income debtors has toughened as their capital base and provisioning has strengthened. One UK bank, however, is considering debt forgiveness for the poorer African countries in the wake of the Summit agreement. Official creditors are continuing their case by case approach to middle income debtors and little change is in prospect ahead of the US elections. If Dukakis were elected, however, the US approach might change.

Nigeria causes increasing concern. The IMF programme agreed in 1986 went badly off tack, and the balance of payments position is now critical. The prospects of a satisfactory new programme are poor. An IMF mission returned to Washington from Lagos recently reporting a lack of appreciation at the political level as to the seriousness of the situation and no coherent strategy for budgetary, credit or exchange rate policies. Nevertheless, the Fund's Managing Director has agreed to send the IMF team back after a plea from the Nigerians. We have told the Fund that we want to see a firm adjustment programme. It would have been wiser for the Managing Director to have waited for some action from the Nigerians before agreeing to send a mission back. The Nigerians are seeking 'Toronto' concessions on their debt, but we do not believe that these should be even considered unless and until the Nigerians are at least close to agreeing an IMF programme. The absence of progress with the Fund means that the Nigerians will need a further roll-over of principal payments to banks beyond 30 June.

Brazil has agreed a multi-year rescheduling with the steering committee of commercial banks bringing to an end the moratorium declared last year. The agreement provides for some $5.2 billion of new money and increased short-term credits. It will go alongside a new 18-month IMF Standby Arrangement which is expected to be put to the Fund's Executive Board in late-July. Brazil's

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external trade surplus has risen in the wake of domestic recession but budgetary problems remain and excessive credit expansion is leading to 600 per cent inflation. The Fund programme, therefore, will need to ensure that the authorities regain control of public finances, particularly ahead of the 1989 election.

Argentina is likely to face a hostile attitude from commercial banks now that the banks' agreement with Brazil has freed them to concentrate on the Argentine problem. The IMF programme is off track with disbursements suspended. Budgetary policy is proving less restrictive than targetted. The Argentines have also failed to fill the 1988 external financing gap with at least some banks unwilling to provide new money. Negotiations with the Fund and with other creditors are likely to prove very difficult. Alfonsin has already called for a cut in interest rates to 4 per cent. Arrears to banks are mounting and some US banks may classify Argentina loans as non-performing.

Egypt's inadequate IMF programme has broken down - as feared - and there is no early prospect of bridging the gap between the authorities and the Fund. The budget deficit has risen to about 17 per cent of GDP, real interest rates remain negative and the official exchange rate remains over-valued. Egypt may well seek 'Toronto' concessions but is not on the World Bank's list for Special Assistance and, in any case, the absence of an IMF programme will jeopardise any future Paris Club rescheduling.

Yugoslavia has finally concluded a new round of agreements with the IMF, the Paris Club and the commercial banks - supported additionally by a bridging facility organised by the BIS. The IMF programme contains an ambitious set of desirable structural liberalisation measures which may nevertheless be difficult to reconcile with the macro-economic need to curb inflation, restrain domestic demand and secure an adequate external payments performance. Arguments continue within Yugoslavia on the direction of economic policy. Repayment fo the BIS facility will be from the proceeds of IMF disbursements later this year so that implementation of the programme is important to achieve this.

I am copying this letter and enclosures to Bob Pierce (FCO), Jeremy Godfrey (DTI), and John Footman (Bank of England).

Yours sincerely

J M G TAYLOR
Private Secretary

0277u

COVERING CONFIDENTIAL

(Based on information as at 24.6.88)

INTERDEPARTMENTAL DEBT REPORT: JUNE 1988

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INTERNATIONAL DEBT GROUP REPORT: JUNE 1988

Main points

- Overall, external economic conditions faced by debtors have generally improved.

- At the Toronto economic summit the G7 responded to the UK's long standing call for debt relief to the poorest countries.

- Brazil has reached a preliminary agreement both with its bank creditors and on the outlines of an IMF SBA.

- Argentina's IMF programme is off-track. While export prospects have improved, recent changes in domestic financial policies have yet to produce results.

- Yugoslavia has adopted a tough SBA and reached agreement with the banks and the Paris Club.

- An IMF agreement with Nigeria still seems along way off although the Fund staff are giving the authorities every opportunity to adopt the necessary measures. A large unfilled financing gap remains over the forseeable future.

- Cote d'Ivoire's agreement with the banks would effectively penalise "free-riders". However, failure to meet IMF targets may mean the agreement is doomed.

- Egypt's impasse with the IMF continues. However, ECGD has reached agreement on the terms of its Paris Club bilateral, without conceding a lower spread.

- Sudan's political and economic position has deteriorated once again. Prospects for an international rescue package remain bleak although efforts continue.

- Jordan is facing increasing external difficulties highlighted by trade problems with Iraq.

CHART 1

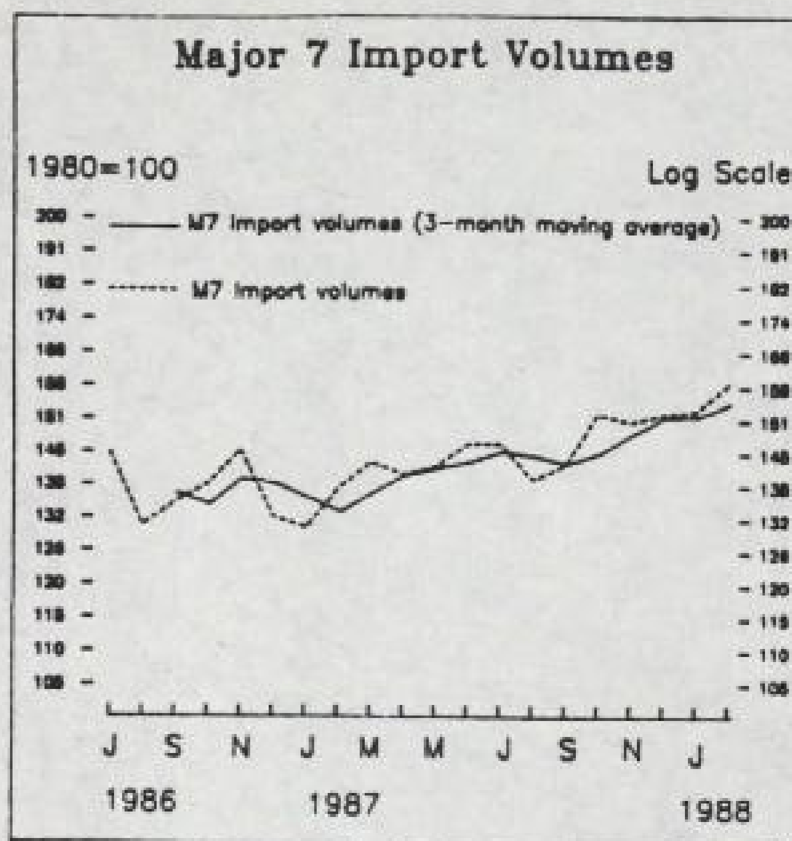
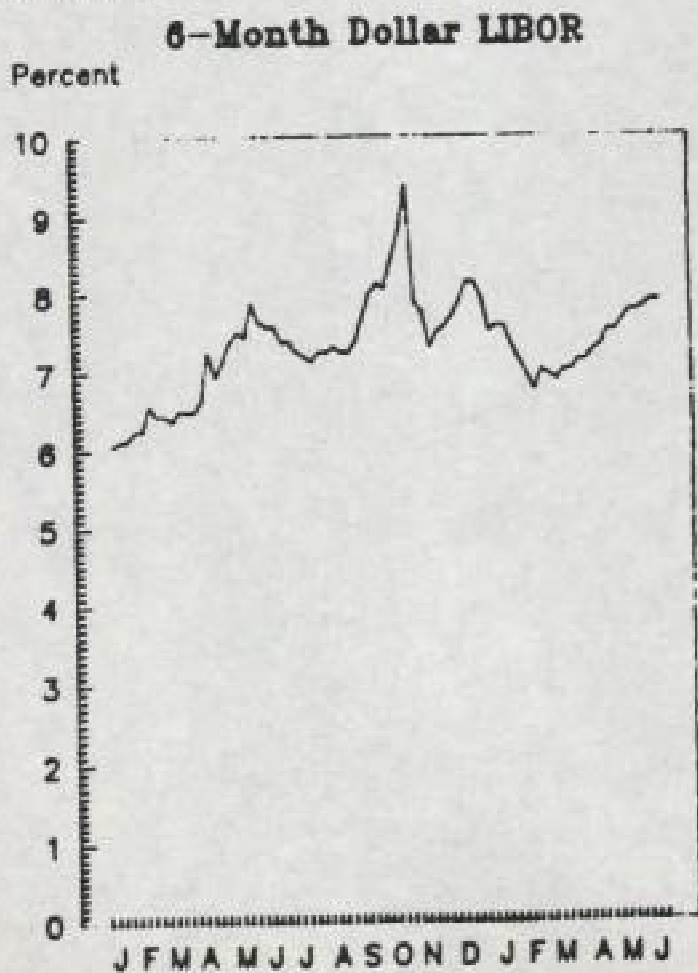


CHART 2



INTERNATIONAL FINANCIAL SCENE

World Economy

Activity in the industrial countries so far in 1988 appears to have been stronger and more broadly based than was expected late last year in the aftermath of the stock market collapse. Demand for developing country exports has probably been sustained (chart 1). Moreover, encouraging US trade figures, while partly reflecting exceptional and favourable seasonal influences, may have allayed the worst fears of a collapse of the dollar and helped to induce comparative calm in international financial markets. The strength of US exports, and a marked slowdown in US import volume growth despite the robustness of domestic final demand, suggest that the dollar's depreciation is taking effect and points to the efficacy of the adjustment undertaken by surplus countries, particularly Japan. Nevertheless, the risks of another period of exchange rate instability - leading initially to sharply higher interest rates - and then to a recession - remain latent. Concerns over inflation, prompted by the strength of recent real economy indicators, have led the Fed to tighten policy, and eurodollar rates have moved up by about a percentage point since early March (chart 2). The dollar has been firmer.

The strength of activity has also been reflected in further increases in commodity prices (chart 3). Between March and mid-June SDR prices of industrial materials rose 25.1%, with metal prices up 32.1%. While recent increases have reflected supply difficulties in a number of sectors - notably nickel and zinc - and in some cases exceptionally low levels of stocks, the increases have been sufficiently broadly based as to suggest the predominance of demand factors. China and the Asian NICs are being quoted alongside Japan as significant buyers. Food prices - particularly grains and their close substitutes - have risen in response to fears of crop failure following drought in the US and their recent strength may not be sustained. Oil prices have recovered somewhat from March lows but remain below levels at the beginning of the year. The recent OPEC decision to extend existing quotas until the end of the year has had little impact.

Table 1 indicates how the benefits (costs) of changes over the past year are likely to have been distributed across the main debtors. The changes shown reflect spot price movements; in many cases their impact on export prices is likely to be somewhat attenuated and will come through only after a lag. The main beneficiaries have been metal and food producers. Losers include oil and beverage exporters.

Assessment

This - generally favourable - economic background has contributed to the absence of major upsets to the debt strategy and, on balance, some progress. As is described further in the regional summary section, Brazil has reached a provisional agreement with its bank Advisory Committee and an IMF agreement looks distinctly probable. Mexico's anti-inflationary policies have had initial success although its non-oil trading performance has faltered a little. Chile's successful adjustment continues. Yugoslavia has accepted a tough IMF programme. Nevertheless, doubts linger regarding the ability and willingness of debtor governments to carry through adjustment and structural reforms. Objections within the G7 to UK proposals for sub-Saharan debt relief have fallen away, although the complexity of the package agreed at the Toronto summit will test Paris Club negotiators charged with formulating the fine print. A key objective for the UK will be to ensure that the principle of equal burden sharing is effectively implemented.

Less encouraging developments include a deterioration in the Colombia's economy and growing unrest, while Ecuador's agreement with the banks remains in limbo. Jordan's problems could become more serious. However, for the moment the three problem countries are Argentina, Nigeria and Egypt, but their diversity in terms of location, culture, economic structure and strategic importance to creditors reinforces arguments for case-by-case treatment. The difficulties of Argentina and Nigeria are now so acute that their resolution will severely stretch the established approach to middle income debtors. As a group these countries have moved no nearer to an effective common front - the Cartagena group, at a technical level meeting in June, elected not to make a formal submission on debt matters to the G7 and Argentina's recent call for interest relief sounds like special pleading. Nevertheless, led by Mexico, they are actively seeking ways to reduce their debt burden through increasingly sophisticated market mechanisms. The emergence of such initiatives poses a challenge to creditors but may also be seen as a positive contribution to the resolution of the debt problem.

A number of more general developments over the past three months are reviewed below.

Spring Meetings

At the Spring Meetings G7 Ministers and Governors reaffirmed their commitment to a market-based, case-by-case approach to middle income debtors and their rejection of any global debt forgiveness scheme which would effectively transfer the risk or cost

TABLE 1

Effect of commodity price changes over the past year

	Change in SDR spot price of primary exports (1987 Q2 - 1988 Q2(est))	% of total 1985 merchandise exports due to primary commodities	Important primary commodity exports
Fuel Exporters			
Algeria	-16.8	97.7	oil, gas
Ecuador	-15.2	83.3	oil, coffee, fruit
Egypt	-16.5	94.1	oil, cotton
Indonesia	-9.9	74.8	oil, gas, rubber
Iraq	-16.8	89.0	oil
Mexico	-14.8	65.2	oil, coffee
Nigeria	-17.0	94.7	oil
Saudi Arabia	-16.8	94.6	oil, gas
Venezuela	-16.8	91.3	oil
Mineral Exporters			
Chile	42.6	77.6	copper, fruit
Jamaica	92.2	66.2	alumina, sugar
Peru	13.2	63.9	copper, zinc, oil
South Africa	3.6	82.0	iron, coal, gold
Agricultural Exporters			
Argentina	7.2	67.3	oil, oilseeds, wheat, maize
Brazil	4.5	47.9	iron, animal feed, fruit, coffee
Colombia	-0.4	72.9	oil, coffee, fruit
Cote d'Ivoire	-9.5	57.6	coffee, cocoa, timber
Malaysia	-0.5	57.6	timber, rubber, palm oil, oil, gas
Philippines	41.4	31.6	fruit, coconut oil, sugar, nickel
Sudan	5.0	72.9	rice, oilseeds, cotton
Thailand	25.2	47.3	rice, maize, fruit, rubber
Uruguay	25.4	43.9	beef, rice, wool
Australia	23.1	69.5	wool, wheat, iron, coal
New Zealand	15.3	49.0	wool, beef, lamb
Manufacturing Exporters			
Poland	-2.7	37.4	iron, copper, coal

Notes: Changes in SDR spot prices of primary exports compiled by weighting commodities using 1985 trade weights.

: For many commodities movements in producer prices have been considerably less than the movements in spot prices shown here. In addition, many countries produce commodities in a less processed form than those sold on these spot markets (eg. metal ores rather than refined metals), and have benefited to a lesser extent.

to creditor governments. The G10 commissioned a study of the role of the Fund and the World Bank in the debt strategy. The banks' call (through the IIF) for a new SDR allocation failed to win the support of most industrial countries although it is favoured by Camdessus and most ldcs.

Details of the new External Contingency Mechanism - outlined by Baker at the last Annual Meetings - were agreed. The new facility will be combined with the existing CFF enabling qualifying countries to draw up to 105% of quota in total rather than 83% at present. Changes to the Extended Fund Facility (EFF) (encouraged by Camdessus as a carrot to middle income debtors to complement the various initiatives on sub-Saharan African debt) were also announced. Where appropriate, actual access within existing limits (270% of quota or exceptionally 330%) may be raised, three year arrangements may be stretched to four, and programme reviews may be held biannually rather than quarterly.

On the debtors' side the G24 reiterated their call for a reversal of net resource transfers to creditors and urged a reduction in the stock of debt - by market mechanisms in the case of middle income debtors and direct forgiveness in the case of low income ldcs.

Toronto Economic Summit

The announcement of a consensus on tackling the debt burden of the poorest countries was a highlight of the recent summit (for further details see below). The communique reiterated the established stance towards middle income debtors and stressed the potential contribution of new flows of direct investment to adjustment and growth. It also notes, somewhat cryptically, that the debt problems of many heavily indebted countries constitute a threat to political stability that merits "special attention". Debtors - particularly the Philippines, the only individual country cited (at US insistence) - may read more into this than was intended, ie they may interpret it as indicating some slight shift towards the possibility of debt relief. The communique made no reference to an agreement to study a Japanese proposal whereby debtors would establish trust funds under multilateral aegis to collateralise both new money and bonds offered in exchange for discounted debt. Initial reports of this proposal were confused but it has become clear that the Japanese are not calling for a creditor government contribution to the trust funds.

Debt of the poorest countries

The summit consensus calls on Paris Club creditors to provide further debt relief to the poorest countries by offering to reschedule their claims on highly concessional terms (providing adjustment programmes are being implemented). Creditors will be able to choose the form of that relief - concessional moratorium interest rates on shorter maturities, or longer repayment periods at commercial rates, or partial write-offs of principal due during the consolidation period, or some combination of the three. The Paris Club has been urged to work out the technicalities by the end of this year. It has also been reported that a major British bank may well follow official creditors in providing debt relief.

The UK has indicated that it will choose the interest rate option. Our concern is that the choices open to creditors should be comparable in terms of sacrifice particularly in the event that debt rescheduled under "Toronto" terms requires to be further rescheduled. In a note circulated by the Chancellor to other Finance Ministers the UK indicated that rough comparability could be achieved by the following-

Interest rates: reduction of 3 percentage points on debt rescheduled over 15 years, 7 1/2 grace. Reductions in rates should be expressed in terms of percentage points rather than in proportional terms (eg, a halving as has been proposed by France) - since this ensures equal sacrifice in terms of real interest rates).

Longer reschedulings: rescheduling over at least 25 years, 12 1/2 grace.

Principal writedowns: 1/3 of face value written off, remainder rescheduled over 10 years, 5 grace.

While principal forgiveness and interest rate cuts both involve a clear reduction in the net present value of a debtor's obligations, longer reschedulings only do so if the risks to creditors choosing this option are higher. This is by no means clearly the case; moreover the risks are not independent of creditors' choices since the more genuine relief is offered through principal forgiveness or interest rate concessions, the less will be chances of the debtor falling into future debt difficulties. The UK is concerned that in the event of a further restructuring of the debt being required, the higher sacrifices borne over the initial years of the earlier "Toronto"

rescheduling by creditors who had chosen interest rate reductions or principal writedowns should be recognised; ie these creditors should be allowed to (re-)reschedule their claims on more favourable terms than other creditors.

First indications of intentions of other countries are as follows -

US - longer reschedulings (but there may be resistance to going out as far as 25 years).

Japan - effective forgiveness of ODA loans made over last 10 years, longer rescheduling of export credits.

Germany - longer reschedulings, but interest rate reductions may also be considered. (The Germans have also extended RTA on aid loans to a further five African countries.)

France - write-offs.

Italy - interest rate reductions over longer reschedulings.

Canada - interest rate reductions.

As regards eligibility, the UK has indicated that it will accept the criteria drawn up by the IBRD for its special assistance programme for Africa (at present 17 countries qualify) but there may be attempts (for example by Japan) to extend the net beyond Africa.

World Bank GCI

On 27 April the IBRD's $75 bn general capital increase was approved raising the Bank's authorised capital by about 85% to $171bn. 3% of the increase will be paid in over a 5 year period to September 1993, the remainder being callable. This will enable the Bank to carry out its planned lending which is to increase commitments by around 10% per year over the next 5-6 years to more than $20bn pa by the early 1990s.

MIGA

The Convention establishing the Multilateral Guarantee Agency (MIGA) entered into force on 12th April, and the MIGA Board first met on 8th June. MIGA's main function will be to offer insurance to private investors against non-commercial risk attached to portfolio and direct investment in developing countries. It could therefore make a contribution to the restructuring of the external balance sheet of debtor countries and complement the activities of the IFC. The four categories of risk covered are host government restrictions on currency conversion and transfer, expropriation by host governments, breach of contract by host governments in cases where the investor has no effective judicial recourse, and military action or civil disturbance. MIGA will have an authorised capital of about $1.1bn and will initially be able to insure risks totalling 1.5 times its capital and reserves, although this ratio can be raised to a maximum of 5. It will not insure export credits.

Because of its relatively small capital it is unlikely that MIGA could play the role of an international insurance agency for new bank loans of the kind proposed by the Japanese at the last year's Annual Meetings. However, it has been suggested that the banks could themselves establish a mutual insurance fund administered by MIGA under a trust arrangement. (Under a similar idea for mutual insurance it has been proposed that banks might make premium payments as an alternative to provisions.)

Recent Market Borrowing

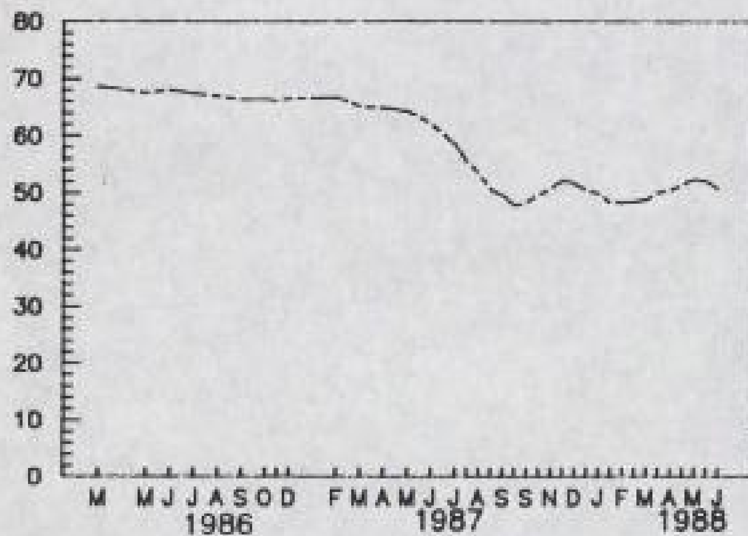
Since early March, Hungary and Turkey have made major borrowings from banks and in the eurobond market. Significant issues have also been made by China, Greece and Algeria. Venezuela is to borrow DM 92 mn from German banks under a German government guarantee and several eurobond isues are planned. Japan's recycling effort is reflected in yen issues by Algeria and Barbados. Zimbabwe's Agricultural Marketing Authority raised £40 mn from banks.

Apasco, a Mexican cement company, is to launch a $46 mn Euro commercial paper (ECP) programme. This represents the first attempt by a Mexican private company to raise money from the international markets since the debt crisis broke in 1982. The ECP programme is to be guaranteed by Fuji Bank (which in turn has obtained a counter-guarantee from the IFC) and is part of a reduction/restructuring of the company's external liabilities which has also involved debt:equity conversions and the retirement of debt through purchases in the secondary market. The latter has been financed by a loan from the IFC.

CHART 4

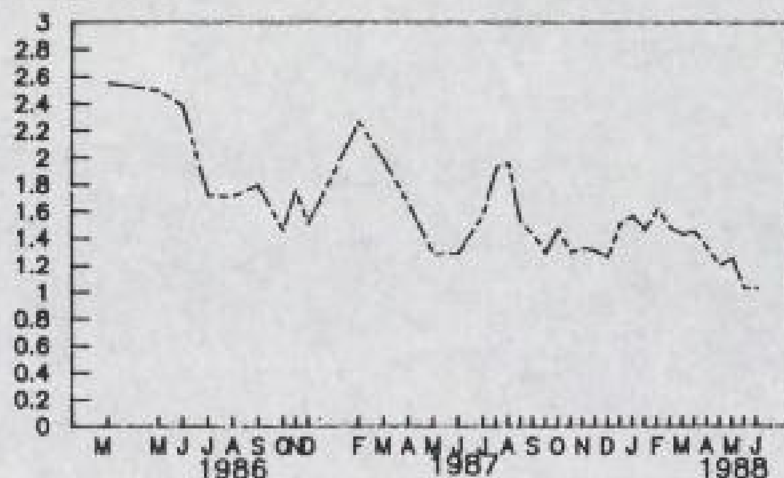
INDICATIVE SECONDARY MARKET PRICES[1]

ALL IDR COUNTRIES (WEIGHTED AVERAGE)



SELECTED MAJOR DEBTORS

BID/ASK SPREADS



(1) Source : Salomons, mid-point of bid-ask spread

among Latin American debtors), participation in the Costa Rican proposal runs up against familiar arguments in terms of bailing out the banks as well as encouraging other middle income countries whose debt problems are almost as acute (eg Argentina and Nigeria) to believe that the same support would be forthcoming in their case. The recent instance of a call for a reduction in the guarantee fee due to the IBRD on bank loans to Chile was resisted by the UK and US authorities on just such grounds, although in the event the proposal went through. (A similar proposal has since been made in respect of Uruguay.) As has been evident for some time there is clearly a difficult balance to be struck between facilitating the restructuring/new money process and creating uncomfortable precedents.

Developments in the "menu"

The banks' new agreement with Cote d'Ivoire (which, it must be said, may collapse if the Ivorian authorities continue to fail to make certain due payments and to comply with their IMF programme) employs the legal device of a "novation" in an effort to forestall potential free-riding banks who are tempted to refuse the choice of exit bonds or new money.

Under the new arrangement, Cote d'Ivoire will effectively agree to release the banks from their obligations under the existing rescheduling agreement, these being assigned (in somewhat revised form) to what is legally a third person, namely the banks who are signatories to the new agreement. Cote d'Ivoire will then indicate that while it will not formally repudiate accumulated interest arrears due to banks that fail to sign, it will not feel constrained to settle them within any particular time period. However, all creditors will receive other interest and principal payable, but only under the terms of new agreement. It remains to be seen whether potential free riders will be willing, or find it cost-effective, to offer a legal challenge. At present many of the smaller banks may be unaware of the full implications of the scheme, the initiative for which came from the banks' steering committee.

The device, if unchallenged, is thought to have wider application. If so, it could undermine the position of proponents of controversial proposals to employ Article VIII of the IMF Articles to sanction, as an approved exchange restriction, the non-payment of debt service to banks unwilling to participate in new restructuring agreements (a step strongly opposed by the UK).

The Cote d'Ivoire agreement also provides banks with the option of providing new money through interest capitalisation. This had been pressed for by some European banks in the Brazil package partly as a means of ensuring an equitable burden among creditors and partly for tax reasons. Opponents (mainly US banks) are concerned that such a direct link between new money and interest due would place them in a difficult position with their own regulators regardless of whether they themselves took up the option. There is also the more general concern that if interest capitalisation became established it would encourage debtors to assume that interest due would be automatically rolled forward and so discourage adjustment efforts. The Brazil agreement also brings forward the exposure base date for determining the distribution of new money to March 1987 which should encourage participation by banks who reduced their exposure before that date.

Provisioning

The authorities have advised Japan's banks that they will be allowed to raise provisions on their exposure to 38 ldc debtors from 5% to 10%. Formal tax relief is still restricted to 1%. However, it is reported that some further Latin American exposure has been sold to the Cayman Islands Factoring Company thereby increasing - if only marginally - effective tax relief.

Canadian banks have been directed to raise their loan loss reserves against an expanded basket of ldc debtors from a range of 30%-40% to 35%-45% by the end of this year.

In the US the General Accounting Office (GAO) has criticised US regulators and banks, contending that current reserve levels are too low and ought to be based on secondary market discounts. As yet it is unclear how much influence, if any, the GAO recommendations will have.

Further details on individual countries are given below.

LATIN AMERICA AND CARIBBEAN

Brazil

Preliminary agreement has been reached between Brazil and the IMF on the outlines of an SBA, and a formal request is expected to be made to the Fund Board in late July or early August. Reports indicate that the 18-month SBA will be for about $1.6 bn (SDR 1170 mn), 80% of quota. No further details of the agreement are available beyond operational PSBR targets of 4% GDP this year and 2% GDP in 1989 (cf 5.5% in 1987). The absence of a firm monetary policy is leading to increasingly serious inflation with consumer prices rising by 124% in the first five months of the year (an annual rate of nearly 600%). The trade balance has continued to benefit from the recession (industrial production has continued to fall), with a $5 bn surplus recorded in January-April (cf $1.1 bn in the same period of 1987). However, import demand is likely to pick up later this year as a result of the authorities' decisions in May to ease trade financing conditions and remove some protectionist measures.

Brazil and the banks' Advisory Committee announced their agreement on the term sheet for the medium-term financing package on 22 June: $61 bn originally due 1986-93 will be rescheduled over 20 years/8 grace (final maturity being in 2007) at LIBOR +13/16%; new money of $5.2 bn will be advanced over 12 years/5 grace, at LIBOR +13/16% except for a trade deposit facility which will be for 9 years. The new money, which will require banks to increase their exposure by 11.4% above a March 1987, instead of a 1982, base date amount, comprises $750 mn cofinanced with the World bank, $2.85 bn lent in parallel with the World Bank, $1 bn, part of which may be subscribed in "new money bonds", and a $0.6 bn medium-term trade deposit facility. Interbank and trade lines will be restored to at least their 1986 levels and committed until end-1990. Exit bonds will be available to convert existing exposures and will pay 6% with a term of 25 years/10 grace; they will be eligible for debt-equity swaps through the official auction. No World Bank guarantees are involved.

The package includes several debt-equity swap options. The issue of sovereign immunity has been resolved by a compromise whereby only Brazilian commercial assets may be seized. There will be early participation fees of 3/8% flat for those committing before 5 August and 1/8% for those committing between 5 August and 2 September. Brazil has agreed to pay (from its own reserves) about $350 mn of interest due for March on 24 June; on 30 June it will pay $1 bn for April and May. The issue of payment of interest for June-August is still unresolved (for their part the banks would prefer that bridging be provided by the official sector). The

intention is to distribute the term sheet by 25 June, to be followed by road shows in early July; signing of the agreement might begin on 12 September with the first drawdown occurring by mid-October (this is important for Canadian banks who could book the loans in this year if disbursed before the end of their financial year which ends on 31 October). The linkage involved in the package requires that the initial disbursement of $4 bn will be triggered by Fund Board approval of the SBA; a further $0.6 bn will be disbursed (probably by end-1988) following a letter from the Fund MD indicating that the SBA is on track and the existence of an Agreed Minute from the Paris Club; the final $0.6 bn will be disbursed when Brazil has made all the drawings to which it is entitled under the SBA (subject to a waiver by banks holding 85% of the exposure to Brazil). $3 bn of the initial disbursement will be used to repay the 1987 Interim Financing Arrangement ($1 bn was disbursed last year to cover Q4 interest and $2 bn is due to be disbursed as a bridge to the effectiveness of the medium-term package to allow the Brazilians to repay outstanding 1987 arrears). Although both sides have expressed great satisfaction with the deal the timetable envisaged may be tight.

Mexico

Real GDP rose by only 1.4% in 1987, the strongest sectors being mining (including petroleum) and financial services. The Economic Solidarity Pact (ESP) has had some initial success in curbing inflation. Monthly inflation has slowed from 8.3% in February to 1.9% in May, bringing the 12 month rate down from the February peak of 180% to 148%. In late May, the authorities extended the freeze on the exchange rate, wages, and prices of a basket of basic consumer goods until at least end-August, thereby covering the period of the elections on 6 July. Nominal interest rates have, however, not fallen as some had expected (this may reflect investors' doubts that the fall in inflation will be sustained). Continuing high nominal rates could threaten the government's fiscal targets (the indexation element on government interest payments was 16% of GDP in 1987). Although the exchange rate has been virtually unchanged since end-1987, the reserves are reported to have been rising by about $1/2 bn a month to perhaps $17 bn at end-April. The erosion of competitiveness and liberalisation of imports have led to some deterioration in the trade surplus ($1.5 bn in Q1 cf $2.3 bn a year earlier). Nevertheless, non-oil exports continue to grow strongly.

Mexico drew the final $0.6 bn of the banks' parallel sector loan and the $0.5 bn growth contingency loan on 30 March, the latter borrowing triggered by low manufacturing output in Q1 1987. The final SDR 350 mn drawdown under the SBA was

also made, the programme expiring on 31 March. In a speech no doubt intended for local consumption ahead of the elections, but also perhaps indicative of a more robust line towards creditors, Gurria, Director of Public Credit, has indicated that Mexico intends to exploit the low secondary market valuation of its debt. As a first step, further securitisation schemes, such as that held in March which retired a net $1.1 bn of debt, will be tried. Should these prove unsuccessful, further reschedulings and new money would be sought and if no progress was made, a unilateral limit on debt servicing would be considered. This strategy has been subsequently reiterated by Salinas. The proposed sale of the state-owned Cananea mine to Grupo Protexa has run into trouble. The deal was to be financed by a debt:equity swap, but the banks, who in effect would be exchanging old claims for new shorter maturities, have baulked at the size of the discounts being demanded.

Argentina

GDP grew by only 1.6% in 1987, with a poor performance by the external sector acting as a drag on overall growth. The economy has continued to deteriorate this year with the IMF programme now off-track. These difficulties have been reflected in the secondary market price for Argentine debt. Disbursement of the penultimate tranche of the SBA, scheduled for 20 May, has been delayed. Although most of the end-March performance criteria appear to have been met, or missed by small margins, the SBA purchase was also dependent upon progress having been made towards meeting the 1988 financing gap, and on this aspect there has been virtually no movement. The end-June performance criteria also look unlikely to be met. Argentina's domestic financial position has continued to deteriorate this year. In particular, tax reforms and other measures approved in January have apparently failed to provide the expected increase in tax receipts and forced savings (optimistically projected at 7% of GDP) and some further measures, including temporary levies on cigarettes, public bond transfers and earnings on short-term deposit accounts, are reported to be under consideration in order to meet increases in teachers' salaries and alleviate acute financial difficulties faced by many provincial authorities. The government is also considering extending the privatisation programme. Inflation was boosted by the liberalisation of prices in April, which caused the CPI to rise by 17.2% and brought the 12 month rate to nearly 250%.

On the external side imports rose by 9.3% in 1987 and exports fell by 6.4%, the trade surplus declining from $2.1 bn to $0.5 bn. Trade perforamnce in Q1 of this year (a surplus of $410 mn cf $240 mn in 1987) partly reflected an unexpectedly strong rise in manufactured exports (admittedly from a small base) while imports fell 6%. Although

better harvests in Q1 1988 have improved the prospects for exports this year, Argentina's external position remains precarious and the liquidity position is extremely tight. Interest arrears to the banks have been building up, and $150 mn of the 1987 bank new money package remains undisbursed pending the release of the next tranche of the SBA. The Argentines have not made a formal new money request to the banks, but preliminary talks have indicated that some US banks at least will be unwilling to put up new money for Argentina this year. By end-June interest to banks will be 90 days overdue requiring US banks to put their loans onto a non-accrual basis. It is unclear whether President Alfonsin's recent statement that Argentina was looking to reduce interest rates on bank debt to 4% pa is intended to form the basis of a negotiating position or is simply a restatement of previous occasional speeches. Moreover, even the substantial relief called for by Alfonsin might be insufficient to ensure medium-term balance of payments viability.

Venezuela

The authorities have set a target of 3.3% GDP for the 1988 fiscal deficit (4% GDP in 1987), trimming planned capital spending by 30%. A major uncertainty affecting future fiscal and external trade performance is the prospect for oil revenues. The 1988 budget is based on an average oil price of $16.7 pb, and average prices this year for Venezuela's oil exports have yet to reach this level. The government is hoping to increase production of light crudes and products to offset the possible shortfall. The indefinite price freeze imposed in December on publicly-provided goods and services led to a 1.6% fall in the CPI in Q1, the 12-month rate falling to 28.7% (cf 40.3% at end-1987).

Nevertheless, continuing concern over inflation makes a devaluation of the bolivar unlikely before the December elections and this may hinder the expansion of non-oil exports and may also make it difficult to squeeze imports as planned. Talks with IBRD staff on trade liberalisation began in 1987 but there is no sign that any measures would be supported by a policy loan. Venezuela is making further attempts to return to market borrowing, and a DM 92 mn ($52 mn) loan guaranteed by the German government has been signed with German banks. An $80 mn-equivalent yen-denominated bond issue is planned for later this year in co-operation with the Japanese Exim Bank and Bank of Tokyo, a further $100 mn eurobond, to be marketed in New York, is in an advanced state of negotiation with Chase Manhattan, and a DM 100 mn ($56 mn) euro-bond issue is also being considered.

Chile

GDP growth in 1987 has been revised up to 5.7% (the same as 1986), and higher copper prices are expected to boost the economy in 1988. A reduction in import tariffs in January and a tighter monetary stance over the past year have dampened inflation, with the 12 month rate falling from 21.5% at end-1987 to 15.6% at end-May.

In Q1 the trade surplus was $0.6 bn ($0.2 bn in Q1 1987) reportedly followed by a surplus of $0.4 bn in April. (The authorities' target this year is $1.4 bn.) $1.4 bn of inward foreign investment was approved in Q1 ($1.1 bn being in respect of the La Escondida copper mine) of which $0.2 bn was disbursed. Amendments to the terms sheet of the banks' financing package are expected to be signed in July. These include a reduction in spreads and a provision allowing Chile to collateralise voluntary new money with non-reserve assets, implicitly giving seniority to new loans. The IBRD has also agreed to reduce from 5/8% to 3/8% the fee it charges the banks for loan principal guaranteed under the 1985 co-financing agreement. This was agreed only reluctantly since the IBRD, rather than the banks, is effectively bearing the burden of the cut in interest spreads on the guaranteed part of the loan.

Ecuador

The economy has continued to deteriorate this year. The 12 month inflation rate rose to 48% in May, reflecting a decline in the sucre since October as confidence has waned. After attempts to hold up the exchange rate through intervention failed, the authorities were forced to re-introduce a multi-tiered exchange rate system.

The financing package agreed with commercial banks in November has yet to be signed. The banks contend that the delay has been exacerbated by remarks by Mulford, the US Assistant Treasury Secretary, which were mis-interpreted as suggesting that the Ecuadorean negotiators had been weak. (In fact Mulford was criticising the banks for what he saw as their lack of initiative in putting together a menu.) The banks hope that the package can still be signed before the incoming President, Borja, takes office in August - he has said that he will seek to renegotiate the terms of Ecuador's debt.

Peru

The economy continues to slide. Sharp price and wage increases announced in March brought the 12 month inflation rate to 210% in April. The trade deficit in

January-February 1988 was $87 mn ($157 mn in January-February 1987) but foreign exchange reserves have fallen to about two months' import cover. Despite higher demand for foreign exchange from importers, the central bank has been forced to reduce further the availability of foreign exchange for imports of goods and services - to $190 mn per month ($739 mn in Q1 1988).

Discussions with the IBRD resulted in proposals for the IBRD to encourage bridging finance from creditor governments to enable Peru to clear its arrears of $280 mn to the IBRD and then to release $416 mn in project lending which has been approved but not disbursed. (Canada was believed to be the most promising source of bridging finance.) In return, Peru would implement a three-year adjustment programme which would include the restoration of relations with external creditors. However, press reports indicate that the Government has rejected the proposals out of hand.

Colombia

After two years of successful adjustment and high growth, the economy has faltered. There are, moreover, growing signs of political instability (the entire cabinet resigned on 9 June) and an intensification of violence by drug traffickers and left-wing rebels. Prices rose 14.6% in January-April, bringing the 12 month inflation rate to 28%. A loosening of fiscal policy appears to have been the main factor. The fiscal deficit target has slipped from 2.7% GDP to 3.1% GDP despite recent cuts in public investment. Nevertheless, the prospects for external trade remain reasonable despite the weakness of coffee prices. Oil is expected to overtake coffee as the major foreign exchange earner this year, and the outlook for both coal and nickel exports is promising. The authorities still seem committed to seeking a further $1.5 bn in new money for 1989-1990 despite the difficulties in completing the 1987 agreement and some domestic pressure for a rescheduling.

Uruguay

GDP grew by 4.9% in 1987. Several of the targets under IMF enhanced surveillance were missed, but not by wide margins. The fiscal deficit was 1.4% GDP (cf a 1.1% target); both inflation and monetary growth were above targeted levels, and the trade surplus fell to $0.1 bn (cf $0.3 bn in 1986). Nevertheless, higher wool prices have kept export revenues buoyant.

Costa Rica

Costa Rica's revised SBA programme was approved by the IMF Board in April in the face of US and UK abstentions. A Paris Club meeting has been scheduled for June to discuss Costa Rica's request for a restructuring on exceptional terms, including the rescheduling of 100% arrears and maturities (including PRD) due 1988-90, over 20 years with 7 grace at below-market interest rates, and with a bringing forward of the cut-off date. Negotiations with the banks have reached a total impasse. The lead bank, Bank of America, has made an innovative debt reduction proposal. This involves consolidating principal on existing debt into a single payment 20-year maturity, backed by a zero coupon bond which would be held in a trust fund administered by the IBRD. Interest would be reduced to a fixed 4% pa and a second fund would be created with subscriptions from Costa Rica and aid donors to ensure interest payments; the World Bank would again be trustee and coordinate donors' contributions. Costa Rica has also been negotiating an agreement to restructure its $150 mn debt to Mexico (14 years, 4 grace at 6-month LIBOR). A novel feature is that Costa Rica will service the rescheduled debt by tendering Mexican debt purchased in the secondary market, the discount being shared between the two countries.

Panama

Restrictions and political uncertainty have led to the withdrawal of several banks. Paralysis of the cheque clearing system prompted Panama to ask the Andean Reserve Fund to take on the National Bank's clearing functions. In response to US economic sanctions the authorities are considering whether to allow currencies other than the US dollar as legal tender, or to create their own currency. At end-March commercial banks agreed to the rollover to end-Q2 of $421 mn principal due in Q1, but political upheaval has since prevented any further negotiations.

Other Countries

Following the better economic performance in 1987, the Bolivian authorities are targeting 1988 GDP growth of 3% and inflation of 10%. Reserves (including gold) were equivalent to 7 months' imports at end-March. The delay in IMF Board discussion of a new economic programme has held up negotiations in the Paris Club. Discussions on a commercial banks' rescheduling are expected to begin shortly. Jamaica's SBA expired at end-May, with all drawings having been made. A follow-on programme and a Paris Club rescheduling are being sought. The recently approved budget for FY 1988/89 envisages a deficit of 0.6% GDP (cf 3.4% GDP programmed for 1987/88).

SOUTH AND EAST ASIA

Philippines

Official estimates of real GNP growth in 1987 have been revised upward from 5.1% to 5.7%. Real GNP in Q1 1988 is reported to have been 7.6% higher than a year earlier. The official target for 1988 is 6%-6 1/2%. The Reagan administration is reported to be in the preliminary stages of co-ordinating a "mini Marshall Plan" for the Philippines. However it is unlikely that in final form it will represent any radical shift in the Baker strategy. Hawks in the Philippines Senate are once more calling for a tougher stance towards commercial creditors. However, Finance Minister Jayme continues to stress the need for a co-operative approach.

Malaysia

Malaysia's 4.7% real GDP growth in 1987 exceeded earlier expectations and the authorities are predicting 5.3% real GDP growth for 1988.

Indonesia

Non-oil export volume rose by almost 27% in 1987. Higher production of key commodities such as palm oil and rubber have augmented buoyant exports of manufactured goods, especially textiles and furniture. As expected, President Suharto began his fifth term of office by reshuffling his Government. No shift in economic policy, however, is expected. This year's session of the Inter-Governmental Group on Indonesia (IGGI) is due to meet in the Hague in June. The IBRD has recommended that total aid commitments be increased from $3.2 bn to $3.6 bn.

Thailand

The economy continues to boom: real GDP growth was 6.6% in 1987, and forecasts for 1988 range from 6 1/2% to 7 1/2%. The favourable macro-economic environment, combined with low labour costs, have boosted foreign investment in Thailand, which is predicted to rise from $7 bn in 1987 to $8.8 bn in 1988. Following inter-party disagreements within the ruling coalition, new elections have been called for July. The outcome is not expected to alter existing policies.

China

With a loosening of monetary and fiscal policies since late 1986, the economy shows distinct signs of overheating with prices, in particular those of foodstuffs, rising rapidly. Externally, however, China is still in relatively comfortable position. Total external debt at end-1987 was around $26.3 bn whilst the debt service ratio stood at around 7%. Both, however, are likely to rise as China's modernisation programme continues.

India

Severe drought was an important factor behind sluggish growth last year (less than 2% in FY 1987/88). However, on the assumption of a return to more normal monsoon conditions, the IBRD is projecting a growth rate of around 7% this fiscal year. Despite a large rise in non-oil imports, a sharp reduction in oil imports and a strong growth in exports led to some narrowing of the trade and current account deficits. External debt has risen to around $45 bn but the debt service ratio (expressed as a proportion of total current account receipts) has fallen from a peak of 27% in 1986 (caused by a bunching of IMF repurchases) to 23% at end-1987.

South Korea

A second successive year of double digit GDP growth was recorded in 1987, reflecting a sustained export boom as well as rising domestic investment. Rather than build up international reserves, the authorities have used the surplus on current account (up from US$4.6 bn in 1986 to US$9.7 bn in 1987) to reduce the country's external debt. This has fallen from US$44.4 bn (45% of GDP) at end-1986 to US$35.6 bn (29%) at end-1987, with the debt service ratio falling from 21% to 17%. Total outstanding foreign debt should fall to US$29 bn (about 21% of GDP) by the end of 1988 with the DSR down to 12%.

EASTERN AND SOUTHERN EUROPE

Poland

No progress has been made in resolving differences with the commercial banks over the finer details of the six year, two stage MYRA which was struck last July. Under the proposed agreement all of Poland's medium and long-term commercial bank debt would be

consolidated and rescheduled over 15 years at Libor +15/16%. In the meantime Poland is honouring the existing agreements. Bilateral discussions with official creditors have stalled but the 1987 rescheduling agreement also continues to be honoured. The prospect of reaching an agreement on a couple of project loans with the IBRD appears to be receding on "technical" grounds.

An IMF mission recently returned from Warsaw expects the current account deficit to stabilise at around the $400 mn level seen in 1987. The original timetable for a shadow programme in 1988 is no longer possible given the difficulties in concluding bilateral negotiations with official creditors. Dorosz, the Deputy Finance Minister and chief debt negotiator, has asserted that the Poles gain little in rescheduling compared with the accumulation of arrears unless creditors offer new money.

Yugoslavia

The commercial banks reached agreement, at end-April, on an 18-year rescheduling (6 years' grace) of all arrears accumulated since June 1987 and all principal falling due up to end-September 1996 at a margin of Libor +13/16%. They also agreed to provide $300 mn new money in the form of a trade and deposit facility. The IMF SDR 306 mn one-year SBA was approved in principle on 1 June following a 24% devaluation of the dinar and the liberalisation of the foreign exchange, imports and price regime. The IMF have identified a residual financing requirement of $1.2 bn; $500 mn to be provided by official creditors, $400 mn from international agencies and the $300 mn new money facility from the commercial banks. The SBA will become operative once the banks' new money package reaches critical mass (90%). At present 85% is committed and it is hoped to reach critical mass by end-June. Yugoslavia has accepted the terms of a $200 mn BIS bridge facility and a $50 mn parallel facility from the US. Under pressure from the US, drawings on the bridge, to be made in three tranches, will be linked to the first three drawings of the SBA, the first being made on 15 June. The Bank of England's participation, with an HMT indemnity, is $30 mn. The Paris Club agreed to reschedule 100% of principal and interest (including previously rescheduled debt, but excluding that covered by the 1983 Berne Agreement) falling due between 1 April 1988 and 30 June 1989 over 10 years with 6 grace. There were no new money pledges and there remains a shortfall of some $200 mn in the $500 mn new money package identified by the IMF.

Hungary

Following settlement of differences over interest and exchange rate policies, the IMF SDR 265 mn one-year SBA was approved on 16 May. Hungary has returned to the market with a $200 mn eight year credit but at the higher margins of Libor +1/2% for the first five years, rising to 5/8% thereafter. First quarter b of p figures were quite favourable - the convertible-currency current account deficit narrowed to $254 mn ($485 mn in Q1 1987) and export receipts in the year to end-May were up by 20% on the same period in 1987. Gross debt declined by $0.6 bn to $17.3 bn in the three months to end-March.

Romania

Romania prepaid the commercial banks $0.6 bn at end-March (one-third of total commercial bank debt) and has recently agreed terms with the IBRD on the prepayment of the $1.8 bn owed. There are reports that it is seeking to prepay the banks a further $0.5 bn later in the year. As a result of these developments Romania is expected to reach its objective of zero net debt (around $3 bn gross) by September.

Turkey

Export receipts rose 44% in the first four months of 1988 and the trade deficit narrowed to $320 mn ($380 mn in the same period of 1987). Receipts from workers' remittances and tourism are reported as buoyant; on current trends the current account deficit should remain under $1 bn in 1988. The Central Bank has confirmed that Turkey has raised all its 1988 financing needs, except for a small amount in October. The repayment hump of $2.6 bn in June-July is being met from new commercial credits and an IBRD "B" loan.

Greece

Following last year's improvement in the external position, the trade deficit deteriorated again in Q1. Although 12 month inflation had fallen to 13.2% by March, recent sharp increases in prices of public services will make further reductions harder to achieve. Without significant cuts in public spending there is a danger of the fiscal deficit rising rapidly, and there seems little prospect of such measures at present. A further deterioration could mean new net external borrowing next year. (This year the government has said borrowing will be limited to refinancing old debt.)

Ireland

Ireland recorded a current account surplus ($0.35 bn) in 1987, the first in 20 years, reflecting strong growth of export volumes. The government has made considerable progress in improving the fiscal position: both the Exchequer Borrowing Requirement (EBR) and PSBR undershot their targets last year and, as a percentage of GNP, the EBR, at 10.3%, reached its lowest level since 1977. Last October the government drew up a "Programme for National Recovery", which aims to stabilise the debt/GNP ratio by 1992. Nevertheless, the level of external debt, which amounted to $21.7 bn last year, or 74% of GDP, remains uncomfortably high.

Denmark

In the face of a domestic recession Denmark last year recorded its first trade surplus since 1983. The current account deficit narrowed to 2.9% of GDP from a record 5.2% of GDP in 1986. However, at 39% of GDP, the level of foreign debt remains a cause for grave concern. The official objective is to eliminate the current account deficit by 1992.

Portugal

The Portuguese economy is relatively healthy at the moment. Although the current account is likely to move into deficit soon, total external debt is stable, with a part being refinanced on more favourable terms. The government is also taking advantage of the present political stability, and entry into the EEC, to carry out some much needed structural reforms.

SUB-SAHARAN AFRICA

Nigeria

A recent IMF review mission has reported little progress on the fiscal front or towards a reduction in the level of official funding of the foreign exchange auction. However, following meetings between the Nigerians and the Fund management a further mission will go to Lagos in mid-July. By approving a follow-up mission so quickly, Camdessus may have given ground and clearly wishes to give the authorities every opportunity to take the necessary measures, although hopes of progress are not high. With the prolonged weakness of the oil market, over-funding of the auction,

and delay in reaching the IMF agreement which is needed to unlock fresh capital inflows, the balance of payments position has become critical and usable reserves are likely to be exhausted by the end of the year. Arrears continue to mount to the Paris Club, and the commercial bank roll-over of 1988 maturities expires at end-June with no tangible improvement as yet in Nigeria's relations with the Fund. Attempts to persuade the Nigerians to focus on their difficulties have not been helped by suggestions made in Lagos by the French (backed by the IBRD) that Nigeria would be eligible for debt relief, optimistic assumptions by the IBRD regarding the amount of new funds likely to become available from the banks , the IBRD itself and Japan, and the decision of two major export credit agencies (US EXIM and HERMES) to resume medium-term cover.

The Steering Committee is expected to meet with the Nigerians on 27 June. In the event that an IMF agreement is reached, commercial bank and Paris Club creditors will need to provide exceptional relief if the 1988 and 1989 financing gaps are to be closed and the UK may well be called upon to take the initiative in putting a package in place. Our line is for a full IMF programme, with preferably a drawing (Nigerian political sensitivities have so far prevented this).

South Africa

In an attempt to cool down the economy, the South African authorities have announced a rise in interest rates and a package of credit restricting measures. Stals, Director General of Finance, has said that the country cannot afford growth of more than 2-3% pa without running into balance of payment problems.

Cote d'Ivoire

Developments in Cote d'Ivoire have continued to be dominated by the prolonged deliberations with the London Club. Agreement has now been reached and a term sheet signed, but certain conditions are required to be fulfilled before the agreement becomes active. Banks which do not put up new money or buy exit bonds will be penalised by being denied payment of interest arrears. However, the Ivorian authorities have failed to meet two key elements of the IMF programme - the restraint of public sector wage increases and a reduction of guaranteed prices to cocoa producers. Had the drawing under the SBA been available arrears to the banks due by 27 May under the new agreement could have been paid. If the programme falls at the first review at the end of June, the banks' agreement looks doomed.

Kenya

The first review of Kenya's SBA and SAF (approved in February) is due at end-June: a satisfactory performance here is vital if Kenya is to stand a chance of an ESAF. The budget presented on 16 June could indicate problems - the 1987/88 budget deficit could be as high as 6.2% of GDP and public expenditure in 1988/89 is due to continue at uncomfortable levels. A World Bank Industrial Sector Adjustment Loan for SDR 74 mn has been approved.

Malawi

Malawi reached agreement with the Paris Club in late April. The Malawians had asked for the consolidation period to run from September 1987 (the start of the shadow programme). Although this was declined (ie the consolidation period is to run from February 1988 to May 1989), the Paris Club did agree to reschedule arrears on the same terms as current maturities. The granting of rescheduling over 20 years with 10 years grace was, perhaps, surprising given that these terms have previously only been granted to "basket cases". The Club's refusal to reschedule previously rescheduled interest was partly designed to distinguish Malawi from these countries.

Somalia

Somalia was declared ineligible to draw by the IMF board on 7 May, after failing to clear its arrears. A recent IMF mission has, nevertheless, successfully negotiated the essentials for a new SBA. This is still subject to the President's agreement.

Sudan

Any subdued optimism occasioned by the shadow programme agreed with the IMF last autumn, and the successful mini-CG meeting in December, has been largely dissipated. Political uncertainties have grown following the dissolution of the government in April and the divisive inclusion of the fundamentalist NIF in the new government; and the costly civil war has escalated. IMF targets for government borrowing have been significantly exceeded, and the fiscal position has been undermined by higher defence spending and public sector salary increases. Arrears, including $890 mn to the Fund, could reach $5 bn by end-1988 and the IMF staff now project financing gaps in excess of $1.5 bn pa up to 1998. A Fund team has since returned to Khartoum but discussions on a new programme appear to have broken down over the exchange rate and subsidies.

At the Spring meetings, the Chancellor cited Sudan as a country with "no hope" of repaying the Fund from its own resources and suggested a further shadow programme which, provided performance was satisfactory, could unlock ESAF drawings, including back-dated disbursements. Erb, the IMF's Deputy MD, has recently put forward an external financing framework paper envisaging a phased "two-track" approach involving, inter alia, aid and exceptionally generous debt relief and eventual access to ESAF resources after clearance of IMF arrears. Discussions, however, continue to be predicated on firm Sudanese adjustment which seems unlikely given the composition of the new government, the increasing disruption of the war and rumours of military takeover in Khartoum.

MIDDLE EAST & NORTH AFRICA

Egypt

The very weak SBA has broken down with no early prospect of bridging wide differences between the Egyptians and the IMF on major policy issues and the pace of reform. The Fund Board and management were insistent on the need for stronger adjustment at the Article IV discussions on 25 May. In response the authorities cite shortfalls in 'promised' external assistance and political/social contraints on the speed of reforms - although there have recently been price increases in petroleum (30-40%) and cigarettes (20%). The public sector deficit for 1987/88 could exceed 17% GDP (compared with the IMF target of 13%) because of higher than expected wage and subsidy costs. Despite considerable progress towards exchange rate unification, the new 'free market rate' is now significantly overvalued and the authorities will only contemplate the elimination of the even more unrealistic "official rate" for key commodities over a ten year period. Confidence in the domestic financial system has recently been undermined by emerging problems among the hitherto unregulated Islamic Investment Houses following a recent announcement that three of these houses would 'temporarily' cease paying out depositors' funds.

Although some other creditors have had to concede a generous moratorium interest rate in concluding Paris Club bilaterals, ECGD has reached agreement on a 0.5% spread at the relatively minor cost of accepting a retiming of the first repayment and so forgoing 6 months' late interest. Pressures on the Egyptians to sign stem from the fact that the next round of Paris Club talks, to reschedule maturities between July 1988 and end-1989, can only begin if the current round of bilaterals is complete and an IMF programme is on track.

Arrears may continue to build up while the Egyptians seek new aid flows and the further multilateral rescheduling. Any new Fund programme will have to be at least notionally tougher than the last (the US can be expected to be less pliant) but its chances of success (if agreed) may be no higher than its predecessor. The steady economic decline seems set to continue.

Jordan

Jordan's economic and financial position is a cause of growing concern. Hitherto, careful management has helped the economy weather the regional recession reasonably successfully (real growth was 3.7% in 1987 and inflation negative). But the economy has always been vulnerable, because of dependence on Arab aid, remittances and regional trade; and prospects have worsened as a result of the prolonged Gulf war, continuing oil market uncertainties and recent problems in trade with Iraq.

Growth is now slowing (projected at 2% for 1988) and unemployment, already high (17% unofficially), is likely to increase because of demographic pressures. The 1986-90 Development Plan is no longer viable. There are long standing structural weaknesses in the budget and the 1987 deficit was again larger than projected. Despite an improvement in the 1987 trade deficit, the scope for further improvement is limited while world prices for Jordan's principal exports (phosphates and potash) remain depressed. Continued import compression may not be sustainable if growth is not to weaken further. Jordanian projections for Arab aid and inward remittances also appear very optimistic in the light of the regional recession.

The vulnerability of Jordan's external position has been exposed by serious problems in trade with Iraq, Jordan's main export market. In the face of falling reserves and growing Iraqi arrears the Central Bank of Jordan has ceased to honour L/Cs drawn by Iraqi importers under a bilateral agreement. The move has severely shaken confidence in the financial system and private sector. The authorities have ruled out a formal devaluation but the Central Bank has had to borrow $150 mn from local banks to finance intervention and has tightened exchange controls to take pressure off the rate. With reserves still low Jordan may have to approach the markets this year. Although the last borrowing was eventually successful, bankers express doubts about Jordan's ability to tap the market again. Total debt stands at around $5 bn (excluding military/oil loans) and the debt service ratio is already high at about 20% (again excluding sizeable military debt) and set to rise further by 1990.

Morocco

The IMF SBA programme was completed in April although drawdown of the final tranche required further waivers. Fiscal problems persist - last year's budget deficit of 5.7% of GDP was well above target and will be little changed in 1988. Nevertheless, arrears to official and commercial creditors were reduced considerably in 1987 (there are now no arrears to ECGD) and the authorities aim to eliminate the remainder during 1988. Fund staff are considering a follow-on standby or EFF, which is a pre-requisite for activating the second phase of the previously agreed rescheduling with banks and a new Paris Club.

Algeria

Continued foreign exchange shortages have meant further import compression and foreign companies have so far won few contracts this year. With the outlook for the oil market likely to remain uncertain, non-hydrocarbon exports are being actively encouraged. However, these start from a low base (less than 5% of export revenues in 1987) and it is likely to be several years before they make a significant contribution.

Despite IMF projections of current account balance in 1988, Algeria will still have to borrow heavily to finance amortisation payments of $3 1/2-4 bn. Even Japanese banks, which have hitherto shown continued willingness to lend, appear increasingly concerned about Algeria's creditworthiness. Of particular concern to creditors is the growing currency risk - Algeria, more than most hydrocarbon exporters, is vulnerable to a falling dollar because much of its debt is denominated in yen or European currencies.

PACIFIC

Australia

Following growth of 1.8% in 1986, real GDP rose by 4.4% in 1987 with the main contribution coming from net exports. In 1988 economic growth is expected to be around 3%. Although import growth is likely to rise, the firmer trend in commodity prices should see the trade account move into surplus. Latest forecasts suggest the current account deficit could narrow to US$8.0 bn in 1988 from US$8.5 bn in 1987. Official estimates suggest that the debt burden as a proportion of GDP should stabilise at around 34% within the next 3-4 years.

New Zealand

After falling 0.6% in 1986 real GDP rose 0.5% last year. Projections for 1988 are more encouraging with a stronger performance from investment and exports likely to raise real GDP output by about 2%. The improving trend in the trade deficit evident over the last year should continue, but the current account deficit, burdened by debt repayments, will narrow only slowly. There are fears that the government's radical programme of economic restructuring could slow down following an apparent rift between Prime Minister Lange and Finance Minister Douglas.

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RECENT SOVEREIGN BORROWING BY LDCS

Date Announced	Borrower	Amount (mn)	Maturity/Grace (years)	Spread or Fixed rate (%)
BANK BORROWING				
Africa				
15/4	Zimbabwe - Agricultural Marketing Authority	£40	1	7/8
Asia				
13/5	Pakistan - International Airlines	$63	7	
Communist				
16/4	Hungary-National Bank of Hungary	$200	8	1/2-5/8
5 Europe/Middle East				
15/4	Turkey	Yen 2 bn	8/4	1 3/8
8/3	Turkey - Central Bank of Turkey	$100	3	1 1/4
19/3	Turkey - Tupras	$200	1	3/4
BONDS				
Africa				
3/3	Algeria - Banque National d'Algerie	Yen 8 bn	5	6.5
19/3	Algeria - Banque National D'Algerie	DM 150	6	6.25
5/4	Algeria - Banque National d'Algerie	Yen 8 bn	7	6.4
Communist				
14/5	Czechoslovakia	Yen 10 bn	10	5.5
25/3	China - Bank of China	$200		
5/3	Hungary - National Bank of Hungary	DM 200	7	6.25
12/3	Hungary - National Bank of Hungary	Yen 25 bn	10	5.7
18/3	Hungary - National Bank of Hungary	$50		
South Europe				
30/4	Greece - Public Power Corporation	DM 200	7	5.875
3/3	Turkey - Turizm Bakasi	Yen 10 bn	7	6.4
Caribbean				
14/5	Barbados	Yen 7.5 bn	10	6.8
Pacific				
14/5	Nauru	Yen 4 bn	7	6.5

OVERDUE FINANCIAL OBLIGATIONS TO THE FUND(1)

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding as at 25. 5.88 SDR (mn)	Forthcoming Obligations (to 1999)
Kampuchea	13 March 1975	31.3	13.1
Guyana	31 May 1983	70.7	39.8
Viet Nam	6 February 1984	82.5	71.4
Sudan	12 July 1984	560.2	304.0
Liberia	14 March 1985	194.9	101.2*
Peru	9 December 1985	411.2	347.2**
Zambia	6 June 1986	421.0	436.4**
Sierra Leone	13 February 1987	29.2	60.3**
Somalia	2 July 1987	22.7	118.1**
Honduras	9 November 1987	9.7	46.3*
Panama	28 December 1987	40.6	257.6#
		1874.0	1795.4

(1) Includes both overdue repurchases and charges of members with at least one obligation overdue for more than one month.

NB The above figures are from Fund papers issued with respect to individual country complaints. There will have been further obligations falling due subsequently, so the figures are not entirely up-to-date. A Fund source indicates that total arrears, were SDR 1,929.9 mn as at 21.4.88 but this figure is not broken down by country.

Guyana, Viet Nam, Sudan, Liberia, Peru, Zambia, Sierra Leone and Somalia are ineligible. Kampuchea is out of contact with the Fund.

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* Liberia and Honduras only to 1992

** Peru, Sierra Leone, Somalia and Zambia only to 1993

Panama only to 1994

0072u CONFIDENTIAL

INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1987*	End-June 1987	End-March 1987 [2]	End-March 1987 [3]
Latin America				
Argentina	57	3.3(1.1)	0.2	0.2
Brazil	121	6.7(4.9)	1.0	1.9
Chile	20	1.2(1.0)	-	0.1
Colombia	15	0.5(0.9)	0.1	0.1
Ecuador	10	0.6(0.5)	0.1	0.1
Jamaica	4	0.1(0.1)	-	-
Mexico	104	6.3(2.6)	0.7	1.3
Peru	16	0.3(0.3)	0.1	0.2
Uruguay	4	0.3(0.3)	-	-
Venezuela	36	2.1(0.8)	-	-
Far East and Australasia				
Australia	80	7.3(24.3)	0.5	1.0
China	26	1.0(7.0)	0.2	3.0
India	45	1.3(2.0)	0.5	1.8
Indonesia	46	0.6(3.6)	0.9	1.8
Malaysia	23	0.8(2.3)	0.1	0.1
New Zealand	22	1.0(4.6)	0.2	0.3
Philippines	29	1.4(0.1)	0.1	0.2
South Korea	36	2.0(5.7)	0.4	0.7
Thailand	18	0.2(1.3)	0.1	0.1
Eastern Europe (convertible currency)				
Bulgaria	7	0.2(0.3)	-	0.1
GDR	19	0.6(1.9)	0.1	0.2
Hungary	18	0.4(0.3)	-	0.1
Poland	39	0.7(0.4)	1.3	1.4
Romania	5	0.2(-)	0.3	0.4
USSR	38	0.7(1.3)	0.6	0.8
Yugoslavia	20	0.8(0.8)	0.7	0.9

[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 44 countries amounted to $162 million at end-December 1987.

[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 1987*	End-June 1987	End-March 1987 [2]	End-March 1987 [3]
Europe				
Denmark	56	2.6(4.2)	0.1	0.1
Eire	22	2.1(5.8)	0.2	0.3
Greece	20	1.4(1.9)	0.1	0.3
Iceland	3	0.1(0.5)	0.0	0.0
Norway	56	1.6(7.7)	0.5	1.2
Portugal	18	0.9(2.0)	0.2	0.2
Turkey	38	0.5(1.7)	0.2	0.6
Sub-Saharan Africa				
Cote d'Ivoire	10[6]	0.3(0.1)	0.1	0.1
Nigeria	27	1.4(1.2)	2.5	3.5
South Africa	21	3.7(5.6)	0.9	2.5
Sudan	11[6]	0.1(0.1)	0.2	0.2
Kenya	4	0.1(0.1)	0.3	0.3
Middle East and North Africa				
Algeria	27	0.4(0.8)	0.2	0.4
Egypt	50	0.3(1.8)	0.3	1.3
Iraq	60[4]	0.1(0.8)	0.6	1.6
Israel	33	0.3(0.9)	0.1	0.2
Jordan	5[6]	0.2(0.1)	0.1	0.7
Morocco	20	0.2(0.2)	0.2	0.3
Oman	3	0.1(0.4)	0.7	1.9
Saudi Arabia	14[5][6]	0.7(1.9)	0.2	0.3

[4] Includes $30 bn from Arab countries.
[5] Excludes unguaranteed non-bank claims.
[6] Total external debt at end-December 1986.
* Current estimate.

BILATERAL AGREEMENTS - CURRENT POSITION AT 1 JUNE 1988

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
ANGOLA I	-	-	17.11.87	04.12.87 (London)	04.12.87		Agreement initialled, documents sent to FCO to arrange conclusion of Exchange of Notes.FCO awaiting Portugese translation,1/6.
ARGENTINA I	16.01.85	30.06.85	23.04.85	15.05.85 + 29-31.01.86 (Paris)	28.08.87		English and Spanish texts agreed. FCO arranging Exchange of Notes through "Protecting Powers"-Switzerland and Brazil.Swiss passed bilateral documents to Argentinians 12/1. Reminder sent to Berne 8/3.
ARGENTINA II	20.05.87	31.12.87		To be arranged			Draft text prepared; awaiting signature of Agreement No 1 before sending to Argentinians. Debt list sent 17/12.
COTE D'IVOIRE III	27.06.86	31.01.87	08.10.86	24.10.86 (Paris)	24.10.86		Due to Agreement IV superceding part of this agreement text has been changed (with the Ivoreans consent) and resubmitted for Exchange on Notes to take place simultaneously with Agreement No 4.
COTE D'IVOIRE IV	18.12.87	31.05.88	08.04.88	13.04.88 (Paris)	13.04.88		Documents sent out to complete Exchange of Notes 3/6.
ECUADOR III	20.01.88	31.08.88	07.04.88	26/28 April (Quito)	28.04.88		Agreement initialled 28/4. We are waiting for Ecuadorean comments on Spanish text.
EGYPT I	22.05.87	31.10.87	07.08.87	21/22 January (London)			Negotiations held 1/87. Text agreed but no agreement on interest rate.

XXXIII

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
GABON II	21.03.88	31.10.88		To be arranged			Draft bilateral text under preparation. May be negotiated in June.
GUINEA REP I	18.04.86	31.12.86	16.09.86	29.10.86 (London)	29.10.86		Documents have been submitted to Guinea but no response as yet.
JAMAICA III	05.03.87	30.09.87	20.05.87	09.06.87 (London)	09.06.87	16.03.88	Exchange of Notes concluded. Amendment needed, however, to reflect extended Consolidation Period.
MALAWI III	22.04.88	31.12.88		To be arranged			Draft bilateral text under preparation.
MAURITANIA II	16.05.86	31.12.86	14.07.86	28.11.86 (London)	28.11.86		Documents passed to British Embassy in Paris 14/1. FCO chased 29/2. No response from Mauritanians.
MAURITANIA III	15.06.87	29.02.88	08.01.88	By correspondence	03.03.88		FCO despatched Exchange of Notes on 4/5.
MOROCCO III	06.03.87	30.09.87	29.07.87	19-20 October (London)	20.10.87		Documents forwarded to FCO to arrange conclusion of Exchange of Notes.FCO chased 25/1;they have written to Rabat to ascertain latest position.Reply received from Post suggests that at present there is little chance of obtaining signature.
MOZAMBIQUE II	16.06.87	30.06.88	31.12.87	To be arranged			Preliminary discussions held with MoF in London on 11 January;commercial rate of interest unacceptable to Mozambicans.A further visit was made by a Bank of Mozambique Official who accepted the text of the Agreement but no further progress was made on the interest rate(19/4).

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
NIGER V	21.04.88	30.09.88	23.05.88	26.05.88 (London)	26.05.88		Agreement initialled during negotiations.
PHILIPPINES II	22.01.87	31.03.88	13.07.87	17-18 November (Manila) and 1 March (London)	01.03.88	24.03.88	Exchange of Notes concluded. However minor amendment necessary. This is being drafted and will be sent to N#TD for comments.
POLAND IV	16.12.87	31.05.88	04.02.88	9-10 March (Warsaw)			Offer put to Poles in negotiations rejected on 30/3. We have reaffirmed our position but left way clear for another meeting.
SIERRA LEONE IV	19.11.86	30.04.87	23.03.87	26.03.87 (London)	26.03.87		Ambassador in Freetown sent note to MoF 22/5. Despite numerous "chasers" the High Commission are finding it hard to make any progress.
SOMALIA II	22.07.87	31.12.87	27.11.87	8/9 December (London)	09.12.87		Agreement initialled. Documents sent to Mogadishu on 7/1, FCO chased 17/3
SUDAN IV	03.05.84	28.02.85	24.07.85	08.08.85	08.08.85		Formal signature still outstanding. No action taken to pursue due to increasing arrears under previous agreements and Sudan's position in relation to IMF.
TOGO VI	22.03.88	31.10.88		To be arranged			Draft bilateral text sent to FCO for translation 6/6.
UGANDA III	18.06.87	29.02.88	23.10.87	5 November (London)	06.11.87	17.05.88?	We were informed by Post on 17/5 that Exchange of Notes had been signed.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE OF [illegible]S SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
ZAIRE VII	15.05.86	31.12.86	16.06.86	07.07.86 (London)	07.07.86		Delays on part of Zaire to arrange conclusion of agreement. Subject raised 7/10; delegation commented that signature would take place shortly. FCO chased 20/1,25/4.
ZAIRE VIII	18.05.87	31.12.87	30.09.87	06.10.87 (London)	07.10.87		Agreement initialled. Documents sent to Kinshasa on 26/1.Embassy have requested details for a formal signing ceremony (presumably for VII and VIII).
ZAMBIA III	04.03.86	31.10.86	09.05.86	In correspondence	20.08.86	13.04.88	We have finally received confirmation that Agreement has been signed.

PARIS CLUB FORWARD PROGRAMME

Country	Extant bilateral agreements (rescheduling/ refinancing)	Possible timing of next Paris Club restructuring	Non-consolidated arrears at 31 December 1986	Non-consolidated forward exposure		Expiry date of last bilatera
				FY 1987/88	FY 1988/89	
Bolivia	1 (1/0)	Sept 1988	0	GBP 1.68m	GBP 3.64m	30.06.87
Brazil	2 (1/1)	Sept 1988	0	GBP111.68m	GBP129.66m	30.06.87
Costa Rica	2 (2/0)	July 1988	GBP 0.26m	GBP 0.84m	GBP 0.20m	31.03.86
Cuba	4 (4/0)	Sept 1988	0	GBP 3.29m	GBP 2.73m	31.12.86
Guinea Rep	2 (2/0)	1988	0	0	0	28.02.87
Jamaica	3 (3/0)	Sept 1988	0	0	GBP 2.18m	31.03.88
Liberia	4 (4/0)	1988	GBP 8.28m	GBP 7.50m	GBP 4.67m	30.06.8
Madagascar	5 (5/0)	July 1988	0	GBP 0.33m	GBP 1.34m	[illegible]
Mauritania	3 (3/0)	Sept 1988	0	0	GBP 3.60m	31.05.8
Mali	0 (0/0)	July 1988	0	0	0	31.05.8
Morocco	3 (3/0)	July 1988	0	0	0	30.06.8
Nigeria	1 (1/0)	1988	0	GBP 66.59m	GBP266.39m	31.12.8
Peru	3 (3/0)	?	GBP20.92m	GBP 10.12m	GBP 9.34m	31.07.8
Sierra Leone	4 (4/0)	1988	0	0	0	13.11.8
Yugoslavia	4 (1/2)	June 1988	0	0	GBP 82.90m	31.03.8
Zaire	8 (8/0)	July 1988	0	0	0	14.05.8
Zambia	3 (3/0)	?	0	GBP 14.05m	GBP 13.28m	31.12.8

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PA ECON POL Rept

Foreign and Commonwealth Office

London SW1A 2AH

9 June 1988

CDP 9/6

Dear Charles,

French Initiative on Debt

Further to my letter of last night, this is just to confirm what you and Jonathan Taylor have already heard on the telephone this morning - that the considered view of our people in Paris, who have discussed with Treasury experts, is that the French word "consolidation" should be translated as "consolidation" in English. Mitterrand's proposals are not very specific. The word can apparently encompass both rescheduling and refinancing.

I am sending copies of this letter to Jonathan Taylor (HMT) and Miles Wickstead (ODA).

Yours ever,

Lyn Parker

(L Parker)
Private Secretary

C D Powell Esq
10 Downing Street

Foreign and Commonwealth Office

London SW1A 2AH

8 June 1988

Dear Charles,

French Initiative on Debt

Thank you for your letter of 8 June enclosing a copy of one to the Prime Minister from President Mitterrand. As requested, I enclose a translation.

There is one point to which I should draw your attention. Our translators have opted to translate the French word "consolidation" as "rescheduling", on the grounds that the literal translation (consolidation) does not appear to make much sense in the context, and because the World Bank glossary gives "rescheduling" as an acceptable translation. The traditional term for rescheduling is however "rééchelonnement". I am making further enquiries, and hope to be able to confirm early tomorrow morning whether "rescheduling" is an accurate translation, or whether there is a degree of ambiguity in the French.

I am sending copies of this letter to Jonathan Taylor (HMT) and Miles Wickstead (ODA).

Yours ever,

Lyn Parker

(L Parker)
Private Secretary

C D Powell Esq
PS/No 10 Downing Street

RESTRICTED

8R

cc NCW

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary 8 June 1988

FRENCH INITIATIVE ON DEBT

I enclose a copy of a letter to the Prime Minister from President Mitterrand putting forward a French initiative on debt which he hopes will be discussed at the Economic Summit in Toronto. I should be grateful if the Foreign Office, to whom I am also copying this letter and the message, could arrange for an urgent translation.

The subject will also come up at the Prime Minister's meeting in Paris with President Mitterrand on Friday and you will want to cover it in the briefing.

It would be helpful to have advice in due course on whether the Prime Minister needs to reply in writing to the message ahead of the Summit.

I am copying this letter and enclosure to Lyn Parker (Foreign and Commonwealth Office) and Myles Wickstead (Overseas Development Administration).

(C. D. POWELL)

Alex Allan, Esq.,
HM Treasury.

RESTRICTED

Ò/S.

cc PC

AMBASSADE DE FRANCE

LONDRES

7th June, 1988

Dear Prime Minister,

I have just received the text of a message addressed to you by Monsieur François Mitterrand, Président de la République.

I enclose it herewith.

Yours sincerely

Bouillane de Lacoste

Jean-Noël de Bouillane de Lacoste
Ministre Conseiller

The Rt. Hon. Margaret Thatcher, M.P.
Prime Minister,
10, Downing Street,
London S.W.1.

MESSAGE DE MONSIEUR FRANCOIS MITTERRAND,
PRESIDENT DE LA REPUBLIQUE

A

THE RT. HON. MARGARET THATCHER, M.P.
PRIME MINISTER

Paris, le 7 juin 1988

"Madame le Premier Ministre,

Jamais il n'a été aussi urgent et aussi nécessaire d'agir pour aider les pays du tiers monde, le fossé ne cessant de s'élargir entre pays riches et pays pauvres.

Alors que diminuent leurs ressources, en raison notamment de la chute du cours des matières premières, alors qu'ils ont à affronter famines, épidémies, fléaux naturels et que l'extrême pauvreté croît en Afrique, en Amérique Latine et dans de nombreuses régions d'Asie, les pays en développement les plus pauvres ne sont pas, et ne seront pas, en mesure de rembourser aux pays développés l'intégralité de leurs dettes, selon les conditions qui leur sont aujourd'hui imposées.

.../...

Nous ne pouvons plus admettre une situation où les transferts financiers du Sud vers le Nord excèdent de près de 30 milliards de dollars les transferts inverses, le poids des remboursements l'emportant sur les crédits nouveaux.

Lors du Sommet de Venise, nous avions reconnu la nécessité d'un programme spécial en faveur des pays les plus pauvres qui ont entrepris des efforts "d'ajustement". Nous étions convenus de rechercher un accord sur un allongement des périodes de remboursement : cela a été fait. Nous n'avons pas en revanche progressé dans l'application de taux d'intérêts plus bas pour les consolidations de dette.

Pour sortir de l'impasse actuelle, je propose donc d'assouplir les conditions de remboursement des pays les plus pauvres, définis selon les mêmes critères que nous avions arrêtés lors du Sommet de Venise, en laissant le choix aux pays créanciers de leur proposer l'une des trois possibilités suivantes :

- une annulation immédiate du tiers de la dette, dans le cadre d'accords de consolidation sur une période de l'ordre de 10 ans ;

.../...

- une consolidation de la dette aux taux du marché, mais avec une durée maximale de 25 ans (au lieu de 20 ans au plus aujourd'hui) ;
- une consolidation de la dette à un taux préférentiel, réduit au moins de moitié sur une durée de remboursement de l'ordre de 15 ans.

Je souhaite que cette proposition puisse rencontrer votre approbation et celle de tous les autres Chefs d'Etat et de Gouvernement participant au prochain Sommet de Toronto.

Je vous indique d'ores et déjà que la France entend pour ce qui la concerne offrir, en tout état de cause, à tous les débiteurs concernés qui le voudraient, d'annuler le tiers de ses créances; cette option qui présente l'avantage d'entraîner une baisse immédiate de l'encours de la dette me paraît la mieux adaptée à la situation des pays les plus pauvres.

L'intensification de l'action menée au bénéfice des pays les plus démunis ne signifie évidemment pas pour autant que nous devrions relâcher notre effort en faveur des pays dits "à revenu intermédiaire" qui sont souvent lourdement endettés.

.../...

Il faut faire preuve de plus d'imagination, et de réalisme, par exemple en élargissant le champ des consolidations des créances publiques, étendu si nécessaire aux échéances d'intérêts. La mobilisation de ressources nouvelles et le recours à de nouveaux instruments financiers, s'inspirant des techniques de marché, doivent être encouragés pour les créances bancaires. Enfin il est indispensable de mettre en oeuvre plus rapidement les décisions multilatérales récentes, je pense par exemple à l'augmentation du capital de la Banque Mondiale, prises en matière d'aide publique au développement.

Je me réjouis, Madame le Premier Ministre, de pouvoir discuter avec vous de toutes ces questions à Toronto et je vous prie de croire à l'assurance de ma haute considération et de mes fidèles sentiments.

signé : François Mitterrand"./.

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

7 April 1988

Prime Minister

C Powell Esq
Private Secretary
No.10 Downing Street
London SW1

Dear Charles

INTERNATIONAL FINANCIAL SCENE

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

The economic outlook as it affects debt problems over the year ahead remains difficult. GDP growth in the major industrial countries is expected to average about 2½ per cent in 1988 - slightly less than in 1987. The rise in the volume of world trade also seems likely to be a little lower at about 4 per cent. Oil prices have fallen since the beginning of the year which will worsen the prospects for oil producers. Other commodity prices, however, have risen on average which will benefit other debtors. Over the slightly longer time horizon risks to growth and trade remain depending at least partly on the ability of the US to overcome its budgetary and payments problems without recession and/or protectionism.

The Chancellor will be discussing debt issues with other Finance Ministers at the Spring IMF/IBRD meetings in Washington in mid-April. We shall be looking to reinforce the existing strategy for middle income debtors. In particular we shall be stressing the need for strong adjustment by debtors underpinned where necessary by appropriately firm programmes agreed with the international financial institutions. We shall be seeking to prevent any dilution of IMF conditionality.

We shall need to recognise the increasing fragmentation of commercial banks' views. Their negotiations with debtors are their own responsibility but we shall be looking for a development of the 'menu' approach. We shall be opposing global schemes involving governments bailing out banks. We welcome banks' increased provisioning.

In the case of the poorest debtors we shall be seeking further support for the Chancellor's initiative to provide interest relief to the poorest countries, mainly in sub-Saharan Africa. We shall be seeking credit for our major contribution to the IMF's Enhanced

Structural Adjustment facility which will increase IMF lending to these countries.

Argentina provides the most recent example of weakening IMF conditionality. The Board was asked to approve further disbursements despite a huge financing gap and a projected accumulation of arrears to banks. Several countries, including the UK were ready to abstain on this. A weak compromise was proposed by the Managing Director. The UK was still ready to abstain but lacked adequate company. It was carried by consensus.

President Sarney's speech on 29 February acknowledged the damage to Brazil's international credit of the 1987 moratorium. This acknowledgement sends a welcome signal to other debtors who might contemplate a moratorium. Agreement has been reached provisionally with commercial banks on terms for rescheduling 1987-93 maturities over 20 years together with a new money package up to the first half of next year. Interest payments of $1 billion were made to banks in the first quarter. A Fund mission is to visit Brazil in April to start work on drawing up an 18-month programme. The external sector has performed better than expected but at the cost of slow growth. Inflation remains rampant, and the Government has not yet put together a comprehensive package of measures.

The experimental Mexican exit-bond auction backed by 20-year zero coupon US Treasury bonds resulted in only a modest reduction of the stock of debt and annual debt service. The final price paid by the Mexicans was higher than the current secondary market price and reflected the banks' provisioning for Latin American debt. Banks' general lack of enthusiasm to sell at anything like the prevailing secondary market prices could reflect caution in the face of innovation as well as uncertainty as to the ultimate value of their Mexican loans and reluctance to forego claims. Overall, despite inflation of 180 per cent, the Mexican economy is performing strongly at present and the IMF programme was completed in March. There has been substantial turn-around in its current account. A new package of policy measures including a modified price and wage freeze was introduced in March. Mexico may now seek an enhanced surveillance agreement with the Fund.

Prospects of progress in resolving Nigeria's debt problem have deteriorated. The 1988 Budget is excessively expansionary and the decline in oil prices will reduce export earnings. Discussions with the IMF on a new programme are stalled. Relations with the London Club are also strained following Nigeria's request in mid-March for a rescheduling of 1988-91 maturities over 25 years, including recent letters of credit. A similar request is expected to be made to Paris Club creditors who will undoubtedly also find it unacceptable. The Chancellor will be seeking to persuade the

Nigerian Finance Minister, Mr Okongwu, in Washington to reach an agreement with the IMF stressing that this is essential for the conclusion of agreements with other creditors to whom Nigeria will need to offer modified terms. He will be pointing out that although the UK is ready to help Nigeria, the scope for this is limited in the absence of agreement on an IMF programme.

Egypt continues to pose problems. The IMF programme is effectively dead. The Egyptian authorities have not yet shown themselves willing to accelerate reforms, and the Fund staff are still seeking a basis for agreement. Only half the bilateral negotiations stemming from last year's Paris Club rescheduling have been agreed. ECGD's has not. These will need to be completed, as will negotiations on a new Fund programme, before a follow-on Paris Club rescheduling can be negotiated. We shall be working with other G7 Directors to try to ensure that any new Fund programme does not suffer from the weakness of last year's agreement.

Yugoslavia's financing difficulties remain acute and bridging finance perhaps through the BIS may be requested shortly. The current account out-turn for last year was better than expected but reserves had to be reduced sharply to meet Yugoslavia's obligations. The domestic economic and political situation remains unsettled. Inflation accelerated to 170 per cent last year and the temporary price freeze since November will not provide a lasting solution. Talks with the IMF on a new programme promise to be difficult and it is doubtful whether agreement can be reached before the summer which will delay Paris Club talks. Negotiations with banks are also proceeding only slowly.

I am copying this letter and enclosures to Robert Culshaw (FCO), Jeremy Godfrey (DTI) and John Footman (Bank of England).

Yours sincerely

Jonathan Taylor

J M G TAYLOR
Private Secretary

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INTERNATIONAL DEBT GROUP REPORT: MARCH 1988

Main points

- Brazil has reached a preliminary agreement with its Advisory Committee. The deal is likely to involve $5-6 bn of new money and trade lines although the banks are seeking an IBRD guarantee on part of the new loans. Q1 interest is being paid and an IMF agreement is no longer such a distant prospect.

- Mexico's buy back auction received lukewarm support: $3.7 bn of debt will be exchanged for $2.6 bn of bonds. Further elements of the counter inflationary strategy have been introduced.

- Argentina's immediate liquidity crisis has been averted by a US bridging loan. More determination to tackle fiscal problems is apparent.

- Chile has raised the possibility of voluntary financing from the banks, part of the proceeds being used for buy-backs.

- Poland is attempting to revise the terms of its recent reschedulings agreement with the banks and the Paris Club. It may, however, agree to a shadow IMF programme.

- Concerns over Yugoslavia's inability to put its house in order continue to mount. Creditors seem willing to tolerate a build-up of arrears as long as progress on reaching a strong IMF programme continues.

- The IMF management have railroaded through approval of disbursements under Cote d'Ivoire's programme, despite an outstanding financing gap.

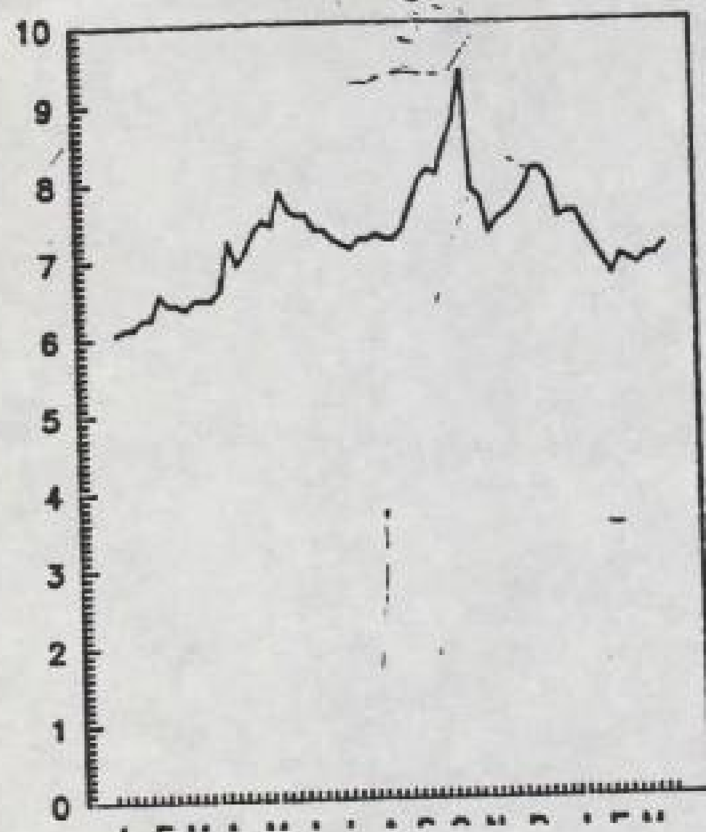
- Only slow progress has been made in negotiations on Nigeria's IMF programme. With money short, the authorities are seeking a 25 year rescheduling at low interest rates from the banks and will demand similar concessions from the Paris Club.

- Egypt's IMF programme is effectively dead and several of its Paris Club bilaterals are stalled over interest rates.

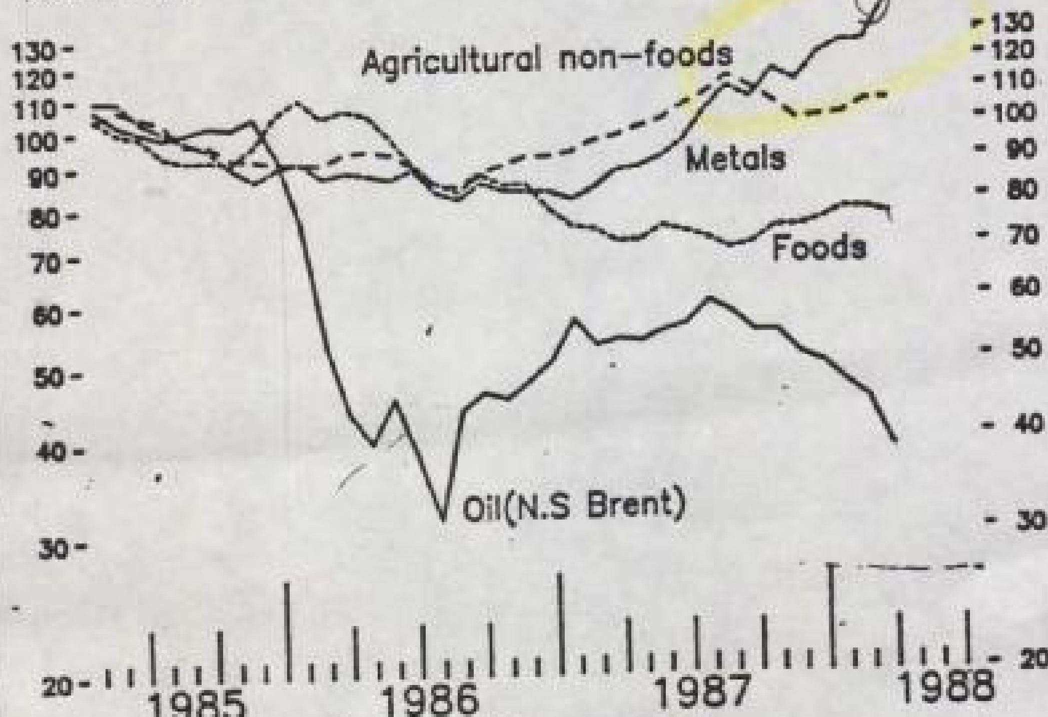
- The Wass Report on Sub-Saharan African debt suggests that a further $2 bn pa in the form of debt relief or oda will be required on top of recent multilateral initiatives. Little progress in securing creditor support for interest rate reductions was made at the latest Paris Club.

6-Month Dollar LIBOR

Percent



"Economist" Indices of Spot Commodity Prices



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INTERNATIONAL FINANCIAL SCENE

World Economic Developments

Uncertainty surrounding the likely strength of the US economy this year continues (the Administration's forecast of just under 2 1/2% real growth being at the top of the range). The most recent data point to some slowdown in Q1 after the unexpected strength of Q4. The trade deficit has narrowed in recent months. In contrast, domestic demand in Japan continues to be strong but the latest trade figures suggest that no significant reduction in its trade surplus is immediately in the offing. The OECD has revised up slightly its estimate for German growth, but business sentiment continues to be weak, orders have fallen, and there are indications of an involuntary build-up of stocks. After a period of relative stability the US dollar has weakened and interest rates have edged up. (Chart 1.)

Since the end of January the Economist index of non-oil commodity prices has risen by 10% in SDR terms, led by strong metal prices (aluminium +36%, nickel +123%) although these are expected to weaken later this year as supply difficulties, which are partly responsible, subside. (Chart 2). Increases in other industrial materials have been much more modest. Amongst foods, tropical beverages remain in substantial over-supply. Oil prices have fallen sharply as OPEC production appears to have edged up once more in February and the relatively mild winter is not creating the usual seasonal drawdown of stocks. An announcement that OPEC's price monitoring committee was to meet to consider possible production cuts led to some recovery in prices but the market remains nervous.

Prices of ldc debt in the secondary market have generally fallen back; the price of Argentine debt has declined sharply. (Chart 3.)

IMF: World Economic Outlook (WEO) (Table 1)

Data released in the latest WEO show some improvement last year in the current account and in ratios of debt to exports in the Baker 15 countries, following a sharp deterioriation in 1986. However, this was achieved at the cost of severe domestic restraint: import volume and per capita GDP fell. Unlike the Baker 15, Sub Saharan Africa countries did not enjoy an improvement in their terms of trade; their debt ratio continued to rise, growth in imports was minimal, and per capita GDP declined.

The WEO projections, based on unchanged policies,and broadly stable real commodity prices, exchange rates and interest rates, suggest that the demand for exports of the heavily indebted countries will be significantly stronger in 1988 than last year, largely as a result of recent real exchange rate depreciation and on the assumption of sustained domestic adjustment efforts and structural reforms. While debtors' terms of trade may deteriorate a little, and financing will remain tight, there may be scope this year for the first significant upturn in import volumes since the early 80s (although the level will remain well below that pre-1982). Debt to export ratios in the Baker 15 should also continue to decline.

The report notes, however, that the risks to the projections are largely on the downside, and cautions that the structure of world current account imbalances could be unsustainable. The report investigates the impact of a number of medium term scenarios highlighting the risks to the ldcs of protectionism and of international financial tensions but also demonstrating the potential benefits to them of structural reform in the industrial countries. A further scenario considers the impact of $10 bn pa of additional financing to the Baker 15 on the utopian assumption that the additional debt finances higher imports of investment goods which are used productively. Although debt service ratios initially deteriorate, the rise in productive potential and exports leads to improvements in GNP as well as domestic output within four years.

Debtor Creditor Relations

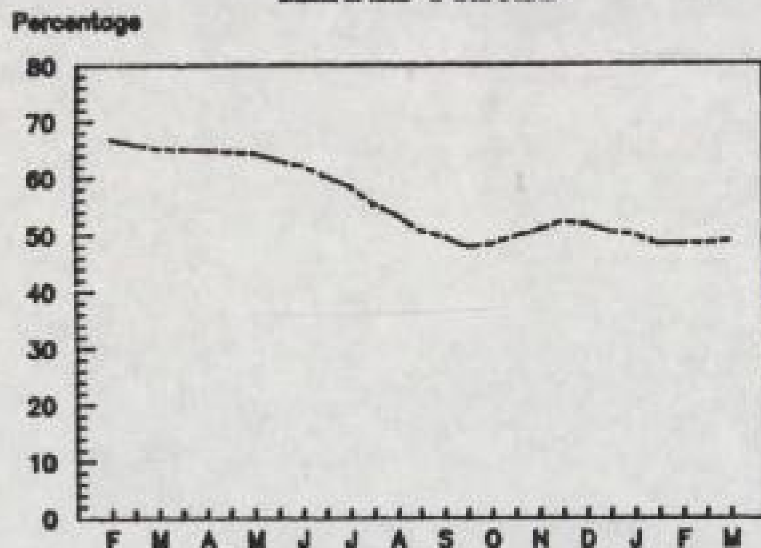
Negotiations between Brazil and the banks have progressed well and a rapprochement with the IMF appears possible. In Argentina a liquidity crisis has been forestalled by a US-financed bridging loan and there seems to be more determination on the part of the authorities to get to grips with the country's chronic fiscal problem. Mexico, despite minimal real growth in recent years, has embarked on a counter-inflationary policy which may stand more chance of success than some previous Latin American efforts because it is underpinned by fiscal restraint. The worst fears regarding the external environment facing debtors following the crash may prove to be exaggerated. Lessons seem to have been learned from the chastening experience of Brazil and others who have embarked on confrontational policies, and even Peru appears to be reversing its ruinous policies. In particular, some debtor governments have come to realise the cost to themselves of being off export credit cover; indeed the current strategy might be reinforced by promising a more prompt restoration of cover as a carrot.

Nevertheless, the risks of another false dawn are high. The authorities in the major debtors may yet succumb to domestic political pressures. In Brazil, the new Finance

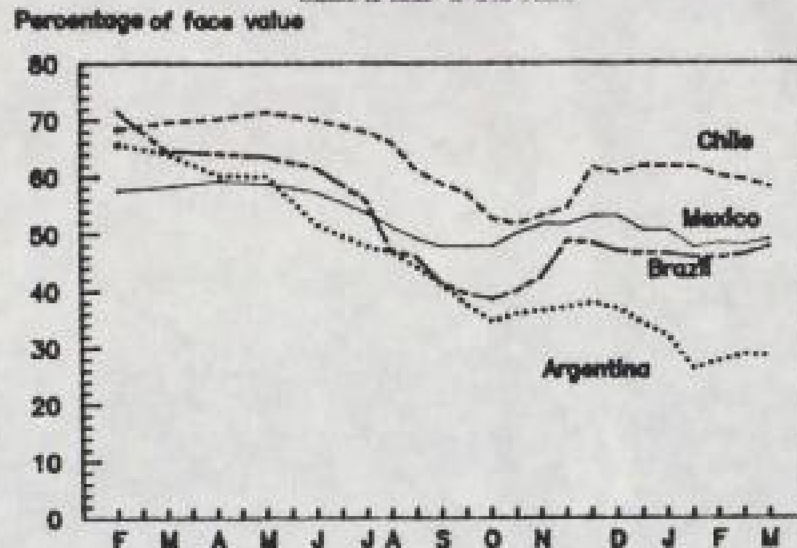
CHART 2

SALOMONS SECONDARY MARKET PRICES

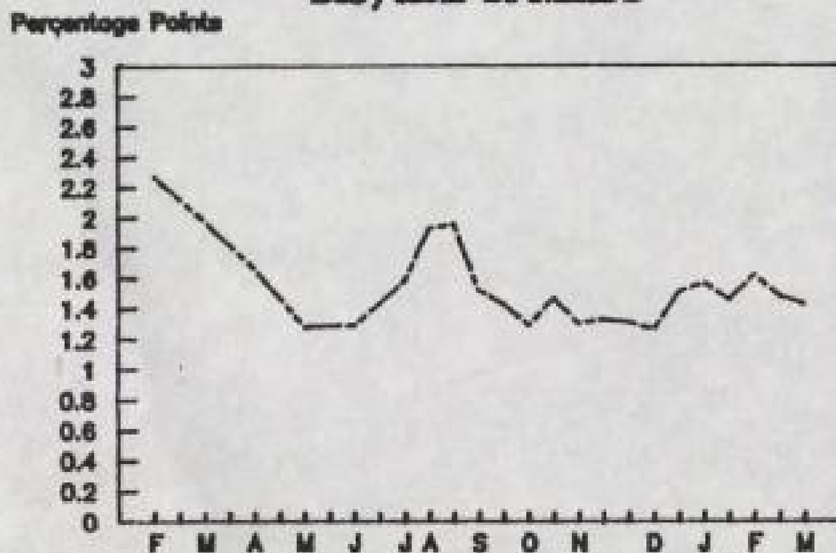
ALL IDR COUNTRIES (WEIGHTED AVERAGE) MIDDLE PRICES



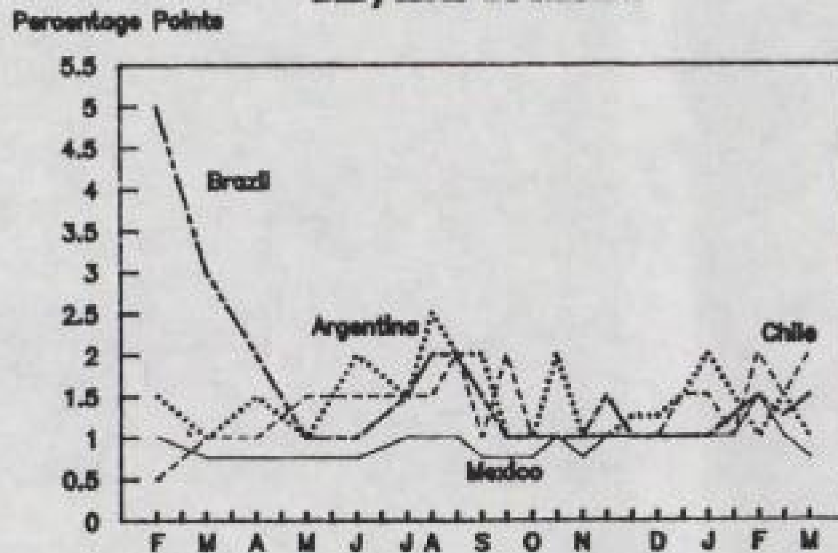
SELECTED MAJOR DEBTORS MIDDLE PRICES



BID/ASK SPREADS



BID/ASK SPREADS



Minister, Nobrega, may be unable to pilot an IMF agreement through the Congress. Support from President Sarney may waver. With elections approaching in Mexico and Venezuela there must be limits on the firmness of any policy response to continuing weak (or a further fall in) oil prices. In Argentina Presidential elections are due at the end of next year. Nigerian and Yugoslav reluctance to implement much tougher measures are only two among many signs of debt fatigue. The lukewarm response to Mexico's bond offer (details below) could undermine support for market-based solutions. A further spell of dollar weakness and higher interest rates cannot be ruled out and non-oil commodity prices could also weaken.

Mexico's Debt For Bonds Swap

Mexico has accepted $3.67 bn in bids of existing bank debt for $2.6 bn of new, 20 year, floating rate bonds carrying a spread of 1 5/8% (twice that on rescheduled loans). The debt was thus exchanged at an average price of about 70% of face value (compared with a secondary market price of 47%). Of around 500 banks eligible, 139 made bids (up to 5 were allowed per bank) but 45% were rejected. 95 banks had their tenders accepted. Mexico will pay $532 mn for 20 year zero coupon US government securities to be held as collateral for its new bonds and some existing issues. The net annual interest saving after taking account of the loss of interest on reserves is only about $40 mn.

These modest reductions in the stock of debt and annual debt service will have disappointed Mexico's most optimistic expectations and may have reinforced sceptics' demands for a negotiated rather than a market based write-down. Nevertheless, the exercise will probably have secured a reduction in the number of banks required to participate in future concerted loan packages. Judged as an exit bond, it represents a significant advance on that devised for the Argentine package. However, it has also shown that most banks remain, as yet, unwilling to sell out at anything like the prevailing secondary market discounts or even at their generally more modest provisioning levels. This may well reflect considerable uncertainty as to the ultimate value of their loans as well as a reluctance to forgo a claim to a portion of their contractual rights even though these have a low probability of being paid.

The IMF and Middle Income Debtors

With the ESAF now in place, the IMF management has turned its attention increasingly to the middle income debtors. With the alleviation of the debt burden certain to be a prolonged affair, emphasis has been given to revitalising the moribund Extended Fund Facility and, given the likelihood of future shocks, to enhancing the Fund's

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TABLE 2

PROBLEM COUNTRY PROVISIONS

	Amount (£mn)		% Provided	Equity:Assets ratios (%)	
	1987 H1	1987	End-87	End-86	End-87
Lloyds	1066	1066	34	5.8	5.3
Midland	916	1016	29	4.0	5.5
Barclays	570	713	29	4.8	4.8
NatWest	480	518	33	5.6	5.7
Total	3032	3313	31	5.1	5.3

contribution to contingency financing. These two basic objectives have received qualified support from major creditor goverments (and Baker proposed that the CFF be replaced by an External Contingency Facility at the last Annual Meeting). However, there are concerns lest conditionality should be eroded in the process and that the Fund, by lending signficantly greater amounts and at longer term, could end up refinancing commercial bank lending and interest. The provision of medium term money for structural reform overlaps with the World Bank, and the Fund would be quite unable to finance more than a small part of the additional obligations that would follow, say, a significant rise in interest rates, even assuming that were desirable.

A second, more sinister, element may also be creeping into the IMF management's strategy. In an effort to compel recalcitrant banks to participate in new concerted lending packages (or to exit on terms that would effectively provide the same present value of cash relief to the debtor) there is a suggestion that the Fund might approve programmes prior to having reasonable assurances that financing gaps were being filled by other creditors, and then to use its powers under Article VIII to sanction any subsequent arrears to non-participating banks as approved exchange restrictions. In the recent case of Cote d'Ivoire, disbursements under programmes were approved in undue haste (the UK and 3 others abstaining) before even the terms sheet of a commercial bank financing had been agreed; it is normal practice not to approve a programme until "critical mass" has been reached. There is a suspicion that when data are available, end-year performance criteria will be shown not to have been met. The Fund management's action can also be seen as an attempt to support Cote d'Ivoire and participating banks with large exposures. Under the new proposed agreement banks that failed either to provide new money or to buy exit bonds would not receive interest arrears. Moreover, principal due to them under the 1986 agreement would not be paid as the authorities have indicated they will pay all banks only under the proposed terms of the new agreement which provides for that principal to be rescheduled. The legality of the proposals may be challenged.

Provisioning

The large provisions against problem country exposure which the four UK clearers made at the half-year were slightly increased at end 1987 to an average of 31%. The £3 bn provisions were offset by about £1 bn of expected tax relief. Capital ratios were hit by the provisions at the half-year, but have improved since. (Table 2).

Canadian banks (who have around $25 bn of exposure to problem debtors - about twice that of US regionals who have recently raised their provisions sharply) will be required to

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Table 3

Condolidated deterioration in net external position of Sub Saharan Africa (ex Nigeria) 1979-81 - 1985-87

	$ bns pa
Terms of trade losses	2.9
Increased interest payments	2.1
Reduced net credit flow	2.4
Reduced direct investment	0.2
Increased official grants	-1.1
Net deterioration	6.5

In the absence of reschedulings debt service would have been $5-6 bn higher per year

Source: UN Secretariat

Table 4

IBRD Special Programme of Assistance for Sub-Saharan Africa, 1988-90[1]

		$bns
Financing gap before rescheduling[2]		22.3
Rescheduling		
Concessional debt service	3.6	
Principal on non-concessional debt	8.8	
		(12.4)
Financing gap after rescheduling[3]		10.4
Financed by:		
Additional IDA-8 disbursements		1.0
ESAF disbursements (150% of quota)		4.1
Remaining gap to be filled by cofinancing and other sources[3][4]		6.5

(1) 26 countries, 17 of which are currently regarded as making sufficient adjustment efforts to qualify.

(2) Assuming growth in per capita consumption of 0.9% pa. Figure is net of surpluses for some countries.

(3) After allowance for surplus countries, ie represents total of remaining deficits.

(4) $6.4 bn of cofinancing has been pledged. However the country distribution and timing of this amount would not, on present plans, close the gap over 1988-90. The remaining gap could also be closed by rescheduling interest on non-concessional debt, and moratorium interest on newly rescheduled debt, on concessional terms. $2.4 bn of interest might be consolidated in this manner.

Figures do not add because of rounding.

Source: IBRD

provide up to 45% for the year ending 31 October 1988. This compares with current provisioning levels of 37/38%. The markets had been expecting a larger increase.

In the US, the Financial Accounting Standards Board has ruled that from end-1989 banks will no longer be able to anticipate tax credits (payable when loans are written down) at the time they make provisions against loan losses. The new rules will also apply to past credits. The effect of this change will be that provisioning will no longer serve to boost a bank's primary capital since a higher general provision (tending to raise primary capital) will be fully matched by a decline in shareholder's equity. At present the ability of a bank to claim a deferred tax credit effectively reduced the fall in equity, giving rise to a net increase in primary capital overall. The measure may dampen recent tendencies to engage in competitive provisioning.

Debt Equity Swaps

The Fed has taken further steps to increase the attraction to banks of debt equity swaps by relaxing restrictions on US banks' direct investment in ldcs. Henceforth, US bank holding companies will be able to acquire up to 40% of the equity of any private company in heavily indebted ldcs and will be allowed to lend up to 50% of total credit extended to the affiliate. The stake may be held for 2 years beyond the period disinvestment is prohibited by the debtor country, up to a maximum of 15 years. Investments in non-financial companies must be held by bank holding companies, and if the stake is greater than 25% there must be a larger independent shareholder. Previously US banks were allowed to hold controlling stakes in financial companies, or up to 20% of the equity of non-financial companies (100% if the company was being privatised).

African Debt Initiatives

The Wass Report ("Financing Africa's Recovery"),prepared for the UN Secretary General, identifies three principal causes of sub-Saharan Africa's debt crisis: terms of trade losses, higher interest charges, and reduced net credit flows (see table 3). While the impact of these has been partly mitigated by an increase in official grants and the effect of reschedulings (the latter reducing net financial transfers to creditors by $5-6 bn annually) there remains a net deterioration since the late seventies of about $6 1/2 bn pa. The Report identifies a future annual financing gap of $5 bn, a figure which appears to be based on an extrapolation of World Bank projections for 14 debt distressed countries. (The IBRD's calculations assume a need to reduce debt service ratios to 25% of exports and to provide for an annual rise in real per capita imports of 1%.) The amount is close to estimates made at by the OAU and the UN ECA when their numbers are adjusted for more recent changes in prices and exchange rates.

The Report suggests that $3 bn of the financing gap is likely to be closed by measures taken so far (ESAF, replenishment of the IDA and the AfDF, and greater oda). It recommends that the remaining $2 bn pa requirement be met in roughly equal measure by debt relief and more oda. Specific measures include: graduated and conditional interest relief on reschedulings (as low as 0.5% for the poorest countries); the prompt restoration of ECA cover to rescheduling countries ineligible for interest concessions; refinancing of IBRD loans to the most needy on IDA terms; conversion of oda loans into grants; building upon the IMF's CFF so that funds would be available at low conditionality on a wider range of contingencies and at concessional rates of interest; refinancing of IMF purchases with ESAF money; and, in certain cases, securitisation and oda financing of buy-backs of commercial debt.

While these measures go much further than those recommended in the Chancellor's intitative, and there may be questionmarks over the size of the financing gap the Report identifies, the Report provides useful and timely ammunition. There are already some signs that major European countries may be coming round to the UK view at least on the principle, if not the modalities, of interest relief, leaving the US and Japan isolated. (Recent US farming legislation has also weakened American arguments that it is politically impossible to offer relief if hard-pressed domestic borrowers (especially farmers) are to be denied similar concessions.) If creditors can be convinced that officially-inspired debt relief for Africa can be successfully ring-fenced to exclude middle income debtors (and here the claims of Egypt and Nigeria present tricky problems) substantial progress may be made at the forthcoming G7 summit. However, at the latest Paris Club there was little sign of movement from countries opposed to interest rate relief.

Further progress on the details of the World Bank's special assistance programme for debt-distressed low income Africa countries was made at a donors' meeting on 15-16 March. 17 countries are now regarded as qualifying on grounds of need and effective adjustment effort. Nine other countries could become eligible. A broad outline of the various sources of financing is set out in Table 4. As shown, the financing gap is notionally closed on the (strong) assumption that the full $6.4 bn of cofinancing so far pledged is disbursed and allocated according to need over 1988-90. In practice, this is unlikely. The remaining gap would be substantially reduced, however, if interest payable over this period was rescheduled on concessional terms.

Further details on individual countries are given below.

LATIN AMERICA AND CARIBBEAN

Brazil

Political uncertainties continue to hamper the implementation of economic policy and Nobrega has yet to put together a comprehensive package, though some further piecemeal adjustments to fiscal spending have been announced. The resignation of Milliet, the Central Bank Governor, does not help although his successor, Elmo Camoes, has the backing of Sarney and Nobrega. Meanwhile, inflation remains rampant:consumer prices rose 18% in February taking the 12 month rate to 381%. Signs of recession are clear: GDP rose only 2.9% last year, with industrial output rising by only 0.9%. Partly as a result, the external sector performed better in 1987 than earlier expected, recording a trade surplus of $11.2 bn.

Provisional agreement on a new money and rescheduling package, and the restoration of $600 mn in credit lines, has been reached between the authorities and the Advisory Committee. The details are yet to be finalised but the proposed terms of the rescheduling (covering $68 bn due in 1986-93) are 20 years, 8 grace and at a spread of 13/16%. New money of $5.8 bn will cover the period 1987 to 1989 H1, but may be reduced to around $5 bn if the reduction in spread is applied retrospectively to the 1987 element and interest is retimed. IBRD guarantees are being sought on $500 mn of the new borrowing. Of the $5.0 bn, $3 bn has already been committed under the interim financing arrangement and $1 bn disbursed. Brazil (which had been looking for $7 bn in new money over 1987-88) has agreed to pay $1050 mn of Q1 interest (much more than was expected) out of its own resources, with the balance to follow if negotiations progress. $600 mn of trade lines will be restored. A full term sheet should be available by early April. The first auction under the debt for equity conversion scheme will take place at the end of March.

Nobrega has stated that Brazil soon hopes to begin negotiations with the Fund in April for an 18-month SBA for about $1.7 bn; he hopes this can be approved in June. An IMF mission is to arrive in Brazil on 9 April. It is unlikely that drawings under the banks' facility can be linked to IMF disbursements.

Mexico

An assessment of the results of the exit bond auction is given on page iv above. The current account showed a surplus of $4.4 bn in 1987 after a deficit of $0.7 bn (this included a $0.6 bn interest rebate in 1986). The trade surplus in 1987 was $8.7 bn,

against $4.6 bn in 1986: exports rose nearly 30% in value (with non-oil exports rising by 23% and oil exports rising by 37%); imports rose by 7.6%, with particularly strong growth in H2. Tourism earnings were up 20% and net receipts from in-bond activities rose 10%. Interest payments were also lower. There was a capital account surplus of $2.2 bn, after a $0.3 bn deficit in 1986. Gross reserves rose by about $6-7 bn during the year to about $13-14 bn at end-1987.

The fiscal outturn in 1987 was worse than envisaged in the Fund programme (most of the end-December fiscal performance criteria were probably missed). This reflected late adjustments to public sector prices and revenue shortfalls as a result of unexpectedly slow economic growth. The Fund Board discussed the second review of the SBA and the 1987 Article IV consultation on 10 March and readily accepted the necessary waiver to permit the drawing of the remaining SDR350 mn from the SBA (which expires in March) as recent policy actions have been more convincing. IBRD loans totalling $965 mn have also recently been approved. Mexico hopes to draw the $0.5 bn growth contingency loan, and the final $0.6 bn of the banks' parallel sector loan, on 30 March, to bring total borrowing to $4,972 mn (the original total of $6.0 bn has been reduced because of the interest rebate and better-than-expected trade performance). A further modified stage of the Economic Solidarity Pact (PSE) took effect from 1 March. The PSE is intended to break the inflationary spiral by a combination of fiscal retrenchment (the latest measures includes a 10% cut in non-union staff in all government departments) and a freeze or near-freeze on prices, wages and the exchange rate. During March, state sector prices and the official exchange rate will be frozen and wages allowed to rise only 3%. Private sector producers have agreed to exercise price restraint. Thereafter, there will be a system of forward-looking indexation whereby wages and the exchange rate will be indexed to the cost of a basket of 75 basic commodities, many of whose prices are government controlled. The hope is to reduce monthly inflation to 2% by the end of the year. In February monthly inflation fell to 8.3% (giving a 12 month rise of 180%) but earlier higher figures had reflected initial adjustments of state sector prices and wages as part of the Pact.

Argentina

The combined public sector deficit was 7.1% of GDP in 1987 against 4.5% in 1986 and a much-revised Fund target of 5.6%. Government revenues have been hampered by delays in the implementation of October's fiscal measures, which were amended and approved by Congress on 8 January. Following the lifting of the price freeze, the CPI rose 10 1/2% in February bringing the 12 month rate to 189%. The wage freeze was also lifted in December and union pressure to raise wages is now mounting.

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Performance on the external side was poor in 1987 with the overall balance of payments deficit being $4 bn, against $2 bn in 1986. Provisional data show a 1987 trade surplus of $500 mn, against an original forecast of $2.5 bn: agricultural exports were significantly lower following poor harvests.

The IMF Board considered the SBA review and a request for a SDR 233 mn CFF on 18 March. The CFF and disbursement of the next SDR 165.5 mn tranche under the SBA were approved, but further drawings will be conditional on satisfactory progress regarding external financing in 1988. A variety of policy changes have been put forward by the Argentines, in particular a major strengthening of public finances to reduce the operational deficit to, at most, 2% of GDP in 1988 (cf 6.8% in 1987), and to eliminate it completely in 1989. Reducing inflation to 4% a month and lowering the overall balance of payments deficit to $3 bn in 1988 are also important objectives. The stalling of the Fund programme initially delayed further disbursements from the banks' $1.95 bn new money package, but the third drawdown of $550 mn was eventually made on 25 March. Nonetheless foreign exchange reserves had fallen to one or two month's imports, and there is clearly a liquidity crisis. Although Bonex payments of $350 mn were made as scheduled in February, arrears to virtually all creditors are being accumulated. The situation had been eased, however, by the granting of a $550 mn bridging loan by the US authorities, to be repaid from the drawdown of the SBA purchase now approved, the first disbursement of the CFF, and from World Bank funds under the Agricultural Sector Loan approved in 1986. Nevertheless, $2.6 bn of additional financing will be needed to meet Argentina's financing requirements this year. Discussions on 1988 new money from the banks are due to commence in April.

Venezuela

GDP growth was some 3% in 1987 (5.2% in 1986). The consolidated public sector deficit fell to 4% of GDP in 1987, against 6.7% in 1986 and a Fund projection of 6.3%: the government attributes the improvement to higher-than-projected oil revenues and delays in the implementation of certain investment projects. However, inflation continues to worry the authorities and the government's main priority in 1988 will be to reduce price increases. An indefinite price freeze on public sector goods and services imposed in December was reflected in only a 0.5% rise in prices in January, and the CPI reportedly fell 1.5% in February.

The overall balance of payments deficit in 1987 was $1.4 bn, well below that for 1986. The current account deficit narrowed to $71 mn from $2 bn in 1986, while the trade

surplus rose to $2.2 bn from $0.8 bn, with sharply recovering oil revenues more than offsetting a modest increase in imports. Imports in H1 1988 are to be restrained by a tight budget for exchange at the official rate for the private sector.

In February the government, in conjunction with Morgan Guaranty and Banco de Venezuela, issued a $100 mn eurobond, the first sovereign borrowing on the capital markets since 1983. The bond has a 5-year maturity and a coupon of 11 1/8% (350 basis points over US Treasuries); 90% of the issue was pre-placed mainly with Venezuelan insurance companies and other domestic financial institutions. It is being quoted at around par, although trading is infrequent.

Chile

GDP growth in 1987 was 5.4% (1986 5.7%). The non-financial public sector deficit was reduced to 0.8% of GDP in 1987, against a Fund target of 1.6%: higher copper prices had resulted in larger-than-expected revenues and privatisation receipts raised the equivalent of 2% of GDP. Twelve month inflation was 20% in January, down from 21.5% in December.

Preliminary data show a current account deficit of $890 mn rather than the $950 mn forecast by the IMF, with the trade surplus of $1.2 bn exceeding the Fund forecast by $250 mn. Revenue from copper exports rose 27%, while non-copper exports rose by 22%; imports increased by 29% Foreign investment increased by 140% to $1.2 bn. With a comfortable external position and its Fund programme on track, Chile has approached the banks with proposals to raise voluntary new money (up to $300 mn a year) and to use part of the proceeds along with other assets for the securitisation/buy-back of its debt. The banks were sceptical that Chile could raise such large sums ($100 mn this year and $200 mn next, or $300 mn in 1989, after the plebiscite, might be feasible) but have given their consent for Chile to use reserves from the Copper Stabilisation Fund for this purpose (although not Banco Central's foreign exchange reserves). The banks are considering a reduction in the spread on amounts restructured last year to 13/16% with effect from 1989 H2 (conditional on an undertaking not to request concerted new money). In January two US banks launched the second debt-equity swaps fund in Chile.

Ecuador

GDP fell by 3.5% in 1987, the oil sector recording a 35% fall as a result of the earthquake in March 1987. Annual inflation rose to 34% in January reflecting higher petrol prices and the devaluation of the sucre. The trade surplus for January-November

was only $190 mn (cf $550 mn in the same period in 1986); exports were down 10%, reflecting a 24% decline in oil revenues, while imports were up 12%. To restrict the latter, and to ease pressure on the free exchange rate, prior import deposits have been sharply increased. The IBRD expect the fiscal deficit to be 8-12% of GDP this year rather than the 1.3% projected by the IMF in December.

There has been little further progress on the commercial banks' package: commitments have reached $328 mn of a possible total $350 mn but most banks with small exposures have not participated. Arrears (mainly interest) have now reached $470 mn and the larger banks are keen to have the package signed as soon as possible and hope to close at below the $330 mn level. Nevertheless, Ecuador has made a request for an additional new money loan of $360 mn.

The first round of the presidential elections on 31 January resulted in defeat for the government candidate, Sixto Duran. Rodrigo Borja and Abdala Bucaram, both left-wing candidates, topped the poll and will contest the second round of elections on 8 May. Both have stated their intent to renegotiate the terms of Ecuador's external debt.

Peru

Real GDP rose by 7% in 1987 (1986 8.5%), but the government has warned of impending shortages due to supply and foreign exchange constraints. Inflation rose to 140% in February. President Garcia has announced an apparently major reversal of the consumption-led strategy followed since mid-1985, although there will apparently be no change in the targeted restriction on debt service to 10% of exports. As part of the new policy large price and wage increases were announced on 9 March.

The trade deficit in 1987 was $344 mn, against $16 mn in 1986: exports were up 2%, while imports rose 14.6%. Gross reserves only provided some 3 months' cover at end-1987, against nearly 10 months at end-1986. The government has announced that the central bank will sell gold and silver holdings ($799 mn at end-1987) to finance imports in the first few months of 1988.

Colombia

GDP growth in 1987 was 5.5% (1986 5.1%). Inflation rose by 3% in January to bring the annual rate to 23.7%. The current account deficit for 1987 is estimated to have been $350 mn, against a surplus of $660 mn in 1986, reflecting a substantial fall in the trade surplus as a result of lower coffee prices. Nevertheless, gross reserves

(excluding gold) remained broadly unchanged during the year, but gold holdings might have been reduced by about 50%. Following difficulties in completing the $1 bn new money loan it was thought unlikely that the Colombians would attempt another borrowing for some time. However, the authorities have indicated that they will seek $1.5 bn from the banks in 1989.

Bolivia

Real GDP grew by 1.7% in 1987, the first increase in 7 years, and inflation was contained to 10-11%. A deteriorating trade position (last year the deficit rose to $204 mn - cf $37 mn in 1986), and rising Argentine arrears on payments for natural gas have been aggravating an already poor liquidity position. A new agreement with Argentina on gas prices will ease the position a little but, for the moment, the benefit may be offset by continuing strikes by mining and petroleum workers. The Fund Board has yet to set a date for the discussion of a proposed 3-year EFF; its delay is holding up discussion of a further Paris Club rescheduling. The debt buy-back closed on 12 March with around half ($306 mn) of debt to the banks being retired or converted into development bonds at 11 cents in the dollar. The Bolivians hope to reschedule the remainder of their bank debt ($360 mn) over 25 years and at a concessional interest rate

Panama

US support for the ousted President, Delvalle, in the current political upheaval has led to the freezing of Panamanian assets held with US banks. It is unlikely that Panama will be able to make interest payments to creditor banks and amounts due on a yen bond issue until the freeze is lifted. Following meetings with the commercial banks in early-February, outstanding arrears were settled. However, they have built up once more and there are also arrears to the IBRD (which has suspended disbursements) and the IMF. Negotiations with the banks were resumed at end-February on a possible restructuring of debt of $1.8 bn and a reduction of interest payments of $100 mn. The new government has requested that banks roll-over $421 mn in past due principal; the Advisory Committee merely forwarded this request to banks without comment, given the uncertainties surrounding the government's authority.

Other Countries

Uruguay's trade balance was probably in small deficit in 1987, against a surplus in 1986. All banks responded positively to the proposed rescheduling and reduction in spreads and the package was signed on 3 March. Costa Rica's SBA has gone off track:

the reserves, arrears, monetary and fiscal performance criteria were all breached: a revised programme will go to the Fund Board on 4 April. Although discussions with the banks resumed on 18 February, no substantive progress has been made on a financing package; no progress is likely on rescheduling Paris Club debt pending revisions to the SBA. The Fund Board discussed the third review of Jamaica's SBA on 22 February: performance under the programme continues to be good. Some targets have been revised: real GDP growth of 5% is now expected for FY 1987/8 and the overall public sector deficit has been set at 3.4% of GDP (cf 6.3% originally) to reflect the decision not to purchase the Clarendon alumina refinery. Annual inflation was 8.4% in 1987.

The IADB Governors elected (by acclamation) Enrique Iglesias (Uruguay's Foreign Minister) as the new President on 18 February; Iglesias was the sole candidate (the Colombians having withdrawn the nomination of their candidate, Garcia-Parra, once it was clear that the majority of the regionals and all the non-regionals were in favour of Iglesias). Iglesias will assume office from 1 April. During the IDB's Annual Meetings (21-23 March) both Iglesias and the US indicated their willingness to resume negotiations on the pre-conditions for the 7th Replenishment. The IDB's own calculations shows that it could make loan approvals of $1.85 bn this year, without a further replenishment, while keeping financial ratios within acceptable limits.

SOUTH AND EAST ASIA

Philippines

While real growth was nearly 5% last year, latest current account projections point to a deficit of between $400 mn and $500 mn. This is much worse than the Fund target of a $32 mn surplus and is bound to impact on borrowing plans in 1988. The annual rate of inflation reached almost 9% in January compared with around 2% in January 1987. The Philippines has failed to meet the IMF targets for base money and reserves and both have been extended until mid-year. Concern is now growing that the present Fund programme is beginning to falter. The government will negotiate 4 new loans from the World Bank totalling $529 mn this year. The loans will support a national housing project ($175 mn), government corporate reform ($150 mn), a geothermal project ($144 mn) and irrigation operations ($60 mn).

Malaysia

Latest estimates from Bank Negara Malaysia suggest that real GDP growth may have been as high as 4% in 1987, a considerable improvement on the 2.7% projected by the Ministry of

Finance in October. The strong performance reflects the stimulus to supply of higher commodity prices, especially of palm oil and timber. Higher commodity prices have also resulted in an improvement in Malaysia's trade surplus which rose to $5.2 bn in 1987, from $3 bn in 1986.

Indonesia

The non-oil sector has now firmly overtaken oil/LNG as Indonesia's principal export earner. Non-oil export receipts totalled an estimated $8.8 bn in 1987, compared with $8.3 bn for oil and gas. As widely expected President Suharto, who has re-appointed for a fifth consecutive term of office in mid-March, has made a number of cabinet changes. Radius Prawiro has replaced Ali Wardhana as Minister-Co-ordinator for the Economy, Finance Industry and Development; Johannes Sumarlin has been named as the new Finance Minister; and Arifin Siregar has moved to become Minister of Trade and has been succeeded as Governor of Bank of Indonesia by Adrianus Mooy. The authorities have continued to resist pressures to reschedule Indonesia's debts despite continuing constraints on domestic economic management.

Thailand

In February, Thailand signed an agreement with a group of 24 foreign banks for a short-term loan facility for up to $300 mn over 5 years. The facility is to refinance existing high-cost loans. The spread is exceptionally fine - LIBOR +0.055%, together with a service charge for utilisation of 33% or more of the facility. The fee will be 0.025% for 33% to 66% of the facility, rising to 0.05% for 67% to 100%.

EASTERN AND SOUTHERN EUROPE

Poland

Despite the erosion of the terms of trade there was a slight improvement in the convertible currency current account deficit in 1987. Although the end-November referendum forced the authorities to slow the pace of price reform, a number of price increases were introduced in February and a further round is scheduled for April. The Poles' attempt to limit the amount of debt eligible for currency conversion has led to a slippage in the signature of the banks' two stage MYRA. Official creditors agreed an interim debt rescheduling last October, but progress with bilaterals has been held up by demands by the Poles to eliminate the spread, to reduce spreads on debt covered by earlier reschedulings, and for the prompt restoration of cover.

The IMF, (presumably with the tacit support of the US) has proposed a shadow SBA along Nigerian lines (ie full conditionality but no drawings). Implementation would strengthen Polard's position in subsequent negotiations with both the commercial banks and the Paris Club. A Fund mission is due to commence talks in early April with a view to obtaining Board approval in late summer.

Yugoslavia

Negotiations with the banks on further debt relief, and talks with the IMF for a new SBA, are proceeding fitfully. The Yugoslavs rejected the banks' offer of an 18-year rescheduling with 6 years' grace because of the margin (they wanted Libor +1/2 against the +1% offered) and the absence of new money. The Yugoslavs have failed so far to translate their declared economic strategy into practical policies and despite Yugoslav pressure for an early agreement on an SBA, the IMF are not confident that a programme can be brought forward for Board discussion before early summer. Paris Club creditors have refused to begin rescheduling negotiations before implementation of an SBA but may tolerate a build-up of arrears and maintain cover as long as negotiations with the Fund are seen to be progressing. Nevertheless, with financing difficulties remaining acute a request for bridging finance seems on the cards.

Hungary

Despite two devaluations in 1987, the improvement in the convertible currency current account deficit to $0.8 bn (cf $1.4 bn in 1986) was achieved largely by import compression rather than a growth in exports. Agreement has been reached with the IMF on the SDR 265 mn one-year SBA. This is linked to a further devaluation against convertible currencies, a revaluation against non-convertible currencies, and a target convertible currency current account deficit of $0.5 bn in 1988. Board discussion is scheduled for 28 March. A DM 200 mn eurobond issued this month sold well, and a Yen 25 bn Samurai issue is imminent. Hungary has said it intends to raise as much as $2.5 bn from Western creditors this year, about half as syndicated loans. This may well be optimistic; since last year spreads have risen from 1/4% to 1/2% and are continuing to firm.

Romania

With a convertible currency current account surplus of around $2 bn in 1987, the Romanians are sounding out the attitude of various creditor groups to further debt prepayments in order to achieve their aim of zero net debt by end-August. The

proposals are ambitious, involving the prepayment of around $1 bn, and would leave the Romanians with little margin for manoeuvre. Nevertheless, they have reached agreement with the commercial banks to pre-pay at par $600 mn (around a third of their debt to the banks) by end-March. They are also seeking to pre-pay IBRD debt: $548 mn by end-March and the remainder by year-end.

USSR

The Soviet Bank for Foreign Economic Affairs has mandated Credit Lyonnais to arrange an eight-year $150 mn syndicated credit with a margin of Libor +3/16. This reflects a +1/16% increase in the margin over that on the slow-moving $200 mn loan arranged by First Chicago last summer.

Turkey

The current account deficit improved in 1987 to just under $1 bn (cf $1.5 bn in 1986). Exports to the OECD increased sharply, compensating for the continued weakness of traditional Middle East markets. However, inflation and the fiscal position have worsened significantly. Although Ozal has introduced some limited measures to dampen domestic demand, the recently announced budget appears to be inadequate to redress the large fiscal imbalance and has not reassured creditors. Whilst monetary measures taken in early February appear to have reduced pressure on the exchange rate, concerns about the rapid growth in debt, and the vulnerability of the external sector to domestic overheating, remain.

Greece

While the authorities have stated that economic developments will be favourable this year, with a 1.5-2% rise in GDP and further falls in inflation, buoyant domestic demand may threaten further progress in reducing the current account deficit and there have been slippages in the control of public finances. Any policy tightening seems unlikely in the run-up to the general election, due before June 1989. A recent capital market borrowing by the Bank of Greece was, however, priced at more favourable terms than a similar loan last year.

SUB-SAHARAN AFRICA

Angola

January marked the official start of the Fund-style Economic Recovery Programme (SEF), although specific policy measures have yet to be enacted. Angola's applications to the Fund and World Bank are proceeding.

Nigeria

Preliminary figures indicate that Nigeria's non-oil sector grew by around 2.5% in 1987; overall output fell marginally because of a contraction of the oil sector. With oil prices weakening, Nigeria's cash flow problems have become acute. Following an expansionary budget, an unwillingness to adopt tougher fiscal action and to reduce the size of fortnightly foreign exchange auctions has held up an agreement with the Fund on the new programme that is required to unlock new money under the banks' 1986/87 agreement and from MDB and ECA sources. The Nigerians have now asked the banks to reschedule,over 25 years with 10 grace (ie similar terms to those forced on unguaranteed note holders), $1.2 bn of medium term maturities falling due between 1988 and 1991, together with letter of credit maturities and arrears of interest and fees totalling $2.6 bn covered by the 1986/87 agreement. They also intend to seek similar terms from the Paris Club. Even after the most generous rescheduling, and on the optimistic assumption that new money previously agreed remains forthcoming, Nigeria still faces a large financing gap which will make the conclusion of a Fund agreement hard to reach. Negotiations on the UK's £200 mn line of credit, which is contingent on a satisfactory relationship with the Fund and an improved arrears position, are progressing.

South Africa

The consolidation of South Africa's economic recovery continues, although the weakness in the price of gold, if sustained, could become a constraint. Meanwhile, political developments in the Republic have acted to reopen the sanctions debate.

Cote d'Ivoire

Real GDP is estimated to have fallen by 2.3% in 1987, as export-related trade and services were adversely affected by declines in both the price and volume of coffee and cocoa exports. (Reaction to these adverse conditions by the authorities was not timely enough and on 25 May last year a moratorium was declared.) Fiscal performance

deteriorated substantially with an increase in the public sector deficit from 4.9% GDP in 1986 to 7.5% in 1987 - this reflected a turnaround in the operations of the Agricultural Stabilisation Fund from a surplus of CFAF 139 bn in 1986 to a deficit estimated at CFAF 53 bn in 1987.

The outlook for 1988 is uncertain. The IMF programme, which was approved in principle in December, was finally made operative on 29 February, despite a term sheet not yet having been agreed for the banks' package and therefore with a financing gap outstanding. The banks' package, which is still subject to a legal all-clear, contains some novel elements including possible provision for the non-payment of interest arrears to those unwilling to put up new money and the absence of a need to achieve critical mass.

Kenya

The IMF approved a $238 mn package for Kenya on 1 February. A SAF will contribute $123 mn, with the remainder coming from an 18 month SBA. Inflation accelerated to 8.6% last year (cf 5.7% in 1986). In a bid to restrict monetary growth, currently growing at an annual rate of 20%, interest rates have recently been increased. Last year the current account deficit deteriorated sharply, from $92 mn in 1986 to $429 mn. Although the capital account showed a substantial improvement, the overall balance of payments is estimated to have recorded a deficit of $102 mn, as opposed to a surplus of $94 mn in 1986. The reserves fell $160 mn to just under two months' import cover.

Malawi

In advance of its SBA (approved by the Fund Board this month but back-dated to January), the authorities have eliminated the commercial arrears pipeline and devalued the kwacha by 15%. At the heart of the SBA is a reduction in the fiscal deficit as a proportion of GDP: from 10.7% for 1987/8 (as targeted in the revised shadow programme) to 8.1% in 1988/9. The March Budget will be of crucial importance. A debt moratorium is still in place but Paris and London Club meetings are scheduled for April. The authorities intend to ask for an ESAF in August to coincide with the first SBA review.

Sudan

The narrow financing gap for FY 1987/88 (which excludes most debt service) seems to have been effectively closed, with aid pledges now totalling $227.6 mn. However, the shadow programme agreed with the IMF looks to be breaking down: targets set for major

indicators, eg domestic credit expansion, were met at end-1987 only by a carry-over into January 1988 which should become apparent when the findings of the recent Article IV Mission are known. Various approaches (all involving the new ESAF) are being considered in Whitehall and Washington to deal with Sudan's arrears and current external obligations, including an informal US proposal to clear IMF arrears through, inter alia, bridging loan and escrow account mechanisms on the part of major donors.

A first draft of the delayed four-year recovery programme (which was to have been ready in time for the joint IMF/IBRD Mission in Jan-Feb 1988) has been reviewed by the IBRD team who recently left Khartoum. It is now intended that a final version will be presented to a Consultative Group meeting, which has been postponed from April to 23 May

Other countries

Portugal (a significant creditor) has joined Italy in granting concessional interest rates on rescheduling Mozambique's official debt. Zaire's President has proposed a 3-year moratorium. In Zambia the January budget was a disappointment and did not signal the hoped-for change of course. There are no immediate plans for a Fund programme. While Zimbabwe's wage freeze has been partially lifted from 1 March, prices remain frozen for the time being.

MIDDLE EAST & NORTH AFRICA

Egypt

The IMF programme is effectively dead: the first review is now several months overdue and no drawings have taken place since the first credit tranche drawing in May. Although the Egyptian authorities show no willingness at present to accelerate the pace of reform, the Fund staff is trying to establish whether they could be persuaded to adopt measures which could form the basis of a new IMF agreement.

Only 9 of the 18 Paris Club bilaterals have so far been completed. No dates have been set for the resumption of talks with ECGD, which broke down in January over the interest rate to apply to the rescheduling. The Egyptians are still unwilling to agree to ECGD's terms (Libor +0.5%) although they have indicated that they might increase their offer from Libor +0.2% to Libor +0.3% (already agreed with Belgium). Disputes over interest rates have also stalled talks with the Swedes and Australians.

Morocco

There has been considerable slippage on the IMF standby (which ends in March) and the drawdown of the final tranche is likely to depend on further waivers. (The main stumbling block to completing the final review has been a failure to reduce domestic arrears. If agreement can be reached the current SBA may be extended to permit the last drawing.) The commercial banks' rescheduling agreement became effective on 4 January clearing most outstanding external arrears. A follow-on SBA (or perhaps an EFF), which is a prerequisite for activating the second phase of previously agreed Paris Club and commercial bank reschedulings, is under consideration by Fund staff. The economy continues to face the problems of a lower 1987 harvest, depressed remittances and structural inefficiencies, with the fiscal deficit a particular problem.

Algeria

Despite stringent austerity measures which restored the current account to near balance last year, gross borrowing of around $4 bn a year will be required until the early 1990's to finance amortisation payments. The Algerians repeated their request at February's UK/Algerian Joint Commission for extended credit terms for consumption goods for which they had previously paid cash. Although the UK side agreed to consider the Algerian request, ECGD is taking a cautious line about increasing its exposure and the market limit has been reduced from £1,420 mn to £1,135 mn.

Iraq

Official creditors have agreed a co-ordinated approach to the bilateral rescheduling of 1988 maturities on the same terms as those negotiated for 1987.

RECENT SOVEREIGN BORROWING BY LDCS

Date Announced	Borrower	Amount (mns)	Maturity/Grace (years)	Spread or Fixed rate (%)
BANK BORROWING				
N Africa				
19/12	Algeria - Banque De l'Agriculture et developpment Pural	$200	8/4 1/2	3/4-5/8
Asia				
04/12	India - IFCI	Yen 14 bn	12/6	1/4-3/8
19/12	India - ONGC	$300	10	3/16-1/4
27/02	India - National Thermal power Corporation of India	Yen 10 bn	15	1/4-3/8
19/01	S Korea - Korea Air Lines Co Ltd	$159.3	3 1/4	3/16
26/02	Malaysia- Perwaja Trenganu	Yen 20 bn	15/8	3/8-1/2
22/01	Thailand	$300	5	0.06
S Europe/Middle East				
12/02	Greece - Bank of Greece	$350	8/5	1/2-3/8
05/12	Israel - National Coal Supply	$25	-	-
05/02	Israel - Israel Electric Corp	DM 30	5	3/4
18/12	Turkey - TC Zicarat Bankasi	$200	1 1/4	3/4
11/12	Turkey - Turkish Electricity Authority	DM 118	7/3 1/2	1 1/4
30/01	Turkey - Electricity Gas and Omnibus Authority of Ankara	$92.2	7/3 1/2	1 1/4
BOND ISSUES				
Asia				
05/12	China - Int Trust & Invest Corp	Yen 15 bn	5	5 5/8
05/12	China - Int Trust & Invest Corp	$200	6	6 3/4
30/01	China - Bank of China	Yen 15 bn	5	5
05/12	India - Industrial Dev Bank	DM 200	7	6 3/8
27/02	Malaysia	Yen 30 bn	10	5.6
S Europe				
05/12	Greece - Bank of Greece	DM 300	5	5 5/8
22/01	Turkey - Export Credit Bank of Turkey	DM 200	6	6 3/4
L America/Caribbean				
05/12	Trinidad and Tobago	Yen 7.5 bn	5	6.7
13/02	Venezuela	$100	5	11 1/8

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OVERDUE FINANCIAL OBLIGATIONS TO THE IMF[1]

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding as at 18. 3.88 SDR (mn)	Forthcoming Obligations (to 1999)
Kampuchea	13 March 1975	31.3	13.1
Guyana	31 May 1983	70.7	39.8
Viet Nam	6 February 1984	82.5	71.4
Sudan	12 July 1984	560.2	304.0
Liberia	14 March 1985	194.9	101.2*
Peru	9 December 1985	374.7	414.0
Zambia	6 June 1986	367.2	512.7
Sierra Leone	13 February 1987	29.4	60.3**
Somalia	2 July 1987	22.7	118.1**
Honduras	9 November 1987	9.8	54.8*
Panama	28 December 1987	28.8	269.4ø
Bolivia	12 January 1988	7.3	136.3*
		1779.3	2095.1

(1) Includes both overdue repurchases and charges of members with at least one obligation overdue for more than one month.

NB The above figures are from Fund papers issued with respect to individual country complaints. There will have been further obligations falling due subsequently, so the figures are not entirely up-to-date.

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

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* Bolivia, Liberia and Honduras only to 1992.

** Sierra Leone and Somalia only to 1993.

ø Panama only to 1994.

INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1987*	End-June 1987	End-March 1987 [2]	End-March 1987 [3]
Latin America				
Argentina	54	3.1(0.2)	0.2	0.2
Brazil	113	6.6(1.6)	1.0	1.9
Chile	19	1.2(0.1)	-	0.1
Colombia	15	0.5(0.1)	0.1	0.1
Costa Rica	4	0.1(-)	-	-
Ecuador	9	0.5(0.1)	0.1	0.1
Jamaica	3	- (-)	-	-
Mexico	104	6.3(0.6)	0.7	1.3
Peru	16	0.3(-)	0.1	0.2
Uruguay	4	0.3(-)	-	-
Venezuela	36	2.1(0.2)	-	-
Far East				
Indonesia	44	0.8(0.3)	0.9	1.8
Malaysia	20	1.1(0.3)	0.1	0.1
Philippines	29	1.4(0.1)	0.1	0.2
Eastern Europe (convertible currency)				
Bulgaria	5	0.3(-)	-	0.1
Hungary	18	0.3(-)	-	0.1
Poland	38	0.6(-)	1.3	1.4
Romania	5	0.2(-)	0.3	0.4
Yugoslavia	20	0.7(0.1)	0.7	0.9
Southern Europe				
Greece	20	1.3(0.2)	0.1	0.3
Turkey	35	0.5(0.2)	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 33 countries amounted to $18 million at end-June 1987.

[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 1987*	End-June 1987	End-March 1987 [2]	End-March 1987 [3]
Sub-Saharan Africa				
Cote d'Ivoire	10	0.3(-)	0.1	0.1
Nigeria	26	1.3(0.1)	2.5	3.5
South Africa	21	3.7(0.5)	0.9	2.5
Sudan	11[6]	- (-)	0.2	0.2
Middle East and North Africa				
Algeria	27	0.4(0.1)	0.2	0.4
Egypt	50	0.3(0.2)	0.3	1.3
Iraq	60[4][6]	0.1(-)	0.6	1.6
Israel	31	0.4(0.1)	0.1	0.2
Morocco	20	0.2(-)	0.2	0.3
Oman	3[6]	0.1(0.1)	0.7	1.9
Saudi Arabia	14[5][6]	0.5(0.3)	0.2	0.3

[4] Includes $30 bn from Arab countries.
[5] Excludes unguaranteed non-bank claims.
[6] Total external debt at end-December 1986.
* Current estimate.

BILATERAL AGREEMENTS CURRENT POSITION AT 1 MARCH 1[illegible]

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
ANGOLA I			17.11.87	04.12.87 (London)	04.12.87		Agreement initialled, documents sent to FCO to arrange conclusion of Exchange of Notes.FCO awaiting Portugese translation,26/2.
ARGENTINA I	16.01.85	30.06.85	23.04.85	15.05.85 + 29 31.01.86 (Paris)	28.08.87		English and Spanish texts agreed. FCO arranging Exchange of Notes through "Protecting Powers" Switzerland and Brazil.Swiss passed bilateral documents to Argentinians 12/1. Letter to FCO 16/2,suggesting reminder.
ARGENTINA II	20.05.87	31.12.87		To be arranged			Draft text prepared;awaiting signature of Agreement No 1 before sending to Argentinians.
BRAZIL II	21.01.87	31.07.87	16.04.87	27 30.07.87 (Brasilia)	29.07.87	04.12.87	Exchange of Notes concluded.
CONGO I	18.07.86	28.02.87	13.11.86	24.11.86 (London)	24.11.86	27.01.87	Correct Congolese Reply Note and Annex now received. Date of signature remains as stated in original Reply Note.
COTE D'IVOIRE III	27.06.86	31.01.87	08.10.86	24.10.86 (Paris)	24.10.86		Comments sent to FCO on 16/9 on Ivoreans' proposed amendments to text.FCO comments received 14/10;FCO advised 20/1 that the agreement should be concluded on previously agreed text.However due to Agreement IV superceding part of this agreement FCO will have to contact Ivoreans to suggest an alteration in the text i.e. to end on 31 Dec 1987 instead of 31 Dec 1988,letter sent to FCO 12/2.
COTE D'IVOIRE IV	18.12.87	31.05.88		To be arranged			Draft bilateral text under preparation.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
ECUADOR III	20.01.88	31.08.88		To be arranged			Draft bilateral text sent to FCO for comments by 8/3.
EGYPT I	22.05.87	31.10.87	07.08.87	21/22 January (London)			Bilateral text sent to Cairo on 7/8. Provisional debt list dispatched 26/8. Debt reconciliation visit to Cairo concluded 17/9;comments on bilateral text received via Post,reply sent 12/10. Negotiations held;text agreed except interest rate.
GUINEA REP I	18.04.86	31.12.86	16.09.86	29.10.86 (London)	29.10.86		Guinean Finance Minister expresses wish to conclude Exchange in Conakry. FCO approval given but nothing arranged.FCO chased 22/9, 4/11,25/1 and 26/2.
JAMAICA III	05.03.87	30.09.87	20.05.87	09.06.87 (London)	09.06.87		Documents sent to Kingston,to effect Exchange of Notes 29/7. Enquired whether Exchange of Notes completed in our letter sent to Kingston 26/8. FCO chased 24/9, on 26/11, and again on 22/1. FCO rang Post 25/2 and High Commisioner to try and resolve situation.
MAURITANIA II	16.05.86	31.12.86	14.07.86	28.11.86 (London)	28.11.86		Documents passed to British Embassy in Paris 14/1 for onward transmission to Nouakchott. No response yet; FCO taking further follow up action 7/5. FCO chased again 10/8 and 4/11. Post chased 18/11. FCO chased 25/1 and 29/2;Post have chased the Mauritanians who have not responded.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
MAURITANIA III	15.06.87	29.02.88	08.01.88	To be arranged			Draft bilateral text under preparation, sent for legal clearance 15/10.FCO comments received 27/10.Mauritanians advised on 12/11 of our intention to try and conclude bilateral in correspondence. Draft documents despatched to Nouakchott via Dakar on 8/1.To chase at beginning of March.
MOROCCO III	06.03.87	30.09.87	29.07.87	19 20 October (London)	20.10.87		Agreement initialled;documents forwarded to FCO to arrange conclusion of Exchange of Notes.FCO chased 25/1;they have written to Rabat to ascertain latest position.Reply received from Post suggests that at present there is little chance of obtaining signature.
MOZAMBIQUE II	16.06.87	30.06.88	31.12.87	To be arranged			Draft bilateral text under preparation, sent for legal clearance 15/10.Comments received 28/10.Mozambicans advised on 6/11 of our intention to try and conclude bilateral in correspondence.Preliminary discussions held with MoF in London on 11 January;commercial rate of interest unacceptable to Mozambicans.Post are trying to meet with MoF to seek the way forward.
NIGER IV	20.11.86	31.07.87	20.01.87	29.01.87 (Paris)	29.01.87	01.02.88	Exchange of Notes concluded.
PHILIPPINES II	22.01.87	31.03.88	13.07.87	17 18 November (Manila)	01.03.88		Exchange of Notes to take place in Manila.
POLAND IV	16.12.87	31.05.88		9 10 March (Warsaw)			Draft bilateral text despatched to Warsaw 5/2.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
SIERRA LEONE IV	19.11.86	30.04.87	23.03.87	26.03.87 (London)	26.03.87		Ambassador in Freetown sent note to MoF 22/5. No response despite chaser sent on 13/7. FCO advised Ambassador 30/7 to press for reply. FCO chased 28/10. FCO chased Post 17/12. Reply re'cd from High Commission suggests they are finding it hard to make any progress.
SOMALIA II	22.07.87	31.12.87	27.11.87	8/9 December (London)	09.12.87		Agreement initialled, documents sent to FCO to arrange conclusion of Exchange of Notes. Documents sent to Mogadishu on 7/1, FCO will chase at beginning of March.
SUDAN IV	03.05.84	28.02.85	24.07.85	08.08.85	08.08.85		Formal signature still outstanding. No action taken to pursue due to increasing arrears under previous agreements and Sudan's position in relation to IMF.
TANZANIA I	18.09.86	30.04.87	20.02.87	05 08.05.87 (Dar es Salaam)	07.05.87	08.08.87	Exchange of Notes concluded in Dar es Salaam.
UGANDA III	18.06.87	29.02.88	23.10.87	5 November (London)	05.11.87		Agreement initialled, documents sent to FCO to arrange conclusion of Exchange of Notes. FCO chased 25/1 and 26/2.
ZAIRE VII	15.05.86	31.12.86	16.06.86	07.07.86 (London)	07.07.86		Delays on part of Zaire to arrange conclusion of agreement. FCO chased June and are doing so again now. UK position of willingness to sign has been frequently stated. Zaireans apparently have habit of losing papers. Subject raised 7/10; delegation commented that signature would take place shortly. Post in Kinshasa chased 14/12. FCO chased 20/1.
ZAIRE VIII	18.05.87	31.12.87	30.09.87	06.10.87 (London)	07.10.87		Agreement initialled; documents forwarded to FCO to arrange conclusion of Exchange of Notes. FCO comments on text received 2/12; replied on 4/1 that would not wish to amend initialled text. Documents sent to Kinshasa on 26/1.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
ZAMBIA III	04.03.86	31.10.86	09.05.86	In correspondence	20.08.86		Zambian Reply Note received but did not quote Annex. Revised Note submitted to Zambians who have yet to respond. FCO chased 8/9,9/11 and 29/2.

PARIS CLUB FORWARD PROGRAMME

Country	Extant bilateral agreements (rescheduling/ refinancing)	Possible timing of next Paris Club restructuring	Non consolidated arrears at 31 December 1986	Non consolidated forward exposure FY 1987/88	Non consolidated forward exposure FY 1988/89	Expiry date of last bilateral
Bolivia	1 (1/0)	April 1988	GBP m	GBP 1.68m	GBP 3.64m	30.06.87
Brazil	2 (1/1)	1988	GBP m	GBP111.68m	GBP129.66m	30.06.87
Costa Rica	2 (2/0)	April 1988	GBP 0.26m	GBP 0.84m	GBP 0.20m	31.03.86
Cuba	4 (4/0)	1988	GBP m	GBP 3.29m	GBP 2.73m	31.12.86
Gabon	1 (0/1)	March 1988	GBP m	GBP 4.79m	GBP 19.16m	31.12.87
Guinea Rep	2 (2/0)	Early 1988?	GBP m	GBP m	GBP m	28.02.87
Liberia	4 (4/0)	1988	GBP 8.28m	GBP 7.50m	GBP 4.67m	30.06.85
Madagascar	5 (5/0)	April 1988	GBP m	GBP 0.33m	GBP 1.34m	31.12.87
Malawi	2 (2/0)	April 1988?	GBP 0.15m	GBP 2.93m	GBP 2.70m	30.06.84
Nigeria	1 (0/1)	Mid 1988?	GBP m	GBP 66.59m	GBP266.39m	31.12.87
Peru	3 (3/0)	?	GBP20.92m	GBP 10.12m	GBP 9.34m	31.07.85
Sierra Leone	4 (4/0)	1988	GBP m	GBP m	GBP m	13.11.87
Togo	4 (4/0)	March 1988	GBP m	GBP m	GBP m	30.04.85
Yugoslavia	4 (0/4)	March 1988	GBP m	GBP m	GBP 82.90m	31.03.88
Zambia	3 (3/0)	?	GBP m	GBP 14.05m	GBP 13.28m	31.12.86

FILE DA

10 DOWNING STREET

From the Principal Private Secretary 21 March 1988

PERIODICAL REPORTS ON INTERNATIONAL DEBT

Thank you for your letter of 18 March about the periodical reports on international debt.

The new timetable for the submission of these reports to No.10, which you suggested in paragraph 3 of your minute, would suit us very well. I agree that you should go ahead on the new basis without further formality, although you will no doubt wish to check that the FCO are content with what you propose.

(N.L. WICKS)

Sir Geoffrey Littler, K.C.B.

H M Treasury
Parliament Street London SW1P 3AG
Switchboard 01-270 3000
Direct Dialling 01-270 ....

P.
This looks OK.
Content? Yes
N.C.W. 21/3
21·3

Sir Geoffrey Littler KCB
Second Permanent Secretary

18 March 1988

Dear Nigel,

PERIODICAL REPORTS ON INTERNATIONAL DEBT

For two or three years Roger Lavelle, and now Tim Lankester, have held a fairly regular review for the Chancellor every six weeks or so, with Bank of England and Whitehall colleagues, of the international debt situation, and it has been our practice to send a letter to No 10 embodying the substance of their report. The current review will lead to a further letter to you very shortly.

2. Tim and I have been reconsidering this. A huge amount of work is involved, particularly for the Bank, and much of it is fairly repetitive, or changes only insignificantly in six weeks. We have concluded that it would both be more economical and make better sense for our operational needs to change the pattern.

3. What would suit us best would be to do the comprehensive review four times a year: a short time before the Annual Meetings of IMF/IBRD in September; similarly before the Spring Interim and Development Committee meetings; plus 'mid-term' reviews to take stock just before the summer holidays and around the turn of the calendar year. We would supplement this from time to time and ad hoc, if and only if there were some significant country or general development to report. We would also naturally do any necessary updating for briefs, e.g. in connection with the Summit.

4. Would you feel deprived if we adopted this arrangement, and may we simply go ahead on the new basis without further formality?

Yours,

Geoffrey

(Geoffrey Littler)

Nigel Wicks Esq CBE
No 10 Downing Street.

4

PRIME MINISTER

You may wish to glance through the paper below, by M. Balladur the French Finance Minister, printed in the Wall Street Journal last week about the International Monetary System.

He proposes, on page 10, that a small group of distinguished people should be established to consider international monetary reform.

My German colleague at the Sherpas' meeting said that he did not entirely rule out President Mitterrand making this proposal at the Toronto Summit. The German Sherpa said that, speaking personally, he was not at all attracted by the Balladur proposal. Geoffrey Littler and myself agreed.

N.L.W.

N. L. WICKS
3 March 1988

REBUILDING AN INTERNATIONAL MONETARY SYSTEM

Since the 1960s, the world's industrialized countries have gradually abandoned the discipline of stable exchange rates based on the gold exchange standard in favor of floating exchange rates.

That system has been a failure. In the final analysis, proving devoid of discipline or constraints, much too tolerant of poorly managed economies, and ultimately harmful for the world economy. Floating exchange rates are probably one of the essential causes of the economic disorders of the past 15 years : variations in the price of oil and raw materials, trade imbalances, financial anarchy brought about by international speculative capital flows, indebtedness.

The merits attributed to floating exchange rates in the early 1970s have not been borne out :

- When they were introduced, it was said that balance of payments adjustments would be facilitated, but not only have imbalances not disappeared, they have become worse.

- It was thought that speculation would be curtailed. On the contrary, never has it assumed such proportions nor had such destabilizing effects.

- It was believed that market forces, at last left to their own devices, would determine the correct exchange rate balance. But never have imbalances been so great, nor fluctuations so wide and erratic and so little justified by economic fundamentals.

- It was hoped that autonomy in economic and monetary policy would be preserved, allowing each country free choice of its monetary policy and rate of inflation. Facts have cruelly belied this illusion.

Those countries with primary responsability for the world economy now recognize the need for international cooperation. Last year's Louvre Agreements marked the end of the floating exchange rate system. Concluded a year ago this week, by the US, Japan, France, Britain, West Germany, Canada and Italy, they contain two complementary aspects : the coordination of economic policy, and more stable exchange rates.

The seven signatories have agreed to policies aimed at reducing their internal and external imbalances. Thus they are making a contribution to stabilizing their exchange relations, jeopardized by the highly excessive deficits and surpluses that have developed in recent years. Moreover they are ready, if need be, to intervene on exchange markets.

Over the past year, the Louvre Agreements have been reconfirmed and adjusted, as required by economic and market developments. On December 23, 1987, the seven countries published a joint declaration, and agreed upon secret exchange rate clauses. This declaration is really a second Louvre agreement, occurring after the Autumn financial upheavals and containing the measures adopted in response. Economic policy commitments have been adapted and strengthened, including those of central banks.

With Louvre Agreements 1 and 2, the seven major industrialized countries have shown that they agree on the collective management of exchange rates and coordination of their economic policies, in the absence of a true international monetary system. It is thanks to this spirit of responsability and cooperation that it was possible to overcome the recent financial crisis, the most serious since World War II. This represents major progress compared with the situation prevailing two years ago.

Thus a first milestone has been reached on the road to rebuilding an international monetary order, though it rests on the will and ability of governments to impose self-discipline. Beyond this stage, how might one envisage a true international monetary system with a

The Treasury are very coy about the secret clause. But I understand it provides for:
(1) Up to $5b. intervention each by US, Japan and Europe.
(2) Within Europe $2½b. by Germany and the other $2½b. shared between the others.
(3) We have declined various invitations from the Germans to join in concerted intervention since Christmas. Up to this week our total participation had been only $20-30m.

RRCG
3/3

standard unit of value, automatic mechanisms and sanctions that would be beyond the control of the countries involved ? The time is ripe for dispassionate consideration of this issue, since inflation has receded and the Louvre Agreements are working well.

There are three possible approaches. Each has advantages and disadvantages.

INTERNATIONAL COOPERATION

The first approach is a system based on international cooperation building on the spirit of the Louvre Agreements.

Their enforcement requires close surveillance of each of the major economies on the basis of such economic indicators as growth rates, inflation rates, fiscal balance, balance of payments, interest rates and exchange rates. This surveillance already is being established gradually .

It would be conceivable to perfect the Louvre Agreements by strengthening economic coordination, in budgetary matters for example, by strengthening cooperation among central banks, particularly on interest rates, and if need be by publicly announcing ranges for exchange rate fluctuations.I shall not dwell on the advisability of such measures.

A problem arises however in trying to perfect the decision-making mechanism.

The ultimate effectiveness of a system based on international cooperation such as the Louvre agreements rests on the willingness of the participating countries to agree. Would they be prepared to sacrifice some measure of national sovereignty ?

How can one build a system comprising automatic mechanisms and sanctions, the enforcement of which would be beyond the control of individual governments ? There is no doubt that while the Louvre system represents major progress over the anarchy of floating

exchange rates, it does not constitute a true international monetary system.

A WORLD EMS

The second possible approach is to build an exchange mechanism similar to the European Monetary System. The EMS, created in 1979, was Europe's response to international monetary disorders and was designed to provide protection for intra-European trade. It offers an illustration of automatic mechanisms and sanctions that could be restored at a world level.

The first feature of an EMS-style world monetary system is a monetary reference unit.

The monetary reference unit of the EMS is the ECU, a weighted average of european currencies, in relation to which all EMS currencies are defined. Similarly, a world EMS would need a basket of international currencies to serve as the standard for the new system. This is not a new idea. The Special Drawing Right or SDR, which was defined in 1974 as a "basket of international currencies", would work well as a world monetary reference unit. The SDR currently contains five currencies : the dollar, yen, pound , mark and franc.

(It should be pointed out that, as in the EMS, a world monetary reference unit would not be used as the main reserve and settlement instrument ; national currencies would retain their international role in those respects).

The second feature of an EMS-style world monetary system is an automatic mechanism.

In the EMS, each country is required, to adhere to margins of fluctuation established around the "central" rates defined for each currency. The same would need to apply to a world EMS. Each central bank would have to be ready to intervene on exchange markets to ensure that its currency did not exceed its limits vis-à-vis another currency. This also is not a new idea. The Bretton Woods system included such

intervention obligations. (In fact, the fluctuation margins within the EMS - 2.25 % - are the same as the ones authorized by the Bretton Woods system as of December 18, 1971).

The third feature of an EMS-style world monetary system is sanctions.

Each central bank, under the obligation to intervene to maintain the value of its currency, would thus be made to spend its reserve assets or to borrow from its partners predetermined amounts in their currencies if its own currency were subjected to downward pressure. The lowering of exchange reserves would in and of itself be a form of sanction.

Moreover, if a parity realignment were required, it could be made only by mutual consent, and after examining the economic policies followed by all. This could be done under the aegis of , for example, the IMF. Devaluation or revaluation of a currency could not be decided unilaterally. from a unilateral decision. Monetary and economic adjustments would go hand in hand.

Again, there is nothing new about such sanctions in the world monetary system. The Bretton Woods agreements restricted each country's leeway to modify its par value and required IMF authorization for realignments exceeding certain limits.

The advantages of an EMS-style world monetary system, in which a world currency made up of a basket of currencies would be the reference monetary unit instead of the dollar, would be substantial when compared with those of the Louvre system. A monetary unit with universal scope would give the system the beginnings of a standard, which does not exist in the Louvre framework. The automatic mechanisms and the sanctions would be both known to all, and institutionalized, whereas the Louvre Agreements rest on constant appraisal of the "meeting of the wills" of the major countries.

Such a system would not however be flawless.

First of all, it would not provide built-in guarantees against an inflationary drift of all the currencies. Second it probably would contain certain asymmetries similar to those of the Bretton Woods system since a national currency could continue to play a dominant role both as a reserve and a settlement instrument.

In all, while a world EMS would represent major progress over the Louvre system, is it possible to go still further, in the direction of an even more objective system including automatic mechanisms and sanctions beyond the control of governments ?

A MONETARY STANDARD

The third approach is that of a system organized around a standard that would play the role of main world reserve asset.

The historical model for such a system is the 19th century gold standard, under which all currencies were defined on the basis of their gold content. All currencies in the system were freely convertible into gold.

Under a pure gold standard , the first automatic mechanism is that parity fluctuations are maintained naturally, without central bank intervention on exchange markets, within narrow bands defined by the "gold points". International settlements can be made at any time either by purchasing foreign exchange on the exchange markets, or by physically transferring gold. The band within which par values may fluctuate on exchange markets is limited by the two extremes defined by the central rate (the gold content ratio between two currencies), to which is added and subtracted the cost of physically transferring gold.

In the same fashion, the second automatic mechanism is that monetary inflation in each country is a direct function of gold transfers. A country with a large deficit has an unbalanced exchange market ; its gold is gradually transferred to surplus countries. The contraction of a nation's money supply - directly linked to the stock of gold at its central bank - leads to recession and lower prices. The counterpart to this contraction in surplus partner countries is credit expansion due to

the inflow of gold which leads to a higher level of activity and prices. Thus the competitiveness of the deficit country rapidly improves and its foreign trade balances out.

If such a system were applied today, countries with large deficits would be driven to important changes in their monetary policies and therefore in the level of their economic activity, surplus countries would be led to reverse changes. The gold standard -along with its automatic mechanisms and sanctions would be objective and beyond the control of governments and monetary authorities, who would be obliged to adapt their policies, on the basis of the results of their balance of payments.

Let us be realistic. The actual operation of the gold standard was in fact far more complex than the short summary just presented - in particular each country could always try to circumvent the discipline of the system by modifying the gold content of its own currency. This model of the gold standard would today give rise to very serious problems of enforcement. First the amount of gold available today depends on the gold producing countries, which are in a position to determine quantities and prices, and which do not necessarily share the values of the Western world. Second although the gold standard, in its purest sense, implies free convertibility into gold, internally as well as externally, no central bank today would be ready to restore the internal convertibility of its currency, a policy that was abandoned beginning with the 1930's. Finally, in every country today there is a consensus to limit inflation as much as possible. It would be difficult to implement a system that uses price increases in countries with surpluses as the major factor in restoring external equilibrium.

Once again, let us be realistic : no Central Bank is willing to relinquish its gold reserves. That proves how important holding gold still is to governments. Furthermore, gold is still valued by the market. In spite of the difficulties mentionned above , is it possible to rebuild a true system without allowing gold to play a role ? I for one do not believe so.

Could we today establish a monetary standard, automatic mechanisms and sanctions that would be just as objective and independent of governments ?

There are two possibilities : an objective standard, comprising gold and if it is possible commodities (a suggestion made last year by the U.S Treasury Secretary, James Baker) or a world currency based possibly on a basket of currencies to which gold might be added. Studies by the Committee of Twenty at the beginning of the 1970s could serve as inspiration. The Committee considered how to devise a reserve instrument with constant real value, in other words an instrument that would be revalued every year on the basis of world inflation.

What about automatic mechanisms ? One possibility would be to let the standard to act as the main world reserve asset. For that to be possible, it would be necessary for each national currency to be convertible into the world currency at a fixed exchange rate. Settlements among central banks would be made by transferring the world currency, the reserve asset held by each national central bank and the central reserve asset of the system.

What sanctions would apply ? The automatic mechanism would include its own sanction, as the system based on the gold standard. No country could remove itself from the external constraint, since all countries would have to maintain their solvency in the world currency.

If such a system was already in existence countries with external deficits would have lost their reserves of world currency. They would have to replenish their reserves to become solvent again and thus would be forced to adjust their economic policy, or failing that, their exchange rate in agreement with their partners. The latter should of course be exceptional. Technical modalities could make it possible to have a symmetrical constraint on surplus as well as on deficit countries.

Such a system - with a stable world currency as the main instrument of reserve and settlement - would have three advantages over

a world EMS : it would be more objective, more automatic and more symmetrical.

Its disadvantages would be related to the difficulties of implementation - the technical difficulty of defining a world currency and its rules of issuance and convertibility, and the very serious political difficulty of making it acceptable to all participating countries. The system would imply that the new standard of reference and value would gradually be recognized and accepted by all, so that governments and monetary authorities could not depart from it without being called to order, not only by an international body, but also by their own economic agents.This raises the whole problem of internal convertibility.

When all is said and done, will not the choice among these three approaches, which introduce an increasing degree of constraint into national economies, depend above all on the degree to which each country will be willing to join in international cooperation and relinquish national egotism ?

None of these three approaches is intended as a definite plan for reforming the international monetary system. But I think that the leaders of the major economies now have the duty to ponder the system best adapted to today's world. In this area as in others, it is the duty of decision-makers to prepare for the future, by studying all possible solutions in an unbiased manner.

Money is at the heart of all the political and social problems. It must not be handled solely by specialists. It is also a matter of policy.

How is it possible not to see the extent to which the Western World has been weakened over the past 15 years, by the monetary and economic disorders caused by the refusal to accept a common discipline ? How is it possible not to see that the economic crises we have suffered, inflation, indebtedness, fluctuations in the price of oil and raw materials, are bound up with monetary disorders ? How is it possible not to fear that these disorders may lead to political and social turmoil in all countries, be they industrialized or developing, turmoil that could alter the balance of the world ?

Inflation has been largely brought under control in the main industrialized countries. Thus, for the first time in fifteen years, this prerequisite for the restoration of an international monetary system has been fulfilled.

I would like the governments to work together to find answers to the questions I have put forward here. I would like us to do so with the greatest of caution and realism but also, with imagination and boldness. That is why I propose that the international community entrust a small group of distinguished people of unquestionable moral authority who have proven their economic, monetary and financial competence with the task of lighting our way.

The point is not to resuscitate an ideal state that has never existed. Order and freedom go together. Economic freedom will have little hope for the future unless it is based on a world order accepted by all and binding for all.

Mr Wicks

I have asked the

Your Ref

Bank to add you to the distribution list, so

with compliments

that in future you will receive their report, when it is issued.

Treasury Chambers
Parliament Street
London SW1P 3AG
Tel: Direct Line 01-270 4881
Switchboard 01-270-3000

Amanda Higgins

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

8 February 1988

T P Lankester Esq
HM Treasury
Parliament Street
London
SW1 3AG

Dear Tim,

INTERNATIONAL FINANCIAL SCENE

I attach the final version of our Report on recent developments in international debt which was discussed at your meeting on 3 February.

I am copying this to other members of the Group.

Yours ever,

L D D Price

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CONFIDENTIAL

INTERNATIONAL DEBT GROUP REPORT: FEBRUARY 1988

Main points

- Contrary to an understanding given to the banks, Brazil did not resume full interest payments on its commercial bank debt. However, after pressure from the US authorities it has now paid some January interest and will make further payments as negotiations on a medium term deal progress. Negotiations on an SBA are due to commence shortly.

- Mexico has invited its bank creditors to swap rescheduled debt for higher yielding 20-year bonds whose principal (but not interest) is backed by US Treasury securities. Other debtors may well come forward with similar proposals to securitise or buy-back their debt on concessional terms. Nevertheless, most Paris Club creditors remain opposed to schemes such as those put forward by AfDB/Warburgs for Zaire.

- Argentina faces an acute foreign exchange shortage over the next few months and has also turned to the US for assistance.

- Following approval of its SBA, Ecuador has negotiated a Paris Club rescheduling. A number of banks continue to be reluctant to subscribe to the commercial bank package.

- While the Paris Club has taken a firm line in response to requests for rescheduling new money from Yugoslavia, the banks have subsequently offered generous terms, although still contingent on an IMF programme. The Yugoslavs have, nevertheless, rejected the banks' offer.

- Nigeria's non-insured creditors have reluctantly voted for proposals to reschedule their claims. A legal challenge to the vote by a minority group of creditors failed.

- Egypt's authorities continues to resist pressure from creditor governments for more effective adjustment. Paris Club bilateral negotiations have been held up by disagreements on moratorium interest rates.

- More US banks have increased their provisions against ldc loans, but major New York banks have not followed suit.

- The IMF's Enhanced Structural Adjustment Facility has been established.

CHART A

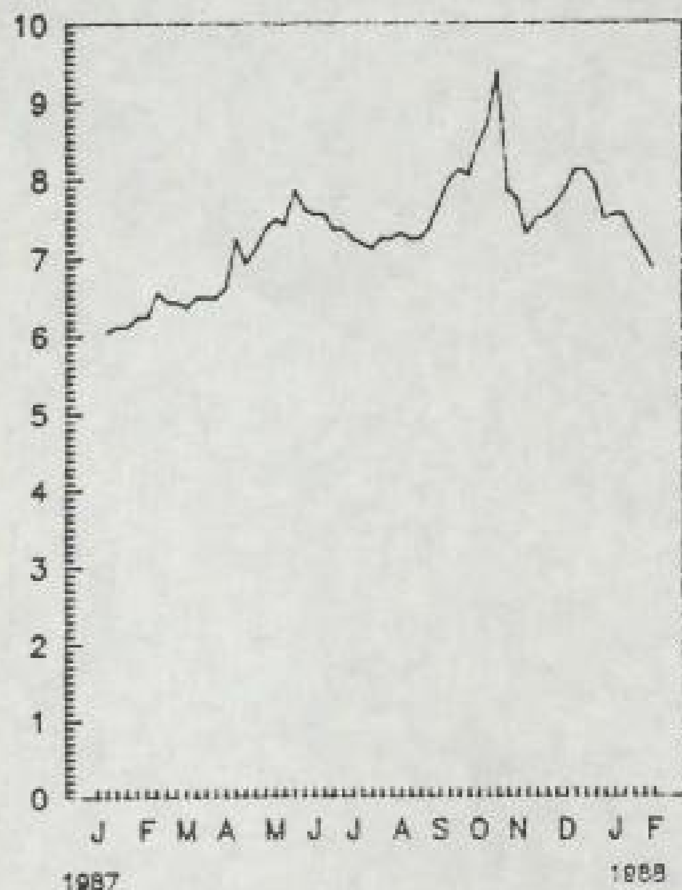
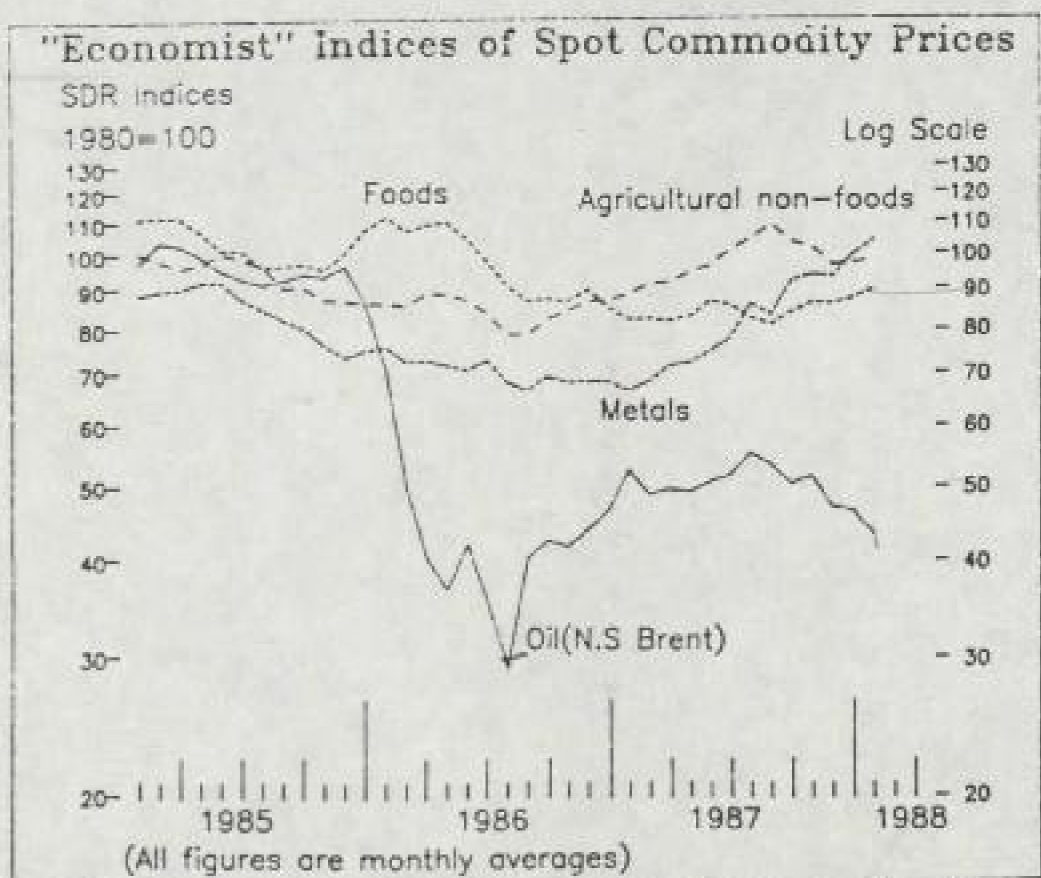


CHART B



I[illegible]ERNATIONAL FINANCIAL SCENE

World Economic Developments

1 Preliminary Q4 US GNP figures provide some portent of a slackening of real economic activity while Japanese domestic demand remains robust. The German economy continues to perform sluggishly. Recent WEP and IMF projections for the overall growth of industrial country domestic demand in 1988 (just under 3%) are little different from the more buoyant outturn now expected for last year, but the pace of activity is likely to decline through the year; the balance of risks may, moreover, be on the downside. The IMF staff expect (perhaps optimistically) real commodity prices to stabilise after several years of decline, and with the competitiveness of a number of developing countries substantially improved by more appropriate exchange rate policies, they continue to project a somewhat better growth performance by indebted ldcs this year than in 1987. However, for the major debtors in particular they have revised down both their October estimates of growth in 1987 and their forecasts for this year, noting the failure of adjustment policies in key countries and the longer term effects on productive capacity of consecutive years of restricted domestic investment. Inflation in the ldcs is also expected to accelerate while external financing will remain tight.

2 Concerns regarding current account imbalances, the dollar and US interest rates have continued to preoccupy financial markets. From the perspective of financial market stability, the preliminary estimates for Q4 suggest that some helpful changes in the pattern of US demand are in train, with a shift of resources from domestic final demand into net trade. After periods of considerable volatility, the dollar's effective rate is little different from that of early December, concerted and open intervention around the turn of the year having done much to restore stability, and the markets responded to unexpectedly good November trade figures. Since early December eurodollar rates have fallen by about 1 1/4 percentage points following a bounce back from the sharp decline in the wake of the stock market crash. (Chart A.)

3 In January non-oil commodity prices were, on average, higher than December (Chart B). There has been a general but modest increase in food prices, while prices of agricultural raw materials have remained flat. However, metal prices have fallen back since the end of December, although it may be premature to conclude that a more sustained period of weakness has set in. On average, oil prices fell between December and January although there are now reports that some OPEC members have cut production back to quota.

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TABLE 1

MEXICO'S BOND ISSUE
(assuming $10 bn of new debt collateralised by US zero-coupon securities are issued)

Conversion Price[1]	Debt extinguished[3] $ bn	Net annual interest saving $ mn	% of exports of g&s[3]
50	10	631	2.9
55	8.2	481	2.2
60	6.7	356	1.6
65	5.4	250	1.1
70	4.3	160	0.7
75	3.3	81	0.4
80	2.5	12	0.1
81	2.3	-	-

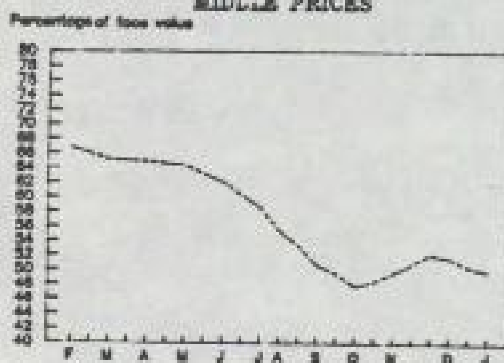
Assumptions: Interest on reserves: 6% (US T3s)
Price of zero-coupon bonds 18.89
6 month LIBOR: 7 7/16

(1) Face value of bonds issued in exchange for $100 of old rescheduled debt
(2) Mexico's total outstanding debt was $104 bn at end 1987.
(3) £22.0 bn in 1986 - now likely to be on the low side.

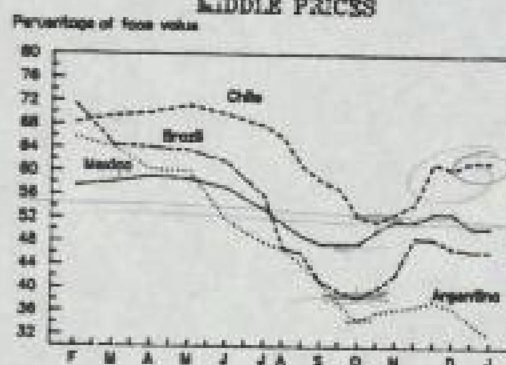
CHART C

SALOMONS SECONDARY MARKET PRICES

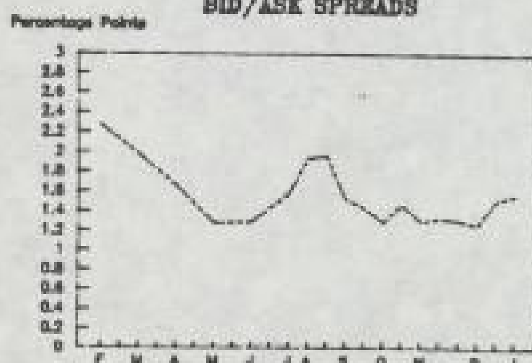
ALL IDR COUNTRIES (WEIGHTED AVERAGE)
MIDDLE PRICES



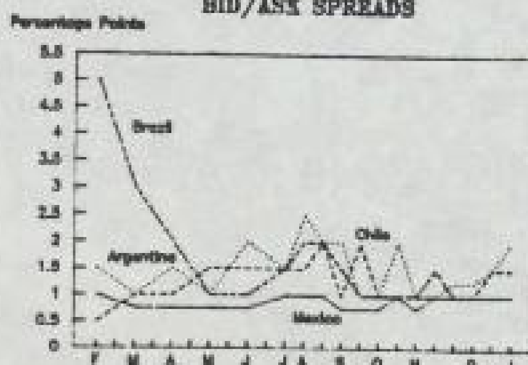
SELECTED MAJOR DEBTORS
MIDDLE PRICES



BID/ASK SPREADS



BID/ASK SPREADS



4 Secondary market prices for ldc debt generally slipped back again in the closing weeks of last year, the exception being Chile where demand for debt:equity conversions was high. The price of Argentina's debt has fallen particularly sharply. (Chart C.) Recent information suggests that, so far, the price of Mexican debt appears to have been unaffected by the announcement of the securitisation proposal.

Mexico's securitisation proposals

5 Mexico has invited its commercial bank creditors to exchange by auction any part of their restructured public sector debt and new money provided under the 1983 and 1984 agreements ($52.7 bn in total) for up to $10 bn of 20 year bonds. These will carry a spread of 1 5/8% over 6 month LIBOR (twice that on rescheduled loans). The bond principal is to be collateralised by Mexico's purchase (at a cost to its reserves of up to $1.9 bn) of a special issue of US government zero coupon securities whose value on maturity will match the face value of the bonds. Interest payments on the bonds remain, however, Mexican risk. (The absence of cross-default clauses on the bonds may given them seniority of a sort.) Delays in circulating details of the scheme have led to a slippage in the timetable but the banks have been asked to agree to waive negative pledge covenants on existing claims by 5 February. Bidding is scheduled for 19 February but may be delayed until 26 February. The result will be known five days later.

6 Seen as an exit bond arrangement, the scheme would allow Mexico to reduce both the stock of its outstanding debt and its annual servicing burden, although these gains seem likely to be fairly small (see table 1). Individual banks might be expected to participate in the auction if the loss they realise (a) on exchange and (b) as the bonds purchased go to a discount* (or alternatively attract provisions in respect of the residual Mexican risk) falls short of the perceived value of benefits. Chief amongst these are the down-payment by Mexico of up to $1.9 bn and the higher spread. Other attractions include greater marketability of their loan portfolio and the intended exclusion of bond holdings from further reschedulings, possible exclusion from new money calls and protracted rescheduling negotiations, and a stronger share price if the market perceives the bank as being able to absorb losses on its ldc loan book. It is clear that accounting, tax and supervisory factors, many yet to be fully resolved, will be an important factor in deciding bid prices. (UK supervisors have indicated that if the bonds are held by banks for trading purposes they will have to be marked to market. However, if they are held for the long term provisions will not be sought, at least in

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* This seems certain since the spread on the bonds, while higher than that on restructured debt, falls far short (after allowance for principal collateral) of the current risk premium on Mexican debt as evidenced by the yield on existing Mexican securities or current secondary market discounts.

the immediate future.) For US regional banks which are heavily provisioned, the [illegible]er may be an opportunity to realise tax losses. In contrast, some continental European banks may be able to sell their loans at a price higher than book value less provisions and so boost their profits but incur a tax liability.

7 At another level the scheme might be seen as a catalyst for a more radical shift in the debt strategy. For Mexico, a concrete sign from its creditors that they were prepared to engage voluntarily in providing debt relief - in recognition of past and prospective adjustment efforts and in the belief that concessions now will increase the prospect of the remaining debt being fully serviced - would be an important coup. (However, as yet there is little sign that UK banks, at least, will participate in the auction on a significant scale.) Such expectations would be reflected in a fall in the risk premium on its debt so reducing the required rate of return on investment in Mexico. This would encourage inward investment and reflows of flight capital and would in turn raise Mexico's capacity to service its debt. Concessional securitisation might be seen as the start of a virtuous circle. A more modest achievement would be the disposal by the banks of claims which would have more appeal to less risk-averse investors. Such a redistribution of risk would also be expected to reduce the costs of debt servicing.

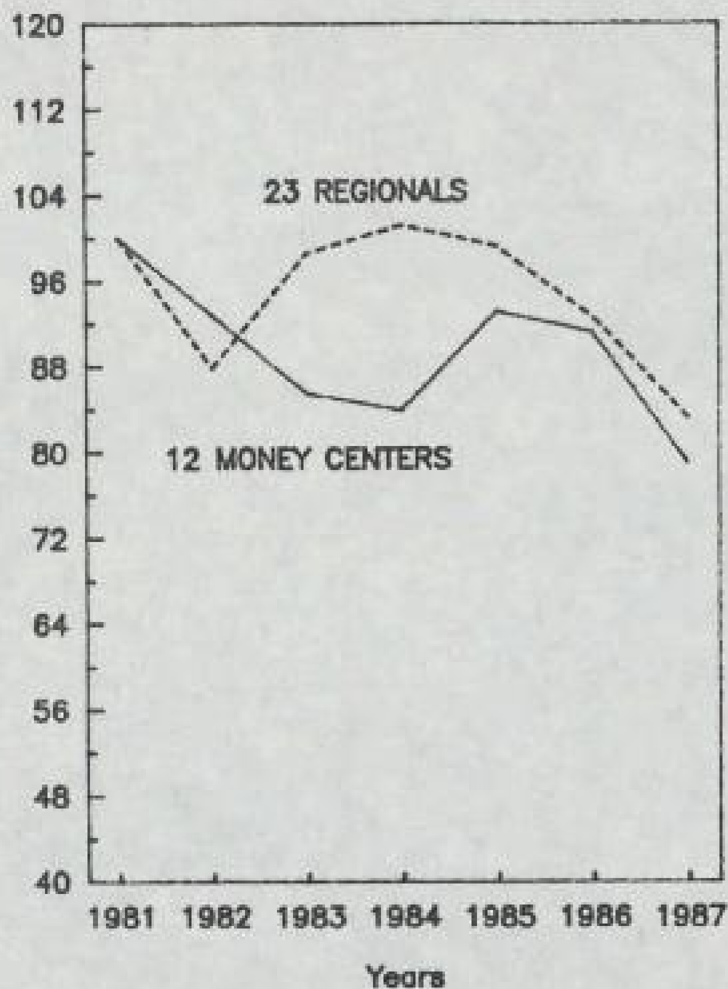
Provisioning

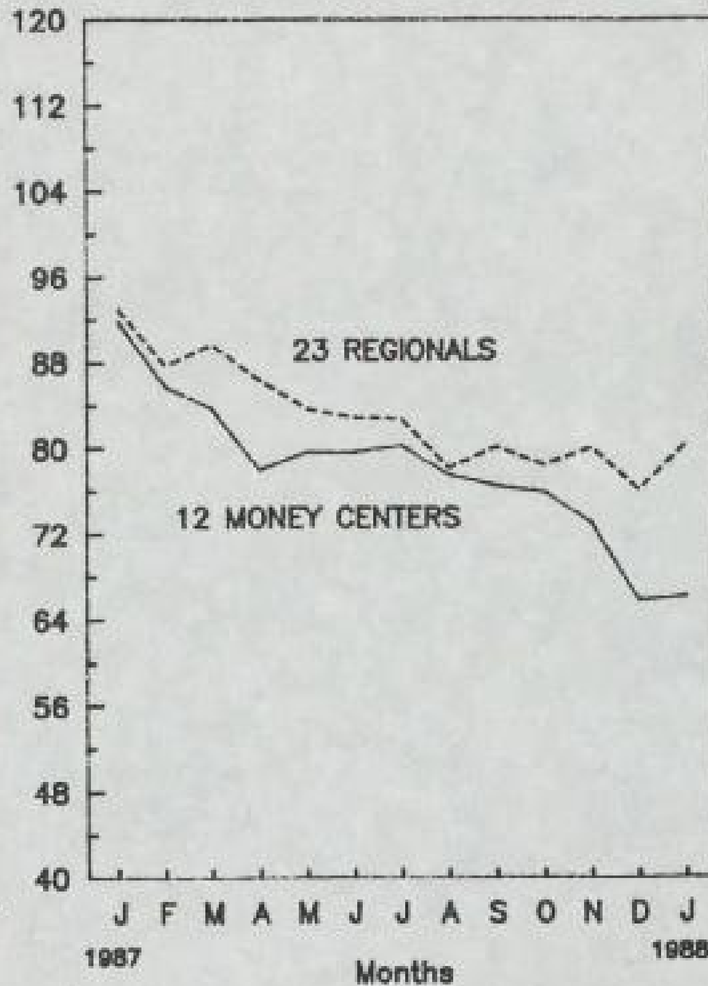
8 The decision by Bank of Boston to raise provisions against its medium and long term ldc loans has, as expected, been followed by a number of other middle ranking regional and money centre banks (including Security Pacific the 7th largest US bank holding company). The new norm for these banks is in the range of 50-60% as against 30-35%. Some have also placed their loans on a non accrual basis and will treat any further cash received as a repayment of principal. Others have written off their loans to the private sector in heavily indebted countries.

9 The largest US money centre banks have not followed suit, a factor which will reinforce UK supervisors in their continued application of the provisioning matrix (which also forms the basis for determining taxable losses by the IR). However, with the largest money centre banks unable or unwilling to increase their provisions, the spectre of competitive (or "macho") provisioning and "tiering" has been raised again. An increase in provisions may also be interpreted by debtors as a signal that creditors' expectations of their loans being repaid or fully serviced have diminished further; this may affect their willingness to pay. Recent moves by the smaller banks have also been seen as a tactic to raise the value of the their stock so making them less attractive targets for take-overs by the major banks. (The differential stock market

CHART D

US BANKS' RELATIVE SHARE PRICE PERFORMANCE*





*Each index as a percentage of S & P 500

SOURCE: SALOMON BROTHERS

performance of regional US banks, with relatively little ldc exposure, and the more heavily exposed money centre banks is evident from Chart D.) As the banks increasingly go their own way in their approach to problem ldc debt, the task of the Advisory Committees in negotiating rescheduling or new money packages becomes progressively more difficult. The Mexican bond offer was, interestingly, pitched at individual banks; the Advisory Committee has been left on the sidelines weakening the banks' collective bargaining position.

ESAF

10 The establishment of the IMF's Enhanced Structural Adjustment Facility (ESAF) was announced on 29 December. The new facility adds SDR 6 bn to the SDR 2.2 bn of resources available to the poorest countries undertaking adjustment programmes under the SAF. Maximum access is likely to be 250% of IMF quota, with provision for higher access in exceptional cases (cf a uniform 63.5% under the SAF). As with the SAF, loans will be for 10 years, 5 1/2 grace with an interest rate of 0.5% (subject to the level of contributions from donors) 62 countries are eligible.

Conclusion

11 Some signs of a slowdown in world economic activity are evident. While interest rates have fallen, the risk of a reversal in the event of another bout of dollar instability remains. As regards the debt strategy, the focus of attention in recent weeks has turned back to the middle income debtors. With the possible exception of Mexico, which has shown a readiness to adopt tough policies (but nevertheless faces a serious inflation problem), the commitment of major debtors to sound adjustment policies is suspect. In terms of external financing, they continue to live on a hand-to-mouth basis, and in Argentina's case this has become particularly acute. The success of Mexico's securitisation proposal will depend on the willingness of the banks to write off part of their debts. They are more likely to do so if gains to free-riders can be minimised. The public sector in creditor countries can scarcely avoid contributing financially through the absorption of tax revenue losses on diminished bank earnings and there may well be pressure for comparable concessions on official credits if only to preserve burden sharing. It is likely that in coming weeks a number of other debtors will take a cue from the Mexican/Morgan and AfDB/Warburg initiatives and come forward with their own proposals. The UK has already indicated to the Paris Club that it would not necessarily rule out the latter approach for poor countries with good track records on adjustment. Difficult decisions on whether similar carrots should be held up for middle income debtors are in prospect.

Further details on individual countries are given below.

LATIN AMERICA AND CARIBBEAN

Brazil

12 The likely course of Brazilian government economic policy over the coming months is confused. The government's capacity to implement policy is more uncertain than ever, and immediate prospects for the economy therefore remain poor. This augurs ill for the successful negotiation of a convincing IMF programme in the near future despite the Brazilian authorities' more conciliatory statements about this recently.

13 Real growth last year is estimated to have been 3.6%, sharply down on 1986 (8.2%). A weakening of domestic demand permitted a rise in net exports, with the trade surplus in value terms rising to $11.2 bn. The current account deficit is likely to have narrowed to around $2 1/2 bn as against $4.8 bn in 1986. Inflation performance has, however, deteriorated sharply, with a mid-year price freeze failing to have any lasting impact on expectations. The CPI rose 366% in the 12 months to December (cf 80% to December 1986) and was accelerating in the last quarter. Monthly inflation in January was 16 1/2%. The government has so far not faced up to politically difficult decisions on the fiscal front, the firm measures needed to reduce inflation and to bolster the confidence of external creditors being likely, in the short term, to depress the economy further. The operational PSBR last year is likely to have been around 6% of GDP against a target of 3.5%, the overall deficit being 25-30% of GDP. An emasculated fiscal package, introduced by the new finance minister Nobrega, is intended to reduce the operational deficit to 2% of GDP this year, but other projections put the likely outcome at 4%.

14 Relations with the banks were further strained when, contrary to an understanding given during negotiations for the interim package, Brazil did not become current on interest payments from 1 January. However, following apparently considerable pressure from the US authorities, Brazil has now paid $350 mn from its own resources to cover part of the $900 mn of interest due in January. Brazil has also reiterated its willingness to normalise relations with its creditors and stated its intention to start negotiations for an SBA within the next few weeks. If agreement on the terms sheet for a medium term package (including difficult issues such as the spread and size of this year's financing gap) can be quickly reached, Brazil has undertaken to continue to pay interest due in the current quarter. Having paid Q1's interest entirely out of its reserves, Brazil would then seek a bridging loan to cover Q2 interest. This would be repaid when the banks' medium term facility and the SBA took effect at the end of

June. The banks are sceptical of the tight timetable set by the Brazilians but regard the proposal as a step forward in negotiations.

Mexico

15 Details of the buyback scheme are discussed on pages 2-3 above.

16 Consumer prices rose 14.8% in December, partly reflecting public sector price rises imposed under the Economic Solidarity Pact (PSE). The 12 month rate was 159% against 106% in the year to December 1986. Real GDP growth is thought to have been just over 1% and the target for this year has been lowered to 2% although even this seems unlikely to be achieved. A $7.8 bn trade surplus in the first 11 months of last year was double that of the corresponding period of 1986. The controlled peso is to be devalued by around 2 1/2% in February but the government's intentions regarding the exchange rate from March, when the wage indexation measures announced as part of the PSE take effect, remain unclear. The overall PSBR outturn last year was 15.9% of GDP but the government has forecast a reduction to 8.2% this year.

Argentina

17 First available estimates (by the UN) suggest that the economy grew by only 2% in 1987 (cf 5.3% in 1986). The 1987 public sector deficit is unofficially expected to have been around 7% of GDP (cf the IMF's November projection of 5.6% GDP). The bulk of the October tax package, critical for the success of the IMF SBA, received legislative approval only after government concessions on tax reform which will reduce their revenue impact substantially although it is hoped that the PSBR will be reduced to less than 4% of GDP. At end-December, the authorities relaxed the price freeze imposed in October and authorised a 4% increase in most prices. It was also announced that public sector wages would be increased by 4% in January, and that controls on private sector wages would be lifted. Prices rose by 3.4% in December, following an increase of 10.3% in November, bringing the 12 month rate to 175% (cf the IMF's revised target of 150%).

18 External trade performance continues to be poor. The trade surplus for January-September 1987 was only $588 mn, as against more than $1.9 bn in the corresponding period of 1986. At end-December, the austral was devalued (for the first time since 14 October) by 6.6%, and it was announced that the commercial rate would subsequently be devalued on a crawling-peg basis in line with inflation. The continuing overvaluation of the austral has adversely affected export performance.

Despite recent disbursements by the Fund, World Bank, and commercial banks, which were triggered by Fund approval of a much-weakened amended SBA, Argentina appears to be rapidly running out of money, prompting speculation of a moratorium. $450-$500 mn of bonds become due in mid-February, arrears to the banks, Paris Club and IDB have built up, and reserves are at a critically low level (cash reserves are less than $500 mn, just over one month's imports). The bonds are to be refinanced. Once again the authorities have turned to the US for help but at this stage the Americans have only said that any accomodation will be contingent on the Argentine IMF programme staying on track.

20 Bids totalling $225 mn, twice the official forecast, were submitted for the first $50 mn of debt offered under the new debt-equity scheme. Bids must accept a new minimum discount of 25% on the conversion of the debt into australes and have the approval of the Economy Ministry. The scheme envisages $1.95 bn of swaps over the next five years.

Venezuela

21 The Venezuelan economy is estimated to have grown by around 3% in 1987 (5.2% in 1986), with non-oil GDP rising by 3.2%. Unemployment is estimated to have fallen to 8.5% in H2 87. Inflation continues to be a problem: prices rose 40% in 1987 as against 13% in 1986. In an attempt to slow the rate of increase, the government has announced an indefinite price freeze on all goods and services sold and produced by the public sector.

22 Higher oil prices more than accounted for an improvement in the overall export performance in 1987. Non-oil exports were lower than targeted, reflecting stronger domestic demand and an over-valued exchange rate (the free market rate for the bolivar is currently at a 55% discount to the official rate). The current account deficit was $71 mn (cf $2.1 bn in 1986) and an overall balance of payments deficit of $1.2 bn ($4.8 bn in 1986) was met partly by a $600 mn drawdown of reserves. Central Bank reserves, boosted by a switch of $0.8 bn from the Venezuelan Investment Fund (VIF), stood at $9.2 bn at end-1987 (cf $9.85 bn at end-1986).

23 Venezuela is estimated to have obtained $844 mn in new foreign credits in 1987, including two credits worth $360 mn recently granted by Japan; most of the new funds are for the state-owned aluminium and steel companies. Net direct foreign investment is estimated to have increased by $480 mn. The authorities are also looking to make a number of bond issues and a $100 mn, 5-year bond with a coupon expected to be 3.5 percentage points above US Treasuries, has been announced. DM bonds may also be

issued. Discussions have also taken place with Japan regarding the possible issue of Venezuelan private sector bonds in Tokyo, and with two US banks. Following Mexico's announcement, the Venezuelan authorities announced their intention to put together a similar securitisation scheme. In 1987, the VIF proposed a buy-back of rescheduled debt, but the banks refused to permit this. The VIF has, however, purchased some of the $4.8 bn of non-rescheduled debt, although the amounts repurchased have not been disclosed.

Chile

24 Chile's buoyant economic performance continued through 1987 with GDP estimated to have grown by 5.4%. Strong growth provided a stimulus to private investment, which is reported to have increased by 30% in 1987, to 7% GDP. Twelve month inflation rose to 21.5% in December (cf 17.4% in 1986 and a revised IMF target for 1987 of 16%). However, a rise of only 0.3% in December (cf 1.9% in November) may reflect the impact of tighter monetary policy earlier in 1987: M1 rose by 9.1% in the 12 months to September 1987 as against 35-45% at the beginning of 1987.

25 The large increase in copper prices, which reached $1.40/lb on the London market at end-December (and averaged 81 cents/lb in 1987 cf 62 cents/lb in 1986), has boosted the trade surplus to $1.08 bn in 1987. The current account deficit is now expected to be $890 mn rather than the $950 mn forecast by the IMF. For political reasons the US has recently removed Chile from its General System of Preferences, thereby ending duty free sale of Chilean goods in the US. Partly to counteract this, a 3.9% devaluation and a reduction in the general level of tariffs from 20% to 15% was announced on 4 January. The reduction in general tariffs will mean a cut in government revenue but should boost exports since many Chilean exports have a high import content (as much as 50% of total value). The abolition of a 50% special tax on luxury goods is likely to raise consumer goods imports.

26 Chile has approached its bank Advisory Committee to request lower spreads on its restructuring deal concluded only last June, arguing that the more favourable terms given recently to other borrowers and its own economic performance justify this. Among other proposals to be discussed later this month,Chile is seeking the banks' consent in principle to use its reserves, or the proceeds of a proposed $900 mn voluntary lending programme, to purchase zero-coupon bonds in connection with a Mexico-type securitisation of part of its debt. Between January and November 1987 a further $1.6 bn of debt was extinguished through the debt capitalisation schemes, bringing the total since the schemes began to $2.9 bn (15% of total external debt).

..ador

27 Despite the fact that critical mass on the banks' package has not yet been achieved, the IMF has approved Ecuador's request for a fourteen-month SBA for SDR 75 mn and an SDR 43 mn Compensatory Finance Facility to cover an export shortfall in the year to September 1987. The SBA concentrates on reducing the PSBR from 10.5% GDP in 1987 to 1.3% GDP in 1988, and the continuation of flexible interest and exchange rate policies. The success of the SBA will depend crucially on the price of oil (assumed under the programme to average $17.25 pb in 1988). OPEC has granted Ecuador an increase in its quota to 310,000 bpd until September 1988 to make up for lost oil production in 1987. With the SBA in place, the Paris Club has agreed to reschedule $275 mn of debt payments in arrears or falling due over the programme period: $150 mn of new maturities over 10 years/5 grace, and $125 of previously rescheduled debt over 8 years/5 grace. The IBRD has approved a $100 mn loan for the financial sector. Central bank intervention and news of the preliminary agreement with the banks in December contributed to an easing of pressure on the exchange rate, which strengthened from sucres 290/$ at end-November to sucres 250/$ at end-December.

28 Commitments to the commercial bank package reached $321 mn (92% of the total $350 mn sought) by 26 January, with many banks, mainly US regionals, yet to commit. Hopes of getting the deal signed before the first round of the Ecuadorean Presidential elections on 31 January were disappointed. The IBRD has been pressing reluctant banks to participate.

Peru

29 Latest figures continue to highlight the deterioration in Peru's external trade performance: in the first nine months of 1987 there was a deficit of $153 mn against a surplus of $1,233 mn over the same period of 1986. The government's latest strategy to improve the external accounts (adopted despite Garcia's reluctance) lays greater emphasis on a more realistic exchange rate; rates for exports and imports will be adjusted monthly on the basis of 85% of the rise in the previous month's CPI. As a prelude to this, the official rate was devalued by 39.4% on 14 December.

30 Public sector debt servicing payments in 1987 were announced as $300 mn (10% of merchandise exports). This figure is thought to exclude payments in kind (eg to Midland and First Interstate, to other Latin American governments, and to socialist countries). The Soviet Union has agreed to reschedule the equivalent of about $1 bn of rouble debt over 10 years at an interest rate reduced from 7.5% to 3%. Over 1988-90 the debt will be serviced by the Russians taking around $140 - $170 mn a year in traditional and non-traditional exports.

Colombia

31 GDP is reported to have grown by 5.5% in 1987 (5% in 1986) and unemployment has fallen. Inflation, however, increased in the year to November to 24.7% (cf 20.9% at end-1986), and the rate of increase in M1 rose to 29.3% (22.8% at end-1986). Municipal elections in March this year seem to make it unlikely that the government will tighten its monetary policies in the immediate future.

32 Weaker coffee prices sharply reduced coffee export earnings last year ($1.5 bn - cf $2.7 bn in 1986) but an improvement in non-coffee exports, particularly oil, has in part compensated. Exports in January-September were $3.4 bn, down only $0.4 bn on the comparable period in 1986, although it is not yet clear to what extent the slower depreciation of the peso in 1987 (17%, cf 27% in 1986) will have affected export competitiveness. The commercial banks' $1 bn new money loan was signed on 8 January by 112 banks. The loan will be split between the Colombian government ($540 mn), the Cerrejon Norte coal project ($260 mn) and the power sector ($200 mn), the latter loan in turn being a cofinancing with the IBRD as part of a $1.3 bn financing package for the power sector, involving the IBRD, IDB and foreign governments.

Bolivia

33 There has been little progress on the debt buy-back scheme which has to be completed by 11 March. The Bolivian authorities have offered to buy back at 11 cents in the dollar. The UK is unlikely to participate and only three countries - the Netherlands, Spain and Switzerland have offered grants for the purpose. Japan and Germany are prepared to increase other forms of bilateral aid.

Panama

34 With reserves down to $30 mn (the equivalent of only a week's imports) and with growing arrears to MDBs and private creditors, Panama is seeking from the banks a $1.8 bn rescheduling, a further delay in overdue interest, and a $100 mn reduction in future interest payments.

Other Countries

35 The Uruguayan economy grew 5.8% in the year to September (6.3% in the year to June). Inflation, at 57% in the year to December, was a little above the authorities' end-year target of 55% but significantly lower than in 1986 (71%). Continued high demand for imports reduced the trade surplus for the first nine months to $56 mn (cf

5 mn in 1986). Costa Rica's 1987 current account deficit was $280 mn (6.5% GDP, cf 5.1% in 1986). As promised, creditor banks were paid $5 mn at end-October and end-November to facilitate the refinancing negotiations. A new money proposal has been presented to the banks, including an option to capitalise interest. Strong growth in Jamaica has led to some deterioration in the trade balance: a deficit of $455 mn was recorded in January-October 1987 (cf $315 mn in the same period in 1986). The current account deficit for January-October 1987 was $81 mn (cf $28 mn for the same period in 1986) but was more than matched by net capital inflows allowing the reserves to rise by $283 mn.

SOUTH AND EAST ASIA

Philippines

36 Real GNP growth is officially estimated to have been around 5% last year (cf 1.5% in 1986) despite the prolonged drought and slower than expected aid disbursements. The introduction of a standard 10% VAT on 1 January has provoked widespread protests, but the authorities have argued that the VAT replaces more complex purchase/retail tax arrangements and should have no overall inflationary impact. The commercial debt rescheduling agreement was finally signed by all 483 creditors on 22 December. It is rumoured, however, that the Philippines will approach the banks for a new money package in 1988 and will also attempt to re-negotiate the terms of the 1987 agreement.

Malaysia

37 Real GDP is expected to have grown by 2 1/2-3% last year. Malaysia's trade surplus in the first 10 months of 1987 rose to $4.1 bn (cf $2.3 bn in the same period of 1986), partly reflecting higher prices for palm oil and rubber. The current account should show a surplus of $0.8 bn last year (cf a deficit of $0.5 bn in 1986).

Indonesia

38 The government has announced a new series of trade reforms and unveiled a conservative 1988 budget. The trade package is the sixth in three years. The latest measures reduce import monopolies, lift import quotas and adjust rates of duty on a number of commodities. Holders of business licences are now allowed to export freely - previously export licences were necessary. The package has been welcomed by business, but even the authorities admit that further reforms are still necessary. A projected increase of 27% in nominal terms in government spending announced in the budget is

partly a reflection of a nearly 60% increase in debt servicing costs, mainly attributable to a fall of the rupiah against the yen, but other spending is expected to rise by about 5% in real terms. Civil service and armed forces pay has, however, been frozen for a third successive year. Estimates of oil and other revenues could be optimistic.

Thailand

39 GDP growth is likely to have been around 6% last year. Thailand's export boom continues, with strong exports of manufactures more than compensating for weak exports of rice and tapioca caused by the drought. Imports, however, have grown even faster. Although tourism receipts have been buoyant, the current account showed a deficit of $0.3 bn in Q1-Q3 (cf a surplus of $0.25 bn in the same period of 1986).

EASTERN AND SOUTHERN EUROPE

Poland

40 Shortly after signature of the 1987 Paris Club rescheduling agreement, Deputy Finance Minister Dorosz indicated that Poland would seek a reduction in interest rates and provision of new money during the bilateral negotiations with official creditors. The banks hope to sign their two stage MYRA in March. Following the end-November referendum, the government has made known its revised plans for price increases, which will now be spread over three years rather than concentrated in 1988. With the rise in basic foodstuffs in 1988 now fixed at 40% rather than 110% as originally planned, and with proposed increases in energy, heating, and rents halved to around 50-100%, the RPI is expected to rise over 1988 by 27% rather than 40%. Most other reforms are expected to go ahead on the basis of the original draft. On 1 February the zloty was devalued against the dollar by 15.8% and food prices were raised 40%. Further price increases are scheduled on 1 April. To cushion the blow, wages were increased 20%, a larger rise than earlier indicated; this may indicate some further softening of the Government's line.

Yugoslavia

41 A sharp improvement in trade performance during 1987 has offset a decline in workers' remittances, and the convertible currency current account surplus is thought to have been around $1 bn ($0.2 bn in 1986). Allowing for an estimated $1 bn reserve drawdown, the residual financing gap was only closed by the accumulation of arrears with the commercial banks; at end-December these amounted to some $0.5 bn. An IMF team has

...n in Belgrade negotiating the terms of the Fund programme and although the Yugoslavs are unlikely to meet official creditors formally at this stage, they held informal talks with Trichet, Chairman of the Paris Club, on 11 January. Trichet described Yugoslav thinking as "original": they proposed a 20-year rescheduling of all maturing principal over 1988-1990, including previous rescheduled debt, and, as a temporary alleviation of cash flow problems, a standstill on payments due in Q1. They also requested a reopening of cover. The Club has emphasised the need for a strong IMF programme as a pre-requisite, although there are doubts that the present regime has the political clout to implement reforms.

42 The Paris Club's position has been made more difficult by the decision of the banks to offer an 18 year rescheduling (with 6 years' grace) of principal arrears and maturities falling due over the period June 1987 to September 1988 at a spread of 1% over LIBOR. The offer is, however, conditional on an IMF programme. The Yugoslavs have initially rejected the offer on the grounds that the spread is too high and no new money is to be provided.

Hungary

43 The Hungarians and the IMF staff have reached agreement on a proposed 1 year SDR 260 mn SBA, linked to exchange rate adjustment and other reforms and a target current account deficit of $0.5 bn in 1988. The programme is likely to go to the Fund Board in March. The hard currency trade deficit last year was $361 mn (cf $470 mn in 1986).

Romania

44 The Romanian trade performance appears to have strengthened further during H2 1987 and the convertible currency current account surplus for the year may have been in the region of $2 bn ($1.3 bn in 1986). The Romanians have now backed away from a CFF, and with the goal of zero net debt by end-August 1988, there would appear to be no let-up in the policy of rapid debt repayment and their push to prepay debt on concessional terms has been extended to include the IMF. As part of an attempt to pin the blame for current economic difficulties on overseas creditors, Romania has repeated complaints that the IBRD's method of assessing interest on loans in strong currencies (which Romania claims it was forced to borrow) is unfair. (The method worked in Romania's favour during the early eighties when the dollar was strong.)

USSR

45 The Soviet Bank for Foreign Economic Affairs has successfully raised a 10 year SFr 100 mn bond with a coupon of 5%. It is the first bond issue by the Russians since the Revolution.

Greece

46 In Greece, most of the performance targets attached to the EC loan were missed last year. In December inflation was 15.7% against an original target of 10%. The PSBR outturn is estimated at 12.1 - 12.6% of GDP compared to a target of 9.7%, and monetary growth continued to overshoot. Although there was a further reduction of the current account deficit from $1.7 bn (4.3% of GDP) to an estimated $1.2 bn (2.6% of GDP), this was largely attributable to higher remittances from abroad and a rise in transfers from the EC. This year the current account may well deteriorate as a result of a combination of a loss of competitiveness and the strength of domestic demand, and spontaneous capital inflows may decline. However, the authorities believe that the recent current account improvement should avoid the need for further net foreign borrowing in 1988.

SUB-SAHARAN AFRICA

Nigeria

47 The outlines of Nigeria's 1988 budget were announced at the end of December. It is disappointingly expansionary at a time when the authorities should be looking to consolidate past structural gains and offset the extensive fiscal slippages of last year. Interest rates have been cut and credit ceilings increased at a time when lending has already been growing too rapidly. Another sizeable deficit is expected, and there is a danger that pressures on the balance of payments and exchange rate will also increase. On account of fears that an announcement of petrol price increases would spark off social unrest, the issue was deliberately avoided, though a gradual and partial reduction of the "subsidy" was strongly implied (Fund and World Bank staff believe the budget figures assume a 30-50% reduction). Finally there are concerns that the level of foreign exchange set aside for external debt payments may not be adequate for Nigeria to meet its 1988 commitments even after generous rescheduling. The Fund staff were disappointed by the budget and agreement on a new Fund programme is likely to be that much more difficult. The World Bank, however, has been cautiously optimistic, arguing that the economy was in need of a degree of reflation. The commercial banks

hoping for an early Fund agreement. Their own 1986/7 agreement, although effective, is closely tied to a new Fund programme. Unless a new SBA has been approved by the end of March, both the rescheduling and new money agreement will lapse.

48 ECGD cover for completion of the Biwater project (£22 mn) was announced unconditionally by the Prime Minister during her recent visit. This was triggered by the last-minute clearance of some arrears of moratorium interest. The remainder of the ECGD package, including a £200 mn line of credit, remains contingent on agreement with the IMF and the clearance of the balance of interest arrears outstanding from June 1987 and those accuring from December 1987.

49 Nigerian proposals for the rescheduling of $3.25 bn of promissory notes were approved by the required majority at a meeting of noteholders on 14 January. The result was unsuccessfully challenged in the courts by a Hong-Kong based group of creditors opposed to the proposals.

South Africa

50 On 15 January, it was announced that the authorities have implemented the option included in the second interim debt agreement permitting the conversion of blocked debts into South African equity investments or property. Blocked debts so released will then be able to be repatriated at the (discounted) financial rand rate.

51 Preliminary figures indicate that South Africa may have achieved overall GDP growth of about 2% in 1987; even so, the Governor of the Reserve Bank has called for fiscal discipline to protect the balance of payments current account surplus (vital to finance scheduled repayments due under the debt agreement). Short term interest rates are now rising and an increase in banks' prime lending rates (from 12.5% to 13%) has been announced. Initial fears that legislation included in the recent US Revenue Act (which ends the availability to US companies of foreign tax credits for South African source income) could lead to a fresh surge of disinvestment appear to have been overstated.

Cote d'Ivoire

52 The weak SBA was approved last month only on the understanding that it would be strengthened at the first review, with a strong hint that depreciation was required. The 1988 budget has been published with expenditure expected to rise 2.6%. The deficit of 7.5% GDP estimated for 1987 is expected to double, despite steps to increase revenue. Coffee and cocoa prices have continued to fluctuate - amidst speculation of further quota cuts (coffee) and of an agreement on price support amongst producers (cocoa).

Malawi

53 In advance of an SBA, the Kwacha has been devalued by 15% against a basket of currencies. A SAF and fourth SAL are due later in the year.

Mozambique

54 Following a concession by Italy, which has targeted Mozambique as a prime candidate for bilateral aid, the authorities are pressing for reduced interest rates in their remaining bilateral agreements with Paris Club creditors. The IMF programme remains on track.

Zaire

55 A revised proposal to securitise Zaire's debt at a concessional interest rate along the lines proposed by the AfDB/Warburgs has been rejected by major Paris Club creditors.

Zambia

56 A Fund mission just returned from Lusaka has reported a ramshackle state of affairs with planning for the end-January budget well behind schedule. It is hoped that, during the next few months, a rescue package will be put together with the UK playing a leading role. The outstanding problem is the size of arrears to the Fund which will reach $600 mn by end-June. A number of options to resolve this difficulty involving ESAF money which give Zambia an incentive to adjust are under consideration.

Sudan

57 Following the successful mini consultative group meeting in early December, when donors agreed to cover over two-thirds of the (then calculated) "narrow" financing gap of $207 mn for FY 1987/88, there have been reports that even this minimal requirement has been seriously underestimated. Even if this new problem can be resolved, donors and creditors have yet to decide how to deal with the $4.8 bn of debt falling due in the current financial year. This figure includes growing IMF arrears which will reach SDR 620 mn by June 1988. Various approaches involving the ESAF in some form are being considered in Whitehall and Washington (including an informal US proposal to clear IMF arrears through, inter alia, an escrow account and bridging loan on the part of major donors). The aim would be to take things forward at a full consultative group meeting scheduled for April, although much will depend on Sudan's continued commitment to economic reform.

58 The domestic outlook remains precarious and output is projected to fall in 1987/88, after a 5.2% increase last year. The fiscal deficit (including unpaid interest) is forecast to rise from 11.5% of GDP in 1986/87 to 12.1% in 1987/88. A Fund team is in Khartoum for Article IV consultations and to discuss policies for 1988, within the framework of the economic recovery programme which is due to be published by end-January.

MIDDLE EAST & NORTH AFRICA

Egypt

59 The IMF programme remains seriously off-track and the first review has still not been completed. The Egyptians have so far failed to adopt corrective measures or implement earlier assurances to strengthen and accelerate adjustment. HMG has liaised with the US (now taking a tougher line) and Germany in the hope of securing early action on, inter alia, the budget deficit and interest rates so as to pave the way for a reinstated, or even new, Fund programme. But in discussions with the Prime Minister and Chancellor, President Mubarak showed little, if any, willingness to accept IMF remedies or hasten reform.

60 Most of the Paris Club bilaterals, originally due to be concluded by end-October 1987, have still not been negotiated as the Egyptians have demanded an interest rate of no more than the Libor +0.2% which France and Spain have conceded. Not unexpectedly, negotiations on the UK bilateral on 21-22 January broke down as the Egyptians would not accept ECGD's offer of a spread of 0.5%. No date has been set for talks to resume.

Morocco

61 Provisional data indicate that Morocco met the main end-October performance criteria under its IMF stand-by; and a long delayed commercial bank rescheduling agreement finally became operational on 4 January. But the end-1987 performance criteria are unlikely to be met. The poor cereal harvest (46% down in volume terms on 1986) means that the H1 1987 improvement in the external position was probably not sustained in the second half of the year. The IMF now expect the current account to remain in deficit until 1991 compared with earlier projections of a return to surplus in 1988.

62 On the domestic side the scope for further cutbacks in government expenditure, which reduced the budget deficit to 6% of GDP in 1986 and 1987, is also limited. The 1988 budget projects an unchanged deficit in relation to GDP - substantially higher than the authorities' previous target. Although growth is officially targeted at 4.5% (cf 1% in 1987), the IMF expect inflation, which fell from 8.8% in 1986 to 4% in 1987, to rise to 6% this year.

Algeria

63 Recent IMF estimates suggest that a further 21% cut in import volumes and higher hydrocarbon revenues may have restored the current account to approximate balance in 1987, compared with a $2.2 bn deficit in 1986. A $200 mn loan, co-financed by the World Bank, is currently being syndicated. Repayment is over 8 years, with 4 1/2 years' grace; the spread is 3/4% above Libor for the first six years, 5/8% for the last two. Despite World Bank participation, the spreads and management fees are higher than in previous loans, reflecting banks' increasingly cautious attitude towards Algerian risk.

64 The domestic economy remains depressed. After falling in 1986, output probably rose only 0.8% last year. The official forecast of 4.1% for this year looks optimistic as the recently announced 1988 budget allows for no relaxation of austerity. The need to strengthen the economy through further structural reforms was re-emphasised by President Chadli in his "state-of-the nation" speech in December.

65 A meeting of the Anglo-Algerian Joint Commission will take place in London on 17-18 February. ECGD is, however, very cautious about undertaking new commitments under existing protocols and is recommending a significant reduction in the market limit.

INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1987*	End-June 1987	End-March 1987 [2]	End-March 1987 [3]
Latin America				
Argentina	54	3.1(0.2)	0.2	0.2
Brazil	113	6.6(1.6)	1.0	1.9
Chile	19	1.2(0.1)	-	0.1
Colombia	15	0.5(0.1)	0.1	0.1
Costa Rica	4	0.1(-)	-	-
Ecuador	9	0.5(0.1)	0.1	0.1
Jamaica	3	- (-)	-	-
Mexico	104	6.3(0.6)	0.7	1.3
Peru	16	0.3(-)	0.1	0.2
Uruguay	4	0.3(-)	-	-
Venezuela	36	2.1(0.2)	-	-
Far East				
Indonesia	44	0.8(0.3)	0.9	1.8
Malaysia	20	1.1(0.3)	0.1	0.1
Philippines	29	1.4(0.1)	0.1	0.2
Eastern Europe (convertible currency)				
Bulgaria	5	0.3(-)	-	0.1
Hungary	18	0.3(-)	-	0.1
Poland	37	0.6(-)	1.3	1.4
Romania	5	0.2(-)	0.3	0.4
Yugoslavia	19	0.7(0.1)	0.7	0.9
Southern Europe				
Greece	20	1.3(0.2)	0.1	0.3
Turkey	33	0.5(0.2)	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 33 countries amounted to $18 million at end-June 1987.

[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.

INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1987*	End-June 1987	End-March 1987 [2]	End-March 1987 [3]
Sub-Saharan Africa				
Cote d'Ivoire	10	0.3(-)	0.1	0.1
Nigeria	26	1.3(0.1)	2.5	3.5
South Africa	21	3.7(0.5)	0.9	2.5
Sudan	11[6]	- (-)	0.2	0.2
Middle East and North Africa				
Algeria	27	0.4(0.1)	0.2	0.4
Egypt	47	0.3(0.2)	0.3	1.3
Iraq	55[4][6]	0.1(-)	0.6	1.6
Israel	31	0.4(0.1)	0.1	0.2
Morocco	20	0.2(-)	0.2	0.3
Oman	3[6]	0.1(0.1)	0.7	1.9
Saudi Arabia	14[5][6]	0.5(0.3)	0.2	0.3

[4] Includes $30 bn from Arab countries.
[5] Excludes unguaranteed non-bank claims.
[6] Total external debt at end-December 1986.
* Current estimate.

0318C.

RECENT SOVEREIGN BORROWING BY LDCS

Date Announced	Borrower	Amount (mns)	Maturity/Grace (years)	Spread or Fixed rate (%)
BANK BORROWINGS				
Asia				
4/12	India IPCI	Yen 14 bn	12/6	1/4 - 3/8
21/11	India IFCO	$60	10/5	0 - 1/4
19/12	India - ONGC	$300	10	3/16 - 1/4
21/11	Indonesia	$300	8-10/5	5/8 - 3/4
21/11	Thailand - Thai Airways	$35	9-12/5	1/8 - 1/4
S Europe/Middle East				
7/11	Greece - Athens	$40	7	5/8 - 3/4
7/11	Greece - OTE	$175	8	1/2
21/11	Turkey - HDPPA	$80	7/3 1/2	1 1/4
18/12	Turkey - TC Zicarat $200 Bankasi	1 1/4	3/4	
11/12	Turkey - Turkish Electricity Authority	DM 118	7 3 1/2	1 1/4
BOND ISSUES				
Asia				
5/12	China - Int Trust (	Yen 15 bn	5	5 5/8
5/12	& Invest Corp (	$200	5	3/4
5/12	India - Industrial Development Bank	DM 200	7	6 3/8
S Europe				
5/12	Greece - Bank of Greece	DM 300	5	5 5/8
L America/Caribbean				
5/12	Trinidad and Tobago	Yen 7.5 bn	5	6.7

OVERDUE FINANCIAL OBLIGATIONS TO THE FUND(1)

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding as at 12. 1.88 SDR (mn)	Forthcoming Obligations (to 1993)
Kampuchea	13 March 1975	30.8	14.1
Guyana	31 May 1983	70.7	33.8*
Viet Nam	6 February 1984	82.3	46.8*
Sudan	12 July 1984	517.3	322.3
Liberia	25 January 1985	171.0	133.5
Peru	9 September 1985	338.4	414.0
Zambia	30 April 1986	291.5	585.2
Siera Leone	16 January 1987	21.5	68.3
Somalia	2 July 1987	8.5	144.6
Uganda	17 August 1987	13.9	218.9
Honduras	30 October 1987	8.2	56.7*
		1,554.1	2,038.2

(1) Includes both overdue repurchases and charges of members with at least one obligation overdue for more than one month.

NB The above figures are from Fund papers issued with respect to individual country complaints. There will have been further obligations falling due subsequently, so the figures are not entirely up-to-date. A Fund source indicates that total arrears were SDR 1,573 mn as at 4.12.87 but this figure is not broken down by country.

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

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* Guyana, Honduras and Viet Nam only to 1992.

External copies to:

Lankaster	
Mr Mountfield)	
Mr Hew Evans)	
Mrs Case)	HMT
Mr Pitcairn)	
Mr Walsh)	
Mr Sedgwick)	
Mrs Lomax)	
The Hon H Maud)	
Mr T L Richardson)	
Mr Broadbent)	FCO
Mr R Braithwaite)	
Mr Drummond)	
Mr P Short	
Mr S Gray)	
Mr Dinwiddy)	Cabinet
Mr J B Unwin)	
Mr Owen)	
Mr David Dell)	DTI
Mr Stephens)	
Mr Fowell)	
Mr Kemp)	
Mr Van Slooten)	ECGD
Mr G Breach)	
Mr J Willis)	
Mr J Vereker)	
Mr B R Ireton)	ODA
Mr J Caines)	

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary 29 December 1987

INTERNATIONAL FINANCIAL SCENE

The Prime Minister has read the summary of developments in the international debt scene conveyed in Jonathan Taylor's letter of 24 December. She has commented that the IMF is being too weak, with the result that some debtor countries seem to have stopped trying. It follows that she agrees very much with the Chancellor on the costs where he proposes that we should take a firm line, for instance over Argentina and Egypt.

I am copying this letter to Robert Culshaw (Foreign and Commonwealth Office), Alison Brimelow (Department of Trade and Industry) and John Footman (Bank of England).

(C. D. POWELL)

Alex Allan, Esq.,
HM Treasury.

mjd 2/48Jn

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

24 December 1987

C Powell, Esq
No.10 Downing Street
London SW1

Dear Charles

INTERNATIONAL FINANCIAL SCENE

I attach the regular report on developments in the international debt scene. The Prime Minister may find this useful background for her forthcoming visits, in particular her visit to Nigeria.

The last report, prepared immediately after the fall on world stockmarkets, noted that it was then too early to reach conclusions about the longer term impact on the debt scene. Developments since then - the substantial cut, world-wide, in interest rates, the stronger than expected growth of activity in the autumn, and the strength of forward-looking indicators - suggest that the outlook for the world economy will be less recessionary than had been feared. The main impact on debtors will be through the US dollar and dollar interest rates. US interest rates are well below their mid-October level and upward pressures on US interest rates in recent weeks have so far been largely resisted, but the downside risk for the debtors is a serious one. Uncertainties on this score, together with some of the other developments noted below, make the overall debt situation less easy to manage than appeared in the early autumn.

There has, however, been positive progress on the IMF's extended structural adjustment facility to which the UK has offered a significant contribution, rising to some £40 million a year, and on additional co-financing disbursements for aid loans to debt distressed countries (UK contribution £120 million) following a IBRD sponsored meeting in December. For the moment, no further progress has been made on the interest rate component of the Chancellor's initiative, though a lengthened re-scheduling period is now the norm for debt distressed countries in Africa attending the Paris Club. Since the last report, 2 major internaitonal meetings have focussed on debt: the Acapulco meeting of Latin American Heads of State and the OAU Debt Summit. Little mew emerged. Their main importance appears to have been political rather than financial.

On a less favourable tack, there has been a worrying weakening in Fund conditionality, most recently on Argentina (on which the UK

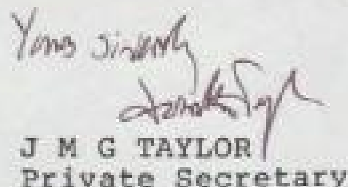
abstained) and Cote d'Ivoire (which the UK reluctantly approved but asked for a strengthening of the programme at the first review).

Among individual countries, the outlook for Nigeria's adjustment programme continues to cause concern. Although considerable progress has been made, the recent Fund Article IV Mission Report (due to be discussed in the Board on 6 January) showed a major and alarming slippage in fiscal policy during 1987, with no sign of improvement in 1988. UKDEL will be briefed to use discussion in the Fund Board to reinforce the message in the brief for the Prime Minister's visit that much more must be done, above all, to reduce the fiscal deficit, and to stiffen the Nigerian Government's resolve to adhere to an economic adjustment programme endorsed by the IMF.

Despite agreement on an interim banking package, Brazil remains a major problem. There is already considerable uncertainty about the next stage of the banking package, on which negotiations should already be tarting. With the resignation of Bresser the chances of an early IMF programme - already limited - seem likely to have receded. Whatever approach the Brazilians choose to adopt over the next few months may set a precendent elsewhere in Latin America.

Finally, the Egyptian programme is off-track. Despite their undertaking when the Fund Board approved the original very weak programme that this would be strengthened at the time of the first review,the authorities are unwilling to take corrective measures. Surprisingly, in the light of their attitude towards the original fund programme, the US are at last taking a tougher line and have lobbied in this sense in Cairo. They would like other G5 countries to follow suit and also to try to stiffen the Managing Director's resolve. We shall want to reinforce the US message both in Washington and Cairo. A further opportunity to do so will be during President Mubarak's visit to London in January.

I am copying this letter and enclosure to Robert Culshaw (FCO), Alison Brimelow (DTI) and John Footman (Bank of England).



J M G TAYLOR
Private Secretary

4/150/LJB/79/1

PA Problem Countries

CONFIDENTIAL

FROM: A F CASE

DATE: 23 DECEMBER 1987

CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Evans
Mrs Lomax
Mr Mountfield
Mr Allen
Mr Davis
~~Mr~~ Halligan
Mr Lankester

INTERNATIONAL DEBT SCENE: DEBT GROUP REPORT

I attach the usual report on the international financial scene. This should go to Number 10 before Christmas in order to provide background - on Nigeria in particular - for the Prime Minister's forthcoming visit.

A F CASE

030/150/LJB/79/1

DRAFT LETTER TO NO. 10

cc PS/FCO
PS/DTI
PS/Governer

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opportunity to do so will be during President Mubarak's visit to London in January.

CONFIDENTIAL

INTER-DEPARTMENTAL DEBT GROUP REPORT: DECEMBER 1987

Main points

- the dollar's decline has led to interest rate cuts by strong currency countries while upward pressure on US rates has so far been largely resisted. There are as yet few signs of a weakening of OECD economic activity following the stock market collapse and non-oil commodity prices have continued to strengthen. The decline in oil prices accelerated after the December OPEC meeting.

- major commercial banks have agreed to subscribe to Brazil's interim financing package. British banks have done so, however, only on the basis that any commitment to the proposed medium term facility will be contingent on Brazil keeping current on interest payments from the beginning of next year and seeking a fully-funded IMF programme. Doubts on the ability of the Brazilians to deliver realistic adjustment measures have been reinforced by Senhor Bresser's resignation.

- while Nigeria has implemented some notable policy reforms, acute problems on the fiscal front (likely to be aggravated by the fall in oil prices) remain. These could be a stumbling block in securing a new IMF programme which is needed to trigger disbursements of new money from the banks. The terms of Nigerian proposals to reschedule amounts due to uninsured creditors are harsh and unsatisfactory.

- Yugoslavia's external position has deteriorated and its recent economic package is unlikely to satisfy creditors. The authorities have agreed to seek an IMF programme but may well lack the political strength to implement tough adjustment policies.

- arrangements for establishing the IMF's Extended Structural Adjustment Facility (ESAF) have progressed, with the UK offering a substantial sum to finance the interest subsidy. The IBRD has secured an estimated $3 bn in additional commitments for aid to the poorest debt-distressed countries.

Chart 1

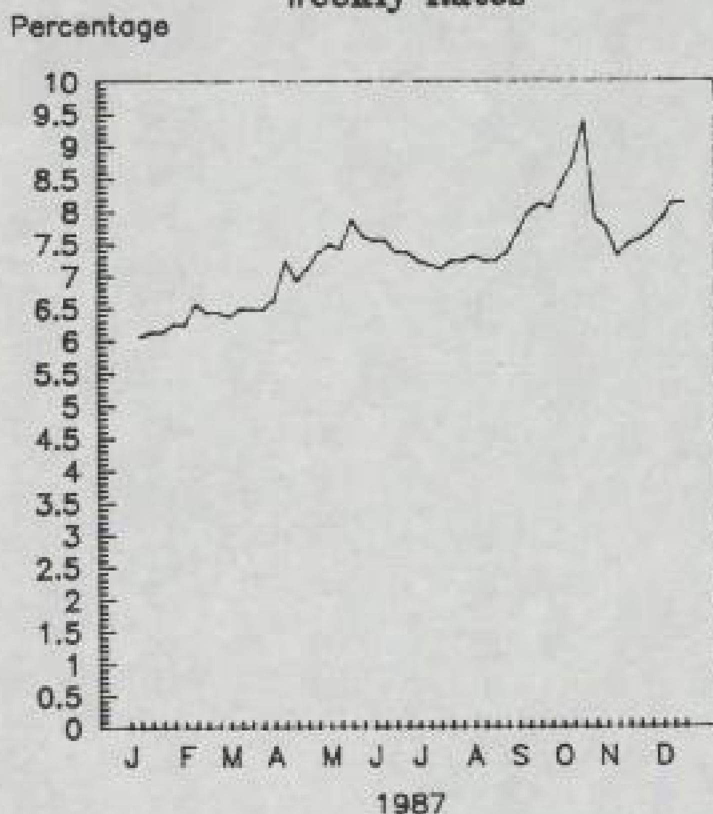
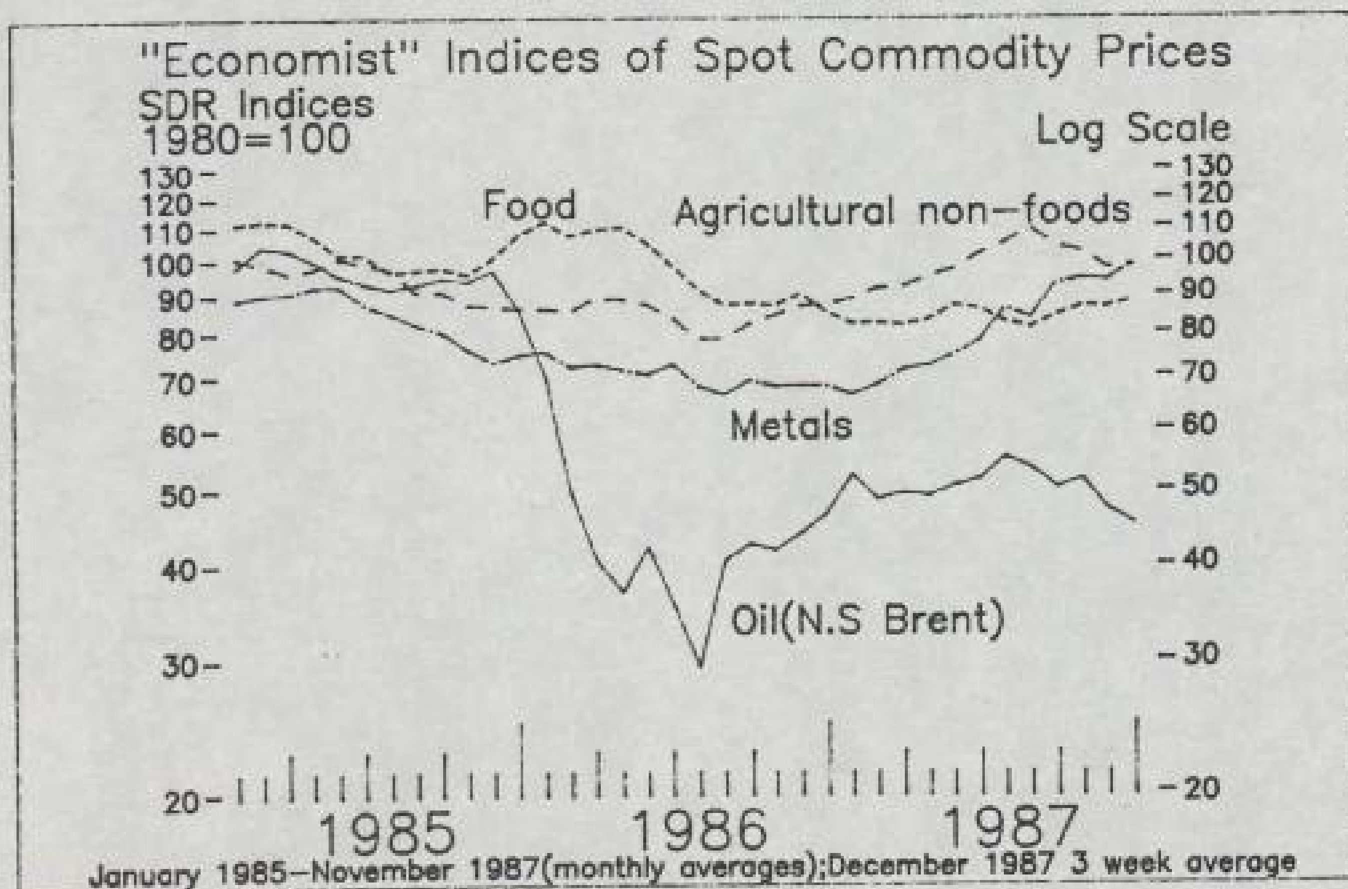


Chart 2



- under pressure from the US authorities who feared that Argentina was close to declaring a moratorium, the IMF Board (with the UK abstaining) has agreed to an extraordinarily soft amendment of its already weak Stand-by Agreement (SBA). A weakening of IMF conditionality is also evident in an SBA recently agreed for Cote d'Ivoire.

- some regional US banks have increased the level of their provisioning against ldc debt significantly beyond that established by Citibank and others earlier this year. While the move may not be followed (or could not be afforded) by major US banks, it may signal a less unified approach by creditors and could reinforce debtors' demands for relief.

- signature of the "Acapulco Commitment" by Heads of State of 8 Latin American countries, and the threat of 10 year suspension of debt service at the OAU debt summit reflect debtors' growing impatience with the current strategy. However, such moves fall far short of effective concerted action by debtor countries.

INTERNATIONAL FINANCIAL SCENE

World Economic Developments

1 There is, as yet, little sign of a weakening of OECD economic activity attributable to the collapse of world stock markets. Third quarter data indicate that prior to the crash growth was unexpectedly strong, and the latest indicators for the US provide little evidence of a slackening of output and investment, although consumer demand is flat. With post-crash fears of recession receding a little, and given the fall in the dollar that has occurred (over 5% in effective terms since end-October) coupled with a round of interest rate cuts in Europe, the Fed may be less resistant in future to upward pressure on US interest rates. These have firmed somewhat in recent weeks from lows recorded after the crash (Chart 1). While domestic concerns will remain paramount, the US authorities are no doubt also mindful of the dangers higher rates pose for the debt strategy (Table 1).

2 Since early November, non-oil commodity prices have also strengthened (Chart 2), although apparently more in reaction to short run supply side factors than more bullish expectations of demand. Metal prices have recovered particularly sharply, although prices of agricultural raw materials have remained flat. A rise in food prices largely reflects lower grain harvests and anticipation of higher Russian demand for soya meal and sugar.

TABLE 1

VULNERABILITY OF DEBTOR COUNTRIES TO A 1% RISE IN LIBOR

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Country	total debt at end 1986 $Bns	foreign currency reserves at end 1986 $Bns	% of debt floating	cost of 1% rise in LIBOR gross $Bns	net*	Exports of goods & services(XGS) in 1986 $Bns	1% rise in LIBOR as % of XGS gross	net*
Mexico	98.1	5.7	80.1	0.8	0.7	22.0	3.6	3.3
Argentina	51.7	2.3	60.2	0.3	0.3	8.7	3.6	3.3
Brazil	110.3	5.8	71.5	0.8	0.7	24.3	3.2	3.0
Venezuela	36.0	6.4	93.4	0.3	0.3	9.4	3.6	2.9
Chile	19.3	2.4	81.5	0.2	0.1	5.0	3.1	2.7
Poland	33.5	0.7	50.0	0.2	0.2	7.1	2.4	2.3
Morocco	17.8	0.2	36.3	0.1	0.1	3.0	2.2	2.1
Ecuador	8.4	0.6	71.7	0.1	0.1	2.6	2.3	2.1
Peru	15.0	1.4	40.3	0.1	0.0	3.3	1.8	1.4
Uruguay	3.9	0.5	64.3	0.0	0.0	1.5	1.7	1.4
Cote d'Ivoire	9.3	0.0	47.6	0.0	0.0	3.9	1.1	1.1
Egypt	44.6	0.8	12.8	0.1	0.0	4.5	1.3	1.1
Philippines	29.3	1.7	35.2	0.1	0.1	8.3	1.2	1.0
Nigeria	20.3	1.1	41.7	0.1	0.1	7.6	1.1	1.0
Bolivia	3.7	0.2	26.4	0.0	0.0	0.8	1.2	1.0
Yugoslavia	19.4	1.5	61.0	0.1	0.1	12.8	0.9	0.8
Colombia	15.0	2.7	40.7	0.1	0.0	6.5	0.9	0.5
Jamaica	3.9	0.1	18.8	0.0	0.0	1.4	0.5	0.5
Total sample	539.5	34.1		3.2	2.9	132.8	2.4	2.2

* interest on debt less foreign currency reserves

3 Oil prices have declined more than 15% since July against a background of surplus stocks and overproduction, particularly by Iran, Iraq, Kuwait and the UAE. Differences within OPEC over future pricing and production policy were not resolved at the Ministerial meeting (which merely reaffirmed existing quotas and the $18 benchmark) and prices subsequently fell sharply. If sustained, weaker oil prices will compound the problems of debtors who are major oil exporters, while bringing only limited benefit to others whose net oil imports have declined sharply since the price shocks of the 70s (Table 2).

4 Significant sovereign or sovereign guaranteed market borrowing by debtors since end-October include syndicated credits to Indonesia ($300 mn) and Greece's telecommunications utility OTE ($175 mn). International bond issuers include China's International Trust and Investment Corporation ($362 mn), the Industrial Development Bank of India ($120 mn) the Bank of Greece ($180 mn) and Trinidad and Tobago ($56 mn)[1].

Debtor Creditor relations

5 Signature of the $3 bn interim financing package for Brazil began as scheduled on 15 December. For purposes of selling the deal domestically it was important for Brazil to claim that the banks had been persuaded to put up new money (in respect of 1987 Q4 interest) without a formal IMF programme being in place. On the other hand the banks will be receiving more in interest than they are lending. British banks have made it clear that their participation in any medium term facility (which will trigger the second tranche of the interim facility - this amounts to a bridging loan covering 1987 interest arrears) will be contingent on Brazil seeking a fully funded IMF programme and being current on interest from the beginning of 1988. (However, discussions on a Fund programme have not yet commenced). Peer pressure had to be applied to some UK banks (those standing to receive less in net terms relative to their exposure) before they agreed to participate. The banks will be relying on an unwavering stand by the Paris Club which is now insisting on an SBA in return for agreeing to reschedule 1987 principal. The resignation of the Finance Minister, Senhor Bresser, in protest over the slow progress on the fiscal front casts a shadow over the prospects of securing medium term financings associated with adequate adjustment measures.

6 Past attempts by debtors to present a united front (eg the Cartagena Declaration of June 1984) have met with little success, largely owing to a lack of political commitment and a diversity of interests. The "Acapulco Commitment [to Peace, Development and

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(1) Amounts shown are US dollar equivalents. Annex Table H lists bank borrowing and international bond issues over the past three months.

TABLE 2

VULNERABILITY OF BAKER 15 TO A $1 PER BARREL FALL IN THE OIL PRICE

Country	Change in value of net oil exports (1) (million dollars)	Exports of goods & services (XGS) in 1986 (billion dollars)	$1 FALL in oil price as % of XGS
Argentina	-43.4	8.7	-0.5
Bolivia	NA	0.8	NA
Brazil	185.1	24.3	0.8
Chile	19.1	5.0	0.4
Colombia	-39.6	6.5	-0.6
Cote d'Ivoire	6.9	3.9	0.2
Ecuador	-74.5	2.6	-2.8
Mexico	-484.9	22.0	-2.2
Morocco	36.0	3.0	1.2
Nigeria	-452.6	7.6	-5.9
Peru	-20.4	3.3	-0.6
Philippines	51.0	8.3	0.6
Uruguay	9.8	1.5	0.7
Venezuela	-560.0	9.4	-6.0
Yugoslavia	73.7	12.8	0.6
Egypt	-91.3	4.5	-2.0
Total Baker 15 (Omitting Bolivia but including Egypt)	-1385.1	123.5	-1.1
Memoranda			
Major net exporters (Ecuador,Mexico,Nigeria Venezuela and Egypt)	-1663.3	46.1	-3.6
Remaining countries	278.2	77.4	0.4

(1) Calculated from 1986 net export volumes (Egypt figure based on 1985 and Cote d'Ivoire figure a 1985 projection), assuming no supply / demand adjustment as a consequence of the price fall.

Democracy]" recently signed by eight[1] Latin American Heads of State is more a reflection of debtor frustration with the current strategy than a signal of the beginning of a concerted approach to future debt negotiations. None of the objectives set out in the Commitment is new and emphasis is given to supporting fellow signatories in their individual negotiations with creditors. While the document falls short of calling for unilateral limitations on debt service, it does suggest that such a step may become necessary if negotiations fail. Its expression of solidarity with those countries who have already opted for a partial moratorium may persuade others to follow suit.

7 Contemporaneous with the stance taken at Acapulco, the special OAU Debt Summit concluded with a call for a conference with creditors to agree a concessional rescheduling of Africa's debt over 50 years and an increase in aid flows. In the event of a failure to reach agreement, a 10-year suspension of debt service from next year was threatened. The Summit was, however, poorly attended and it is unlikely that the more moderate leaders would join a moratorium.

IFI Conditionality

8 With agreement on an effective IMF programme for Brazil a distant prospect at best, the credibility of the IMF's conditionality has, at least in UK eyes, been undermined by the Executive Board's approval of soft amendments of Argentina's already weak SBA. The UK abstained and would have voted against had it not been for the risk that such a step would have been regarded as politically motivated. Under pressure from the US authorities and M Camdessus, who had become convinced that Argentina would have declared a moratorium, the Board was effectively presented with a fait accompli. Other countries, which unlike the UK had participated in the bridging loan, had little choice but to support if they were to get their money back (Board approval was required for the disbursement of IMF and IBRD funds). The move is, however, likely to be interpreted by debtors, and particularly the Brazilians, as a weakening of creditors' resolve when under pressure. The IMF also loses credibility with the banks, whose reluctance to participate in future credit packages will only have been reinforced. Recent Board approval in principle of a weak programme for Cote d'Ivoire is also unhelpful, although the UK received some support in calling for the programme to be strengthened at its first review. The US does, however, appear to have hardened its previously soft attitude to Egypt's weak SBA. Political

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(1) Argentina, Brazil, Colombia, Mexico, Panama, Peru, Uruguay and Venezuela. The Cartagena group excludes Panama but also includes Bolivia, Chile, Ecuador and the Dominican Republic.

opposition to a third Structural Adjustment Loan for Chile was led by the US in the World Bank, although the loan was approved. The UK, supported by Germany and Japan, took the line that there were no economic grounds for refusing the loan and to do so for political reasons would threaten the integrity of the Bank and would lay open creditors to the charge of inconsistency. While supporting the loan, the UK has used the opportunity (as on a similar occasion last year) to underline our concerns on human rights through a direct approach to the authorities in Santiago.

Secondary market

9 Debtors have increasingly pointed to the large discounts on their debt in the secondary market (Chart 3 - but prices are available only to late November) as a basis for debt relief (capturing a share of the discount was stated to be one of the primary objectives of the Acapulco Commitment). Apart from a basic resistance in principle to calls for relief to middle income debtors, creditors have stressed that turnover in the market represents a tiny proportion of the debt outstanding and is often motivated by special tax and regulatory factors; prices struck in the market may therefore be unrepresentative of expectations regarding future debt service. A serious objection to basing debt relief on secondary market discounts (assuming that relief had indeed been conceded) is that of moral hazard: a good part of the discount can be attributed to the unsound policies of the debtors themselves and their perceived unwillingness to service their debts in full.

10 Given these arguments, it is unfortunate that the Bank of Boston (one of the largest regional banks in the US), in announcing an increase in provisions against non trade-related ldc loans to levels well above those established following Citibank's move last May, should cite deep secondary market discounts as a factor. The bank has also written down the value of its loans and placed them on a non-accrual basis; in future it will effectively treat interest receipts as repayments of principal. Other middle-ranking US banks have also raised their provisions. Such moves are unlikely to be followed (or can be afforded at present) by the main money centre banks (which have a heavier ldc exposure), but may well encourage debtors in their demands for relief. (Prepayments of private sector debt at large discounts to face value also appear to have been prominent in the capital outflows which accompanied the collapse of Mexico's stock market. With the rescheduling terms on this debt recently extended to 20 years, some banks were prepared to bear the cost in return for immediate repayment.) Secondary market sales do not formally absolve the banks from contributing to new money packages but such divestments are likely to mean an increasing reluctance to participate.

Support for the Poorest Countries

11 The IMF's SDR 8.2 bn Extended Structural Adjustment Facility (ESAF) (SDR 6 bn plus what remains of the original SAF) continues to take shape. The UK has offered to contribute sufficient funds to finance an interest subsidy on about SDR 1 bn (about one sixth) of the low interest loans to be made available. A UK proposal that access limits to the new facility be formally skewed in favour of the most debt-distressed is unlikely to be adopted, although in practice such countries are likely to enjoy a larger than average quota share of the resources available. At a donor's meeting held under IBRD auspices, $6.3 bn of assistance over 1988-90 (about half representing additional sums) was pledged. The UK announced that it expected to provide £250 mn of programme aid grants, of which £120 mn would be in the form of co-financing with World Bank policy based loans. At the Paris Club an IBRD presentation, using rescheduling options for Zambia as a model, usefully reinforced the UK case for cuts in moratorium interest rates for the poorest countries making genuine adjustment efforts. The UK also proposed that the Club examine revised AfDB proposals (formulated by Warburgs) for the concessional securitisation of African debt, recognising that these continue to present problems in terms of effective conditionality, sovereignty and equality of treatment between creditors. Securitisation was also raised at the Franco-African summit. The UK, along with other donors, has also increased its contribution to the Fifth Replenishment of the African Development Fund to compensate for a shortfall in the US contribution.

Further details on individual countries are given below.

LATIN AMERICA AND CARIBBEAN

Brazil

12 The domestic recession, which has been an important contributory factor to a strong improvement in the trade balance, continues: industrial output fell over 5% in the year to September (against a rise of 7.6% in the year to July) and unemployment has returned to the levels of H1 1986. In spite of the temporary price freeze (lifted at the end of August), inflation remains high and has increased to 338% in the 12 months to November. The trade surplus for January-November was $10.1 bn.

13 The authorities are considering further action to control the inflationary impact of the fiscal deficit by creating a capital gains tax and eliminating a range of tax incentives for certain imports and investment funds. They have, however, withdrawn proposals for a 1/2% personal wealth tax. The short-term impact of these measures,

if implemented, will probably damage the prospects for industrial growth. The 1987 operational deficit is now projected by the authorities to be nearly 5% of GDP rather than the original 3.5%, and 1988's operational deficit is forecast to be 4%. Finance Minister Bresser's frustration with the slow progress on the fiscal front led to his resignation.

14 More generally, political uncertainty has increased: the Constituent Assembly's "systematisation" committee has voted for a parliamentary form of government and to restrict President Sarney's term of office to four years; Congress is likely to endorse this decision which would require a presidential election in late 1988.

15 The timetable for progress towards a medium-term financing is as follows: terms sheet to be agreed by 15 January, critical mass (undefined) of commitments by 15 March, effectiveness by 16 June. If effectiveness is not achieved as scheduled no disbursements will be made under stage two of the interim deal.

Mexico

16 Trade figures which will reflect the recent weakening of oil prices are not yet available. In the first 8 months of the year non-oil trade was in approximate balance with exports up 27% and imports down 3% on a year earlier. There are signs, however, of import growth picking up sharply. Oil exports in the year to August were 46% higher than in the same period of 1986. Tourist receipts in the first 7 months were 35% up on a year earlier.

17 Prices on the domestic stock market, which had risen spectacularly earlier in the year, suffered a dramatic reversal in recent weeks: by 19 November prices had fallen 75% from their peak before recovering subsequently. As investors switched into dollars, interest rates were raised to record levels. When Central Bank support for the free market peso was withdrawn on 18 November, the rate fell 35-40% in 2 days before partly recovering. Despite recent losses the reserves remain high, at over $14 bn.

18 With inflationary expectations boosted by the sharp depreciation, and the unions threatening a general strike, the Government has secured a new "Economic Solidarity Pact" (PSE). Elements of the package include a 17 1/2% devaluation of the controlled peso, a wage-price package involving immediate once-off increases in wages and public sector prices to be followed by a 2 month freeze and subsequent de facto wage indexation, cuts in government spending, and a reduction in import tariffs. The aim is to increase the primary fiscal surplus from 5.4% to 8.3% of GDP and to reduce the

overall deficit (which includes the inflation indexed element of interest paid on domestic debt) from 22% to 20.5% of GDP. By the end of 1988 the authorities aim (optimistically) to have reduced monthly increases in consumer prices to 2%.

19 Disbursements from the banks' financing package reached $4.37 bn in November following the drawing of the second tranche of new money ($872 mn) after the effectiveness of the package was attained on 22 October. The IBRD approved a second Trade Policy Loan for $500 mn on 12 November, rewarding measures taken in 1987. The debt-equity scheme was suspended for two weeks in November while the authorities reviewed its potential inflationary impact. Since the scheme's inception in April 1986 applications have totalled $2.5 bn, approvals have been $1.7 bn, and up to H1 1987 $815 mn had been put into effect.

Argentina

20 Industrial activity declined by 0.5% in Q3. The IMF's forecast for real GDP growth this year has been revised down by half to 2% (against actual growth of 5 1/4% in 1986). Following the introduction of the wage-price freeze in October the authorities expect inflationary pressures to ease, but prices still rose by 10% in November, the 12 month change increasing to nearly 180%. Argentina's external position continues to deteriorate although any benefits from October's 10.8% depreciation have, of course, yet to work through. The current account deficit for Q1-Q3 was $2.2 bn against $2.9 bn in the whole of 1986.

21 The IMF Board approved an amended SBA on 2 December, the UK, Australian and Dutch directors abstaining. Performance under the existing programme had been extremely poor: five of eight performance criteria were missed at end-August. Only three, much weaker, end-year performance criteria have been specified under the new programme and end-year targets for macro-economic indicators have been substantially relaxed. The PSBR is forecast to be 5.6% of GDP, against 3.9% projected in August. Inflation is forecast to be 150% by December, against 82% in 1986. The overall balance of payments deficit is forecast to rise to $4 bn and will be met by a postponement to 1988 of the proposed decrease in arrears and drawings from international reserves. There are no targets or projections for 1988 but a significant financing gap exists. Approval of the SBA amendments permits disbursement of the second tranche of the programme (SDR 165.5 mn) and of the second tranche of the World Bank Trade Policy loan which together provide the take-out for the official bridging loans of $475 mn, disbursed on 11 November and due to be repaid by 31 December. (Repayment may be delayed as payment of the IBRD money may not be made until January.) Disbursement of the second tranche ($500 mn) of the commercial bank new money package is also

conditional upon the resumption of Fund drawings. The amended programme's success depends upon proper implementation of measures contained in October's economic package. However, Congressional approval of the measures is proving difficult and there have been strikes and other public opposition. There has been a surprising measure of agreement between the Radicals and Peronists in Congress on a range of issues including tax reform. But this is likely to result in dilution of tax measures and further slippages against already weak IMF targets. Despite the obvious weaknesses of the programme, the UK has little choice but to participate in a new Paris Club rescheduling (assuming bilateral agreements for the 1985 and 1987 reschedulings are signed).

Venezuela

22 Real GDP growth is expected to slow from 5.2% in 1986 to 2.8%. The PSBR for 1987 is officially forecast to be 6.2% of GDP, virtually the same as last year, but, somewhat optimistically, is expected to decline to 4% in 1988 even though expansionary policies are set to continue. Despite the price freezes since May, inflation continues to be a problem as the effects of last December's devaluations and the mid-year compensatory wage bonus continue to be felt: prices rose by 2.4% in October to give an annual rate of 34.9%, against 13.4% at October 1986. The high rate of inflation has pushed the fixed official exchange rate to an even more over-valued position.

23 All commercial banks signed the amended public sector MYRA on 13 November, ahead of the 16 November deadline: Venezuela may now benefit retroactively from the reduced interest rate spread which will be applied from 1 April 1987. Some progress has been made on the private sector debt rescheduling but several issues remain outstanding. Hector Hurtado, who has replaced Azpura as Finance Minister, has stated that Venezuela is seeking $8 bn of additional external borrowing before 1991 to finance large-scale industrial and infrastructure projects. He is also seeking to increase short-term credits to the private sector from $2.5 bn to around $4 bn. No formal request for new money from the banks has, however, been made.

24 Following a mission earlier in the year, the IBRD has declared Venezuela re-eligible for loans (having graduated from IBRD lending in 1975): trade reforms are being discussed and may form the basis of a trade policy loan. The Fund Board is due to discuss Venezuela's Article IV report on 18 December: Fund staff were still critical of the government's expansionary policies and recommended a reduction of fiscal spending plans and a more effective exchange rate policy.

Chile

25 GDP grew by 6 1/2% in H1 compared with H1 1986, and 5% growth is expected for 1987 as a whole. Domestic demand remained buoyant in Q3. The inflation rate continues to rise (22.3% in the 12 months to October). While exports have been boosted by the rise in copper prices, imports are up strongly - consumer goods imports were 26% higher than during the same period last year, and may partly reflect greater black-market trade with Bolivia, goods being subsequently smuggled from Chile to Bolivia. In the first 9 months of the year there was a trade surplus of $742 mn, against $905 mn for January-September 1986. The IBRD Board has approved a third SAL (see para 8 above).

26 Debt-equity swaps rose from an average of $50 mn a month to $100 mn in October, partly in response to the change in legislation which now allows foreign-owned investment funds to invest debt-equity swap proceeds in the stock market.

Ecuador

27 The January-September trade deficit was $5 mn (cf a surplus of $541 mn during the same period in 1986). Oil exports have, however, resumed since August. The exchange rate continues to be under pressure: the free market rate depreciated by 50% in the period January-November while the official rate fell 31% over the same period, despite various measures including higher reserve requirements and import deposits. Inflation has begun to slow, however, falling to 27.3% in the 12 months to October as against 32% in July.

28 Ecuador and the banks reached a preliminary agreement at end-October: old debt of $4.3 bn will be rescheduled over 19 years/7 grace at LIBOR +15/16%, old "new" money ($631 mn) will be rescheduled over 10 years/3 grace at LIBOR +1%. $350 mn in new money from the banks has also been requested and will be provided without IBRD co-financing but with a parallel loan. A condition of the loan, that interest payments be current from 15 November, has broadly been met. A Paris Club rescheduling has been set for January.

Peru

29 The economy goes from bad to worse with the authorities doing little but to respond to the pressure of events. During January-July there was a trade deficit of $109 mn, against a surplus of $347 mn during the same period last year: exports were little changed while imports were 46% higher and were boosted by rising consumption

and a huge (57%) appreciation of the real effective exchange rate in the first nine months of 1987. There was, however, a nominal devaluation of 20% in October followed by a 39% devaluation in December. Interest rates may also be sharply raised to stem capital flight. In H1 the current account deficit was $792 mn. The IMF foresees a current account deficit of $1.6 bn for the year. Inflation continues to rise: the CPI rose 104.8% in the twelve months to November, against 62.9% at end-1986. Real GDP growth of 6% is forecast for 1987. The PSBR (including arrears) is expected to reach 9.1% of GDP in 1987, up from 7.4% in 1986: net losses of parastatals are of particular concern and are likely to reach 5.3% of GDP against a 2.6% surplus in 1985. Arrears are expected to rise by $2.6 bn (10.6% of GDP) in 1987 to total $7.6 bn (31% of GDP). (Arrears to the IMF and the IBRD have risen to SDR 350 mn and $157 mn respectively.) Central bank net reserves were only $240 mn at end-November, against $958 mn at end-1986.

30 Public sector debt servicing during January-July was 14.8% of goods exports, against a 19.5% outturn for 1986. The government has recently contacted the Paris Club and other creditor groups but has not offered anything really new. A resumption of IBRD lending has been requested, including a possible $1 bn in programme lending. No Fund programme is being contemplated. The banks have been asked for de jure recognition of the 10% debt servicing limit and the build-up of principal arrears: a meeting between the banks and Peru may occur in the second half of January. Reference has also been made to further "unorthodox" deals with creditors following the three debt-for-goods deals that have already been signed. At the political level President Garcia's popularity continues to decline but neither right nor left is able to present a credible alternative.

Colombia

31 With coffee prices falling sharply, there was a trade surplus of $221 mn on a cash basis in the first 7 months of the year as against $642 mn in the same period in 1986. Non-coffee exports, however, were up 27%, being boosted by higher oil exports. Total reserves (excluding gold) have remained constant this year, and were $2.7 bn at end-September; however, during the same period gold holdings have declined by half, suggesting that some liquidation has been occurring to compensate for lower export receipts. On the domestic side, the monthly rate of inflation has slowed slightly, although the October's 12 month figure was 24.8%, against 15.6% in October 1986.

32 The authorities' implementation of the tax reform introduced in December 1986 appears to have had some success: the PSBR forecast has been revised to 2.6% of GDP for 1987 against an earlier projection of 3.3%. The Fund's recent Article IV report

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was broadly favourable in its appraisal of the direction and implementation of Colombian economic policy. However, attention was drawn to the need to maintain a cautious fiscal policy to dampen inflationary pressures. The IBRD Board is expected to approve a $300 mn power sector loan on 8 December, as part of a $1.3 bn financing package for the power sector which also involves the IDB, foreign governments and commercial banks.

33 The banks' "voluntary" loan closed at $1 bn on 11 December. Earlier, the Colombian authorities, frustrated with the slow pace of progress, had threatened to suspend principal payments if the original 90% critical mass was not reached. All the major British banks have committed to the loan, though one has done so for less than its pro-rata share because of commitments to other new business with the Colombian government. All the loan will be disbursed in 1988.

Bolivia

34 The debt buy-back scheme took legal effect in November, following the Cabinet's approval of the scheme on 13 November. Bolivia now has a four-month period in which to make a repurchase offer to the banks. The Bolivians have said that any debt still outstanding after the repurchase period elapses will need to be rescheduled on concessional terms. There have been no further specific offers of funds from donor governments since the last Report. ODA has not yet come to any decision on the possible redirection of its aid contributions to the buy-back scheme. A delay in approval of the new Fund programme has resulted in the Paris Club discussion of a further rescheduling being deferred from December to February or March 1988.

Other countries

35 Uruguay has enjoyed stronger than expected growth and made progress in reducing inflation. Its trade balance has, however, deteriorated. The IMF have, exceptionally, approved an SBA for Costa Rica even though the authorities and the banks have not yet reached an understanding on a new financial package and interest is only being partly paid. Jamaica has benefited from a boom in tourism and is meeting targets under its SBA. No further commercial bank rescheduling is expected but a further approach to official creditors is likely. Political unrest in Panama led to a suspension of US aid and a delay in negotiations with the Fund on an SBA. Although a short term rescheduling package was agreed with the banks at the end of August, in the absence of an IMF programme no progress has been made in rescheduling Paris Club Debt. In late November ECGD guaranteed a soft loan of £14.2 mn for Panama for a power station project. The loan blends an export credit with a grant from ODA's ATP soft loan scheme and is the first such loan to finance UK exports to Latin America.

SOUTH AND EAST ASIA

Philippines

36 Real GNP was 6.8% higher in Q3 than a year earlier. However, the current account recorded a $219 mn deficit in the first three quarters of 1987 (cf a surplus of $809 mn in the same period of 1986), markedly worse than official forecasts. The authorities have pinpointed higher than expected purchases of capital goods as the main culprit but argue that this underlines the strength of the economic recovery. On the political front President Aquino's position has strengthened, promising greater stability than of late.

37 A compromise has finally laid the issue of Planters Products Inc. (PPI) to rest. Barclays and fellow creditors have agreed to a discount of 15% on PPI debt, as opposed to 12 1/2% originally proposed. The somewhat complex mechanics of the compromise deal result in the banks exchanging PPI debt for Central Bank debt. On the strength of the compromise, Barclays signed the rescheduling agreement on 13 November and it is almost certain that the remaining loose ends will be tied up before the new deadline of 22 December.

Malaysia

38 In Malaysia the FY1988 Budget was presented on 23 October. Total Federal Government expenditure is earmarked to rise by 4% (around 3% in real terms) in 1988, whilst the Government expects higher domestic demand and more buoyant tax receipts to push revenue up by 20% (the projected consolidated public sector deficit is nevertheless equivalent to 15% of GDP). The government's recent move to ban three newspapers and imprison over 100 prominent activists (44 have subsequently been released) is unlikely to improve the climate for foreign investment.

Indonesia

39 In Indonesia the recent crash in global equity markets is seen, at least in the short term, as helpful by the authorities, as nervous investors are said to have switched their money out of foreign equities and back into deposits with the banks in Indonesia. As a result, the level of readily usable reserves, which had been depleted after a major capital flight panic in the summer, is probably higher than the latest estimate of $4.5 bn (4.8 months' of imports of goods and services). The authorities are also expected to announce a cut in interest rates in the near future - from 17% to around 15.5% on 30 day deposits. Nevertheless, with inflation currently

running at around 7% p/a (down from a peak of 11% in August) real interest rates remain high. Although the fall in US interest rates following the stock market crash will have a beneficial impact on Indonesia's dollar debt servicing, this will be countered by dearer payments on the country's yen borrowings. Yen denominated debt makes up a third of total external debt at present.

EASTERN AND SOUTHERN EUROPE

Poland

40 At end-November Poland made the first payment ($73 mn) to official creditors under the rescheduling agreement reached at the October Paris Club and signed on 17 December. The banks continue to make progress in the documentation of their two-stage MYRA and it is hoped to sign in March. At this stage it is unclear to what extent the recent referendum result will have the effect of decelerating the pace of the planned reforms, but the Poles have probably lost the opportunity of using the result to counter US opposition to an IMF programme this side of the Presidential election. Recent changes in the Party politburo and Central Committee have, however, favoured the reformers. IBRD loans in support of exports and agriculture are apparently under discussion.

Yugoslavia

41 The commercial banks at their meeting with Yugoslavia in New York at end-October rejected a request for a 9-year MYRA to be repaid over 20 years with 7 years' grace and $0.9 bn new money. Negotiations are due to resume in mid-January and the banks will be looking for greater realism from the Yugoslavs. The Paris Club has made it clear that no negotiations can take place before an agreement is reached on a Fund programme. The package of economic measures announced in October was clearly an inadequate response, and the prices and wages freeze announced in November has already begun to fall apart. With cash flow problems becoming critical, the Yugoslavs have now requested an SBA but it remains to be seen whether the government's political position is sufficiently strong to enable it to implement the required adjustment measures.

Hungary

42 Preliminary negotiations between Hungary and the IMF over an SDR 700 mn programme, either in the form of an EFF or a succession of SBAs, ran into difficulty over the pace of adjustment. The Fund are pressing to reduce the convertible currency current account deficit to $400 mn in 1988 while the Hungarians envisage $500 mn. A

compromise is likely and it remains feasible that an agreement can be reached in the early new year. Tax measures announced in September and due to be introduced in the new year will dampen import demand. A recent government reshuffle also provides encouraging signs of commitment to reform.

Romania

43 Some discontent with current austerity measures has been reported. Imports have been severely constrained and reserves are very low as a result of the rapid debt repayment policy. The Romanians are seeking a CFF from the Fund in order to help finance the pre-payment of more expensive IBRD debt, although it is uncertain that they will qualify. Ceausescu has recently reaffirmed Romania's commitment to service its hard currency debt following earlier reports that Romania would not service IBRD loans until more favourable terms had been negotiated.

Greece

44 Although the current account position has improved this year, the end-1987 target for inflation look likely to be missed. The fiscal position has deteriorated sharply. Despite this there are indications that policy will be further loosened next year in advance of a general election. However, judged by the terms of recent borrowing, market confidence appears to remain unaffected.

Turkey

45 Prime Minister Ozal won 292 of the 450 seats in Turkey's general election on 29 November. The timing of the election has led to a four month postponement of the budget, in which austerity measures to curb the deficit are expected to be announced; long-delayed public sector price increases have, however, been implemented. Ozal has denied any intention to reschedule Turkey's debt ($33.1 bn at end-June) and indicated that the policy of gradual depreciation of the lira will continue rather than a step devaluation.

SUB-SAHARAN AFRICA

Nigeria

46 In late November, the Nigerians and the Steering Committee of commercial banks finally signed the 1986/7 rescheduling and $320 mn new money agreement. The main focus of attention is currently on the negotiations for a new Fund programme, agreement on which will trigger the first tranche of the banks' new money.

Although the Nigerians have made impressive progress in several areas such as exchange rate reform, the authorities will be urged to do more. The previous SBA broke down in the face of considerable slippages in fiscal policy and greater than programmed foreign exchange expenditure. While the government are prepared to take some action on the petroleum subsidy and have announced a number of price rises, the Fund is concerned that the 1988 budget will nevertheless be more expansionary than this year's, and that the Nigerians apparently intend to limit their debt service ratio in 1988 to 30%. According to the Fund, this will be inadequate to service Nigeria's likely external commitments even after rescheduling. As regards filling the 1988 financing gap, the Fund and World Bank are hoping for generous rescheduling of principal and interest from the Paris Club together with $500 mn of new money from ECAs, and that the commercial banks will maintain their exposure through 1988. These assumptions appear optimistic given, among other things, Nigeria's poor record in 1987. Banks will probably want to reduce their exposure and the Paris Club will be unwilling to reschedule interest if the banks are, in effect, taking it out. Uninsured creditors have been offered harsh terms for the rescheduling of promissory notes. A meeting of noteholders will be held in London on 14 January.

Cote d'Ivoire

47 The weakness of coffee and cocoa prices continues to dictate Cote D'Ivoire's economic fortunes. It is estimated that the loss of export earnings in 1987 from these two commodities ammounted to one half of the total debt service due. After declaring a moratorium in May, the Ivorians had protracted negotiations with the IMF and World Bank over a new adjustment programme. The new SBA is, however, weak, providing for inadequate fiscal adjustment and offering no prospect of balance of payments viability. Substantial financing gaps are in prospect into the early 1990s. Nevertheless, following approval of the SBA, the Paris Club agreed a rescheduling with a consolidation period matching that of the SBA. (100% of principal and 95% of interest were rescheduled over 10 years with 6 years' grace.)

Kenya

48 Also a victim of sharp falls in the price of tropical beverages and of the recovery in the oil price, Kenya has seen its balance of payments position deteriorate sharply this year and the financing gap is likely to be filled by IMF borrowing. Kenya's vulnerability to swings in commodity prices has meant that it has been a frequent user of IMF resources. It has, nevertheless, an excellent record in adopting Fund policy prescriptions and meeting programme targets. Kenya has so

far avoided a rescheduling of its debt. Its relatively weak bargaining position means, however, that it has to pay a higher spread on its borrowing than, for example, the problem debtors of Latin America.

Malawi

49 The authorities have accepted the need for a Fund programme together with a Paris and London Club rescheduling. An SBA could come to the Board early in 1988 with a SAF and a fourth SAL late in the year.

Zambia

50 President Kaunda has now accepted that certain aspects of the Interim National Development Plan (INDP) are 'negotiable'. This, coupled with the appointment of a new Bank of Zambia Governor, may possibly indicate an interest in moving towards a rapprochement with the international financial community.

Sudan

51 Despite the new found willingness of the authorities to implement adjustment policies, the immediate economic prospects for Sudan remain grim. Export earnings (which do not appear to reflect higher cotton prices), workers' remittances and aid flows (from the Gulf States and EC) have all been lower than expected. As a result, the narrowly defined financing gap for the balance of payments - which allows only for the most essential debt servicing and excludes clearance of arrears, eg, to the IMF and Paris Club - has been increased to $207 mn from $150 mn for the financial year ending June 1988.

52 On the domestic front, the situation is much the same. Lack of foreign exchange has caused severe shortages of essential imported inputs and limited budgetary resources have resulted in cutbacks in public investment.

53 The IMF is due to return to Khartoum in January for the Article IV consultations when it is hoped to discuss policies for 1988 in the context of a draft 4-year economic plan which the Sudanese authorities hope will be available by then. Arrears to the Fund now total SDR 520 mn and it is by no means clear that the international donor community will provide funds on the scale necessary to enable this position to be regularised. If an arrangement can be agreed to finance the arrears, Sudan may be a candidate for ESAF funds.

54 In the meantime, a fairly successful mini consultative group meeting took place on 2 December. Firm offers of aid were received totalling $140 mn including the UK (£10 mn), USA ($65 mn) and Netherlands ($30 mn), and the financing gap is expected to be closed by further contributions from Germany, Japan and Saudi Arabia. UK support was particularly well received by the Sudanese delegation. The meeting was followed by inconclusive discussions with the London Club.

MIDDLE EAST & NORTH AFRICA

Egypt

55 An IMF review mission to Cairo in early November found the adjustment programme off track and the Egyptian authorities unwilling to specify corrective measures. Without further measures, the budget deficit for FY 87/88 is likely to be 16-17% of GDP, compared with a targeted 13%. The government is concerned that rapid adjustment will arouse political opposition and further depress the economy. But unless there is significant movement - on the budget and interest rates in particular - by the authorities, the Fund Staff will find it difficult to complete the first review when they return to Cairo in January. Previously soft US attitudes to the weak SBA have recently hardened and the UK will be keen to support any initiative to strengthen the programme.

56 The authorities are moving faster than expected in the crucial area of foreign exchange reform. However, even though the new 'free rate' has attracted $1.3 bn of foreign exchange in the first five months since May, there are signs that it is being held artificially high and a parallel market has re-emerged. And the problems imposed for foreign banks, including Lloyds, remain unresolved: many of those affected are reconsidering their continued presence in this market.

Morocco

57 Despite H1 1987 improvements on the external account - exports rose 6.3% while import growth was restricted to 2.6% - the effects of a poor harvest and lower levels of remittances are likely to lead to a deterioration in the second half of the year. At the same time, domestic inefficiencies and fiscal austerity have depressed growth expectations; real GDP is now projected to grow by only 1% this year, down from 3% originally projected. As a result, it now seems certain that Morocco will be unable to meet all of its end-1987 performance criteria under the IMF programme; and there are signs that the authorities intend next year to give higher priority to protecting

the lower paid, with adverse implications for the fiscal position. The rescheduling agreement with the commercial banks has reached critical mass and the deal will become effective on 4 January.

Algeria

58 Estimates of Algerian indebtedness have recently been revised sharply downwards although the true position remains uncertain. Nevertheless, the economy remains depressed as the authorities continue to restrain imports and government expenditure. The IBRD recently reported that GDP fell in 1986 and forecast only 2% growth until 1990, less than expected population growth of 3.2% pa. Externally, it appears that Algeria has met its financing requirements this year (estimated at around $5 bn). Debt service is officially projected to increase in 1988 to $5.5 bn, giving a financing requirement of some $4 bn; with banks still very cautious about Algerian risk, further generous credit terms will be required if increased payments delays or rescheduling are to be avoided. Algeria's Finance Minister recently floated a number of proposals (eg seeking untied credit, and extended terms even for "cash" goods) particularly to those countries (including the UK) with which the Algerians think they have a bilateral trade deficit. Some (including the US) have agreed to provide food aid on generous terms or, like West Germany, to increase purchases of gas. HMG have resisted the Algerians' demands and pointed out that if the Algerians deliberately exclude UK goods which are better or cheaper than those produced by competitors, then they will suffer more than the UK. HMG remains keen to promote UK/Algerian trading links - and there will be a first meeting of an Anglo/Algerian Joint Commission early next year.

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10.12.87

OVERDUE FINANCIAL OBLIGATIONS TO THE FUND[1]

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding as at 10.12.87 SDR (mn)	Forthcoming Obligations (to 1999)
Kampuchea	13 March 1975	30.8	14.1
Guyana	31 May 1983	67.3	43.0
Viet Nam	6 February 1984	82.3	46.8*
Sudan	12 July 1984	517.3	322.3*
Liberia	25 January 1985	171.0	133.5
Peru	9 September 1985	338.4	414.0*
Zambia	30 April 1986	291.5	585.2
Siera Leone	16 January 1987	21.5	68.3*
Somalia	2 July 1987	8.5	144.6
Uganda	17 August 1987	9.6	214.5*
		1,538.2	1,986.3

(1) Includes both overdue repurchases and charges of members with at least one obligation overdue for more than one month.

NB The above figures are from Fund papers issued with respect to individual country complaints. There will have been further obligations falling due subsequently, so the figures are not entirely up-to-date. A Fund source indicates that total arrears were SDR1,542 mn as at 12.11.87 but this figure is not broken down by country.

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

* To 1993 only.

INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1987*	End-June 1987	End-March 1987 [2]	End-March 1987 [3]
Latin America				
Argentina	54	3.1(0.2)	0.2	0.2
Brazil	113	6.6(1.6)	1.0	1.9
Chile	19	1.2(0.1)	-	0.1
Colombia	15	0.5(0.1)	0.1	0.1
Costa Rica	4	0.1(-)	-	-
Ecuador	9	0.5(0.1)	0.1	0.1
Jamaica	3	- (-)	-	-
Mexico	104	6.3(0.6)	0.7	1.3
Peru	16	0.3(-)	0.1	0.2
Uruguay	4	0.3(-)	-	-
Venezuela	36	2.1(0.2)	-	-
Far East				
Indonesia	44	0.8(0.3)	0.9	1.8
Malaysia	20	1.1(0.3)	0.1	0.1
Philippines	29	1.4(0.1)	0.1	0.2
Eastern Europe (convertible currency)				
Bulgaria	5	0.3(-)	-	0.1
Hungary	18	0.3(-)	-	0.1
Poland	37	0.6(-)	1.3	1.4
Romania	5	0.2(-)	0.3	0.4
Yugoslavia	19	0.7(0.1)	0.7	0.9
Southern Europe				
Greece	20	1.3(0.2)	0.1	0.3
Turkey	33	0.5(0.2)	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 33 countries amounted to $18 million at end-June 1987.

[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 1987*	End-June 1987	End-March 1987 [2]	End-March 1987 [3]
Sub-Saharan Africa				
Cote d'Ivoire	10	0.3(-)	0.1	0.1
Kenya	4	- (-)	0.2	0.5
Nigeria	26	1.3(0.1)	2.5	3.5
South Africa	21	3.7(0.5)	0.9	2.5
Sudan	11[6]	- (-)	0.2	0.2
Middle East and North Africa				
Algeria	27	0.4(0.1)	0.2	0.4
Egypt	47	0.3(0.2)	0.3	1.3
Iraq	55[4][6]	0.1(-)	0.6	1.6
Israel	31	0.4(0.1)	0.1	0.2
Morocco	20	0.2(-)	0.2	0.3
Oman	3[6]	0.1(0.1)	0.7	1.9
Saudi Arabia	14[5][7]	0.5(0.3)	0.2	0.3

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[4] Includes $30 bn from Arab countries.
[5] Excludes unguaranteed non-bank claims.
[6] Total external debt at end-December 1986.
* Current estimate.
[7] Gross external debt to banks at end-December 1985.

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

9 November 1987

C Powell Esq
10 Downing Street
LONDON
SW1

Dear Charles

INTERNATIONAL DEBT SCENE

... I attach the regular report on developments in the international debt scene. The main developments since the Bank and Fund meetings in Washington in September are summarised on the first page of the report.

The major new development discussed by the Interdepartmental Debt Group was the impact of the collapse in world stock markets on the outlook for debtor countries. It is too early to reach any firm conclusions on this. The eventual outcome will depend on what happens in the markets, on the policy response in the major industrialised countries and on the effects on confidence. But it is clear that the debtor countries' export prospects will be damaged by any slowdown in growth, particularly in the US, and by the likelihood of lower commodity prices. The JIC plans to make a fuller assessment in December, if the situation has got any clearer by then.

The earlier Bank and Fund meetings themselves made a constructive contribution towards the overall debt strategy with progress being made on a GCI for the World Bank, enhancement of the IMF's SAF and acknowledgement of the need for special treatment for the poorest most heavily indebted countries (to whom the Chancellor's initiative is directed). Some interesting ideas emerged from Secretary Baker and Managing Director Camdessus on how to keep adjustment programmes on track by allowing some flexibility, particularly in the short term for events outside the debtors' control. Baker proposed that the Compensatory Finance Facility be developed into a conditional External Contingency Facility (covering a wider range of contingencies including interest rates) and Camdessus proposed greater use of the Extended Fund Facility. Fund Staff are now working on these ideas.

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On individual countries, Brazil and the commercial banks' Advisory Committee have reached an understanding under which $4.5 billion would be made available - $3.0 billion from banks and $1.5 billion from Brazil - as an interim package to enable Brazil to pay interest arrears. The agreement includes a commitment by Brazil to seek an IMF programme as part of a further medium-term package, which is to be in place by mid-1988. These are welcome developments but the Advisory Committee may still have problems "selling" the agreement to other banks.

Elsewhere, the report notes the inadequacy of the recent measures in Argentina and the need to send a suitable response in the Fund Board, and a further deterioration in the outlook for Yugoslavia. On the positive side, Mexico continues to perform well and the Poles have reached a new agreement with the Paris Club covering the period to the end of 1988. Although the Fund programme has broken down, there are some indications that the Nigerians will take the steps necessary to put their adjustment programme back on course.

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

Yours sincerely

Jonathan Taylor

J M G TAYLOR
Private Secretary

Attached to PS/CLEQ, to CDP 9/11

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INTER-DEPARTMENTAL DEBT GROUP REPORT: NOVEMBER 1987

1 Main points

- The collapse in world stock markets, while accompanied by a partial reversal of recent increases in interest rates, is likely to have an adverse impact on the export prospects for ldcs and, overall, to aggravate their external financing difficulties.

- The IMF/IBRD meetings produced a number of initiatives. Momentum on the SAF expansion and the World Bank GCI has built up.

- Brazil's negotiations with the banks remain delicately poised. However, an interim financing package, which would commit the Brazilians to seek an IMF programme as part of a longer term arrangement, is nearing agreement. It should prevent US loans to Brazil from being declared "value impaired" by ICERC*

- Argentina has introduced an economic package and will have been encouraged by the readiness of the US to assist with bridging finance. The government's policies, while probably insufficiently tough to satisfy creditors, have provoked a Peronist-led general strike.

- Only two-thirds of a $1.06 bn "voluntary" loan to Colombia has been taken up.

- Poland and Uruguay have reached rescheduling agreements with the Paris Club and the banks respectively.

- Nigeria has made progress in meeting IMF conditions for an SBA, raising hopes of a signing of a modified agreement with the banks and a resumption of IBRD lending. The Nigerians have made proposals to reschedule promissory notes to unguaranteed commercial creditors on terms far inferior to those negotiated by the Paris Club.

- The credibility of IMF adjustment programmes will be tested by forthcoming consideration of programmes/waivers for Argentina, Ivory Coast and Egypt.

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* The US Inter-Agency Country Exposure Review Committee

CHART 1

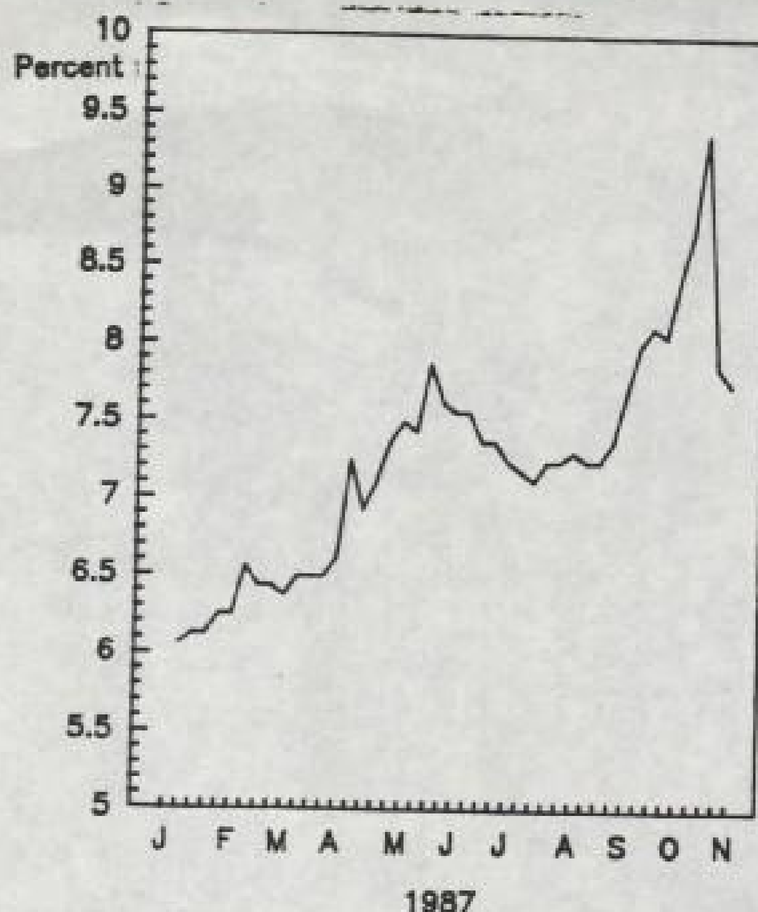


TABLE 1

VULNERABILITY OF DEBTOR COUNTRIES TO A 1% RISE IN LIBOR

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Country	total debt at end 1986 $Bns	foreign currency reserves at end 1986 $Bns	% of debt floating	cost of 1% rise in LIBOR gross $Bns	net* $Bns	Exports of goods & services (X&S) in 1986 $Bns	1% rise in LIBOR as % of X&S gross	net*
Mexico	98.1	5.7	80.1	0.8	0.7	22.0	3.6	3.3
Argentina	51.7	2.3	60.2	0.3	0.3	8.7	3.6	3.3
Brazil	110.3	5.8	71.5	0.8	0.7	24.3	3.2	3.0
Venezuela	36.0	6.4	93.4	0.3	0.3	9.4	3.6	2.9
Chile	19.3	2.4	81.5	0.2	0.1	5.0	3.1	2.7
Poland	33.5	0.7	50.0	0.2	0.2	7.1	2.4	2.3
Morocco	17.8	0.2	36.3	0.1	0.1	3.0	2.2	2.1
Ecuador	8.4	0.6	71.7	0.1	0.1	2.6	2.3	2.1
Peru	15.0	1.4	40.3	0.1	0.0	3.3	1.8	1.4
Uruguay	3.9	0.5	64.3	0.0	0.0	1.5	1.7	1.4
Cote d'Ivoire	9.3	0.0	47.6	0.0	0.0	3.9	1.1	1.1
Egypt	44.6	0.8	12.8	0.1	0.0	4.5	1.3	1.1
Philippines	29.3	1.7	35.2	0.1	0.1	8.3	1.2	1.0
Nigeria	20.3	1.1	41.7	0.1	0.1	7.6	1.1	1.0
Bolivia	3.7	0.2	26.4	0.0	0.0	0.8	1.2	1.0
Yugoslavia	19.4	1.5	61.0	0.1	0.1	12.8	0.9	0.8
Colombia	15.0	2.7	40.7	0.1	0.0	6.5	0.9	0.5
Jamaica	3.9	0.1	18.8	0.0	0.0	1.4	0.5	0.5
TOTAL SAMPLE	539.5	34.1		3.2	2.9	132.8	2.4	2.2

* interest on debt less foreign currency reserves

International Financial Scene

2 Prior to the collapse in world stock markets, interest rates had continued to rise, driven by inflationary fears and concerns regarding continuing fiscal and external imbalances within the G3. On 19 October 6-month eurodollar rates had risen to 9.44%, more than 3 percentage points higher than their level at the end of 1986. Had the increase been sustained, it would have raised net annual payments by the Baker 15 middle income debtors by about $6 bn, or around 4% of exports of goods and services. (The vulnerability of individual debtors to changes in interest rates is shown in Table 1.)

3 Interest rates have subsequently fallen back sharply (Chart 1) as a global shift in portfolios out of equities found its counterpart in heavier investor demand for government securities and for liquid assets. While the reversal of recent interest rate trends will benefit indebted ldcs, the effect may well be outweighed by the adverse implications of the stock markets' collapse on growth in the industrial countries. Although the consequences of the impact on agents' wealth and investors' confidence is hard to quantify, and in any case will be conditioned by any changes in fiscal and financial policies within the G3, it seems likely that previous expectations regarding short term prospects for nominal income growth in industrial countries will not be realised. The WEP forecast completed before the collapse suggested domestic demand growth in major industrial countries (ex UK) over the next 2 years of around 2 3/4% pa, with import growth a fairly healthy 4-4 1/2%. With these growth rates now being marked down, ldc export markets and commodity prices will be less buoyant. More subdued real activity and fading inflationary fears should help to depress world interest rates. This prospect could, however, be upset by a sharp adjustment of the dollar with the attendant risk of higher US rates. Moreover, from the perspective of the debtors, real interest rates on borrowing will depend not only on the general trend in nominal rates but on their export prices (which could weaken) and on the risk premium demanded by lenders (which may well rise if their financing difficulties are perceived to have worsened). A widening in the spread between bank deposit rates and TB rates in the US (this had jumped sharply at the time of Citibank's provisioning but had subsequently fallen back) may partly reflect a deterioration in debtors' prospects. A recession could also strengthen protectionist sentiment, particularly in the US Congress. Overall, the external economic environment facing undebted ldcs has probably worsened.

4 Non-oil commodity prices have been volatile in recent weeks. (Chart 2.) Prior to the collapse in equity prices, which has had a knock-on effect in the commodity markets, metal prices had more than reversed earlier falls, with large gains in

CHART.2

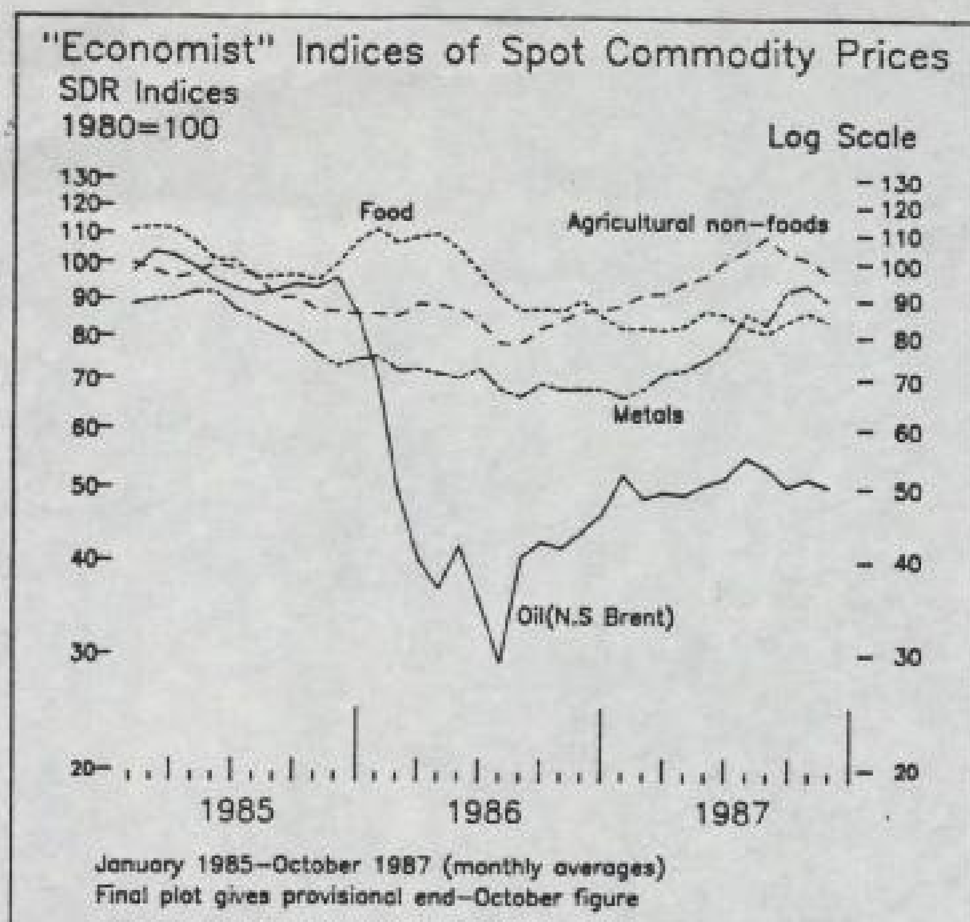


TABLE 2

Estimated Changes in Terms of Trade (%)
1986 Q4 to 1987 Q3(1)

Venezuela	24
Egypt	15
Mexico	12
Chile	9
Philippines	-2
Yugoslavia	-2
Zimbabwe	-3
Kenya	-5
Argentina	-6
Brazil	-7
Ivory Coast	-9

(1) Rough estimates based on movements in spot commodity prices and export prices of manufactures by industrial countries.

aluminium and copper. Prices fell more than 8% as equity prices dived. Prices of agricultural raw materials have weakened 10 1/2% since early September and food prices have reversed earlier gains over the past two months. The recent general weakness, conceals, however, a diverse pattern of commodity price movements in the year to the third quarter which is likely to have been reflected in the main debtors' terms of trade. Table 2 shows rough estimates of changes in the terms of trade of a number of debtors since 1986 Q4 based on spot commodity price movements. The recovery of oil prices has clearly been a major factor benefitting the terms of trade of net oil exporters, but countries dependent on agricultural exports have probably seen a further deterioration. Beneficiaries of the rise in metal prices include Chile and Peru.

5 Recent market borrowing by ldcs has included a 5-year, $200 mn bond at 1/16% over LIBOR by the Bank of China (the first Chinese eurobond issue in London since the settlement of the dispute over pre-revolution bonds) and a 9 1/2 year credit (3/8-5/8 over LIBOR) for the Chinese agency Liangmake Towers Co Ltd. A 5 year $100 mn syndicated loan was also arranged for Pakistan. Of greater significance to the debt strategy is a $50 mn 1 year bankers' acceptance for National Bank of Commerce of Tanzania (at a spread of 1 3/8% over eligible bill rate) providing pre-export finance for next year's coffee crop. This represents the first bank financing for a poor debt-distressed country subsequent to a rescheduling under an IMF programme. Cameroon has also been granted a FF184 mn ($30 mn) bank facility effectively subsidised by Brazil's ECA to finance imports of agricultural machinery.

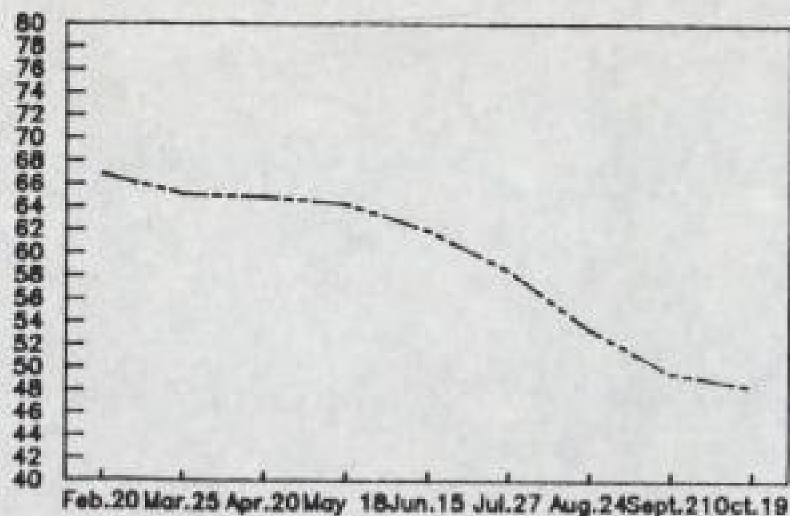
6 Overall, secondary market prices for ldc debt have fallen in recent weeks, but at a declining rate. (Chart 3 - but data are only available for the period prior to the stock market crash.) Bid/offer spreads, which had risen sharply in the late summer, have fallen back. The uncertain outcome of Brazil's negotiations with the banks and Argentina's growing economic difficulties had led to sharp decline in the market value of their debt. More recently, the price of Brazil's debt has stabilised. Mexico's relatively strong performance has both limited the fall in the price of its debt at a time of a general decline in values and has subsequently led to some recovery.

7 Bankers Trust has complied with a recent High Court judgment, after obtaining special licences from the US Treasury, and paid the Libyan Arab Foreign Bank the $292 mn (plus interest) frozen in London and New York, following the US blocking of Libyan assets in January 1986. Similar court cases are a possibility if Libyan entities now seek repayment of further dollar balances frozen in London.

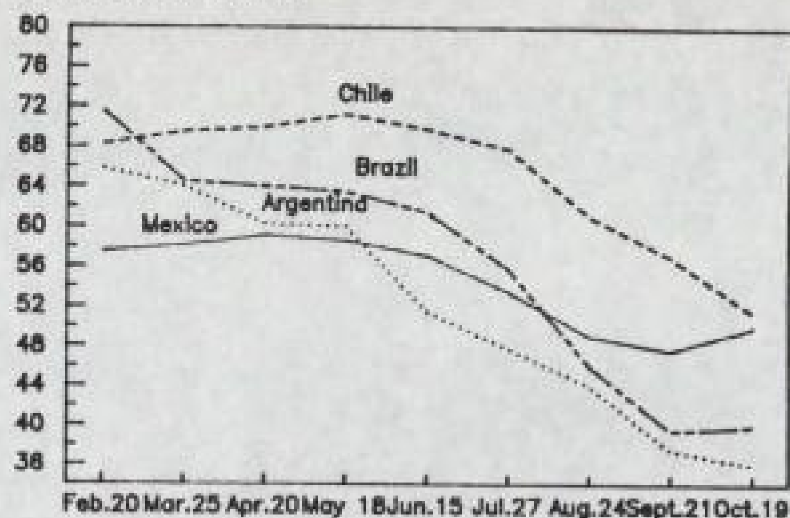
CHART 3

SALOMONS SECONDARY MARKET PRICES

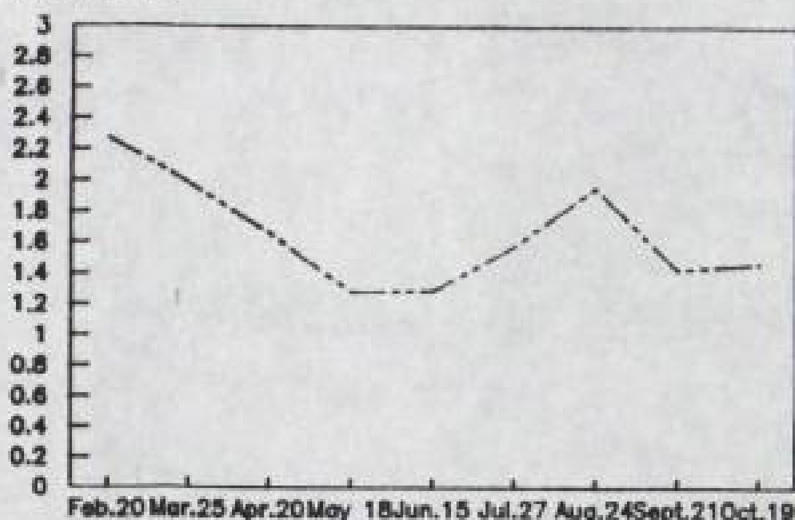
ALL IDR COUNTRIES (WEIGHTED AVERAGE)
MIDDLE PRICES



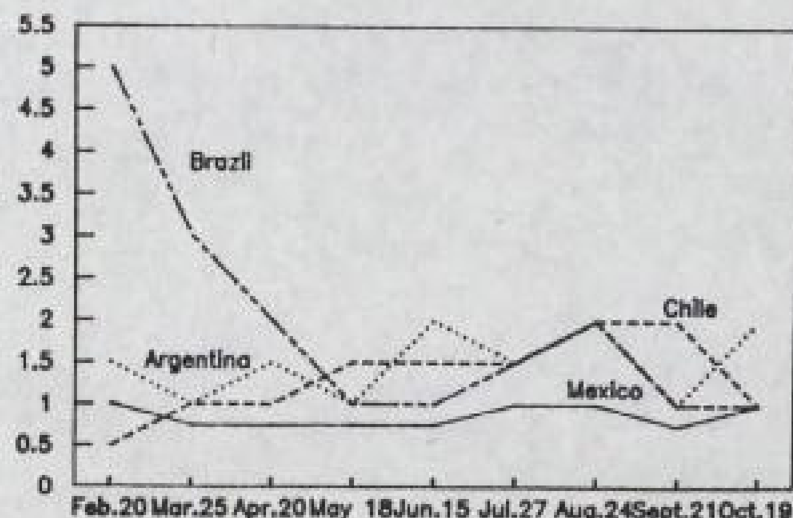
SELECTED MAJOR DEBTORS
MIDDLE PRICES



BID/ASK SPREADS



BID/ASK SPREADS



8 Although well-established positions were re-stated, speeches at the IMF/IBRD Annual Meetings were, nevertheless, generally conciliatory in tone and progress in key areas such as the proposed expansion of the SAF and GCI was apparent. Debtors predictably emphasised the burden of high interest rates and again aired the notion of a "sharing" of secondary market discounts with creditors. Senhor Bresser, speaking on behalf of Latin America and the Philippines, nevertheless rejected confrontation, and stressed the need for internal adjustment and the danger of pursuing "populist" policies.

9 Creditors, while remaining insistent on sound and sustained adjustment policies, and rejecting relief for middle income debtors, gave greater emphasis to the need for growth and stressed the importance of adequate financing from all sources over adjustment periods that now seem likely to be prolonged. Several creditors (including the UK) stressed the importance of expanding the "menu" of commercial bank lending. M Camdessus suggested that countries should make more use of the Extended Fund Facility and proposed measures to make Fund conditionality more flexible and administratively less burdensome while maintaining its effectiveness. Mr Baker proposed further development of the Compensatory Finance Facility into a conditional "External Contingency Facility" as a way of ensuring that growth-oriented programmes were not blown off course by events beyond a debtor's control. Such events would include, inter alia, a "sustained" rise in international interest rates. An expansion of the Fund's resources for the Facility was, however, explicitly ruled out.

10 At the meeting the US pledged support for a World Bank GCI and for the expansion of the SAF - providing the latter was financed by surplus countries. IMF staff are currently sounding out potential creditors regarding the capitalisation and interest subsidy elements of the expanded Facility. The UK has suggested a skewing of access limits in favour of the poorest debt distressed countries. As expected, however, most creditors remain resistant to UK and World Bank proposals to reduce interest rates on rescheduled official credits to the poorest countries, although other elements of proposed relief packages have received qualified support. Discussion of the SAF expansion and sub-Saharan African initiatives is likely to take place in a number of fora over the next few months. The IBRD have planned a special multidonor meeting in Paris on 3-4 December to review progress and, more specifically, to seek commitments on amounts to be made available by governments for cofinancing. This will follow a high level DAC meeting on 1-2 December. From the UK and other creditors' standpoint, damage limitation will be the main objective at a forthcoming UNIDO debt colloquium in Bangkok, the OAU debt summit, and the UN General Assembly's Second Committee.

11 Japan's foreign ministry has stated that Latin America will receive $4 bn of the $20 bn additional finance for indebted developing countries announced last May. Most of this will, however, be on non-concessional terms. Disbursements will be over the next three years, to countries following IMF-agreed adjustment programmes. Untied credits from Japan's EX-IM Bank will form 15% of the funds; 40% will go as capital replenishments for the IADB and the World Bank or private subscriptions to their bond issues; and 45% will be mixed credits from EX-IM Bank, the Overseas Economic Co-operation Fund and Japanese banks. As part of a wide-ranging package of measures for the Middle East, Japan also announced it will give aid to both Oman and Jordan (up to $200 mn and $300 mn respectively) and is also reported to be ready to provide assistance to Iran and Iraq for post-war reconstruction. (Such aid will be particularly welcome in Jordan where recent evidence suggests further deterioration in the government's finances and in the external position.)

12 Commonwealth Heads of Government endorsed the Chancellor's proposals for debt relief to Sub-Saharan Africa. At the CPM Mr Seaga's debt proposal (targeted at middle income debtors with a large share of debt to IFIs which cannot be rescheduled) was effectively sidelined.

13 Argentina, Brazil and Mexico have established a Latin American Group of 3 to strengthen consultations. Several basic points on debt were agreed: adjustment by debtors was only part of the solution; capital flight must be controlled; mechanisms should be found to create more automaticity in the provision of agreed disbursements and the financing of interest; better terms should be provided related to the real repayment capacity; individual IFIs should continue to be net lenders. Nevertheless, trenchant criticism of IMF policies made around the time of Argentina's election has not been repeated. The Argentine authorities will have been encouraged by positive US reactions to a new economic package and the haste at which a bridging loan has been proposed. The Americans' early support may have effectively finessed any move by other creditors to toughen conditions for further Argentine drawings under the SBA.

Details on individual countries are given below.

LATIN AMERICA AND CARIBBEAN

<u>Brazil</u>

14 Despite an easing of domestic price controls from end-August, monthly inflation in September fell slightly to 5.9% (6.4% in August); year-on-year, prices have risen 274%. A tightening of monetary policy since early 1987 is now having a dampening

impact on domestic demand. Cost-push factors, however, have continued to fuel inflationary expectations and, with the CPI expected to rise by about 9% in October, short-term interest rates, having dropped in September, rose back to 13% a month by mid-October. The downturn in domestic demand is underlined by the continuing strength of the trade balance, which registered a surplus of $1.5 bn in September, bringing this year's total to $7.8 bn (cf $8.7 bn January-September 1986). However, there continues to be strong pressure on both President Sarney and Finance Minister Bresser to resist deflationary measures and to take a hard line against an agreement with the IMF (but see para 16 below). Sarney's position looks particularly weak with Congressional calls for early Presidential elections.

15 Under the agreement reached in January, the Paris Club required a positive summing-up from the IMF MD on the basis of an Article IV report as a condition of implementing the rescheduling. At its September meeting, the Club did not consider the summing-up to be sufficiently positive and notified the Brazilian authorities that compliance with a full IMF programme would be a precondition of any rescheduling of 1987 maturities. The Brazilians have responded with a request for further discussions.

16 Negotiations with Brazil's commercial bank creditors resumed on 25 September when the authorities made a formal presentation to the Advisory Committee of their macroeconomic plan and 1987-89 financing requirement. The latter is broadly as reported previously, the major change being that the authorities have raised their financing requirement (either in fresh loans or in capitalisation of interest) by $3.1 bn, to $10.4 bn, spanning 1989 as well as 1987-88. The banks remained unwilling to consider financing of the magnitude requested and over such a time-scale unless the Brazilians also sought a fully-funded IMF programme. At a meeting on 2 October the Brazilians indicated a desire to have contingency facilities to cover changes in international interest rates and in terms of trade.

17 The pace of negotiations increased in late October with both the Brazilians and US banks anxious to head off an ICERC decision to classify loans to Brazil as "value-impaired". To avoid this step, which could threaten the provision of future new medium-term credits and short term lines, the US authorities themselves prepared an interim financing proposal which would require Brazil's agreement to seek an IMF programme. Under direct pressure from Baker, Bresser has apparently conceded this crucial point. The Advisory Committee are preparing a preliminary terms sheet but

the deal may still be hard to sell. The arrangements involve two stages and the establishment of an escrow account at the BIS. In stage one, which covers only interest payments due in Q4, Brazil will place $1/2 bn in escrow and the banks will make a binding commitment to lend $1 bn. Payment of the interest will be in two tranches: $1 bn on 30 November and $1/2 bn on 31 December. In stage two, which will cover interest arrears from 20 February to 30 September this year, the Brazilians will place $1 bn in escrow and the banks will commit $2 bn. The funds will be drawn on 16 June next and provide a 2 week bridge to be repaid on 30 June when, it is assumed, a drawing of new money will be available under a longer-term agreement to be negotiated.

Mexico

18 Mexico's trade surplus of $6.3 bn in the first nine months of the year (cf $2.4 bn in the same period of 1986) reflects both the recovery in oil prices and a rise of more than 25% in non-oil exports. Imports, moreover, have fallen 10%. The current account was in surplus of $3.1 bn in H1 (cf a deficit of $1.1 bn in 1986 H1). Gross reserves have risen strongly ($14.6 bn at end-August as against $7.0 bn at end-December). A 25% minimum wage rise from 1 October implies a continuing fall in real wages, contrary to the Government's public pronouncements. Monthly inflation slowed a little between August (8.2%) and September (6.6%), but September's 12 month change rose to 135%. The authorities hope that real exchange rate appreciation, tariff cuts and import liberalisation will help reduce inflation. Higher oil revenues resulted in a significantly lower PSBR in the first half of 1987 than had been targetted by the IMF.

19 Mexico's ruling party, the PRI, announced that the Budget and Planning Minister Carlos Salinas de Gortari would be their candidate in next July's Presidential elections, which the PRI is certain to win. The selection was greeted enthusiastically by the Mexican stock market and by foreign bankers, but not by the unions. His appointment tends to signal continuation of current policy.

20 Mexico will draw the second and third tranches ($0.9 bn) of its commercial bank loan on 4 November, after the rescheduling agreement became effective on 22 October. (A drawing in August foundered because one US bank, in the throes of a takeover, delayed its signing of the rescheduling agreement. These tranches, unlike the first, depend on the agreement being in effect.) Total borrowing under the banks' financial package will rise to $4.4 bn on receipt of the money, leaving $1 bn to be drawn from the $6 bn new money component; under the terms of the agreement, the size of the package has been reduced by $569 mn because of $250 mn saving on interest and $319 mn

"excess" external receipts in H1. The $500 mn growth contingency facility remains available as does (at least notionally) $172 mn of the oil-price linked investment support facility. Mexico's debt:equity programme is to be reviewed with the aim of minimising its expansionary monetary impact.

Argentina

21 Against a background of rapid inflation, a deteriorating trade surplus, and critically low foreign exchange reserves, the authorities have announced a package of measures including an indefinite wage-price freeze (after initial selective increases), a significant real devaluation of the exchange rate, tax increases, and structural reforms. The government's policies, while insufficiently tough to please creditors, have nevertheless provoked an opposition-led general strike and the threat of further disruption.

22 The wage-price freeze, following in the wake of a 12 month inflation rate of 136% in September, was, however, preceded by real increases in the minimum wage level and family benefits; prices of certain items will be excluded from the freeze so as to minimise shortages. (Prices are reported to have risen 18-20% in October.) In the foreign exchange market the commercial rate, normally subject to regular minidevaluations broadly in line with relative inflation rates, was devalued by a further 10.8% following an 11.5% devaluation earlier in the month, while the newly-created "financial" rate (used for virtually all dollar transactions carried out by Argentine residents) is to be left to float freely, which it has done initially at a discount of almost 20% to the commercial rate. (A third-tier black market still operates.) The improvement in competitiveness should eventually help to offset part of the effect of weak agricultural prices which have been an important factor depressing the trade balance. Before the measures, the 1987 trade surplus was expected to be between $1 bn and $1.5 bn compared with $1.9 bn forecast earlier by the IMF. Argentina's trade surplus for the first 8 months of 1987 was $650 mn (cf $1930 mn in the same period in 1986). Exports were 19% lower and imports 12% higher. Fiscal measures include an increase in income and property taxes and a rise in the rate of import duties from 10% to 15%. Structural measures include a freeing of domestic money market interest rates, a forced-savings scheme, the elimination of a 45% discount on world oil prices on purchases of crude from local producers by the state oil company, and a lifting of quotas on a number of imported industrial inputs. Further privatisations will also be undertaken.

X 23 The package, whose main weakness is the absence of lacking measures to curb government spending, does contain a number of welcome elements. Moreover, following elections which saw significant Peronist gains, President Alfonsin retained his

Economy and Finance Ministers and still appears to retain sufficient political support to pursue modest counter-inflationary reforms including a reduction of the fiscal deficit (now reported to be as high as 10% of GDP), financial reforms and privatisation. Nevertheless, the overall effectiveness of the measures must be in doubt. The package is presumably intended to anticipate potentially tricky negotiations with the IMF on the next stage of the revised SBA which was activated by the signing of the banks' new $1.95 bn new money loan in August. (The loan was oversubscribed and the first tranche of $750 mn was disbursed on 6 October.) Having failed to meet end-August targets under the SBA, it is unclear whether the authorities will obtain a waiver to enable the second drawing under the existing SBA (SDR 165.5 mn) to be made, or whether a new programme will have to be agreed. In considering a request, the UK will have to decide whether to press for agreement being made conditional upon Argentina abandoning its discrimination against UK commercial interests. The drawing, which is unlikely to take place this month as scheduled, is required to trigger disbursement of the second ($300 mn) tranche of bank money. The Federal Reserve is in the process of putting together a further bridging loan for Argentina; the loan, for $475 mn, would be repaid from the second tranche of the SBA ($210 mn), and IBRD trade policy and project loans ($265 mn). As with previous bridging facilities, the loan will be arranged under the auspices of the BIS. The UK was not asked to contribute. The "drop-dead" date for the bridge is 10 November after which time the offer will no longer stand. (The authorities have recently been backing off from criticism of the IMF and its policies.)

Venezuela

24 In September, the authorities declared an indefinite extension of the price freeze on "essential goods". Prices rose by 0.8% in August, bringing the year-on-year rate to 32.6%. While the recovery in oil prices has strengthened the trade balance, non-oil export performance continues to suffer from an over-valued exchange rate, with the bolivar at a discount of 55% on the official rate at end-September. At 16 September, gross international reserves of the Central Bank were reportedly $9.7 bn, following the transfer of $485 mn from the Venezuelan Investment Fund (reserves were $9.9 bn at the end of 1986). Despite criticism from internal and external observers, including the IMF, the government seems committed to its expansionary policies. The 1988 draft budget reportedly includes a 5% real increase in expenditure over the revised 1987 budget.

25 The Venezuelan government and some of the banks have signed the MYRA covering $21.2 bn of public sector debt but completion of the signing which began on 21 September has been delayed over administrative problems; although some banks

originally said they would not sign the MYRA until difficulties relating to the rescheduling of private sector liabilities had been solved, banks are now anxious to complete signature of the deal. It is hoped that the MYRA will be signed by 16 November, the deadline for ensuring that Venezuela will benefit retroactively from the reduced spreads. Banks have refused to discuss the possibility of new money until the MYRA is signed.

26 Press reports suggesting that Venezuela was on the verge of issuing a series of floating rate bonds appear to be unfounded, although Venezuela has obtained a number of project financings. Japanese banks and Japan's Ex-Im Bank have agreed to provide $324 mn in yen-denominated loans for a hydro-electric project (the loans are maximum maturity of 8 1/2 years, at an interest rate of 5.7%; it is not known whether they are tied). The Japanese are also discussing a separate credit of $100 mn for a bauxite mine. The Spanish state agency Focoex has agreed to lend $20 mn to Alcasa, the state aluminium company (15 years, with 7 grace). In September, the Andean Reserve Fund approved a $271 mn balance of payments loan (4 years, 1 grace, Libor +0.5%). The authorities have also claimed that Venezuelan private banks have been receiving significantly more in trade credits (up $800 mn in the period January-August, to nearly $3 bn).

Chile

27 After real growth of 6 1/2% between 1986 H1 and 1987 H1, the IMF expects GDP to rise 5% in 1987. Buoyant domestic demand has, however, led to a rise in inflation to 21% over the twelve months to September and the authorities have said that their inflation target of 15% for the calendar year is likely to be missed. The strength of domestic demand has also brought about some deterioration in the trade balance despite a recovery of copper prices and higher exports of manufactured goods. In January-August the trade surplus was $679 mn (cf $870 mn in the same period last year) while the overall balance of payments deficit widened to $538 mn in H1 (cf $272 mn in 1986 H1). Normal ECGD cover has been restored.

28 On the political front, the National Workers' Command staged the first strike in over a year to press for a 22% pay rise and a 64% increase in the minimum wage. However the strike was not well supported.

29 The World Bank will shortly discuss Chile's request for a third SAL (possibly for $250 mn). The SAL is to consolidate advances made in the export orientation of the economy, raise public sector savings and reduce the social costs of structural adjustment. The Chilean authorities expect the US to abstain from voting on the loan

on human rights grounds (as they did for the second SAL); nevertheless, the Chileans believe that the loan will be approved. Ministers will need to decide how the UK should vote in this event; last year the UK voted in favour of the second SAL but made a demarche on human rights in Santiago and encouraged a PQ on the reasons for our vote.

30 Recent changes in legislation have opened the way for foreign-owned investment funds to invest the proceeds from debt-equity swaps on the stock market thus providing further scope for the reduction of debt. Midland Bank and the IFC are each investing $7.5 mn in the first of such funds which will be for a total of $75 mn.

Ecuador

31 Real GDP is now expected to contract by only 1.5% in 1987 - previous estimates had suggested that the decline would be much greater (4-8% GDP) - and the Finance Minister has forecast real growth of 6-8% in 1988. The public sector deficit is, moreover, expected to be contained to roughly 3% of GDP compared with earlier IMF projections of 8.6%. Inflation is still rising (32% in the 12 months to July), but may slow over the remainder of the year. External performance has, however, been worse than that projected in the Fund's post-earthquake forecasts, with a trade deficit of $71 mn over January-August 1987 (cf a surplus of $469 mn in January-August 1986). Net reserves were $58 mn at end-September (cf $147 mn at end-September last year).

32 Both the banks and the authorities are keen to agree a financing package before the first round of the Presidential elections in January. The banks' preliminary offer is a rescheduling of old debt (previously rescheduled in 1983 and 1985) over 19 years including 7 years' grace and a margin of 15/16% over LIBOR; old new money from 1983 and 1985 ($631 mn) would also be rescheduled over 10 years/3 grace at LIBOR +1%, thus giving Ecuador slightly inferior terms to those for Mexico, Argentina and Venezuela. Ecuador has requested new money of $350 mn, equal to interest arrears. $100 mn may take the form of a four-year deposit relending scheme, and a further $100 mn as low interest bonds with a maturity of 7 years including 2 years' grace. The remaining $150 mn may involve World Bank cofinancing, although the IBRD is not keen to take part on the grounds that its support may be interpreted as bailing out the banks. The US authorities are also known to be unhappy with the idea of World Bank involvement. Japanese and Canadian banks are, nevertheless, adamant that the Bank should participate. A condition of the loan would be that Ecuador should start paying current interest, possibly from 15 November. A further consideration is that the first drawdown from the banks should be conditional on the first drawing being made under an IMF programme. The Ecuadorean authorities have now officially accepted

the banks' proposals. Preliminary discussions with the Paris Club have taken place for the rescheduling of 100% of principal repayments due in 1987-88. Negotiations will begin once a bank rescheduling is in place.

Peru

33 The government's main economic objectives for 1987-90 have been outlined. The plan adds little to the policies of the past 2 years, but, optimistically, envisages average annual GDP growth of 5%, firm control of inflation, increased efficiency in the public sector (including improved tax systems), higher taxation and a public sector deficit of below 4% of GDP, the maintenance of foreign exchange reserves equal to at least 3 months' imports, an import programme that directs foreign exchange towards productive and export activities, and a more competitive exchange rate for exports. GDP growth in the first 6 months of 1987 was reported to be 8.6% at an annual rate. In August consumer prices rose by 7.4% (annual inflation is now 88.2%). Recent data indicate that government revenues fell by 15.3% in real terms between H1 1986 and H1 1987, while spending rose by 7.8%. Over the same period imports rose by 51.4%. Between end-1986 and mid September, reserves fell by $401 mn to $557 mn, suggesting that the government is not being successful in maintaining its reserve target of three months' import cover. $208 mn of this decline occurred following President Garcia's announcement of bank nationalisation of end July.

34 The Senate passed the bank nationalisation bill on 28 September, but added an amendment to exclude foreign banks already established in Peru: these can continue to accept current account deposits, but must retain their compulsory credit lines to the Government. However, foreign banks will not be allowed to open new offices. Implementation of the nationalisation continues to be problematic because of constitutional obstacles and has been accompanied by some violence on the part of the authorities. Uncertainty surrounding the bill may explain falls of 2.9% in real credit and 1.1% in the real money supply during August.

35 A Fund team visited Lima in the second half of September to complete the Article IV consultations and the Board is to consider the report no later than 25 November. An IBRD mission has visited Peru and a further visit may be made in November to discuss a normalisation of relations with the government in October: arrears to the Bank in early October were $128 mn. The Paris Club has indicated its willingness to meet the authorities but has made its usual condition that an SBA would be needed for a rescheduling. The Peruvians have also contacted Citibank, with a proposal to re-open discussions with a view to an agreement by the second half of January. Their terms, however, include a limitation on debt service and no IMF programme.

36 Two debt-for-goods deals have been signed. Midland Bank will sell the equivalent of $145.7 mn in non-traditional exports on behalf of Peru. From the proceeds the Peruvian Government will receive $87.4 mn in cash, and $58.3 mn in short-term working capital debt will be retired. An initial $23 mn "pilot" scheme, which cancels $8.8 mn of debt must first be completed by the end of 1987. The details of another scheme, also involving only short-term debt, appear to be in dispute. The Peruvians claim that First Interstate Bank will retain only $14mn of the $42 mn proceeds of sales of goods, but the bank says it will retain more than that. Such deals seem to threaten creditor solidarity.

Colombia

37 Banks had to commit by 16 October to take advantage of the full facility fee for the proposed $1,060 mn "voluntary" loan, but commitments so far total only 66% (including all the major British banks, although one has done so for less than its pro-rata share). The lead banks met on 22 October to discuss what, if any, further action they could take. The Colombian government has been under pressure from opposition parties to convert the loan into a formal rescheduling, on grounds of cost (the spread, 15/16%, is high compared with most other recent Latin American reschedulings).

Bolivia

38 Real growth is likely to be over 2% this year following six years of economic decline; inflation too continues to be relatively low - 10.9% in the year to August. There has been little further progress on the debt buy-back scheme, the basis of which is that Bolivia should secure aid funds from donors to buy back uninsured debt from the banks at a discount. So far, only the Dutch and the Spanish are believed to have given a specific commitment of funds, although some other governments are thought to be sympathetic. Ministers will need to decide whether to agree to the Bolivian request to divert an existing aid commitment for this purpose (the Bolivians accept that no new money will be provided). This raises the issue of whether governments should finance such schemes or leave the debtor and the banks to find their own market solution. On 21 October, the Fund Board authorised the Fund's role as trustee of a "voluntary contribution account" set up for the scheme.

39 Fund Board discussion of three-year EFF had been held up by the failure of Argentina and Bolivia to settle their dispute over the price of Bolivia's gas exports. Agreement was finally reached this month on a new (lower) price for the gas

and on the settlement of outstanding debts, and the Board is likely to discuss the EFF in November. Separately, Bolivia has been offered a concessional loan of $220 mn from the USSR, (20 years, 8 years' grace, interest at 2.5%).

Uruguay

40 GDP in H1 was 6% higher than a year earlier and the central bank has released a forecast showing 5% growth for 1987 as a whole, significantly higher than earlier government projections. Inflation was 60% over the twelve months to September 1987, but was down from 71% at the end of 1986, and is likely to fall close to the government's estimate of about 55% by the end of the year. The strong growth in activity has led to a deterioration in the trade surplus: $38 mn in the period January to August (cf $154 mn during the same period in 1986). Increased sales to the EC and Argentina compensated partly for the reduction in exports to Brazil. Imports, however, were a third up on the same period in 1986, mainly reflecting higher oil prices and imports of raw materials and capital goods.

41 Uruguay and the banks reached agreement on a $1.8 bn rescheduling package. This will replace last year's rescheduling of $1.7 bn of loans originally falling due between 1985 and 1989, and also includes $100 mn of debt due to be repaid in 1990-91. Loans will be rescheduled over 17 years with 3 years' grace at a spread of 7/8 over LIBOR.

Costa Rica

42 Emergency measures were introduced on 4 September because a long-awaited tax package, approval of which is an important part of the programme proposed to the Fund, is still being blocked by the opposition in the legislature. The package includes greater control of public expenditure as well as expenditure cuts and measures to improve tax collection. The Fund Board has now approved an SBA, and an SAL is in the pipeline. A late October meeting with the banks made no further progress but discussions will resume in December. The Paris Club is likely to consider a rescheduling later this month. Disbursement of economic support from US AID for 1986 ($40 mn), and that tentatively budgeted for 1987 ($85 mn), is reportedly still under discussion; a failure to liberalise the domestic banking system is the major issue to be resolved.

Jamaica

43 The economy grew rapidly in H1 with industrial production up 12.2%. Strong import growth led to a deficit on current account of $10 mn (cf a surplus of $45 mn in

1986 H1). The pace of activity has since slackened and consumer prices rose 2.1% in H1 1987, against 5.3% in H1 1986, and the annual rate remains on target at 7%. The end-September performance criteria were comfortably met and the Fund Board will discuss the second review of the SBA later this month.

Cuba

44 The Paris Club has indicated to Cuba its willingness to discuss the conclusions of the Club's "Task Force" report and possible developments in Cuba's financial relations with creditor governments. The banks' Steering Group is scheduled to meet by mid-November to discuss refinancing possibilities; a meeting with the Cubans may follow soon afterwards.

IADB

45 The IADB Committee of Governors met in Guatemala City on 6-7 October to try to resolve the deadlock regarding the 7th Replenishment (for 1987-90). However, negotiations stalled over the issue of voting mechanisms in the Executive Board, and no further meetings are in prospect. In the absence of agreement on a new Replenishment, loan approvals will continue to be made from the carry-over of funds available under the 6th Replenishment and repayments; the rate of commitment remains to be decided. The IADB's lending plans, however, may well have to be curtailed which will place more of the region's financing burden at the door of the World Bank, emphasising the need for an early GCI.

SOUTH AND EAST ASIA

Philippines

46 In its second review of the Philippines SBA, the IMF has highlighted the success of the Aquino administration in implementing structural reforms and supportive financial policies despite the volatility of the political situation. The Fund, nevertheless, has revised downwards its forecasts for growth in 1987 from 6.5% to 5.6% and the new target still appears ambitious. In a major speech to business groups that was well-received, the President hit back at her critics and promised a newly-decisive administration.

47 Following the August coup attempt, the peso has come under speculative pressure and has fallen by 10% in the black market. This has increased inflationary pressures and an annual inflation rate of 8% by Q1 1988 is a distinct possibility. Slower than

expected disbursements of aid and official transfers have been largely responsible for a deterioration in the current account and a run-off of reserves. H1 1987 figures show a current account deficit of $0.1 bn as against a corresponding projected surplus, and reserves stood at only 2.7 months of imports of goods and services, considerably lower than the Fund target of 3.8 months. About thirty of the creditor banks have still to sign the latest debt restructuring agreement as they seek to obtain a satisfactory resolution to the question of non-performing loans extended to Planters Products Inc, whose debts the previous administration had agreed to honour. However, there are some signs that a compromise may be reached before the deadline for signatures of 15 November. The Senate has passed a resolution allowing the Government to conclude the rescheduling agreement on condition that new negotiations are opened in the near future. The resolution replaces three bills designed to limit debt-service payments.

Malaysia

48 In its annual pre-budget report, the Ministry of Finance has forecast that real GDP growth will increase from 2% in 1987 to 4% in 1988. The forecast is based on continued increases in the prices of and demand for Malaysia's oil and traditional commodities (such as rubber and palm oil) as well as for manufactures (especially electronics, textiles and agri-based goods). The report projects current account surpluses of $0.8 bn this year and next - rather better than most earlier forecasts. It has been announced that Malaysia will prepay $2 bn of external debt later this year drawing from reserves (currently at $7 bn). This will help to smooth a bunching of repayments due in future years.

Indonesia

49 GDP growth in FY 1986/87 was 3.2% (against 1.9% a year earlier) reflecting a strong performance of the non-oil sector. A partial recovery of oil and gas prices has improved prospects for this year although the effects of a prolonged drought could depress real incomes and push up inflation. A recent bout of speculation against the rupiah appears to have been halted by higher domestic interest rates, and foreign direct investment inflows are set to rise considerably, with commitments in the first half of 1987 registering a four-fold increase on a year earlier.

Thailand

50 The economy continues to strengthen with the growth rate for 1987 now predicted to be at least 5.4% (cf 3.8% in 1986), assisted by a firming of international prices of major crops and almost full capacity operation of export-oriented industries. Whilst

exports have risen by around 10% in the eight months to August, imports have risen by some 32%, leading to a sharp rise in the trade deficit. However, invisible earnings, particularly from tourism, are said to be running at an all-time high. Thailand's current account has switched to a deficit of $150 mn in the first eight months of 1987 from a surplus of $282 mn in the same period of 1986.

EASTERN AND SOUTHERN EUROPE

Poland

51 On October 31, a Paris Club agreement was initialled which reschedules over 10 years (5 grace) $8.5 bn of arrears, and interest and principal due in 1988. Under the agreement, Poland will pay a total of $1010 mn between end-November 1987 and end-March 1988, including 50% of the arrears outstanding under the 1987 agreement. (The terms are less favourable than those obtained by the commercial banks in their recent rescheduling.) The discussions were characterised by a seriousness of intent on the part of the Polish authorities which contrasted with some earlier meetings. The US representative at the meeting made no explicit reference to an IMF SBA, progress towards which is also a condition for the release of significant IBRD resources. The payments now due to creditors over the next fifteen months should, on present policies and in the absence of unanticipated shocks, leave some modest margin for slippage within Poland's likely payments capacity. Foreign exchange receipts have strengthened in dollar terms in the first 9 months of 1987, reflecting an increased trade surplus and higher inflows of private transfers. The speed of implementation of different elements of the government's proposals to reform the domestic economy, in particular the price structure and subsidies, will largely depend upon the outcome of a nationwide referendum to be held on 29 November. By the end of 1987, real output should be less than 5% below the pre-crisis level attained in 1978, while real per capita consumption should regain its 1980 peak. However, inflationary pressures have increased and prices are rising at an annual rate of around 23%.

Yugoslavia

52 The Paris Club has advised the Yugoslav authorities that a rescheduling would have to be tied to an SBA (or EFF) and not to enhanced surveillance. Although some official creditors report arrears, the brunt of Yugoslavia's current financing gap is being met by delays in payments to banks. The banks rejected on 29 October an initial Yugoslav request which asked for (inter alia) $1 bn of new money and a 9 year MYRA repayable over 20 years at a margin of 1/2% and made no mention of a Fund programme. Full details of the authorities' long awaited economic package have yet to emerge.

Hungary

53 It is hoped to open negotiations on a SBA in November with a view to an Executive Board discussion in January. IMF staff envisage a three year adjustment package (either in the form of a succession of SBAs or an EFF depending upon the programme agreed with the Hungarians) of around $1 bn gross (some $300-400 mn net). The aim will be to limit the current account deficit to around $400 mn in 1988 and achieve balance by 1990. The Hungarians are likely to approach the IBRD for an Industrial Restructuring Loan. Commercial banks are becoming increasingly uneasy: short term lines are being maintained but there is little interest in medium term loans and response to the DM 1 bn loan has been mixed.

Greece

54 There has been some improvement on the external side recently: two monthly current account surpluses totalling $753 mn in July and August have brought the cumulative deficit for the first eight months of the year down to $712 mn (compared to a target of $1.25 bn for the year). On the domestic front, inflation fell by 2.2 percentage points between July and August to 16.3% (year-on-year), but little progress has been made in reducing the PSBR, largely because of expenditure overruns by the social insurance funds. The government has announced an end to the wage freeze, which was imposed in October 1985 (real wages have been cut by almost 13% in the past two years), and has pledged tax reductions for 1988.

SUB-SAHARAN AFRICA

Nigeria

55 The Nigerians have reportedly made significant progress in meeting Fund conditions for a fresh SBA: the necessary measures, including elimination of the petroleum subsidy, have been approved for inclusion in the forthcoming budget. It is hoped that a Letter of Intent will be signed in early January, leading to Executive Board approval of a new SBA in February. A Fund mission is leaving for Lagos on 7-8 November. A World Bank mission is currently there, and the Nigerians hope that the budget measures will allow a resumption of Bank lending. In the light of the Fund timetable above, the commercial banks have modified their, as yet unsigned, 1986/7 rescheduling and new money agreements. The modifications will be recommended to participating banks by the Steering Committee this week for approval by end-November. The agreement, originally contingent on the previous SBA being in place, is now tied to approval and implementation of a new Fund programme. Half of

the $320 mn new money element would be disbursed upon Executive Board approval of the programme, and half on compliance with the first quarter IMF performance criteria. The banks are not insisting on the existence of a Fund programme as a pre-condition for the rescheduling part of the agreement, but if no new IMF programme is agreed, this would constitute a default, and short-term credit lines would lapse. The delay in the disbursal of new money pending a new IMF programme will increase Nigeria's cash flow problem. To ease this, the banks have delayed and rephased payments of principal and interest due under earlier versions of the agreement. Before news of progress with the Fund and the banks broke, the Paris Club was intending to send a strongly worded message to Lagos urging compliance with the Fund, more rapid progress with other creditors, and adequate payments to ECAs under negotiated agreements, which we have now asked should be delayed. The deadline for completion of bilaterals and the reconciliation of debt lists was extended to end-February.

56 Following negotiations with the Law Debenture Trust Corporation (LDTC), the authorities have announced rescheduling proposals for the $3.2 bn of promissory notes already issued. The terms (repayment over 22 years starting 1988, with a yield equivalent to an interest rate of around 5% per annum) are far inferior to those achieved by the Paris Club for comparable debt. The proposals also include a termination of the process of reconciling claims (implying, in effect, the rejection of some $2.6 bn of debt), though there is a provision for the issue of further notes in respect of claims that have already been matched and which are under review by the Central Bank of Nigeria (CBN). The proposals, described by LDTC as the "best attainable", have been greeted by noteholders with a mixture of resignation, disappointment and infuriation. A meeting of noteholders will be convened by the CBN (probably in January) to vote on whether to accept the proposals.

Angola

57 After failing to gain support from creditors for its debt securitisation proposals, Angola has now applied for membership of the IMF with a view to negotiating a conventional Paris Club rescheduling. The US has still not revealed whether or not it will support the application.

Cote d'Ivoire

58 The moratorium in Cote d'Ivoire continues, although a second Letter of Intent has been agreed. The terms are even softer than those envisaged in its now defunct predecessor although not as weak as the Ivorians wanted. The World Bank has yet to agree to the programme outline and shows no signs of ending its insistence that any

new programme must be 'growth oriented'. An added problem is that the Ivorians want the Fund to agree to softening of terms on exchange restrictions. Even if these difficulties between the Bank and the Fund are resolved, a weak programme may well encounter strong resistance in the Fund's Executive Board.

Zambia

59 Zambia has been lobbying IFIs and donors for support for its New Economic Recovery Programme (NERP). The response seems to have been to welcome Zambia's intention to adjust its economy, but to register concerns over the viability of the plan.

Zimbabwe

60 The Zimbabwe authorities have held discussions with the IBRD. Relations between Zimbabwe and the IBRD appear to have improved over the last year and there is now agreement over the diagnosis of Zimbabwe's difficulties. Differences remain, however, in particular over the speed of trade liberalisation and the nature of reform of foreign exchange allocation. The Zimbabwe government has shelved the Export Promotion Programme.

South Africa

61 It has been revealed that nearly $0.5 bn of debt caught in the moratorium has been converted into the 10-year loan option available under the second interim arrangement.

Sudan

62 On 3 October the Finance Minister announced - incorrectly and for reasons which remain obscure - that an "agreement" had been signed with the IMF which would open the way to IFI and donor assistance of some $5 bn. The reality is, however, very different. The Sudanese have introduced a package of measures agreed with the IMF in August. These include a 44% devaluation, commodity price increases, a reduction of import duties and closer control of the money supply. The Sudanese have also been promised immediate supplies of oil and sugar from Saudi Arabia and the EC respectively, although not as much as they wanted. The IMF has not, however, offered any money and donors remain hesitant given continuing doubts about the programme's adequacy and implementation, particularly in the light of the uncertain position of the coalition government and the costly civil war. A Fund team is now

in Khartoum to agree, inter alia, quarterly benchmarks for performance criteria and will report back to the Executive Board on 6 November. A consultative group meeting is to be held in December under Fund/Bank auspices to consider the provision of $150 mn to cover Sudan's immediate foreign exchange requirements in FY 1987/88. (This would exclude clearance of IMF arrears and normalisation of debt service obligations.) Ministers will be asked to decide whether the UK should contribute.

MIDDLE EAST & NORTH AFRICA

Egypt

63 In Egypt, where President Mubarak was re-elected unopposed for a second 6-year term on 5 October, all of the IMF's end-June performance criteria, under the SBA agreed in May, may, unexpectedly, have been met (although the position is unclear). The foreign exchange position has been significantly strenthened by the recovery in oil prices in 1987 and by a recovery in tourism. The next round of discussions with the IMF, which will focus on (privately promised) measures to strengthen the acknowledged weaknesses in the programme, is due to take place in Cairo later this month. The discussions will be difficult, not least over the promised increases in domestic interest rates. The Fund staff are, moreover, concerned about both the size of the public sector deficit, which at 17% of GDP for FY 1986/87 has overshot the indicative target by 2 percentage points, and its financing - much apparently from undisclosed external sources. The Staff also have doubts about the operation of the new foreign exchange system which has, so far, failed to attract the hoped-for flows of remittances back into official channels. The position of foreign bank branches remains very difficult. The authorities have, however, indicated a willingness to accelerate the process of exchange rate unification; and there have been confused reports that banks may soon be permitted to use 20% of the new foreign exchange pool to cover private sector debts (estimated at some $3 bn).

64 Although the deadline for signing bilaterals under the May Paris Club has been missed, progress has been made. Negotiations with the UK cannot begin until January although the eligible debt has been reconciled and a draft text of the bilateral has been sent to Cairo; an agreement has now been signed with France (with no major concession on interest rates); Germany is reportedly close to signing. Egypt is also seeking to reduce agreed payments into its special account at the Bank of France (as provided for under its Paris Club rescheduling) by the value of the repayments it needs to make the US, pursuant to the Brooke Amendment, to avoid it being declared ineligible for further US aid. The US-Egypt bilateral has yet to be signed.

Morocco

65 Morocco finally signed its rescheduling agreement with commercial banks on 23/24 September. Allowing for the consolidation process, the deal should become effective on 4 December. The agreement should bring Morocco fully into line with the performance criteria under its IMF programme (which has required waivers on the external arrears criterion in the past).

Algeria

66 Banks are becoming increasingly cautious: a 7-year syndicated loan for state-owned bank, Credit Populaire d'Algerie, (admittedly, at the fine rate of LIBOR +5/8%) raised only $35 mn of the $50 mn sought, with only 4 banks participating; and the market has still to be approached for a $200-250 mn loan, co-financed by the World Bank, originally expected to be syndicated in the summer. The delay may well be related to the emergence of arrears to the World Bank (now over 90 days). These difficulties in maintaining substantial capital inflows, combined with Algeria's need to finance a current account deficit of around $1 bn this year and meet heavy amortisation payments, has renewed press speculation about a possible rescheduling. Such speculation has been given more plausibility by the Algerians recently floating a number of unacceptable proposals to HM Ambassador in Algiers (eg untying ECGD cover, and extended terms even for "cash" goods). This provides an inauspicious background to the first meeting of a Joint Commission intended to foster commercial links between Algeria and the UK.

Iraq

67 ECGD has agreed to provide Iraq with new lines of credit worth £175 mn, which, in maintaining the UK's favoured creditor status, should lead to a reduction in the level of exposure. Most other creditors however continue to face payments delays and demands for rescheduling principal repayments as they fall due. In September, a $1.5 bn contract for a new pipeline through Saudi Arabia (IPSA II) was finally awarded after several months of delay. Payment is to be mainly in oil. On completion (due in mid-1989) the pipeline will add 1 mbd to Iraq's export capacity (currently around 2.2 mbd).

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OVERDUE FINANCIAL OBLIGATIONS TO THE FUND✓

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding as at 9.10.87 (SDR mn)	Forthcoming obligations (to 1993 except* 1992)
Kampuchea	13 March 1975	30.3	48.6
Guyana	31 May 1983	59.9	42.6*
Viet Nam	6 February 1984	73.7	54.5
Sudan	12 July 1984	481.1	353.5
Liberia	25 January 1985	156.7	426.5*
Peru	9 September 1985	305.8	442.9
Zambia	30 April 1986	262.1	486.9
Sierra Leone	16 January 1987	12.3	72.7
Somalia	2 July 1987	7.4	132.8
Uganda	17 August 1987	8.7	215.1
		1398.0	2276.1

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 1,480 mn as at 28.9.87 but this figure is not divided country by country.

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

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

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CONFIDENTIAL

INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1986*	End-June 1987	End-March 1987 [2]	End-March 1987 [3]
Latin America				
Argentina	52	3.1(0.2)	0.2	0.2
Brazil	110	6.6(1.6)	1.0	1.9
Chile	19	1.2(0.1)	-	0.1
Colombia	15	0.5(0.1)	0.1	0.1
Ecuador	8	0.5(0.1)	0.1	0.1
Jamaica	4	- (-)	-	-
Mexico	98	6.3(0.6)	0.7	1.3
Peru	15	0.3(-)	0.1	0.2
Uruguay	4	0.3(-)	-	-
Venezuela	36	2.1(0.2)	-	-
Far East				
Indonesia	42	0.8(0.3)	0.9	1.8
Malaysia	21	1.1(0.3)	0.1	0.1
Philippines	29	1.4(0.1)	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	0.7(0.1)	0.7	0.9
Southern Europe				
Greece	20	1.3(0.2)	0.1	0.3
Turkey	31	0.5(0.2)	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.

CONFIDENTIAL

INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1986*	End-June 1987	End-March 1987 [2]	End-March 1987 [3]
Sub-Saharan Africa				
Cote d'Ivoire	9	0.3(-)	0.1	0.1
Nigeria	20	1.3(0.1)	2.5	3.5
South Africa	22	3.7(0.5)	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	0.3(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]	0.5(0.3)	0.2	0.3

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

BILATERAL AGREEMENTS - CURRENT POSITION AT 1 OCTOBER 1987

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
ARGENTINA I	16.01.85	30.06.85	23.04.85	15.05.85 + 29-31.01.86 (Paris)	28.08.87		English and Spanish texts agreed. FCO arranging Exchange of Notes through "Protecting Powers".
ARGENTINA II	20.05.87	31.12.87		To be arranged			Draft text prepared;awaiting signature of Agreement No 1 before sending to Argentinians.
BOLIVIA I	18.07.86	31.03.87	14.11.86	02.03.87 (London)	02.03.87	08.06.87	Exchange of Notes concluded.
BRAZIL II	21.01.87	31.07.87	16.04.87	27-30.07.87 (Brasilia)	29.07.87		Documents for Exchange of Notes on agreed rescheduling basis sent to Brasilia 28/9. Signature to be effected shortly.
CHILE IV	01.04.87	31.10.87	04.06.87	02.07.87 (London)	02.07.87		FCO chased 23/9;Ambassador sent Note to MFA,who advised Central Bank should reply.Necessary authority to be obtained for this.
CONGO I	18.07.86	28.02.87	13.11.86	24.11.86 (London)	24.11.86	22.01.87	Correct Congolese Reply Note and Annex now received. Date of signature remains as stated in original Reply Note.
COTE D'IVOIRE IV	27.06.86	31.01.87	08.10.86	24.10.86 (Paris)	24.10.86		Comments sent to FCO on 16/9 on Ivoreans' proposed amendments to text.Translation Branch to give their agreement prior to FCO responding to Abidjan.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
CUBA IV	16.07.86	28.02.87	04.11.86	10-12.03.87 (Madrid)	11.03.87		Final text sent to Havana. FCO chasing position on 29/7; hoped to finalise arrangements for signature in W/C 17/8. FCO chasing position again in W/C 7/9.
EGYPT I	22.05.87	31.10.87	07.08.87	October/November (London)			Bilateral text sent to Cairo on 7/8. Provisional debt list dispatched 26/8. Debt reconciliation visit to Cairo concluded 17/9;comments on bilateral text received via Post.For assessment/response prior to arranging negotiations.
GABON I	21.01.87	31.07.87	19.05.87	11-12.06.87	12.06.87		Copies of initialled text sent to FCO on 17/6. FCO spoke to Post early August; most officials on holiday to month-end.FCO chased 22/9;signing of agreement anticipated by mid-October.
GAMBIA I	19.09.86	30.04.87	07.01.87	17-20.03.87 (Banjul)	18.03.87		Copies of agreed bilateral text sent to FCO on 31/3. Error spotted in text, fresh documents sent to FCO on 14/5. chased FCO on 10/8; no news.Further papers requested from Banjul 1/9;FCO chased again 22/9.
GUINEA REP I	18.04.86	31.12.86	16.09.86	29.10.86 (London)	29.10.86		Guinean Finance Minister expresses wish to conclude Exchange in Conakry. FCO approval given but officials on holiday until early September.FCO chased 22/9.
JAMAICA III	05.03.87	30.09.87	20.05.87	09.06.87 (London)	09.06.87		Documents sent to Kingston,to effect Exchange of Notes 29/7. Enquired whether Exchange of Notes completed in our letter sent to Kingston 26/8. FCO chased 24/9. 1st Sec (Commercial) to chase o/r 5/10.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
LIBERIA IV	17.12.84	30.06.85	14.06.85	18.06.85	18.06.85		Documents have been prepared for formal signing ceremony; meanwhile Liberians await Full Powers. Signing in London arranged for 15/10.
MADAGASCAR V	23.10.86	30.04.87	19.01.87	13.03.87 (Paris)	13.03.87	03.06.87	Exchange of Notes concluded in Antananarivo.
MAURITANIA II	16.05.86	31.12.86	14.07.86	28.11.86 (London)	28.11.86		Documents passed to British Embassy in Paris 14/1 for onward transmission to Novakchott. No response yet; FCO taking further follow-up action 7/5. FCO chased again 10/8.
MAURITANIA III	15.06.87	29.02.88		To be arranged			Draft bilateral text under preparation.
MOROCCO III	06.03.87	30.09.87	29.07.87	W/C 19 October (London)			Draft documentation despatched to Rabat. Moroccans proposed negotiations in London mid-October;awaiting reaction to proposal for talks W/C 19/10.
MOZAMBIQUE II	16.06.87	29.02.88		To be arranged			Draft bilateral text under preparation.
NIGER IV	20.11.86	31.07.87	20.01.87	29.01.87 (Paris)	29.01.87		Documents passed to British Embassy in Paris 12/2 for onward transmission to Niger Ambassador in Paris. No response yet. FCO chasing for reaction. FCO chased 1/5 and 10/8.
PHILIPPINES II	22.01.87	30.09.87	13.07.87	Early November (Manila)			Embassy in Manila advise negotiations now proposed for early November.Response to be sent indicating suitable dates for visit to Manila.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
SIERRA LEONE IV	19.11.86	30.04.87	23.03.87	26.03.87 (London)	26.03.87		Ambassador in Freetown sent note to MoF 22/5. No response despite chaser sent on 13/7. FCO advised Ambassador 30/7 to press for reply.
SOMALIA II	22.07.87	31.12.87		To be arranged			Draft bilateral text under preparation,sent for clearance to FCO 17/9.
SUDAN IV	03.05.84	28.02.85	24.07.85	08.08.85	08.08.85		Formal signature still outstanding. No action taken to pursue due to increasing arrears under previous agreements and Sudan's position in relation to IMF.
TANZANIA I	18.09.86	30.04.87 +	20.02.87	05-08.05.87 (Dar-es-Salaam)	07.05.87	08.08.87	Exchange of Notes concluded in Dar-es-Salaam.
UGANDA III	18.06.87	29.02.88		Early November (London)			Draft bilateral text under preparation,sent for clearance to FCO 7/7;reply sent 17/9 - yet to be evaluated. Post advise Ugandans avaiable to visit London early November; reply to be sent outlining available dates.
YUGOSLAVIA III	13.05.86	28.02.87	25.11.86	10-12.12.86 (London) + 23-24.02.87 (Belgrade)	24.02.87	29.07.87	Agreement concluded in Belgrade.
ZAIRE VII	15.05.86	31.12.86	16.06.86	07.07.86 (London)	07.07.86		Delays on part of Zaire to arrange conclusion of agreement. FCO chased June and are doing so again now. UK position of willingness to sign has been frequently stated. Zaireans apparently have habit of losing papers. Hope to arrange conclusion when Zaire delegation in London to negotiate Agreement No 8.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
ZAIRE VIII	18.05.87	31.12.87	30.09.87	06.10.87 (London)			Draft documentation sent to Zaire Embassy in London 30/9;negotiations proposed for 6/10.
ZAMBIA III	04.03.86	31.10.86	09.05.86	In correspondence	20.08.86		Zambian Reply Note received but did not quote Annex. Revised Note submitted to Zambians who have yet to respond. FCO have no news of progress.

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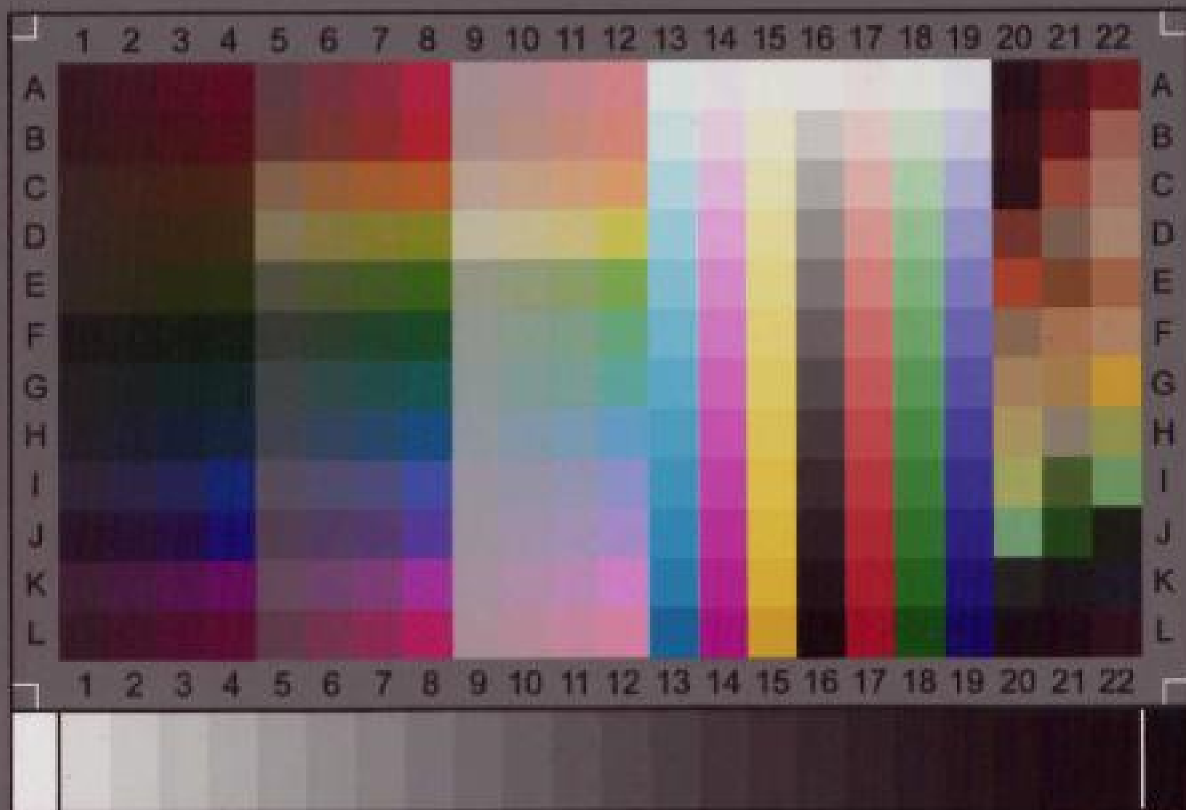
PART 6 ends:-

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

PART 7 begins:-

HMT to CDP. 9.11.87.



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