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Prime Minister ② 6

I asked for this report. Annex II is worth reading.

MCS 21/9

Treasury Chambers, Parliament Street, SW1P 3AG
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20 September, 1982

M. Scholar, Esq.,
10, Downing Street,
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Dear Michael,

THE INTERNATIONAL BANKING SCENE

In your letter of 1 September to John Kerr you recorded the Prime Minister's Seminar that day on the international banking scene. You may like to have some further notes and comment on recent developments.

2. Worries about international banking and the debt positions of some countries and their possible implications were a dominant feature of the Toronto meetings. You have seen the telegram in which the Chancellor reported generally to the Prime Minister, as well as a copy of his plenary speech. In the substantial passage of the speech on the international banking system, the Chancellor took the opportunity of developing ideas which he (and some others) had been pressing and will continue to press in discussions in the IMF and other Committees and Groups, notably:

- the need for economic adjustment in many countries. We must continue to support the IMF in its central role in helping to restore the creditworthiness of its members; creditworthiness maintains the flow of finance for borrowers, and interest and capital repayments to lenders;

- the need to continue to rely on private markets to provide the bulk of finance needed by sovereign borrowers. Although the IMF should be supplied with adequate resources (and some progress was made in Toronto towards settling a future increase in quotas), the international financial institutions are likely to continue to account for no more than a modest proportion of the total;

- the need for further improvement in cooperation between central banks and national banking supervisory bodies covering risk assessment, prudential standards, monitoring and control. Much has already been done, but further progress is needed: in particular in determining a water-tight allocation of supervisory responsibilities and, by individual national authorities, in taking any necessary legal and administrative steps to support it;

- the need to continue to tackle each problem case on its merits, whether it is a corporation, a country or a bank

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that is in trouble; and to resist calls for general or automatic assistance that would relieve banks of the costs of imprudent lending and debtors of the need to adjust;

- the help that the world's major countries can give through lower interest rates if they manage their economies sensibly.

This approach and the emphasis on particular lines of action was both well received at the meeting and well reported in the press.

3. Two particular aspects of the subject which were touched on in Toronto and in subsequent press comment were: whether there should be an international emergency fund for rescue operations in cases like that of Mexico; and how far a reduction of lending to countries which are in difficulty over debt obligations is likely to lead to deflation in the world economy.

4. I attach a short note on the first of these topics. On the second, it certainly seems wrong to assume that such a possible reduction of lending could be a major factor determining world growth: the dominant influence on world activity is much more likely to be the development of the economies of the US and other major industrial countries. Moreover, if banks are more cautious in lending to some Latin American countries and to Eastern Europe this may in part lead to some diversion of credit elsewhere, rather than an overall contraction. It is said that the US and UK Governments are already benefiting from what has been called a "flight to quality" in the markets, meeting their financing needs at lower interest rates than would otherwise have been available. The whole subject will, however, be considered further at a meeting of Permanent Secretaries which Sir Robert Armstrong is arranging for October.

5 There was of course also in the margins of the Toronto meetings much discussion of individual cases, particularly Mexico and Argentina. In both these cases events have moved on. The final enclosure to this note is a commentary, largely by the Bank of England, on recent developments and market reactions to them, and a series of notes on the present position of a number of countries in difficulties.

6. On other points which came up at the Seminar:

- the Bank of England have now provided the schedules of exposure and indebtedness for Mexico;

- the Treasury is working up, in consultation with the ECGD, concrete proposals for tightening criteria for official credit and guarantees.

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

Yours,

Margaret

(MARGARET O'MARA)

ANNEX I

AN INTERNATIONAL EMERGENCY FUND

1. In recent discussion of the international banking scene, one thread of argument has been that it was not enough to tackle each succeeding case of problems with a country's debt as it arose. There ought to be some more automatic system or fund for dealing with these problems which would give greater reassurance to the banks and ultimately to world trade and growth.

2. One has to distinguish between rescue arrangements for countries and for banks. Central banks, operating through an agency like the Bank for International Settlements, may play a part in the short-term in rescue operations for countries but beyond the short-term such rescues must be for the IMF or some other form of inter-governmental action (eg the European Community Medium-Term Credit). Rescuing banks is however essentially a central bank matter, often linked to their supervisory responsibilities. The Chancellor's IMF speech included proposals for improving both the supervisory and "last resort" functions of central banks on international banking.

3. On rescuing countries, the G77 have proposed automatic debt rescheduling for LDCs. Nobody has taken that up seriously. It is an assertion of the priority of LDC development over banking obligations. It would lead either to a complete drying up of bank credit for LDCs or to some kind of international public sector fund which would look after the banks and relieve the LDCs of their debts in defined circumstances.

4. That brings us back to the idea of an emergency fund. But the trouble with an international back-up fund is much the same as the trouble with a domestic fund for bailing out companies in trouble, with the added complication that the international version requires the negotiation of a very difficult international agreement. It takes risk out of lending for the banks and reduces the incentive on countries to pursue prudent policies or to undertake adjustment. For similar reasons central banks have not wished to give flat assurances of rescue in need to every bank.

5. The US proposal for an IMF Emergency Fund has not so far been closely defined but may be intended to avoid these pitfalls by a requirement for full IMF conditionality. But then it is not clear

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how it differs from ordinary IMF resources. They have suggested that its use be confined to cases like Mexico where the international system was at risk. However that seems a poor basis on which to admit one country to it but not another. The bigger your debts, the better your claim. In the mid 1970's a proposal by Henry Kissinger led to negotiation of a similar scheme (the OECD Support Facility), which however Congress subsequently frustrated by refusing to approve any US contribution. The latest US proposal could be vulnerable to similar Congressional opposition. However it is now to be considered by the IMF Executive Board.

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ANNEX II

THE INTERNATIONAL FINANCIAL SCENE

1. Conditions in the international money markets have remained uncertain since the IMF meetings in Toronto. Some banks are taking defensive measures to reduce exposure to customers from suspect countries. Recent downward movements in interest rates in the major countries have been helpful, although they appear at present to have reached a floor. Financial markets have so far been relatively calm.

2. Developments in Mexico are at the centre of current concern. Following Silva Herzog's meeting with the President (post-Toronto) there was a welcome announcement from Mexico City that negotiations with the Fund, on the basis of the Fund's memorandum outlining economic objectives and the main thrust of an economic programme, would be resumed. IMF negotiators are due in Mexico City this week. A message on 11 September confirming that the international money market obligations of Mexican banks would be excluded from the 90-day standstill of Mexico's public sector debts was another positive factor. Nevertheless Mexican banks in London and New York are finding it very difficult to renew maturing deposits and, in some cases, are only managing on a day-to-day basis whilst finding it virtually impossible to raise new funds. The Bank of England in London and the Federal Reserve Bank in New York are in close touch with branches of Mexican banks established in these centres, to ensure that accidental defaults by those branches do not occur. The Banco de Mexico has drawn four times on the joint BIS/US facility at the Federal Reserve Bank in order to enable Mexican branches in New York to meet pressing needs for liquidity.

3. An advisory group of 13 major banks, on which LBI (Lloyds Bank International) is the sole British representative, is co-ordinating the approach of the more than 1,000 banks with loans to Mexico in one form or another. This group, which meets in New York, has provided the channel through which, with the encouragement of the main central banks, lending banks have been urged to roll over their deposits with Mexican banks in order to avoid a further erosion of confidence in the banking markets.

4. The position of the Mexican banks in the international markets seems very likely to remain precarious until the uncertainties surrounding Mexico's negotiations with the IMF are resolved. There have been unsubstantiated press reports of negotiations for a $12 bn loan to Mexico from Saudi Arabia. Until more is known of such a loan it is difficult to assess how it might affect the international banking markets; as a major injection of liquidity it could help confidence, but it might increase fears that IMF conditionality could be by-passed.

5. Deposits are being moved from the smaller banks, as well as from the banks of LDCs, to the larger banks in the main centres; and the unusually wide spread of interest rates in the banking markets is reflecting this discrimination. There has been a transfer of funds to the British clearing banks, to the principal Japanese banks and to some of the biggest US banks. These banks can raise funds cheaply at present. However, the markets are taking a cautious attitude to certain other major US banks which are being obliged to pay uncharacteristically higher rates. The leading Canadian banks, which recently reported sharply lower profits, are also paying more than usual for funds. The banks from European countries, as a rule are managing reasonably well in the current crisis; but the Banco Ambrosiano affair continues to cast a shadow over Italian banks and the well-publicised difficulties attending the rescue of the AEG-Telefunken group continue to create a certain unease for some W.German banks.

6. Following the removal of restrictions on and by Argentina, reports from UK banks indicate that most of the Argentine deposits in London have still remained here. We also hear from LBI in Buenos Aires that "the working relationship with Argentina appears to be getting back to normal" and that first steps are being taken to facilitate payments due.

7. Further notes on countries in difficulty are attached.

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NOTES ON PROBLEM COUNTRIES, SEPTEMBER 1982

A - LATIN AMERICA

Argentina - Total indebtedness $37 billion

The rapid deterioration in Argentina's creditworthiness has been exacerbated by the inflationary policies adopted by the Bignone regime since the end of the Falklands crisis and by growing signs of political and social instability. With mounting overdues on repayments of capital and interest, there seems no prospect that Argentina can meet the massive debt service due in the remainder of the year. Principal payments including arrears of some $12 billion fall due for payment by end 1982. The reciprocal removal of UK-Argentine financial sanctions has cleared an obstacle to the major rescheduling which now looks inevitable. The IMF has agreed to send a mission to Buenos Aires for preliminary talks about the financial support programme which would need to accompany a rescheduling operation. Internal political instability is bound to complicate the negotiations. ECGD remain off cover.

Bolivia - Total indebtedness $2.5 billion

Has been in dire financial straits for some time. Negotiations with the IMF have collapsed, causing commercial banks to grant successive waivers to the clause in the debt rescheduling agreement signed in April 1981 which called for an IMF programme. In the meantime the Bolivians have continued to make interest payments, albeit with difficulty. However on 9 September the Central Bank announced that its foreign exchange reserves were exhausted and that a $10 million interest repayment would have to be delayed. But it is doubtful if the banks will actually call a formal default. UK exposure is small; ECGD has been off cover for some time.

Brazil - Total indebtedness expected to reach over $80 billion at end 1982, ie. the same order of magnitude as Mexico

Planning Minister Delfim Neto has pursued generally responsible economic policies and kept debt maturities long. But there are uncertainties about Brazil's short term prospects: policy relaxations before the elections due in November, a deteriorating current account performance and greater caution by the banks following events in Argentina and Mexico may cause Brazil problems in meeting this year's external borrowing programme, which still requires another $4 billion to be raised. Indeed there are already signs that certain Brazilian banks are encountering difficulties in the international money markets. If Delfim Neto - who has consistently opposed domestic pressures for rescheduling - were to go, this could spark a crisis of confidence. But confidence may be helped by a package of austerity measures just announced (involving an increase in the banks' compulsory reserve requirements), which indicates that the authorities are alive to the dangers they face. ECGD remains open for cover, but new commitments are being carefully controlled.

Cuba - Total indebtedness $3 billion
The Cuban authorities formally approached the UK and other Western creditor countries at the end of last month to request a rescheduling of medium and long term debts amounting to over $1 billion. We and other creditors have insisted on multilateral negotiations. Cuba's non-membership of the IMF is a complicating factor. The UK is not a major creditor; ECGD is off cover.

B - EAST EUROPE

Yugoslavia - Total indebtedness $20 billion
Notwithstanding an IMF upper tranche programme, Yugoslavia has failed to come to grips with increasingly severe payments imbalances resulting from high growth and investment rates in the late 1970s. There are now increasing signs that Yugoslavia will have great difficulty in avoiding a debt rescheduling, but imports are being cut drastically, affecting domestic production and exports, and the Yugoslavs say they will not reschedule. Negotiations have been taking place for some weeks with a group of US, Canadian and Japanese banks for a $200 million loan (with moral support from the State Department) and the BIS is being sounded on the possibility of providing a large stand-by facility. The Governor of the National Bank of Yugoslavia is to visit London later this month to seek further loans from British banks but the latter are unlikely to be enthusiastic. ECGD, which has a substantial exposure (£700 million), is now virtually off cover, except for short term business.

Poland - Total indebtedness $27 billion
Convertible currency obligations falling due in 1982 amount to $10 billion, virtually none of which has been paid. But progress is being made on the rescheduling of unguaranteed banking debt due in 1982, and an agreement may be signed in the Autumn, under which the Poles will receive back about half the interest paid this year in the form of a 3 year credit. Western official creditors agreed after the imposition of martial law not to resume talks on official rescheduling for the time being. Some creditors are now reconsidering, since the effect of this refusal is to allow Poland 100% de facto relief on both principal and interest. But the US (and France) still firmly oppose the resumption of talks. Although to some extent Polish insolvency has been discounted by the banks, many of which (eg. in Germany) have written off a proportion of their loans, total default would still impose a burden.

Hungary - Total indebtedness $9 billion
Faces short term liquidity problems, and a substantial debt burden over the next few years. The immediate position has been eased by a $210 million BIS support package earlier in the year (in which Bank of England participation without official backing is $30 million) and a new commercial bank loan of $260 million. The Hungarians have requested a further $300million BIS facility and this will be considered at Basle on 28 September. Hungary's prospects depend on the outcome of current negotiations with the IMF over a stand-by arrangement which will require tough adjustment measures. Rescheduling remains a possibility. ECGD commitments are modest and under tight control.

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Romania - Total indebtedness $11 billion

Agreement with Western Government creditors on the rescheduling of official debts was reached in July. However, an agreement with the banks may not be signed until later this year. An IMF stand-by agreement, withdrawn because of a build up of payments arrears, has been re-activated but seems unlikely to survive for long. There are considerable doubts whether the Romanian authorities are prepared to take the necessary adjustment measures to strengthen the external position, restore banking confidence and avoid the need for further reschedulings. ECGD is off cover.

GDR - Total indebtedness $13 billion

GDR's liquidity position is tightening because of inability to raise substantial new credits from Western banks. It has introduced measures to cut imports from the West and boost exports to convertible currency markets. But a request for debt rescheduling cannot be ruled out in 1982, though is more likely to occur in 1983. ECGD has introduced tighter market limits but is still on cover.

Econ Pol, Aug '84,
Western Banking
System