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Prime Minister (2)

AT 1/3

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

28 February 1985

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew,

INTERNATIONAL FINANCIAL SCENE

I enclose the latest assessment of developments on the international financial scene which has been discussed in the Treasury's International Debt Group. Brian Unwin had an opportunity to discuss the same issues with his G5 Debt Deputy colleagues in Paris on Friday.

As the Bank's paper notes, 1984 was a satisfactory year for the problem countries, with significant progress made by a number of major debtors. But recent events, stemming from lack of domestic policy adjustment in Brazil, Argentina and even Mexico, together with the continuing resistence by Nigeria to significant adjustment, are casting something of a shadow over the current outlook.

The main worry is Brazil, where the negotiations with the commercial banks on a multi-year rescheduling agreement covering 1985-1991, which were almost complete, have been suspended because of Brazil's failure to comply with its Fund programme. The Fund are not prepared to grant a waiver and this will prevent Brazil's next drawing from the Fund at the end of this month. Serious negotiations with the Fund, the banks and the Paris Club will not to resume until the new government assumes office on 15 March when additional policy measures will be required and may need Congressional approval.

All this will take time. The Fund are now thinking in terms of a new programme running from July 1985. In the meantime, the banking Advisory Committee with de Larosiere's support has urged the banks to maintain until the end of May the very large interbank and trade lines of credit which expire around 19 February. On this round the banks seem to have responded favourably but the whole bridging exercise may need to be repeated

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at the end of May. As a result of this deterioration in performance, the G5 Debt Deputies view last week was that no multi year rescheduling agreement for official debt could be agreed. It must also be uncertain whether the banks will be prepared to resume negotiations on that basis.

It now seems unlikely that any multi year rescheduling agreement, on the lines endorsed at the London Summit, will have been agreed with official creditors, as opposed to bank creditors, before the April meetings of the Interim and Development Committees. However, the French (in their Paris Club role) have agreed to explore the possibility of holding discussions with the Ecuadorians before the April meetings. They want multi-year agreements with both official and bank creditors and their recent track record has been good.

Of the other major debtors, the outlook for Argentina later in the year is precarious - despite her recent agreements with the Fund and both commercial bank and official creditors - with a real likelihood that the Fund programme will go off course. The January inflation figure at an annual rate amounted to some 1200% compared with 150% target for end-1985. The new economic team have a lot to get to grips with.

In Mexico, where the 1985 programme is being discussed with the Fund, the divergences from the earlier programme look containable. There are no signs, despite a recent Fund mission, of any willingness by Nigeria to reach an agreement with the Fund and it remains uncertain whether the rescheduling negotiations with Poland can be brought to a conclusion, given her insistence on promises of new credit from the West before signature.

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

Yours ever
Rachel.

MRS R LOMAX
Principal Private Secretary

INTERNATIONAL FINANCIAL SCENE

There have been mixed developments since the last Report: Latin American debtors, meeting at Santo Domingo, decided not to press for an immediate political dialogue, but instead appeared content to await the outcome of the April meetings in Washington; and negotiations with a number of major debtors, notably Poland, the Philippines and Argentina, made significant progress. But a major set-back has recently occurred in Brazil, where hope for a multi-year deal between the banks and the outgoing Government has been abandoned; and in Argentina the sudden change of Minister of Economy and central bank President has added a further element of uncertainty. The economic background to the debt problem has not, on balance, showed much improvement.

Real GNP in the USA rose provisionally by 1% in the fourth quarter of 1984 (revised from the "flash" estimate of 3/4%), bringing growth in the year as a whole to 6 3/4%. However, the major contribution to growth in the fourth quarter came from a reduction in the trade deficit, mostly attributable to a fall of 7 1/2% in the volume of imports. Overall, domestic demand in the US was much weaker in the second half of the year than in the first. Three-month euro-dollar interest rates fell steadily from 11 1/2% from the beginning of October to around 8 1/2% at mid-January (helped initially by a relaxation of monetary policy and subsequently by favourable news on inflation), but have since risen by about half a percentage point, reflecting renewed market concern over the "twin deficits", and a growing consensus that monetary policy is unlikely to be eased further. In the short run, rates are, if anything, likely to rise further. Outside the US, the recovery in activity appears to be levelling off: for example, real growth in West Germany is expected to be much the same this year as in 1984, at 2 1/2%. This slow pace of recovery has been accompanied by a continued reduction in inflation in the major industrialised countries. At the same time, many debtor countries have been assisted by firmer prices for a variety of agricultural products and industrial materials, leading to an improvement in their terms of trade for the first time in several years. Spot market prices for oil have firmed recently, after the OPEC meeting at end-January, which brought administered prices more into line with market prices.

Recent BIS data show that total external assets of banks in the BIS area fell in the third quarter of 1984, the first decline since the Herstatt crisis in 1974. Within the total, however, claims on developing countries rose by $1.4 bn, which was wholly accounted for by drawings on new money packages for Brazil, Chile and Mexico. The cumulative rise in loans to developing countries in the first nine months of 1984 was $5.1 bn, or only 2% at an annual rate, compared with the IMF forecast for the year as a whole of 5%. (There was a considerable catch-up in the fourth quarter of 1983, which is unlikely to have been repeated last year.)

After protracted negotiations, the proposed multi-year deal between Brazil and the banks has had to be abandoned for the time being, because of a serious deviation in the fourth quarter from the Fund's target on net domestic assets. New negotiations with the IMF and, subsequently, with the banks and Paris Club members cannot now be concluded until after the new Government takes office on 15 March. Elsewhere in Latin America, final documentation on two elements of Mexico's MYRA (the $23.6 bn of debt rescheduled in 1983/84 and 1983 new money) is shortly to be distributed to the banks, although signing is not expected to be completed before May. Progress on Venezuela's MYRA is also proving to be slow, although "road-shows" may begin next month. The smaller countries are all continuing to experience problems with their creditors, apart from Ecuador which could well be the first Latin American country actually to sign a MYRA, provided that satisfactory arrangements can be made with Paris Club creditors.

At the end of December, the IMF approved Argentina's request for a 15-month Standby for SDR 1.4 bn: this enabled the authorities to draw down a US Treasury loan to pay interest arrears to banks, which in turn allowed US regulators to upgrade loans to Argentina, thus facilitating the task of obtaining the banks' commitment to put up $4.2 bn of new money. However, the unexpected appointment of a new Minister of Economy and central bank President on 18 February has inevitably given rise to uncertainties regarding the Government's commitment to the adjustment programme.

In Eastern Europe, an agreement between Poland and its official creditors was initialled in mid-January, rescheduling arrears of principal and interest due in 1982-4; but provision of new credit and the rescheduling of 1985 maturities have yet to be settled. Negotiations between Yugoslavia and its commercial creditors are to resume later this month, following earlier disagreement over the shape of a proposed MYRA.

In the Far East, the Philippines has now reached agreement on rescheduling official debt, following earlier agreements with the Fund and the banks.

Contact between Nigeria and the IMF has resumed, but the authorities remain opposed to the key elements of a Fund programme.

The much-publicised Citibank-Cigna insurance contract collapsed in early February, when it became clear that Cigna could not arrange reinsurance for the $900 mn deal: the insurance company paid an undisclosed penalty to Citicorp, and refunded the initial premium of some $4.5 mn.

Foreign and Finance Ministers of the eleven Latin American countries comprising the Cartagena Group met in Santo Domingo (Dominican Republic) on 7-8 February to continue their regional consultation on external debt issues. Although Ministers have reportedly renewed calls for more generous rescheduling terms for all countries in the region, the meeting appears to have signalled a greater willingness to discuss differences with creditor governments within the ambit of existing international institutions. Significantly, the Group plans to submit written proposals to the April meetings of the IMF Interim and IBRD Development Committees, and will await the outcome of these meetings before pressing ahead with the idea of a joint political dialogue with major creditor governments.

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

(i) Latin America

Negotiations on Brazil's debt have suffered a major set-back. After final differences had been virtually resolved with the Advisory Group of banks on a MYRA, the deal (covering $45 bn of maturities falling due between 1985-91) has had to be abandoned for the time being. A steep rise in the monetary base in December produced a serious deviation from the Fund programme and prevents the next purchase under the EFF from taking place on 28 February. The Managing Director's view is that there is no question of a waiver. Meanwhile, the rate of inflation rose further to 230% (year-on-year) in January. In spite of emergency measures announced on 7 February, which are designed to cut Treasury disbursements by 80% in February and March, the Fund is now only willing to finalise the 1985 economic programme with the new government which takes office on 15 March.

Without the Managing Director's endorsement, the Advisory Committee are not in a position to recommend the MYRA to creditor banks. Instead, with strong support from de Larosiere, they have telexed banks world-wide, asking them to extend to 31 May the very large interbank and trade lines of credit, which were to have expired on 19 February, in order to allow time for new negotiations to reach a successful conclusion.

President-elect Tancredo Neves had hoped to see negotiations concluded before his inauguration on 15 March. As a result of this set-back, he will now be more open to Congressional pressures when discussions resume after he has taken office.

On 28 December, the IMF Board approved Argentina's request for a 15-month Standby for SDR 1.4 bn and a CFF for SDR 275 mn. Some Board members were sceptical about the programme. In particular, as prices have risen by 760% in the last twelve months, the proposed reduction in the rate of inflation to 300% (year-on-year) by September is very ambitious. The agreement with the IMF allowed Argentina to draw down a $500 mn bridge loan from the US

Treasury. This was used at end-December, along with a $100 mn loan from Mexico and a drawing on international reserves, to pay $850 mn to the commercial banks to reduce interest arrears on public sector debt: subsequently, the US banking supervisors agreed to upgrade Argentine loans from the "substandard" category to "other transfer risk" (under which the desirability of provisions is officially considered to be less strong). In January, the US Treasury loan was repaid following disbursement of IMF funds.However, in spite of these positive developments, some banks - notably Spanish, Italian and Swiss - have held back from committing themselves to the new money request which accompanied the rescheduling proposals for 1982-85. As a result, commitments are still nearly $140 mn short of the $4.2 bn total.

On the official side, the Argentines reached agreement with the Paris Club on 16 January, under which 90% of principal and interest falling due in 1985 ($0.6 bn) will be rescheduled over 10 years (with 5 years' grace), and 75% of arrears of principal and interest ($1.1 bn) over 8 years (3 years' grace). Bilateral agreements will need to be completed by end-June. There have been no formal discussions so far on Argentina's request for $1 bn of new official export credits.

Progress towards completing the debt package may be slowed down by the abrupt replacement on 18 February of the Minister of Economy and central bank President, although the new Minister is expected to comply with the agreements reached by his predecessor with the IMF, banks and Paris Club.

In Mexico, difficulties in devising a standard text for the currency switching option have delayed the finalisation of the MYRA. Documentation relating to the $23.6 bn of previously rescheduled debt and the 1983 new money loan is not likely to be signed before May, while agreements covering the remaining $19.8 bn are not expected to be finalised much before the end of the year. Progress on negotiating Venezuela's MYRA has also been slow, although the Advisory Committee has now reconvened, which may lead to "road-shows" next month. It now appears that Ecuador might be the first Latin American country actually to enter into a MYRA: the authorities are currently marketing a package covering [illegible].3 bn of commercial bank maturities falling due between 1985 and 1989, and response to the "road-shows" has so far been favourable. However, the package is dependent, inter alia, on Ecuador receiving 85% relief from official creditors in each of the years covered by the MYRA, which may not be acceptable to the Paris Club.

Chile is still negotiating with the IMF on a new Standby, and with commercial banks on a one-year rescheduling and a new loan of around $750 mn to $1 bn. Although Peru made a payment to creditor banks of $50 mn in January to bring interest arrears within 180 days, there seems little chance that it will be able to resurrect its IMF programme. Consequently, the banks will almost certainly not release the final $100 mn of new money originally negotiated in 1983, and will probably roll over maturities on a monthly basis until some time after a new government takes office in July. Colombia continues to hold out against an IMF programme, but the commercial banks have notified the authorities that their request for $875 mn of new money would be extremely hard to market without such a programme.

(ii) The Far East

In the Far East, the Philippines has consolidated its agreement with the IMF on the terms of a Standby and with commercial banks on debt restructuring, by concluding a Paris Club agreement for the rescheduling of official debt. However, failure to meet the first quarter's performance criterion on reserve money (notes in circulation, till money and bankers' balances at the central bank), and strict conditions recently imposed on concessional assistance flows this year, do not augur well for the future. Elsewhere in the region, Indonesia's external performance has continued to improve, with the current account deficit for fiscal 1984-85 now projected at $3 1/4 bn (4% of GDP), compared with $4 1/4 bn in the previous year. With reserves at present equivalent to around eight months imports and undrawn commercial credit amounting to some $1.5 bn, reductions in the price and output of oil - costing $300 mn and $1.2 bn per annum respectively - should present no short-term problems. External borrowing by the public sector this year is expected to be under $500 mn, well within the capacity of the markets. In contrast, Korea will again be a major borrower in the euromarkets: syndicated loans amounted to $5.5 bn last year, making Korea the largest borrower after the major OECD countries. The gross external borrowing requirement this year has been officially announced to be $5.8 bn. The current account deficit improved slightly over 1984 as a whole to an estimated $1.4 bn (1.7% of GDP) from $1.6 bn in the previous year.

(iii) Eastern Europe

Poland initialled the agreement to reschedule arrears of principal and interest due in 1982-84 at a Paris Club meeting on 15 January. The Poles are expected to seek new credits in discussions on the bilateral agreements prior to signature of the multilateral agreement (which creditors hope will be in June). Preliminary discussions on rescheduling 1985 maturities are to be held on 4 March. Meanwhile, the Poles have paid over to the UK only part of the 30% instalment of the 1981 debt agreement arrears. A Fund mission has visited Warsaw to familiarise itself with the economy before considering Poland's membership application later this year. The banks failed to reach agreement with Yugoslavia on rescheduling during talks in London from 8 to 16 January; discussions are to be renewed during February. The Yugoslavs are to enter into a follow-on Fund programme for one year, with enhanced monitoring thereafter, and an IMF mission is currently in Belgrade. It is hoped that the Letter of Intent can be approved by early March, and the Yugoslavs have proposed a meeting with official creditors on 18 March.

Hungary, which has decided not to pursue a follow-on programme with the Fund, has taken advantage of continued market confidence by making two FRN issues in January, its first return to the bond market since 1982. The GDR has benefited from US banks' renewed interest in lending to Eastern Europe by seeking a euro-loan (initially for $150 mn, but subsequently raised to $300 mn) for seven years, on better terms (LIBOR + 7/8%) than were obtained last year (LIBOR + 1%).

(iv) Southern Europe

Greece looks likely to have come close to meeting (unambitious) targets for inflation (18%) and the current account deficit ($2 bn) in 1984. But with no tightening in prospect of a rather lax fiscal policy, further progress on both external and internal adjustment seems doubtful, and market confidence appears to be delicately poised.

Portugal again sharply cut the current account deficit in 1984 to $0.8 bn (compared with the IMF Standby target of $1.25 bn). The Standby which expires this month is not to be renewed and, with Presidential elections scheduled for the end of the year, the government is aiming at a modest reflation of the economy: a return to positive real growth is expected to widen the current account to around $1 bn, and the Budget deficit is projected to rise to 9.5% of GDP (compared with 8.5% in 1984). Market sentiment is currently favourable to Portugal, but could be adversely affected by emerging political uncertainties.

(v) Other

The dialogue between Nigeria and the IMF has been resumed with the visit of a Fund mission at end-January for routine Article IV Consultations, but the Nigerian authorities remain opposed to the key conditions for a programme. Progress has been slow on the issue of notes to uninsured creditors, but interest payments have begun on notes already issued. The first interest payment on certain insured arrears was to have been made on 5 January, provided that processing of these arrears had by then been completed; but this was not achieved, and the first payment is not now expected to be made until April at the earliest.

The Israeli Government has secured the agreement of industry and the unions to further counter-inflationary measures, has announced cuts in government expenditure, and taken steps to restrict the outflow of foreign exchange. The current account deficit narrowed last year, partly because of the prepayment of US grant aid, but the US has yet to respond to an Israeli request for an increase in aid this year and next.

The external position of Turkey continues to give cause for concern. The current account deficit last year, at an estimated $1.9 bn, was only slightly better than in 1983. Future projections for the current account, when taken in conjunction with medium-term debt maturities and a growing volume of short-term debt, suggest that greater priority will need to be attached to improving the external position if payments difficulties are to be avoided in the next few years.

Bank of England
February 1985

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INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt	British-owned banks' exposure[1]	ECGD Principal at risk	ECGD Total amounts at risk
	End-Dec 1984	End-June 1984	End-Dec 1984 [2]	End-Dec 1984 [3]
Latin America				
Argentina	48	2.6	0.2	0.3
Brazil	100	6.6 (0.5)	0.7	1.7
Chile	19	1.3	-	0.1
Colombia	12	0.7	-	0.2
Ecuador	7	0.6	0.1	0.1
Mexico	96	6.2 (0.6)	0.5	1.2
Peru	14	0.4	0.1	0.1
Venezuela	35	2.3	-	-
Eastern Europe (convertible currency)				
East Germany	12-13	0.6	0.1	0.1
Hungary	8.5	0.5	-	0.1
Poland	27	0.5	1.0	1.1
Romania	8	0.3	0.2	0.4
Yugoslavia	19	1.0	0.7	1.1
Southern Europe				
Portugal	15	1.3	0.2	0.3
Spain	38*	2.8 (1.0)	0.1	0.1
Greece	10*	1.5	0.2	0.4
Far East				
Indonesia	35	0.9	0.7	1.4
Philippines	25**	1.3	0.2	0.2
South Korea	43	2.7 (0.7)	0.4	0.7
Other				
Morocco	12*	0.1	0.1	0.2
Nigeria	20*	1.2	1.5	3.0
Israel	30**	0.6	0.1	0.1
Turkey	20	0.3	0.2	0.3

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

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

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

* End-December 1983   ** End-June 1984

Amounts in brackets represent undisbursed commitments where these exceed $1/2 bn.

- 1 MAR 1985