

CONFIDENTIAL



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 Prime Minister ②

To note - with progress
 report attached. AT 10/6

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

7 June 1985

Andrew Turnbull Esq
 10 Downing Street
 London SW1

Dear Andrew,

DEBT: ARGENTINA AND PERU

The Prime Minister should be aware that there may be some important developments in the next few days. They arise because the US bank regulators have their regular quarterly review meeting on 10 June, at which they will consider whether the debts of either or both these countries should be downgraded because of interest payment arrears. This could mean that the banks concerned who had not already made adequate provision would need to set large sums aside out of their profits to cover their potential losses.

ARGENTINA

As you know from earlier reports, the banks are assembling a \$4.2 billion package which will be approved once the IMF has agreed a new programme to replace the one which collapsed earlier this year. This is taking time to assemble; and the Alfonsin government has been very slow to negotiate a fresh IMF programme. Annualised inflation is now around 1000 per cent and the first quarter public sector deficit, at an annual level of 10 per cent of GDP, was over twice the IMF target. Domestic financial confidence has been damaged by the collapse of the Argentine Banco de Italia. Meanwhile, substantial arrears (over 180 days) have accumulated on overseas debt. This means that under the normal rules, the US banking regulators at next week's meeting may classify the loans as 'value impaired' (requiring a 10 per cent provision) or 'substandard' (a less serious problem).

We learnt on Wednesday night that the US Treasury were considering an emergency bridging operation. This would be designed to enable Argentina to bring interest up to 90 days' arrears,



sufficient to avoid reclassification. They would, however, only do so on receipt of assurances from de Larosiere that he was satisfied with the progress of negotiations with the IMF. At a meeting of the G5 'Debt Deputies' held here in the Treasury on Thursday, the US Treasury confirmed this and the French representative said (unprompted) that France was ready to join in a bridging operation. The German and Japanese representatives had not been asked. Nor were we: but Brian Unwin made it quite clear that the UK would not be able to join in.

We heard today that Argentina has been added to the agenda of the BIS this Sunday in Basle, apparently at French suggestion, to consider a rescue package. The Governor will be attending. It is not clear whether the UK will be asked to contribute. The Governor however has no intention of doing so. Nor will he seek actively to block a BIS operation, provided Argentina can offer adequate security - probably gold. Treasury officials believe that, if the Managing Director can report satisfactory negotiations with the Argentines, it is in our interests that the bridging operation should succeed.

We subsequently heard this afternoon that de Larosiere has now told the IMF Board that in discussions with the Argentines agreement has been reached on the main elements of a new stand-by programme. This agreement is yet to be translated into a formal Letter of Intent so that no immediate decisions by the Board are required. Details will follow by telegram.

PERU

The outgoing Peruvian government has built up very substantial arrears of debt (to banks and to governments). It will be for the new APRA government, which takes over on 28 July, to straighten out the economy and reach a settlement with its creditors and the IMF. (This may not be easy: the President-elect has publicly attacked the IMF and demanded much easier terms; but privately he seems ready to accept the need for a realistic solution.) Officials under Treasury chairmanship here have been preparing contingency plans against a possible Peruvian default after the change of government and are discussing them informally with other Finance Ministries. But the 10 June meeting of US bank regulators may pose a more immediate threat.

The US Treasury (at Thursday's G5 debt deputies meeting) believe the regulators may be prepared to postpone reclassification until the new government has had a chance to consider its policy. Apparently they have the discretionary powers to do this. But



there is still a danger that the loans will be reclassified next week. The regulators may be more disposed to take tough action if the immediate Argentine threat has been lifted, because the effects on the banks generally would be less serious.

GENERAL

In both cases, there are two risks. The more immediate one is that some of the US banks concerned may be badly-hit by the need to make big provisions out of profits, or even out of reserves. We do not know in detail how many banks might be involved. The second danger is that a sharp loss of confidence in Argentina, especially if coupled with enhanced risk of a Peruvian default, will cause some of the banks progressively to withdraw from Latin American loans, putting an increasing strain on the big money-centre banks and on governments to take over their shares. It is this threat which has apparently led the US Treasury to consider another bridging operation; they profess not to be seriously worried about the immediate impact on their own banks, although this must be very much on their minds after Continental Illinois last year.

Treasury officials are keeping in close touch with the US Treasury, and with the French, German and Japanese Finance Ministries (all of whom met in London on Thursday). The Bank of England is watching the implications for British banks very carefully.

The next regular report on the debt problem generally will be coming forward next week. But because events may move more rapidly in the next few days I am sending you this advance warning now with copies to Len Appleyard (FCO) and John Bartlett (Bank of England).

Yours sincerely

*Yours ever
Rachel.*

RACHEL LOMAX
Principal Private Secretary

7 JUN 1985

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