010

002/025

CONFIDENTIAL

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

Prime Minister
Covering letter only. I suggest
CDP 1/x.

Charles Powell Esq
10 Downing Street
LONDON SW1

1 October 1985

Dear Charles,

INTERNATIONAL FINANCIAL SCENE

I attach a summary of our latest assessment of the international financial scene prepared by the group under Roger Lavelle's chairmanship. Two key events of last weekend - the G5 meeting in New York, and the Mexican earthquakes - are both of considerable potential significance in any assessment of the debt prospect, though it is too early yet to say how far reaching they may prove.

Mexico's financial and economic position had been causing concern before the disaster. They had fallen out of compliance with the Fund programme (fiscal policy too loose, inflation too high), while the Mexican administration (traditionally a moderate influence) had been using increasingly hawkish public language on debt generally. This had, in part, reflected their disappointment at the failure of spontaneous renewed bank lending to emerge. Had the earthquake not occurred it had become increasingly likely that a package of concerted lending in parallel with a new Fund programme would be necessary, similar to the events of 1982.

This is to a degree overtaken by the earthquake. Immediately, unconditional Fund assistance under its emergency relief facility will be proposed in the Board (the G5 agreed to this in principle at their recent meeting in New York). Bilateral assistance will also have a part to play. In the longer term a new Fund programme will almost certainly be required when the prospects for the Mexican economy become clearer.

The Mexican authorities will try to use the tragedy of last weekend as a lever to extract easier terms from their creditors. Nevertheless, the prospect of immediate, quick-disbursing Fund

assistance together with other bilateral aid may help to bind Mexico more closely to the international community and maintain a relationship with the IMF on which to build negotiations towards a new programme.

Turning to the G5 discussions, to the extent that the dollar continues to soften and interest rates pressures the burden on debtors generally will be reduced. (Not all benefit; for example any additional weakening of oil earnings that may result from the lower dollar could damage Mexico more than other factors will assist her.)

Both the consensus on the over-valuation of the dollar and the effort to fend off protectionist pressures should help creditor nations defend the debt strategy more generally, both at Seoul and afterwards. As Seoul approaches, the Americans are engaged in working out new proposals for the next stage of the debt strategy. Those proposals are not yet finalised, but some form of enlarged role for the World Bank will be the centre piece. However, there are no signs yet that the US is prepared to support the idea of a General Capital Increase for the World Bank.

A strengthened role for the World Bank is in many respects to be welcomed. There are a number of ideas in this area which the UK can support - eg the closer involvement of the Bank in targetting worthwhile projects for export credit support. Others would be less attractive - eg the too ready giving of guarantees for commercial bank lending. We will need to examine in detail any specific proposals which emerge. The Economic Secretary, who will be representing the Chancellor at Seoul, will be so briefed.

Four other debtors are worth highlighting in this report. First, the picture in Latin America remains mixed. Argentina appears at least to be attempting sensible adjustment measures (though their resolve in following through with them has yet to be tested). Brazil, by contrast, is deliberately following a more relaxed fiscal policy than the IMF would advise. Their trade account and reserves are strong enough for there to be no anxiety about an early settlement with the Fund. Nevertheless, it remains difficult to see how the gap between the Brazilian administration and the Fund staff can be bridged.

Peru is also of concern. Since President Garcia's inauguration at the end of July, there had been hopes that, despite his initial rejection of a role for the IMF in resolving Peru's difficulties, in practice Peru's policies might be similar enough to an IMF prescription to allow some informal Fund endorsement of them

on which to build towards a settlement satisfactory to Peru's creditors. However President Garcia's hawkish speech at UNGA casts doubts on whether this is a realistic probability, particularly in view of the implication that Peru's unilateral restriction of debt service to 10 per cent of export earnings would apply permanently, and not merely to 1986.

The prospects in Nigeria are also difficult to judge. Immediately after President Babangida assumed power, it seemed possible that he would be able to make use of the window of opportunity available within which he could move quickly to an agreement with the Fund, without the trappings of the previous administration's position to hinder him. More recently there have been increasing signs of delay. Babangida spoke of the need for a national debate on the issue of the Fund's proposals. Now two committees have been set up, one to consider the relationship with the Fund, the other to look at policy on counter-trade.

While it must be hoped that these committes will help the President forge a national consensus in favour of a deal with the Fund, they risk damagingly delaying matters. The UK representatives at Seoul (the Economic Secretary and the Governor) hope to make informal contact with the Nigerian Finance Minister, building on the Foreign Secretary's trip earlier this month and impressing on the Nigerians the urgent need for them to move to a Fund agreement.

The report contains little new about South Africa; the situation is still very confused, but the appointment of Leutwiler as mediator, announced this week, should help.

I am copying this letter and the attachment to Len Appleyard (FCO), John Mogg (DTI) and John Bartlett (BOE).

Yours ever
Rachel

RACHEL LOMAX
Principal Private Secretary

0071u

CONFIDENTIAL

INTERNATIONAL FINANCIAL SCENE

The devastating earthquakes that hit Mexico between 19 and 21 September have for the moment turned attention from the country's longer-term debt problems. Full assessment of the economic impact of the earthquakes has yet to be made, but it has been reported that the US Treasury, IMF and IBRD are working together to assemble an emergency rescue package for Mexico, estimated by one source to amount to nearly $3 bn. The country's productive capacity appears to be largely intact, but substantial resources will clearly have to be employed on reconstruction work, and receipts from tourism are bound to fall. There will be further serious upward pressure on the public sector deficit, but the impact on some of the external indicators - such as the level of the reserves - is perhaps less certain.

Until the Mexican earthquakes, South Africa had in the previous weeks probably been the principal concern of many of those involved in debt questions. A number of banks cut their credit lines to South Africa in August following a rapid drop in confidence as a result of internal unrest, political uncertainty, and mounting pressures for sanctions. The country's heavy reliance on short-term debt, as noted in the last Report, made it particularly vulnerable to such swings in confidence, so liquidity problems followed rapidly, and on 1 September it had to call a four month moratorium on principal repayments. Interestingly, and inevitably given the maturity profile of South Africa's debt, in a break from the pattern that had been established with other countries experiencing debt-servicing problems, this time short-term (ie interbank and trade) as well as longer-term debt was included in the moratorium.

Nevertheless, although overshadowed by South Africa, recent developments in Latin America (even apart from the Mexican earthquake) are in some ways perhaps more worrying: amongst these

developments are the tougher line on debt issues that the Mexican authorities have recently been taking, and the protracted nature of the negotiations and arrangements for MYRAs for some other Latin American countries.

The final stage of the Mexican MYRA was signed on 29 August. However, earlier expectations that the completion of a MYRA would lead to a more settled debt situation seem to have been misplaced. The Mexican Finance Minister, in the face of a serious deterioration in the economic position of his country, used the opportunity of the signing of the MYRA to assert that new ways would have to be found to ease his country's debt burden: partial capitalisation of interest, and 'voluntary' new lending, were mentioned. With Mexico formerly having been the 'model' debtor, any perceptions that its economic strategy had not brought it success would be bound to have serious implications in other debtor countries regarding their commitment to adjustment policies. Conversely, any concessions that were granted to Mexico would be likely to be demanded by other debtors, and experience of handling the debt situation over the last three years has shown that it is difficult to be selective in granting them.

The impact of the earthquakes on Mexico's attitude to its debt obligations is not yet clear. On the one hand, some might expect that the massive international response to the earthquakes would indicate to the Mexicans the benefits of not cutting themselves off from the international community. Alternatively, however, the Mexicans might feel that the strength of both the economic and the moral case for additional resource flows has now increased, and they may be less willing to accept IMF demands for further austerity.

Mexico is the only important debtor where a bank MYRA is now in operation. Discussions over the Brazilian MYRA seem unlikely to lead to early agreement, and the Brazilians are reported to be prepared to let negotiations go on into the New Year. The signing of Ecuador's MYRA too has been delayed, although it is now expected by the end of the month. The Venezuelans expect their MYRA to be signed in October, but this may be optimistic.

Economic performance in debtor countries recently has been mixed. Whilst Mexico's performance on the external side has so far been considerably less successful than last year, Brazil still seems on course to meet its external targets. Internally, however, whilst both countries have taken measures to reduce their fiscal deficits, both remain well over target. Inflation too remains stubbornly high. In contrast, after the austerity measures and the currency reform announced in June, Argentina's inflation has been cut dramatically, from 30% in June to just 3% last month. With public opinion reportedly still firmly behind the adjustment programme, prospects for Argentina seem at the moment to be much more hopeful than had earlier seemed likely, although the real test will be in the coming months.

On the wider economic field, developments over the past few weeks have been mixed. Eurodollar interest rates have risen slightly (the 6-month rate now lying around 8 1/2%), but are still well below the levels of the beginning of the year. The US economy does not appear to have slowed to the extent that had earlier been feared: revised figures for the second quarter show a growth rate of 2% (ar), and the fall in US unemployment in August - to 7.0%, from 7.3% in July - suggests that growth continued into the current quarter, although some more recent indicators have been slightly more gloomy. On the negative side, from the viewpoint of most debtors, was the reversal in early September of July's depreciation of the dollar: after being relatively stable in August, the US dollar rose strongly at the start of this month, and reached its highest level since April, although in effective terms still 9% below its February peak. Even more worrying, and of course not unrelated to the continued strength of the dollar, was the increasing threat of serious protectionism in the US. In the face of strong Congressional pressure for the introduction of protection, the White House announced its own proposals to move against the "unfair trading practices" adopted by a number of countries, including two of the largest debtors, Brazil and Korea. In response to growing fears about the strength of the dollar, the US invited Finance Ministers and Central Bank Governors from the G5 countries to meet on the weekend of 21/22 September. The resulting announcement that all the G5 wished to see a lower dollar, and were taking action to bring this

about, and heavy central bank intervention in the foreign exchange markets since then, have helped to push the US dollar down, by over 4% in effective terms. Whether this downward trend will be maintained, and whether this is sufficient to deflate protectionist pressures in Congress, has yet to be seen.

Non-oil commodity prices continue in general to be weak; the oil price too remains weak, although fears of a more rapid fall have so far not been realised. The new government in Nigeria has expressed its opposition to its predecessor's oil barter policy; how it intends to react to OPEC more generally is not yet clear. The Nigerian government may be adopting a more positive attitude to the Fund: some encouragement may be had from the appointment as Finance Minister of Dr Kalu Kalu, a World Bank economist who has made sensible remarks in public about a realistic exchange rate.

Borrowers from non-OECD countries have taken just over $1.7 bn from the international markets since 1 July. Nearly all of this is split between South Korea ($1.0 bn), Hungary ($0.3 bn) and Turkey ($0.25 bn). South Korea and Hungary borrowed both through syndicated credits and fixed and floating rate bonds, while Turkish borrowers used only syndicated credits. The terms on these loans continue generally to be at similar fine spreads to those achieved earlier in the year. South Africa made three bond issues early in July, amounting to slightly less than $100 mn, but naturally has not been in the market more recently.

Attention will now be turning to the IMF/IBRD meetings in Seoul, where debt issues will be discussed. The paper prepared by the G24 on international monetary reform, for instance, makes a number of recommendations (most of which reflect long-standing themes). These include calls for increased IMF lending, for IMF surveillance to encourage symmetric international adjustment between creditors and debtors, for interest rate reductions, and for developed countries to take action to roll bank protectionist measures and to discourage capital flight from debtor countries. Little progress is expected on these proposals at the meetings, but indications are that debtor countries will not be seeking a confrontational approach; there is no evidence that any debtor is

contemplating the sort of radical approach advocated by Castro at the conference on debt which he hosted in Havana at the end of July, nor has any other debtor so far followed the lead of Peru in unilaterally declaring a limit to the debt-servicing it was prepared to offer. Nevertheless, debtor countries are likely to be pressing keenly for action that might ease their debt burdens. The US seems to have become increasingly concerned at the debt situation and is likely to propose a new initiative at Seoul which would involve a greater role for the IBRD.

Further details on individual countries are given below.

(i) Latin America

Argentina's economic policies continue to win endorsements from the IMF and the creditor banks. In June, the Argentine government introduced a currency reform and wage/price freeze which, along with the earlier devaluation of the peso and a number of measures designed to reduce the public sector deficit from 12% of GDP in the first half of the year to 2% in the second half, represented a radical departure from Argentina's earlier half-hearted approach to economic adjustment. In support of the new programme, early in August the IMF Board reinstated the SDR 1.4 bn Standby (agreed last December). The commercial bank debt package has now been signed, comprising $4.2 bn of new money and agreement in principle to the rescheduling of $13.4 bn of public and private sector maturities falling due between 1982 and 1985. The first disbursements of new money will depend upon the Argentines having satisfactorily met the performance criteria of the IMF programme.

Although certain deficit-reducing measures have still to be implemented - for example a banking transactions tax and an enforced savings scheme - measures already adopted - which include increases in oil prices and export taxes - have led to an improvement in public finances: in August Treasury revenues actually exceeded expenditure. Furthermore, price increases have been cut from a monthly rate of about 30% in June to only about 3% last month. Renewed confidence has reportedly also led to the repatriation of significant amounts of capital. The main

concerns at the moment are that, in the run-up to the November congressional elections, President Alfonsin may ease back on his counter-inflation strategy, and that the fixing of the austral to the US dollar, and the deterioration in Argentine competitiveness that this is bound to bring about, may lead to a deterioration in the country's trade performance. Overall it is too early to judge how successful the new economic strategy will prove in the short-term or to gauge the political will of the government to maintain appropriate policies over the necessary medium-term adjustment period.

In contrast, recent developments in Brazil have given rise to more general concern about economic policy and prospects for agreement with the IMF, and this has for the time being halted progress towards a MYRA. At the end of August, both Finance Minister Dornelles and Central Bank President Lemgruber resigned because of their opposition to the direction of economic policy. Their replacements - Dilson Domingos Funaro and Fernao Bracher - are, in their dealings with IMF, likely to adopt the more expansionary line advocated by Planning Minister Sayad and Presidental Economic Adviser Rosemberg: namely, that any IMF programme must be consistent with real GDP growth of 5% per annum, and must permit increases in social spending. Meanwhile, although some action has been taken to restrain the public sector deficit, the IMF are urging an even tighter fiscal policy. In response, Rosemberg has apparently proposed a 'shadow programme' for the remainder of 1985 and early 1986, leaving negotiations on a new Standby until next year. This augurs badly for an early agreement on a MYRA. It may also dissuade banks from agreeing formally to the Brazilians' request for a 140-day rollover, from end-August, of $16 bn of short-term lines and Phase 1 maturities. Meanwhile, on the wider economic front, the pattern established in 1984 continues: the trade account is performing strongly, but the rate of inflation, artificially depressed by price controls in the four previous months, sumped by a record 14% in August after the controls were removed, pushing the rate of inflation in the twelve months to end-August back up to 227%.

Even before the earthquakes there were also worrying developments in Mexico, even though the final phase of Mexico's MYRA (covering $20 bn of debt not previously restructured) was signed on

29 August. At the time of the earthquake it had just been announced that Mexico's EFF had broken down: most of the end-June performance criteria were missed - those relating to the public sector deficit and net international reserves by a large margin. No decisions had been taken on the way forward. A Standby arrangement for next year is now a strong possibility, but it will clearly not be possible to formulate a new programme, with targets for the public sector deficit, net reserves etc, until an assessment can be made of the public expenditure implications of the earthquake and of related inflows of aid. Enhanced surveillance by the IMF, due to have started in 1986, must now be deferred. Meanwhile, the inflation forecast for the year has been revised upwards, and is now expected to be close to 60%, whilst the strong trade performance of 1984 has not been fully sustained. At the same time, the general weakening of Mexico's economic position seems to have led to some hardening of Mexico's attitude towards external creditors. Finance Minister Silva Herzog has called for partial capitalisation of interest and for more voluntary lending to Latin America, if necessary throughout the life of MYRAs, whilst President de la Madrid, has called for continuing dialogue and negotiation. The Mexicans are likely to lobby creditors at the IMF/IBRD annual meetings.

Elsewhere in Latin America, a number of debtor countries seem to be getting closer to finalising debt agreements, and some - but not all - of them have resolved outstanding issues with the IMF. In Chile, the attainment in August of a 'critical mass' of commitments to the $1,085 mn of commercial bank new money for 1985 and 1986 activated Chile's SDR 750 mn EFF (agreed earlier this year). However, commitments for $35 mn of the new money facility are still being sought, and the banks do not expect to sign the MYRA until mid-1986. Nevertheless, Chile has reached an agreement with eight Paris Club creditors on rescheduling $170 mn of maturities falling due between July 1985 and end-1986. Colombia's economic programme has been approved by the IMF Board, which also agreed to IMF enhanced surveillance of the economy until the end of 1986. Commitments to the $1 bn of commercial bank new money are still some way short of the total, but the bank Consultative Committee expect the loans to be signed, and the

first tranche to be disbursed, this month. Ecuador's $200 mn new money agreement was signed in August and has now been fully disbursed; signature of the 1985-1989 MYRA is expected later this month. There is, however, some uncertainty over the country's SDR 106 mn Standby programme agreed in March. The second drawing, due after 1 August, has not been made, because, although all macroeconomic performance criteria were met, Ecuador has so far failed to unify its official and intervention exchange markets. Although Ecuador transferred most of the remaining transactions to the intervention market in the last week of August, certain transactions have been kept on the official market. The IMF Board is to discuss the situation on 20 September. The signing of Venezuela's $21.2 bn MYRA, for 1985-1989 public sector maturities, has been put back until October, although even this might be optimistic.
President Garcia of Peru continues to urge radical solutions to the debt issue. In his inauguration speech of 28 July, he stated that Peru would limit debt service payments to 10% of export earnings and would by-pass the IMF in its negotiations with creditors. Nevertheless, it seems that Garcia may seek some modus vivendi with the IMF. In the meantime, Peru has asked the banks to approve a moratorium on principal falling due before 31 January 1986; the bank's Steering Committee has made no recommendation on how individual banks should respond to this request, partly because the Peruvians have given no indication of when interest payments will be resumed, nor of what their economic programme will be.

(ii) Far East

Within Asia there are increasing signs of strain between the IMF and the Philippines. The country is arguing that the conditions attached to the current Standby Arrangement have been too harsh, and that they are causing unnecessary austerity. Despite this, the IMF are asking for a further tightening of the fiscal position, as well as greater urgency to be given to structural reform. The Philippine authorities are currently assessing the situation.

As regards South Korea, in response to pressure from a number of industrialised countries, the authorities have stated that they would refrain from making drawings under the IMF Standby they have recently negotiated if balance of payments developments should turn out to be significantly better than currently expected. Meanwhile, expected GNP growth for 1985 has been revised down again to 5-6%; and, in order to achieve this rate, the government has moved to reflate the economy. Indonesia's reserves (including foreign assets of state-owned banks) still exceed $10 bn, giving a substantial cushion against the present weakness in the oil market.

(iii) Eastern Europe

Yugoslavia has finally reached agreement with the banks on terms for rescheduling 1985-88 maturities. A meeting between Poland and its official creditors to discuss rescheduling of 1985 maturities, originally set for 16 September in Paris, has been postponed until creditors are satisfied that the Poles have paid interest due at the end of August. An IMF team is to visit Warsaw shortly to assemble the remaining information for the staff paper on membership. Romania has been obliged to accept a split spread of 1 1/4% - 1 3/8% for a 5-year $150 mn loan to ease its current liquidity problems. Hungary, which now seems likely to fall well short of its convertible currency account surplus target for this year, is sounding out the banks on a possible $400 mn financing which could include more flexible options such as a note issuance facility, while Bulgaria has returned to the market for a further $125 mn credit at a margin of 3/8% and Czechoslovakia is to prepay a relatively expensive $50 mn credit arranged in 1983.

(iv) Southern Europe

There is increasing evidence in Portugal of further improvement this year in the external account and a reduction in the rate of inflation. Prospects for 1986 are clouded by uncertainty about the outcome of next month's elections.

(v) Africa

In Egypt arrears are building up on military debt, and, with little propsect of an upturn in most of the major sources of revenue (oil, overseas workers' remittances, tourism and Suez Canal dues) approaches have been made to the IMF for some form of assistance. Morocco's request for a Standby arrangement with the IMF and for a purchase under the Compensatory Financing Facility was approved by the Fund's Executive Board in the second week of September, on the basis of agreement between the banks' steering committee and the authorities on rescheduling 1983-4 commercial bank debt. This approval enabled the Paris Club to agree a rescheduling of official claims on 17 September. The new military government in Nigeria has indicated that it may resume negotiations for an IMF programme, although it is not yet clear what its attitude will be to the major obstacle of devaluation. Foreign exchange shortage has caused some interruption of medium-term debt servicing, and there has been concern about the painfully slow process on issuing notes to uninsured creditors in respect of agreed trade arrears. Restructuring of insured trade arrears awaits an agreed IMF programme.

South Africa announced a four-month moratorium on certain categories of external debt repayments, including funds borrowed in the interbank market, on 1 September. This followed the widespread cutting of lines to the country, particularly by US banks, and severe downward pressure on the exchange rate, in part because of non-resident sales of rand securities. The country will attempt to use the moratorium period to reach agreement with creditors to reschedule debt, but creditors are unlikely to wish to be seen to be too co-operative. The South African economy, however, seems to be in a strong position, with serious adjustment measures already having been undertaken over the last year, and on present economic trends one might expect the country to be able to get by without any need for "new" money. However, the political situation remains highly uncertain, and may lead to further adverse shocks on South Africa's economic performance and its debt-servicing ability. From a systemic point of view, South Africa is perhaps of less concern than other problem

debtors, as the contagion from developments in South Africa is likely to be limited. Nevertheless, it remains of particular concern to the UK, not least because the highest exposure to the country rests with British banks.

Discussions continue between the IMF and the Sudanese authorities on measures which could permit a new Standby. The main outstanding issues are the exchange rate and Fund arrears. De Larosiere has invited the UK and other donors to contribute to paying off arrears, and is to call a meeting of the G5, plus Saudi Arabia, Kuwait and the Netherlands in Seoul to sort the matter out. Meanwhile, a re-rescheduling of $800 mn of unguaranteed commercial bank debt has been agreed.

(vi) Other

Following the government-sanctioned price increases in Israel prior to the latest three-month freeze, consumer prices surged by 27.5% in July, bringing the year-on-year rate to 445%. No agreement has yet been reached on measures to follow the freeze, which ends at the beginning of October. The transfer of $750 mn US supplementary economic aid is expected this month. An IMF team have arrived in Turkey for routine consultations, but Government officials have said that there is no intention to seek a further programme. Turkey broke off talks about a further Standby in April following Fund concern about the country's budget deficit and ambitious growth targets.

CONFIDENTIAL

23. 9.85

INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1984	End-Dec 1984	End-June 1985 [2]	End-June 1985 [3]
Latin America				
Argentina	48	2.5	0.1	0.2
Brazil	100	6.6	0.7	1.7
Chile	19	1.3	-	0.1
Colombia	12	0.6	-	0.2
Ecuador	7	0.5	0.1	0.1
Mexico	97	6.2	0.5	1.3
Peru	14	0.3	0.1	0.1
Venezuela	39	2.2	-	-
Far East				
Indonesia	35	0.8	0.8	1.6
Philippines	26	1.3	0.2	0.2
South Korea	43	2.4 (0.5)	0.4	0.8
Eastern Europe (convertible currency)				
East Germany	13	0.6	0.1	0.1
Hungary	9	0.5	-	0.1
Poland	27	0.5	1.1	1.3
Romania	7	0.3	0.2	0.5
Yugoslavia	19	0.9	0.7	1.0
Southern Europe				
Greece	16	1.3	0.2	0.4
Portugal	15	1.2	0.2	0.3
Spain	39	2.5 (1.1)	0.1	0.1
Africa				
Egypt	32*	0.4	0.2	0.9
Morocco	12	0.1	0.1	0.2
Nigeria	18	1.3	1.9	3.3
South Africa	25	5.0 (1.1)	0.8	2.8
Sudan	9	-	0.1	0.2
Other				
Israel	30	0.5	0.1	0.2
Turkey	21	0.3	0.2	0.4

[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. (End-June 1985 figures will be available in mid-October.)
[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.
Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans.
* current estimate