

PRIME MINISTER

*Minted
MCS. 7/5
We must try to
stop the signature
on the medium term loan*

MF

Argentina, IMF and Commercial Bank Loans

The promised paper from the Treasury, FCO and Bank has now arrived and is attached.

It is a disappointing paper, in that it nowhere tells us what would happen if we asked the banks to freeze their share of the undrawn \$300m in the bridging loan (paragraph 4a) and withdraw from the medium term loan, which is still unsigned; nor does it explain how we would present publicly ^{such a} the change of policy. (The Opposition would say that nothing new has happened since it was always likely that these loans would be used, or were being used, for arms purchase purposes). Nor does the paper ask whether our objective is to stop Argentina buying arms, or simply to disassociate ourselves from arms purchases which would be going ahead anyway.

The two practical issues are:-

i) Can we do anything about the May drawing under the IMF facility? I think not. The Fund have given Argentina until the July drawing to remove their discrimination against UK companies, and so, provided that Argentina meets the Fund's normal criteria, the May drawing will take place.

ii) Evidence of Russian arms sales to Argentina? We are promised a paper by the Americans on this, and should clearly wait for this before reaching any conclusions. John Coles and I think that you should have a better paper than the attached. Agree that the Cabinet Office should be asked to produce an OD paper on the whole issue, for consideration immediately after the Election?

*Yes
MF*

MCS

16 May 1983

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10 DOWNING STREET

From the Private Secretary

17 May 1983

ARGENTINIAN IMF AND COMMERCIAL BANK LOANS

Thank you for your letter of 16 May, and for the attached paper on the Argentinian loans and arms sales.

I showed this to the Prime Minister. She has enquired when it is envisaged that the medium-term loan will be signed. I should be grateful if you would let me know urgently if there is any prospect of the loan being signed in the near future.

I am sending a copy of this letter to Brian Fall (Foreign and Commonwealth Office) and Tim Allen (Bank of England).

M. C. SCHOLAR

John Kerr, Esq.,
HM Treasury.

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

16 May 1983

Michael Scholar Esq
10 Downing Street

Dear Michael,

ARGENTINA: IMF AND COMMERCIAL BANK LOANS

We spoke a week ago about the paper on financial relations with Argentina, and future policy options, which was in preparation in the Treasury. I now attach the final version, agreed with the FCO and the Bank, of this paper. It has been seen by the Chancellor.

Copies of this letter go to Brian Fall at the FCO and Tim Allen at the Bank.

Yours ever,
J O Kerr

J O KERR

ARGENTINA : IMF AND COMMERCIAL BANK LOANS

This note reviews the current state of play, and the options for UK policy, on the IMF and international commercial bank loans to Argentina.

Indebtedness

2. Argentina's total indebtedness at end-1982 was estimated at £39 billion, including £2.7 billion in arrears.

3. At end 1982, ECGD had an estimated £260 million at risk. Consolidated unguaranteed claims on Argentina by UK-registered banks at the same date were £3.1 billion; and by British-owned banks £2.3 billion.

Credit facilities

4. There are four main elements:-

a. A bridging loan of £1.1 billion from international banks was signed in December 1982, of which UK banks' share is £111 million. £800 million net of this loan has so far been disbursed.

b. An IMF standby facility of SDR1.5 billion was agreed in January 1983. Disbursement is in five quarterly instalments over a period of 15 months, subject to fulfilment of quarterly performance criteria (covering balance of payments deficit, public sector borrowing, domestic credit expansion and public sector net external borrowing), paying off all external arrears by end-June, and removal of discriminatory exchange restrictions against the UK by end-July at the latest. SDR 300 million has been drawn so far, and a further SDR 300 million can be drawn later this month provided the Fund are satisfied with Argentina's first quarter performance (as seems likely).

c. A medium term loan of £1.5 billion (UK banks' share £159 million) is still under negotiation with international banks, and signature, which has been several times postponed, is now unlikely before June. Argentina's need for external

finance may now be rather less acute, reflecting her fairly strong trade performance.

d. A £500 million BIS facility (not involving the Bank of England) was agreed in January, but this is unlikely to be drawn before the May expiry date because of technical problems concerning gold negative pledge clauses.

Rescheduling proposals

5. Talks on rescheduling of £5.5 billion of public sector debt maturities due to the banks in 1983 are aiming at agreement by end-June. Refinancing of short-term private sector debt and foreign currency swaps is still under negotiation. There is no sign at present of any request for a rescheduling of officially guaranteed debts in the Paris Club.

Policy considerations

6. Two kinds of difficulties arise on the position the Government has taken so far on the IMF support package and the commercial bank loans:-

a. The continuing general hostility, in Parliament, the media and from the public at large, to the UK apparently helping to bail out Argentina, in the wake of the Falklands War and reports of continued Argentine arms purchases. These problems would be exacerbated should recent indications that Argentina may be considering the purchase of arms from the Soviet Union gain general currency. Although the source of arms would not affect the financial case for UK participation in the support operation, it would add a new and troublesome dimension of political difficulty. It may in practice be very difficult to establish whether reports of possible Russian arms sales have any substance or can safely be discounted.

b. The remaining discriminatory financial restrictions affecting UK banks and other companies under Argentine Law 22591. The Argentine authorities have been told by Larosiere that removal of these restrictions is a condition for further drawings on the standby facility beyond July. British banks involved in the medium term loan are also pressing for

removal of these restrictions before confirming their participation. The attached note by the Bank of England describes the nature and impact of these restrictions, and their bearing on the IMF and commercial bank facilities.

Scope for Government action

IMF Standby

7. Various scenarios can be envisaged.

8. If Argentina fails to satisfy the Managing Director that the discriminatory restrictions have been lifted, then the programme should lapse without further Executive Board discussion. In this event, it is almost certain that the commercial banks will not be prepared to proceed with their medium term loan and the question of British banks' participation will then no longer arise.

9. If the Managing Director is satisfied, the IMF programme is likely to be brought to the Board for review in July or August, and we would at that point have to decide whether we agreed with his view. This question would be partly a legal judgement, but would depend also on whether the banks and other UK companies concerned are satisfied with the position. It appears rather unlikely that there would be a difference of view between us and the Managing Director, given the very firm position he has taken on this issue. Assuming no breach in the performance criteria of the standby agreement we would have no ^{grounds} for causing difficulties during the Board review.

10. Assuming that the problem of discrimination is resolved to the Fund's and our own satisfaction, the possibility remains that Argentina might have to seek a waiver of its undertakings to the Fund because of a breach of the performance criteria. If this were to happen at a time when rumours of Soviet arms sales to Argentina were widespread, this would raise the question of whether the UK should support a request for a waiver.

11. If a situation did arise in which the UK decided to oppose within the Executive Board continuation of the standby programme for Argentina, the issue would be decided on a simple, majority vote. Our own voting share on the Board is 8%.

Medium term loan by commercial banks

12. The Government has no legal power to interfere with the decisions of the 30 or so British commercial banks, led by Lloyds Bank International, which are involved in the medium term loan. But it could adopt various public postures towards British participation, ranging from (at the positive end) active endorsement of the banks' position, through studied neutrality to (at the negative end) clearly dissociating itself from a decision to proceed.

13. As noted above, the key issue for the banks is likely to be whether discrimination has in fact been satisfactorily removed. But, even if this requirement is met, the Government nevertheless might wish to distance itself from involvement by Lloyds and others in the medium term bank loan if worries remained on Soviet arms.

The possibility of default

14. If the IMF programme or the commercial bank loan did collapse without intervention by the UK Government or banks, the possibility would of course arise of an Argentine default, perhaps an explicit repudiation of all her external debt. Our response would need to be concerted with other creditor countries, but the risk that other major debtor countries in South America might quickly follow suit ^{though it could be excluded entirely} seems less than a few months ago. If, on the other hand, circumstances arose in which action by the UK alone might have the effect of blocking the loans, we clearly would need to assess carefully in the light of circumstances at the time the possible consequences, including the risk of financial counter-measures aimed against us and the effect of repudiation on British banks.

15. On the latter point, at the end of 1982 twelve British banks had exposure to Argentina of almost £1,600 million, equivalent to about 10% of their capital and reserves. In addition 19 consortium banks in London (predominantly foreign owned, but incorporated in the UK and supervised by the Bank of England) had a total exposure to Argentina of £430 million (about 40% of capital and reserves). The exposures of the great majority of the banks are small both in absolute amounts and in relation to the size of the bank.

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16. In the event of a repudiation by Argentina it seems likely that banks would have to write off their Argentine exposure right away. In the first instance the cost of doing so would have to be borne by the current year's profit. If, after write-offs, the banks made a loss for the year this would have to be absorbed out of reserves, share capital and loan capital. Assuming that banks' profits run at much the same level as last year, it appears that five of the eight largest British banks would probably still show a profit, although in some cases at less than half last year's level. The remaining three would make losses, which could easily be absorbed out of their reserves, although not without damage to confidence in them. The most seriously affected would be the consortium banks. It is possible that one might become insolvent as a result of writing off its Argentine exposure; at least six others would suffer serious depletion of their reserves, although probably not to the extent of depositors losing money. The Bank have received "comfort letters" from the shareholders in all of the consortium banks in which they undertake to provide support if necessary; although it is not easy to judge in advance how far the shareholders' own ability to provide support would be impaired by an Argentine repudiation.

17. By comparison, of the four US banks with the largest exposure to Argentina it appears that one would make a loss, which could be absorbed out of reserves, two would roughly break even, and one would see its profit halved.

Conclusion

18. There is no immediate need for action and decisions are unlikely to be required until July. Lloyds are well aware of the pressure we have put on the IMF and that the IMF has given strong support to the UK position; they and other UK banks are therefore unlikely to commit themselves to the \$1.5 billion loan if discrimination has not been lifted by Argentina. On the other hand we see no grounds at this stage for raising afresh with the banks the hypothetical question of Russian arms sales to Argentina; they are aware of the sensitivity of this issue and no doubt, if rumours of such sales began to develop, would approach the Bank for guidance. In that event a rapid reassessment would be needed in which developments in other Latin American debt situations, and of the international debt outlook more generally, would have to be taken into account.

ANNEX

FINANCIAL DISCRIMINATION AGAINST THE UK : LAW 22591

On 19 May 1982 the Argentine National Executive power approved Law 22591 which states that -

"The non-disposability is decreed of all assets within the territory of the Argentine Republic ... which are the property of the United Kingdom ... the British Crown, British subjects not resident permanently in the Argentine Republic ... and any company ... directly or indirectly controlled thereby (Article 1)".

2. Under Article 4 this Law also provides for the appointment of overseers or co-administrators to the companies mentioned in Article 1; and a Supervisory Committee (committee of vigilance) was created (Article 5) to ensure these restrictions were enforced.

3. Despite the mutual lifting of financial sanctions on 18 September 1982, Law 22591 remains in force. Its main practical effect is to prevent British companies from remitting profits and dividends to the UK. Non-British companies may make such remittances through purchases of dollar-denominated public bonds (BONEX) from the Central Bank at the official rate of exchange, the bonds then being held to maturity (5 years or, more usually, sold overseas. British companies may purchase BONEX but may not dispose of them).

4. We have carried out regular checks this year with a number of UK companies which have operating companies in Argentina and their position has remained substantially unchanged during that period, ie Law 22591 continues to be administered in a restrictive way. In broad terms the position of UK companies is as follows:-

(i) 6 have made no profits and therefore have not purchased BONEX.

(ii) 3 have not attempted to purchase BONEX, despite having profits, mainly because they wish to keep a low profile.

(iii) 4 have purchased BONEX but have been refused permission to market them.

(iv) 2 have BONEX but have not asked permission to dispose of them.

In recent weeks, however, there have been instances of UK companies in Argentina being authorised to remit royalties and service payments to the UK - a very slight easing of the Argentine position.

5. Given the cessation of hostilities the IMF now view the implementation of Law 22591 as an act of discrimination by one member country against a fellow member. The Fund's Managing Director has so far taken a robust line on this issue and has stated that the payment restrictions have to be removed by Argentina as a condition of making further drawings under the existing standby arrangement after 31 July 1983. Nevertheless the Chancellor took the opportunity of a meeting with him in the margins of the Development Committee meeting in Washington on 28/29 April to underline the importance attached by the UK to the ending of discrimination.

6. The Argentine Government is now apparently considering a revised law to change the entire Law 22591 but the content of this remains unknown to us. The financial authorities are clearly aware of the need to remove discriminatory restrictions but have not so far been able to persuade the military junta that action must be taken. Failure to act would deprive Argentina of the following drawings on the IMF standby agreement:-

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SDR 300 mn on or after 20 August 1983

SDR 300 mn on or after 20 November 1983

SDR 300 mn on or after 20 February 1984

Furthermore, the medium-term \$1.5 bn loan from commercial banks would almost certainly not proceed. UK banks are unlikely to participate without the removal of financial sanctions and other banks would in all probability insist on Argentina being in good standing with the Fund.

Economic Policy & Institutions