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C.A.W.

TELEPHONE
01-601 4444

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BANK OF ENGLAND
LONDON EC2R 8AH

7 July 1983

Michael Scholar Esq
10 Downing Street
London
SW1

Prime Minister

You asked for a paper on Brazil by Anthony Loehnis.

MCS 8/7

A very weak paper - especially after the talk we had about the Cooke committee at the Richardson dinner.

Dear Michael

BRAZIL

I enclose a report on the current Brazilian situation as requested in your letter of 1 July. This has been discussed with Treasury officials who are in broad agreement with it.

The Chancellor will be letting you have another in the series of regular monitoring reports on the wider debt situation early next week. This will provide an opportunity to update the Brazilian situation in the light of any developments in Brazil itself or arising from discussions at the meetings in Paris and Basle either side of the weekend.

I am sending a copy of this letter and its enclosure to John Kerr (HM Treasury).

Yours sincerely

John Bartlett

John Bartlett
Private Secretary to the Governor

(1) What ARE the views of Germany, Switzerland & Holland? If against, then I think we should join them. But I suspect they will wobble. In that case we should only agree to a 2 week FINAL postponement.
MT

SECRET

BRAZIL

Background

1 Since 1967 Brazil has recorded very substantial GDP growth and a strong increase in exports. The latter, combined with Brazil's enormous natural wealth and reputation for able economic management, encouraged a steady flow of lending by international banks. Brazil's external borrowing was generally put to good use insofar as it was directed largely to productive investment (although some of the investments are now considered to have been too large in scale); and with borrowing controlled by the authorities the resulting debt structure was considered good insofar as there was no bunching of maturities.

2 There were, however, major weaknesses in Brazil's position. Since the second oil shock of 1979, oil imports accounted for some 50% of total imports; inflation was, and is, endemic and its symptoms were dealt with by a complex system of indexation; and the size of its external borrowing needs by 1982 had become so large that any interruption to the inflow of foreign resources was bound to have a rapid and disastrous effect on the country's balance of payments. In August 1982, Mexico's declaration of a 90-day moratorium quickly led to a drying up of Brazil's external sources of funds, when only $11 bn of the $16 bn of gross bank borrowing planned for 1982 had been secured.

Financial Assistance

3 In response to the liquidity crisis which then quickly emerged, governments, banks and the IMF responded with a variety of short and longer-term facilities. The first to respond was the US Treasury, with resources drawn from the Exchange Stabilisation Fund and swaps from the Fed totalling $1.53 bn. On 23 December Brazil obtained a $1.2 bn bridging facility from the BIS (later supplemented by a further $250 mn backed by SAMA). Proposals put by Brazil to commercial banks on 20 December with the full support of the IMF's Managing Director were for a four project package: (1) an 8-year jumbo loan of $4.4 bn (the first $2.5 bn tranche of which would repay a $2.2 bn bridging loan extended by the banks earlier in the month), (2) the rescheduling over 8 years of 1983 maturities of

debt due to banks totalling $4.7 bn, and the re-establishment at former higher levels of (3) trade related credit lines and (4) inter-bank lines. Agreements covering projects (1) and (2) were signed on 25 February and at the same time the commercial banks were morally committed to achieving the targets set for projects (3) and (4).

4 Meanwhile parallel negotiations were taking place with the IMF and on 28 February a three-year Extended Financing Facility for SDR 4,239 mn was approved by the IMF Board. The programme supported by the EFF required the reduction of the public sector financing requirement from 16.9% of GDP in 1982 to 8.8% in 1983 and aimed to increase the trade surplus from $0.8 bn in 1982 to $6 bn this year, implying a halving of the current account deficit to $7 bn and no change in net international reserves after a $8.9 bn fall last year. The IMF also approved a Compensatory Financing Facility for SDR 499 mn in December and a further CFF for SDR 466 mn in February.

5 At this point the outlook looked reasonably promising, particularly as on 21 February, shortly before the EFF was approved Brazil devalued its currency by 23% (and undertook to continue its programme of "mini-devaluations") and introduced additional export taxes. Nevertheless, over the following three months it became increasingly clear that Brazil was still suffering acute cash flow difficulties on its external payments, partly because the Brazilian authorities had under-estimated their financing needs for 1983, partly because the commercial banks failed to provide the total amount of finance that had been envisaged as necessary under the original four-project financing, and partly because the improved trade figures had not been reflected at that stage of the year in the actual cash flow figures.

6 The Brazilian authorities had probably been ill-advised by the US banks who helped them devise the four-part financing package, in particular with regard to project (4) which required over 450 banks around the world to re-establish interbank lines at the higher of the 30 June 1982 or 31 December 1982 levels - an unrealistic proposition. It was one thing to seek to hold interbank lending at the level it had reached when emergency action had to be taken (this had effectively been done in the case of

Mexico): it was quite another thing to ask banks to reconstitute earlier levels of interbank lending which they knew would effectively be illiquid medium-term funding.

7 By the end of February the original target of $10 bn for interbank lending had been reduced to $7.5 bn (justified in part because the commitments under project (3) proved higher than had been expected) but the current level is only about $6.0 bn. At the time the Fund agreement was signed at the end of February the Managing Director was given a moral undertaking by the banks that the "missing" $1.5 bn of bank finance would be found in one way or another. Despite the expenditure of a great deal of time and energy by Galveas (Minister of Finance) and Langoni (President of the Central Bank), it has proved impossible to raise the interbank total much above $6 bn, and until recently there has been a persistent tendency to haemorrhage.

Breakdown of IMF Programme

8 In the last week of May the IMF's Managing Director revealed that Brazil had exceeded nearly all its ceilings under the programme and would not be eligible to make its scheduled drawing under the EFF at the end of May. This had other serious consequences. IMF drawings at the end of May, August and November had been earmarked to repay the balance of the BIS bridging facility: the May repayment to the BIS has been postponed, originally to 30 June and now to 15 July. In addition, only $2.5 bn out of project (1) money had been drawn down immediately, the three remaining tranches (approx $633 mn each) to be disbursed in tandem with the IMF resources as and when these were due: the second tranche is effectively frozen until a further Fund drawing can be made. Meanwhile, payment arrears continue to mount.

i.e. out of $4.4b

9 The main areas in which the Fund were not satisfied by Brazil's performance were in the substantial overruns in public spending which boosted the public sector borrowing requirement and led to the agreed monetary parameters being exceeded. There is some disagreement

between the Brazilian authorities and the IMF Staff about the intepretation of the statistics, the Brazilians maintaining that, according to their methodology, they have passed the tests. Nevertheless, with a view to meeting the Fund's requirements to put the EFF programme back on course, two packages of measures were introduced in the course of June. These included reducing subsidies on agricultural and export credits, increasing commercial banks' reserve requirements, increasing both the scope and collection of taxes and cutting the budgets of state enterprises. So far, however, the Brazilian authorities have shown reluctance to take sufficiently robust measures in the field of de-indexation of wages and pensions which the Managing Director sees as an essential prerequisite for a successful programme to reduce inflation, and where earlier undertakings have not been fulfilled. At the end of June the heads of the Fund negotiating team were recalled to Washington as a sign of displeasure (although they were due to return to Brazil earlier this week).

10 The problem of implementing the necessary additional measures is basically a political one. The economic team consisting of Delfim Netto,(the Planning Minister and economic overlord), Galveas and Langoni appear to be lobbying the President to take the necessary action, but other advisers are thought to be warning him of the possibly damaging social consequences of further austerity measures and some may even be advocating a suspension sine die on all debt payments. Delfim Netto has recently (28 June) reiterated in the Chamber of Deputies his opposition to any such suspension. The situation is further complicated by President Figueiredo's imminent departure for treatment for a weak heart in the USA. This will put Vice-President Aureliano Chaves in charge, who is reputed not to be on good terms with Delfim.

The Way Forward

11 The viability of the rescue package for Brazil as originally envisaged has now been overtaken by events. The problem has been that although the banks and the IMF have aimed at restoring Brazil's financial and economic viability in the long run,

immediate short-term difficulties have remained. For instance, although Brazil's hopes of a $6 bn trade surplus appear achievable (the surplus in January-June being $2.95 bn), the IMF programme was perhaps not sufficiently geared to the fact that export earnings are seasonal and tend to accumulate in the second half of the year. In addition, although the first three projects in the banks' package have been a relative success, as discussed in paragraph 6 there has been a major shortfall on project 4 (the restoration of interbank credit lines). With hindsight it may be that the Brazilians should have sought a larger injection of medium-term money under Project 1.

12 The question, then, is whether a rescue package of some kind can be re-established, or whether the consequences have to be faced of a breakdown either deliberately provoked by the Brazilians or arising from a failure to reach agreement on the reinstatement of the Fund programme which is the sine qua non for the restoration of, or increase in, the flow of bank finance.

The Fund Programme

13 The main areas of disagreement between the IMF and Brazil concern wage indexation and the control of public expenditure. The Fund mission will be reporting later this month whether it judges the measures that have already been taken, or which the Brazilians agree to take, go far enough. Recent telegrams from the Embassy in Brasilia suggest that the Government is ready to make some moves by eliminating price increases arising from adjustment measures already taken from the cost of living index and to permit a degree of wage bargaining rather than strict indexation. Nevertheless, as the Managing Director reported during his visit to London last week, there are worrying signs of a lack of political will to grasp the nettle with sufficient vigour and speed. Even if they do it may be that the Fund will not be able to satisfy itself that the necessary measures have been taken until well into August and the Fund programme cannot be reinstated without Board approval which would have to be sought thereafter.

14 Assuming a satisfactory outcome to the Fund negotiations, the chances of making arrangements for the restitution of bank finance may have improved. The banks have recently formed an

Advisory Group under the chairmanship of Rhodes, the Citibank man who masterminded the banks' side of the Mexican operation. The attempt to flog further life into project 4 has been abandoned and the banks are talking about raising further medium-term money: \$3 bn for the rest of this year (including making good the shortfall under the original financing plan) and \$4 bn for next. In addition it is envisaged that banking debt maturities falling due in 1984 will also have to be rescheduled. The banks are also pressing for further official participation in this second phase of Brazil's rescue and would like to see the rescheduling of maturities owed to official creditors through the Paris Club.

15 The most immediate point for decision relates to the repayment of the \$400 mn due on the BIS bridging loan on 15 July which will be discussed in Basle next Monday, 12 July. The Brazilians are almost certain to request a postponement. The BIS could agree voluntarily to this or else treat the Brazilians as in default and therefore require the substitution agreement to come into effect, whereby the underwriting central banks will be severally substituted for the BIS in respect of the bulk of its rights and obligations under the loan agreement. The loan would then be overdue to the central banks concerned, rather than to the BIS, and those central banks would collectively have to pay the \$389 mn due to the BIS. (The Bank of England's share would be \$17.5 mn; any ultimate loss on this would be covered by HM Treasury's indemnity to the Bank.)

16 Though the implementation of the substitution agreement would not per se greatly affect the underlying reality of the Brazilian situation, the fact that it was action by the BIS which effectively forced the Brazilians into a default would surely have a damaging effect on confidence generally, as indicative of a minimalist approach by the BIS to its role in the overcoming of the international debt problem. It would also increase the risk of dissensions, once the 17 participating central banks became actual creditors of Brazil along with the BIS, about the appropriate way thereafter to handle the problem.

17 The decision will be one for the BIS Board to take (France, Germany, Italy, Belgium, the Netherlands, Switzerland, Sweden and

the UK are represented). They will no doubt be influenced by the views of the Managing Director of the IMF who will be in Basle at the time. He may argue that to let the substitution agreement take effect rather than rollover for a further period would be helpful in bringing the Brazilians to an agreement. On the other hand he may feel that chances of reaching agreement would be jeopardised if the BIS were to withdraw from the bridging loan when negotiations between the Fund and Brazil were still in progress. In either event, care will need to be taken as to how the BIS's decision is publicly presented. There is a danger that a further rephasing of the bridging loan will be interpreted as weakness, but this need not be so, so long as there is seen to be a reasonable prospect that the IMF drawings which are the other end of the bridge will be restored. There could be an equal danger to the confidence of both debtor countries and of creditor banks if the BIS is seen to withdraw.

18 The whole Brazilian problem is to be discussed by the G5 Deputies who are meeting in Paris on 8 and 9 July and also by the Governors of the G10 countries and Switzerland in Basle. De Larosiere will also be in Paris and Basle at the same time. This will give an opportunity to take stock of the position with our partners. In the light of this we will need to consider whether there are any additional means of putting pressure on the Brazilians to push them towards compliance with the IMF's requirements.

19 HMT and the Bank are studying the sequence of events that would follow the deliberate cessation of payments by Brazil and the actions we might have to take. The consequences of a cessation of payments by Brazil alone would be serious enough, in terms of the potential damage to banks and the reduction in trade. They would be dangerously multiplied if Brazil's example led to imitation. In order to minimise the temptation to other countries which have accepted and lived up to IMF programmes a strong, internationally agreed response, would be needed.

20 The Cooke Committee of Bank Supervisors met in Basle last week and has very much in mind the prudential consequences for banks following from a unilateral cessation of payments. That committee is not, however, the appropriate forum for discussion of possible sanctions that might be taken against a debtor that took such a step, which would require political decisions and lie mainly outside the field of banking supervision.

Conclusion

21 The cause of international confidence and the chances of achieving realistic Fund adjustment programmes with other indebted countries will not be enhanced if the Brazilians are seen to get away with failing to live up to the Fund's criteria. Our main interest therefore lies in supporting the Managing Director in his attempts to achieve a satisfactory agreement between the Fund and the Brazilian authorities which would get the Fund programme back on track, allow IMF drawings (and the linked drawings on the banks' medium-term loan) to be resumed and open the way to the completion of a revised refinancing package with the banks.

They have already failed.

22 In these circumstances, but subject to the IMF Managing Director's most up-to-date assessment of the situation, we believe the BIS should be prepared to agree to a Brazilian request for a further postponement of repayment of the instalment due on 15 July. To insist in vain on repayment might well precipitate a breakdown in Brazil's negotiations with the IMF. There is admittedly a risk that Brazil is seeking to defer necessary decisions regarding her domestic economy, but we believe the IMF should be given further time, if necessary, to determine whether this is the case. At the same time, we should press ahead with contingency plans for concerted international action in the event that the Brazilians deliberately espouse the moratorium route, or such a route becomes inevitable because a satisfactory agreement with the Fund proves impossible to achieve.

6 July 1983