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PRIME MINISTER

BRAZIL

I have seen the report on the current Brazilian situation sent to you by the Bank of England on 7 July. I shall be letting you have a further monitoring report on the wider international debt situation early next week: the section on Brazil will take account of discussions in Paris and in Basle this weekend, and any other developments. But the following are my immediate reactions to the Bank's paper.

2. First, our number one priority must be to maintain the maximum pressure on Brazil to implement the IMF's adjustment programme. Some progress has been made on the external side - the latest trade figures are encouraging - but we still need evidence that the Brazilian Government are prepared to undertake the action necessary to control public expenditure, and - the most vital element of the programme - to break the wage indexation system which prevents the necessary adjustment process from taking place. As the Bank's note points out, the Brazilians last month took some measures to reduce spending and tighten credit: but they need to do more. Unless they show willing to implement effectively the critical parts of the IMF programme, we shall have to consider withdrawing our support - to do otherwise would risk wrecking the overall strategy for dealing with international debt problems.

3. Secondly, however, it would be right, at least in the very short term, to continue to support Larosiere, which means awaiting his judgement on how best to increase the pressure on the Brazilians. A Fund mission is in Brazil now, and the Managing Director will be best placed, in the light of its reports, to assess the prospects for getting the Fund programme back on the rails. Unless, therefore,



Larosiere takes the view in the discussions over the weekend prior to the BIS meeting that the Fund programme is beyond recovery, I agree with the Bank's assessment that we should be prepared to go along with the BIS in agreeing to a further very short postponement of the repayment of the instalment at present due on 15 July. Insistence on repayment on 15 July would not in my view achieve any practical benefits. The Brazilians would not repay (and the substitution agreement would transfer the rights and obligations from the BIS to the central banks). And the action by the BIS would almost certainly be interpreted by the international community as a declaration of default by Brazil: the consequences could take matters out of Larosiere's hands. On the other hand, a further short extension of the BIS facility will provide a little time for him to step up pressure on the Brazilians, and make a final judgement on whether the Fund programme can be put back in place. The end of this month should in my view be the limit. I have asked the Governor to do all he can to ensure that this pressure is reinforced by the terms under which the BIS agree to this final postponement.

4. I have asked officials to step up work on a contingency plan for action if the negotiations break down.

5. I am copying this minute to the Foreign and Commonwealth Secretary, to the Governor of the Bank of England, and to Sir Robert Armstrong.

J. Kew

PP.

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8 July 1983

[Approved by the Chancellor]