

SECRET



CAW

Prime Minister

①

8

Agree to X?

MCS 22/7

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

21 July 1983

Michael Scholar Esq
10 Downing Street
LONDON SW1

There really is nothing to share. Volcker was in the group at No. 10 which briefly discussed these things and then never does it. Let it - much further out

Dear Michael,

BRAZIL

I attach a paper which summarises the results of a study by various Departments and the Bank of England on the implications of a withdrawal of IMF support from Brazil.

As you will see, the judgement is that there are limits on action which the United Kingdom could take against Brazil, but certain contingency work is being put in hand to cover this, as well as to examine the question of possible demands for support for British banks in difficulties.

It is hardly surprising that one conclusion is that action and persuasion by the United States will be much more important than that of any other countries. In this connection, the Chancellor considers that it would be useful for us to share our thinking - as reflected in the attached paper - with the United States Treasury. It would be sensible to discover whether they have a similar appraisal. If the Prime Minister is content, we shall arrange this, via Nigel Wicks in Washington.

Copies of this letter go to Brian Fall (FCO), Jonathan Spencer (DTI), Richard Hatfield (Cabinet Office) and John Bartlett (Bank of England).

Yours ever,
John Kerr

J O KERR
Principal Private Secretary

SECRET

BRAZIL: CONTINGENCY PLAN FOR A DEBT MORATORIUM

This note sets out what might happen and what action we might take were the Brazilian debt situation to worsen sharply. Much of the analysis would apply to any other major debtor in similar circumstances. It summarises a longer paper produced by Treasury/Bank/FCO/DTI officials.

Chain of events

2. The most likely trigger would be public impasse in Brazil's negotiations with the IMF together with a decision by the BIS and its constituent central banks to seek prompt repayment of their loan. Initially the most likely reactions would seem to be:-

- (i) the IMF would make it clear the door remained open, if the Brazilians had second thoughts.
- (ii) The Brazilians would seek to avoid formal default/debt repudiation by a declaration of willingness to resume payments in due course, and to discuss matters with creditors.
- (iii) The major creditor banks, while beginning to make provisions, also would tend to hold back from forcing a formal default, because of the more immediate impact of that on their balance sheets. Official export insurers would have to begin to pay out on claims - ECGD facing claims of £220 million by the end of 1984, with a corresponding addition to the PSBR.
- (iv) Other debtor countries would watch the situation with interest.

3. This state of de facto moratorium could last for some time; but could be pushed into a formal moratorium/default by one or more banks taking legal action to seek to protect their position, or by action by creditor governments. The situation could also deteriorate rapidly if other debtor governments were tempted to follow Brazil's example.

Consequences of de facto moratorium

4. At first sight Brazil might seem to stand to gain from a period of de facto moratorium. In 1983 Brazil is set for a current account surplus on items other than debt interest. But in practice there would be considerable trade disruption, at least for a period. Trade credit would dry up - and with 180 days credit now available on Brazil's \$10 billion a year oil imports this would put a large temporary strain on the balance of payments. Even if foreign exchange flows on imports and exports balanced, in a country like Brazil (in contrast, for example, to Poland) it might be difficult for the authorities to ensure that receipts from exports were available to importers. It could take several months to build up effective alternative trading arrangements.

5. Despite these problems, internal political pressures in Brazil could not be expected in the short-term to be for a return to the international fold; the reverse is more likely. Brazil has few essential imports apart from oil. And it could take some time for longer term difficulties, arising from lack of access to international capital markets and development finance, to build up.

6. As time passed other debtor countries might be tempted to follow Brazil's example; or be forced to do so if banks' concern about Brazilian developments led them to be less accommodating to other borrowers. International banks would have to begin to set aside growing provisions against their Brazilian loans.

Consequences of default/explicit moratorium

7. Once a clear default had been called the consequences for Brazil would be much sharper. A scramble to attach assets could be expected. Brazilian assets abroad that could be vulnerable to legal action and seizure include \$4.1 billion of Brazilian bank deposits in Western countries (\$2.3 billion in the US; \$0.9 billion in the UK). Also vulnerable would be Brazilian ships and aircraft; and any shipments of goods (eg oil) to Brazil that could be deemed to have been paid for, or exports that were still the property of the Brazilian exporter. International payments would have to be made anonymously through bank accounts in friendly banks in third countries, to avoid attachment.

8. No doubt various barter and other arrangements would evolve. Moreover not all Brazilian assets would be accessible to legal action - for example if they did not belong to a specific debtor, or if they were protected by State immunity legislation. But Brazil could expect very considerable disruption for some time through widespread legal action, both to trade and to such external assets as exist.

9. There would also be consequences for international banks. With only modest amounts of attachable assets available in relation to \$60 billion of bank loans to Brazil, many international banks would face losses, to be met in the first place out of earnings and then out of capital. There could be severe liquidity problems for the more exposed banks. 10 of the largest US banks account for more than 80 per cent of US exposure, and several of them would lose a half of their capital base, or more. Two London clearing banks would lose around a third of their capital base. The capacity of British banks and other banks abroad to undertake new lending domestically and internationally would be greatly reduced. The authorities in the UK and elsewhere would be faced with having to undertake very substantial support operations.

Conclusions: Options for Action for HMG

10. The UK has an important role, as a large creditor, and through the IMF, the G5 and other groupings of creditor countries. But in relation to Brazil, both for financial and political reasons, the US is bound to be in the lead. We should also avoid unnecessarily prejudicing our political position in Latin America (including the use of Brazil by flights to the Falklands when refuelling fails). Action would need to be agreed with our partners, and the US in particular.

11. There are two conflicting considerations:-

- (a) the risk to the international financial system, and to political developments in Latin America, of pushing Brazil to formal default. The US is likely to be particularly conscious of both, given her financial and political interests in the region.
- (b) The longer term risk to the financial system if the IMF or creditor governments were seen to let a debtor like Brazil off the hook of economic adjustment. Other countries would quickly try to follow suit; and without adjustment private flows could be expected to dry up, posing a choice between providing larger official flows, or more widespread default.

12. In the end we cannot allow the former consideration to outweigh the latter. But it is right for as long as possible to seek to steer a course between the two: that is to look for ways to maximise the pressure on Brazil without pushing her to default. To this end:-

- (i) we must clearly maintain as long as possible the threat of withdrawal of financial support, and assert our willingness to press matters to a point likely to inflict real damage to the Brazilian economy. We must also impress on the Brazilians - with the US likely to be the most powerful persuaders - the risk they would run, eg to their trade, if our support were withdrawn. (The impact of the recent BIS discussion is, as far as it goes, encouraging).
- (ii) If a state of de facto moratorium did come about, we should seek to maintain in public as well as private a very sharp distinction between Brazil, where IMF discussions had broken off, and other countries where Fund programmes continued. This is an important message both to seek to discourage other countries from following Brazil's example, and to help ensure a continuing flow of private finance to them.

Beyond that, other practical actions that could be taken against Brazil are:-

- (iii) Legal action to attach Brazilian assets to cover overdue payments on the BIS loan. This would be a way to precipitate formal default, if that was what we wanted. It would not seem the right immediate response to a debt service failure, but could be a possibility to hold in reserve.
- (iv) A trade embargo. FCO and DTI officials do not believe wide enough agreement could be obtained to make this effective. In any event it would certainly lead to a formal default if one had not occurred already, and would add little if anything to the trade disruption that such a default would bring through the operation of market forces.
- (v) Action by the Bank of England to close the operations of Brazilian banks in London. This could not in itself be a major deterrent, but might be worth considering at a stage short of clear default, as a signal of our intent.
- (vi) A freeze of Brazilian assets in the UK, by an order similar to that used last year against Argentina. This might serve a useful purpose after a default had occurred, to keep all potentially attachable Brazilian assets within UK jurisdiction.

14. We have put further contingency planning in hand on items (v) and (vi) above. We are also considering further with the Bank the extent to which and on what terms we should be prepared to provide support to British banks in the event of a major international default.

HM Treasury

20 July 1983

21 JUL 1953

0 1 2 3 4
5 6 7 8 9



Brazil.

PA

Michael

What do we do about the non-sequitur in your letter of 25/vii?

The Chancellor claims that there was v. little discussion of Brazil with Votkes at the Richards dinner.

But even if he's wrong; so what? We want N. Wickes to talk to the US Treasury.

TOW
MV
very
Go ahead

|| Do we go ahead; or do we have to come back to you?

MES

The Chancellor thinks he'd better discuss it at next

Not needed

week's 'bilateral', but it would be good to avoid that. J.D.L. 27/vii

SECRET

file

da



9

10 DOWNING STREET

From the Private Secretary

25 July 1983

Dear John,

Brazil

The Prime Minister read with interest the paper on Brazil attached to your letter to me of 21 July.

You suggested that it would be useful for us to share our thinking - as reflected in the paper - with the United States Treasury, through Mr. Wicks in Washington. The Prime Minister has commented that she thinks little will be gained by this, since the substance of the paper was discussed in a small group which included Mr. Volcker at the recent dinner here for Lord Richardson.

I am sending copies of this letter to Brian Fall (Foreign and Commonwealth Office), Jonathan Spencer (Department of Trade & Industry), Richard Hatfield (Cabinet Office) and John Bartlett (Bank of England).

Yours sincerely,

Michael Scholer

—

John Kerr, Esq.,
HM Treasury.

SECRET

da