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Prime Minister (2)
To note. I am considering how to reflect this in Guildhall speech. No need to read beyond p. 4 of attachment.
AT 7/11

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

7 November 1983

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew,

INTERNATIONAL FINANCIAL SCENE

I enclose the latest assessment of the international financial scene by the Bank of England, which the Treasury have discussed with the Bank and other Departments. The Prime Minister may find it useful background reading before the Anglo-German Summit.

On Brazil, our approach remains as agreed between the Prime Minister and the Chancellor in September. Problems over the introduction of the wage de-indexation law have however caused fresh uncertainties about the IMF package, and the Fund are currently assessing the impact of the revised law. Our Executive Director and other G10 colleagues saw the Managing Director on 3 November. There is no sign so far that the Fund staff are taking a less stringent view of Brazil's adjustment requirements. The Executive Board discussion is still planned for 18 November. At the 3 November meeting the Managing Director's main concern was to try to firm up an official package in order to be able by 14 November to indicate its approximate size to the commercial banks, who have been asked to make their commitments by then. The Americans confirmed that they were prepared to fill up to half of the $2.5 billion "financing gap" but that they looked to other official creditors "in the aggregate to make a matching commitment". So far only the Canadians ("an appropriate share") and the Dutch ("if the US contribution were more than 50 per cent") have made any commitment. The Japanese and the Germans remain unforthcoming: both see problems in providing new export credit to a country rescheduling its debts, but neither has finally ruled out making a contribution. We propose (and this is understood by the Fund and our G10 colleagues) to stick on our participation in the Paris Club rescheduling. The Chancellor is confident that the American contribution will in the end be above $1.25 billion.

/As for Argentina,

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As for Argentina, it is too early to say exactly how the election results will affect debt repayment. Sir Alfonsin has said that Argentina will honour its international debt obligations, and his policy line is more moderate than that of the Peronists. But the transitional period, before he and his government assume power, will inevitably be one of further risk to the implementation of the IMF programme. We shall be monitoring the situation closely, and work has of course started on the remit from last week's Cabinet on arms sales and the commercial bank loan.

Our next overall assessment will come forward in mid December.

As usual, I am sending copies of this letter to Brian Fall at the FCO, Callum McCarthy at DTI, and John Bartlett at the Bank of England.

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

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INTERNATIONAL FINANCIAL SCENE

General situation

Two major developments since the last Report have created much uncertainty on the international debt front. First, Congress has not yet endorsed the USA's higher contribution to the Fund which, together with the related delay in the BIS' credit facility to the Fund, threatens to restrict the IMF's ability to lend at a critical stage. Second, prospects for the Brazilian package - on which much else hinges - now depend essentially on the Fund's reaction to the recent decree on wage indexation. With the Philippines having entered the emergency ward and the long anticipated Argentine elections imminent (30 October), the general atmosphere is highly tense, and confidence in current case-by-case techniques of debt management will be severely tested in the months ahead. The run-up to the IMF Board discussion of Brazil on 18 November will be a crucial period.

Economic background

Economic recovery is continuing in the major industrial countries. In particular, there have been encouraging signs during the third quarter of further non-inflationary growth in the United States. This industrial revival should benefit indebted countries in terms of export demand and has already given some impetus to commodity prices, thus improving the terms of trade for some ldcs - although a number of others continue to suffer from weak prices for their main exports. Recent declines in US short-term interest rates from their peak in August should also bring some relief, but they still remain well above the level obtaining for much of the past year. Moreover, the future course of US interest rates remains highly uncertain. While these developments are on the whole encouraging, there is no general confidence that the recovery in industrial countries is yet broadly or firmly based.

The floating off hypothesis

International lending

Recent figures confirm the marked slowdown in international bank lending. The latest BIS statistics show that international banks' total net lending rose by $15 bn in the second quarter, compared with $30 bn in the corresponding period of 1982, and a quarterly average of $24 bn last year. Data for the third quarter from the London market suggest that the downward trend has continued. Within the total rise in the second quarter, net lending to non-oil developing countries increased by $4 1/4 bn, bringing the rise in the first half-year to some $6 bn. So new bank borrowing by ldcs in 1983 is likely to be much less than was expected at the beginning of the year; and the IMF, for example, have reduced their projection from $20 bn to $15 bn. Managed borrowing will predominate, and could "crowd out" other borrowers, who might then face severe balance of payments financing problems. For the most part, only prime borrowers are at present able to raise funds in the market.

Problems of this kind have already arisen for the Philippines, which has been forced to call a 90-day moratorium on its debts (estimated at $25 bn), pending a rescheduling. For the present, the market is responding calmly to this development, with no signs yet of any tendency to link the Philippines with other Far Eastern borrowers such as South Korea, Thailand and Indonesia, since these countries are considered to have managed their economies, and their external debt, extremely well. Indeed, some of them have already reacted swiftly to the situation in the Philippines by cutting back borrowing programmes and making the necessary adjustment to their economic policies. Nevertheless, there is still a risk that a further general cutback in lending would produce cash flow problems, even for these previously relatively creditworthy borrowers.

In contrast, minor OECD countries, over some of which question marks have been raised in the past, continue successfully to be able to raise funds. Moreover, the market is still prepared to lend, though modestly and at a price, to Latin American borrowers such as Panama, Paraguay and Colombia, which have not experienced debt servicing problems.

Current problems

The whole process of international rescues for problem countries is currently being severely tested on a number of fronts simultaneously.

In the key country, Brazil, rejection by Congress of law 2045 on wage determination, and two subsequent replacement decrees - the latest of which reduces its severity - has created renewed uncertainties, after the encouraging response to the "roadshow". It remains to be seen how the IMF and the banks will react to the latest decree. Meanwhile, efforts are being made to assemble the components of a financial package within the next three weeks. De Larosiere has asked for written assurances by 14 November that $6 1/2 bn will be available from banks, and $2 1/2 bn from governments, to enable him to recommend the Brazilian programme to the IMF Executive Board on 18 November. The sheer size of the bank credit, its softer terms and the need to muster a quorum of committed banks to make the syndication viable, make selling the loan package to the banks a formidably difficult task. In particular, the banks will watch closely for assurances that the official contribution is fully subscribed and represents genuine new money. Such contributions will be seen not only as a signal of confidence in the recovery programme, but may also influence the degree of bank commitment to the present and prospective packages for Brazil (and other countries).

In many ways, Argentina is even more worrying than Brazil, because domestic political uncertainties make breakdown more likely. The political will to tackle the debt problem seems to be lacking, and the IMF programme could be on the verge of collapse, while the central bank's liquid assets are dangerously low. By itself, the uniquely difficult domestic political situation in Argentina, combined with its essentially favourable balance of trade, should make it an isolable problem; but a breakdown in Argentina at this rather delicate stage elsewhere could lead to a damaging deterioration of confidence. Developments in Mexico, on the other hand, remain encouraging, with a government willing and able to undertake appropriate adjustment; and there is unlikely to be much difficulty in securing the requisite new funds for next year, even though the authorities seem certain to demand, and might well be thought to deserve, better terms.

Role of the IMF and BIS

The effectiveness of the IMF in providing leadership, as well as credible adjustment programmes, could be impaired by apparent lack of official support. Latest expectations are that the IMF bill, which is crucial to the Fund's ability to take part in rescues, should ultimately be passed by the US Congress before the Thanksgiving recess beginning 19 November. In the meantime, agreement on a special BIS credit facility of SDR 3 bn to the IMF (which will next be discussed on 7 November in Basle) has been delayed, because some central banks - notably the Bundesbank - will not give their approval until it becomes clear that the American quota increase will be forthcoming, and partly because some central banks have still to swallow more fundamental reservations about the tenor of the loan and the USA's non-participation in it. This has already obliged the IMF to restrain the granting of new commitments.

Conclusion

The next few weeks will severely test the informal coalition between borrowers, banks, creditor governments and the IMF, which has so far managed to contain the debt crisis. A successful outcome, especially on Brazil, will be vital if considerable knock-on effects are to be avoided, and if confidence in present case-by-case techniques of crisis management is not to be seriously weakened. Without such confidence, the outlook for next year will be bleak.

The following sections assess the current position in major debtor countries in rather more detail.

Brazil

Brazil is still the largest single problem country on the international debt scene, and prospects are now even more uncertain after the Brazilian Congress' rejection of the crucial wage de-indexation Decree (No 2045) on 19 October. Although the government lost little time in issuing a new substitute Decree (No 2064), this in turn has now been replaced by a further, and less severe, decree (No 2065): it is not yet clear whether the IMF will consider this adequate. The provisions of Decree 2045 were at the heart of the revised IMF programme, for which the Brazilians signed a letter of intent on 15 September. Indeed, the IMF Managing Director not only required sufficient finance to be committed in support of the programme, but was also not prepared to recommend the programme to the Executive Board until the Decree had passed into law. A financing gap of $11 bn has been identified for the remainder of 1983 and 1984, which it is proposed to fill through a $6.5 bn new commercial bank loan, a $2 bn Paris Club rescheduling, and $2.5 bn from export credit and other official sources. The bankers' Advisory Group has agreed to market the new money loan on significantly better terms than for earlier funds, which is likely to set a precedent for other Latin American countries to follow. (Indeed, the Argentines have already sought similar concessions, both for the 1983 debt currently being discussed and for 1984 debt to be rescheduled). Initial reaction from banks, who have been asked to commit themselves to the new money loan by 14/15 November, has been one of philosophical resignation. Although political uncertainties within Brazil may create nervousness abroad, bankers' general attitude to the defeat of Decree 2045 and its subsequent amendments, will doubtless be determined by the IMF's reaction.

Prospects for raising $2.5 bn from official sources also remain uncertain. The USA, through the Eximbank, has indicated a willingness to provide $1 1/2 bn export credit facilities, on condition that other countries also contribute. But we are not aware that any other firm commitments have yet been received, while HMG remains opposed to putting up further official money for Brazil (over and above rescheduling of Paris Club maturities).

The latest wage decree improves prospects of early Congressional approval; but if this were not forthcoming before mid-November, the IMF Executive Board meeting (scheduled for 18 November) would be delayed, and further increases in arrears (already nearing $3 bn) would result. Such a development would be of concern to many US banks, in view of the regulatory requirement to classify loans as non-performing when interest arrears reach 90 days.

Other problem countries

(i) Latin America

Foreign banks' debt negotiations with Argentina have been bedevilled in the last month by increasing political interference ahead of the Presidential elections on 30 October, and by continuing build-up of payments arrears. However, having overcome an attempt by an Argentine federal judge to freeze the rescheduling talks, the Government has now reaffirmed its intention of finalising all rescheduling agreements by 30 November. Disbursement of the long-delayed first tranche of the $1.5 bn medium-term credit is now unlikely before 30 November at the earliest. The further delay reflects continuing payments arrears and a decision by banks to await the outcome of the elections in order to test the authorities' commitment to the refinancing package. The banks' Working Committee is currently seeking to reach final agreement with the Argentines on revised conditions attaching to the disbursement, which will primarily be used to make a repayment under the $1.1 bn bridging facility. Meanwhile, the IMF programme appears to be on the verge of collapsing, and the central bank's liquid assets are now dangerously low.

Relations between the Venezuelans and the banks continue to be soured by the steady accumulation of interest arrears, now totalling around $600 mn. Several default suits are reported to be in the pipeline. Meanwhile, the banks have had no option but to agree to a further extension of the 90-day moratorium which expired at end-September. The Government had sought a 120-day extension, but the banks, conscious of the need to adopt a hard line if progress in rescheduling negotiations was to be made, have granted only 30 days.

If, in the Advisory Committee's view, the Venezuelans have made significant headway towards paying off interest arrears and negotiating an IMF economic adjustment programme, it will recommend a further 90-day extension until the end of January.

In sharp contrast to the other major problem countries, Mexico's position continues to provide grounds for optimism. Agreements to reschedule virtually all public sector maturities up to end-1984 have now been signed, and commitments to Mexico's private sector debt rescheduling scheme have risen rapidly in recent weeks. The authorities are soon to begin negotiations on new money requirements for next year, which are reckoned to be $4 bn from banks and $1.5 bn from official sources.

Elsewhere, Peru has been obliged to approach the IMF for a conditional waiver of the EFF performance targets for September and December. The breakdown of the programme will delay the next scheduled drawing from the Fund in November, and hold up the remaining $200 mn to be disbursed under the $450 mn new money loan from banks.

More encouragingly, the Chileans have reported that their standby arrangement returned to its original path by the end-September deadline, although the authorities are now seeking easier terms under the second year of the programme; and Ecuador's commercial bank refinancing package was signed on 12 October.

(ii) Far East

The liquidity crisis in the Philippines has now obliged the authorities to seek a 90-day moratorium on repayments of debt principal to banks. During this period, a new SBA is to be negotiated with the Fund and a financing plan agreed for the remainder of 1983 and 1984, which will no doubt include a formal rescheduling package. Continuing concern about political stability makes the situation even more delicate. However, there has been no evidence that the problems in the Philippines have weakened confidence elsewhere in South East Asia, although one report indicates that Indonesia may wait for more settled conditions before coming to the market again. Otherwise, both that country and South Korea appear to be making further progress in adjusting their economies in the light of lower oil prices.

(iii) Eastern Europe

Official contact with Poland (albeit still on a conditional and technical basis) has been renewed: the creditors' group sent a fact-finding team to Warsaw in early October and will meet on 26 October to review its report and decide whether to invite the Poles to Paris in November to resume rescheduling negotiations. The US position remains unclear. Meanwhile, the commercial banks are expected to sign their agreement in Luxembourg on 3 November to reschedule 1983 maturities. Although the 1983 support programme for Yugoslavia has for the most part still to be implemented, preliminary soundings are being taken by the IMF on the possible format for 1984.

(iv) Southern Europe

Although the external positions of Portugal, Spain and Greece are likely to remain under strain for some time, no debt servicing difficulties are expected in the short term. Indeed, there are positive signs of improvement from both Portugal and Spain. In Portugal, the fairly rigorous programme recently agreed with the IMF for a standby facility worth $475 mn over 18 months - approved in conjunction with a compensatory financing facility worth $275 mn - lays the basis for a staged return to a more sustainable external position, while the current account showed a strong improvement in the first half of 1983. The announcement of the IMF programme also seems to have improved market sentiment: the reception for Portugal's request for a seven-year $300 mn euro-credit was so favourable that it was raised to $350 mn. Meanwhile, Portugal repaid $300 mn of the $700 mn BIS facility arranged in two tranches earlier this year, and a further credit of $300 mn was advanced in August. The Spanish current account deficit has also improved somewhat this year, and faster progress seems likely in 1984. Foreign exchange reserves, however, have been severely depleted, and it will be some time yet before Spain is able to stabilise its external indebtedness, let alone reduce it. Even so, there are no signs of serious resistance to Spain's very considerable financing demands from the market. In Greece, on the other hand, with foreign exchange reserves already low (less than 1 1/2 months' imports at end-June), the current account deficit is expected to worsen slightly this year, reflecting a poor export performance and reduced invisible earnings. Nevertheless, the debt service ratio (including short-term debt) was only 24% in 1982 and should not be much higher this year. Borrowing on the international markets still appears to be well received, and $1 bn was raised in the first eight months of this year, compared with $1.7 bn in the whole of 1982.

INTERNATIONAL BANK LENDING: PROSPECTS TO THE END OF 1984

The IMF has shaded down its 1983 forecast for commercial bank net lending to non-oil ldcs as the year has progressed, and by mid-year had reduced it to a rise of only 5% on end-1982, or some $15 bn. The Bank of England has done likewise, with our latest October forecast coming out at 4%. On the other hand, the BIS, in its press release on the 1983 second quarter figures, sounds a more optimistic note. These forecasts include unspontaneous lending as part of rescue packages, and are based mainly on estimates of the supply of bank credit (ie the willingness of banks to lend), rather than on ex ante demand from borrowers. This slowdown in bank lending has made the borrowers more dependent than usual on official sources of financing: thus, in the first half of the year, the IMF and commercial banks each lent some $6 bn net.

In the next fifteen months, the attitude of the banks is likely to be strongly influenced by the contribution of the IMF, not only financially, but also in designing adjustment programmes which are seen to be effective. In this light, the outcome of the Annual Meetings is hard to interpret. The Fund still lacks the certainty of adequate resources and, without them, the Managing Director is less likely to succeed in persuading banks to extend sufficient new loans. However, the compromise on access limits still gives the Fund some flexibility. On balance, we believe that IMF finance in 1984 will be broadly the same in absolute terms as this year, subject to a number of provisos.

The first, and most important proviso, is that the informal coalition of borrowers and official and private creditors, holds together to make the rescue packages work. This is still assumed to be the case in our central forecast and, if it materialises, 1984 will in many ways resemble this year. But it will not be easy to sustain this coalition: it is subject to a number of risks which vary in their capacity to affect the international financial system. The worst outcome would probably arise from a breakdown of the Brazil package, which might coincide with a breakdown in Argentina and threaten the solvency of some major banks. Each new round of negotiations puts a further strain on the cohesion of the coalition, as the banks are becoming increasingly aware, in a mood of resignation, that they will be faced with requests for more managed lending over the next couple of years.

Another proviso is that banks' appetite for international lending does not become so dulled by unspontaneous lending that it crowds out lending to other ldcs. There is some anecdotal evidence that banks are undershooting their aggregate lending capacity; and any further reduction in lending could begin to create cash flow difficulties, even for creditworthy borrowers.

The current round of fund-raising for Brazil is a major test of the structure of rescue packages which has emerged over the last year or so. Success will strengthen it, failure probably destroy it. This structure reflects two principles which seem to be the key to success - leadership and burden-sharing. De Larosiere has already assumed the leadership role in this round, in relation to both commercial and official contributions. The Brazilian outcome has been made more difficult to assess by the recent rejection of legislation on wage indexation and its replacement by new - and less severe - legislation, to which the Fund's reaction is not yet known. The banks for their part will certainly be influenced by the amount of official assistance offered. In any case, there is likely to be some shortfall on the commercial bank target of $6.5 bn, as some banks with relatively small exposures refuse to take part. If, in addition, there were to be a shortfall on official funds, this might deter those contributors who have made their share in previous rounds conditional on a general response of close to 100% ie a strong demonstration of burden-sharing. In those circumstances, the package could well collapse and jeopardise other forms of financing, such as maintenance of exposure to Brazilian banks in the inter-bank market.

The reports are that de Larosiere wants commitments for a "critical mass" of 90% of the full amount of the new money from banks by 15 November to justify his recommending the programme to the IMF Board. Brazil does not require the full amount immediately, but it is debatable whether the banks would be ready to disburse the first instalment out of the initial commitments, unless and until these cover the whole $6.5 bn required. This target represents an average increase for all creditor banks of 10 1/2% of their exposure at the end of 1982. After allowing for their commitment to round 1, the total increase would be over 17% for 1983 and 1984 combined - considerably faster than the average net lending by banks to non-oil ldcs forecast over this period.

The outcome on Brazil will have an important bearing on banks' attitudes towards some of the other major borrowers.

Argentina has managed to survive so far without recourse to most of the 1983 rescue package. A complete breakdown now seems a distinct possibility, because of domestic political factors rather than because of the way in which the package has been assembled. Whether the impact of such an outcome could be insulated from the rest of the market would depend on timing and official reaction. For example, it would be easier to handle if the breakdown came after, rather than during, the formation of the Brazilian package. Other threats to the present policy of a case-by-case approach could be posed by the chaotic management of Venezuela's finances and by the Philippines. There is no sign yet that the effects will spread to the rest of the Pacific basin, but banks will be keeping a careful eye on South Korea after the assassinations.

By comparison, the outlook for Mexico is encouraging. The authorities are shortly to open discussions on financing for 1984: these are likely to proceed relatively smoothly, firstly in view of the track record so far, and secondly because negotiations will not be complicated by rescheduling of public sector debt, virtually all of which has now been completed. In the circumstances, the bankers may be ready to sign up for the $3.5 - 4 bn fairly quickly, although the Mexicans will certainly be demanding better terms.

By now, the East Bloc debts almost seem a problem of a separate kind. Poland apart, the other Bloc countries have in aggregate adjusted hard and have even been able to accommodate some (essentially involuntary) reduction in their net indebtedness to the West.

However, several of them (notably the GDR and Hungary) are almost certainly still under severe financial strain. The banks will continue to watch them with wariness. Yugoslavia remains in a very difficult position and will continue to need a managed approach for some time ahead.

Given the number of uncertainties, it would be surprising if there were not at least one breakdown in the relationship between borrowers and commercial banks. Nor does success in one round guarantee it in the following. For example, Brazil's programme may come to lack credibility because of a hardening belief that a financing gap will open up again in 1984. Moreover, performance under some of the other country programmes could be disappointing and give rise to a financing gap, which would make further - premature - rounds inevitable. If these factors were to be a prelude to a breakdown in the present case-by-case approach, their impact on other countries would depend essentially on speed and presentation: slow disintegration might provide an opportunity to patch up the coalition, while outright repudiation by a borrower could have very damaging consequences for the international financial system. Either would materially increase the clamour for a "long-term" solution.

The risks so far described concern structural areas in the international banking system. But a breakdown of IMF programmes for technical reasons is also a possibility: these are based in the final analysis on assumptions about the behaviour of the international economy, which may not be validated. One such assumption, which has quite wide acceptance, is that real growth of some 2 1/2% - 3% in the OECD countries would be sufficient to "float off" the debt problem. Even if this were to materialise, however, the present round of rescheduling has built up heavy capital repayments for the future: even with an appreciable improvement in world growth, combined with much lower interest rates, further rescheduling of such debt - which will almost certainly be necessary towards the end of the decade - may prove to be difficult to negotiate satisfactorily. But that is not a problem for 1984 - for which our central forecast, notwithstanding the downside risks that this overview, perhaps over-pessimistically, has emphasised, is still that the system should somehow scrape through.

Econ. Pol 58 Indebtedness Pt. 3

INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt	British banks unguaranteed claims		ECGD amounts at risk
	End-Dec 1982	End-Dec 1982	End-June 1983	End-Dec 1982
Latin America				
Argentina	39	2.3	2.4	0.4
Brazil	83	4.4	4.6	2.3
Chile	18	1.1	1.1	0.05
Ecuador	6	0.5	0.5	0.1
Mexico	83	5.2	5.4	1.6
Peru	12	0.4	0.4	0.2
Uruguay	4	0.3	0.3	0.01
Venezuela	34	2.4	2.3	0.08
Eastern Europe (convertible currency)				
East Germany	15	0.8	0.6	0.2
Hungary	7	0.5	0.4	0.08
Poland	27	0.5	0.6	1.2
Romania	10	0.4	0.3	0.6
Yugoslavia	18	0.9	0.9	1.2
Southern Europe				
Portugal	14	0.8	0.8	0.4
Greece	11	0.7	0.9	0.4
Spain	28	2.4	2.4	0.2
Israel	21	0.4	0.5	0.2
Far East				
Indonesia	24	0.6	0.7	1.5
Philippines	24	1.2	1.3	0.3
South Korea	37	2.0	1.9	1.0
Other				
Morocco	11	0.2	0.1	0.2

Because of differences in definition, the ECGD exposure figures in the final column are not directly comparable with the figures in other columns.