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CHANCELLOR'S MEETING WITH MR REGAN, 8 DECEMBER

US ECONOMY

Points to make

(i) Welcome strong recovery in US economy since the beginning of this year. Important for US and rest of world that this is consolidated into durable growth for the years ahead.

(ii) Recovery so far has depended heavily on increased private consumption, residential construction and a turnaround in stock-building. These have benefitted from the reduction in inflation and interest rates as well as the temporary boost from tax cuts and lower savings.

(iii) Note that falls in both inflation and interest rates appear to have come to an end.

\$ 65-70 billion trade deficit, \$ 40 billion current account deficit this year.

(iv) Disturbing that deterioration in trade balance has been so large - reflects partly of course the US lead in the recovery but probably more significantly the dollar's strength.

(v) Important now that balance of recovery should be shifted if it is to be sustainable with investment playing a full part and the deterioration in the external balance curbed.

(vi) Cannot disguise own view that budget deficit is the key. Unless it is put on a convincing declining path it is likely to pose an increasing threat to both internal and external financial stability.

(vi) Domestically, competition between government and private sector for funds is likely to put upward pressure on interest rates and make Fed's task of monetary control harder. Believe Mr Volcker right to adhere to counter-inflation policy. Monetisation of the deficit would be worse.

← around \$ 200 million and expected to remain there.

(vii) Externally, budget deficit has its counterpart in current deficit. Risk that foreigners will become increasingly reluctant to add further dollar assets to their portfolios, implying either pressure on the dollar or need for higher US interest rates.

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(viii) Recognise pressures on Administration in run-up to next year's elections, but fear that delays in tackling budget deficit could prove high risk strategy economically (and politically?).

(ix) Confidence among markets in a reduction of the budget deficit would help keep down interest rates improving the prospects domestically for a recovery in investment and externally for an orderly dollar decline which would help correct the US trade balance.

(x) Countries outside US have a strong interest in US development and policies because of the impact on their own interest rates and exchange rates. What are Mr Regan's views on European policies for recovery? Hope we can take forward G5 multi-lateral surveillance process with IMF Managing Director.

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INTERNATIONAL DEBT

The general outlook for the international debt scene is still uncertain. The longer term prospects have been improved to some extent by the economic recovery which is now under way in some major industrial countries but there are still difficulties to be faced in the short term.

General debt policy

2. Any durable solution to country debt problems must depend above all on economic adjustment by debtor countries. It is up to them to regain the confidence of commercial banks and other creditors by pursuing sound adjustment policies.
3. Developed countries' best contribution would be to secure non-inflationary growth and avoidance of protectionism.
4. Support the role of the IMF and World Bank by ensuring they have the necessary resources and by supporting such policies in the Board.
5. Governments stand ready to contribute through the IMF, World Bank, official rescheduling and BIS bridging operations as appropriate. They should not normally be expected to make further contributions to the financing burden. To do so could weaken the normal market disciplines on debtors and private creditors and involve unacceptable increases in Government spending or financial exposure.
6. Generally debtor countries are not a homogenous group. Their difficulties are best dealt with on a case-by-case basis, not by generalised and costly schemes. (The flexibility of this approach is already allowing the timescale to lengthen; some of the commercial bank facilities for Brazil run for 9 years.)

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Brazil

7. The largest single problem has been Brazil whose difficulties may well extend several years into the future.

8. The recent round of negotiations passed successfully through the critical period at the end of last month, at which time

- a. the IMF Board approved the revised economic programme enabling drawings to be resumed
- b. a substantial part of the commercial banks \$6.5 billion syndication had been achieved
- c. the Paris Club agreed debt restructuring in respect of official debts of some \$3.8 billion rather than the \$2 billion which had earlier been anticipated by the IMF. (The UK share was \$331 million, rather than \$180 million.)
- d. the IMF were satisfied on the availability of the \$2.5 billion package of new export credits.

9. The British contribution generally has been substantial, but HMG has not made any commitment on the export credit package. No other G10 countries (apart from the US) have made commitments either, but all have some contribution in mind. The US commitment of \$1.25 billion now seems likely to be mostly short-term, and therefore of lower quality than had originally been assumed. This apparently came as a surprise to the French and Germans at a recent meeting of G5 officials. The US response was to say that we (the UK) might count our own continuing short term cover. But this is not the point. We are under no pressure to alter our present position, except in the reports from Brazil itself and even this now seems to have been settled.

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10. One of the immediate problems - of particular importance to the US - is the completion of the commercial bank syndication. If, as seems possible, it is not completed in time to allow disbursement of the first tranche before 31 December, arrears will remain outstanding and US banks may be required to declare certain assets as non-performing.

11. Even if the immediate hurdles can be cleared, Brazil faces a long difficult period of adjustment. The IMF seem to regard the present programme as no more than a holding operation for the next 9-12 months. A series of programmes may therefore be necessary to sustain the economic adjustment. The problem for the Brazilian authorities will be to maintain these policies in the face of the likely domestic political reactions.

Argentina

12. The IMF programme continues to deteriorate. There have been no drawings since last May, partly because of Argentine financial discrimination to the UK but also, now that this has been removed, by continuing arrears. Argentina was meeting performance criteria comfortably early in the year, but no longer seems to be doing so. The IMF will need to renegotiate the programme with the new government, which takes office on 10 December. They do not expect to finalise this before next March.

13. Despite great last minute confusion the first \$500 million of the commercial banks \$1.5 billion medium term loan was advanced last week on 2 December. It comes straight back to the banks in settlement of an overdue instalment on an earlier bridging loan and other arrears. This was particularly important to the American banks who might otherwise have had to classify their outstanding loans as non-performing assets.

14. Because the banks get the money back we have some assurance that it cannot be used for arms purchases.

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In addition, it seems clear that military expenditure will not be a high priority of the new government. We would expect them to cut existing levels of spending, both to accommodate their own policies and to distance themselves from the previous military regime.

15. The US nevertheless intend to reinstate the certification of Argentina as eligible to receive US arms sales, to take effect from 10 December when the new Government takes office. The certification was originally withdrawn on human rights grounds. The return to democracy makes reinstatement almost automatic. We have nevertheless protested at this action in the aftermath of the Falklands conflict. We want to be sure that it will not lead to significant arms sales and that any applications will be properly vetted. We have US assurances on these points, and confidential assurances that they will consult us in particular cases as appropriate.

16. Certification is now scheduled to be announced at the regular US State Department press conference at midday (Washington time) on Thursday 8 December. This is roughly the same time as the meeting with Mr Regan.

Mexico

17. The Mexican economic recovery appears to be progressing well. The detailed application of debt rescheduling is being negotiated and implemented and the Mexican authorities are confident that their financial requirements have been covered in 1983. Requirements for 1984 remain at some \$4 billion, but this is as originally expected.

Venezuela

18. Venezuela's debt service difficulties continue. Venezuela is heavily dependent on oil exports and the US is a major customer. Problems were caused by falls in oil prices and demand. The Venezuelan Authorities have allowed things to drift during 1983, rather than take unpopular economic measures

before the elections on 4 December. The results of the elections are now clear. The Christian Democrat Government has been defeated by the Social Democrat opposition, who will take office next February. We would hope that this will end the hiatus in debt rescheduling negotiation, and enable proper negotiations to resume with the IMF.

Philippines

19. This is building into a particularly difficult case. External debt amounts to some \$25 billion. A 90 day moratorium on repayments of principal to banks is already in force. There will have to be negotiations with the banks, creditor governments in the Paris Club, and with the IMF.

20. The preliminary IMF view suggests a financing gap of some \$4.3 billion up to mid-1985 and the IMF would look to Governments for some \$1 billion over and above any contribution through debt rescheduling. In preliminary discussions at official level we have made it clear that the Fund should not take such a contribution for granted and should explore the alternative of a tighter programme. But we are bound to come under some pressure. In terms of bank exposure at the end of 1982, the US is in the front line with some 45%, Japan has 23% and the UK is third with 14%. It will be important for the Fund to keep in touch with all concerned.

Poland

21. Official talks on Polish debt relief were broken off after martial law was declared in 1981. The commercial banks continued with their own negotiations and they continue to press ahead. Agreements have already been reached for the years up to and including 1983. A meeting in Vienna has already been arranged for 16 December to discuss banking debt in 1984 and perhaps 1985 as well. The bulk of the banks' exposure has already been restructured and the amounts due in these and subsequent years are relatively small.

22. Official talks have just restarted, at a meeting in Paris last month. It made no progress. The Poles opened with unacceptable conditions about IMF membership and new credits, and talks very nearly broke down. Nevertheless it has been agreed that there will be a further meeting in the new year. The negotiations are bound to be long and difficult (not least because the commercial banks have had first go at the available resources) but we would hope to secure some net repayments and properly negotiated agreements for the future.

23. It is in Western financial interests to get the debt negotiations back on the road. It was good that the US Authorities were able to relax their political objections enough to allow last month's meeting to take place. It is disturbing that subsequently, following the strengthening of Polish internal controls, the American political conditions now seem to be back in place. This may mean that, even if the Poles come to the next meeting prepared to negotiate sensibly, we may nevertheless still be baulked by the US.

Yugoslavia

24. Western creditor countries met in Geneva last month (18 November) with the IMF and the Yugoslavs. The purpose was to review progress on the 1983 support package and to look forward to 1984. Two working groups are being set up, one to consider debt restructuring and the other to examine overall prospects for 1984. We expect the 1984 package to be smaller than this years and for the official element to concentrate more directly on debt service payments due. As before the commercial banks will also be expected to make their own contribution to the final package. They are meeting this week.

25. We hope the IMF programme for 1984 will require Yugoslavia to make realistic economic adjustment themselves, keeping

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to a minimum the need for external finance, and hopefully removing the need for any further support in 1985. The IMF currently still envisage a financing gap of more than \$2 billion of which they expect Governments to contribute some \$200 million in new export credits (on top of rescheduling). But a good deal of further scrutiny of these figures will be required. An IMF team is currently in Yugoslavia. The programme is unlikely to be settled before the end of this year.