PRIME MINISTER

Argentina

The paper for this meeting is that prepared by the Treasury in consultation with the FCO and the Bank. In addition, there is the Treasury's latest survey of the international and financial scene and the exchange of correspondence between the Chancellor of the Duchy and the Chancellor of the Exchequer. The latter confirms that the $1.5 billion loan is a legally binding contract. What is not clear and could be established at the meeting is whether there are any conditions in it which, if not observed by Argentina, would mean that the banks would be released from their obligations.

My note of 7 December indicates that this issue can be approached at several levels, ranging from legislation to prevent further tranches of the $1.5 billion loan being drawn through to trying to ensure that future loans are subject to conditions which make the buying of weapons difficult.

AT

ANDREW TURNBULL

21 December, 1983

CONFIDENTIAL

Prime Minister
Things look slightly brighter.
The only news is that at X

AT 21/12

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

20 December 1983

Andrew Turnbull Esq
No 10 Downing Street
LONDON SW1

Dear Andrew,

INTERNATIONAL FINANCIAL SCENE

I enclose the latest of our regular reports on developments on the international financial scene. As usual it has been prepared by the Bank of England and discussed in the Treasury's inder-departmental group on debt problems.

The general picture is more encouraging than in the last report. In particular, the IMF's resources should be strengthened following US Congressional approval of the Quota increase and by the agreements reached on the $3½ billion loan from the BIS and the parallel $3½ billion loan from the Saudis.

On Brazil the IMF has been able to satisfy the banks that the $2.5 billion new money from governments will be forthcoming, and this has unlocked the $6.5 billion new money from the banks, which should now be in place by the end of the year (although some temporary bridging finance may still be necessary).

Argentina will be discussed at the Prime Minister's meeting on Thursday. It is just possible, though at present it seems unlikely, that the second tranche of the August commercial loan could be drawn as early as 15 January. X

A high-level official delegation from Nigeria is now in London discussing possible relief on short-term debt from official and private creditors. They are being encouraged to seek a multilateral solution, and we are in touch with our main partners about this. Nigeria represents our single largest ECGD exposure (some $3.2 billion at end-June 1983).

Copies of this letter go to Brian Fall (FCO), John Rhodes (DTI) and John Bartlett (Bank of England).

Yours ever,
J O Kerr

J O KERR

INTERNATIONAL FINANCIAL SCENE

Some major hurdles have been successfully crossed since the last Report, and this has somewhat improved sentiment about prospects for the immediate future. On the other hand, the longer-term risks remain, with banks' new lending likely to remain lower than in the past, a bunching of debt repayments in about two years' time, and uncertainties whether continued severe adjustment by debtor countries will be politically or socially sustainable.

For the ldcs, developments on the economic front are mixed, but on the whole encouraging. The recovery, albeit patchy, in the large economies has continued; and their current account deficits widened in the third quarter, particularly in the USA, where the deficit was a record $12 bn. At the same time, the current accounts of Latin American countries have improved markedly, though much of this reflects a sharp cut in imports, which may not prove to be sustainable in the longer term; and commodity producers' terms of trade are no longer benefitting from the surge in commodity prices, which now seems to have been checked. On the other hand, oil prices have also tended to be weak. The future course of the dollar remains particularly uncertain, but US interest rates remain relatively high, thus limiting the scope for reductions elsewhere.

The most important developments since the previous Report have been the degree of success achieved in assembling the $11 bn package for Brazil, which has given a boost to confidence, and the ratification of larger Fund quotas. Banks' net lending to ldcs this year should fall within the IMF's latest forecast range of $15 - 20 bn, with a similar range in prospect for next year.

But major short-term problems persist. A particular cause for concern is the Philippines, although there is as yet no firm evidence of knock-on effects elsewhere in the region. The rescue packages for some of the smaller Latin American countries, such as Peru, Ecuador and Chile, are running into difficulties, and second round support operations could well be delayed. In Eastern Europe, no progress was made when discussions were resumed between Poland and its official creditors, and Romania's IMF standby arrangement remains inoperative (although a compromise may now be in sight). On the other hand, only some $250 mn remains to be committed to complete the $6.5 bn banking loan to Brazil; and the IMF have assured the banks that the $2.5 bn new export credit facilities will be forthcoming. Meanwhile, Brazil has suspended the issue of new import licences until 1 January, even though the $6.3 bn target for the trade surplus in 1983 seems certain to be surpassed.

An indication of banks' attitudes may emerge from the IIF's discussion of prospects for international lending, scheduled for next month. But in the medium term, a crucial test will be the performance of borrowers under IMF programmes. The picture here is mixed, with the main anxiety focused on Brazil, where trade targets might be achieved, but those for inflation and public sector borrowing seem much less likely to be met. Elsewhere, such policy statements as have emanated from the newly-elected Radical party in the Argentine seem somewhat contradictory; and in Venezuela, where bankers have no doubt welcomed the change of leadership, it remains to be seen whether the new government, which was elected with a large majority, is prepared to accept the measures recommended by the IMF.

Other major factors which will influence banking attitudes are the impact of international lending on end-year accounts; recent signs of a more active interest on the part of some supervisory authorities towards provisioning against problem loans; and a general tightening of supervisory approaches to capital adequacy, which is taking place world-wide, notably in the USA. There also seems to be a perception among some bankers (as well as debtor governments) that the interest burden faced by a number of borrowers could prove to be too great, and that the net reflows from ldcs to the banks, implied in the structure of the relief programmes, are unsustainable.

A rather more detailed assessment of the current position in major debtor countries is given below.

(i) Latin America

Encouragingly, the various elements of Brazil's Phase II financing package are falling into place. On 22 November, the IMF Board approved Brazil's revised EFF programe, thereby enabling drawings to resume. This paved the way for agreement on a Paris Club rescheduling, and has triggered release of the three remaining tranches of the banks' original Project I loan. Commitments to the $6.5 bn Phase II loan at present amount to about $6.25 bn, and the loan is now due to be signed by 29 December. But an initial drawing cannot be made before the end of the year, and the possibility of further bridging finance by the banks is under consideration. The existing BIS bridging facility was fully repaid on 30 November out of IMF funds, and an earlier bridging loan, provided by the commercial banks, will be repaid out of original Project I money.

As regards the $2.5 bn of new official export credits, the IMF have reiterated that the funds will be forthcoming, although the full list of contributors is not yet known, nor is the way in which facilities will be utilised. Even so, the overall picture is much more encouraging than at the time of the last Report, though it remains to be seen whether Brazil is able to adhere to the revised IMF performance criteria for next year.

Disbursement of the long-delayed first tranche of $500 mn of the $1.5 bn medium-term credit for Argentina finally took place on 30 November, after creditor banks waived requirements in respect of updating interest arrears and implementation of public sector refinancing agreements. The disbursement - used to make a partial repayment under the earlier $1.1 bn bridging loan and to help clear arrears - represented a gesture of good faith by the banks towards the new civilian Administration, which had promised to give the debt issue priority after taking office on 10 December. However, the Radicals are now seeking to delay completion of the 1982/83 public sector rescheduling agreements for six months, and meanwhile to negotiate a broader rescheduling package which would include 1984 maturities: this proposal is firmly opposed by the banks. The authorities have indicated their willingness to pay interest "to the best of their ability" while rescheduling talks are under way. (Surprisingly, arrears of interest on all debt are officially estimated to be as large as $2 bn.)

It is not yet known how far the Radicals will co-operate with the IMF, which hopes to negotiate a new programme to replace the ~~existing~~ standby (now clearly broken down). But their broad economic strategy appears to lack coherence: the authorities have declared their intention to raise real wages and stimulate economic growth, but at the same time to reduce drastically the rate of inflation and the Budget deficit.

Mexico is the only large debtor whose rescue package, as originally conceived, is still intact. The EFF programme remains well on course, with the stage now set for negotiations to begin with banks on next year's new money requirement, put at some $3 1/2 bn. The one outstanding problem relates to delays in implementing the Paris Club agreement, reached in June.

Elsewhere, existing rescue packages for some of the smaller countries are running into difficulties, and second round support operations could well be delayed. Following the suspension of drawings under Peru's EFF, the authorities have now reached agreement in principle with the IMF on a revised programme: a Letter of Intent is expected to be finalised shortly. The attitude of banks towards the country is also hardening, and further disbursements of new money are unlikely in the near future. While Ecuador has so far satisfied all IMF quantitative performance criteria, continued adherence to the standby programme is in doubt. Moreover, some large banks are unwilling to negotiate on 1984 requirements until the results of next January's Presidential elections are known. The Chileans are seeking a relaxation of the IMF standby programme next year, in order to alleviate the effects of domestic recession. Meanwhile, a package of measures has recently been announced, which includes a slower depreciation of the official exchange rate and an undertaking by the central bank to purchase the bad debts of commercial banks.

Little progress on rescheduling Venezuela's public sector debt owed to banks is expected before next February at the earliest, when the Opposition (Social Democrat) party, which won the Presidential elections this month, takes power. The President-elect appears to have ruled out negotiations on an IMF programme.

(ii) Far East

In the Philippines, negotiations are continuing on a financing package which is now expected to comprise an SBA of SDR 615 mn from the IMF, backed by new loan facilities of $3.3 bn (of which half from banks), rescheduling of $2.9 bn of short-term bank debt, and an additional rescheduling (through the Paris Club) of an unspecified amount of longer-term debt to official creditors. The Philippine authorities hope that all arrangements will be finalised and in operation by January; but this seems unrealistic and an extension of the moratorium may be necessary.

Although banks are taking a generally more cautious attitude to Asian borrowers in the wake of the problems in the Philippines, there is as yet no firm evidence that borrowing prospects for other major debtors in the region have been significantly impaired.

(iii) Eastern Europe

Congressional legislation requiring the US Executive Director in the IMF to oppose loans to "communist dictatorships", unless certain conditions are met, seems unlikely to have serious implications for East European members of the Fund.

The IMF standby for Romania remains in abeyance, but discussions in London on 7 December between Finance Minister Gigea and de Larosiere - to be continued in Washington - made substantive progress towards a compromise solution. The Fund Board is expected to meet in mid-January to discuss the Romanian standby. No progress was made in the resumed discussions between official creditors and Poland on 16 to 17 November: a further meeting is expected in January. The commercial bank agreement for 1983 was signed in early November, and discussions on 1984 and (possibly) 1985 maturities may start in mid-December. Official creditors met on 18 November to discuss Yugoslavia, and agreed on procedures for examining financing needs in 1984. Initial discussions with the commercial banks took place in early December, at which the banking representatives indicated their conditional readiness to restructure 100% of medium and long-term maturities in 1984. Meanwhile, discussions with the IMF on a further programme to succeed the present standby are expected to be completed early next month. Yugoslavia's interest in emulating Hungary's success with an IBRD cofinancing has met with little enthusiasm from the banks.

(iv) Southern Europe

Market reception of issues by Portugal, Spain and Greece continues to be favourable. But there are signs that banks may be starting to take a more critical view of Greece's overall economic position.

In Portugal, the adjustment programme associated with the standby facility and CFF is underway and, according to the IMF, it may be succeeded by a medium-term EFF to finance structural reforms in industry and agriculture. Thanks to the strong impact of measures taken earlier this year to constrain domestic demand, the Finance Minister has indicated that the current account deficit in 1983 should be perhaps \$300 mn lower than the government's target of \$2 bn (compared with \$3.2 bn in 1982). Meanwhile, in September Portugal repaid the remaining \$400 mn of the \$700 mn BIS facility arranged in two tranches earlier this year.

In Spain, a rundown of reserves and a smaller current account deficit prevented an increase in outstanding medium- and long-term debt during the first half of the year. Since June, there has been a modest recovery in reserves.

Despite an encouraging initial response in the markets to the \$250 mn package for the Greek Public Power Corporation, private contacts indicate that banks are reappraising the Greek risk, and future borrowing may meet with greater resistance. The 1984 Budget provides for a 9 1/2% reduction in real terms in the government deficit, but the revenue proposals may not go far enough to achieve this target.

Recent measures appear to have stabilised the position in Israel, although the large current account deficit continues to give cause for concern.

Nigeria's external payments position remains fairly tight, in spite of a drastic cut in imports and, more recently, agreements to refinance $2 bn of trade arrears. The Nigerians are also seeking multilateral refinancing of most of the remaining arrears, including officially guaranteed debt; and, being unwilling to use the Paris Club, seem certain to ask the UK - as major creditor and trading partner - to take the lead.

19 December 1983

INDEBTEDNESS AND BRITISH EXPOSURE (end December 1982)

$ billion

	Total external debt	British banks unguaranteed claims	ECGD amounts at risk
Latin America			
Argentina	39	2.3	0.4
Brazil	81	4.4	1.9
Chile	18	1.1	0.06
Ecuador	6	0.5	0.1
Mexico	83	5.2	1.8
Peru	12	0.4	0.1
Uruguay	4	0.3	0.01
Venezuela	33	2.4	0.09
Eastern Europe (convertible currency)			
East Germany	15	0.8	0.2
Hungary	7	0.5	0.07
Poland	25	0.5	1.4
Romania	10	0.4	0.6
Yugoslavia	20	0.9	1.3
Far East			
Indonesia	20⁄	0.6	0.9≠
Philippines	19	1.2	0.3≠
South Korea	37	2.0	0.9≠
[Hong Kong	-*	-*	5.2]

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

⁄ At end March 1983; excludes short-term debt

≠ At end February 1983

* Because of Hong Kong's position as an offshore centre the available figures for external indebtedness and banking exposure to Hong Kong are not comparable to those for other countries shown above and do not provide a meaningful indication of the territory's debt exposure.

21 DEC 1985