3.49 CONFIDENTIAL

Prime Minister ②
To note
AT 27/2

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

24 February 1984

Andrew Turnbull Esq
10 Downing Street

Dear Andrew,

I enclose the latest in the series of reports on developments on the international financial scene, prepared by the Bank of England and revised in the light of discussions in the Treasury's interdepartmental group on debt problems.

The general picture continues to be encouraging, with signs of some restoration of confidence, due to the improved economic outlook and the satisfactory resolution of negotiations with some key debtors. There are signs that banks and other creditors are now beginning to look further ahead to the longer term prospects. On the other hand, there are still downside risks, in particular from the social and political pressures within debtor countries facing prolonged adjustment programmes.

On the general scene, the Prime Minister has already been briefed on the Quito Economic Conference by the Ecuadorian Foreign Minister. Perhaps the most important common theme of the Conference was that the major Latin American debtors, though coming under increasing political and social strain as adjustment bites deeper and lasts longer, continue to reject the idea of repudiation, whether individual or collective. Their aim appears to be both to meet their obligations and to reduce the strains on them by seeking practical improvements in the terms negotiated during debt restructuring operations. We shall want to keep an eye on these developments in view of their relevance to the June Summit. The work which the new Institute of International Finance is now setting in hand may also be relevant in that context.

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The Chancellor met the Nigerian Finance Minister on 20 February and urged him to reach an early settlement with the IMF, explaining that this must be a precondition for a multilateral agreement with other government creditors. It was also made clear that any deal must also safeguard the position of uninsured creditors. The Nigerian team will now have further discussions in Paris and Bonn.

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The latest position on the commercial bank loan for Argentina, is that LBI are continuing to hold their line, and are not under any pressure at present to change it, although they expect pressure before too long. We shall keep you informed of any major developments.

Finally, you may like to draw the Prime Minister's attention to the Greek position. The Greek economy continues to suffer from serious imbalances and distortions. The IMF take the view that the present programme of economic adjustment is not strong enough. We do not expect a financial crisis to develop, but we should clearly be concerned both at the poor performance of another EC county and at the possibility of a call on Community funds if the position continues to deteriorate.

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

Yours ever

John Kerr

J O KERR
Principal Private Secretary

INTERNATIONAL FINANCIAL SCENE

The short-term position of certain key borrowers has eased appreciably since the last Report, while a number of negotiations currently under way appear to be making progress. With day to day management becoming somewhat less difficult, there are indications that both borrowers and banks are beginning seriously to consider medium and long-term issues.

Economic developments continue to be encouraging. Growth was maintained in a number of the major economies during the last quarter of 1983, with little sign so far of renewed inflationary pressures. On preliminary estimates, GNP in the USA grew more slowly in the fourth quarter, while growth in Germany picked up sharply. The increase in GNP last year in the major seven OECD countries taken together, at 2 1/2%, was close to the rate achieved over the previous three years, and was accompanied by a rise in consumer prices of only 4 3/4%, the lowest annual increase since 1972. The external trade of these countries has also continued to recover. Non-oil commodity prices rose further in December and January (to around 10% higher than a year earlier); oil prices remain stable; LIBOR is still around 9-10%, where it has stood since the fall from 13 1/2% at the end of 1982; but the US dollar continued to appreciate in January, in spite of slightly lower US domestic interest rates.

Completion of the Brazilian Phase II package and the favourable response to Mexico's request for $3.8 bn of new money - on much improved terms for the borrower - have boosted market confidence, while indicating to borrowers that vigorous adjustment is likely to be rewarded in the form of better terms on future loans. Although still cautious and discriminating, sentiment towards some of the Eastern European borrowers may also be improving a little.

In Latin America, attention is now focused on Argentina and Venezuela, where new governments are showing signs of coming to terms with their debt problems, although negotiations with creditors will certainly be difficult. Elsewhere, there has been some progress in negotiations with Yugoslavia and, to a lesser degree, with Poland. Nigeria's initial discussions with official creditors have gone fairly well, with the new government appearing to accept the need for a multilateral approach and for a link between debt negotiations and an IMF programme. On the other hand, little progress has been made on the acute problems in the Philippines; and there are signs that banks are beginning to reappraise risk on lending to Greece, which, in spite of its EEC credentials, may encounter market resistance on future borrowing.

The latest figures from the BIS (up to September 1983) confirm that lending to developing countries was severely cut back in 1983, and there seems little prospect of a recovery this year. Only a few borrowers, mainly in the Far East, continue to have ready access to the depressed syndicated credit market; and the international bond markets, which have remained active, will offer no more than a limited amount of funds for certain developing countries. The bulk of medium-term lending will therefore continue to be unspontaneous.

The banks' cautious attitude will be reinforced by efforts to strengthen their balance sheets in response to recent difficulties. For example, provisions made by major banks in 1983 against their international lending are likely to be higher than in 1982. Supervisory authorities have generally sought to strike the difficult balance between encouraging banks to improve balance sheets without discouraging them from continued participation in international lending. In this context, the prudential regulations governing international lending by US banks, which were attached to the IMF Bill, have proved in the event to be less restrictive than had earlier been thought, and have given the US regulatory authorities adequate room for manoeuvre.

With the prospect of managed lending continuing for some considerable time, there are growing indications that banks are beginning seriously to consider longer-term issues. A meeting of the Institute of International Finance earlier this month agreed to establish four working parties to examine questions such as terms on new lending and initiatives which banks might take to assist developing countries

a forum established by commercial banks for discussion of lending issues in covering future financing gaps (the banks wish to keep the existence of these groups secret). One outcome of such "initiatives" might be a collective demarche to the official sector.

Meanwhile, Latin American borrowers are coming closer to formulating a co-ordinated view on matters such as terms on new lending and the maximum proportion of export earnings to be earmarked for debt repayment. To judge by the outcome of the Quito conference in January, the present spirit is one of collaboration with a view to co-operation with creditors, rather than of cartelised confrontation. Nevertheless, a co-ordinated approach to debt problems seems to be gathering momentum and will reportedly be further considered in other fora which bring together Latin American countries.

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

(i) Latin America

Immediate concern about Brazil's debt position eased perceptibly after the signature of the Phase II financing package on 27 January; and the country's liquidity will improve when the first drawings (totalling $3 bn) of the $6.5 bn new money facility are made towards the end of February. But there is still a degree of uncertainty about the $2.5 bn of new official export credits: for the present, the Advisory Committee are satisfied with de Larosiere's assurances that the credits will be made available, but it is still not clear which countries (apart from the US) will be contributing, nor whether the funds can be fully utilised this year.

Further new money from banks should not be required this year, provided that international interest rates or oil prices do not rise, and that the projected trade surplus of $9 bn is broadly met.

The spotlight has now turned on Argentina, where the new government has begun serious discussions with banks and the IMF. With the current Fund programme broken down, an IMF staff mission has started to negotiate a new Standby arrangement, which will certainly not be easy, given the degree of adjustment likely to be demanded. Meanwhile, the authorities are seeking disbursement of the remaining $1 bn of the banks' medium-term loan agreed last August. Most groups of banks appear willing to tie disbursement to the mere signature of a new Letter of Intent, but UK banks consider that a new Fund programme should first be in place. As this is not likely to occur before April at the earliest, repayment of the banks' bridging loan (amounting to $750 mn) would need to be further postponed and arrears of interest would continue to accumulate, putting pressure on US banks in particular, because of their need to report "non-performing" loans on 31 March.

Mexico successfully met the IMF's performance criteria throughout 1983; and against this background, the Advisory Committee are currently seeking commitments from creditor banks towards the 1984 new money requirement of $3.8 bn, on much improved terms compared with last year. Commitments have now reached $3.2 bn, and signature is expected around the end of February. The commercial bank rescheduling schemes are progressing smoothly, and the Paris Club recently cleared the way for restructuring of $1.9 bn of officially-guaranteed private sector debt.

Progress has been made in the second round support operations for some of the smaller Latin American borrowers, although many problems remain. Peru has now signed a Letter of Intent to the IMF for a new Standby arrangement to replace the EFF which was formally abandoned after major deviations from performance criteria. This has enabled the authorities to obtain much better terms in their agreement with the Advisory Committee over rescheduling 1984 and 1985 maturities. However, with mounting political pressures to depart from IMF austerity policies, it remains to be seen whether the IMF programme can be successfully implemented ahead of next year's Presidential elections. In Chile, the authorities have concluded negotiations with a Fund mission which have led to some relaxation of the Standby programme this year to alleviate the effects of the recession. Meanwhile, discussions have begun with the Advisory Committee about this year's new money requirement of around $800 mn.

The second round support operation for Ecuador has been hampered by the Presidential elections: banks have refused to reach an agreement covering the whole of 1984 until the outcome of the second round of the elections becomes known in May and a new Standby has been negotiated with the IMF. As regards Venezuela, the banks have had little option but to grant a further 90-day extension to the moratorium which expired on 31 January. The first formal meeting between the Advisory Committee and the new Administration is expected shortly. The replacement of the previous Central Bank President and the appointment of a new foreign debt co-ordinator have been taken as likely to facilitate negotiations.

(ii) Far East

In the Far East, there has been little material progress towards assembling a support package for the Philippines, where negotiations with the IMF have been complicated by doubts about the reliability of external statistics and a sharp acceleration in monetary growth. A Fund team is in Manila to settle the statistical question and to re-open discussions on a Letter of Intent. Meanwhile, the debt moratorium has been extended for a further 90 days, to 15 April. Elsewhere in the region, both South Korea and Indonesia continue to show a steady improvement, and the latter is now approaching the market for a major loan ($500 mn) - the first of this order since the Philippine crisis broke.

(iii) Eastern Europe

Sentiment towards Eastern Europe may be improving a little, although it remains essentially cautious and discriminating. The USSR has negotiated a fine margin of only 5/8% over LIBOR on its first syndicated borrowing ($150 mn over five years) for general balance of payments purposes since 1979. Both Czechoslovakia and Hungary (which recently entered into a further Standby arrangement with the IMF) can be expected to come to the market again this year, although terms and timing will need to be carefully pitched, with the margin very much higher than in the Soviet case. Elsewhere in Eastern Europe, the GDR continues to meet payments on time, despite its undoubtedly tight liquidity; and Romania seems likely to avoid rescheduling this year, after the resolution of its differences with the IMF and release of the remaining drawings under the now terminated Standby arrangement.

Meanwhile, both official creditors and commercial banks have agreed in principle to reschedule Yugoslavia's medium and long-term maturities falling due in 1984 over seven years, including four years' grace. Final agreement is conditional upon the satisfactory conclusion of current negotiations with the IMF on a one-year Standby arrangement. The banks are considering the possibility of a multi-year rescheduling arrangement for Poland. Negotiations on the number of years to be included and on the possible provision of trade credit began in Warsaw on 16 and 17 February. Official creditors met in Paris on 6 February and agreed to consider the possibility of rescheduling overdue principal and interest arrears in conjunction with a settlement of the arrears under the 1981 agreement. They agreed to inform the banks that in future they would be seeking comparability of treatment (which had been in abeyance while official creditors were providing 100% of de facto relief). A meeting with the Poles is tentatively scheduled for the week beginning 19 March.

(iv) Southern Europe

In Portugal, where domestic demand is being progressively squeezed, the current account deficit was almost halved last year to $1.7 bn (some $300 mn below the target set under the Standby arrangement); and a further, though smaller, improvement is in prospect this year.

Last year, the Greek economy was characterised by high inflation, a large public sector deficit, and another current account deficit of nearly $2 bn. At the same time, external debt is estimated to have risen by some $1 1/4 bn and the debt service ratio to nearly 17%. No perceptible improvement is in prospect this year: a generous incomes policy, which has recently been announced, is likely to impair competitiveness and sustain inflation at a rate some three times faster than the Community average. Reserves stand at only 4-5 weeks' imports. The IMF staff have indicated that, in the absence of stronger adjustment, a further sizable increase in the debt service ratio is likely over the next few years. Although no immediate crisis seems in prospect, there are signs that international banks are beginning to take a less sanguine view of Greek risk.

Further measures to stabilise the position in Israel have been announced, including a 4% cut in government expenditure in the fiscal year commencing 1 April and a tightening of exchange controls.

In Nigeria, recent IMF figures show that medium and long-term debt outstanding is rather larger than was previously thought, as are capital repayments due to be made this year and next. Meanwhile, the Nigerians have recently resumed discussions with the IMF on the possibility of an extended facility and have had talks with official and private creditors in the UK, France and Germany. It has been made clear to the Nigerians that the consolidation of their debt to, or guaranteed by, official agencies must take place in a multilateral framework along Paris Club lines. Indications are that the Buhari regime intends to approach Nigeria's acute liquidity problem responsibly and is willing to accept the IMF's medicine, though the degree of exchange rate adjustment required is likely to prove contentious.

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