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Prime Minister (2)

On X there is a further minute updating the situation. No need to read past page 3 though the table on page 9 is interesting.

AT 18/5

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

17 May 1984

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew

INTERNATIONAL DEBT

I attach the latest in our series of regular reports, prepared by the Bank of England and discussed at a meeting of the interdepartmental group of officials chaired by the Treasury.

Since that meeting was held, we have had a meeting in London of the "Debt Deputies" of the G5, and an IMF representative, from which the following further points emerged.

The first concerns the recent meeting of Central Bankers in New York. All the G5 representatives, and the Fund representative, were anxious to play down the significance of this meeting, which was an entirely informal and non-executive affair, at which no generalised solutions were sought. There will be no follow-up; all the ideas will be further considered by Central Bankers. In particular, nothing happened to alter the American position, which a White House meeting recently reaffirmed. American statements (eg at this week's OECD Ministerial meeting and the Summit) are still expected to reaffirm their existing policy, concentrating on the need for strong adjustment programmes in debt countries and the case by case approach.

X On Argentina, the Debt Deputies were more optimistic than we are. Both the American and IMF representatives were reasonably confident that a satisfactory IMF programme would, with patience, eventually be agreed. It might well not be approved before 30 June, but the Americans say they have no intention of mounting another major international rescue operation. (They strongly insisted that the March package was put together in response to Latin American

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political pressure, and not as a bailing out operation for US banks.) We remain more sceptical about the prospects for progress and, although the possibility of default was not thought sufficiently serious to merit concerted contingency planning at this stage, we secured the agreement of the US Treasury to accept responsibility for consulting the other G5 members and concerting appropriate action should the situation deteriorate. In the meantime, we shall continue our own domestic contingency work.

Copies of this letter go to John Bartlett (Bank of England), Callum MacCarthy (DTI), and Len Appleyard (FCO).

Yours ever

David

D L C PERETZ
Principal Private Secretary

INTERNATIONAL FINANCIAL SCENE

Argentina's problems continue to be the main focus of concern, although tension has temporarily eased somewhat since March. Elsewhere in Latin America and in Eastern Europe, there have been a number of favourable developments. More consideration is now being given to the new methods of management which will be required in the next - medium-term - phase of handling the international debt situation.

Recent developments on the economic front are not entirely encouraging. The US-led recovery in most of the large industrial economies continues to benefit LDC exports, but there is growing concern about the impact of high US interest rates on major debtors. There is an increasing sense of frustration among the major debtor governments; a greater risk, following the Quito conference, of a more collective approach to debt issues; and more insistent calls for fresh thinking on methods of dealing with debt service problems. Brazil and Argentina are leading the demand for a reduction in interest rates. On 9 May, the Brazilian Government issued a statement calling on creditor governments to consider the repercussions of their policies on debtors.

GNP in the USA rose by an estimated 2% in the first quarter of 1984, compared with 1 1/4% in the previous three months, and recovery also appears to be continuing in most other large economies, leading to a further improvement in the current account position of developing countries, notably in Latin America. Commodity and oil prices have remained stable in recent weeks. At the same time, dollar interest rates continued to rise during April, with long-term rates reaching their highest point since August 1982. This heightens the dilemma facing the US monetary authorities who remain determined to control inflation by monetary means while recognising the impact which a tighter policy would have on major debtors. The dollar has also recovered still further from the low point reached at the beginning of March, which will tend to accentuate most developing countries' debt servicing problems.

Latest BIS data show that international lending rose sharply in the fourth quarter of 1983, in particular to Eastern Europe (USSR and

Hungary) and to non-oil developing countries (notably Thailand, Korea and Israel). Lending to Latin American countries was mainly unspontaneous. Over the year as a whole, banks in the BIS area increased their exposure to non-oil LDCs by only 5%, but the rise might have been around 7% if part of the rescheduled debt had not been taken over by national export credit agencies. Even so, it is clear that financing pressures on the LDCs remained severe: indeed, in the eighteen months after the onset of generalised debt problems in June 1982, lending to Latin American countries fell by 7 1/2% on the previous eighteen months. There are, however, some tentative indications that the recovery in the fourth quarter may have continued in the early months of this year. If so, the IMF forecast of a rise of 5-7% (equivalent to around $20 bn) for the year as a whole might have a reasonable prospect of being achieved, particularly as Brazil and Mexico have already secured more than $10 bn.

The BIS data also show that some developing countries (notably Mexico and Brazil) have been able to build up their deposits with banks - reflecting not only the disbursement of bank loans, but also a very marked improvement in the trade balance. (Indeed, Mexico ran a current account surplus last year.)

Turning to individual countries, Argentina is still the main cause for concern. Although the end-March accounting problem for US banks was overcome (see below), the government has yet to demonstrate the will or capacity to tackle its debt problems. Consequently, it is still not possible to predict when an IMF programme will be implemented and a rescue package agreed. Meanwhile, arrears continue to accumulate, and the accounting problem for US banks will recur at the end of June.

Elsewhere in Latin America, developments have generally been encouraging. Mexico has at last secured the signature of its $3.8 bn loan for 1984, and Brazil's liquidity is much healthier, with nearly $4 bn of this year's new money already disbursed and a further improvement in the trade balance. Peru has reached agreement with the IMF, but delays persist in negotiations with Ecuador and Venezuela. Following a Fund mission to Chile to confirm the Stand-by programme with the new Ministers, an IMF Board discussion took place on 14 May.

There has been some further improvement in Eastern Europe. The USSR and Hungary are successfully tapping the market, and even the GDR has been able to return to it in a small way. Commercial bank negotiations with Poland have been successfully concluded. The Yugoslav restructuring is agreed in principle with both banks and official creditors, although the Yugoslavs are objecting to some aspects of the draft governmental agreement.

Progress has been made in Nigeria's negotiations with its uninsured, but not its official, creditors. As regards the Philippines, the banks expect that a new money package is not likely to be assembled until several months after an IMF agreement has been reached.

For the future, now that 1984 new money for Mexico and Brazil has been secured, attention has turned to Argentina, where the delays and problems noted above could well make banks reluctant to meet a financing requirement estimated at $4 1/2 bn. Brazil is also expected to make a request in the autumn for some $3 bn of new bank money for 1985: here, too, experience with the last package suggests that at least some of the smaller banks may be unwilling to participate. On the other hand, it is possible that Mexico may be able to meet part, or even all, of its requirement for bank finance in 1985 (estimated at some $4 1/2 bn) through normal market borrowing.

More generally, attention is beginning to focus on ways of managing the next - medium-term - phase of the debt problem, including the treatment of interest payments and the problem of maintaining cohesion in assembling financial support packages. The co-ordinated approach adopted in Quito by debtor countries has maintained its momentum, but it is not yet clear how far this may influence the balance of power between banks and borrowers or present case-by-case methods. Meanwhile, study groups set up by banks under the auspices of the Institute of International Finance to examine such issues are expected to produce interim reports early in July.

More detail about the position in major debtor countries is given below.

(i) Latin America

Argentina remains the major problem at present for the financial community. Following the breakdown of negotiations for reinstating the 1983 new money loan, a $500 mn emergency financial package was arranged to enable Argentina to pay interest on its public sector debt up to 2 January, and thus avoid the need for US banks to classify loans as non-performing when reporting first quarter earnings. The package included loans totalling $300 mn from Mexico, Venezuela, Brazil and Colombia, to be taken over by the US Treasury on signature of a Letter of Intent with the IMF, $100 mn from the banks, and $100 mn out of Argentina's own reserves. The banks have also had to roll over (to 16 June) the $750 mn outstanding under the 1982 bridging loan. Progress on a new IMF programme is still proving very difficult; meanwhile, government policy is having little impact on the country's economic problems.

The improvement in Brazil's liquidity has been maintained: a further tranche of new money (totalling $875 mn) was drawn on 13 April, and the trade balance has improved further. All arrears (other than those which might qualify for Paris Club rescheduling) were eliminated by end-March. Official attention has now switched to inflation: it remains to be seen whether a decline in the monthly rate in April was the start of a downward trend. The Fund Board met on 9 May to consider a recent Article IV Consultations paper, an EFF review, and a request for a CFF.

The $3.8 bn new money loan for Mexico was finally signed on 27 April and a first drawing (of $950 mn) is expected to be made in mid-May. Little information is so far available on Mexico's economic performance this year, but it is becoming increasingly clear that the target for inflation (40% year on year in December) is unlikely to be achieved.

Elsewhere, a major Cabinet reshuffle took place on 2 April in Chile, which included new Ministers of Economy and Finance. A Fund mission has confirmed the programme for the second year of the Stand-by with the new Ministers, and a Board discussion is scheduled for 14 May. Meanwhile, commitments to this year's new money from

banks have reached 95%, and signature is expected early next month. Although a new team in Peru tried to secure modifications to a recent Standby, the programme approved by the IMF Board on 26 April does not differ substantially from the earlier agreement. However, it remains to be seen whether the authorities will be able or willing to implement its terms in the run-up to next year's Presidential elections, although in the short term the agreement with the IMF should facilitate early signature of the 1984/85 refinancing package. In Ecuador, agreement in principle has been reached on the 1984 refinancing package, which incorporates much better terms than last year. But creditor banks are reluctant to sign until the outcome of the second round of the Presidential elections becomes known in May and a new Standby has been agreed with the IMF. As regards Venezuela, there are signs that the authorities are beginning to show real willingness to accommodate their creditors: arrears of interest on public sector debt had been eliminated by mid-April (though they are beginning to build up again), and action is being taken to speed up payment of private sector interest arrears. The Advisory Committee has accepted a further extension of the moratorium until end-July, but it is not yet clear whether an agreement on rescheduling can be reached without the need for an IMF programme. Progress on such an agreement will not be helped by the publicity given to a recent requirement of the US regulatory authorities that US banks should classify loans to Venezuela as "sub-standard".

(ii) The Far East

In the Philippines, substantive progress towards signing a Letter of Intent - the main essentials of which are agreed - awaits implementation of a number of policy measures which the authorities would not undertake before the 14 May Parliamentary elections. The moratorium has been extended for a further 90 days to 12 July and, as negotiations with the banks are expected to be protracted into the late summer or autumn, at least one further extension is likely to be necessary. The Advisory Committee of banks met again on 7-8 May in an effort to seek a compromise over the treatment of the frozen deposits with Citicorp, Manila. Elsewhere in the region, Indonesia's highly successful euro-loan in March, together with an

expected satisfactory outcome at the annual meeting of the Inter-Governmental Group on Indonesia, should mean that the country's financing needs for the year ahead have now been effectively secured. With comfortable reserves and low short-term debt, Indonesia is now unlikely to face a payments crisis.

(iii) Eastern Europe

There is further evidence of an improvement in market sentiment towards Eastern Europe. A syndicated loan to the USSR, which was oversubscribed, was increased from $150 mn to $250 mn, and is to be shortly followed by a loan for $100 mn for the Moscow-based International Investment Bank. Hungary, which has already been active in the market this year, is seeking further large co-financing loans. Even the GDR is currently testing the market with a modest $50 mn "club" loan for five years, on terms (1% over LIBOR) which compare very favourably with the high rates recently being paid on its shorter-term paper; and there are suggestions that Bulgaria may be contemplating a loan of $50 mn.

Approval of the new Stand-by Arrangement for Yugoslavia has paved the way for creditor governments to sign the framework agreement rescheduling all medium and long-term maturities falling due in 1984 over seven years, including four years' grace. However, the Yugoslavs have taken exception to some aspects of the draft agreement, and signature could therefore be delayed. Signature of the series of agreements with the commercial banks will start on 16 May. The banks have reached agreement with Poland on a multi-year rescheduling and the provision by end-1985 of some $700 mn trade finance, of which just under half will be new money. Signature is expected in July and will complete the rescheduling of virtually all the original stock of debt due to banks. The Poles now seem to have accepted the provisional agreement on settlement of arrears under the 1981 rescheduling agreement with official creditors, reached in Paris in March. A Task Force is due to meet the Poles later this month, and negotiations may begin in early June.

(iv) Southern Europe

After a successful $150 mn FRN issue last month by Greece, a favourable reception to a 7-year syndicated credit has prompted the authorities to raise the amount from $350 mn to $400 mn. The coupon, at 5/8% over LIBOR, is the same as was obtained on the $500 mn credit raised by the Bank of Greece in March 1983. To some extent, this relatively favourable response reflects a shortage of better quality borrowers in the market. Meanwhile, the central bank's recent Annual Report includes some measured criticism of current economic policies, emphasising in particular the need to reduce the current account deficit and the dangers which would flow from an increase in real wages this year.

Turkey's new one-year Stand-by has been approved, but unless the pace of external adjustment turns out to be faster than currently envisaged, the country could well experience payments difficulties within the next three years, when debt service payments peak. The OECD takes a gloomier view than the IMF and does not rule out the need for special assistance in 1985, when rescheduled debts being to mature.

Provisional figures for the first quarter of 1984 show that Spain's external position improved further, with the trade deficit less than half as large as in the corresponding period last year. Medium and long-term debt rose by only $3/4 mn during 1983, compared with $1 1/2 bn in 1982 and $3 1/2 bn in 1981. Substantial capital inflows in recent months have prompted the authorities to encourage early repayment of foreign debt.

Portugal's external adjustment effort is beginning to show results, with a current account deficit last year of $1 3/4 bn, compared with an IMF target of $2 bn and an outturn of $3 1/4 bn in 1982. Nevertheless, external indebtedness remains uncomfortably high, at $14 1/4 bn in September (of which $3 1/2-4 bn short-term), and is projected to rise further in the medium-term. Against this background, conditions for borrowing in external markets remain far from easy.

In April, the Nigerians made an offer to uninsured commercial creditors, after securing agreement in principle from a representative group of major creditor companies. An IMF mission arrived in Lagos in early May to resume negotiations of a three-year EFF. The mission's departure was conditional on official willingness to make an initial devaluation against the dollar, and had been delayed by earlier Nigerian reluctance to take this key step. The recent Budget proposals, although making no reference to devaluation, are in most other respects likely to meet with Fund approval.

INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt End-Dec 1983 (except where stated)	British-owned banks' exposure [1] End-Dec 1983	ECGD amounts at risk[2 End-Dec 1983
Latin America			
Argentina	43.6	2.5	0.1
Brazil	91	6.1	2.1
Chile	17.4	1.3	0.1
Ecuador	6.6	0.6	0.1
Mexico	95.3	6.3	1.5
Peru	13	0.4	0.2
Venezuela	34	2.4	0.1
Eastern Europe (convertible currency)			
East Germany	13	0.7	0.2
Hungary	7.4*	0.5	0.1
Poland	27	0.5	1.0
Romania	9	0.3	0.5
Yugoslavia	18.8	0.9	1.3
Southern Europe			
Portugal	14.2*	1.4	0.4
Greece	12.1	1.6	0.4
Spain	40	2.8	0.2
Israel	29	0.6	0.2
Far East			
Indonesia	31	0.8	1.7
Philippines	25.6	1.4	0.3
South Korea	40	2.6	1.0
Other			
Morocco	11.5	0.1	0.3
Nigeria	20	1.3	4.1

* end-September 1983

[1] This column now shows exposure defined as consolidated external claims, adjusted for certain inward and outward risk transfers in respect of guaranteed loans, plus any net claims on local residents in local currency.

[2] Because of differences in definition, these estimates are not directly comparable with the figures in other columns.

Indebtedness