FILE

RM

10 DOWNING STREET

From the Private Secretary

21 May, 1984

ARGENTINA

The Prime Minister has seen and noted without comment your letter to me of 18 May reporting on further developments on Argentina's debt position. She has also noted the Chancellor's doubts about whether a default by Argentina would create a domino effect.

(A. Turnbull)

Miss J. Simpson,
HM Treasury

CONFIDENTIAL

NR.

Prime Minister
To bring you up to date.
FERB
18.5

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

18 May 1984

Andrew Turnbull Esq
10 Downing Street

Dear Andrew,

ARGENTINA

This letter reports further developments in the Argentine debt situation since David Peretz's letter of 17 May recording the views expressed at the G5 Debt Deputies meeting.

The Working Committee of commercial banks, of which LBI is a member, met unexpectedly in New York on Tuesday to consider a proposal from the Argentines for release before the 30 June deadline of the outstanding $1 billion remaining undrawn from the 1983 $1.5 billion medium term loan. The new proposal is that the $1 billion should be used as follows:-

(i) $750 million to repay the outstanding principal of the bridge loan which falls due in mid June;

(ii) $100 million to repay the banks' share of the US-organised March package; and

(iii) the balance of $150 million, together with about $350 million from the Argentine reserves, to extinguish banks' interest arrears up to 30 April.

The drawdown would be on condition that the Argentines made a firm statement that they had made substantial progress on the measures in the Letter of Intent, together with explicit endorsement and commendation of this by the Managing Director of the Fund and satisfactory resolution of various outstanding aspects of the package put together at the end of March and the rolled-over bridging loan.

The Working Committee's reaction to this proposal was in general positive. When they sought the IMF's reaction, the Managing Director is said to have told them that progress remained slow and negotiations were a long way from resolution, but that a favourable response from the banks would be helpful to the IMF cause because it would add a further element of pressure on the Argentine Government to conclude a satisfactory agreement with the Fund. (There seems to be some breakdown of communication within the Fund on this point. The Deputy MD says the Fund has not been approached and would be unenthusiastic.)

LBI, who informed the Bank of this proposal, have since reported that the UK clearers on balance support it. Their main consideration is that it would clear the decks on existing arrears and the outstanding bridging loan. The Chancellor's view is that the proposals should not have the Government's blessing. This latest proposal is considerably weaker than the earlier two tranche proposal (under which a second $500 million tranche would be released on condition that the Managing Director had forwarded a Letter of Intent to the IMF Board and recommended its approval but release of the final tranche of $500 million would depend on actual Board approval of a satisfactory programme). The Prime Minister endorsed this in March, provided there were no further concessions. Although it could provide the Argentines with an incentive to come to terms with the Fund, the new proposal would establish an unwelcome precedent for the release of funds before a Fund programme is assured. Even when a satisfactory Letter of Intent has been signed and commended, a good deal will need to be done before the Board can be confident of Argentine intentions.

On the Chancellor's instructions, the Bank therefore told LBI that they must form their own view of their best commercial interest but that the proposal did not commend itself to HMG. If the banks were to go ahead, the Government would consider itself free to say publicly that in their view it would have been better to wait until the Argentine Government had undertaken a new programme which satisfies the Fund.

The banks have considered this message seriously, and at least two of them have consulted their Chairmen. Nevertheless, taking into account the tremors caused in the US banking system by the Continental Illinois crisis, and the desire of all parties including the IMF to encourage responsible behaviour by the Argentine Government, the banks have authorised LBI to signify its agreement to the proposed reply by the Working Committee to the Argentine request. Assuming that other banks on the Working Committee react similarly, the next step would be to commend the proposal to the other banks. A final decision will not be made until after this process of consultation; and final release only if the conditions were met.

If the loan were to go ahead, as seems likely, the possibility of Argentina defaulting is less. In any event, the Chancellor feels that the Prime Minister's comment during her talks on 15 May with Sir Robert Muldoon that "if Argentina were to default, the domino effect would be very serious" probably overstates the case. If Argentina did decide to repudiate its debts, it would put its Latin American neighbours into a very difficult position, especially in those countries where political pressures are already acute and where they will have been strengthened by recent increases in interest rates. On the other hand, several of the major countries now have rescue packages in place and therefore a vested interest in discouraging actions by more recalcitrant neighbours. Their involvement in the recent Argentine bridging loan demonstrated this. The Chancellor considers that, although the risk of a domino effect cannot be entirely ignored, it is unlikely that other Latin American countries would follow suit. The consequences of such action in terms of the drying up of international credit and trade lines would be considerably more serious for most of them than for Argentina which is not heavily dependent on imports for either energy or food. Brazil, for example, is not so well placed. Nevertheless, one aspect of the contingency planning we have in hand is the role of sanctions or the threat of sanctions which would deter copycat action elsewhere.

Yours ever,

Judith

MISS J C SIMPSON
Private Secretary