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CONFIDENTIAL

Prime Minister ②

To note. Paras 4 and 5 cover the Cartagena debtors conference and an account of the most recent debt negotiations with Argentina.

AT 17/7

CHANCELLOR OF THE EXCHEQUER

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

16 July 1984

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew

INTERNATIONAL FINANCIAL SCENE

I attach the latest report by the Bank on developments on the international financial scene, which has been considered in the Treasury's international debt group.

Despite some favourable signs, the outlook for interest rates seriously increases the downside risks; and the timing of the latest rise in US rates has made it more difficult for the moderate debtor countries to restrain the militants. This is a pity, since the Cartagena meeting, of which we have already sent you a brief appraisal, represented something of a victory for the moderates, although it also marked a further move towards collective action by the Latin American debtors. Another meeting, in Buenos Aires and with an Argentine secretariat, is scheduled for just before the IMF/World Bank meetings in September.

A further possible difficulty ahead is the effect of the increase by 1.2 per cent on 15 July of the OECD export credit consensus rates, under the automatic adjustment arrangements introduced last year. This was, however, an important part of a hard won agreement (against strong French opposition) designed to bring consensus rates closer to market rates to reduce the cost of export credit subsidies, and we should not wish to see any of that agreement unpicked.

Following the London Summit, Treasury officials are working on the practicalities and technicalities of multi-year rescheduling, in consultation with G-5 colleagues. The most likely candidates for official multi-year rescheduling are Brazil and Yugoslavia.

As the attached note indicates, among individual debtor countries Argentina remains the main concern. The position in Nigeria is also worrying. There is still no sign of a Fund agreement there either, and recent political developments have obviously increased the uncertainties. ECGD has substantial sums at risk; failure to agree a refinancing of insured arrears (which is itself contingent on agreement on a Fund programme) could add some £200 million to the PSBR in 1984-85 and some £220 million in 1985-86. We are consulting with our G-5 partners and the Fund on the next steps.

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CHANCELLOR OF THE EXCHEQUER

Finally, I should add that at a meeting in Paris a week ago, negotiations between Polish officials and official creditors broke down over Poland's failure to make the down payments agreed as a precondition for further rescheduling. There is as yet no arrangement to resume talks.

I am copying this letter to Len Appleyard (FCO), Callum McCarthy (DTI), and John Bartlett (Bank of England)

Yours ever

David

D L C PERETZ
Principal Private Secretary

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A combination of factors, notably the Continental Illinois crisis, the renewed pressure on debtors stemming from rising interest rates, and the growing momentum behind debtor co-ordination, now being encouraged particularly by Argentina - a country whose approach to its economic problems is itself a cause for much concern - has served to create an atmosphere of edginess in the financial markets. Brazil and Mexico continue to perform well, but Colombia, which has so far avoided debt problems, may shortly need to apply for rescheduling. Against this background, proposals for medium-term solutions to the debt problem are coming more to the fore: procedures adopted over the last two years are undergoing critical reappraisal, with a stronger demand for more direct involvement by creditor governments.

On balance, the economic news is discouraging. US interest rates rose further in June and are now some 2 - 2 1/2% higher than at the beginning of the year, adding more than $5 bn to the annual interest burden of the Latin American region. Moreover, the signs are that rates may rise again over the coming months. The dollar has appreciated further, while commodity prices weakened significantly in June. On the positive side, growth in the major economies - particularly in the US, Germany and Japan - has been maintained without any sign of a significant acceleration in inflation; and the combined current account deficit of these countries widened further in April. The US continues to be the main engine for this economic expansion and revival of trade, but there are growing doubts as to whether the present rapid growth rate and record current account deficits in the US can be sustained for much longer.

good for inflation though!

Among the debtor countries, Argentina remains the major source of immediate concern. Since a number of US banks have decided voluntarily to follow the more restrictive change in US supervisory rules (which formally come into effect at the end of September), they no longer had the incentive - which they had in March - to extend new money to Argentina in order to preserve existing loans as "performing". However, the banks' Working Committee has been under pressure - from the Fed as well as Argentina - to make a further bridging loan, simply to prevent negotiations from breaking down. The Committee eventually decided to advance a further $125 mn (secured by Argentine reserves held in escrow at the Fed in New York) to help Argentina to reduce arrears of interest by some $400 mn. Meanwhile, the countries which provided temporary support to Argentina in March have put pressure on the Argentines to settle their differences with the IMF, but have extended their own loan for a further month.

Brazil and Mexico continue to register large surpluses on visible trade. The latter is about to begin negotiations with banks on a multi-year rescheduling covering maturities from 1985 to at least 1988. New economic teams in Chile and Peru have satisfied the IMF that their economic policies are acceptable: Chile has accordingly obtained $780 mn of new money from banks for 1984, and Peru has reached agreement with its official creditors on rescheduling maturities up to mid-1985. Bolivia has officially suspended debt service payments to commercial banks, but this merely formalises the earlier position. Bolivia's difficulties are particularly severe, and there is no question of the suspension influencing the attitudes of other Latin American debtors. In Venezuela, where arrears continue to accumulate, an extension of the moratorium at end-July seems inevitable, but some progress was made recently when the government and banks agreed to initiate formal rescheduling negotiations. The authorities will be seeking to negotiate fixed, rather than floating, rates - the first time such a proposal has been made by a debtor country. Prospects do not look at all encouraging in Colombia, which has so far avoided debt servicing problems, but may shortly need to apply for rescheduling and an IMF Standby.

In Eastern Europe, Yugoslavia has signed agreements with its bank and official creditors on restructuring 1984 maturities; and Poland hopes to sign a multi-year rescheduling, covering 1984-1987, with its bank creditors in mid-July, although negotiations with official creditors have temporarily broken down.

Elsewhere, negotiations with the Philippines and Nigeria continue to be delayed by failure to agree programmes with the IMF: the Philippine authorities have gone some way towards meeting IMF requirements, but the Nigerians are still resisting a step devaluation of the naira.

As the debt problems move into their third year, and against the background of a damaging rise in US interest rates, attention is turning towards debt management strategy over the medium-term, with particular reference to ways of alleviating the interest burden on debtor countries. The outcome of the London Summit, which advocated multi-year reschedulings, was generally regarded as modestly helpful, though it did not fully satisfy the debtors' desire for trade, development and finance to be more closely linked. Following their meeting at Cartagena in June, the Latin American debtors responded by reiterating - moderately but firmly - a request (originally made at Quito) for further assistance to enable them to honour their obligations. This movement towards a co-ordinated approach by Latin American countries to debt negotiations is gaining momentum, not least because even moderate debtors have become seriously concerned at the way in which rises in interest rates have eliminated much of the hard-earned gains from their policies of adjustment. Another debtors' meeting is to be held in Buenos Aires around the time of the IMF Annual Meetings in September. The venue and timing, together with Argentina's new key role in the Latin American collaborative efforts, all suggest that a harder line could emerge. Indeed, Argentina is already endeavouring to co-ordinate a Latin American response to rising US interest rates, which could mean that the meeting may be brought forward. Meanwhile, the banks are also considering long-term issues, mainly in the framework of the Institute of International Finance: some preliminary results of their discussions are expected to emerge in July.

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

(i) Latin America

Regional developments in recent months have been characterised by a greater politicisation of the debt question and by moves towards closer co-ordination of strategies for resolving present problems. On 21-22 June, Latin American Foreign and Finance Ministers, representing eleven countries (Argentina, Bolivia, Brazil, Chile, Colombia, Dominican Republic, Ecuador, Mexico, Peru, Uruguay and Venezuela), met in Cartagena, Colombia, with a view to defining "the most appropriate initiatives and means of action capable of reaching solutions satisfactory to all interested countries". The meeting had been called by the Presidents of Argentina, Brazil, Mexico and Colombia, following a joint declaration, issued on 19 May, warning of the political and economic consequences for the region of high international interest rates and increased protectionism. In the event, the consensus reached at the meeting was relatively moderate in tone and resulted in another general - if more pithy - statement of principles and broad policy objectives designed to ease the region's debt servicing burden. The steadying influence of Brazil, Colombia and Mexico successfully blocked more radical proposals (such as limiting debt service payments to a specific proportion of export earnings) made by hardliners in the Argentine camp, eg Bolivia, Ecuador and the Dominican Republic. The moderates have also been constructive in exerting pressure on Argentina to agree an IMF-approved programme.

The governments represented at Cartagena are to meet again in Buenos Aires in September ahead of the Annual General Meetings of the IMF and IBRD, in order to review the response of western governments to their call for more far-reaching co-operation and assistance to resolve the debt problem. It was agreed at Cartagena that the debt problem must be treated at a political level and cannot be left solely to technocrats and creditor banks; and the Latin Americans are accordingly also seeking a high level political dialogue with governments of the industrialised countries for a "joint reflection" on the debt problem.

The rise in prime rate which immediately followed the Cartagena meeting can only serve to weaken the position painstakingly achieved by the moderates and to strengthen the case of the hawks led by Argentina, which provides both the venue for the next meeting and the group's first temporary secretary.

As regards individual countries, Argentina remains the most worrisome. It has now formally approached the Paris Club, but agreement cannot, of course, be reached until an IMF programme is approved. Although the Argentines have sent a "Letter of Intent" to the IMF Managing Director, they failed to obtain the approval of Fund Staff in advance and a wide gap remains between the two sides. An Argentine mission to the IMF in the latter part of June, and Grinspun's visit to Washington on 26-27 June, failed to make significant progress, although negotiations are continuing. Meanwhile, Argentina pressed the banks' Working Committee to advance a 90-day loan of $125 mn as part of a new package to bring interest arrears more up-to-date. The package was to include a contribution of at least $225 mn from Argentina's reserves (in addition to $100 mn paid to the banks on 20 June) and a 90-day rollover of both the $750 mn outstanding under the 1982 bridging loan and the $100 mn provided under the end-March package. Argentina latterly insisted that the package should go forward without any linkage (as had originally been proposed) to a Letter of Intent being approved by the IMF Managing Director or to any fixed timetable for such approval; the banks were at first ready to consider this demand only if the Managing Director indicated that progress in the negotiation was being made, but he was unable to do so. The Working Committee accordingly decided on 27 June not to advance the $125 mn, but on the following day the US banks were persuaded by the FRB to reverse the decision, on the grounds that the banks would still be reducing their overall exposure to Argentina as a result of the deal, without reducing the pressure on Argentina to reach agreement with the Fund. On 29 June, all members of the Working Committee agreed to participate in the loan, LBI doing so only at the last minute, in order to preserve the unity of the Committee. The terms of the loan require Argentina to have reached agreement with the Managing Director of the IMF by 15 August: if agreement is not reached, the loan falls due for repayment on that date, and irrevocable instructions so to repay it from Argentina's accounts with the FRBNY have, we understand, been given. The other elements of the package (outlined above) were also agreed.

The governments of Brazil, Colombia and Mexico - the position of Venezuela is not clear - had agreed to postpone repayment of their $300 mn contribution to the end-March package until 31 July, despite the US Treasury's decision not to extend its guarantee arrangement beyond 15 June, provided that the banks extended their $100 mn bridging loan for 90 days and that Argentina made some progress in reducing interest arrears to the banks.

Brazil's trade account continues to strengthen, and the cumulative surplus in the first six months of this year amounted to two thirds of the surplus targeted for 1984 as a whole. This improvement should enable the country to absorb the full impact of recent rises in international interest rates - which Brazil has sharply criticised - without jeopardising the target for the current account. In the Phase III negotiations, due to begin later this summer, the authorities may well seek to capitalise on the country's improved performance by requesting a multi-year rescheduling, possibly covering maturities falling due in 1985-87.

It is now widely accepted in the international community that Mexico's successful efforts to adjust should be rewarded with an agreement on a multi-year rescheduling of maturities falling due from 1985 to at least 1988, including debt restructured during 1983. Discussions with the Advisory Group are tentatively scheduled to begin early in July.

Elsewhere, the new economic team in Chile appears to have accepted that, at least for the time being, there is little scope for expansionary policies. This stance paved the way for a succcessful quarterly review of the Fund programme in mid-May and for signature of the $780 mn new money package from banks on 14 June. However, Chile now looks likely to miss this year's IMF target on reserves, essentially because of low copper prices and higher US interest rates, in which event a waiver would no doubt be requested. Against this background, and with the possibility of US restrictions on imports of Chilean copper, the authorities have recently been taking a harder line on regional debt co-ordination and the need to limit debt service payments. Recent economic measures introduced by the Peruvians indicate that their new economic team too has opted - at least for the present - for less expansionary policies. A favourable IMF report enabled the Paris Club to sign a $1.05 bn rescheduling agreement on 5 June, covering maturities due to end-July 1985. However, future adherence to Fund targets must remain in doubt. For Ecuador, the banks will agree to a request for $350 mn in new money only if the Febres Cordero Administration, which takes office on 10 August, adopts a new Fund programme. An application to reschedule Paris Club debt, formally presented in early June, is subject to similar conditions. Venezuela continues to make very slow progress on eliminating interest arrears: renegotiation talks are now scheduled to start on 23 July, and another extension of the moratorium, which expires at end-July, appears inevitable. Finally, Colombia is approaching a foreign exchange crisis: a serious trade imbalance, together with capital flight and a cut-back in bank credit lines, has reduced liquid reserves to a critical level, and the authorities may have no alternative but to turn to the IMF and to reschedule bank debt in the near future.

(ii) The Far East

In the Philippines, the authorities have taken a number of measures - including a further (22%) devaluation of the peso and supporting tax increases - which go some way towards meeting the IMF's requirements for agreeing a Letter of Intent. However, the Fund are seeking further action to reverse the excessive monetary growth of the past nine months and to restore government control of spending by parastatal bodies. Talks with the IMF have resumed after discussion in the Board of the 1984 Article IV paper on 29 June; negotiations with the Advisory Committee of banks meanwhile remain in abeyance. The authorities have requested a further three-month extension (from 17 July) of the moratorium on repayments of principal. Elsewhere in the region, South Korea has completed a successful review of its two-year Standby with the Fund, having met all performance targets in the first year of the programme; and a steady improvement in the current account, now likely to be close to balance this year, has been reflected in finer terms for borrowing in international markets.

(iii) Eastern Europe

The commercial banks hope to sign their multi-annual rescheduling agreement (for 1984 to 1987) with Poland in London on 13 July. The agreement virtually completes the rescheduling of original maturities due to banks and provides an element of new money in the form of trade finance. Meanwhile, at least some governments have received less than they were expecting by way of a down-payment on arrears, which was to be made as a pre-condition of the resumption of official negotiations. As a result, negotiations have temporarily broken down, and it is not yet clear when they will resume. Arrangements with commercial bank and official creditors for restructuring 100% of Yugoslavia's 1984 maturities have been concluded, and the bank which chairs the banks' International Co-ordinating Committee has publicly raised the possibility of a multi-annual rescheduling agreement for Yugoslavia from 1985 (subject to the effective continuance of IMF programmes).

(iv) Southern Europe

Spain and Portugal each continue to make satisfactory progress on the current account of the balance of payments, and Standard and Poor have recently up-graded Spain to "A1 plus" for commercial paper. The Greek current account deficit in the first four months of this year showed no improvement on the same period last year, but the government has ruled out any major change in the direction of policy. In Israel, the introduction of a number of electioneering policies gives little hope of an early improvement in the economic situation.

Little progress has been made by Nigeria in negotiations with the IMF over a three-year EFF, essentially because the Nigerians have not yet agreed on an initial step devaluation. Meanwhile, official credit agencies continue to insist that a multilateral restructuring of insured arrears cannot be negotiated until agreement has been reached with the IMF.

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-Mar 1984
Latin America			
Argentina	44	2.5	0.2
Brazil	92	6.1	2.1
Chile	18	1.3	0.1
Colombia	12	0.7	0.0
Ecuador	7	0.6	0.1
Mexico	91	6.3	1.6
Peru	12	0.4	0.2
Venezuela	34	2.4	0.1
Eastern Europe (convertible currency)			
East Germany	13-14	0.7	0.2
Hungary	7.4*	0.5	0.1
Poland	27	0.5	0.9
Romania	9	0.3	0.5
Yugoslavia	19	0.9	1.2
Southern Europe			
Portugal	14	1.4	0.4
Greece	12.1	1.6	0.5
Spain	40	2.8	0.3
Israel	29	0.6	0.2
Far East			
Indonesia	31	0.8	1.8
Philippines	25	1.4	0.3
South Korea	40	2.6	1.0
Other			
Morocco	12	0.1	0.3
Nigeria	20	1.3	3.7

* 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.