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File X6

cc Mr Redwood

10 DOWNING STREET

From the Private Secretary

14 November 1984

INTERNATIONAL FINANCIAL SCENE

The Prime Minister has seen your letter to me of 12 November and the report by the Bank which was attached to it. She agrees with the Chancellor in rejecting an approach to international debt problems which identifies a "financing gap" which is to be filled by Government contributions. She agrees with him, also, in rejecting any contribution by the UK Government to such a gap in the case of Argentina.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office), Callum McCarthy (Department of Trade and Industry) and John Bartlett (Bank of England).

ANDREW TURNBULL

TMS

David Peretz, Esq.,
H.M. Treasury.

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10 DOWNING STREET

Prime Minister (2)

To note latest report on International Financial Scene.

Agree the strong line UK representatives have been taking: on

(i) "non-gapology" as a general approach

(ii) in refusing any HMG participation in closing the gap?

AT 13/11

Yes MT

8.17

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cc JR

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

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

12 November 1984

Dear Andrew

INTERNATIONAL FINANCIAL SCENE

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

Among the individual countries discussed, Argentina remains the main concern and two-thirds of the recent meeting of G5 Debt Deputies in Washington was spent in discussing it.

It was evident from those discussions that the Managing Director was prepared to go forward with a programme based on the Argentine Memorandum of Understanding provided that the "financing gap" for 1984 and 1985 of $5.34 billion, after taking account of flows from the Fund, Paris Club and bank rescheduling, could be bridged in full. The Fund had discussed this with the banks, whose position was that they would consider putting up $3.5 billion of new money at the most, subject to a firm commitment by governments to provide the rest. The Fund, therefore, with the US representatives's support, invited contributions in the form of additional trade credits in 1985 (ie a repetition of the Brazil exercise last year).

This provoked a very hostile reaction from other G5 represenatives who questioned both the assumptions behind the calculation of the gap and the Fund's whole approach which we had criticised last year in the case of Brazil. As a result of these criticisms, the Fund have amended their arithmetic, narrowing the "financing gap" to $820 million (rounded up, for safety, to $1 billion) but remain unrepentent in seeking trade credit contributions.

to be filled by Governments

The Chancellor's view is that we must reject this firmly as indeed our representative did at the Washington meeting. There can be no question of any official UK contribution, although we will

? need to consider whether there are any circumstances in which we would be willing to take part in a Paris Club rescheduling. Meanwhile, we shall continue to make clear our objections to the Fund's approach, which stand irrespective of the country involved. The French and German Governments seem likely to take a similar line.

We will report separately any substantive developments in advance of the next regular report which will be available shortly before Christmas.

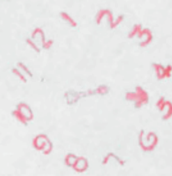
I am copying this letter to Len Appleyard (FCO), Callum McCarthy (DTI), and John Bartlett (B/E).

Yours ever

David

DAVID PERETZ
Principal Private Secretary

12 NOV 1984



A ASSESSMENT

The recent easing in US interest rates, after some months of stability, will certainly have come as a welcome development for debtor countries. CD rates dipped below 10% for the first time since the beginning of the year, and US rates in general are back down to the levels seen last Spring. Though the cause is probably lower than expected growth in the US economy - 2.7% (ar) in Q3 compared to an earlier estimate of 3.6% (ar) - which would tend to depress demand for debtor countries' products, a substantial part of the slowdown in the US seems to have been due to a further worsening in its net trade position, and imports into the US continued to grow strongly. The recent cuts in North Sea and Nigerian oil prices will, if they are sustained, be of benefit to a number of countries. (But insofar as the agreed OPEC production cuts can be achieved, the effect of the price cuts will be limited and possibly only temporary.) Oil exporting countries, such as Mexico and Nigeria itself, will obviously be adversely affected by the price cuts, but initial calculations suggest that the impact on Mexico, at least, may not be so great as to threaten its current strategy. On the other hand, the general weakness of commodity prices remains a negative factor for many countries.

Little has changed on the financial scene. The international banking figures for Q2 show that lending overall was a bit more buoyant - indicating that the problems with Continental Illinois had no significant impact on international lending. The flow of finance to developing countries rose from $1.2bn to $4.7bn* between Q1 and Q2, but it remained no more than a trickle, mostly consisting of unspontaneous lending to Latin American countries. Taken together these countries once again made net deposits of funds with the banking system (even excluding interest payments); gross deposits made increased from $3.6bn in Q1 to $7.2bn in Q2, leaving the net flow of funds from these countries little changed at $2.6bn ($2.4bn in Q1). One noticeable feature is that lending to Mexico ($2.2bn) exceeded (by $1.2bn) her drawdown of unspontaneous lending. At the moment, it is not yet clear what accounted for this increase, but it is unlikely to reflect a return to normal

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* Figures adjusted for exchange rate effects.

market borrowing: indeed, a possible cofinancing deal between commercial banks and the IADB has been postponed until the financial package has been finally agreed by the Mexicans and the banks, indicating that the return to normality will need careful handling if it is to be brought about successfully.

Negotiations between debtor countries and both the IMF and the commercial banks continue with varying degrees of progress. On September 25th Argentina reached initial agreement on the terms of an IMF programme, but there is widespread scepticism both about the adequacy of the programme itself and the ability, if not the determination, of the authorities to carry it out. Nevertheless, the agreement has paved the way for discussions with the banks about a rescheduling and new money package, although the banks are also looking for greater participation by Governments. Argentina's payment of most interest due up to the beginning of May this year probably helped persuade US regulators meeting on 2 November not to downgrade the status of all US banks' loans to Argentina, but some loans were classified as sub-standard. The Philippines has also mananged to reach initial agreement with the IMF and, subsequently, the commercial banks. Banks will be asked to provide new loans of $925mn and to maintain trade lines and reschedule non-trade maturities; this $925mn, however, falls considerably short of the $1.65bn originally sought by the Filipinos. In part, the shortfall is to be made up by an increase in the funds to be sought from official creditors, but it is not clear that firm commitments for these additional funds have yet been secured. Brazil has submitted a further Letter of Intent (its sixth). The opening of the next round of negotiations with the banks has been postponed until mid-November, but later meetings will be required to allow the banks to hear a report on the views of an IMF mission which is shortly due to visit the country. No progress has been made in the negotiations between the IMF and Nigeria. Most exporters with uninsured trade arrears appear to have accepted the rescheduling offer put to them by the Nigerians, but the promissory notes rescheduling these arrears are now expected to issue after the year-end, rather than October as originally planned. Export credit agencies meanwhile remain insistent that a multilateral agreement on rescheduling insured trade arrears is conditional on agreement being reached with the IMF; as an interim measure the Nigerians have agreed to pay an amount equivalent to interest on these arrears.

The multi-year rescheduling agreement proposed for Mexico (the banks have yet finally to agree) is setting a precedent for other countries. A similar arrangement has already been agreed in principle for Venezuela, and the advisory banks would be ready to consider a MYRA for Brazil if time before the elections permits (which is doubtful). Yugoslavia has pressed for multi-year rescheduling both from commercial bank and official creditors; the banks have not yet commited themselves, whilst official creditors are not proposing to negotiate any rescheduling until agreement has been reached with the IMF on a further programme.

Another innovation in the proposed Mexican arrangements is the option of currency diversification, under which non-US banks would be permitted, with the agreement of their authorities, to convert up to 50% of their Mexican exposure into local currency over a 42 month period. This innovation too is likely to set a precedent: thus, in Venezuela's case, it has also been proposed that perhaps 45-50% of dollar exposure, subject to a ceiling of $3bn for all eligible banks, should be convertible into non-dollar currencies.

Quite a stir was caused in September by the news that Citibank had insured itself against some losses on part of its problem country exposure. On closer examination, however, it was found that this insurance was extremely limited and, being related to Citibank's particular needs and objectives, was unlikely to be the forerunner of generalised attempts to spread the risks of bank lending to problem countries.

The regional co-ordination of debt strategies took a further step forward on 13/14 September, when Foreign and Finance Ministers of the eleven Latin American countries represented at Cartagena in June re-assembled in Mar del Plata (Argentina) to review developments over recent months and plan the way ahead. The meeting discussed a number of major specific proposals (mostly aimed at boosting the resources and operation of the IMF, IBRD and IADB), but made no mention of these in its final communique. Instead, the communique suggested that creditor countries had lost the sense of urgency needed to solve Latin America's debt problem, and re-affirmed

unequivocally the group's determination to seek to politicise the debt problem and obtain more far-reaching co-operation and assistance from creditor Governments. This was reflected in an explicit decision to invite the industrialised countries to participate in a "direct political dialogue", ideally during the first half of next year. Demands to that end from the debtors - including the so-called "moderates", Mexico and Brazil - do not appear to have been satisfied by the subsequent decisions of the Interim and Development Committees to consider the debt crisis in greater depth at their April 1985 meetings. The Latin Americans have already made clear their frustration over the handling of debt problems on a purely technical plane, arguing that the regional debt crisis is sui generis and, as such, merits additional discussion outside existing technical institutional fora, preferably at a high-level inter-Governmental meeting.

The next full follow-up meeting to Mar del Plata is to be held in the Dominican Republic at an unspecified date during the first quarter of 1985. Meanwhile, the Latin Americans are likely to continue to review developments through informal contacts (Cartagena Foreign Ministers will be holding talks in Brasilia on 12-17 November), and are likely to define more closely what they would hope to achieve in any creditor/debtor summit - no doubt pressing their case, when the occasion arises, directly with individual creditor Governments.

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B REGIONAL SUMMARIES

(i) Latin America

Argentina eventually reached agreement, on 25 September, with the IMF on the terms of a Memorandum of Understanding in support of its request for a 15 month Standby for SDR 1.4 bn. There is, however, widespread scepticism in the international financial community as to the adequacy of the Memorandum, which is vague and somewhat evasive in character, and as to the real political will/ability of the authorities to pursue sufficiently rigorous adjustment, in particular through wages and fiscal policies, to reduce inflation from a current year-on-year rate of almost 700% to an annual rate of 150% in the final quarter of 1985.

Nevertheless, the Fund agreement has improved relations between Argentina and its foreign bank creditors. At end September the banks agreed a formal 4-month rollover to 15 January of the $750 mn outstanding under the 1982 bridge loan in return for Argentine repayment to them of their $100 mn participation in the end-March emergency package and some progress on the question of arrears. More recently, on 24 October, Argentina spontaneously paid $58 mn to creditor banks in order to bring interest "substantially current" to 2 May. Its motive was to try to avoid an adverse classification of its US bank loans by keeping them under 180 days in arrears at 2 November, when US regulators met to review the standing of loans to problem countries. Argentina's action was successful insofar as there was no general downgrading of US banks' loans, as noted earlier. Meanwhile, on 16th October, negotiations began with the banks on a rescheduling and new money package. The Fund's MD has made his recommendation of the Standby programme to the Board conditional on a commitment by principal creditors to provide sufficient new money to cover Argentina's external financing requirement up to end-1985. Argentina is seeking to reschedule 1982-1985 maturities over 14 years from 1986, and to obtain $5.45 bn in new money for 1984/5, including reinstatement of the undrawn $1 bn from the 1983 $1.5 bn medium term loan. The Working Committee has already made clear that the identified new money requirement is unrealistic and has urged the Argentines to approach the IMF, IBRD, US and other governments for further assistance. The Paris Club

has formally been asked to reschedule some $1.5 bn in 1983-85 maturities. Much depends on the response of governments to a new request for credit facilities, on top of the Paris Club rescheduling, which would help to reduce the proportion of the financing gap that would have to be provided by the banks.

Following discussions with the IMF staff, the Brazilians have submitted a sixth Letter of Intent, incorporating revised EFF performance criteria for the second half of 1984, scheduled for Fund Board approval on 9 November. Phase III negotiations with the banks will now start in mid-November, but further rounds of discussion will be necessary as the banks will wish to be informed of the outcome of the next Fund mission (not due in Brazil before 10 November) which will be looking at 1985 external financing requirements as well as 1984 Q3 performance criteria. In preliminary talks, the banks had wanted to limit initial agreement to 1985 financing needs only, delaying a multi-year agreement until the outcome of the January Presidential election was known. Following Brazilian insistence, however, the Advisory Committee chairmen have agreed to recommend consideration of a MYRA to the Committee, subject to four conditions: (i) that no new money is required in 1985 (ii) that Paris Club Governments participate in the package (iii) that the Presidential candidates undertake not to undermine any agreement while it is being canvassed in the market and (iv) that the Fund's MD and the Chairman of the FRB lend their support. However, with the delays in the negotiating timetable shortening the period before the election, it is increasingly expected that the outgoing Brazilian Administration will not in the event be able to meet the above conditions.

The Mexicans mounted a "roadshow" in October to gather support for the MYRA agreed with the Advisory Group of banks two months previously. There is no indication as yet of creditor banks' reactions.

Following closely on the heels of the Mexican deal, a multi-year rescheduling was agreed in principle between Venezuela and its Advisory Group on 21 September. The agreement, which is conditional on a satisfactory resolution of the private sector debt problem, covers $20.75 bn of public sector maturities falling due between 22 March 1983 and end-1988. Terms include a maturity of 12 1/2

years from end-1984 and interest at LIBOR + 1 1/8% throughout. A roadshow is scheduled for early November.

Elsewhere, Chile introduced a devaluation package on 17 September aimed at ensuring compliance with performance criteria for the final six months of the current standby programme. Subsequent domestic political pressure has, however, resulted in a dilution of the measures, and in the resignation of the cabinet at the beginning of November. It is not yet known if the economics ministers are to be changed. In a new round of debt rescheduling negotiations, expected to take place in November following the IMF's current quarterly performance review, but which may now be postponed because of the cabinet's resignation, the Advisory Group of banks is likely to press the Chileans to seek Paris Club relief in order to reduce the substantial new money requirement, of $0.8 - 1 bn, envisaged in 1985. In Ecuador, the new Febres Cordero Administration has introduced a number of exchange rate and other measures primarily aimed at improving the trade balance. Disappointingly, however, they are less comprehensive than originally expected. Negotiations with the IMF on a new Standby are continuing.

Peru breached second quarter IMF performance targets, and there are now serious doubts over the Government's political will in getting the Standby programme back on course. This will hold up signature of Peru's bilateral agreements with Paris Club creditors, and delay indefinitely the completion of the $2.5 bn commercial bank refinancing package. Meanwhile, arrears to all creditors are steadily mounting.

Although Colombia's reserve loss has slowed down recently, Government finances are in a parlous state, and it remains to be seen whether the substantial tightening of demand management policies urged by the IMF in recent Article IV consultations can be implemented outside a formal programme. Creditor banks are now seeking a broader strategy than the current piecemeal rescheduling of private sector debt.

(ii) Far East

The Philippines reached agreement with the IMF on a draft Letter of Intent for an 18-month Standby Arrangement for SDR 615mn.

Subsequently, the Advisory Committee of Banks approved a package including new money ($925mn) to be committed during the remainder of 1984 and 1985 and a rescheduling of debt maturing in the period between October 1983 (when the debt moratorium was first introduced) and the first quarter of 1986; the terms have not yet been put to the individual banks involved. The amount now being proposed for the banks is substantially less than the $1.6bn originally calculated on the basis that the private and the official sectors should contribute equally. It is not clear that commitments have been received from the official sector to make up this shortfall. Once a "critical mass" of new banking money has been promised, and if the IMF do obtain assurances on adequate official lending (they are now seeking $2.1bn), the Standby Arrangement will be discussed by the IMF Board. We understand that preliminary Paris Club talks may begin in December.

(iii) Eastern Europe

Little progress was made when Poland and its official creditors began substantive negotiations in Paris on 22 and 23 October on the rescheduling of debt due from 1982 on. The talks are likely to be resumed at end-November.

Negotiations between Yugoslavia and its creditors over 1985 maturities, and possibly those beyond, are at an early stage. The commercial banks' International Co-ordinating Committee met at end-September, but did not commit themselves on the Yugoslav request for a MYRA covering all maturities falling due between 1985 and 1988 including those relating to previously rescheduled debt and non-spontaneous new money. Meanwhile the official creditors also have been asked for a MYRA, but agreed in Paris on 24 October to reply that a meeting to reschedule debt (as opposed merely to review general economic prospects) be held only after Yugoslavia had reached agreement with the IMF on arrangements to follow the expiry of its current Standby.

Following another poor harvest, the USSR appears to be attaching high priority to the protection of its foreign exchange position, not least by an enforced improvement in its terms of trade with Eastern

Europe, where the recent improvement in external finances is rather superficial, having been effected largely by cuts in imports of capital goods. Exports from Eastern Europe have shown little dynamism in the face of sluggish markets and growing competition from the newly industrialised countries. In general, economic prospects for the region remain gloomy.

(iv) Southern Europe

Portugal's trade performance shows continuing improvement and indications are that the IMF Standby target of a current account deficit of $1.25 bn in 1984 should be comfortably met. For 1985, however, forthcoming Presidential elections, and the assumptions contained in a medium-term recovery plan now under consideration by the Government, point to some relaxation of policy; and little improvement is reportedly envisaged in the current deficit over the next three years. In the meantime, Electricidade de Portugal's recent mandate for a $50 mn credit was well received in the market and was doubled to $100 mn.

The Greek current account deficit in 1984 is likely to be around last year's level of $2 bn, although reserves have shown some improvement. Greek loans continue to be favourably received (although an initiative to lower borrowing margins has been unsuccessful), but Parliamentary elections due next year provide an unfavourable background to prospects of further progress with adjustment, and any deterioration in performance could have a significant impact on international banking sentiment.

There are indications that Turkey's current-account deficit this year will not be reduced to the $1.3bn forecast by the Fund, but may total $2bn (against $2.2bn in 1983 and an earlier target of $0.3bn for this year). The Government's failure to reduce this deficit significantly is likely to affect creditor sentiment adversely and augurs ill for the country's prospects of meeting substantial debt maturities over the medium-term without recourse to renewed rescheduling.

(v) Other

No progress has been made in Nigeria's negotiations with the IMF. The Nigerian President has stated that acceptance of the conditions on which IMF is insisting would be tantamount to political suicide. Most exporters with uninsured trade arrears have agreed to the Nigerian offer to reschedule the arrears in the form of six-year promissory notes and the notes are expected to issue after the year-end. Official credit agencies, on the other hand, have insisted on a multilateral restructuring of insured trade arrears, conditional on agreement being reached with the IMF; as an interim measure the Nigerians have agreed to pay an amount equivalent to interest on these arrears calculable from the beginning of 1984.

The Israeli Government of National Unity has announced a series of measures designed to protect the foreign exchange position and cut the budget deficit, but a number of these measures have yet to be implemented. Although the external position for 1984 has been largely stabilised by the pre-payment of US economic aid, there is growing concern about trends in the domestic economy (particularly the sharp acceleration in inflation - which reached 450% in the twelve months to end-September and is expected to rise further).

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INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt	British-owned banks' exposure [1]	ECGD amounts at risk[2]
	End-Dec 1983	End-June 1984	End-June 1984
Latin America			
Argentina	46	2.6	0.2
Brazil	92	6.6	1.9
Chile	20	1.3	0.1
Colombia	11	0.7	0.2
Ecuador	7	0.6	0.1
Mexico	91	6.2	1.4
Peru	13	0.4	0.1
Venezuela	35	2.3	-
Eastern Europe (convertible currency)			
GDR	12-13	0.6	0.2
Hungary	8	0.5	0.1
Poland	24	0.5	0.8
Romania	9	0.3	0.5
Yugoslavia	19	0.9	1.2
Southern Europe			
Portugal	14	1.3	0.3
Greece	12	1.5	0.4
Spain	38	2.8	0.1
Far East			
Indonesia	33	0.9	1.5
Philippines	25	1.3	0.3
South Korea	40	2.7	0.9
Other			
Morocco	12	0.1	0.3
Nigeria	20	1.2	3.3
Israel	29	0.6	0.2

[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] Excluding claims paid (net of recoveries). Because of differences in definition, these estimates are not directly comparable with the figures in other columns.