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10 DOWNING STREET

From the Private Secretary

31 December 1984

The Prime Minister has seen and noted your letter of 27 December to Andrew Turnbull about the international financial scene.

David Barclay

Miss Margaret O'Mara,
HM Treasury.

2

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

27 December 1984

Andrew Turnbull Esq
10 Downing Street

Prime Minister

28/12

Dear Andrew,

INTERNATIONAL FINANCIAL SCENE

I enclose the latest assessment of developments on the international financial scene which has been discussed in the Treasury's International Debt Group.

2. Of the individual countries discussed, the various elements in the Argentine package are moving forward fast. The prospects for putting together the commercial banks' contribution, agreed by the Advisory Committee, seem quite good. Assuming that the critical mass of banking contributions is reached by then, we expect the IMF Board to approve Argentina's application for a Standby Arrangement and her CFF request on 28 December. Negotiations on the rescheduling of officially guaranteed debt would then follow in the Paris Club in January.

3. There have also been recent developments in relation to Yugoslavia and Poland. After some hesitation, the Yugoslavs have decided to seek a one year Standby Arrangement from the Fund running from April 1985 when the present Standby expires. This will allow official creditors to go ahead with the rescheduling of 1985 maturities agreed in principle in Geneva last month. But the Yugoslavs continue to press both bank and official creditors for a multi-year rescheduling agreement. Official creditors are sceptical about this in the absence of continuing IMF conditionality.

4. On Poland, significant progress was made at the last Paris Club meeting in November when agreement on the terms of a generous rescheduling agreement covering the period from 1982 to 1984 was reached. However, the expected meeting to initial this has been cancelled by the Poles, who are apparently unable to resolve difficulties they have created by seeking to link the rescheduling agreement with new Western credits.

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

Yours sincerely,

Margaret O'Mara

MISS M O'MARA

Attachment to HMT [illegible] 27.12.84
International Financial Scene.

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INTERNATIONAL FINANCIAL SCENE

The past few weeks have seen some encouraging developments, notably a further fall in US interest rates and the agreement reached between Argentina and its bank working committee. But the fall in interest rates is unlikely to go much further and has been associated with a slowing down of growth in the US. The forthcoming Presidential election in Brazil adds a further major element of uncertainty.

In the USA, CD rates fell during November from 9.9% to 9% - the lowest since the first half of 1983 - and the Federal Reserve cut its discount rate from 9% to 8.5%, reversing the rise in April this year. However, renewed concern about the growth of the money supply may well mean that the fall in interest rates has, at least for the time being, come to an end. At the same time, growth in the US economy has slowed down. Real GNP in the third quarter rose by only 1/2%, compared with 2% in each of the previous two quarters, and leading indicators do not suggest that growth at previous rates is likely to be resumed in the near future; nor is growth elsewhere in the industrial world likely to make up the difference. On the face of it, therefore, debtor countries should find it more difficult to go on improving their trade performance (given that they must resume some import growth). However, the US trade deficit itself shows no sign of shrinking - rather the reverse - and debtor countries may still, therefore, be able to achieve an acceptable trade balance. A number of debtors should also be assisted by signs of an upturn in some commodity prices and by continuing weak oil prices - although some major debtors, notably Mexico, Venezuela and Nigeria, would be adversely affected by a significant and sustained fall in oil prices.

The developing countries as a group are likely to continue to press for special attention for their particular needs. The Latin Americans will maintain their advocacy of a Summit on Latin American debt; the Indians, with NAM support, will again call for an international conference on the reform of the world monetary and financial system and the Africans will ask for assistance on both debt and development to help them deal with the economic crisis in Africa. The urgency with which these groups present their case will depend on the performance of the international economy: falling growth rates and rising interest rates will greatly exacerbate their difficulties. But whatever the economic outturn during the first quarter of 1985, the eyes of the developing countries will be firmly fixed on the meetings of the interim and Development Committees of the IMF and IBRD in Washington on 17-19 April. From these meetings they hope - but do not necessarily expect - to receive some sort of positive response from the industrialised countries to what they regard as their not unreasonable requests for help. But despite the essentially technical nature of those meetings, the developing countries will doubtless try to score political points (whether inside or outside the conference room), not least with the aim of influencing the conclusions of the Bonn Economic Summit 3 weeks later.

At the beginning of December, Argentina reached agreement in principle with its bank working committee on a package which includes the rescheduling of $17 bn of public and private sector maturities up to the end of 1985 and $4.2 bn of new money (details are given below) in 1984 and 1985. Terms are less favourable than for Mexico, but the package is expected to be difficult to sell, not least because the new money element implies an increase of nearly 17% in exposure to Argentina.

Elsewhere in Latin America, a number of debtor countries have shown satisfactory economic performance, while making little progress in negotiating further packages. Brazil's performance in the third quarter permitted a drawdown under its EFF, which in turn released the final tranche of new money for this year. But negotiations for a MYRA are being delayed by uncertainties among banks ahead of the Presidential election in January. Progress on negotiating Venezuela's MYRA has also been slow, and the "roadshows" have been postponed to early 1985. Chile's third quarter performance was satisfactory, but negotiations on a rescheduling and new money package for 1985 have not yet begun.

In Eastern Europe, considerable progress was made at the end-November meeting with the Poles, but they cancelled a subsequent meeting planned for 18 December, at which it had been hoped to initial an agreement to reschedule arrears of principal and interest arising from 1982 to 1984. This appears to reflect a continuing desire for Western support for resumed membership of the IMF and for substantial new credits. Although the USA has subsequently lifted its ban on IMF re-entry, creditors continue to oppose any linkage between new credits and rescheduling. Yugoslavia, which rejected an offer of a serial MYRA by the banks, continues to seek a block rescheduling. Official creditors remain opposed at present to any form of MYRA and will only consider rescheduling 1985 maturities if an IMF Standby is arranged for 1985.

In the Philippines, the position has improved considerably: several austerity measures recommended by the IMF are already in place, the Fund has agreed a Standby arrangement, and the authorities are now finalising arrangements with official and commercial creditors both for rescheduling and for new money to meet the 1985 financing gap. On the other hand, South Korea has had to come to the markets to finance a higher than expected current account deficit this year, and prospects for the external position next year are not too favourable.

The proposed arrangements for Citicorp to insure itself against prolonged delays in receiving interest payments from debtor nations have attracted the disapproval of the New York State Insurance Commissioner. It is not clear whether any contract in fact exists, but in any case it is becoming increasingly apparent that these arrangements cannot be seen as a precedent for other banks.

Banks continue to show an interest in swapping (as opposed to selling) doubtful debt; but for legal and accounting reasons, it seems that this type of business has - so far at least - been on a modest scale.

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

(i) Latin America

The major development since the last report has been the agreement in principle reached during the weekend of 1-2 December between Argentina and the commercial bank Working Committee. The speed with which agreement was reached surprised some bankers, coming only three weeks after the US banking regulators had categorised certain loans to Argentina as "substandard". The main elements of the agreement are (a) the rescheduling of $17 bn of public and private sector maturities falling due between 1982 and 1985; and (b) $4.2 bn in new money for 1984 and 1985, of which $3.7 bn is in the form of a medium-term loan, and the balance a four-year trade credit. Overall, the terms are more generous to Argentina than those set in the agreements of 1983. Under the proposed deal, the Argentines are committed to repay the $750 mn outstanding from the 1982 $1.1 bn bridging loan in the first quarter of 1985, and to eliminate all interest arrears by the second quarter (including a down-payment of $750 mn before end-1984). The Working Committee's figures show a net transfer of financial resources to the banks of

#5

around $6.5 bn in the period to end-1985; but even so, it is clear that the package will be difficult to sell. In particular, smaller US and European banks could prove very reluctant to participate, given that the new money element of the package entails an overall increase in bank exposure to Argentina of nearly 17% over the base level chosen. "Roadshows" have now begun (the one for UK and some European banks was held in Zurich on 13 December), and a good deal of "arm-twisting" is likely to be required: some of the larger banks (including LBI) have already indicated that they will not take up any shortfall created by non-participation by smaller and medium-sized banks.

As regards the rest of the Argentine package, the official sector is being asked for a substantial contribution, including a rescheduling in the Paris Club of 85% of principal and interest (about $1.8 bn) falling due in 1984/85, and of around $1 bn in new export credits; and a $0.5 bn bridging loan from the US Stabilisation Fund to cover the first tranche of Argentina's Standby, together with a drawing of SDR 275 mn under the CFF. The bridging loan is subject, inter alia, to the IMF Managing Director agreeing to put the 15-month SDR 1,419 mn Standby to the Board, which he wishes to do before end-December while 1984 access limits still apply. In turn, th MD will put the Standby request (plus the CFF application) to the Board only when a "critical mass" (not yet defined) of commercial bank commitments to the package has been secured. The Board, which is due to consider Argentina's request on 28 December, provided the above conditions are met, will take account of recent mildly encouraging developments in Argentine economic management, including a tightening of monetary and fiscal policy and depreciation of the peso in real terms.

In Brazil, a $371 mn drawdown under the EFF took place at the end of November, following satisfactory performance in the third quarter. This facilitated release of the final $875 mn tranche of the $6.5 bn 1984 new money package. Consequently, attention has turned to the next stage of the EFF and Phase III of the debt rescue package. An IMF team is currently negotiating with the Brazilian authorities, who have agreed on a tighter target for fiscal policy for 1985; other targets (for the final quarter of this year and the first quarter of 1985) have still to be decided. Brazil's performance on external account has been exceptional, but the failure of demand management policies to slow down inflation gives cause for much concern. However, an attack on the country's complex indexation laws is politically difficult ahead of the indirect Presidential elections, scheduled for mid-January. For similar reasons, the banks are concerned about the implications of granting Brazil a MYRA: many fear that Tancredo Neves (who is likely to defeat Paulo Maluf, the pro-government candidate, in the Presidential elections) will wish to renegotiate an "inherited" MYRA, even though he has made assurances to the contrary. Thus, it is possible that, in their meeting on 17 December, the Advisory Group will steer the Brazilians towards an interim rescheduling agreement covering 1985 maturities. The Brazilians are unlikely to ask for new money in 1985. An approach is likely to be made to the Paris Club later this month on a further round of rescheduling.

With more than 50 individual loan agreements involved, the Mexican MYRA is not expected to be signed until February. Meanwhile, the external account continues to perform strongly, and a substantial increase in reserves (of around $5 bn) is forecast for this year.

Elsewhere in Latin America, slow progress has been made on the MYRA which was agreed in principle between Venezuela and its Advisory Committee on 21 September. The agreement was a major factor in the decision last month by US-banking regulators to lift the "substandard" classification from US bank loans to Venezuela. However, resolution of the private sector debt problem - a condition of the MYRA - has not been achieved, and Venezuela has therefore postponed its "road-shows" from early November to January/February 1985. Meanwhile, Venezuela's Advisory Committee agreed on 1 November to a seventh 90-day moratorium on payments of principal on public sector debt. In Chile, satisfactory performance in the third quarter prompted the IMF Board to approve a drawdown of the final tranche under the Standby, which was released on 14 December. In turn, this should trigger release of the final tranche of the 1984 new money.

87

However, some recent measures suggest that the Chileans may be wavering a little in their commitment to the adjustment effort in the face of popular discontent and economic difficulties which stem from external developments beyond their control (notably the historically low price of copper on international markets). However, the banks will insist on progress towards a follow-on Standby before considering Chile's request for a rescheduling (possibly multi-year) and $800 mn of new money in 1985.

Peru's Standby has effectively lapsed, with the fiscal deficit running at over 10.1% of GDP, compared with an IMF-agreed target of 4.1%. The impasse with the banks, IMF and Paris Club, described in the last report, might not be broken until April, when the Peruvians will elect a new President and Congress. In Ecuador, the new Febres Cordero Administration is edging towards a new Fund programme, and has reached agreement in principle with the steering committee of banks on a MYRA covering maturities falling due in 1985-89, on $350 mn of new money, and on a new trade facility for $700 mn. Colombia is still attempting to avoid a Fund programme and is trying to attract new money from the banks on the strength of its own economic adjustment programme. Piecemeal rescheduling of private sector debt is continuing.

(ii) The Far East

In the Philippines, rescheduling and new money proposals have been offered to commercial and official creditors: to date, commercial bank acceptance of the proposals has reached 92%. At the same time, the authorities have accepted the IMF's conditions for a Standby, as well as increasing administered prices and further liberalising exchange control.

Elsewhere in the Far East, South Korea has come to the markets for around $375 mn, in order to cover a higher than expected current account deficit for this year. If the external position deteriorates further, Korea's favourable credit standing could be adversely affected, which would be a particular cause for concern given the country's large amount of short-term debt (some $12 bn). In contrast, Indonesia's external position continues to improve, and the current account deficit for fiscal 1984/85 is likely to be below $4 bn (compared with the governments's target of $4.7 bn), even though oil production was reduced temporarily following the OPEC agreement.

(iii) Eastern Europe

Official creditors reached provisional agreement with Poland in late November on the financial terms of a rescheduling covering some $11 bn falling due in 1982 to 1984. The terms provide for 100% relief on principal, interest and arrears of interest, now to be repaid between 1990 and 1995. In addition, 50% of the moratorium interest falling due in 1985 will be rescheduled over the following four years. The agreement was due to be initialled on 18 December, provided that the Poles paid 30% of the arrears under the 1981 agreement and abandoned some political rhetoric in the draft text. This last point appears to have caused difficulties in Warsaw for the Polish negotiators, and they cancelled the meeting. The US has subsequently lifted its ban on IMF entry, but official creditors continue to oppose any linkage between new credits and rescheduling.

On 26 November, official creditors received a Yugoslav request for a multi-year rescheduling agreement covering debt maturities in 1985-88 without a further IMF programme. They indicated their willingness to consider rescheduling 1985 maturities, but only if a Standby agreement was in place and, while recognising the need for relief in later years, did not commit themselves to its form, although they underlined the need for IMF conditionality in any such operation. The next move now lies with the Yugoslavs: no date has been set for a further meeting, and a moratorium on 1985 debt maturities seems inevitable. The Yugoslavs have rejected a commercial bank proposal for a four-year serial MYRA (including privileged credits) and are insisting on a block rescheduling. A further meeting is scheduled to be held in London on 8 January: meanwhile, a 3-month moratorium has been agreed.

Elsewhere in Eastern Europe, a $150 mn six-year credit for the GDR has been heavily oversubscribed and increased to $400 mn; and a $250 mn six-year credit for Hungary was raised to $300 mn. The Hungarians have formally applied to the IMF for a follow-on programme to replace the Standby which expires in January. The new programme is designed to put an IMF seal of approval on their reform programme, rather than to provide resources, and the Hungarians have intimated that they do not intend to make any drawings. However, the surplus on the convertible-currency current account remains modest in relation to forthcoming debt maturities, and both the GDR and Hungary continue to be vulnerable should banking sentiment change.

Romania has survived 1984 without recourse to further rescheduling, but may be unable to meet the peak of $1.5 bn debt maturing in 1985 without some accommodation from creditors. However, recent steps - including a 30% revaluation of the exchange rate - have reversed the measures taken at the IMF's request, and imply that the Romanians do not expect to seek Fund assistance.

(iv) Southern Europe

Contrary to earlier expectations, it is now possible that Portugal will meet the official target of reducing year-on-year inflation to 23% by the end of 1984, while the current account deficit is expected to decline to $0.8 bn (well below the Standby target of $1.25 bn). But rumours persist of political pressures for a more expansionary stance than the Finance Minister feels to be prudent, and prospects for the current account next year seem less favourable.

In Greece, the 1985 Budget aims to do no more than hold the deficit at the same proportion of GDP (10.2%) as this year. The current account deficit of the balance of payments is expected to be much the same this year as last, at around $2 bn.

In Turkey, the current account deficit for the first eight months of this year, at $1.4 bn, was little changed on the same period in 1983 and already exceeds the target for the year as a whole. This disappointing performance comes at a time when maturities from earlier reschedulings are beginning to fall due, and the total financing requirement in 1985 is likely to be in excess of $7 bn. The country is no longer eligible for IBRD Structural Adjustment Loans, and there are reports that it may not seek an IMF programme next year. There is a danger that a further round of rescheduling will be needed.

(v) Other

Nigeria has made no progress in negotiations with the IMF on a possible three-year EFF (SDR 2.4 bn if annual access is set at 95% of quota). The first tranche of the promissory notes rescheduling uninsured trade arrears was issued on 9 November: the authorities have indicated that most of the remainder will be issued by the year-end, and interest payments are to be made from 5 January 1985. Official credit agencies remain insistent that restructuring of insured trade arrears should be negotiated within a multilateral framework and be conditional on agreement being reached with the IMF. As an interim measure, the Nigerians have confirmed that they will pay an amount equivalent to interest calculable from 1 January 1984 at a rate of 1% over LIBOR on those insured arrears registered by Chase Manhattan and reconciled with importers' submissions to the Central Bank.

The Israeli government has reached agreement with trade unions and employers on a three-month wage and price freeze. Although the trade deficit in 1984 was largely offset by the prepayment of US aid, the domestic situation remains very disturbing, and only a few stabilisation measures have been implemented.

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INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt End-Dec 1983	British-owned banks' exposure [1] End-June 1984	ECGD amounts at risk[2] End-Sept 1984
Latin America			
Argentina	46	2.6	0.2
Brazil	92	6.6	1.7
Chile	19	1.3	0.1
Colombia	11	0.7	0.2
Ecuador	7	0.6	0.1
Mexico	91	6.4	1.3
Peru	13	0.4	0.1
Venezuela	35	2.3	-
Eastern Europe (convertible currency)			
East Germany	12-13	0.6	0.1
Hungary	8	0.5	0.1
Poland	24*	0.5	0.7
Romania	9	0.3	0.4
Yugoslavia	19	1.0	1.1
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	1.4
Philippines	25	1.3	0.2
South Korea	40	2.7	0.8
Other			
Morocco	12	0.1	0.2
Nigeria	20	1.2	2.9
Israel	29	0.6	0.1

[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.

*Excluding interest arrears of some $3 bn.