



Prime Minister

MUS 26/5

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

26 May 1983

Michael Scholar Esq  
10 Downing Street  
LONDON  
SW1

Dear Michael,

#### INTERNATIONAL FINANCIAL SCENE

In my letter of 16 May I promised to send you, before Williamsburg, a further assessment of the international financial scene. I accordingly enclose an up-to-date paper prepared by the Bank of England, and discussed with them and with other Departments. Detailed notes on some of the main problem countries in Latin America are included; and, as before, a table showing the exposure of ECGD and British banks to the major problem countries in Latin America, Eastern Europe and the Far East is attached.

Despite the continuing signs of world economic recovery, the general tone of this latest assessment is a little less optimistic than the one I sent you on 6 May, largely because of the deterioration in the Brazilian situation, which I reported on 16 May. Apart from Brazil, however, the major IMF - led rescue packages appear to be holding together reasonably well, though there remain many uncertainties ahead as the number of countries facing debt service problems continues to increase, and banks remain cautious in their lending policies.

The Chancellor has asked me to draw attention to the following particular points:-

(a) There were disturbing press reports last week that the Bank for International Settlements (BIS) had decided not to grant any more bridging loans of the kind recently provided for Mexico, Brazil and others. Fortunately, however, these were quickly corrected in a statement by the President of the Bank, which did not rule out further lending. In practice, we hope that, with the major problem cases now identified and in the hands of the IMF, there will be little further need for totally new BIS facilities for emergency bridging assistance. But some flexibility over repayment arrangements on existing loans may be required, and the BIS have indicated they are prepared to consider this on a case-by-case basis.

(b) Brazil's failure to meet IMF performance criteria and restore the shortfall in inter-bank lending lines is likely to delay, at least for some weeks, further IMF drawings. This may necessitate short term bridging finance or new medium term bank lending. Repayments of the BIS bridging loan due to be made at the end of this month from IMF drawings now unlikely to be available may have to be rolled over for a limited period. If





so, the Treasury indemnity covering the Bank of England's outstanding participation in this facility (some \$47m) would also have to be extended. The Brazilian authorities' task in pressing ahead with necessary economic adjustment measures may be complicated by domestic political pressures, though the latest reports suggest that the disturbances in Sao Paulo have died down.

(c) On Argentina, as I reported in my letter of 23 May, the \$1.5 billion medium term commercial bank loan is still held up by several outstanding issues of substance. It is most unlikely that these can be resolved quickly; and our assessment, after discussion with the Bank, is that the facility will not now be ready for signature before mid-June at the earliest. (As you know, we shall receive prior notification.) Within the IMF, we are ensuring that certain key Executive Directors are aware - as the Managing Director of course already is - of the importance we attach to the ending of financial discrimination against UK companies as a pre-condition for access to IMF drawings after July.

(d) The financial difficulties of Nigeria have also been the subject of a good deal of recent press comment. Nigeria's overall indebtedness is small in comparison with the major debtor countries, and its problems - which largely arise from the accumulation of arrears on short term trade debts now amounting to around \$5B - are rather different in character. Nevertheless, the UK has an extensive commercial involvement, and ECGD are heavily exposed there. We shall therefore keep a careful eye on progress on the Nigerians' approach to the IMF, and their negotiations with the banks.

(e) We thought it worth including an assessment of Hong Kong's current financial and economic situation. But this does not of course indicate that we see many similarities between that situation and those of the other countries discussed in these papers.

I am sending copies of this letter to Tim Allen (Bank of England), Brian Fall (FCO) and John Rhodes (DOT).

Yours ever,  
J O Kerr

J O KERR  
Principal Private Secretary



INTERNATIONAL FINANCIAL SCENE

1 General Market Situation

In recent weeks international banking markets have in general remained more settled than at the turn of the year. Banks everywhere have continued to be more cautious and selective in their interbank business, and announcements of medium-term credits have remained subdued. Nevertheless the extremely worrying Brazilian situation, which is in part attributable to the unwillingness of some banks to renew interbank lines, and the continuing problems in the Argentine, could yet make markets more jittery and aggravate the difficulties of finding continuing solutions to the problems of these countries and some of the other badly placed countries.

Brazil's difficulties, however, also reflect a failure to meet IMF performance targets, particularly as regards control over public expenditure. These targets and their timing are under discussion with the IMF and a waiver will have to be granted in respect of the breaches. But banks will then have to decide how to put up the further contribution that will be needed from them: major banks may prefer to make additional finance available in the form of new loans rather than increase their interbank lending, and it may well not prove possible to maintain, either in the case of Brazil or for other countries, the principle of equal-burden sharing which has so far been considered most important in the rescue schemes that have been put together.

Brazil's difficulties, however, are not unexpected and the major banks (at least in the UK) could undertake needed additional lending without pressure being put on their balance sheet ratios. Thus there is a reasonable chance - though no certainty - that the deterioration in Brazil's financial situation may not prove contagious to the other Latin American problem countries, or have wider adverse repercussions.

In this regard, the general world economic outlook offers some hope of a slightly better environment in which to continue to deal with the world debt problems. In the past few weeks economic indicators in the US have provided further confirmation of a strong upturn in



activity, even though there remain doubts about its sustainability. These hinge, inter alia, on worries about the likely path of interest rates. On the one hand, it is felt that the Fed will seek to avoid action which could abort the domestic recovery and aggravate international debt problems. On the other hand, there is some concern, among both commentators and markets, at the possible revival of inflationary expectations as hopes of a budget compromise recede and M1 continues to grow outside its target range.

Another potentially encouraging development for major debtors has been some further strengthening in dollar non-oil commodity prices. At present this seems to reflect mainly an expectation of increased industrial demand rather than any actual upturn in raw material usage but in time it could lead to an improvement in these countries' external earnings. The new official price structure for oil, on the other hand, is holding up quite well, and though there has been some slight tendency for spot prices to soften, the prospect of further falls in the energy bills of the problem countries seems less likely.

On the other side of the coin, the capacity of US banks to lend abroad could be affected in years to come by Congressional legislation at present under discussion within the important context of increasing the US commitment to the IMF and the GAB. The proposals in question are concerned with strengthening the supervisory control over US banks' international lending in various ways. In particular, the House of Representatives' draft would require banks to set aside specific provisions on all international lending where they cannot apparently be repaid without a major restructuring or additional lending; this criterion could apply to a large number of countries with operational IMF programmes whose efforts to adjust could therefore be hampered. The House draft also instructs the US Executive Director actively to oppose IMF loans to countries which practise apartheid (although as yet there has been no parallel move in the Senate). Subsequently the House of Representatives' Committee has announced hearings on draft legislation to restrict lending by US banks to South Africa. These are symptoms (amongst others) of an inward-looking mood in Congress which is at best unhelpful and at worst potentially damaging to the international trading and financial system.



Latin America

As indicated above, the likelihood of completing Brazil's financial package, as originally conceived, appears increasingly remote. The programmed IMF drawing of \$411 mn on 31 May is now unlikely to take place before July, with a consequent delay in the scheduled disbursement under the new money facility from banks. Brazil is likely to be forced to seek short-term bridging finance or a further medium-term jumbo fairly soon; in the meantime, payment arrears will mount up.

Confirmation by the IMF Board on 23 May that the Fund programme is broadly on course has raised hopes among some leading banks that Mexico may avoid the need to raise additional new loans later in the year. A rescheduling agreement covering the public sector debt is likely to be ready for signature shortly. The authorities have now clarified that they will be seeking a long-term restructuring of officially guaranteed private sector debt, while intimating that negotiations on a multilateral basis - but not under the Paris Club label - are acceptable.

There are firmer indications that the IMF are generally satisfied with Argentina's performance so far under its standby arrangement, and the second Fund drawdown should have been made on schedule on 20 May. There are however continuing difficulties over conditions relating to the \$1.5 bn new money loan from banks. Signature is unlikely before mid-June at the earliest pending, inter alia, full repayment of interest arrears and changes in Argentina's bankruptcy law which discriminates against foreign creditors. Conclusion of a rescheduling agreement covering public sector debt is unlikely before September. The Argentines have apparently now submitted a revised law to change the entire content of Law 22591 (which governs existing discriminatory financial restrictions against UK companies) but the text of this is not yet available to us for assessment. Political difficulties could yet throw Argentina's financing programme off course.

Elsewhere in Latin America, progress on the various rescue operations has been mixed. In the case of Chile agreement has been reached



With the Advisory Group of banks and the IMF Managing Director hopes to receive a written commitment by 15 June that all banks will participate so that he can present a waiver request to the Executive Board. Bridging finance of some \$500 mn, which is necessary to keep the IMF "shadow" programme on course, is being arranged by the Advisory Group and by the BIS. In contrast, the Venezuelan talks with creditor banks have barely got off the ground. To date they have concentrated on balance of payments projections with considerable discrepancies remaining between the authorities' forecasts and those of the bankers who believe that an IMF standby (and conditionality) is now essential. With national elections due in December the authorities are reluctant to adopt an austerity programme. The negotiations look likely to be complex and prolonged, and an extension of the existing moratorium which expires on 1 July appears inevitable. The situation has been hindered by the emergence of further interest arrears.

### 3 Eastern Europe

Elements in the support operation for Yugoslavia are gradually being put in place. The BIS has granted a \$500 mn bridging facility of which \$300 mn, backed by central banks, has already been disbursed. Release of the balance remains conditional on the resolution of difficulties over the pledging of the gold collateral. Meanwhile the commercial banks are working towards completion of their package by the end of June. The banks are expected to sign an agreement soon with Romania on the rescheduling of commercial maturities in 1983 but are still discussing amongst themselves the request by Poland for a long-term accommodation covering maturities during the next several years. Governments have reached agreement with Romania about the rescheduling of official maturities in 1983 but have not yet agreed to re-open negotiations with Poland. Among East European countries which are still meeting their original debt obligations Hungary recently raised a \$200 mn syndicated banking credit, but the repayment of a \$300 mn facility to the BIS towards the end of April left its liquidity position strained and, exceptionally, it was granted a further facility, for \$100 mn, until



the proceeds of a Fund drawing became available at the end of June. So far, too, the GDR is managing to struggle through.

4 Southern Europe

Although there are no immediate problems in Southern Europe, the market is showing growing caution towards several countries which have large borrowing programmes to finance their continuing deficits. This is particularly true of Portugal where the absence of effective government during discussions between the parties over the formation of a coalition is delaying a formal approach to the IMF and unsettling banking confidence. A recent, ineptly timed, \$300 mn eurocredit for seven years was agreed only with difficulty and at higher interest margins than originally expected by the Portuguese; but this and a \$400 mn facility from the BIS against gold should temporarily ease the liquidity position.

5 Far East

The most significant development in the Asian region has been the decision by the Indonesian government, announced at the beginning of May, to revise four major industrial projects, with the aim of making foreign exchange savings of some \$4 bn in fiscal 1983-84. Prior to this decision the likely current account deficit was of the order of \$7-7.5 bn. Besides the large prospective reduction in the deficit, the decision is important as an indication of political willingness to curb development in the interests of financial stability.

Mention should also be made of Hong Kong. In contrast to the other countries covered by this note whose situation is characterised by an excessive or potentially excessive burden of external indebtedness, Hong Kong's difficulties are primarily domestic and largely the product of a slump in the property market, the impact of which has been exacerbated by continued high interest rates, a fragile state of confidence due to uncertainty about the future of the territory, and the world recession. (A fuller note is annexed.)



Attached are Notes\* which bring up to date the position on certain countries (all Latin American) in which there have been significant developments since the last assessment. Also attached is a table showing the external indebtedness of each of the problem countries considered in this or previous assessments and the exposure of British banks and the ECGD.

	Page
ARGENTINA	1
BRAZIL	3
CHILE	4
MEXICO	6
VENEZUELA	7
INDEBTEDNESS TABLE	8

---

\*Each note begins with an estimate of the country's total external debt. The source for the estimates varies and might have come from the IMF, official sources within the country (Ministry of Finance, Central Bank etc) or reports from elsewhere (Embassies, press etc). In each case the figures quoted are the ones judged to be the most accurate and up-to-date.



ARGENTINA

Total indebtedness at end-1982 was officially estimated at \$39 bn including \$2.7 bn in arrears.

Reportedly the IMF team which visited Argentina in April was generally satisfied with performance in the first quarter of 1983 and the second tranche (SDR 300 mn) of the standby credit is likely to be made available on 20 May as scheduled. Receipt of the IMF credit will allow for disbursement of the third and final tranche (\$300 mn) of the \$1.1 bn bridging loan. Further IMF drawings, however, are dependent upon the ending of discrimination against UK companies under Law 22591. The Argentine Government have apparently now submitted a draft to change the entire content of Law 22591 but the text of this has not yet been passed on to us for assessment.

Signature of the \$1.5 bn medium-term loan (UK share of \$159 mn) is now unlikely before mid-June. Repayment of interest arrears, a pre-condition of the loan, continues to lag, although repayment of public sector interest arrears corresponding to February (\$280 mn) has been completed and March arrears have begun to be paid. The Argentines are expected to bring interest payments to date by using the final tranche of the bridging loan. Other pre-conditions for the medium-term loan have not yet been met.

The original regulations for the refinancing of short-term private sector debt covered by Central Bank exchange guarantees and \$1.4 bn in foreign currency swaps, rejected by Argentina's creditor banks as being inadequate, are expected to be reissued shortly. The banks are seeking a higher interest on the five-year bonds and promissory notes which the Central Bank will issue to refinance the private sector loans than the 2% over LIBOR stipulated at



present. The banks also want the bonds and promissory notes to be made available in the name of the debtor as well as the name of the creditor so that they are free to retain a direct relationship with Argentine private sector clients if they so wish. Talks on the rescheduling of \$5.5 bn of public sector debt maturities overdue on 1 December 1982 and falling due from that date to 31 December 1983 are now unlikely to be concluded until September. The terms are expected to involve a six-year repayment schedule with a three-year period of grace.



## BRAZIL

Total indebtedness at end-1982 was estimated by the IMF at \$81.3 bn.

Hopes of maintaining the financial package completed at the end of February are now more doubtful. Despite record trade surpluses of \$500 mn in March and \$600 in April, Brazil continues to suffer from acute short-term liquidity problems [arrears are said to amount to some \$500 mn net and could rise steeply]. Although outstanding credits from banks under Project III [short-term trade-related credit lines] are not thought to be in jeopardy, progress in recouping an extra \$1.5 bn in inter-bank lines under Project IV is at a virtual standstill, and there now seems little hope of recovering the outstanding amount. Attempts in the last few weeks by the Brazilians and the liaison group banks to encourage individual US regional, Arab, Swiss and German banks to make up shortfalls on their "fair share" have met with virtual rejection. A compromise solution to overcome this problem by combining Projects III and IV (some US banks being more willing to commit trade-related finance than bank-to-bank credit) has been rejected. As a further possibility, the Brazilians suggested that inter-bank lines should be made directly available to the Central Bank but this also seems to be unacceptable to most banks.

Brazil's difficulties are now compounded by the failure to meet end-March IMF targets under the EFF programme. Central Bank President Langoni was in Washington on 16 May to discuss the non-compliance with the Fund Staff and has probably requested a waiver from performance criteria. The next tranche of IMF resources (\$411 mn) due from 31 May will thus be delayed, and also the next instalment of Project I money which is dependent on compliance with the IMF programme. With these resources delayed, discussions in the next few days will concentrate on ways of raising alternative finance. It has been suggested that the banks may be approached for either a \$1-1 1/2 bn short-term loan to clear arrears or a further medium-term jumbo of \$2-3 bn. Another possibility would be to postpone repayments under the banks' bridging facility. But any new agreement with the banks would probably be dependent on renegotiation of IMF targets. Langoni is thought to have talked to the US Treasury about a further loan. Whilst the BIS take the line that the repayment schedule of the existing facility must be respected (\$400 mn is due on 31 May), a new short-term advance may be a possibility.



FILE

Total indebtedness at end-1982 was \$18 bn (two-thirds private sector).

The Fund telexed the Advisory Committee on 22 April to detail Chile's 1983 financing needs and stress that a return to the original programme by end-September requires the bankers' co-operation. The "shadow" programme was on course and the economy appeared to be responding favourably. The IMF's financial plan requires creditor banks to maintain short-term trade-related credit outstanding as at 31 January 1983 and to refinance or reschedule the repayment of short-term financial debt and amortisations of medium and long-term debt due from 31 January 1983 through 31 December 1984. Chile's total financing requirement for 1983 is \$5.1 bn (including a projected current account deficit of \$1.3 bn); gross capital inflows of \$3.8 bn are projected, leaving \$1.3 bn to be financed from additional-bank loans. de Larosiere has requested that the Advisory Committee provide him with a written commitment by 15 June that the \$1.3 bn new money will be made available so that he can present a waiver request to the Executive Board. It is proposed that the funds be disbursed as follows: \$500 mn around end-July following approval by the Board of a waiver and purchase by Chile of its outstanding cumulative entitlement under the standby (SDR 54 mn), \$570 mn by to 30 September and \$230 mn by 31 December. In order to keep the Chileans in line with their revised reserves target, bridging finance of \$400 - 500 mn is required in the period up to end-June - to be repaid out of the new money loan. The Advisory Group has agreed to contribute \$180 mn but this may be reduced since the BIS has made up to \$350 mn available to the Chileans.

At a meeting on 28 April agreement was reached between the Advisory Committee and the Chileans on the terms of the rescheduling. Finance Minister Caceres telexed around 600 creditor banks on 29 April to seek their ratification of the package which includes:

- (i) the rescheduling, over eight years including four years' grace, at 2 1/8% over LIBOR or 2% over Prime of \$3.4 bn principal repayments due from 31 January 1983 to 31 December 1984 on public and private (financial) sector debt; \$1.3 bn of this relates to short-term working capital credits;



- (ii) \$1.3 bn new credit (representing an 11 1/4% increase in exposure for individual banks on levels outstanding at 31 January 1983) over seven years including four years' grace at 2 1/4% over LIBOR or 2 1/8% over Prime;
- (iii) the restoration of \$0.2 bn short-term trade-related lines to reach level outstanding as at 31 January 1983; level to be maintained through 31 December 1984.
- (iv) the renewal for another 90 days of the suspension of capital repayments which expired at the end of April.

Although "official" (ie ECGD type) debt is excluded from the rescheduling, a condition of the new money loan is that Chile will either have requested that its official creditors reschedule such debt on a comparable basis or have obtained satisfactory evidence for the banks that current outstandings will not be reduced. A further condition of the loan is that the external debt of the two banks liquidated in January be assumed by the state-owned Banco del Estado, where appropriate subject to rescheduling on the terms above, and that interest on it be brought up to date.

Progress on the restructuring of private corporate sector debt, which was included in the moratorium, was hampered initially by the government's reluctance to provide liquidity support but, following pressure from foreign bankers, some support was provided to companies in difficulties. Caceres' telex spelt out at some length the measures which have already been taken to promote the recapitalisation of the private sector. It also stated that the government will guarantee the rescheduled private financial sector debt and that, although it will not offer guarantees on corporate sector foreign debt, foreign exchange will be made available to companies on as favourable a basis as for public and private financial sector entities to enable them to meet their obligations. The Ibanez Commission, which was set up to examine the troubled conglomerates, is expected to make decisions as to their viability in time for them to be dealt with in a debt restructuring with foreign banks by end-June.

Bankers have been asked to commit themselves to the package by 23 May and Caceres appealed for their co-operation. In addition to the debt relief detailed above, Chile will require new money of \$633 mn. in 1984.



MEXICO

Total indebtedness at end-1982 was an estimated \$83 bn.

While interest payments on public sector debt are reportedly being kept current, arrears on private sector debt remain substantial. On 11 April the authorities made a further small arrears payment of \$37 mn (equivalent to 5% of the balances in dollar-denominated accounts established under the so-called "peso deposit" scheme introduced last December). This is only the second payment on arrears built up between 1 August 1982 and 31 January 1983 and brings the total of such payments to under \$100 mn. Balances not paid by 30 September 1983 are to be refinanced.

With regard to officially guaranteed/disbursed private sector credits, following Paris Club discussions on 11-13 April, Camdessus telexed the Mexicans on behalf of creditors to emphasise the understanding until now that Mexico would not request a rescheduling of official credits and to seek clarification on the subject by 24 April. Although this deadline was not met, on 29 April the Mexicans took the opportunity of the Development Committee meeting in Washington to call a meeting of representatives of the G10 countries and Switzerland to clarify their plans for dealing with officially guaranteed private sector debt-arrears and 1983 maturities on which total around \$1.5 bn (of which about half is due to US Eximbank). Essentially a restructuring is being sought on terms similar to those recently agreed with Spain, which has been the first creditor country to break ranks by deciding on a bilateral deal, involving a refinancing loan over six years, including three years' grace. A telex formally setting out these proposals, and replying to Camdessus' earlier telex was expected in time for the next round of Paris Club discussions on 17 May. The indications are that the Mexicans will agree to negotiate on a multilateral basis (albeit not under the Paris Club label); however, the terms likely to be acceptable to creditors are not yet clear. ECGD are currently canvassing other Whitehall departments on proposals which involve suspending cover for the Mexican private sector while continuing to offer the UK share of \$150 mn in new official credits to the Mexican public sector.



VENEZUELA

Total indebtedness at end-1982 is estimated at \$33 bn.

The Advisory Committee discussed an economic sub-Group's report on the Venezuelan authorities' cash-flow projections at its meeting on 4-5 May. The Group's conclusions were considerably more pessimistic than those of the authorities; as a result, the Committee has recommended that the Government adopts an economic adjustment programme in conjunction with the IMF. At Finance Minister Sosa's request the Fund has prepared a report detailing what would be required for a standby to be agreed. The IMF's conditions - including a devaluation of the bolivar and corrective fiscal measures - may be regarded by the authorities as being too severe in an election year, but bankers are certain to press hard for a programme to be implemented. The next meeting of the Advisory Committee was scheduled for 17 May.

The Venezuelans are reported to be seeking a longer-term solution to the country's debt problems involving a more comprehensive debt rescheduling. A number of options are currently under consideration and detailed discussion of rescheduling terms is not therefore expected to begin for some weeks. However, it appears almost certain that medium and long-term repayments falling due this year (amounting to \$2.2 bn) will need to be rescheduled in addition to short-term maturities (\$6.6 bn State agencies plus \$4.2 bn State banks) and that new money may now be required. Further difficulties exist over the treatment of private sector debt, which is not included in the moratorium but which bankers wish to discuss within the main rescheduling negotiations. In addition, arrears of interest are believed to be mounting - affecting the willingness of many banks to be cooperative.

ECGD withdrew Section 1 cover for new business outside the short term on 11 May; in future short-term business will only be covered under Section 1 on CILC terms.



INDEBTEDNESS AND BRITISH EXPOSURE (end December 1982)

	Total external debt	British banks unguaranteed claims	ECGD amounts at risk
\$ billion			
<u>Latin America</u>			
Argentina	39	2.3	0.4
Brazil	81	4.4	1.9
Chile	18	1.1	0.06
Ecuador	6	0.5	0.1
Mexico	83	5.2	1.8
Peru	12	0.4	0.1
Uruguay	4	0.3	0.01
Venezuela	33	2.4	0.09
<u>Eastern Europe</u> (convertible currency)			
East Germany	15	0.8	0.2
Hungary	7	0.5	0.07
Poland	25	0.5	1.4
Romania	10	0.4	0.6
Yugoslavia	20	0.9	1.3
<u>Far East</u>			
Indonesia	20 <del>/</del>	0.6	0.9 <del>/</del>
Philippines	19	1.2	0.3 <del>/</del>
South Korea	37	2.0	0.9 <del>/</del>
<u>/</u> Hong Kong	-*	-*	5.2 <del>/</del>

Because of differences in definition the ECGD exposure figures in the final column are not directly comparable with the figures in the other two columns.

~~/~~ At end March 1983; excludes short-term debt

~~/~~ At end February 1983

\* Because of Hong Kong's position as an offshore centre the available figures for external indebtedness and banking exposure to Hong Kong are not comparable to those for other countries shown above and do not provide a meaningful indication of the territory's debt exposure.



## HONG KONG

Hong Kong's public sector external debt is minimal, comprising only the balance outstanding (US\$52 mn at end-1982) on loans from the Asian Development Bank. The Hong Kong Government has however also issued guarantees on borrowings by the Mass Transit Railway of some HK\$5.3 bn (US\$0.8 bn). There are no statistics on private sector indebtedness, other than banking debt - and the latter essentially reflects Hong Kong's role as a major international financial centre and cannot be taken as an indication of the territory's debt exposure.

At end-June 1982, total claims of BIS area banks on Hong Kong amounted to US\$37.7 bn, but liabilities to Hong Kong were US\$34 bn, giving a net claims position of US\$3.7 bn. The Hong Kong statistics which have a more comprehensive coverage (including what is likely to be a substantial level of business by regional banks), show the Hong Kong monetary system had liabilities to all banks outside Hong Kong of US\$55.7 bn at end-March 1983, and claims on such banks of US\$44.3 bn - a net liability position of US\$11.4 bn: however, the monetary sector also had claims on non-banks abroad of some US\$16 bn. The main element in these claims is lending to SE Asian countries and other offshore centres.

The Hong Kong economy, which is largely export-oriented, is suffering from the combined effects of the world recession, a slump in the property and stock markets and the continuing depressing effect on confidence of uncertainty about the territory's future. The world recession had begun to hit trade performance in 1981 but its effects had been partly offset by buoyant private domestic consumption. In 1982, however, with a deterioration in both the external and domestic sectors, growth slowed sharply to 2.4%, from an average 12% in the previous five years. Exports fell 3.9% but somewhat less than the decline in imports, and the deficits both on visible trade (\$2.6 bn) and the current account (\$1.2 bn) narrowed from the level of the previous year. The external assets of the Exchange Fund, effectively Hong Kong's reserves, amounted to \$5.4 bn at end-1981. \



The long-sustained property boom collapsed in mid-1981, mainly under the influence of high interest rates, and prices fell sharply in the second half of 1981. Uncertainty about the future of the Colony after the expiry of the lease in 1997 has increased the severity of what was otherwise a timely shakeout in the property market and developed property values are now up to 50% below their mid-1981 peak. As a result, several major property companies (notably Carrian and EDA) have serious financial difficulties. Pressures from the recession, as well as the property slump, have squeezed corporate liquidity generally and further problem situations may still come to light. These developments have had their impact on the financial sector and the deposit-taking companies (DTCs) have been further hit by legislation aimed, broadly, at shifting short-term deposits from the DTCs back to the banks over a two-year period which ends on 30 June. A weakening of confidence in the financial markets sparked off a withdrawal of interbank facilities to the secondary banking sector last November and eight registered deposit-taking companies have now had their registrations revoked.

Reflecting these developments, at end-1982 the Hang Seng index of the stock market was only 40% of its mid-1981 all-time peak, although it has now recovered to 50% of this level. The exchange rate is 12% weaker in effective terms than at end-1981 and 22% down against the US\$, having recently fluctuated around a record low point of HK\$7.00/US\$1. Inflation, down to 8.0% year on year in January, is back to 10% year on year.

For 1983, the Government have forecast 4% growth (assuming 2% growth in the US economy) and recent indications from export orders are encouraging. World recovery would do much to ease the present strains on Hong Kong's financial system though the property market, with a substantial existing overhang, cannot be expected to show any significant revival for some time to come. A few further DTCs are expected to go out of business around the middle of the year, as a result of the structural changes mentioned above, but this need not have significant repercussions on the rest of the domestic system. Further corporate failures, particularly in the property sector, are



also possible. The worst dangers of a major banking and financial crisis may now be past, however, and the authorities, with the support of the major banks, should be able to contain any further difficulties in the short to medium term. Continuing political uncertainty, however, may be reflected in periodic pressure on the exchange rate and the stock market, with possibly more damaging effects on confidence and the economy as a whole in the longer term.

At end-March 1983, ECGD had £708.5 mn at risk under Section I and £2,636.1 mn under Section 2 - Hong Kong represents ECGD's largest single exposure. At end-December 1982, UK-registered banks' consolidated external claims on non-banks - a better measure of amounts at risk to Hong Kong residents than the figures for total exposure - amounted to US\$2,022 mn; claims by British-owned banks totalled US\$1,721 mn of which US\$1,035 mn was unguaranteed.\* Figures for total exposure to Hong Kong (including off-shore business) were: UK-registered banks US\$4,694 mn; British-owned banks US\$4,071 mn of which US\$2,028 mn unguaranteed.

Bank of England  
May 1983

---

\*BIS figures now provide a bank/non-bank split of claims of domestic branches of banks in the reporting area but, as off-shore branches are not included, this gives only a limited picture of their total exposure, and a breakdown has not, therefore, been given in this note.