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Prime Minister

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Treasury Chambers, Parliament Street, SW1P 3AG
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12 February 1988

C Powell Esq
10 Downing Street
LONDON SW1

Dear Charles

INTERNATIONAL FINANCIAL SCENE

... I attach the first regular report of 1988 on developments in the international debt scene.

The economic outlook for 1988, as it affects the evolution of the debt problem, remains essentially unchanged since our last report. Industrial countries' growth is expected to be just under 3 per cent, although slowing towards the end of 1988 and in 1989; with sustained growth in world trade. US dollar interest rates have remained broadly unchanged over the past few weeks, kept down for the moment by fear of recession in an election year; and real commodity prices excluding oil are now higher than they were some months ago. This should benefit debtor countries. However, there are some risks, in particular the implications for trade and growth if there were to be renewed downward pressure on the dollar.

Over the next few weeks there will be important discussions of the debt problem in the run-up to the April meetings in Washington. These will take account of current developments, in particular the tendency for the commercial banks to become more fragmented in their approach, their reluctance to participate in new money packages, and the emergence of market based ideas such as the Mexican buy-back scheme. We will be looking to these new ideas to develop the existing strategy rather than overturn it. Thus, we will continue to emphasise the need for appropriate policies and strong adjustment on the part of the debtors, and the need for the banks to continue to have the prime responsibility for the working out of their debt problems. The April Meetings - and the Summit if the Canadians have their way - will focus more on the middle income debtors than on the poorest. The impact of debt problems on the world economy will be on the agenda for the OECD Ministerial meeting in May.

Turning to individual countries, the most recent developments in Brazil look more encouraging. The Brazilian Government appears to have re-evaluated the costs of the confrontational approach and is now seeking normalisation of its relations with the international financial community. As a first step the Brazilians have made an unconditional payment to the commercial banks of some 1988 interest due in order to get negotiations on a medium-term package moving ahead. The Government has also said that it will negotiate a programme with the IMF and a deal with Paris Club creditors. Among G7 Governments there is agreement that such an IMF programme must precede any Paris Club rescheduling or a resumption of export credit cover. But the real test will be whether the Government of Brazil is prepared to adopt realistic measures to strengthen its economy.

For Mexico, the main focus is on the outcome of the debt buy-back scheme. This involves bank creditors swapping rescheduled debt for higher yielding 20 year bonds whose principal (but not interest) is backed by US Treasury securities. The likely outcome of the operation is difficult to judge at this stage. It seems unlikely that the US majors will bid, although the US regional banks may well treat the offer as an exit bond. US banks seem unlikely to make more than token bids. Once we can evaluate the success of the Mexican operation, we will need to consider whether it - or versions of it - would provide a useful addition to the strategy. Other debtors may well come forward with similar proposals. Only Chile so far has asked its commercial bank creditors for changes in existing agreements to give it the flexibility to contemplate a similar arrangement in the future.

The outlook for several other major debtors is poor. Argentina appears to be fast running out of money. The Argentines are being asked by the Fund to adopt additional measures to prevent the existing Fund programme from collapsing. In the meantime bridging finance is likely to be needed and the Argentines have looked to the US for help. If Brazil really does re-establish relations with its creditors, the US authorities may be more inclined to lean on the Argentines to implement a stronger programme.

The Yugoslav liquidity position is also becoming acute. They may turn to the BIS for a bridging loan in the near future. The Paris Club has emphasised the need for a strong IMF programme as a pre-requisite for any rescheduling of official funds. However a recent Fund mission made no progress. Despite their anxiety to conclude an early Standby Arrangement, the Yugoslavs seem unwilling and unable to engage in serious discussion.

Egypt too continues to pose problems. It was clear from President Mubarak's recent talks with UK Ministers that the Egyptian authorities are unlikely to agree to the necessary measures to enable the current IMF programme to continue. He seems to have taken the same line in his talks in Washington and Bonn where he was also urged to reach early agreement with the Fund. We shall want to keep up pressure on the Fund to ensure adequate conditionality in the Egyptian (and other) programmes. We will be keeping in close touch with Fund staff on this and with the Executive Directors of other G7 countries.

I am copying this letter and enclosure to Robert Culshaw (FCO), Jeremy Godfrey (DTI) and John Footman (Bank).

Yours sincerely

Jonathan Taylor

J M G TAYLOR
Private Secretary