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20 March 1986

Charles Powell Esq
10 Downing Street
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Dear Charles,

INTERNATIONAL FINANCIAL SCENE

... I enclose the latest in the regular series of reports on developments on the international debt scene. On this occasion the report provides background material for the forthcoming international economic meetings, including the OECD Ministerial Meeting, the Spring Meetings of the Interim and Development Committees and the Economic Summit.

Our judgement is that the debt strategy and international institutional framework which supports it, looks valid - though challenging - provided the oil price stabilises within limits of about \$12-20 a barrel. This is somewhat more optimistic than our last report, reflecting more detailed assessments of the impact of the oil price change and the moderate response so far from those major debtor countries most affected. However, recent IBRD calculations for the Development Committee Meetings suggest a need for total additional capital inflows to major debtors of between \$14 billion and \$21 billion a year. This is a more challenging target than that implied by the figures in the Baker package. It assumes a need, in political terms, to maintain an acceptable level of per capita consumption growth. This may lead to pressure at the Spring Meetings for greater financial flows from the commercial banks. Combined with demands for further adjustment as a precondition for new money, this will inevitably lead to some politically difficult negotiations. Mexico will be in a key position here.

In addition to the generally benign impact of the oil price fall on the world economic outlook, other developments, including interest and exchange rate movements, are pointing

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in the right direction. Agreement on the Preparatory Committee for a GATT round is a further positive factor. There has been some criticism of the lack of progress in implementing Baker but this under-estimates both the political difficulties of the adjustment measures required by the IFIs and commercial banks and the effort which is now being put into working out policy reform loans for key debtors, in particular by the IBRD.

On individual countries Mexico, despite its difficulties, is taking a non-confrontational path and has reduced her estimate of new money required in 1986. She is embarking on an intensive round of discussions with the IBRD, IMF, IADB and perhaps the Paris Club as well as with the commercial banks. The latter will not be easy. The Mexicans are looking for a concession on interest rates which would not only improve their external account but, even more important, would reduce the size of their fiscal deficit now running at some 10 per cent of GDP. The Fund see this as more of a problem than the external financing gap which is judged to be coverable.

Since our last report Brazil has reached agreement with its commercial bank creditors on a holding operation under which, despite the absence of an IMF programme, 1985 arrears have been rescheduled whilst 1986 maturities, including short term trade credit, have been rolled forward for a further year. Government creditors remain unwilling to reschedule in the absence of an IMF programme. Within the last two weeks Brazil has introduced a new package of monetary measures to control inflation: prices are frozen for a year, the economy is largely de-indexed and a new currency, the cruzado, has been introduced. This is a step in the right direction but doubts remain about whether the fiscal and monetary package goes far enough or will be adequately carried through.

On non-Latin American debtors, the Paris Club has reached agreement with Poland on a generous 1986 debt relief package. Official creditors have conceded about 60 per cent of total debt relief sought from the West, in line with official creditors' share of original stock of debt. The commercial banks and other creditors will now need to give equivalent relief. But even if they do, the Poles may well run out of money later in the year. However, the problem is sufficiently sui generis not to be contagious.

On the Philippines, the outlook remains uncertain following the replacement of the Marcos Government. Radical statements on debt made by President Aquino during the election campaign have not been formally repeated since she took office although

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there have been suggestions that some categories of debt should not be paid.

Over Egypt there is increasing concern. The already poor outlook has been seriously damaged by the oil price fall. Egypt must now be judged a very risky market on which there is an unwelcome overhang of UK arms sales and other commitments.

Finally, the banks have now agreed in principle to the proposals for South African rescheduling put forward and the details are being considered in a technical group.

I am copying this to Len Appleyard (FCO), John Mogg (DTI) and John Bartlett (BoE).

Yours ever
Rachel

MRS R LOMAX
Principal Private Secretary

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International Financial Scene

1 The continued fall in oil prices since the last Report has brought expectations of lower inflation and higher growth in the world as a whole, but is greatly exacerbating the problems facing a number of oil-exporting debtors. At the moment it seems that some of these countries will be unable, or unwilling, to offset the shortfall in their prospective export earnings fully through domestic adjustment, and that they will therefore be seeking increased inflows or reductions in their debt payments. With the likelihood that little visible progress will have been achieved in putting together Baker money by the time of the Interim Committee meetings in April, there is a danger that some debtors might seek alternatives to the existing framework for handling their debt problems. The steering committee of the Cartagena Group has already held a special meeting to discuss the implications of the oil price fall. Although the meeting stopped short of unilaterally setting lower interest rates on commercial debt, it declared that "substantial modifications to existing debt agreements could no longer be postponed, in particular with regard to current interest rate levels". On the banks' side, the projected growth in their balance sheets - and likely further strengthening of their capital ratios - means that the 2-3% increase in total exposure called for under the Baker initiative in fact represents a decline in proportionate exposure to the debtor countries; therefore - assuming the other legs of the Baker initiative are in place, in particular the stipulation that debtor countries take measures to improve the structures of their economies - it may well seem prudent for banks to increase their exposure along the lines envisaged by Baker.

2 Spot oil prices have continued to fall over the past few weeks, and are now 50% in dollar terms below the peak levels of last autumn. Taking all LDCs together, it seems that the initial effect of the price falls on the aggregate trade balance of this group of countries is roughly neutral, with gains to importers roughly offsetting losses to exporters, although the effect is clearly negative if one looks only at the Baker 15. But the fall in oil prices should stimulate economic activity in the industrial countries, and the second-round beneficial effects from this might eventually outweigh the initial adverse effects of the price falls for some of the smaller oil exporters. But in any case, the overall effect on the debt situation cannot be evaluated simply by aggregating the trade balance effects on all the individual countries. The fall in oil prices may, for instance, benefit

countries not currently needing new money anyway (eg Brazil) whilst adding substantially to the burden of some countries already in difficulty. In any case, rapid changes in prices tend to intensify problems, as countries become unable to adjust to the new circumstances with the necessary speed.

3 Evaluation of the prospects for oil-exporting debtors is greatly hampered by the absence of any firm expectations on where the oil price is heading. But it is clear that, even with some rebound from current price levels, Mexico will face financing needs on a scale substantially greater than those envisaged a few months ago and, arguably, greater than those which would be consistent with the flows specified in the Baker initiative. Although the Mexican authorities last week revised downwards their expected financing gap for 1986 to about \$6 bn from earlier estimates of \$9 bn, and reportedly agreed with the US Treasury that this amount could be generated from existing sources, they will undoubtedly face considerable difficulty over the coming months in pulling their required financing together. And, in any case, serious questions have been asked - both inside and outside Mexico - whether the country should accept so much additional finance, since it would add to an interest burden that the country already finds insupportable.

4 Other countries being seriously affected by the oil price falls include Nigeria, Egypt and Venezuela. Even if the price rebounds somewhat from current levels, Nigeria and Egypt will have major difficulty in meeting their financing requirements. Venezuela, on the other hand, is likely to be protected by its sizeable reserves unless the oil price continues to fall. And if the oil price does fall further, other countries not yet in difficulty, such as Indonesia, may not find it possible to continue obtaining their financing requirements at fine spreads in the market. Exporters with more diversified economies such as Malaysia are less likely to be seriously affected. Some additional countries may be affected by knock-on effects from oil prices on to prices of complementary and competing products. Coal prices are particularly likely to be affected, with major exporters of coal including Poland and Colombia. Most countries, however, will expect to gain from the fall in the oil price. For a country such as Jamaica, which is in a critical debt situation, which relies heavily on oil imports and on exports of a commodity (bauxite) whose usage is heavily energy-intensive, the fall in oil prices could bring substantial relief.

5 A major general concern is how the fall in oil prices will affect countries' attitudes to handling their debt. Some optimists have suggested that the fall in oil prices might actually help resolve Nigeria's debt situation, since the country will now be under increased pressure to recognise that it cannot get by without a

Fund programme. However, recent weeks have seen more worrying developments, with the meetings of the Mexican and Venezuelan Presidents, and the repeated calls - now endorsed by the steering committee of the Cartagena Group - for lower interest rates on existing debt. The US authorities have apparently been working on a deadline of providing the first Baker money before the Interim Committee meetings in April. Whilst some recent arrangements (Ecuador, Uruguay) could arguably be said to derive from the Baker initiative (even though negotiations began before the Seoul meetings), there is as yet no clear example of a country being a recipient of Baker funds. Argentina, Mexico, Chile and the Philippines have all been mentioned as early candidates. Insofar as the Baker initiative may have raised expectations amongst debtors, this may increase the likelihood of some reaction, perhaps along the lines of the Peruvian example, as these expectations are disappointed. For the poorer debtors, the first round discussions on both the IMF Trust Fund and IDA 8 were held, and further rounds are due in late March/early April.

6 Against these developments, prospects for the world economy have in general improved, with expectations of higher activity and lower inflation as a result of the falls in the oil price. A fall of \$10 pb in the oil price is estimated to raise output in the major industrialised countries by a total of 2-3% over three or four years, and to lower the price level by 3% over this period. Partly in anticipation of lower inflation, interest rates - both short-term and long-term - have been falling in recent weeks. Three-month eurodollar rates are now below 7 1/2%, over one and a half percentage point below the level of early last year, and four and a half percentage points below the level of two years ago. Certain aspects of the Gramm Rudman legislation were declared unconstitutional in a District Court but it remains in force, pending appeal.

7 Debtor countries are also likely to be helped by the continued fall in the US dollar, which in effective terms is now 18% below its level at the time of the Plaza Agreement and 25% below its February 1985 peak. The US economy is now estimated to have grown by only 1.2% in the final quarter of 1985, but this slowdown was largely due to a higher than expected trade deficit and official growth forecasts for this year remain unchanged. Nevertheless, with the non-oil trade deficit likely to grow for much of this year as a result of J-curve effects (January saw another record US trade deficit), there is a possibility that protectionist pressures, which seem to have receded for the moment, may revive.

8 Commodity prices have been fairly stable recently: in the first two months of the year the Economist index fell just 1.8% in SDR terms. Of the sub-indices, food prices fell almost 3%, largely as a result of lower vegetable oil seed prices;

these have fallen rapidly as a result of the glut in palm oil supplies following record Malaysian output. Coffee prices have risen very slightly overall since the beginning of the year, although they have behaved erratically, and remain well above levels prevailing before the recent drought scare; cocoa prices have fallen, adding to the difficulties of some of the West African countries.

9 Looking at developments in individual countries, the future of the Philippines' economic policy is at present uncertain following the recent change of administration; the rise in the stock market, and the reported increase in reserves and improvement in the currency, suggest however that the conclusion of the earlier political chaos has brought some reassurance. Brazil seems finally to be trying to come to grips with its accelerating inflation. On 28 February the authorities announced a package apparently modelled on the Argentine austral plan of last summer: prices are frozen for a year, the economy is largely de-indexed, a new currency (the cruzado) has been introduced, and the 'crawling peg' depreciation against the dollar suspended. First reports suggest a popular welcome for these measures. There are, however, some doubts about whether these measures will fully achieve their objectives, because no further action has been taken to reduce the fiscal deficit.

10 Uncertainty over the South African debt situation has receded for the moment, following acceptance by major creditor banks and the South Africans of revised proposals from Leutwiler, the mediator, which ensures higher spreads, a 5% repayment of maturing debt to the banks this year and the maintenance of other lines until March 1987. Banks seem now to be less reluctant than earlier to be seen to be negotiating with the South Africans, and a small technical group has been formed to consider the details of the agreement.

11 Following the clearance of its arrears to the Fund, Zambia's SBA and CFF were approved on 21 February. Other countries, however, remain in difficulty over Fund arrears: Sudan has now been declared ineligible to use Fund resources, and Peru will be declared ineligible on 14 April if it has not paid a minimum of SDR 70 mn towards clearing its arrears by that date.

12 East bloc borrowers have raised just under \$700 mn on the capital markets so far this year, with both USSR and Hungary coming to the markets in each of the first two months. Hungary is still the only East bloc country to step outside the syndicated credit market, with the National Bank issuing a floating rate note of \$100 mn and a DM fixed rate bond equivalent to US\$62 mn. Indian and South Korean borrowers were the most active among LDC borrowers in the first two months of the

year, taking nearly two thirds of the \$1.75 bn total raised. The South Koreans used all areas of the euro capital markets in borrowing \$500 mn; Indian borrowers too made use of bond and syndicated credit markets for their total of just over \$500 mn. A small deal for Siderca SAIC, of Argentina, marked the first appearance by a borrower from that country for four years.

Further details on individual regions and countries are given below.

13 Latin America

At the beginning of February the Presidents of Argentina, Brazil, Mexico and Venezuela called for an emergency meeting of the Cartagena Group to discuss the outlook for their countries in view of the weakening oil market and falling commodity prices, and on 22 February the President of Mexico asserted that the international financial community should play its part in assisting the regional debtor countries. Subsequently, on 27-28 February, Foreign and Finance Ministers of the steering committee of the Cartagena Group met in Punta del Este, Uruguay. Argentina reportedly hoped that the meeting would lead to agreement to press for preferential below-market interest rates for debt already contracted; a figure of 2.5% below LIBOR was to be suggested, with the aim of providing an interest saving of \$10 - 15 bn pa for the region. However, whilst the steering committee declared that "substantial modifications to existing debt agreements could no longer be postponed, in particular with regard to current interest rate levels", the meeting drew back from unilaterally setting a specific level of interest rates. Mexico in particular was apparently concerned that such a move could jeopardise its own negotiations with banks and official creditors.

14 Turning to events in individual countries, Argentina continues to hold the support of the international financial institutions for its implementation of the austral plan announced last June. Following agreement with the Argentine authorities on revised fiscal targets for the first quarter of 1986, the IMF Board on 10 March approved a decision enabling Argentina to make the scheduled third purchase of SDR 236.5 mn under the current SBA. However, because of the earlier lack of agreement on end-1985 targets, the scheduled second purchase of SDR 236.5 mn was cancelled and the SBA has been reduced accordingly from SDR 1.42 bn to SDR 1.18 bn. The programme itself will be extended from end-March to end-May. Agreement with the Fund is expected, in turn, to trigger drawdown of the third, and penultimate, tranche of the commercial bank \$4.2 bn new money loan. Discussions are continuing on a follow-on Fund programme of at least a year. In early February Argentina announced that it was also seeking a rescheduling of some of the Paris Club debt falling due in 1986, and declared a moratorium on payments of both

principal and interest of Paris Club debt pending negotiations; the Paris Club has expressed a willingness to discuss such a rescheduling, once agreement has been reached on the new IMF programme, but has informed the Argentinians that the moratorium is not acceptable. Negotiations with commercial banks were put to one side while discussions with the Fund were taking place, but contact was resumed in the first week of March. Meanwhile, the introduction of the 1986 budget - the 'second stage' of the austral plan - in early February shows the authorities' determination to continue with the present economic strategy. The overall emphasis remains firmly on controlling inflation, and the authorities have so far shown the political will to continue the strategy despite a certain amount of popular opposition: a General Strike on 24 January was well supported, but government/union talks on the 'social pact' may help to defuse the situation. January inflation was 3% (cf 30% in June, before the austral plan), and the monthly inflation target of 2% (28% over 12 months) looks within reach.

15 Brazil continues to perform strongly on the external account. The trade surplus in February was \$719 mn (cf \$545 mn February 1985). The authorities have estimated that the country will receive an additional \$700 mn in export earnings this year, as a direct result (paradoxically) of higher world coffee prices in the aftermath of the Brazilian crop failure. In addition the country will gain \$1.2 bn this year from the recent fall in oil prices, if there is an average price of \$18 per barrel, and is again likely to surpass its trade surplus target (\$12.5 bn). On the domestic front, however, inflation has continued to be the major problem. The inflation rate for February was 14.4%, bringing the year-on-year rate to 255% (cf 234% at end-1985). In response, the government introduced a package of radical economic measures on 28 February (the "cruzado" plan), modelled on the Argentine austral plan: the main elements are (i) the introduction of a new currency, the cruzado (equivalent to 1,000 old cruzeiros) which will be pegged to the US dollar (ii) a 12-month freeze on consumer prices and measures designed to ensure wage restraint and (iii) a virtual de-indexation of the economy. The plan has received a generally favourable response in Brazil, although difficulties are already emerging. Whilst it certainly represents a welcome attempt to tackle the problem of spiralling inflation, doubts persist about the capacity of the authorities to carry the plan through. The apparent lack of supporting fiscal measures is a particular area of concern.

16 Negotiations between the banks and the Brazilian authorities on the details of a debt package covering 1985-86 medium-term maturities and short-term credit lines resumed in the week beginning 10 February, and agreement was reached on 2 March. Some \$6 bn of 1985 debt has been rescheduled for seven years with repayments

starting in 1991, and a further \$9 bn of 1986 debt is to be rolled forward until next March. Interest margins on 1985 and 1986 maturities have been cut to 1 1/8% from 2%. The agreement has been described by the negotiators as "a bridge to a future multi-year rescheduling package". Informal discussions also took place between the Central Bank President, Bracher, and French officials at the weekend of 22 February on the rescheduling of Brazil's Paris Club debt. The Paris Club, however, is unwilling to agree to a rescheduling if Brazil continues to by-pass the IMF in its negotiations with the banks; for its part, Brazil remains unwilling to make interest payments to Paris Club creditors in the absence of a rescheduling.

17 Mexico is heavily affected by the weakening oil market. Average Mexican oil prices have been reduced by some \$9-10 pb since the start of the year; moreover, the volume of exports in January was only 1.1 mbpd, against a target of 1.5 mbpd (at which volume each dollar's drop in the price reduces export revenue by over \$500 mn). While oil export revenue will be substantially less than the \$12.25 bn originally forecast by the Mexicans late last year (based on a price of \$22.5 and volume of 1.5 mbpd), the ultimate impact on the external financing requirement - originally put at \$4 bn - will depend also on the extent to which the Mexicans undertake further domestic adjustment. Perhaps as worryingly, the loss of oil revenue will have a major adverse impact on the country's domestic fiscal position. President de la Madrid announced on 21 February that Mexico would be unable to meet its external financing requirements, and called on the international community to play its part in assisting the country; however, no formal request for new money was made when the Mexicans met the banks' Advisory Committee in early February. The Mexicans are thinking of withdrawing an earlier request to the Paris Club for a multi-year rescheduling of official credits with retention of export credit cover, because they wish to consider further the problem that much of the relief they might gain from rescheduling could be offset if some countries withdrew cover. The Paris Club remains willing to consider a request if and when it is forthcoming. The UK line will be that, while the Paris Club may offer a MYRA in principle, no details can be discussed at this stage and any agreement has to be dependent on the Mexicans reaching agreement with the IMF. Meanwhile, the UK will be prepared to continue cover. The latest indication is that Mexico will require altogether about \$6 bn this year, which may be made up of new bank money (\$2.5 bn), interest relief from banks (\$1 bn), which banks will be reluctant to concede because of the precedent it would set for others, inflows from IFIs, (\$1.5 bn) and Paris Club financing (\$1 bn).

18 Although Venezuela is cushioned from the immediate effects of weakened oil prices by international reserves amounting to \$14 bn, the Advisory Committee agreed in the second week of February to reschedule \$923 mn of payments due in 1985-1986

under the MYRA which was signed at the end of the month. The Advisory Committee have also agreed that the Venezuelans may reassess their position within a month of signing in the light of continuing uncertainties in the oil market. These concessions by the banks are being seen as reflections of their desire to tie up their agreement with Venezuela before the oil market worsens further. Like Mexico, Venezuela has lost market share, with export volume in January being only about 1 mbpd, against the authorities' target of 1.4 mbpd. But, as part of a more aggressive marketing strategy, the state oil company PDVSA has now announced that it will negotiate prices individually with foreign buyers rather than set an official price for its oil. Early indications are that this more aggressive marketing is bringing Venezuelan market share back up near to previous levels.

19 Most of the smaller countries continue to make progress in their external financing arrangements, the major exception still being Peru. Bolivia's external situation also remains precarious, and has been exacerbated by the tin crisis. Following reports of policy slippages in December after the IMF Letter of Intent was signed, another Staff Mission was sent to La Paz on 14 February to investigate recent developments and the implementation of proposed reforms. Bolivia's request for an SBA, reportedly of SDR 50 mn, and for a CFF of SDR 55 mn, is thus unlikely to be discussed by the Fund Board before the end of April. The World Bank is apparently discussing a rehabilitation package of about \$40 mn, of which \$20 mn might be through the IDA. Negotiations are unlikely to proceed with the Paris Club and the commercial banks until agreement has been reached with the Fund. Chile signed its \$1,085 mn new money agreement in December, and agreed in principle a MYRA covering about \$4.5 bn due 1985-87. It is hoped that model contracts now being discussed under the bank MYRA will be signed by end-June. All bilaterals have now been completed for the Paris Club rescheduling of 65% of principal due July 1985 - December 1986. Since oil accounts for about 11% of imports, the benefit to the balance of payments of the fall in oil prices will help to offset a likely shortfall in copper revenue.

20 Following the signing of the \$1 bn new money agreement in December, an IMF Staff Mission visited Colombia in January to conduct an appraisal under the enhanced surveillance agreement to which drawings under the loan are subject. If, as expected, the Fund gives its approval to Colombia's performance against end-year targets, this would trigger drawdown this quarter of the first \$515 mn tranche of bank money. Colombia's economic position continues overall to strengthen, with the country well-placed to take advantage of the suspension of coffee export quotas by the International Coffee Organisation on 19 February, although it may find some difficulty in maintaining its coal exports in the present environment. Oil plays a relatively small part in the trade balance, although Colombia should become a (small) net oil-exporter this year.

21 Ecuador may be seriously affected by the oil price decline. A public sector commercial bank MYRA (\$2.5 bn due 1985-89) was signed in December, and a private sector MYRA (\$1.4 - 1.5 bn, also 1985-89) is expected to be signed shortly. However, the weakening oil market has impaired prospects for successful implementation of the country's IMF adjustment programme. The authorities have claimed that they would be able to meet external obligations if the price stabilised at \$19 pb, but at current price levels the position is likely to be much more difficult. International reserves (at about five months' imports) provide only a limited cushion. However, the authorities are reportedly putting together a package of import and monetary measures to ease the impact of the latest oil price falls. In Jamaica, the 'new look' mission, comprising the IMF, the World Bank and USAID, has made little progress in persuading the Prime Minister that present policies are unsustainable. A report is expected at the end of March. Meanwhile, the IMF Board approved a review and modification of the SBA - in abeyance since last September - which entails maintenance of the existing exchange rate with tighter monetary and fiscal measures: as a result, a drawing of SDR 26.6 mn has been approved.

22 Peru's relations with its official creditors remain poor. Arrears to the IMF currently stand at about SDR 85 mn. Following a meeting on 10 February, the IMF has given Peru until 14 April to pay a minimum of SDR 70 mn (\$75 mn) to avoid being declared ineligible to draw on Fund resources; President Garcia has said he will announce on 13 April whether or not Peru will pay. The country has now built up reserves to about \$1.5 bn. A Staff Mission was due to visit the country shortly to carry out the delayed 1985 Article IV consultation, but the Peruvians have now postponed this visit indefinitely. In a further ominous move Peru has moved gold held abroad back to Lima, allegedly to avoid risk of seizure by creditors. On the commercial bank side the Peruvians failed to make the payment requested by the banks by 12 February to reduce arrears by 90 days. Garcia has warned the country that foreign banks may in retaliation now begin to seize Peruvian assets held abroad. The authorities are continuing their expansionary domestic economic strategy, but so far with limited success. Meanwhile Uruguay has agreed in principle a commercial bank MYRA, covering \$1.6 - 2 bn of debt due 1985-1989. All end-year targets were met under the 18-month IMF SBA, approved in September, and the authorities' battle against inflation will be helped by the fall in the price of petroleum products, which accounted for 30% of imports in 1984.

23 South and East Asia

After a period of political chaos following the disputed presidential election in the Philippines, the recent change of administration will provide some

reassurance. However, the new administration will need some time before it can get to grips with the country's difficult economic situation, although the retention of Central Bank Governor Fernandez provides some continuity. Meanwhile pre-election spending seems set to bring about a breach of the IMF's existing monetary target at end-March. President Aquino intends to review the terms of the Programme, and says that she will seek new, and better, terms, similar to those given to Argentina. A Fund team arrived in Manila on 11 March.

24 Balance of payments projections for Indonesia indicate a sustainable scenario, should oil prices return to an average of \$20 per barrel in 1986, although further severe retrenchment will be necessary. Problems become increasingly pressing as oil prices remain below this level. At present the Indonesians are compensating for falling oil prices by increasing production, but they are also prepared to cut spending further. A Yen 100 bn credit has recently been arranged. Although Malaysia too is adversely affected by the fall in oil and other commodity prices, its position seems sustainable even if prices fall below current levels.

25 By contrast, falling oil prices will have a beneficial effect on South Korea, which may now achieve its 1986 target of 8% real growth (up from 7% originally), balanced current account and inflation of 3% or less. External targets will also be helped by the strength of the yen. In Thailand the authorities seem to be persevering with their austerity programme despite some domestic opposition.

26 Eastern Europe

At the end of January the Poles sought debt relief of some \$1.1 bn this year (100% rescheduling of principal and \$250 mn in new credits) from the banks, in conformity with the official creditors' position on burden sharing. After considering the request, however, the banks' Steering Group offered only 75% rescheduling of principal (\$600 mn) at a meeting in Frankfurt on 25 February. The banks seem to be losing patience with the Poles, and may be moving towards countenancing default. A further meeting is scheduled for 17 March. On 7 March Paris Club creditors intialled an agreement rescheduling \$1.9 bn of debt due in 1986; the \$550 mn moratorium interest over-due from end-1985 is now to be paid in 1986 in two tranches. It is hoped this early agreement will put pressure on other creditors to offer comparable relief. The IMF membership committee has decided to recommend a quota of SDR 680 mn.

27 Under concerted pressure from Fund Staff and creditors Yugoslavia has abandoned its earlier opposition to positive real interest rates; rates were raised to 68% in

accordance with the SBA formula on 1 February (one month late) and will be raised to at least 73% at the next review on 1 April. The IMF Board was to consider interest rate and other missed performance criteria on 12 March; this is the day Yugoslavia is scheduled to prepay some \$258 mn of the \$600 mn 1983 new bank money in advance of the first loans, due to be disbursed on 25 March, under its refinancing agreement. The timing for the bank MYRA is therefore tight. The authorities have now requested a meeting with creditor governments to discuss an official MYRA in Geneva on 14 April. Romania failed to make two principal repayments in January, and requested the banks to spread them monthly from March to December. Faced with a heavy repayment schedule in 1986 - particularly mid-year - the likelihood of new cash flow problems and further ad hoc reschedulings must remain a high probability. (Nevertheless, Romania's external debt has been reduced from \$7.1 bn at end 1984 to \$6.1 bn at end 1985.) The USSR, with over half of its convertible currency earnings deriving from energy exports in 1984, will be seriously affected by the falls in the oil price.

28 Southern Europe

In Greece, economic policy remains tight, with the announcement of a reduced target for the PSBR in 1986 of 11.2% of GDP. Inflation continues to rise as a result of the October devaluation and increases in administered prices. All four tranches of the first half of the ECU 1.75 bn Community loan have now been raised by the EC.

29 Portugal is estimated to have moved into current account surplus (\$150 mn) last year, for the first time since 1973. Despite concern that 'controlled expansion' would boost the volume of imports, the government now expects that lower oil and other commodity prices will restrict the deficit in 1986 to around \$200 mn. The introduction of VAT this year is likely to undermine efforts at reducing inflation, although the authorities still project a modest decline to 14%. The recent election of Dr Mario Soares (the former Socialist Prime Minister) as President may create difficulties for the centre-right Social Democrat government and hinder the implementation of its economic policy.

30 Africa

Even before the recent fall in the oil price Nigeria was facing severe balance of payments difficulties in 1986. And as a result of the likely loss of revenue this year (oil contributed 95% of foreign exchange earnings), the country will require generous debt relief as well as substantial sums of new money if it is to avoid the accumulation of arrears and maintain sustainable import levels. Paris Club

creditors remain insistent on an accommodation with the IMF before agreeing to a rescheduling, and hope that the Article IV mission which recently arrived in Lagos will allow negotiations to begin, although probably on a confidential basis given continued political opposition to an IMF agreement. Meanwhile, commercial bank creditors have been frustrated by the absence of an initiative from the Nigerians. However, the Nigerian Ministry of Finance has now asked Barclays to co-ordinate a meeting of creditor banks, which is scheduled to take place in London on 27 March. The banks too require a link with the IMF before agreeing a rescheduling, although some banks may be prepared to accept something less than a formal programme: however, it is unlikely that new money would be made available without a SBA. Progress on the reconciliation of short term trade arrears continues to be slow.

31 There has been some speculation in the press that Algeria may find it necessary to reschedule some of its foreign currency debt, which is estimated to have reached over \$18 bn. The government recently sought to raise a further \$500 mn 10 year market loan, but had to settle for \$300 mn, as the markets appeared to start questioning the fine terms on which Algeria has been borrowing. The IMF has advised Egypt that, until economic reforms are implemented and an effort is made to close the country's 1986-87 external financing gap, it can do no more than lay the groundwork for a Programme. A parallel approach to the Paris Club seems inevitable. Recent unrest in the country is certain to depress tourist revenue still further, thus intensifying the country's economic difficulties.

32 Morocco has made some modest progress with rescheduling its commercial bank debt (but has widespread arrears to the Paris Club). The agreement covering 1983-84 maturities became effective on 21 February, and this has cleared the way for discussions on 13-14 March on restructuring 1985-86 maturities and for an IMF mission to return to Morocco to complete the first review of the current Standby arrangement. On 20 February, under the chairmanship of Dr Leutwiler, South Africa and a group of major creditor banks reached a "broad consensus" on proposals for the repayment of some of the \$14 bn of debt covered by the current standstill. The outcome was described not as a rescheduling but rather as a short-term interim arrangement that will allow the country time to return to a more normal financial situation. Final details of the arrangement are being clarified by a small technical group of major creditor banks.

33 Sudan was declared ineligible to use IMF resources on 3 February. An Article IV discussion is scheduled for 12 March, but it is unlikely that progress can be made towards putting a new programme in place until after the elections in April. Zambia's SBA and CFF (for SDR 229.8 mn and SDR 68.7 mn respectively) were approved

on 21 February even though the recent accumulation of some US \$40 mn arrears on Zambia's commercial oil facility technically breached the Fund's approval criteria. The restoration of Zambia's access to IMF resources was vital to resolving the immediate financial crisis and as a prelude to comprehensive debt relief; a successful Paris Club meeting was held on 4 March and a request to the London Club is expected shortly.

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INDEBTEDNESS AND BRITISH EXPOSURE

CONFIDENTIAL

	Total external debt	British-owned banks' exposure[1]	\$ billion ECGD amounts at risk	
	End-Dec 1985*	End-Dec 1985	End-Dec 1985 [2]	End-Dec 1985 [3]
<u>Latin America</u>				
Argentina	51	2.5	0.2	0.2
Brazil	100	6.7(0.6)	0.9	1.8
Chile	20	1.3(0.1)	-	0.1
Colombia	14	0.6(0.1)	-	0.2
Ecuador	8	0.6	0.1	0.1
Mexico	98	6.4(0.3)	0.6	1.3
Peru	14	0.3	0.1	0.1
Venezuela	38	2.3(0.1)	-	-
<u>Far East</u>				
Indonesia	36	0.7(0.3)	0.8	1.6
Philippines	27	1.3(0.1)	0.2	0.2
South Korea	46	2.2(0.5)	0.4	0.8
<u>Eastern Europe</u> (convertible currency)				
Hungary	11	0.5(0.1)	-	0.1
Poland	30	0.5	1.2	1.3
Romania	6	0.2	0.3	0.8
Yugoslavia	18	0.9(0.1)	0.7	1.0
<u>Southern Europe</u>				
Greece	16	1.3(0.2)	0.2	0.3
Portugal	16	1.2(0.1)	0.2	0.3
Turkey	22	0.4	0.2	0.6
<u>Africa</u>				
Egypt	40	0.4(0.3)	0.2	0.9
Morocco	14	0.2	0.1	0.2
Nigeria	19	1.3(0.1)	2.0	3.2
South Africa	22	4.0(0.5)[4]	0.9	2.7
Sudan	9	0.0	0.3	0.3
<u>Middle East</u>				
Israel	30	0.5	0.1	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. Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans.

[2] Defined as unrescheduled principal disbursed, plus political claims paid and claims under examination.

[3] Defined as guaranteed principal and contractual interest, plus political claims paid and claims under examination.

[4] Data not compatible with those previously shown, because of deconsolidation of subsidiaries which are no longer majority owned.

* current estimate