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12 May 1986

Charles Powell Esq
10 Downing Street
LONDON SW1

Prime Minister

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Dear Charles,

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INTERNATIONAL FINANCIAL SCENE

I enclose the regular report on developments in the international debt scene which was prepared just before the Summit meetings. As usual the paper provides considerable detail on the individual countries now regarded as problems.

On the outlook, our judgement - confirmed in discussions at the Summit - remains that the position overall is reasonably satisfactory. Movements in both interest and exchange rates have been positive. However the oil price collapse has created acute difficulties in relation to major oil exporting debtors such as Nigeria and Mexico.

On individual countries, many of the smaller Latin American countries are making progress, in particular Colombia, Chile, Ecuador, Uruguay and even Bolivia. Mexico's negotiations with the Fund are still proceeding, although differences over the appropriate size of the public sector deficit remain to be resolved.

why? Brazil's position remains very difficult. She has paid no principal or interest on official debt since end-1984 and continuing buoyancy on her trade account is reinforcing her unwillingness to negotiate with the Fund. Given this, a rescheduling demand has recently been rejected by the Paris Club, although there are signs that Brazil wants to continue these discussions. Some recent indications suggest that the Brazilians themselves are aware that the present situation cannot last but in the short term creditor leverage is limited. The UK is however supporting a US attempt to use the provision of new export credit as a lever.

Cuba has now imposed a unilateral moratorium on debt payments. In financial terms, this is not significant but could provide an unwelcome example. On the other hand, Peru, threatened with immediate ineligibility unless she undertook to clear all arrears to the Fund by mid-August, has given an undertaking to do this.



Elsewhere, there are some recent developments worth noting in Eastern Europe. The 1986 Paris Club agreement with Poland remains unsigned but the banks have improved their rescheduling offer and are now offering to reschedule 95 per cent of 1986 maturities and 90 per cent of 1987 maturities. Yugoslavia initialled a three-stage agreement with official creditors last month covering the period mid-1986 to 1988. This is the first Paris Club agreement without a formal IMF programme. In its place the agreement incorporates very tough provisions for Fund monitoring of economic performance. Hungary's external performance is now giving rise to concern and we shall be keeping a close eye on developments there: in the meantime we are taking a very cautious line on new credit.

Finally, on Nigeria, there are some positive indications to report in the form of an apparent willingness to seek an IMF programme (without drawing or standby) which has impressed some key IBRD staff. This would certainly be progress but we should continue to be sceptical about the speed and extent of any new measures until the IMF satisfy themselves and the measures themselves are implemented.

I am copying this letter to Tony Galsworthy (FCO), John Mogg (DTI) and John Footman (Bank of England).

Yours ever
Rachel

RACHEL LOMAX
Principal Private Secretary

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INTERNATIONAL FINANCIAL SCENE

1 Interest rates have recently been falling dramatically. With significant cuts in domestic interest rates in all the major financial centres, three month eurodollar rates fell almost to 6 1/2%, down from around 8% at the beginning of the year, 9% early last year, and 12% about two years ago (although there has been a slight reversal in recent days, and rates are now around 6 3/4%). Most debtors have also been helped significantly by the continued fall in the US dollar, which by 30 April had depreciated by 19% in effective terms since the Plaza agreement last September and 28% from its peak level of February 1985.

2 As noted in earlier Reports, the impact on debtor countries of the continued fall in oil prices is more mixed. The Baker 15 countries are in aggregate oil exporters, and some of the countries most heavily dependent on oil exports - in particular Mexico and Nigeria - were in extremely serious financial difficulty even before the oil price began its recent decline. Despite the increase in political tension in the Middle East, with the continuing absence of full agreement on output restrictions amongst OPEC members, there seems little immediate prospect of a rapid revival of oil prices from their present depressed levels - though the advantages to OPEC of collective production restraint remain. Prices are now in SDR terms over 65% below their peak levels of last autumn.

3 Contrary to some earlier expectations, the substantial deterioration in the financial prospects of oil-exporting debtors has so far not led to a clear radicalisation of the debtors' stance. In particular, the Cartagena Group meeting at Punta del Este at the end of February, whilst expressing support for any country wishing to take unilateral action, did not itself press a more radical line. With economic prospects for the majority of Cartagena Group countries appearing to improve, these countries seem unwilling to take the risks inherent in overturning the current case-by-case strategy. For their part, the banks have been seeking to underpin the resolution of such countries, by completing rescheduling agreements with a number of countries, thereby in effect isolating Mexico, which has been seen as the most serious threat to the current debt strategy. Mexico itself seems to be standing back for the moment from earlier proposals that interest rates on its loans should be cut to below commercial levels; but the country still says that it will

accept only \$4 bn increase in debt towards its projected \$6 bn financing gap this year, although it has so far not offered specific proposals to bridge the difference.

4 In the event, discussion of debt problems at the Interim and Development Committee meetings on 9-11 April passed relatively uneventfully. General optimism (at least amongst creditor countries) about the world economic environment, plus the absence of any feeling of imminent crisis about any of the major debtors, meant that debt problems did not dominate the meetings in the way that they had done in many recent international financial fora. Amongst debt-related matters covered at the meetings, the Interim Committee's clarification of the possibility of going to the maximum in access limits, and perhaps beyond in 'exceptional circumstances', will have been helpful. Moreover, there seems now to be agreement among all donors except the US that \$12 bn should be the goal for IDA 8. The meetings noted agreement by the IMF Board to the establishment of the Structural Adjustment Facility which will help mainly the poorer African debtors pursuing adjustment programmes. Several countries including the UK used the opportunity to sign the MIGA Convention. On the other hand, continued US opposition to agreeing a timetable for a World Bank capital increase was, if not unexpected, disappointing, although some progress was achieved in securing a firmer commitment from the US for an eventual increase. The possibility of an oil facility, suggested earlier in the year to compensate (non-OPEC) oil exporters, now seems dead.

5 Discussion of the Baker initiative appears to have receded marginally from the limelight. It is generally accepted that the initiative should be viewed more as an overall approach to handling the debt situation rather than as specific proposals for particular amounts of money to identified debtors. No clear recipient of "Baker" funds seems likely to be forthcoming - or, indeed, willing to be identified - in the near future. However, one result of the Baker initiative seems to be the higher profile of the IBRD in a number of countries, and the increased role for it in providing structural or sectoral financing for problem debtors. A package of \$465 mn for Mexico was approved in March, and a further \$500 mn loan for that country is being negotiated; in April \$250 mn was approved for Colombia and \$350 mn has recently been agreed for Argentina.

6 Nevertheless, serious concerns do remain. As already noted, the falls in oil prices exacerbate the difficulties of a number of debtors, and the falls in the dollar and in interest rates will provide only partial relief for them. Some banks are likely to be hit by oil-related problems more widely, and will be particularly reluctant to increase their involvement with oil-dependent debtor countries.

Moreover, internal developments in a number of debtor countries are not reassuring: Brazil has re-introduced partial indexation of wages; the Argentine authorities face continued domestic opposition to their economic programme and have exceeded their IMF fiscal target for the first quarter; Mexico still has significant differences with the Fund over the size of its prospective fiscal deficit for this year; uncertainty surrounds the prospective economic policies of the Philippine authorities; Egypt remains unwilling to countenance serious economic adjustment although its economic condition continues to deteriorate; Peru continues its policy of virtual non-co-operation with the banks, although it has made token payments to the banks (of \$18 mn) and to the US (\$16), as well as SDR 30 mn to the Fund to reduce its arrears; and, although the Nigerian authorities are now giving more positive signals about their willingness to reach agreement with the Fund, there are still considerable doubts about the firmness of their commitment on this issue.

7 Furthermore, the world economic environment is not entirely bright. The recent interest rate reductions have been a response in part, especially in the US, to slower than expected economic growth. US growth in 1985 Q4 has been revised downwards to 0.7% (ar), and whilst Q1 figures for 1986 suggest 3.2% growth, largely because of improved exports and stockbuilding, prospects for the year remain mixed. With the US trade deficit likely to rise this year (because of J curve effects), and industrial production indicators in February and March showing their largest two-month decline (1.2%) since late 1984, increased protection remains a serious threat. Treasury Secretary Baker has suggested that further dollar depreciation and/or faster growth in other industrial countries will be necessary if protectionist pressures are not to increase; however, other countries, in particular Japan, now seem to be resisting further dollar depreciation.

8 Since the beginning of the year, there has been some reversal in the downward trend in commodity prices, and the aggregate Economist Index rose by 4% in SDR terms (8.6% in dollars) in the first quarter. During March, agricultural raw material prices rose relatively strongly (by 6.3% in SDRs), and food prices also continued to rise (+5.5% in SDRs), with most commodities moving upwards. Metal prices overall were roughly unchanged, with heavy falls in the price of tin offsetting rises in other metals. More recently, there has been some downward movement in prices, but this may have been only a transitory development.

9 East Bloc borrowers have continued to borrow heavily on the capital markets, raising nearly \$1 bn in March and April. The USSR has arranged a further non-dollar denominated loan, for DM 1 bn (\$450 mn). Hungary arranged a \$275 mn

Credit on improved terms, comparable with many OECD countries; and a \$250 mn FRN continues the country's sophisticated use of the market which may not yet have fully caught up with the underlying deterioration in the country's economic prospects. There has been little LDC borrowing since February, with only \$350 mn raised in March and April, including a \$175 mn credit for Tunisia (taking advantage of a tax-sparing agreement concluded with the UK in 1985).

Further details on individual countries are given below.

10 Latin America

Following the emphasis of the Austral Plan on cutting inflation in Argentina, pressure on the authorities to introduce measures to stimulate economic (and export) growth has been mounting. A 3 1/2% devaluation of the currency, announced in early April, and an additional 1.2%, announced on 24 April, may be insufficient to restore the country's competitive position, although further adjustments are said to be under consideration if required. Despite the announcement of permissible wage increases for the rest of the year of between 18-25% in the private sector (18-21% public sector), labour unrest continues. Plans for a general strike on 24-25 April were postponed after the major unions agreed to talks with Labour Minister Barrionuevo, but the agricultural sector strike on 20-21 April went ahead and attracted widespread support. Efforts to promote more dynamic growth in agricultural output and exports are being underpinned by a recently approved IBRD agricultural sector loan of \$350 mn. However, export prospects for this year are likely to be badly hit by continued low grain prices.

11 On the financing side, the March Fund drawing under the extended SBA which expires at end-May paved the way for disbursement during the week ended 18 April of the penultimate \$600 mn tranche of the commercial bank facility. One final drawing remains to be made. A possible \$1.4 bn follow-on SBA is now under consideration by a Fund mission, and negotiations have begun with commercial banks on the financing needs for 1986, which banking sources put at around \$500-700 mn (although Argentina will probably ask for much more). However, the Ministry of Economics has recently stated that the IMF target for the Q1 fiscal deficit was exceeded; this may complicate the final purchase from the IMF under the current SBA and the final drawdown of the commercial bank facility. It may also complicate the current negotiations with the Fund and the banks for 1986-7.

12 Brazil continues to perform very strongly on its external account. The first quarter trade surplus stood at \$2.6 bn, compared with \$1.9 bn in the same period

last year. Exports increased by 16% to \$5.8 bn (cf \$5.0 bn), non-oil imports rose 30.6% to \$2.2 bn (cf \$1.7 bn), whilst oil imports fell by 26% to \$1.0 bn (cf \$1.4 bn). The impact of the government's tough anti-inflationary measures ('the Cruzado Plan') led to a fall in consumer prices in March of 0.9%, the first fall since September 1957. Other preliminary signs of the Plan's impact are encouraging: the gap between the official and parallel exchange rate has narrowed, and the stock exchange indices in the major cities have reached record levels. However, there is some concern that the effectiveness of the Plan may be weakened by the government's recent decision to reintroduce partial indexation of wages and salaries, a move designed to placate trade union opposition to the reforms. In addition to the automatic upward adjustment when inflation reaches 20%, there will now also be an automatic end-year adjustment to compensate for 60% of the annual inflation rate. This decision has received a mixed response in Brazil.

13 Brazil re-opened talks with the Paris Club on 15 April to discuss rescheduling about \$2.4 bn of official debt falling due in 1985 and 1986. The discussions were heated, with the Brazilians proposing that current arrears be repaid over seven years (for principal) and four years (for interest) with an initial payment of 15% of arrears due between October 1985 and end-April 1986. They also proposed a moratorium on maturities falling due between May 1986 and June 1987. These demands were rejected and the US responded by announcing that it had decided to withdraw medium-term export credit cover. Brazil has paid no principal or interest on official debt since end-1984, and remains adamant in its refusal to negotiate with the Fund; the Brazilians are temporising over the date of the forthcoming Article IV mission.

14 Mexico was slow to adjust its oil price this year, and has substantially lost market share. Exports in March were only 1.1 mbd, compared with 1.5 mbd in March 1985. The economy seems to have slowed dramatically after its reported 2.7% growth last year; and inflation is accelerating slightly, with prices rising by 19% in the first quarter of this year. Although discussions with creditors continue, Mexico has yet to propose formally its 1986 financing plan. The authorities continue to estimate their overall financing requirement to be \$6 bn, but stress that external borrowing will be limited to \$4 bn. An Institute of International Finance analysis suggests that, on certain (favourable) assumptions, the financing gap might be only \$2 1/2 bn, and banks have suggested that this might be filled without need for any new bank money. Some progress has been made in Mexico's negotiations with the IMF; however, the public sector deficit continues to cause difficulties, although the authorities are now taking measures which should reduce the deficit by the

equivalent of \$2 bn, bringing it to about 9% of GDP for this year, through both increased tax revenues and reduced subsidies. In the absence of a provisional agreement with the Fund, no meeting with the banks' Advisory Committee has yet been called. Mexico's external financing for this year has been assisted by the approval in late March of a package of IBRD loans totalling \$465 mn (including \$400 mn for earthquake rehabilitation), and an IBRD trade policy loan of \$500 mn is currently being negotiated. Silva Herzog has been in Japan and is reported to have requested \$1 bn from the Japanese to finance three projects covering oil, steel, and export promotion. On 17 March a major export promotion package was introduced which is expected to boost non-oil revenues by \$1 bn in 1986. Meanwhile, the reserves seem to be holding up well (about \$6 bn at end-March), and have been aided by the faster depreciation of the controlled peso rate against the dollar. (The free rate has been broadly stable since end-1985: it is now only 2% above the controlled rate, against 25% at the start of the year.) Although it had been suggested that by the beginning of this month the Mexicans might need to consider limiting debt service payments to protect the reserves (there have been suggestions that a 90-day suspension of interest payments is being contemplated) it now seems that they can get by at least until July without needing to take action. At end-March the banks agreed to a further 6-month rollover of \$950 mn due in April and previously rolled over last October.

15 On 23 April the Venezuelan authorities sent telexes to their creditors confirming that the country would invoke the contingency clause in the \$21.2 bn MYRA, which was signed at end-February, and seek a resumption of discussions with the banks. (Under the MYRA, Venezuela was able to request talks on further restructuring within one month of signature if the uncertainties in the oil market continued.) Although the Venezuelans are still expected to make the \$750 mn down payment due under the MYRA this year, there are reports that they may seek to defer the \$2 bn principal due in 1987-88. Banks are likely to resist reopening discussions at this stage, especially as the Venezuelans still have reserves of almost \$14 bn. Meanwhile, oil exports in Q1 1986 averaged 1.35 mbd at \$18 pb, bringing revenue of \$2.2 bn, down 30% from the comparable period last year. The authorities have again ruled out voluntary cuts in production, preferring to defend market share rather than price.

16 Of the smaller countries, Peru's stance remains problematic. Relations with the commercial banks have deteriorated even further. At a meeting with the banks' Advisory Committee on 12 March, Central Bank President Figueroa restated an earlier promise by the Peruvian government to make a token payment to reduce interest

arrears on bank debt, and on 28 April a payment of \$18 mn was made. (The Peruvians also made a payment of \$16 mn to the US.) However, given that arrears currently stand at about \$400 mn, the banks remain unhappy at what they see as Peru's repeated prevarication in debt negotiations.

17 Following Peru's payment of SDR 30 mn to the Fund to reduce arrears, which currently stand at about SDR 97 mn, the IMF Board decided at its meeting on 14 April against an immediate declaration of ineligibility. After much discussion, and against the wishes of de Larosiere (who wanted a review in two months), a narrow majority, which included the US, UK, Germany and Japan, voted to adjourn the meeting only to 5 May, at which time they will vote for immediate ineligibility unless Peru has given an assurance that it will clear all arrears by mid-August.

18 Prospects for Colombia continue to look good. The report of the IMF Staff mission's visit in January/February has now been published. It confirms that the end-1985 targets under the enhanced surveillance agreement were amply met. Enhanced surveillance is to continue this year, and the Fund Board will discuss a staff report on Colombia's 1986 programme on 23 May. The second tranche (\$150 mn) of the World Bank's trade policy and export diversification loan was released on 27 March, thus enabling release of part of the \$1 bn commercial banks' loan. Signing of the banks' loan was completed on 5 April, and drawing of at least a part (\$350 mn) of the first tranche (\$515 mn) is expected in late May (after ratification of the loan by the Council of State); Colombia has indicated that it may not wish to draw the second tranche. On 15 April, the IBRD approved a \$250 mn trade and agricultural policy loan.

19 Bolivia is making slow and unsteady progress towards reaching agreement with the IMF on an adjustment programme. A second IMF Letter of Intent was signed at the end of March following a Fund mission to La Paz to investigate policy slippages since the previous Letter of Intent was signed in January. Bolivia's request for an SBA, reportedly of SDR 50 mn, is now scheduled to be discussed by the IMF Board at the end of May or in early June, with discussions with the Paris Club likely to follow some time in June. However, this timetable is dependent on the Paz administration succeeding in passing a tax reform package through Congress. The collapse of tin prices to less than half their pre-suspension levels is expected to reduce 1986 export revenue to no more than \$300 mn (compared with \$550 mn in 1985).

20 Chile's economic prospects for 1986 have been improved by the fall in oil prices. On 14 March there was a drawing of SDR 62.5 mn from the SDR 750 mn EFF,

followed by a \$150 mn drawing on the \$1,085 mn commercial bank loan on 27 March. The first contract of the multi-year rescheduling agreement was signed on 11 April, covering \$2.6 bn of the \$6 bn of public and private sector debt due 1985-89, to be rescheduled over 12 years, with 3 years' grace, at Libor + 1 3/8%. It is hoped to complete the MYRA by mid-June. Both the release of the third tranche of the bank loan and the next IMF disbursement, which should occur late May or June, are conditional upon the MYRA.

21 In Ecuador a commercial bank MYRA covering public and private sector debt due 1985-9 was to have been completed in February. The first part of the agreement, covering \$2.5 bn of public sector debt was signed in December, but agreement on the second part of the package, covering \$1.5 bn of private sector money, has been delayed; the Advisory Committee are now pressing for signature by end-May. The economic outlook has been very badly affected by the fall in oil prices; if prices remain around current levels, this could result in oil export revenue (\$1.9 bn in 1985, 64% of exports) falling by \$1/2 bn this year. The fiscal impact of lower oil prices has so far been minimised by greatly improved tax administration, as a result of which the collection of certain taxes doubled in January-February 1986 compared with a year earlier. Until recently the authorities maintained that the loss of oil income would not lead them to seek fresh finance; however, they now hope to receive \$600 mn in soft loans from foreign agencies and governments. Banks are meanwhile considering whether they could stretch their existing oil facility, and whether more money might be put up with the World Bank. A new SBA reported to be about SDR 130 mn is expected to be signed shortly, following on from the one-year SBA for SDR 105 mn which ended in March. The new programme was to be initialled by the Fund MD by 30 April; otherwise, the existing trade facility would formally expire and require a waiver.

22 In Uruguay the economy may be pulling out of its long recession. Following an upswing in late 1985, the authorities are seemingly on track for their 2% target growth for the year to end-June 1986. A \$45 mn IBRD co-financing loan for an energy project is expected to be signed soon with an IBRD guarantee for repayment of half the loan. Uruguay's bank MYRA, covering \$2 bn of debt due 1985-89, is also expected to be signed soon; debt is to be rescheduled over 12 years, with 3 years' grace, at Libor + 1 3/8%.

23 A Paris Club Task Force visited Cuba from 22-26 April. The Cubans indicated that 1985's foreign exchange deficit was about \$150 mn (\$110 mn more than indicated at the previous rescheduling last July), due partly to lower oil prices and sugar

prices. The deficit for 1986 is projected at about \$450-500 mn. To meet their financing needs the Cubans have told western creditors they require a rescheduling over 12 years of all principal and interest due on loans contracted before August 1982, plus either new money of around \$450-500 mn or additional reschedulings and a smaller new money loan. The Cubans have declared a moratorium on principal and interest payments (excluding short-term commercial debts and unguaranteed supplier credits) from 5 May, pending a satisfactory conclusion to negotiations within a 90-day period. The Paris Club is due to discuss the proposals at its next meeting, from 12-16 May, and discussions with banks may begin after that meeting. However, it is unlikely that either the Paris Club or the banks will respond favourably to the proposals; they are likely to insist on evidence that Cuba is ready to take action to cut its financing requirements or to obtain some assistance from its socialist allies. Meanwhile, the "new look" mission's draft report on Jamaica has been to the IMF, IBRD and US AID for comment, and the final version was taken by the mission to Jamaica on 17 April. The report apparently calls for "comprehensive economic adjustment measures" but is not specific about what these should involve. Assuming that the report is quickly agreed by the government, an operational summary will be prepared for despatch to donors in May, and will form the basis of discussions during May and June.

24 South and East Asia

Following significant breaches of performance criteria of the Philippines' existing IMF Standby (negotiated by the previous administration), the programme has now been abandoned. Instead, a new programme will be negotiated, which, when in place (perhaps by June), is then expected to release the remaining \$350 mn of new commercial bank lending, provided that the creditor banks agree to an extension of the drawdown period. At a meeting of the Advisory Committee on 15 April, Finance Minister Ongpin indicated that he, personally, did not support a selective repudiation of external debt, although parts of the Cabinet were in favour - as reported recently in the press. Ongpin also mentioned that some \$600-700 mn of aid may be forthcoming this year, and a further approach to the Paris Club to restructure maturities falling due after June 1986 can be expected.

25 Some banks now appear to be re-appraising Malaysia's credit rating, and an unfortunate comment reportedly made by Prime Minister Mahathir, that the country would be seeking to reschedule its debt next year, will not have not helped. The prospect of a rescheduling has subsequently been firmly denied, and Mahathir may have been referring to normal market refinancing. On the economic side, knock-on

effects from the weak commodity prices, especially for oil and palm-oil, could lead to negative growth this year, while the current account deficit may widen from \$1 bn last year to at least \$3 bn. The ringgit has depreciated by over 20% over the last six months. Nevertheless, the debt service ratio is only 14% at present and, despite increasing amortisation payments, should remain under 20% in the next few years. The position should therefore be sustainable, as long as confidence in the country is maintained. Indonesia has responded to the lower oil price by seeking to reduce public expenditure, but the authorities are still avoiding an outright devaluation of the rupiah. South Korea, by contrast, looks set for an excellent year. Growth of at least 8% is expected, and a current account surplus of around \$1 bn may be achieved. Both net external debt and the debt service ratio should fall.

26 Eastern Europe

Following the absence of significant progress in the talks between Poland and the banks' committee in Warsaw on 8 April, when the banks improved their rescheduling offer from 75% to 80%, the banks conceded further ground at a meeting in London on 28-29 April. They have offered to reschedule 95% of 1986 maturities over 4 years, to recommend a rescheduling of 90% of 1987 maturities also over 4 years (75% by rescheduling and the remaining 15% to be covered by an increase in the revolving trade facilities), and to extend the 1983 revolving trade credits by a further two years in order to take the Poles beyond the 1987 debt hump. While continuing to emphasise that there is no possibility of new money, the banks estimate total relief offered over the two years at \$2 bn. No further meeting is scheduled, but the banks have asked the Poles to respond before 10 June, the due date of their next major repayment. Meanwhile, the IMF Executive Board have endorsed the Membership Committee's recommendations (the US quietly abstained), and the draft resolution has been passed to the Board of Governors. Voting will close on 27 May, and it is intended that Poland should be admitted to the Fund in early June.

27 Yugoslavia initialled a three-stage agreement with official creditors in Paris on 17 April covering debt maturing between mid-May 1986 and end-1988. For the first stage, creditors have agreed to reschedule 85% of principal falling due between mid-May 1986 and mid-May 1987 over 9 years including 4 years' grace. There will be no formal IMF programme, but Fund staff will monitor economic developments and creditor governments will be able to require Yugoslavia to seek a Standby programme if performance deviates from planned targets. For the second stage, covering maturities from mid-May 1987 to end-March 1988, official creditors have

agreed to reschedule a smaller percentage of principal, the precise level to be decided at a later date. For the third stage, maturities until end-1988 are covered by a goodwill clause. The liquidity crisis in Romania remains serious: ECGD now report delays in payments, and arrears with the IBRD are accumulating fast. Romanian officials are currently in London for discussions with the banks, presumably about the country's financing gap ahead of the large payments due in mid-year. A \$275 mn credit for Hungary has been oversubscribed and may be increased. There is, however, some concern about Hungary's continued weak external performance, and a number of banks may be reluctant to increase their exposure to the country, particularly given the present low margins (Libor + 1/4%, rising to +3/8% after two years). The USSR is adjusting to the lower oil price through planning to reduce imports by up to a third, so as to restrict the amount of new borrowing it would otherwise require.

28 Southern Europe

In Greece the effects of the tight economic policy initiated last October are beginning to be felt, with a substantial fall in imports listed under the import deposit scheme, and a slight fall in the rate of inflation (to 24.4% in February). Following two small public sector loans in March, the Bank of Greece announced a \$300 mn 6-year syndicated credit in early April at a spread higher than that on a similar loan last year. The authorities remain confident that a reduction in the current account deficit from \$3.3 bn in 1985 to the target of \$1.7 bn this year will be met, as a result of the benefits from the oil price fall, higher revenues from the EC and an easing of pressure on the drachma.

29 Although the Portuguese government's programme of 'controlled expansion' is likely to result in a deterioration of the current account this year, lower oil prices are expected to limit the current account deficit to below \$300 mn. The continuing decline in the rate of inflation (year-on-year rate of 12.2% in March) recently prompted the authorities to reduce the discount rate by 1 1/2 percentage points to 17 1/2%. The 1986 budget, due to come into effect on 1 May, projects a decline in the budget deficit from 13% to slightly over 11% of GDP.

30 Africa

On 27 March a Nigerian delegation led by Finance Minister Okongwu met in London with a Steering Committee (co-chaired by Barclays, Banque Nationale de Paris and Citibank) representing commercial bank creditors. The Nigerians were seeking to

reschedule principal maturities covering 1986-89 over 10 years with five years' grace. This first meeting turned out to be largely a ground-clearing exercise and in the event the Nigerians requested and were granted a 90-day standstill on principal repayments of public debt with an original maturity of over 12 months. The Nigerians made it clear, however, that they would be seeking a formal rescheduling of both commercial and official debts (the latter to cover interest as well as principal). At a meeting on 17 April between the Nigerians and a Paris Club Contact Group, creditor countries refused to agree to a standstill on repayments of official debt, and continued to stress the need for the prompt conclusion of a Standby arrangement with the Fund as a pre-condition for rescheduling. Such an arrangement now looks more likely following Okongwu's statement at the Paris Club in which he indicated that the Nigerian authorities were ready to talk to the Fund, and that they were prepared to move on the crucial question of the exchange rate. This came as a surprise to creditor governments (and to some members of the Nigerian party). The World Bank, which seems to have taken the lead in drawing up an adjustment programme, gave a strong measure of support at the Paris meeting for Nigeria's commitment to adjustment. It seems, however, that any agreement with the Fund would take the form of an "empty programme", whereby a letter of intent would be signed but no money would actually be drawn, in order to assuage opposition within Nigeria to the use of Fund resources. A further meeting between the Nigerians and the banks' Steering Committee took place on 23 April, at which the banks continued to stress the importance they attached to linkage with the Paris Club and thus with the IMF. The Steering Committee also appointed an economic sub-committee which is due to visit Lagos shortly. Their report is likely to form the basis of the next full meeting due to be held on 11-12 June in New York, at which the IMF and the World Bank will be present.

31 Although economic prospects have improved somewhat, mainly as a result of lower oil prices, Morocco has encountered further difficulties in its negotiations both with commercial bank creditors and the IMF. Significant differences have emerged over the terms of a 1985-7 rescheduling package with the banks, notably over Morocco's request for new money, and a further meeting between the Moroccans and the banks' steering committee is not envisaged until the end of May at the earliest. An IMF mission in early April was once again unable to complete the first review of the current Standby, and substantial arrears to the Paris Club remain. But a further IMF mission is planned in early May, with the aim of agreeing a programme for 1986 for possible submission to the Executive Board in June. After originally seeking a loan of \$500 mn, Algeria succeeded in concluding a borrowing of \$300 mn on

fine terms (LIBOR + 3/8% over 10 years), but very largely with only Japanese banks participating. The Algerian State Bank for Agriculture and Rural Development is now seeking a further borrowing of \$300 mn, of shorter maturity (eight years) and on terms less favourable for Algeria (LIBOR + 1/2% for the first 5 years falling to 3/8% thereafter). The Planning Minister has said that Algeria will seek substantial borrowing over the next three years rather than drastically cut its development plan. At the same time, a series of austerity measures is to be introduced, which is expected to include cuts of 11% and 26% in the 1986 current and investment budgets respectively and some, as yet unspecified, reductions in import quotas, commodity subsidies and travel allowances. Greater flexibility is being shown in respect of the renegotiation of maturing long-term export contracts for natural gas, which will reflect market prices rather more closely.

32 In Egypt the outlook for foreign exchange earnings, already bleak in the wake of falling oil prices, has deteriorated further following Iraq's recent decision to restrict emigrants' remittances (hitherto a valuable source of hard currency). The Egyptian government has continued to introduce minor economic measures in a piecemeal fashion, but has yet to embark upon the major reforms sought by the IMF. Although there have been several IMF missions to Cairo, and the Governor of the Central Bank of Egypt has had talks in Washington about a possible Standby, agreement on an appropriate programme now seems unlikely before the end of the year. Routine Article IV discussions were due to begin at the end of April. The Egyptians are now lobbying G7 countries, in advance of the Tokyo Summit, to support - and help finance - the establishment of a \$25-30 bn Middle East Development Fund (originally proposed by Israel and since taken forward by the US). The Egyptians regard this as a response to the problems caused by falling oil prices and a way of alleviating their debt repayment difficulties. It is however far from certain whether the proposed fund will get off the ground.

33 After extensive discussions with the banks' technical committee, South Africa's debt rescheduling has now been agreed in principle, and the proposals have been circulated to all creditor banks; so far, only about one third of the banks have accepted them. There have been reports that some banks (possibly Swiss and Italian) are prepared to accept an option of a rollover of released funds: as a result, it seems likely that rather less than the estimated \$420 mn due on 15 April under the 5% down-payment will actually have been paid. Following the recent elections in Sudan a moderate coalition government will assume office on 6 May, but the rebellion in the South continues. In the recent IMF Article IV discussions, emphasis was once again placed on the urgent need for Sudan to adopt an effective

set of adjustment measures and eliminate arrears to the IMF (to which it is the largest single debtor). But the prospects for early or decisive action are remote. At a critical stage in the country's adjustment process President Kaunda has appointed a completely new economic team in Zambia, including the replacement of the widely respected Finance Minister Mwananskiku. The former team had won the confidence of western donors, and its replacement has been greeted with suspicion by the banks. The government has stated that there will be no change of policy, but this remains to be seen.

34 Middle East

Although Iraq's oil production has continued at a level well above its OPEC quota, revenues have been depressed by the low oil price. Rescheduling talks with official credit agencies in both India and West Germany have recently broken down. The authorities have introduced new austerity measures, including even tighter restrictions on emigrant remittances; and 720 day credit is being sought on a range of imports.

INDEBTEDNESS AND BRITISH EXPOSURE

\$ billion
ECGD
amounts
at risk

	Total external debt	British-owned banks' exposure [1]	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(0.1)	0.2	0.2
Brazil	100	5.8(0.9)	0.9	1.8
Chile	20	1.2(0.1)	-	0.1
Colombia	14	0.5(0.1)	-	0.2
Ecuador	8	0.5(-)	0.1	0.1
Mexico	98	5.7(0.3)	0.6	1.3
Peru	14	0.3(-)	0.1	0.1
Venezuela	38	1.9(-)	-	-
<u>Far East</u>				
Indonesia	36	0.7(0.2)	0.8	1.6
Philippines	27	1.2(0.1)	0.2	0.2
South Korea	46	2.1(0.4)	0.4	0.8
<u>Eastern Europe</u> (convertible currency)				
Hungary	11	0.4(-)	-	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	1.2(0.2)	0.2	0.3
Portugal	16	1.0(0.2)	0.2	0.3
Turkey	22	0.3(0.2)	0.2	0.6
<u>Africa</u>				
Egypt	40	0.3(0.3)	0.4	0.9
Morocco	14	0.1(-)	0.1	0.2
Nigeria	19	1.0(0.1)	2.0	3.2
South Africa	22	3.6(0.7) [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] Because of deconsolidation of subsidiaries which are no longer majority owned, the data shown from end-June 1985 is not compatible with those previously shown.

* current estimate