

CONFIDENTIAL

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1 August 1986

Dear Charles,

INTERNATIONAL FINANCIAL SCENE

I enclose the pre-holiday edition of our regular report on developments in the international debt scene. The most important concern Mexico, which our last report identified as likely to set the tone for other debt negotiations.

The outcome and timing of current negotiations on a package of financial assistance for Mexico, worth some \$12 billion, remain uncertain. Our assumption is that the Managing Director will want to seek Board endorsement of the IMF Standby Agreement in early September before the Fund/Bank meetings and will want assurances of support from the commercial banks before then. It remains to be seen whether support will be forthcoming on the scale demanded. The signature of the Letter of Intent by the Mexican Government has been greeted with relief though there are considerable doubts in at least two areas about the nature of the agreement. It is too early (in advance of the IMF Staff appraisal) to reach firm conclusions about the measures proposed by Mexico. Despite the US Government's public enthusiasm some aspects seem weak. Indeed, its long term viability is in doubt except on the assumption of an increase in the oil price to at least \$14-15 a barrel. Second, the agreement contains some novel features, in particular the provision for additional financing if oil prices fall (and conversely reduced financing if they rise) and access to further loans for capital expenditure if growth falls below 3-4% per annum in 1987. Even if the conditionality - which looks distinctly generous - attached to these proposals is acceptable in the case of Mexico, it seems inevitable that the precedent will be seized on by other countries eg Nigeria and Egypt in the hope of avoiding or deferring unpalatable adjustment.

As far as the general outlook is concerned, the Mexican Letter of Intent is undoubtedly a favourable factor (despite the doubts



expressed above) in terms of handling the debt problem and isolating those, like Peru, who are taking a confrontational path. This needs to be seen against a slightly worse outlook on the economic front. Both the Treasury and Bank summer reviews of debtor countries' economies emphasise that recent developments, in particular the fall in oil prices, have increased the heterogeneity of the debt problem and complicated its handling. It is doubtful whether the gains to oil importers will reduce their borrowing as much as the losses to oil exporters increase theirs. In the last few weeks oil prices have continued to fall whilst other commodity prices have also fallen heavily (almost 9% in SDR terms with large falls for food prices); the fall in interest rates has been limited and growth in industrialised countries sluggish. The Bank's report picks up the issue of agricultural subsidies and protection emphasised in the IBRD World Development Report.

On other individual countries, the political log jam in Nigeria appears to be moving in the right direction. The picture should become clearer when an IMF mission returns at the end of next week, provided that the question of South Africa does not intrude. In Latin America Brazil has continued to perform strongly on the external front but the Government has announced two sets of measures in June and July in response to an acceleration in the rate of inflation. Peru seems unlikely to clear its arrears to the IMF by the 15 August deadline but the resulting declaration of ineligibility by the Fund seems unlikely to provoke any dramatic response from other lenders eg the commercial banks. In Eastern Europe there are signs that Yugoslav commitment to adjustment is weakening, possibly leading to a breach of the targets built into the enhanced surveillance underlying the debt rescheduling arrangements.

The next report will come forward in mid-September and will provide an opportunity for a considered look at the debt scene and individual countries in advance of the autumn IMF and IBRD annual meetings.

I am copying this letter to Tony Galsworthy (FCO), Tim Walker (DTI) and John Footman (BOE).

*Yours
Alex*

A C S ALLAN
Principal Private Secretary

TO be Attached to HMT to CDP 1.8.86
International Financial Scene
(Letter in Box 1.8.86) but CDA
didn't want this to go in)

INTERNATIONAL FINANCIAL SCENE

1 On 22 July Mexico signed an agreement with the IMF, designed to be the first stage in the country's attempts to put together a financing package of some \$12 bn over the next 18 months. With the outcome of the Mexican negotiations likely to dominate perceptions of the overall debt situation for some time to come, news of the agreement will have provided a measure of reassurance, although some doubts remain about the nature of the agreement. With Mexico's financial position deteriorating rapidly - the trade surplus for the first four months of the year was less than \$1 bn, compared with over \$3 bn and \$5 bn for the corresponding months of 1985 and 1984 respectively, and with interest payments of \$600 mn falling due each month - rapid conclusion of the negotiations was essential. The Fund agreement includes some novel features, including the provision that if oil prices fall below \$9 pb Mexico will receive additional financing from the Fund and other creditors; conversely, if prices rise above \$14 pb, external financing will be reduced. Emphasis on linkage with IBRD loans, and on providing for growth in Mexico from 1987, maintains the thrust of the Baker Initiative, and should facilitate presentation of the agreement domestically in Mexico.

2 With some time to go before Fund money is likely to be disbursed, Mexico's immediate financing needs may be covered by a \$1.5 bn bridging loan probably involving the US authorities, the BIS, other central banks and the commercial banks. In response to a request from de Larosiere, the Bank of England has agreed to participate in the bridging loan (HMT would give the Bank an indemnity). But a major outstanding uncertainty over all these arrangements is how the 500 commercial banks involved will react: at a meeting with the Advisory Committee in New York on July 23 and 24, banks were asked to provide around \$6 bn of new money over the next 18 months, and some were asked to participate in the bridging loan. So far they have expressed a cautious welcome for the Fund agreement, but have indicated a number of reservations over the proposed bridging loan. At the Advisory Committee meetings a Working Party under Sam Cross of the Fed was established to resolve the bridging finance issues. Negotiations may well be difficult.

3 Whilst Mexico has been working towards agreement with the Fund, Venezuela has incensed commercial banks by its unilateral restructuring of \$6.9 bn of private sector debt. Law 33506, passed by the Venezuelan Congress on 5 July, provides for the swap of private sector debt into 15-year dollar bonds with a 5% coupon; if

implemented, this law would effectively halve the value of affected debt. Bankers are deeply concerned that the Venezuelans would seek to extend such a restructuring also to the public sector, and that other countries might follow Venezuela's unilateral example. Some US banks are variously reportedly as threatening, in retaliation, to call all Venezuelan debt into default, to cut all lines to the country, or to institute proceedings to seize Venezuelan assets; the Fed is reported as intending to classify all loans, public and private sector, to Venezuela. However, after intensive representations, Finance Minister Azpurua has now said that he will try to have the law amended. The Venezuelan Congress will meet in special session in August to review changes in the plan, but the outcome remains uncertain.

4 The economic background to the Mexican and Venezuelan developments has been one of continued deterioration in oil-exporters' prospects, although for a number of other debtor countries prospects have been significantly improving. The renewed slide in oil prices in mid-July to below \$10 pb, and the diminished prospect of an early OPEC agreement which could lead to a significant rebound in prices, worsened the already bleak economic prospects facing many oil exporting debtor countries. A number of other commodity exporters - such as Argentina and the Philippines - also face some deterioration in prospects: in the six weeks to mid-July commodity prices fell heavily (by 8.9% in SDR terms, 6% in \$); within this, food prices fell over 10%, with falls of almost 30% in sugar prices and around 20% in wheat and maize prices, resulting in part from expectations of record world grain harvests. Food prices are now overall about 17% below their 1985 Q4 levels in SDR terms (10% in \$); with non-food commodities having fallen by about 10% in SDR terms over this period, prices overall (as measured by the Economist all-items index) are 13% in SDR terms (6% in \$) below their level at the end of last year.

5 Benefits to output in industrialised countries from the falls in oil (and other commodity) prices are coming through more slowly than expected. In the United States industrial output fell by 0.5% in June following a fall of 0.4% in May. GNP growth in Q2 is put at 1.1% ar (although the first quarter rate has been revised up to 3.8%). The Federal Reserve has revised down to 2 1/2%-3% its expected growth rate for the US economy for the year. GNP fell in Japan and Germany in Q1, although more recent indicators suggest performance now is more buoyant.

6 The continued fall in the dollar has been providing at least a partial palliative to many debtors: it fell by over 5% between the beginning of June and 29 July, to stand 10% (in effective terms) below its level at the beginning of the year and almost 20% below its level at the time of the Plaza agreement. Moreover,

as a result of relatively depressed economic performance, and no apparent immediate resurgence in inflation, interest rates have resumed their downward movement. The Fed discount rate was cut from 6.5% to 6.0% from 11 July (although this was not followed by moves in Germany and Japan), and three-month eurodollar rates are again near their lowest levels of the year, slightly above 6 1/2%. However, taken in conjunction with falling prices for their exports, and expectations of little revival of prices in the near future, real interest rates for many debtors continue extremely high.

7 Of renewed concern to debtor countries is the recent identification in industrial countries, particularly in the United States, of increased agricultural export volumes from LDCs (often as part of IMF or IBRD programmes) with depressed prices, and financial problems, for domestic farmers. With increasing US questioning of support for bilateral and multilateral loans to promote agricultural activity in debtor countries, the risk of increased protection against agricultural products from these countries is rising. The IBRD's World Development Report, published at the end of June, emphasised the need for LDCs to introduce measures to support agricultural development (as well as for industrialised countries to reduce costly subsidies); but falling world prices, and protectionism in industrial countries, will make LDCs' adjustment more difficult to achieve.

8 Leaving aside Mexico and Venezuela, developments regarding other oil exporters remain mixed. On 11 July the Fund Board discussed Nigeria's adjustment programme, which includes proposals for the introduction of a two-tier exchange rate in October, as a means to facilitate a naira devaluation. Although the Nigerians requested Colombian-style monitoring at the Board discussions, they seem to be moving towards accepting a "classical SBA" (ie SBA without necessarily making any drawings). Ecuador has now asked the Fund for a CFF, in addition to its SBA, in order to compensate for its oil export shortfall, and it seems likely that this will be approved next month. Although Ecuador's good relations with the Fund over the past few years are being emphasised as a justification for granting the CFF, this CFF may set a precedent for other oil exporters (Indonesia has already expressed some interest). On the other hand, whilst Egypt has declared itself prepared to begin serious negotiations on a Fund programme, it is far from certain that the country is willing or able to undertake the kind of drastic adjustment which the Fund is likely to require. Peru has now extended for a further year its restriction of debt-servicing payments to 10% of its exports, and has further tightened this policy by including \$2 bn of private sector debt within this limit for the first time, and by introducing curbs on remittances of profits and royalties.

9 Amongst the oil importers, external prospects for Korea and Brazil continue to improve - although doubts are emerging over the success of the Cruzado plan in breaking Brazilian inflation in the longer term. In response, the Brazilian authorities have introduced further measures to reduce consumer spending and raise fiscal revenues, and are also taking steps to control the spending of the parastatals; in the meantime the June trade surplus - at \$1.08 bn - was a record for the month, and last year's total surplus of \$12.4 bn now looks likely to be exceeded.

10 The declaration of the state of emergency, and the increase in social unrest, have further depressed economic prospects for South Africa. With the imposition of measures of some sort against South Africa looking increasingly likely, there is clearly some possibility that the South Africans will at some stage undertake some retaliatory action on servicing their debt. However, it seems unlikely that this would lead to similar behaviour by other significant debtors.

11 Since the beginning of June, borrowing in the international markets by developing countries (apart from Hong Kong) has been very limited, totalling only \$335 mn. South Korean borrowers raised only \$40 mn, after raising \$800 mn in the previous six weeks (and after withdrawing from a proposed \$500 mn loan when they decided to reduce their new borrowings and to seek finer terms). Banco Itau of Brazil has arranged a euronote/commercial paper facility for \$50 mn; its spread of only 1/4% above LIBOR resulted from the backing of the issue by a letter of credit from Fuji Bank. For East Bloc countries only the UK based Moscow Narodny bank was active in the markets in this period. Its \$100 mn facility with euronote, revolving credit and multicurrency advance options, is the first such for a Soviet name. Among East Bloc borrowers only Hungary has previously used euronotes. Algeria was the only Arab oil producer to borrow in the international markets in this period, with a DM 200 mn (\$90.7 mn) fixed rate bond.

Further details on individual countries are given below.

Latin America

12 Mexico signed a Letter of Intent to the IMF on 22 July, thus opening the way to an SBA involving SDR 1.4 bn over 18 months. The programme has several exceptional features: it envisages "moderate" growth in 1987, with a trigger mechanism for additional external finance if by Q1 1987 manufacturing production has not grown at a predetermined rate; it accepts the operational deficit (ie the fiscal deficit

with the nominal component of interest payments taken out) as a performance criterion alongside the fiscal deficit as conventionally defined; and it introduces a formula whereby programme targets will be adjusted in response to any changes in the oil price from pre-determined levels, and more (less) external finance will be sought if the price falls below \$9 pb (rises above \$14 pb). If the price falls to \$5 pb, Mexico could be eligible for an additional \$2.5 bn under this formula, half from the Fund, and half (it is hoped) from the banks. Mexico has proposed measures to reduce its fiscal deficit by 3% of GDP over 1986-1987 and will continue policies of rationalising parastatal enterprises and further trade liberalisation, and will improve procedures for approving foreign investment. The Fund finance is part of a total 18-month financing requirement of \$12 bn, which will include World Bank loans (perhaps \$2 bn) related to trade policy reform and industrial reorganisation, financial support from foreign governments, and (it is hoped) \$6 bn of financial assistance from commercial banks. Mexico met the bank Advisory Committee plus other key banking representatives in New York on 23 and 24 July when an initial outline of its financing proposal was presented. It is likely that negotiations with the banks will be difficult, as there are indications that certain groups of banks are reluctant to participate in new lending to the country. For its part, the World Bank Executive Board approved loans to Mexico totalling \$700 mn on 29 July (release will be subject to assurances that an adequate financing package will be obtained for 1986). De Larosiere told G10 Fund Directors on 28 July that Mexico needed a Paris Club rescheduling by September and needed a positive response from major creditors to continuation/resumption of cover after the rescheduling. He suggested that the SBA might come to the Board for approval (in principle) in the week beginning 8 September. In the interim period, while the financing package is being developed, de Larosiere had already proposed that a bridging loan be provided (of at least \$1.5 bn), probably by the US authorities, central banks (including some Latin Americans) and commercial banks. However, the Mexican Finance Ministry's alternatives of incurring interest arrears or creating interest deposits in pesos cannot yet be entirely ruled out. Net reserves have fallen sharply in recent months, and reports suggest that the Mexicans are unwilling to see them decline much further; monthly interest payments are believed to be some \$600 mn.

13 By contrast, the situation in Argentina has been relatively quiet since the Fund approved the request for a waiver on 23 June. The waiver opened the way for the final SDR 236.5 mn tranche of the SBA to be drawn on 27 June and this was followed on 30 June by the banks releasing the remaining \$600 mn from last year's new money package. The next step will be to complete negotiations for a new SBA. But, with Argentina already having agreed targets for certain key indicators in the second

half of 1986, in order to obtain the waiver, the discussions over the new SBA appear to be progressing at a somewhat leisurely pace, perhaps as participants await the resolution of the Mexican situation. As a condition of the waiver conditionality, the Argentinians also agreed to pay off arrears to the Paris Club. Once this has been completed, and outstanding bilaterals (including the UK's) are signed, the way would then be open for a resumption of Paris Club discussions; September is the earliest date such talks are likely to begin, although October or November seem more realistic.

14 On the economic side, inflation in Argentina remains relatively high, at around 4 1/2% per month. Whilst the authorities have been re-iterating that their target for the year remains under 30%, achievement of this figure would require a considerable reduction in the average monthly rate - to around 1 3/4% - for the remainder of this year from the levels attained since the Austral Plan was introduced a year ago. With the initial wage/price freeze now being relaxed, this seems most optimistic. Recent trends in economic growth have been favourable: real GDP showed a small rise in Q1 1986 (after a buoyant Q4) and industrial output in June 1986 is put at around 13% higher than when the Austral Plan was introduced. However, recent renewed falls in grain prices may have damaged external prospects.

15 Brazil has continued to perform strongly on the external front. Its trade surplus in June was a record for the month. The surplus in the first half of the year was \$6.15 bn, over \$0.6 bn up on a year earlier, and last year's total surplus of \$12.4 bn seems likely to be exceeded. Nevertheless, some doubts are emerging about the durability of the Cruzado Plan. In May the inflation rate was 1.4%, about one percentage point higher than the government forecast, and this was followed in June by a rate of 1.3%. The acceleration in inflation since the trough levels earlier in the year has been largely attributed to the recent consumer boom, which has led to shortages of many commodities. In response, the government announced a set of measures at the end of June intended to cut total consumer credit by about Cz 9 bn (\$654 mn). Nonetheless, the Central Bank has suggested that the 1986 PSBR may be as high as 8.6% of GDP, compared with last year's 3.2% and an original forecast for this year of 0.5% (although this is still unverified by the government). In a further move to dampen demand and increase fiscal revenue, President Sarney announced on 23 July a package of measures designed to raise up to Cz 350 bn (\$25 bn), largely through compulsory loans from consumers. The revenue will also contribute towards the financing of a three-year development plan reportedly aimed at raising per capita GDP to \$2000 in 1990 (\$1634 in 1985). The package is, however, likely to incur opposition from a number of quarters. ,

Signature of the \$31 bn 1985-86 rescheduling agreement took place on schedule on 25 July, but there are no details as yet about the number of banks signing. Meanwhile, the Finance Minister, Dilson Funaro, has announced that Brazil will be seeking new money or refinancing packages in 1987-1988 so as to limit the country's net payment of interest on external debt to 2-2.5% of GDP in each year. It seems that this represents an opening negotiating stance for the discussions with the banks which are due to begin in the autumn, rather than any threat of unilateral action. Meanwhile, Banco Itau has announced that it has arranged a \$50 mn euronote/commercial paper facility, backed by a letter of credit from Fuji bank, which will enable it to issue paper in both the US and Europe. The financing is the first of its kind involving a Brazilian bank since mid-1982 and is designed to extend the maturity of its existing interbank lines from the current one year to three years.

16 The signature date for the 1985/86 rescheduling was brought forward from 15 August to 25 July in an effort to encourage recalcitrant banks to agree to the terms of the deal. A number of banks are expected to hold back because of the failure to settle the dispute relating to Resolution 63 loans of three banks which failed last year. A creditors' committee has been negotiating with the failed banks' controlling shareholders but, before proposals can be put to the creditor banks, an audit appraisal of the assets of the banks in liquidation must be completed. The Central Bank has advised the creditor banks that it will make every effort to achieve a solution in the shortest possible time.

17 On 17 July, perhaps in response to criticisms in the recent IMF Article IV paper, the Venezuelan authorities announced a 21 point austerity plan - including the abolition of the preferential exchange rate for private debt repayments - aimed at compensating for the loss of 30-40% of fiscal revenue this year resulting from the weakness of oil prices. The authorities have, however, angered the commercial banks by passing legislation at the beginning of July intended unilaterally to re-reschedule payments on \$6.9 bn of private debt (already rescheduled over 7 years at Libor +1.25%). Under this legislation the current foreign exchange contracts between debtors and the Central Bank would be replaced by Central Bank bonds, with a minimum term of 15 years and a maximum interest rate of 5%, issued directly to creditors. The banks, while willing to concede some ground on private debt repayments, have refused to accept the new scheme and some (mainly US) banks have suspended credit lines to the country. Following meetings between the Advisory Committee banks and the authorities, it has been announced that the Venezuelan Congress will meet in special session in August to review changes in the plan. Although the outcome is uncertain, the legislation has been unhelpful both

for banks' negotiations with Venezuela and for the precedent it may be seen to set for other debtor countries. Negotiations with the commercial banks over the possible rescheduling of the MYRA - the \$750 mn down payment on which has yet to be made - have not yet begun.

18 Elsewhere in the region, Peru has extended for another year its limit of 10% of exports for servicing medium and long term public sector debt, and is now including also \$2 bn of private sector debt within this policy; remittances of profits and royalties are also being curbed. It is looking increasingly unlikely that the country will clear its arrears to the IMF by the 15 August deadline; Foreign Minister Allan Wagner said recently they would not be eliminated even by the end of the year. A further partial payment is likely to be the best the Peruvians offer; if so, a declaration of ineligibility by the Fund looks unavoidable. Moreover, as its conditionality is being breached, the IBRD is already delaying disbursements on some of its loans. Yet the government's own perception of the economic outlook remains favourable. Recent official forecasts put the growth in industrial production (which accounts for around one quarter of GDP) at 12% for this year - which would be the highest for a decade. Growth in the first five months was said to have almost achieved that rate. Inflation has fallen over the past year from 200% to 70%. Meanwhile, the political background continues to deteriorate. The recent escalating confrontation with the terrorists increased speculation about the possibility of a military coup, but Garcia appears to have averted this threat - at least for the time being.

19 By contrast, several other countries are making good progress in their negotiations. For Bolivia the IMF Board meeting on 19 June approved a 1-year SBA for SDR 50 mn (55% of quota); this was followed by agreement in principle being reached with the Paris Club on 24 June to reschedule \$430 mn of arrears and all debt service due to mid-1987: \$190 mn of principal and interest in arrears at 30 June 1986 were extended over 10 years (4 grace) and \$224 mn of debt service due July 1986 to June 1987 were rescheduled over 10 years (6 years grace). Bolivia is expected to seek similar terms on commercial bank debt (\$900 mn plus about \$200 mn interest arrears) in negotiations next month. The possibility of a CFF seems to have receded. In Chile all the economic indicators - domestic and external - are on track. On the basis of the recent Article IV Mission the Fund are confident that growth of 4-4 1/2% for the year is a realistic expectation; and annual inflation is now down to 20%. On the debt front, the debt/equity scheme continues to prove attractive (it is said to have reduced outstanding debt by some \$500 mn). However, the political situation continues to give grounds for concern, with attention focussing increasingly on the country's political future after the 1989 elections.

20 Colombia has still not drawn the first tranche of its \$1 bn new money loan, despite having stated that a drawing would occur by end-June. The external situation clearly remains strong and reserves rose by \$0.6 bn in the first half of the year. Ecuador's request for an SBA (SDR 75 mn) is set to be discussed in the Fund Board on 4 August, along with the country's request for a CFF. If granted, the CFF will be the first such loan largely to cover a shortfall in oil earnings, and might be seen as a precedent by other oil exporters - although the justification for granting Ecuador the CFF rests heavily on Ecuador's good relations with the Fund over the past few years. Activation of the Paris Club MYRA continues to be deferred, pending the approval of the new SBA, but progress continues on syndicating the bankers acceptance facility (estimated at between \$150-\$200 mn). The authorities have indicated that they may request a waiver on Ecuadorean counterpart funding for bilateral aid projects (including those with the UK) to help meet the balance of payments shortfall. In Uruguay the authorities signed the contracts for rescheduling \$1.7 bn of bank debt due 1985-9 on 10 July.

21 In Costa Rica, an IMF team has prepared a draft Letter of Intent for consideration. The World Bank, for their part, are satisfied with recent measures to reduce subsidies and import surcharges, and have released \$40 mn from the SAL thus allowing USAID to release an equal sum. Although some interest arrears to banks have been cleared, Costa Rica remains technically in default on its debt to the banks. Cuba imposed a moratorium on medium and long term debt service obligations from 1 July. However, the Cubans provided the Paris Club with revised projections of the 1986 balance of payments which show a reduced new money requirement, and met the Paris Club on 15 July, when agreement on a rescheduling package was reached. However, no agreement was reached with the banks at the meeting with the Steering Committee on 18 July; a further meeting will be held in early August. Unconfirmed reports suggest that the moratorium on debt service has been extended to cover short term debts from mid-July. Jamaica's relations with the Fund continue to deteriorate. Fund Staff visited Jamaica in mid-July and will probably suggest suspension of the current SBA and the negotiation of a new programme. Meanwhile, the question of arrears to the IMF (which have risen to SDR 49 mn) was considered under the Fund's complaints procedure on 23 July. Given that arrears on Nicaraguan debt were more than two years overdue on 1 June, the World Bank agreed on 24 June to make provisions (in the accounts for the year ended June 1986) against 20% of the total loans outstanding to the country - the first time such provisions have been made. Nicaragua has since promised to pay the amounts overdue beyond two years (\$1.9 mn), but with no indication of timing. If this payment is forthcoming before the Bank's accounts are audited in late July, the provision will be eliminated; it now seems, however, that no payment will in fact be made.

22 Discussions in the Inter American Development Bank on the Seventh Replenishment of Resources, which will finance lending over 1987-1990, are making some, albeit rather slow, progress. The Board of Governors met in Paris from 16-18 July to continue negotiation on the size of the Seventh Replenishment and the details of proposed organisational changes; a further meeting is due in September.

South and East Asia

23 An IMF team is in the Philippines to discuss a new Standby programme. The government is pressing for some relaxation in targets, particularly on the monetary front, as previous targets are seen to have contributed greatly to two years of GDP decline and loss of business confidence. On the fiscal side, following pre-election spending by the Marcos administration, the deficit in 1986 is in any case running well above the original IMF target. Whilst it is generally thought that the IMF will be prepared to agree to some relaxation, they are also likely to press for a reform of the tax system. The authorities have already announced a series of import liberalisation measures with which the IMF team is reported to be satisfied. A letter of intent is expected to be signed shortly. Once a new programme is in place, the government is likely also to attempt to renegotiate and extend the terms of its debt rescheduling agreement with the banks. The Economic Planning Minister periodically talks of selective debt repudiation but it seems that this concept does not receive widespread support within the Cabinet.

24 In Indonesia the latest trade figures indicate that the full impact of the oil price fall has yet to be felt. In the first quarter there was actually an improvement in the merchandise trade account, with a surplus of \$3.4 bn (\$2.8 bn in Q1 1985); export receipts fell marginally to \$4.7 bn (\$4.4 bn) whilst import payments were cut more dramatically, to \$1.3 bn (\$1.6 bn). The South Korean economy continues to expand strongly; real GDP growth this year is now expected to be in the range of 9-10%, with the trade account moving into a surplus of \$1.4 bn, following a deficit of \$30 mn in 1985. The government is consequently considering reducing its external borrowing programme this year, by at least \$500-600 mn, from an original \$5.7 bn. Meanwhile, in their report on the 1986 Article IV consultation with Malaysia, IMF staff have suggested that the size of the public sector deficit (17% of GDP) and the weak balance of payments outlook for 1986 and the medium term were most disquieting, and noted that they viewed with concern the prospective increase in the country's external debt burden which could ensue; they therefore urged the Malaysians to persevere with intensified fiscal adjustment and more active use of exchange rate policy to bring about a depreciation of the

ringgit. Prime Minister Mahathir has called a general election for August 3; when this is out of the way, there may be less pressure to delay taking the suggested remedial actions.

25 India recorded a particularly weak trade performance in FY 1985/86 (ended March). The trade deficit increased to \$6.8 bn from \$3.8 bn in the previous year, with exports registering a 10% fall in value terms and imports an 11% rise. If exports fail to pick up soon, Rajiv Gandhi's drive toward greater industrial deregulation and import liberalisation may be called into question, particularly if (as seems inevitable next year) the debt service ratio breaches the 20% ceiling which the government sees as a maximum safe level.

Eastern Europe

26 At the meeting between the Paris Club and Poland on 17 July, set up for the Poles to explain why arrears had been building up on payments due since January, the Poles requested a re-opening of the rescheduling agreement initialled in March, to give further relief of \$500 mn, and also requested new credits. The Poles claimed this was necessary as their forecast trade surplus for 1986 had been revised down by \$200 mn, and the banks had refused to provide new credit, while IMF loans would not be available until mid-1987 (at the earliest). Although the Poles appear to have made most payments due in January, creditor governments expressed disappointment at the Poles' request, and refused to re-open the March agreement. The Poles were expected to seek further relief from other creditors, including the banks, but the possibility of another Paris Club meeting later in the year was kept open. Subsequently, the Chairman of the Paris Club met the co-Chairmen of the banks' Working Party to discuss burden sharing; however, it seems unlikely that the banks will be willing to do anything further this year at least.

27 On the other hand, following discussions with the banks in London on 7-8 July, the Romanians have reached an agreement which should effectively relieve their current liquidity crisis and permit some recovery in reserves (although much will depend upon the settlement of arrears with the IBRD, and continued disbursement of official credits and renewed supplier credits). The banks agreed to reschedule 100% of 1986 maturities under the 1982 agreement (\$354 mn) and 85% of 1987 maturities arising from the 1982 and 1983 agreements (\$456 mn relief). Each payment due under the original agreement will be made in two instalments on a rolling maturity basis beginning May 1989. The margin has been reduced to Libor +1 3/8% compared with Libor +1 3/4% under the earlier agreements. The banks showed some flexibility in concluding these arrangements without insisting on parallel

action by the Paris Club or on an IMF programme (which could have created an impasse, given the Romanians' past and prospective lack of cooperation with the Fund).

28 Economic results in Hungary for the first five months of the year indicate a further deterioration in the country's external economic performance. The hard-currency deficit increased to the equivalent of \$430 mn, compared with \$183 mn in the corresponding period last year, following increases in imports of 14.5% and of exports of only 1.1%. Industrial production has risen only 1.2% (cf a target for the year of 2 to 2 1/2%). With no sign of any reversal in these trends, there are growing prospects that the country may be forced to seek IMF assistance. On present trends the convertible-currency current-account deficit this year may be in the region of \$1 bn, which could seriously undermine market confidence. Meanwhile, there is some concern about extent of the new Yugoslav Government's commitment to policies introduced during IMF programmes, and there are increasing doubts about the country's underlying cash-flow position: even assuming a recovery in the current account surplus to \$0.9 bn, and the raising of \$0.8 bn supplier credits, there is still a prospective financing gap in 1986 of close to \$0.5 bn, after allowing for the implementation of the bank and official reschedulings. If the banks, who have yet to be approached, decline spontaneous financing, it seems likely that additional rescheduling - of already rescheduled and/or of hitherto privileged debt or interest - and/or a new round of export credit pledges will have to be sought before the end of the year.

Southern Europe

29 Although the austerity programme introduced last October has begun to have an impact on performance in Greece, with falling inflation and public expenditure restraint, the current account deficit reached \$1.2 bn in the first four months of 1986 against a \$1.7 bn annual target. The most recent borrowing on the international capital markets - a small \$43 mn ten-year syndicated loan for Olympic Airways at LIBOR +3/4% - saw a worsening of terms compared with earlier loans.

30 Partly as a result of lower oil prices, the Portuguese authorities have increased their 1986 projected current account surplus to \$0.7 bn (3.6% of GDP); this compares with a surplus of \$0.4 bn (2% of GDP) in 1985. In response to the continuing fall in inflation (year-on-year 11.7% in June) interest rates were again reduced in June: the key 6-12 month deposit rate (the 'Pivot Rate') was cut by 3 percentage points to 15 1/2%. The authorities have also been able to reduce the monthly crawling peg depreciation of the escudo, from 0.9% to 0.7% with effect from July.

Africa

31 The Nigerian Article IV consultation was completed by a Board discussion on 11 July. The external position is very weak, with a projected cumulative financing gap of \$10.5 bn in 1986-87. Debt service ratios before rescheduling are projected at 130% in 1986 and 82% in 1987. In a public address on 26 June President Babangida had announced the introduction of a wide ranging Structural Adjustment Programme, the key elements of which have been designed with the assistance of the World Bank. This aims to reduce the budget deficit to less than 3% of GDP, substantially liberalises the domestic economy and, crucially, establishes a temporary two-tier exchange rate system to facilitate a devaluation. The second tier, which will be a market-determined rate, will cater for all transactions except debt service and payments to international organisations; it is expected to be introduced in early October, but its financing is as yet uncertain. An IMF mission left for Lagos on 19 July with the solution of this problem as a main aim. The mission will be in London on 8 August, and will brief Bank and HMT officials. The banks have tentatively agreed to meet the Nigerians in the second half of August. Progress on rescheduling their debts awaits the calculation of Nigeria's financing gap and the country's agreement of an IMF Letter of Intent. The banks' willingness to include new money in a debt relief package is likely to be influenced by Nigeria's treatment of arrears of letters of credit accumulated since end-1983: since early this year there has been no further issue of promissory notes under the scheme to reschedule pre-1984 uninsured trade arrears.

32 The Paris Club MYRA agreed for Cote d'Ivoire on 26/27 June is the first for an African country (and the second overall). It is to cover 3 years' maturities with a goodwill clause for a fourth year. Principal only is rescheduled, on a declining basis (80% in 1986, 70% in 1987, 60% in 1988, 50% in 1989), repayment is over 9 1/2 years with 4 1/2 years' grace. The London Club has agreed in principle on similar terms covering the same percentages of principal over a 4 year period. Elsewhere, Tanzania and Sierra Leone seem poised to clear their arrears to the IMF and agree new programmes, but programmes in Zambia and Zaire are proving difficult to keep on track. There is concern that increased Government interference with the auction system in Zambia will negate much of its value.

33 The debate on the imposition of sanctions against South Africa continues, both within the EC and the Commonwealth. In the UK, the South African Ambassador's remark that, in the event of extensive sanctions being applied, South Africa could consider not repaying its international loans and that this might have repercussions on other debtors (later contradicted by the South African Minister of Finance) has

not helped business and financial confidence in South Africa. The statement on 3 July (subsequently denied) that Dr Leutwiler had resigned as mediator between South Africa and its creditor banks added to the air of uncertainty. The banks' economic sub-committee has recently returned from South Africa to refine its balance of payments statistics. But with the imposition of the State of Emergency and the continued political turmoil, prospects for any revival of confidence in the country remain very distant.

Middle East & North Africa

34 A team of Egyptian ministers visited Washington in late June to discuss military debt and a planned economic reform programme with US government officials, the IMF and World Bank. President Mubarak has recently visited a number of European countries in an effort to enlist support in the forthcoming IMF negotiations. He appears to have been listened to sympathetically, but little more. The problem of arrears on servicing US military debt has been temporarily eased by the release of \$110 mn in grant aid by the Reagan government. But the package of reforms designed to cut the budget deficit and strengthen the balance of payments - due to be introduced in stages before the end of August - made an inauspicious start when the new tariff system, in the pipeline for a year and due to come into force on 1 July, was delayed again. This inspires little confidence that Egypt is ready to implement the more radical policy measures certain to be required by the IMF for a Standby, notwithstanding Egyptian protestations that they are now ready to agree a programme. In its most recent attempt to regain markets for its oil exports, Egypt has cut the price of its oil to between \$6 and \$7 pb.

35 The latest falls in oil prices have put further heavy pressure on other oil producers in the region. Iraq's acute foreign exchange shortage has steadily worsened in recent weeks, even though oil production has been running at 2.0 mbd (compared with its OPEC quota of 1.2 mbd). Banks reportedly are not confirming letters of credit for Rafidain Bank, the country's only commercial bank, and major delays on payments have become commonplace. Iraq is continuing to service large syndicated credits, including its recent \$500 mn borrowing, but payments are often up to 2 weeks late. Iraqi officials have been visiting creditor countries, seeking to reschedule debt, including short-term bank lines, and offering oil in lieu of cash repayments.

36 Following the break-down of Morocco's IMF programme, Finance Minister Berrada is reported to have said that he wants nothing more to do with the Fund, claiming that it is politically impossible to comply with Fund pressure to reduce the budget

deficit, either by increasing revenue or cutting expenditure. Berrada argued that he saw no alternative to rescheduling capital repayments and ceasing to pay interest altogether. Discussion with the banks on rescheduling 1985-87 maturities and possible new money has been stalled since March, pending a reactivation of the Standby or its replacement. The new civilian government in Sudan has resumed contacts with the IMF and IBRD but agreed to receive a Fund mission only to collect economic data and highlight areas where policy changes were needed. The mission's findings, reported to the Finance Minister on 26 June, showed a continuing economic decline in 1985-86, with inflation running at 50-60%, government expenditure rising by 35%, exports the lowest for several years, and little debt repayment other than to key creditors (IBRD and USAID). With the main budget (due in June) having been postponed, a stop-gap financing budget was approved on 30 June to run for 3 months, by which time the committee charged with devising a new economic policy should have reported. There is no indication that the authorities have taken on board any of the IMF's concerns. The Tunisian authorities have appealed to western governments for urgent financial aid to cover an acute shortage of foreign exchange. Although a syndicated commercial bank loan worth \$120 mn was signed on 30 May, additional funds are necessary to tide over the period until October-November when an IMF programme and World Bank facilities are expected to become operational.

INVESTEDNESS AND BRITISH EXPOSURE

CONFIDENTIAL

\$ billion

	Total external debt	British-owned banks' exposure [1]	ECGD amounts at risk	
	End-Dec 1985*	End-Dec 1985	End-March 1986 [2]	End-March 1986 [3]
<u>Latin America</u>				
Argentina	50	2.8 (0.1)	0.2	0.2
Brazil	102	6.3 (1.0)	0.9	1.9
Chile	19	1.3 (0.1)	-	0.1
Colombia	14	0.6 (0.1)	0.1	0.2
Ecuador	8	0.5 (-)	0.1	0.1
Mexico	97	6.3 (0.3)	0.6	1.3
Peru	14	0.3 (-)	0.1	0.2
Venezuela	37	2.1 (-)	-	-
<u>Far East</u>				
Indonesia	35	0.7 (0.3)	0.8	1.7
Philippines	27	1.3 (0.1)	0.2	0.2
South Korea	45	2.3 (0.4)	0.4	0.8
<u>Eastern Europe</u> (convertible currency)				
Hungary	12	0.4 (-)	-	0.1
Poland	30	0.5 (-)	1.2	1.3
Romania	7	0.2 (-)	0.3	0.5
Yugoslavia	19	0.9 (0.1)	0.7	1.0
<u>Southern Europe</u>				
Greece	17	1.3 (0.2)	0.2	0.3
Portugal	16	1.1 (0.2)	0.2	0.2
Turkey	25	0.4 (0.2)	0.2	0.5
<u>Africa</u>				
Egypt	40	0.3 (0.3)	0.4	1.0
Morocco	15	0.1 (-)	0.1	0.3
Nigeria	19	1.1 (0.1)	2.1	3.2
South Africa	22	3.9 (0.8)	0.8	2.6
Sudan	10	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 ECGD-guaranteed loans disbursed, plus political claims paid and claims under examination.

[3] Defined as ECGD-guaranteed loans (disbursed and undisbursed) and contractual interest, plus political claims paid and claims under examination.

* current estimate