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Dear Charles,

INTERNATIONAL FINANCIAL SCENE

This edition of our regular report on developments in the international debt scene is intended as background for the forthcoming international meetings.

On the world economy, the level of activity in the industrial countries will be a major topic at the Bank/Fund Annual Meetings in Washington. In broad terms (eg the latest IMF World Economic Outlook forecasts) the overall outlook is just about satisfactory from the "debt" perspective and the paper notes some helpful developments eg the decline in interest rates (6 month dollar LIBOR now about 6 per cent, compared with 8½ per cent at the time of Plaza and 12½ per cent at its mid 1984 peak) and the slight hardening in the oil price. But the situation remains fragile. The outlook for developing countries is not good with continuing very weak commodity prices. This too will surface in the Annual Meetings and will link with discussions of trade and protectionism and the burgeoning agricultural debate.

As we noted in August, economic developments over the past year, particularly the fall in oil prices, have increased the heterogeneity of the debt problem. But this has always been taken into account and there are no obvious bonuses in terms of its handling to come from the Annual Meetings, though the IDA8 replenishment should be settled and positive progress will be reported on IBRD lending and co-ordination of export credit. Shortly after the Annual meetings, however, there will be a bunching of difficult issues involving the oil exporting countries - Mexico, Nigeria and Egypt - which may bring debt management issues more sharply into focus. Another cloud on the horizon is the indication in the paper of a pick up in inflation especially in Latin America.

On individual countries, the current focus remains Mexico and the commercial bank package. The Paris Club have now agreed to reschedule Mexican public sector debt on fairly generous terms (100 per cent of principal to 31 March 1988 and 60 per



cent of interest to 31 December 1987 over 10 years including 5 years grace). The agreement will be operative only when the IMF standby comes into force ie when the banking negotiations are complete. The commercial bank element of the agreed bridge finance similarly cannot be drawn until the banking package is agreed. The bank negotiations are unlikely to be concluded rapidly. Some extension of the 21 days allowed by the Fund looks inevitable. The latest news is that the Mexicans have toned down some of the novel features in their original proposals eg the elimination of spreads and that both sides are moving towards common ground, though agreement is still by no means in the bag.

In the case of Nigeria, the important development is the signing of the Letter of Intent to the Fund, although the ~~Nigerians remain totally opposed to~~ any Fund drawing. The Bank of England are currently involved in discussions of a BIS bridging loan of some \$250 million. This could be agreed in principle in the next week or so depending on the attitude of the Bundesbank (who have doubts about participating which we are seeking to allay and the timing of decisions on the IBRD trade policy loan and commercial bank support for Nigeria.

Finally, the news on the third big oil debtor - Egypt - is mildly positive. A recent Fund Mission noted encouraging developments in the field of tariff reform and pricing policy together with a rather smaller budget deficit than initially estimated. Much remains to be done on energy prices, the exchange rate and interest rates and negotiations with the Fund remain at a preliminary stage. There will be an opportunity at the Article IV discussion in early October for our Executive Director to reinforce the line which the Chancellor and the Prime Minister recently took with the Egyptian Prime Minister of sympathetic encouragement for Egyptian adjustment efforts. In the meantime the Chancellor is writing to the President of the EC Commission rejecting the idea of an EC initiative at this stage to assist Egypt resolve its current financial difficulties. There is likely to be continuing political pressure as discussions are carried forward.

Elsewhere, it is worth noting the very special position of Brazil with strong economic growth and large surpluses on its external accounts, at the same time as continuing arrears to Government creditors and refusal to seek endorsement of the IMF to its economic policies to facilitate Paris Club and tougher term bank rescheduling. Finally, Peru having made only a token payment towards its arrears to the IMF, was on 15 August declared ineligible to use IMF resources. Contacts however continue in the hope of encouraging a more orthodox approach to debt obligations.



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