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7 November 1986

Charles Powell Esq
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Dear Charles,

INTERNATIONAL FINANCIAL SCENE

I attach the regular report on developments on the international debt scene. This covers the period since the annual meetings of the Bank and Fund in Washington. The keynote of the report lies in the words used to describe discussion of the debt situation at those meetings: no significant confrontation or new initiative. Indeed, the main focus for those concerned with debt matters at the Annual Meetings was general world economic prospects and particular cases eg Mexico.

The world economic environment is currently mildly favourable. Short term dollar interest rates have been stable, the dollar has continued to weaken, oil prices have been relatively steady and there has been some stabilisation in non-oil commodity prices. However the longer term outlook is less good, in particular protectionist pressures in the US continue strong and there is no real sign of any underlying change in the downward trend of commodity prices. Against this background individual debt cases do not fall into a clear pattern except for the oil exporters.

Similarly there has been no clear focus for debtor demands. The Cartagena Group has been quiet. But there is no shortage of opportunities for discussion which could become political and confrontational. The United Nations will be discussing the debt situation in November, and there will be a Special ECLAC Conference in Mexico in January. UNCTAD will provide yet another opportunity.

Among individual debtors, attention has continued to be focused on Mexico. The deadlines of 29 September and later 31 October for the banks to obtain a critical mass for the financing package have slipped. In the meantime Fund reapproval of the SBA has had to be postponed. Progress has been slower than anticipated.



Most of the UK banks have yet to sign, though for technical reasons. The US banks are also lagging. For the moment we do not think these difficulties give cause for serious concern, although the Managing Director has urged rapid agreement to keep the programme on track.

On Nigeria considerable progress has been made. The Nigerians signed the Letter of Intent with the Fund in early September although they do not intend a drawing. The Nigerian Government have expressed great satisfaction with the role played by HMG and the Bank in putting together an official \$250 million bridging loan which secures adequate funding for the introduction of the second tier foreign exchange market pending disbursements under a World Bank Trade Policy Loan. The second tier market has brought about a reduction in the naira exchange rate of some 63 per cent. Negotiations with the commercial banks are in progress with broad agreement being reached on a rescheduling package. Paris Club discussion is now likely to slip until December.

Once these two major packages have been fully settled there is likely to be a pause while the lessons of those operations - both handling and novel elements - are assimilated. The banks will not want a repetition of the bruising they feel they have suffered, while creditors are likely to want the exceptional features trimmed back to more conventional dimensions.

The other oil debtor - Egypt - continues to give serious cause for concern. Although exchange rate and tariff reforms have been introduced, many in the Fund Board feel that the pace of reform should be stepped up. This has not been well received by the Egyptians and discussions on a Standby involving further adjustment measures eg devaluation, exchange rate unification, high interest rates and the removal of subsidies, are unlikely to proceed smoothly or quickly.

The Brazilian economy continues to perform strongly, although the longer term outlook is uncertain. Further major fiscal and monetary measures are likely to be announced after the elections in mid November. In the meantime, the Brazilians continue to refuse to seek a formal IMF programme and their relations with government creditors are deteriorating as a result of extensive and growing arrears.

Finally, it is worth noting, as a "first", that China has approached the IMF for a first credit tranche drawing (SDR598 million) under a 12 month SBA.

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

*Yours
Alex,*

A C S ALLAN
Private Secretary

*[Mr.
Lutji
has
been
sacked]*

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INTERNATIONAL FINANCIAL SCENE

1 Discussions of the debt situation at the Annual Meetings of the IMF and IBRD at the end of September brought no significant confrontation or new initiative. The focus for those concerned with debt matters was largely on issues affecting general world economic prospects and on the continuing Mexican negotiations with the banks. Although these negotiations were not completed by the 29 September deadline set by the IMF Board for achieving the support of a "critical mass" of banks, they progressed more smoothly than many had expected, and broad agreement with the Advisory Committee was announced on 30 September. Two further weeks of negotiations were needed to finalise the details. Whilst the agreement has not included some of the Mexicans' more radical original proposals (such as the elimination of spreads and the linking of debt service payments to an ability-to-pay formula), it does involve a number of novel features, including a growth contingency facility and a contingent investment support facility, and the Mexicans have achieved a reduction in spreads from the levels negotiated in last year's MYRA.

2 As already indicated in previous Reports, the outcome of the Mexican negotiations is likely to have a major impact on perceptions of the overall debt situation for some time to come. The drawing back of Mexico from its earlier threatened confrontational stance, and the achievement of the agreement, will have brought considerable reassurance. However, the reductions of spreads on existing debts, and the inclusion of contingent facilities, are being seen as precedents by other debtors. The Philippines' Finance Minister, for instance, has already said that the Mexican agreement "opens up new horizons", and that the Philippines will seek terms better than those the Mexicans obtained. Moreover, the Mexican agreement still has to obtain the support of the "critical mass" of creditor banks: indications are that many of the smaller banks, particularly the US regionals, will be very reluctant to go along with it. This may force the authorities, particularly in the US, to consider how far to encourage their banks to participate in the agreement, and may force the larger banks to re-consider how far they should be willing themselves to absorb the share of the contributions due from the smaller banks. Both the IMF itself and the larger banks have used up a considerable part of their store of goodwill and credibility in putting together the Mexican agreements; whilst this has been seen as appropriate because of the significance of Mexico, there will be substantial pressure not to permit similar agreements in the future. In particular, it has been suggested that the process of agreeing significant amounts of "involuntary" new money may now virtually have run its course.

3 One particular issue arising from the Mexican agreement concerns its currency conversion clauses. Under the draft term sheet, banks will be able to convert into home currency 100% of the 1983 and 1984 new money facilities and up to 100% of their restructured debt (conversion to be effected on one interest payment date under each credit agreement for the new money and 24 months for the rescheduled debt).

Preliminary estimates suggest that UK-registered banks may have about \$5 bn eligible for switching (currency switching involves corresponding sales of the home currency if mismatched positions are to be avoided). The Bank of England has asked banks for a statement of their present intentions on switching, and to be informed of any change in intentions. If substantial sales occur on the specified dates, this could lead to downward pressure on the exchange rate.

4 The UK authorities continued to be in the lead in putting together an official bridging loan for Nigeria. The size of the bridge was scaled down to \$250 mn (of which the UK share is \$70 mn), and disbursements delayed beyond the original target by the process of negotiation which was intense and difficult. Full agreement was finally achieved on October 30, with actual disbursements starting on October 31. With the second tier foreign exchange market now already in operation, the contribution of the bridge to Nigeria's cash flow is probably less important than the symbolism of support from the governments of the industrialised countries; this is believed to have helped both, politically, for Nigeria to maintain the momentum of adjustment and, commercially, with the negotiations on banking debt. The goodwill amongst the Nigerians towards the UK generated by the operation has been worth the very considerable efforts of both HM Government and the Bank of England. Reports from Nigeria suggest that UK may gain considerable benefits from the success of this exercise.

5 Apart from Nigeria, some other previously recalcitrant debtors have been reaching agreement with the Fund: the Fund has, for instance, approved a follow-up Standby for Morocco, after the previous programme collapsed shortly after it began. The Fund has also approved a growth-oriented SBA and a CFF for the Philippines. But on the other side, although Peru remains isolated in carrying out unilateral restrictions of debt-service payments, Jamaica's negotiations still seem far from resolution, Brazil continues to insist that it will not subject itself to a formal Fund programme and Argentina has so far not begun substantive discussion on its follow-on programme. Moreover, whilst Egypt had earlier appeared to be moving towards agreement with the Fund, it is now showing itself very resistant to introducing the additional measures which the Fund still considers essential. Little has been heard of the Cartagena Group recently, but representatives of 25 Latin American and Caribbean countries met in Lima on 16 October to examine new

approaches to the problems of debt servicing. The meeting, held under the auspices of SELA (Latin American Economic System) was intended to work out a common approach to present to the United Nations, which will discuss the debt situation in November, and to prepare for the ECLAC Special Conference in Mexico City from 19-23 January. These discussions, and others scheduled over the coming months in a number of international fora, may bring renewed attention on those seeking to pursue a confrontational stance.

6 Economic performance amongst debtor countries continues to diverge. Whilst oil-exporters are generally facing increased austerity, there is now significant growth in a number of countries - including Brazil, Argentina, Chile and Peru - albeit in some cases from a much lower level of activity than they enjoyed earlier in the decade. Other countries previously thought vulnerable - such as South Korea and Thailand - expect this year to be growing rapidly, running current account surpluses, and reducing their indebtedness. However, rapid growth is in some cases being accompanied by a resurgence of inflation: in Argentina prices rose 7.2% in September, bringing the year-on-year rate to 67.4%, its highest level since the introduction of the Austral Plan. And in Brazil, the continuing rapid expansion has led to a (modest) cut in projections for this year's trade surplus.

7 The world economic environment has continued to be mildly favourable for most debtors, although prospects for the longer term may have deteriorated. Short term dollar interest rates have remained fairly stable - three and six month eurodollar rates are around 6% - but fears about a resurgence of inflation, and about the dollar exchange rate, have caused interest rates to rise at the longer end. The dollar has continued to weaken for most of this period; although it revived somewhat the end of the month, it was still 15% below its level at the beginning of the year in effective terms, and almost 25% below its level at the time of the Plaza Agreement. Whilst the fall in the dollar brings relief to most debtors, the longer term implications of the weak US external position seem more worrying: the absence of any turnaround as yet on the trade deficit is expected to lead to continued heavy protectionist pressures for some time to come. On 21 October the US introduced a fee of 0.22% on all imports except those from least developed countries and those in the Caribbean Basin programme (in order to help reduce the budget deficit); Mexico has already filed a formal protest. Meanwhile, Congress is moving to cut US contributions to the World Bank and the other international institutions; it is too early as yet to assess the significance of these moves.

8 Oil prices have remained relatively steady since August, with markets awaiting the outcome of the OPEC discussions on production restraints beyond October. Reports of an agreement on 22 October on a marginal increase in output quotas for

the remainder of the year have led to a slight firming in prices. Non-oil commodity prices too have been stable recently (the Economist Index rose by 4.1% in the two months since the end of August) bringing at least a temporary halt to five months of continuous declines. Nevertheless, the all-items index remains (in SDR terms) more than 14% below its level of the first quarter of this year and over 18% below its level at the beginning of 1985. The more recent stability has derived partly from a supply squeeze on vegetable oil supplies in Malaysia reversing the steep price falls earlier this year (palm oil prices have risen by 80% to reach their highest level since the beginning of the year, and coconut oil prices have more than doubled, returning to their level of last June), from strikes in Canadian mines (zinc rose 4%), and from some rebound after earlier major price falls in cotton (prices rose by almost 40% over the last two months, but are still at historically low levels). Nevertheless, these developments do not yet seem to suggest any underlying change for commodity prices from their continuing long term downward trend.

9 Since the beginning of September there has been a further \$100 mn eurocredit for the National Bank of Hungary; the Soviet Foreign Trade bank is currently negotiating an 8 year \$300 mn credit, at LIBOR +1/8% for the first five years and +1/4% for the last three. Among developing countries there were seven borrowings, totalling \$1.2 bn; India's Oil and Natural Gas Commission, with a three tranche loan, accounted for \$500 mn of this. (Two of the three tranches were arranged under tax sparing agreements with Japan, the UK and Belgium.) South Korean borrowers were totally absent in this period, a reflection of their improving economic condition and their current account surplus.

Further details on individual countries are given below.

Latin America and Caribbean

10 Mexico concluded its negotiations with the banks' Advisory Committee on 14 October, after five weeks in continuous session. The package includes a \$5 bn new money loan, repayable over 12 years (5 years' grace), plus a \$1 bn co-financing of transport sector projects with the World Bank (\$500 mn guaranteed by the World Bank) to be repaid over 15 years (9 years' grace); re-rescheduling of "old debt" under last year's MYRA of \$43.7 bn over 20 years (7 years' grace); and no change in the overall term of the 1983 and 1984 new money loans, totalling \$8.6 bn. The spread on all elements will be 13/16% over LIBOR or cost of funds (ie the Prime option has been removed), the reduced margin on existing debt producing annual savings of some \$300 mn. The package also includes a "growth contingency" facility

for \$500 mn (over 12 years, including 7 years' grace, and with \$250 mn guaranteed by the World Bank) to be triggered by a review of economic activity in Mexico at end-Q1 1987, and a contingent "public sector investment maintenance" facility of \$1.2 bn (over 8 years with 4 years' grace) to be activated if the IMF certifies there has been a shortfall in the Mexican public sector's external receipts. Other broad elements have reportedly now also been agreed: \$11.6 bn of private sector debt will be rescheduled; interbank deposits (about \$6 bn now, minimum required level \$5.2 bn), due to expire at end-1986, will be rolled over to 30 June 1989; and the \$950 mn repayment, due in October and November, is to be rescheduled over 1989-94.

11 The Fund had set a deadline of 29 September, when the approval in principle of the SBA would lapse, for the banks to obtain a critical mass for the financing package, but the Advisory Committee did not even agree the broad terms with Mexico until 30 September. The details of the package subsequently also proved difficult to resolve, and a term sheet was not issued until 16 October. The critical mass (about 90%) of commitments was to be sought by 31 October; there is some slippage beyond that date, but this is not expected to be serious. Although the Fund Board has not reconvened, approval of the SBA will run in effect until early-November when a Board meeting will probably be held - as soon as the critical mass is achieved - to consider the impact of recent events on the programme.

12 In efforts to secure further financing for 1986/7, Finance Minister Petricioli visited Japan in late September to agree loans, totalling \$1 bn, from the Ex-Im Bank of Japan. The US's Commodity Credit Corporation has approved credit guarantees of \$745 mn for delivery of agricultural commodities during US FY 1987 and the Paris Club agreed on 17 September to \$1.5 bn of rescheduling of official debt. The Mexicans made a first repayment (\$270 mn) of the official bridge on 30 September, as required. No more bridging finance may be drawn until the banks have achieved a critical mass for the financing package.

13 General economic developments in Mexico continue to be mixed. The current account recorded a deficit of \$1.57 bn during January-July, better than expected given the weakness of oil prices during the period, and suggesting that the Fund estimate of a deficit of \$3.5 bn for the year may be too high. Industrial production in the twelve months to June fell by 4%. Average oil exports in Q3 were 1.35 mbd (cf 1.35 mbd in Q2 and 1.1 mbd in Q1). Meanwhile, with inflation continuing to rise (the CPI in the twelve months to September rose by 95%), and in response to union calls for the introduction of monthly wage rises, the government has conceded an unprecedented third increase in minimum wages within a 12-month period, of 21.2%, bringing minimum wage rises for the year to 100%. However, the possibility of introducing an "Aztec Plan", involving a wage freeze, seems not yet to have been ruled out.

14 Brazil's economy has continued to perform strongly, but there are concerns that the fiscal targets set under the Cruzado Plan will be exceeded, and further major economic measures to tighten fiscal and monetary policies are likely to be announced after the Senate and State elections on 15 November. Meanwhile, whilst the CPI rose by 1.7% in September, the highest rise since the Cruzado Plan was introduced in February, bringing the cumulative rise in prices since then to 8.2%, the consumer boom has contributed to a fall in the official unemployment rate, to 3.5% at end-August (cf 5% in August 1985). However, on the external side, the authorities have revised their 1986 balance of payments forecast and now expect an overall deficit of \$150 mn (cf an original forecast of a \$800 mn surplus). The 1986 trade surplus target has been revised down \$0.5 bn, to \$12.3 bn. Following the IMF/IBRD meetings, Finance Minister Funaro reiterated that Brazil was unwilling to seek a formal IMF programme to facilitate its expected debt rescheduling negotiations with the commercial banks and the Paris Club. There have been reports that the banks may be willing to accept joint IMF-IBRD monitoring; but negotiations with the Paris Club continue to be hindered by the Brazilians' refusal to settle arrears 21 October. The IBRD has approved loans to Brazil totalling \$371 mn.

15 In Argentina the CPI rose by 7.2% in September (cf 8.8% in August), bringing the year-on-year rate to 67.4% (cf 59.2% in August). Despite the pick-up in inflation and a deterioration in the external outlook, the domestic economy appears to be recovering strongly from last year's recession, with real GDP growth officially forecast at 5% for 1986 (against 4% forecast earlier). An SBA is being sought from the Fund to replace that which expired at end-June: prior to the IMF/IBRD Annual meetings, a Fund mission visited Argentina to gather economic information, and a negotiating mission is scheduled to be sent shortly. The authorities are also reported to want to approach the commercial banks and the IBRD for new finance, but no substantive negotiations have yet taken place with either set of creditors. In the meantime, the authorities have announced changes in banking regulations, including a substantial reduction in the reserve requirements on deposits in Argentine banks. By encouraging a shift of business from the parallel to the regulated sector, the changes should allow the Central Bank to keep tighter control of credit expansion and the money supply. Meanwhile, the integrity of the financial system has been called into question by several recent fraud cases which may involve the previous President of the Central Bank, Alfredo Concepcion, and other senior officials.

16 The IBRD Board is due to discuss a second IBRD SAL for Chile in late November, despite efforts by the US to delay the talks. Under domestic legislation the US may have to oppose the loan on political grounds, because of human rights abuses.

UK policy remains that IFIs' loans should be judged solely on their technical merits. The Chileans are also seeking to fill half their forecast financing gap of \$1.2 bn for 1987-88 from the banks; however, negotiations could be adversely affected by any delay in signing the SAL. Within the domestic economy, inflation continues to decline; the CPI for the twelve months to August rose 17% (cf 36% to August 1985). The trade surplus for January-August was \$806 mn (cf \$555 mn during January-August 1985 and an IMF target of \$955 mn for 1986). Real GDP in H1 was 5.8% above H1 1985 (cf an IMF target of 3-5% growth for 1986 as a whole).

17 Colombia made a first drawing (\$639 mn) from its \$1 bn voluntary bank loan on 9 October; there is no clear indication when the remainder will be drawn, although the loan's existing termination date is end-1986. Meanwhile, it seems likely that the "enhanced monitoring" arrangement with the IMF, which lapses at end-1986, will not be renewed. (This will not bring the bank loan into default as there are provisions for the continuation of the required flow of economic information to the banks in the absence of Fund monitoring.)

18 In Ecuador, Finance Minister Dahik resigned on 26 September (after only 3 months in office), having been impeached by the opposition-controlled Congress and found guilty of introducing policies against the national interest. The Congressional opposition also proposed in September to limit debt service to 25% of petroleum export revenue. However, the Presidential approval needed to make the proposal law is unlikely to be obtained. Export receipts during January-July were \$1.25 bn, 22% less than in the same period last year, despite an 18% increase in non-petroleum export values.

19 Continuing difficulties in Venezuela's negotiations with the banks' Advisory Committee over the country's private sector debt have held up progress on modifying the MYRA covering \$21.2 bn of public sector debt. In a meeting with banks in September, the Venezuelans proposed several changes to the MYRA, including lower spreads, a longer grace period and debt repayments linked to oil revenues and international interest rates. The banks rejected the last proposal outright and will probably not agree to any significant change in the existing repayment schedule. The Venezuelans have agreed to make the \$750 mn downpayment required to activate the MYRA, between November and January. In the external accounts, total export revenue for January-August was \$7.1 bn (of which oil accounted for 77%), while total imports were \$4.2 bn. Reserves were \$11.7 bn at mid-September (cf \$13.7 bn at end-1985). The CPI rose by 0.7% in September, bringing the year-on-year inflation rate to 11.4% (cf 10.8% in the year to August and an IMF target of 11.9% for the year as a whole).

20 The Peruvian authorities and the banks' Advisory Committee held talks on 26 September. No formal proposals were made, but the banks stipulated that the Peruvians make a token interest payment (\$60 mn has been reported) as a precondition for further talks (due to take place within 60 days). The Advisory Committee has told the Peruvians that if payment is not made individual banks will decide how to proceed - in effect, the banks will decide whether to disband the Advisory Committee. Meanwhile, the banks have agreed to send a team of economists to Peru to examine recent data and the country's economic programme. The authorities' current projections are for real GDP growth of 5% in 1986, inflation of 66% (cf 57% year-on-year at end-August), a public sector deficit of 5.2% of GDP (excluding interest arrears of 1.3% of GDP), a \$200 mn trade surplus and a current account deficit of \$232 mn. Finance Minister Alva Castro argued at the IMF/IBRD meetings that Peru's ability to service its external debt could be further reduced in 1987 as a consequence of deteriorating terms of trade and restrictive practices in the main international markets; he expected these factors to reduce the trade surplus to \$50 mn for the year.

21 Among other debtors, Uruguay signed a 12-year \$90 mn energy sector loan on 2 October (\$45 mn from the World Bank and \$45 mn voluntary bank co-financing). All IMF performance criteria for the first three quarters of 1986 have been met, although the end-year inflation target may be missed. The January-July trade surplus was \$129 mn (cf \$45 mn in January-July 1985), with export and import values respectively 31% and 18% higher than in the same period in 1985. GDP growth of 3-4% is now forecast for this year. Bolivia met all end-June performance criteria under the 12-month SBA except for the ceiling on external arrears. Since the Bolivians could demonstrate that remedial action was being taken, the Fund agreed to a waiver to enable a drawdown in September of the second tranche (SDR 8.65 mn) due originally on 15 August. The US has agreed to provide a \$100 mn short-term credit line, to be repaid by 14 November, while negotiations on assistance from IFIs continue.

22 At a meeting with the banks' Advisory Committee on 24 September, Costa Rica advised the banks that it would not be able to maintain debt service beyond that due up to 30 June. At a further meeting on 23 October, the Costa Ricans requested a rescheduling of their debt over 25 years (7 years' grace) at concessional rates. This was rejected by the banks who have urged the Costa Ricans to agree a programme with the Fund. Cuba has continued to build up arrears; there are reports that the country may have taken the decision to default on its debt. The joint IBRD/IMF Article IV mission which visited Guyana in late September found little fundamental

change since last year. Jamaica is reportedly negotiating an 18-month SBA with the IMF to replace the one cancelled recently: Seaga's announcement that he would stand down as party leader in November and as Prime Minister next August may have been intended to strengthen his negotiating position. Jamaica has paid SDR 30 mn of its arrears to the Fund, but SDR 61 mn of arrears remain. The country has indicated a need to reschedule debts due to the Paris Club in 1986/7 and has ceased payments on debts which may be eligible for rescheduling.

23 Some progress was made over the Inter-American Development Bank Seventh Replenishment (1987-1990) negotiations at the meeting of Executive Directors held in Washington at end-September. Agreement was reported to be close on a \$24 bn replenishment, with 2.5% paid-in, allowing a lending programme of \$20 bn, with any additional lending coming from unused Sixth Replenishment contributions. However, prospects for this - as well as for the MIGA and the IFC - are unclear following Congressional moves to cut US contributions to the World Bank and the IADB for 1987.

South and East Asia

24 China has approached the IMF for an SDR 598 mn (25% of quota) SBA, to be considered by the Board with the Article IV Consultation on November 7. The Chinese propose moderate tightening of domestic credit expansion and money supply, but their proposed reduction in external borrowing (based on much higher earnings from non-oil exports) may be more difficult to meet. In 1985 China had a trade deficit of US \$14.9 bn, and a current account deficit of US \$11.4 bn; despite the introduction of import restrictions, the trade deficit in the first nine months of 1986 amounted to US \$8.9 bn. Although China's reserves fell sharply in 1985, from about \$20.5 bn to \$12.7 bn, they have been fairly stable this year, and now stand at \$11.4 bn. There has however been substantial borrowing in 1986 - about \$2.5 bn of concessional debt alone - pushing gross debt (including short term) to about US \$25 bn. The medium term debt-service ratio remains comfortable at about 7%.

25 The Philippine government's efforts to secure further debt relief from commercial and official creditors appear to be on course. The IMF has approved an 18-month growth-orientated SBA (SDR 190 mn) and a CFF (SDR 224 mn) which will trigger \$350 mn of undrawn commercial bank money as well as \$300 mn in loans from the IBRD. On 27 October the Advisory Committee began discussing proposals for the rescheduling of \$3.6 bn of maturities due from 1987-91. The authorities also wish to discuss the terms of the 1983-5 rescheduling. No "new money" is being sought for 1987. Finance Minister Ongpin has indicated that he regards the Mexican

agreement as having "opened a new horizon", and that he hopes to negotiate better terms than Mexico achieved. Meanwhile, the US Senate has finally passed an additional aid package of US \$200 mn for 1987. On the economic side, real GNP declined by 2.3% in H1, but latest estimates by the Fund suggest an increase of 1.5% for 1986 as a whole, and GNP is expected to rise by between 6% and 7% in 1987. Consumer price inflation fell to zero in H1 1986, but is projected to accelerate to 5% by end 1986. The current account is forecast to show a small surplus of US\$0.3 bn (0.9% of GNP) in 1986, reverting to a deficit of US\$0.4 bn (1.2% of GNP) next year. The Philippines' draft constitution is expected to go to plebiscite in January.

26 Malaysia's real GDP fell by 1% last year, and a further fall can be expected in 1986. Per capita income is expected to fall by over 10% this year. The 1987 budget, which was announced on 24 October, whilst undoubtedly restrictive, was not as severe as had been expected. Although expenditure is to be cut by 11% (comprising a 6% cut in operations expenditure and 25% in development expenditure: initial recommendations to the cabinet were for development expenditure to be cut by 30%) the budget deficit for 1987 is projected at 16% of GNP (cf 11% in 1985 and 19% in 1986). Rumours of a devaluation (to follow that in Indonesia) have been denied, and Bank Negara has been using reserves to defend the currency. The financial sector remains dogged by scandal and poor results.

27 In contrast the Indonesian government appears determined to respond to events decisively. The government has stuck by the August OPEC agreement and hopes to see oil prices rise to \$17-19 pb. It is also preparing a series of follow-up measures to the 31% devaluation in September. There have been rumours that it intends to introduce exchange controls and a freeze on time deposits, but these have been firmly denied; however, some banks have suffered withdrawals as a result. Meanwhile, the position of the economy remains precarious. Foreign investment is down yet again and the external account has deteriorated significantly: the current account deficit may widen to around \$5 bn this year from \$2.1 bn in 1985. Total reserves have fallen slightly this year, from \$10.7 bn, but are still a healthy \$10 bn.

28 Elsewhere, in Thailand economic growth may reach 5% this year, whilst a small current account surplus now looks likely, the first in the country's history. On the other hand, the authorities in India have revised upwards the trade deficit for the year ending March 1986 to US \$6.9 bn (4% of GDP). This implies a current account deficit of \$4.6 bn (2.5% GDP), double last year's level.

Eastern Europe

29 Against a background of a financing gap of around \$800 mn this year and, on current weak export performance, around \$2 bn in 1987, Poland held an unproductive meeting with official creditors in Paris on 24 October. There were no formal proposals: Poland would like to reach an agreement covering 1986 and 1987 maturities (including the phasing of arrears under the 1981 and 1985 agreements) but no progress was made and no date set for a further meeting. The Poles intend to start negotiations with other creditors and are to meet the banks in London on 4 November. At the IMF Article IV discussion on 15 October, Directors generally welcomed the proposed package of measures announced by the Polish representative, although concern was expressed that the envisaged pace of their implementation was too slow. The Finance Minister has indicated that Poland will seek an early borrowing from the Fund, but it is likely to take some time before a programme can be agreed.

30 Yugoslavia shows few signs of getting to grips with its problems. Although the National Bank's most recent forecast of a full-year current account surplus of \$0.6 bn is more optimistic than earlier indications, it still falls well short of the original official forecast of \$0.9 bn. Substantial financing gaps seem in prospect for both 1986 and 1987, although at present there is no evidence of Yugoslav anxiety on this score. Prime Minister Mikulic is apparently having difficulty reaching a consensus at republic level, and the long-promised "autumn package" may now prove little more than a series of proposals for debate that will not be implemented before 1987. At the September meeting of the Paris Club the Secretariat was instructed to write to the Yugoslavs seeking an explanation of policies. Intensive lobbying by the Yugoslav representatives at the Washington meetings failed to impress and both Fund and World Bank staff have expressed concern. The banks seemed more optimistic than the official side following the Manufacturers Hanover mission to Belgrade on behalf of the banks in September, but more recent indications from IMF/IBRD staff suggest that some end of September performance criteria may have been missed. It will be for the banks to decide what action if any to take in relation to the next stage of their MIGA.

31 The first half of 1986 witnessed a further deterioration in Hungary's convertible-currency current account with a deficit of \$845 mn being registered (\$434 mn deficit in H1 1985) against a planned surplus of some \$100 mn for the year as a whole. In order to stimulate export performance the forint was devalued by 8%

against its currency basket on 23 September. The USSR recorded a hard currency deficit (excluding arms sales) of \$3.7 bn in the first half of the year compared with a deficit of \$4.3 bn in H1 1985. Romania has cleared a large part of its arrears to the Fund and IBRD.

Southern Europe

32 In Greece the current account deficit amounted to \$1.21 bn in the period January-August, compared with a target of \$1.7 bn for the year as a whole. Non-oil imports have continued to rise, despite the import deposit scheme introduced as part of last October's austerity package; under the conditions attached to the EC loan granted last November, this scheme must begin to be dismantled next month. The Bank of Greece has raised two small syndicated credits since July, totalling \$100 mn, on less favourable terms than for a similar loan at the beginning of the year.

Sub-Saharan Africa

33 After lengthy discussions Nigeria signed a Letter of Intent on 3 September which would entitle it to draw up to SDR 650 million under an SBA. The authorities continue to stress, however, that they do not intend to avail themselves of these funds. Central to the adjustment package was the introduction of the second tier foreign exchange market (SFEM) designed to ensure a more competitive rate for the naira, whilst avoiding the possible political difficulties associated with a formal devaluation. At the first auction on 25 September the naira depreciated by 66 per cent against the dollar. A further modest depreciation resulted at the subsequent weekly auction, but at the 9 October session the naira rebounded sharply, reflecting a change in the method of arranging the bids and an extra \$25 million put through the auction. The naira exchange rate currently reflects a depreciation of 63% compared to the pre-auction rate. In order to ensure adequate funding for the SFEM, an official \$250 mn bridging loan, to be repaid from drawings under a World Bank Trade Policy Loan, has been successfully completed as a result of intensive activity by the UK authorities. Meanwhile, following a meeting between the Nigerian authorities and the commercial banks' steering committee on 8-10 October, broad agreement was reached on a rescheduling package, including some \$320 million of new money for the Nigerians. The outline agreement is notable for not being made conditional on an IMF borrowing. A term sheet was agreed by the banks and put to the Nigerians on October 30; the Nigerians are expected to conduct a short 'roadshow' in the week beginning November 10.

34 The September review of the Interim Agreement between South Africa and the creditor banks passed largely uneventfully. Although planned as a purely economic review, the banks clearly felt that the South Africans had the capacity to repay more debt than originally scheduled. The South African team made it clear, however, that they had no mandate to offer additional payments; the banks did not press the point. Zaire has announced that it intends to restrict its debt-servicing to 10% of exports. Amongst other African countries, Zambia's domestic and external position has further deteriorated, and prospects for retrieving the present Fund programme are rapidly dwindling. The fiscal deficit is again above the original target, and a sizeable bridging loan would be required to close the 1986 financing gap and clear arrears to the Fund - currently SDR 74 mn. Moreover, a large financing gap is projected for 1987, even after assuming generous rescheduling and the minimum viable level of imports.

Middle East & North Africa

35 During the Executive Board's discussion of Egypt's recent Article IV Consultation on 6 October, US and European Directors (including the UK's) welcomed the exchange rate and tariff reforms introduced during July and August, but urged that the pace of reform should be stepped up. This was not well received by the Egyptians. It therefore seems likely that the current Fund Standby mission to Cairo will meet continuing resistance for further measures including devaluation, exchange rate unification, higher interest rates, and the removal of subsidies. Agreement on a programme is unlikely to be reached this year.

36 Following additional budgetary measures undertaken in July-August, the Algerian government has sounded out commercial banks about the terms for fresh medium-term borrowing, expected to total about \$300 mn. There are reports that the response was disappointing. Algeria has already borrowed nearly \$1 bn this year and also drawn down reserves to finance an expected current account deficit of around \$2 bn, brought about by sharply reduced hydrocarbon export revenues. In Morocco real growth is expected to reach 4.7% this year (cf 4.3% in 1985) and inflation continues to decline. However, expansionary monetary and fiscal policies have caused a smaller than programmed reduction in the current account deficit, and external arrears have continued to accumulate. Following lengthy negotiations, agreement has been reached with Fund staff on a Letter of Intent covering a new Standby of SDR 230 mn which will run until March 1988. As a pre-condition, however, Morocco must first reach agreement in principle with commercial banks on the rescheduling of 1985/86 maturities and a new money package of \$200 mn. The banks' steering committee begun discussing terms on 30 October, and it is hoped that the IMF programme will be discussed by the Board early in December.

37 Iraq's acute shortage of foreign exchange has continued, leading to increasing arrears on letters of credit opened by Rafidain Bank. Officials of Rafidain Bank have recently been visiting banks in London to seek a loan, but were unsuccessful. Iraq has also failed to meet a repayment due at end-September under a 1983 international bank loan (although interest on the loan reportedly is being paid). It is reported that the Iraq authorities have requested a formal rescheduling of the \$500 mn loan. In Sudan the new civilian coalition government has so far failed to make progress in resolving the escalating civil war or to take firm action on the economy. The recently announced budget seems based on unrealistic revenue and aid forecasts.

INDEBTEDNESS AND BRITISH EXPOSURE

CONFIDENTIAL

\$ billion

	Total external debt	British-owned banks' exposure [1]	ECGD amounts at risk	
	End-Dec 1985*	End-June 1986	End-June 1986 [2]	End-June 1986 [3]
<u>Latin America</u>				
Argentina	50	2.8 (0.2)	0.2	0.2
Brazil	102	6.3 (1.4)	1.0	1.9
Chile	19	1.4 (0.1)	-	0.1
Colombia	14	0.5 (0.1)	0.1	0.2
Ecuador	8	0.5 (0.1)	0.1	0.1
Jamaica	3	- (-)	-	-
Mexico	97	6.2 (0.5)	0.6	1.3
Peru	14	0.3 (-)	0.1	0.2
Uruguay	4	0.3 (-)	-	-
Venezuela	37	2.1 (0.1)	-	-
<u>Far East</u>				
Indonesia	35	0.7 (0.3)	0.8	1.7
Malaysia	19	1.2 (0.3)	0.1	0.1
Philippines	28	1.4 (0.1)	0.2	0.2
South Korea	45	2.5 (0.7)	0.4	0.8
Thailand	17	0.3 (0.2)	0.1	0.1
<u>Eastern Europe</u> (convertible currency)				
Hungary	12	0.4 (-)	-	0.1
Poland	30	0.5 (-)	1.3	1.4
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 (0.1)	0.2	0.4
Portugal	16	1.1 (0.1)	0.2	0.2
Turkey	25	0.5 (0.2)	0.2	0.6
<u>Sub-Saharan Africa</u>				
Cote d'Ivoire	8	0.2 (-)	-	0.1
Nigeria	21	1.1 (0.1)	2.2	3.3
South Africa	23	3.6 (0.4)	0.8	2.6
Sudan	10	- (-)	0.2	0.2
<u>Middle East and North Africa</u>				
Algeria	20	0.3 (0.1)	0.2	0.5
Egypt	40	0.2 (0.2)	0.2	1.0
Israel	30	0.4 (0.1)	0.1	0.2
Morocco	14	0.2 (-)	0.2	0.3
Saudi Arabia	13	0.6 (0.4)	0.2	0.3

[1] This column now shows exposure defined as consolidated external claims including portfolio investments with a contractual repayment date, 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

INDEBTEDNESS AND BRITISH EXPOSURE		\$ billion		
	Total external debt	British-owned banks' exposure [1]	ECGD amounts at risk	
	End-Dec 1985*	End-June 1986	End-March 1986 [2]	End-March 1986 [3]
<u>Latin America</u>				
Costa Rica	3	0.1 (-)	-	-
<u>South & East Asia</u>				
Pakistan	13 $\emptyset$	0.3 (0.1)	0.1	0.1
<u>Eastern Europe</u>				
USSR	30	0.7 (0.1)	0.7	1.0
<u>Southern & Western Europe</u>				
Iceland	2	0.2 (-)	-	-
<u>Sub-Saharan Africa</u>				
Kenya	4	0.1 (-)	0.2	0.4
Zambia	5	0.3 (-)	0.1	0.2
Zimbabwe	2	0.2 (0.2)	0.2	0.4
<u>Middle East & North Africa</u>				
Iraq	20 $\neq$	0.1 (-)	0.4	1.0

 $\emptyset$ Mid-1985 estimate $\neq$ Mid-1986 estimate