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Prime Minister
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23/12

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Dear Charles

INTERNATIONAL FINANCIAL SCENE

I attach the regular report on developments in the international debt scene. The timing of this report offers a useful opportunity to take stock of the past 12 months and to try to identify the likely problems for 1987.

World economic developments in 1986 were dominated by the fall in oil prices. Its benefits came through more slowly than anticipated while its negative impact on the major oil producing debtors (Mexico, Nigeria and Egypt) was felt immediately. Growth rates in aggregate were adequate, while other positive factors were the fall in interest rates and dollar depreciation.

Looking ahead to 1987, the overall world economic outlook is a little gloomier than it was at the time of the Bank and Fund meetings in September. There has been some firming of oil prices but a number of negative features seem likely to continue, in particular poor terms of trade for developing countries as a result of low commodity prices and uncertainties over future developments in the US economy. Debtors, particularly those in Latin America, could be harmed either by a reduction in the US trade deficit or by increasing protectionism - in which context a new US Trade Bill seems increasingly likely.

On the narrower debt front, the main anxieties of 1986 were oil related. This resulted in a heavy concentration during the year by banks, governments and international financial institutions on those debtors hardest hit by the fall in prices: Mexico, Nigeria and Egypt. However, by the end of 1986, both Mexico and Nigeria had come into the fold with agreed IMF programmes, Paris Club and commercial bank reschedulings. Next year, Brazil, which during 1986 was pushed backstage by the problems of others and, until recently, by its own good external position, seems likely to come to the fore again as a major problem.

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Apart from individual country problems, in particular Brazil, Egypt and the Philippines, three broad issues seem likely to dominate the debt scene next year. First, what impact will absorption of the lessons of the Mexican negotiations have on perceptions of the overall debt situation and its handling. Our last report suggested that the banks would not want a repetition of the bruising they felt they had suffered in that exercise, while government creditors would be likely to want the exceptional features of the Mexico package trimmed back. In current negotiations debtors and creditors variously assert that the Mexican package either is or is not a precedent. Although there have been public indications of a shift in commercial bank attitudes, we will not know how far these attitudes, whether to the provision of finance or towards IMF leadership in such packages, have changed in practice until we come to the crunch in new negotiations.

Second, has the Fund lost direction? In a number of current discussions, particularly on Egypt and Brazil, but also in relation to Mexico and Jamaica, there are signs of the Fund Board accepting weak programmes. It is not yet clear whether this is a temporary feature attributable to a lame duck managing director or, as seems to be the case with Egypt and Brazil, to a shift in approach on the part of some major G5 countries. The departure of the Fund's managing director, de Larosière, will not help in this context.

Third, there are the problems of Sub-Saharan Africa where in many cases there is little chance of their becoming creditworthy or attracting spontaneous flows of new investment capital. The debt issue here is not a systemic one but the possible need for a different approach to these problems is already surfacing on the international agenda. We shall be giving it more thought.

Finally, 1986 saw little by way of political confrontation between debtors and creditors. In 1987 there may be greater politicisation with pressure not only from the developing countries in UNCTAD and elsewhere but possibly also within the G5/G7 where Mitterand, with Italian encouragement, may try to relaunch his recent North/South ideas at the Economic Summit.

All in all a heavy burden for the new Managing Director.

On individual countries, the following points are worth noting. Brazil's Paris Club debts were discussed last week in the light of the qualified "certificate of approval" given by the Managing Director following the recent Article

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IV review and the latest (Cruzado II) economic measures. The creditors agreed to negotiate next month a limited short term rescheduling of 1985 and 1986 arrears but made it clear to the Brazilians that any longer term debt settlement covering 1987 or beyond must be based on a proper SBA or a closer (albeit ill-defined) relationship with the IMF. This partial approach reflects a shared concern among all government creditors about the prospects for the Brazilian economy and in particular the adequacy of the Cruzado II measures and the political constraints on any necessary further policy measures. This was evidenced by the Brazilian reluctance to promise now that they would remain current throughout 1987 when they face considerable cash-flow problems.

The Paris Club also reached a comprehensive agreement with Nigeria, broadly in terms of the original Nigerian requests but after a very difficult meeting. The deal includes rescheduling of 100% of principal and interest payable up to 31 December 1987 over 10 years with 5 years grace, 100% rescheduling of short term debt accrued in 1983 over 8 years including 3 years grace and 90% of short term debt accrued since 1983 over 4 years including 1 year's grace. The outcome on the 1983 short term debt will effectively set the pattern for renegotiating the promissory notes and claims of the uninsured creditors. At a late stage in the negotiations new figures were put forward for the size of the financing gap. Once the IMF have got to the bottom of this we shall need to consider urgently the proposals already discussed for new cover.

The very difficult position we face on Egypt was set out in the Chancellor's minute of 15 December to the Foreign Secretary. The next stage here is the informal Fund Board meeting today to discuss ways of meeting the 1987 financing gap. The Paris Club agreed a common approach recognising the Egyptians' need for rescheduling over a number of years once agreement was reached with the Fund.

Finally, among the recent developments covered in the report below, it may be worth noting the worsening of the economic position in Indonesia in recent months and the consequent deterioration in sentiment towards that country, which is now the world's fourth or fifth largest debtor.

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

Yours ever,
Tony Kuczys
A W KUCZYS

INTERNATIONAL FINANCIAL SCENE

- 1 Commercial bank commitments to their agreement with Mexico reached the "critical mass" (90%) on 19 November. This, together with the subsequent IMF Board approval of Mexico's SBA, has permitted disbursements of various elements of the Mexican financial package. Disbursement of the banks' new money, however, still requires the commitment of a large number of smaller banks that have so far been reluctant to participate.
- 2 Meanwhile, a number of the concessions and innovations which have been required in order to put the package together - in particular the reductions in spreads, the growth contingency facility and the oil price contingency facility - are themselves causing difficulties in other debt negotiations. A number of debtor countries - including the Philippines and Argentina - have indicated that they regard the Mexican agreements as a precedent, and that they intend to secure equal - or better - terms for themselves in the face of insistence from the commercial banks that the Mexican agreements were an unrepeatable special case. At the same time, the IMF has, in the last couple of weeks, modified its earlier insistence on particular adjustment measures in a number of countries: the Fund MD has indicated his willingness to consider a programme for Jamaica that does not require an immediate devaluation of the currency, and Fund Management have been urged by Directors to put together a programme for Egypt despite there being considerable doubts over whether it will be possible to fill future financing gaps.
- 3 Whilst debtors see Mexico as a precedent, many banks are resentful at what they feel they have been forced to concede for Mexico. This is likely to manifest itself in widespread reluctance to participate in any further significant "involuntary" new money packages. There is particular resentment among the banks at what they perceive as the IMF endorsement, without prior consultation with them, of concessional terms proposed by debtors. This could affect banks' willingness to accept IMF leadership in future debt negotiations. As noted above, even participation in the Mexican package itself is to date far from universal: although 93% of the required new money has so far been committed (including a similar figure for the UK share), under 300 of the total of almost 500 banks involved have so far agreed. With banks now better capitalised than earlier, and having made substantial provisions against problem country debt, many feel less constrained in

their negotiations with debtor countries. With markets in secondary debt apparently now growing in significance, many banks are seeking to pass on their problem debts. The withdrawal of banks from the rescheduling process raises questions about the principle of burden sharing which has characterised debt negotiations to date; on the other hand, this reallocation of debt portfolios has a number of important benefits, and has been widely seen as providing a significant route for ameliorating debt problems.

4 Whilst some of these developments had been largely foreseen, concern over their implications had been to a certain extent mitigated by perceptions that the position in other major debtor countries was relatively favourable, so that no further financing packages of the scale of that arranged for Mexico were in immediate prospect. In particular, the Austral Plan in Argentina and Cruzado Plan in Brazil have been widely interpreted, despite some misgivings, as indicating that the authorities in those countries were committed to tackling their countries' economic difficulties, which would reduce further financing packages. The recent deterioration in economic performance in those countries is therefore all the more worrying. Argentina's monthly inflation rate rose to an average of over 6% per month between September and November. The current account has deteriorated this year, with the deficit expected to be \$1.6 bn (cf \$1.3 bn in 1985). Latest estimates suggest that the country may have to seek well over \$1 bn in commercial bank new money in 1987. In Brazil too inflation is causing some concerns (1.9% in October after 1.7% in September). More striking, however, is the sudden deterioration in the country's external position. After seeming until recently to be on track for achieving the earlier forecast of a \$12.3 bn trade surplus for the year, Brazil's surplus for October fell to only \$210 mn, and first reports put the November figure no higher than \$200 mn. The IMF forecast for the year has been revised down to \$10.5 bn. Clearly, any indication that the Brazilians are in serious difficulties would, especially given the attitude of creditors after the Mexican package, be extremely serious. On the positive side, it seems that the Brazilians are aware of the dangers they face: on 21 November, immediately after the Congressional and Gubernatorial elections, the authorities introduced a wide-ranging austerity package designed, inter alia, to cut 3 1/2% of GDP from the fiscal deficit in 1987, and including the introduction of crawling-peg devaluations, intended as a step towards restoring the country's competitive position. However, the public reaction to the new measures has been extremely hostile.

5 Elsewhere, attention has concentrated on a number of other oil exporters. Having achieved agreement on their official bridging loan, which was repaid on December 10, and on a term sheet with the commercial banks, the Nigerians conducted

a short roadshow at the beginning of December. The Nigerian SBA was approved in principle by the Fund Board on 12 December despite some concerns over the operation of the second-tier foreign exchange market. Meanwhile Egypt's new administration presented a package to Fund management which falls well short of the measures recommended by the IMF staff, and it has seemed increasingly unlikely that a financially viable programme could be devised which the Egyptians would find politically acceptable. But because of the risks arising from a breakdown of negotiations, creditor governments, including the G5 except for the UK, have given Fund Management some encouragement to reach agreement with the Egyptians on a softer programme than that recommended by the staff, despite the wider ramifications for the Fund. Even the staff's tougher programme would still leave the current account deficit as high (in absolute terms) in 1992 as in 1985. Venezuela has continued to irritate the banks with its unco-operative stance, particularly in negotiations over private sector debt, although it has now passed legislation on private sector debt which is likely to be accepted. And there is increasing concern over Indonesia's economic situation. Whilst the authorities' firm response to the collapse in oil prices was initially reassuring, the underlying deterioration in the country's economic position is now becoming more apparent. The current account deficit may exceed \$5 bn this year and is unlikely to improve significantly in 1987; the debt service ratio is expected to rise to 35% this year (cf 26% in 1985). The authorities may have to consider an IMF Standby; the Fund has apparently persuaded them not to use the fall in oil prices as the basis for seeking a CFF, despite the precedent for Ecuador, because of the opposition this would encounter in the Board.

6 Amongst other oil-importing debtors, the picture has been mixed. Morocco has reached agreement on a MYRA with the banks covering maturities of 1985-88. On the other hand, Zambia is facing serious difficulties in obtaining bridging finance to clear its growing arrears to the Fund. After serious food riots, the country has had to rescind measures to eliminate subsidies, thereby throwing its Fund programme into further doubt.

7 The wider economic environment shows little change overall in the last six weeks. The cut in the Japanese discount rate in October was not followed by other major industrialised countries; 6-month eurodollar interest rates remained slightly over 6% for most of the period, and have risen a little in the last few days. Indicators of activity in the United States are mixed, but are on the disappointing side. Growth in the fourth quarter is projected at about 3% pa or slightly less. The US trade deficit for October, initially estimated at \$12.1 bn, was somewhat better than expected; these figures are particularly prone to revision, but if they are unchanged they may indicate the beginning of some feed-through from past dollar

depreciation. If sustained, this could help dampen the rise in protectionist pressures in the US, although political factors point the other way. The dollar has weakened slightly since the end of October: on 17 December it was 11% below its level at the beginning of the year in effective terms; this leaves it some 30% below its February 1985 peak in effective terms, and roughly at its level of mid-1981.

8 Having risen in October, non-oil spot commodity prices resumed their downward trend in the five weeks to 9 December. The earlier rises seem largely to have arisen from temporary supply shortages, and did not reflect the underlying position in most commodity markets. Overall, the Economist index rose almost 5% in SDR terms (3% in \$) in October, but lost 3% in SDR terms in the following five weeks, to stand 12.4% below its level of the end of last year. There were dramatic movements over the nine weeks in some food prices with higher vegetable oil seed, maize and sugar prices (coconut oil rose 38.2%, palm oil 20.7%, maize 32.4%, sugar 27.5%) offset by lower tropical beverage prices (coffee prices fell 21.9%, cocoa -6.8%). Overall, the food index ended 21% below its level of the end of last year. Agricultural raw materials are 1.4% higher, whilst metals are almost 10% below end-1985 levels.

9 There is in general increasing interest in innovative approaches to handling debt, with the debt equity conversion schemes introduced by a number of debtor countries attracting particular attention. The Paris Club too has been considering moving beyond its conventional refinancings for the poorer debtors. And the series of conferences on international economic issues organised by Congressman Kemp and Senator Bradley (who has proposed a limited write-down of debts) seems to be gaining recognition in some quarters. At the latest conference on December 4 and 5, Bradley proposed a limited trial of debt relief in parallel with the Baker initiative, although Baker and several bankers pointed out that debt relief and new money sat together very uneasily. The discussions on debt at the UN General Assembly produced no major confrontation, and a consensus resolution, reaffirming the Baker strategy and recognising the importance of the debt issue, was adopted. A Ministerial conference on Latin America's economic problems will be held in Mexico City, between 19-23 January, under the auspices of ECLAC, and will focus on national and international strategies and policies for promoting economic recovery and development.

10 In the period since mid-October two borrowings by East Bloc countries, totalling \$355 mn, have been announced. Vneshtorgbank of the USSR is seeking a syndicated loan of \$300 mn at Libor + 1/8% to 1/4%, slightly finer terms than on its two

borrowings earlier this year; there has however been some market resistance, reportedly because of the fine spreads. During this period the National Bank of Hungary issued fixed rate bonds to the value of \$55 mn. Non-OPEC LDCs borrowed \$770 mn in fourteen loans, whilst OPEC members raised a further \$850 mn. Algeria's borrowing spreads in the syndicated credit market have widened to 5/8% from 3/8% earlier in the year, and a recent loan had to be reduced from \$500 mn to \$250 mn because of market resistance. Indonesia has raised \$350 mn at LIBOR +5/8% to 3/4% although the drawdown period of the loan has been reduced from the four years sought by Indonesia to 18 months.

Further details on individual countries are given below.

Latin America and Caribbean

11 Commercial banks achieved the "critical mass" (90%) for Mexico's financing package on 19 November, having missed the 31 October deadline. The Fund Board subsequently gave the SBA final approval, immediately releasing SDR 225 mn. In anticipation of the critical mass, on 18 November the World Bank had approved disbursement of the first tranche (\$300 mn) from the \$500 mn Trade Policy loan, and the second tranche was approved on 5 December. Achievement of the critical mass made Mexico eligible for funds from various elements of the whole financing package - namely, further drawings from the bridging loans (\$750 mn) and export credits (\$1 bn) from Japan - and the Paris Club agreement of 17 September is now effective. However, the banks' Advisory Committee still need commitments from a large number of smaller banks and broad agreement on other matters before disbursement of the new money can occur.

12 Finance Minister Petricioli presented the draft 1987 Budget on 19 November; this was accompanied by a tax reform bill which should raise government revenue by 1.3% of GDP; the PSBR is projected to be 13.8% of GDP (cf 16.9% forecast for 1986). Amongst the Budget's underlying assumptions for 1987 are growth of only 2-3% (cf 3.5% forecast in the SBA) and inflation of 70-80%. Inflation continues to rise, reaching 104% year-on-year in November (the government now forecast 110% by end-year). Depreciation of the controlled market exchange rate continues, though at a slower rate than previously, and the differential with the free rate remains narrow (at 2%). However, the slower rate of depreciation seems to have discouraged public interest in Pagafes (dollar-linked peso securities introduced in August). The first auction gave a dollar yield of 4.3%; in response to weak demand, the yield rose subsequently to peak at 14.9% on 23 October, but auctions were suspended thereafter. External performance is better than expected; the current account for

January-August showed a \$1.6 bn deficit (cf a forecast of \$3.5 bn for the full year) and the Fund report that net international reserves at end-September were \$1.2 bn better than expected. The January-August trade surplus (\$3.4 bn) was 63% lower than in the same period last year; oil exports were down 59%, but non-oil exports were up 30%, while imports were down 9%. A Fund team was in Mexico in early December as part of the first review under the country's SBA. Early indications are that its report will be mildly optimistic.

13 Argentina's "Austral Plan" seems to be faltering as inflation continues to rise, reaching a year-on-year rate of 79.2% in November (cf 74.2% in October). The government, however, argues that price rises are under control; banking reforms introduced in October should strengthen the formal banking sector and permit tighter control over credit expansion. The real economy is recovering, and industrial production rose by 24% between 1985 Q3 and 1986 Q3, returning to peak mid-1984 levels. It seems that the revised PSBR target of 3.5% of GDP for 1986 will be missed because of expenditure overruns earlier in the year. The current account deficit for the year is now expected to be around \$1.6 bn (cf \$1.3 bn in 1985), and a further deterioration is expected for 1987.

14 Although Argentina is seeking an SBA (possibly for SDR 1-1.5 bn) to replace that which expired at end-June, the IMF and the Argentines are not close to agreement on a programme, and negotiations with the IBRD are also proving difficult. Argentina also is expected to need well over \$1 bn from the banks in 1987; the Argentines met banks at the beginning of December, but some bankers are sceptical about the feasibility of a new money package. Meanwhile, Argentina has proposed a revision to Paris Club procedures for negotiating bilateral agreements which would involve them in launching a capital market issue (at a competitive market interest rate), guaranteed by creditor governments, instead of negotiating interest rates bilaterally.

15 The Fund Board discussed Brazil's Article IV on 10 December. The MD's summary expressed some concern on the country's economic programme. Meanwhile, there are increasing worries about Brazil's economic situation, including, for the first time since 1984, concern about its external performance. The external accounts have deteriorated sharply. The October trade surplus (\$210 mn) was by far the lowest this year, and November is expected to be no higher. The IMF has revised down its 1986 trade surplus forecast from \$12.3 bn to \$10.5 bn. Cash reserves are understood to have fallen from \$6.9 bn in July (6 months' imports) to between \$4.5 bn and \$6 bn in October (4-5 months' imports) and may have fallen to \$4 bn at the end of November. Following its decisive victory in the November Congressional

and Gubernatorial elections, the government introduced a package of sweeping economic measures designed to dampen consumer demand, reduce the PSBR, and halt the recent rise of inflationary pressures (inflation in October was 1.9% compared with 1.7% in September). The package substantially increased the taxes on a wide range of products, and raised public service tariffs; in addition, the immediate closure or merger of 15 state enterprises was announced, with a further 32 closures in the coming months. Wage indexation provisions have also been revised so that only those who have received no increase since February will benefit from an automatic rise when the CPI rises by 20%. The package is expected to raise around Cz 120 bn in 1987 (3 1/2% of GDP) and is expected to eliminate the operational PSBR in 1987. However, the package has been poorly received in Brazil, although a general strike on 12 December against the measures failed to gain much support. Attention will now focus on Brazil's attempts to obtain a rescheduling agreement of \$3.1 bn Paris Club arrears (1985-86 maturities) without an IMF programme.

16 Venezuela's proposed arrangements for handling its private sector debt were made law on 6 December, and now seem likely to be accepted by the banks, thus clearing the way for negotiations over amending the public sector MYRA. The Venezuelans are making the downpayment of \$750 mn needed to activate the MYRA: \$600 mn was paid in November, the remainder will be paid during December-January. Repayments under the MYRA should begin in January 1987, but the Venezuelans are seeking a longer grace period. The economy is generally performing poorly: real GDP is now expected to grow by only 0.8% in 1986, against earlier expectations of 3%, and gross international reserves declined by \$0.8 bn from mid-September to mid-October (cf a \$2 bn decline in the previous 9 months) to stand at \$10.9 bn. On December 6, the government announced a 48% devaluation of the bolivar. The government has presented its draft 1987 Budget, which envisages a deficit of 2.3% of GDP. This seems to have anticipated an alteration to the terms of the public sector MYRA as it contains no provision for 1987 amortisation payments.

17 The meeting between Peru and the banks' Advisory Committee, and a token (\$60 mn) interest payment, did not occur - as stipulated - by 25 November. In response, the banks have not disbanded the Advisory Committee, but are refusing to send an economic sub-committee to Lima, and a stalemate seems to have been reached. Meanwhile, the Peruvians have announced a further unilateral 3-month rollover (to 4 February 1987) of maturing public sector principal. President Garcia's APRA party strengthened its position in November's municipal elections. Garcia subsequently stated that debt service would continue to be only 10% of exports, that price controls would be maintained, and the exchange rate would not be changed before end-year. He also asked the business sector to co-operate with the

government in economic management. In 1987 the authorities are to employ monthly devaluations to depreciate the exchange rates by 30% over the year and have promised tax incentives to stimulate investment. The limit on debt service has boosted domestic economic growth, which is now officially forecast to be 8% in 1986 (cf 1.9% in 1985) - the highest rate for over 20 years. The government also expected to meet its inflation target of 66% for 1986 (cf 158% in 1985): year-on-year inflation in November is reported to be 60%. The end-1986 PSBR is expected to be 5.2% of GDP, hardly changed from 1985. Cuba and the banks' Steering Group have reportedly reached outline agreement on a deal to reschedule 1986 maturities and outstanding short-term deposits, although full details are not yet available. The banks have, however, rejected Cuba's request for \$300 mn in new money to meet an estimated financing gap for 1986 of \$600 mn. The Paris Club Task Force met the Cuban authorities on 18 November and made clear that the Club will not consider 1987 rescheduling needs until all non-rescheduled payments due under the 1986 agreement have been brought current. Ecuador is failing to achieve performance criteria under its current Fund programme. Relations between President Febres Cordero and the opposition-controlled Congress continue to be poor: Alberto Dahik, who had to resign as Finance Minister following impeachment by Congress after only three months in office as Finance Minister, has become the President's economic adviser. Meanwhile, it seems that lower oil prices will halve oil export revenues and reduce fiscal revenue by one-third. Ecuador's OPEC quota was raised by about 21%, to 221,000 bpd following October's OPEC Ministerial meeting, but this will involve significant cutbacks as Ecuador was producing an average of 286,000 bpd earlier this year.

18 Jamaica now seems rather nearer to reaching agreement with the IMF on a new SBA to replace that which was cancelled in July. The Fund have apparently made major concessions on the devaluation issue, agreeing that Jamaica need not devalue for 18 months, providing that targets for inflation and reserves are met. Jamaica is paying off its arrears to the Fund, and may be current by Christmas; its new SBA and proposed CFF could then come to the Board by late January/early February. It remains to be seen how long the new programme will stay on track, and how Jamaica's prospective 1987 financing gap will be filled. The IBRD Board met on 25 November to discuss Bolivia's medium-term economic strategy. This was discussed further in an IBRD Consultative Group meeting on 3-4 December, when the Bolivians also presented proposals for an anti-narcotics programme in the hope of attracting industrial countries' financial support. The Fund board discussed the SBA review and the CFF request on 15 December. Meanwhile, commercial bank creditors are awaiting an offer from Bolivia to repurchase its entire bank debt (\$680 mn). Funding the repurchase may be a problem: Bolivia has told the banks that donor

governments will provide the finance, but it seems that no government has actually made such an offer. The Guyanese authorities have now formally approached the IMF and IBRD for their support in designing an adjustment programme. The IMF may make its support contingent upon the willingness of Guyana's other creditors to participate in a debt restructuring and financing exercise. In any event it is difficult to identify the source of the bridging finance which would be needed to pay off IMF arrears.

19 The Chilean economy is generally performing well: the January-September trade surplus was \$0.9 bn, 50% higher than the same period last year, while industrial production in the nine months to September was 7.4% higher than in the same period last year. Chile's SAL2 loan (\$250 mn) was approved by the World Bank Board on 20 November: the US abstained on human rights grounds, whilst the UK voted in favour, on technical grounds. The first tranche (\$150 mn) will be disbursed by end-year, and the loan's approval means that the last tranche (\$50 mn) of the \$1.1 bn bank loan can be disbursed. On 2 December the IBRD approved a \$400 mn project loan. Meanwhile, negotiations are under way with the banks regarding 1987-88 financing needs, forecast by the Chileans at \$1.2 bn, with \$650 mn expected from banks. The banks, for their part, have urged Chile to approach the Paris Club to cover about \$200 mn and reduce their own provision of finance to some \$450 mn. Some banks are also concerned at the Chilean proposal that interest should in future be paid only annually in arrears, fearing that this might be the first step towards capitalisation. Colombia's economy is performing well. The Fund Board considered the 1986 Article IV and Review of the 1986 Economic Programme on 1 December: all performance criteria to end-September had been met and the end-December criteria were likely to be met. The "enhanced monitoring" arrangement lapses at end-year, and may not be renewed. Real GDP is expected to rise by 5%, against 2.8% last year; while inflation of 20% is forecast for 1986, against 22.5% last year. The PSBR is likely to be 1.6% of GDP this year, against 3.7% in 1985. High coffee prices have helped the external accounts and coffee exports for 1986 are forecast to be \$2.9 bn (cf \$1.7 bn in 1985), producing a much increased trade surplus of \$1.7 bn (cf \$0.1 bn in 1985). The current account is now projected to show a \$0.4 bn surplus against a \$0.3 bn deficit originally forecast. On 9 October, Colombia eventually made a first drawing (\$639 mn) from the \$1 bn bank loan arranged last year; there is no clear indication when the remainder will be drawn, though the existing termination date is end-1986. Uruguay's economy is also performing well: all SBA performance criteria for the first 3 quarter have been met; and real GDP in H1 was 5.8% above H1 1985, against a forecast of 3-4% growth for 1986. However, inflation is still a problem, and was 78.5% in the twelve months to October (cf an IMF target of 45% for 1986).

South and East Asia

20 The Philippine commercial bank debt rescheduling negotiations collapsed on 7 November. The major stumbling block was the Mexican precedent, with the banks determined that it should not become the norm for all future reschedulings and the Filipinos equally determined that it should in their case. Effectively the Philippines wanted to put almost all their debt onto a 20-year maturity with seven years' grace, at a margin of LIBOR +5/8%, together with an undefined "growth facility" to achieve 6.5% pa. economic growth. The Advisory Committee's counter proposals of a much more limited rescheduling at a spread of 1 3/8% were dismissed by the Philippine delegation, and further discussions within the Advisory Committee failed to persuade Citibank and Bank of Montreal to come down from 1 3/8% to 1 1/8% as a final offer. However, it appears that the banks are now prepared to make an offer of 1 1/8% and wish to reopen negotiations. The next meeting may take place in the first week of January. Economic Planning Minister, Mrs Monsod, has suggested that the government should toughen its stance by declaring a "partial moratorium" on interest payments, but it is not clear how much support she commands within the government. The new agreement with the IMF was approved on 24 October, and the Philippines is to be considered by the Paris Club at its January meeting.

21 Various indicators point to a marked deterioration of the economic position in Indonesia in recent months. In particular, earnings from oil and gas are expected to be about half their level in 1985, a drop of some \$6 bn. The current account deficit may exceed \$5 bn this year, and the debt service ratio is forecast to jump from 26% last year to 35% this. In the absence of a sustained increase in oil prices it may prove impossible to reduce the current account deficit significantly in 1987. September's devaluation has now been followed up with a series of measures designed to boost investment and non-oil exports, but only a small stimulus can be expected next year. The authorities may have to consider an IMF standby, despite their sensitivity to outside monitoring and the still healthy reserves position. Apparently Fund Management has argued successfully against a CFF.

22 In Malaysia the budget for 1987 was less tough than had been generally expected. Although development spending is to be slashed by 25% and overall Federal Government spending by 11%, an "operational" deficit will emerge for the first time and the consolidated public sector deficit will not be cut significantly from the 19% of GNP expected in 1986. Official projections indicate an 11% drop in per capita income in 1986, so that further measures would be bound to exacerbate the country's social and political difficulties. However, Malaysia is still well regarded in the international markets, where a \$500 mn syndicated loan was arranged in early October on fine terms.

23 Thailand's impressive economic recovery this year has been sustained, with growth now projected to exceed 5%, inflation steady at only 2% and a small current account surplus likely for the first time. The debt service ratio is forecast to fall from 27.4% in 1985 to 26% this year. Immediate prospects look encouraging.

Eastern Europe

24 Poland's external performance continues to give cause for concern, and the financing gap this year may exceed \$1 bn despite reschedulings by both bank and official creditors earlier in the year. In response to the Chairman's statement at the October Paris Club, the Poles are thought likely to pay some \$130 mn towards meeting arrears and have come up with new proposals for a future debt consolidation, but no further meeting is planned before January. Talks with the banks continued in December but the banks are against offering new money and official creditors will no doubt be expected to bear the brunt of the prospective financing gap of \$2-2.5 bn in 1987. An IMF SBA is unlikely to be agreed before end-1987.

25 Yugoslavia has now revised further downwards its 1986 convertible currency current account projection to \$462 mn, increasing official creditors' doubts as to how the financing gap will be closed. The Finance Minister's reply to the Paris Club Secretariat's letter seeking an explanation of policies was considered vague and unhelpful, but official creditors seem resigned to awaiting the next Fund enhanced monitoring report (probably to appear in mid-February) before taking further concerted action. The Fund Mission arrived in Belgrade on 1 December.

26 Elsewhere in Eastern Europe, Hungary's continued weak performance, and its failure to take necessary remedial action, give cause for increasing concern. The convertible currency trade deficit widened to \$624 mn in the first nine months and a current account deficit in the order of \$0.9 bn this year seems inevitable. However, the recent IMF Mission, due to report in January, appears rather sanguine about Hungary's ability to cope with its financing needs in 1987. Bulgaria's convertible currency trade balance deteriorated sharply in 1986 H1 (largely because of the country's dependence upon re-exporting oil, and on Middle Eastern markets) to a deficit of \$697 mn, and in the year to last June its position with BIS area reporting banks has shifted from a net exposure of only \$0.2 bn to \$2.1 bn. One bright spot - Romania has cleared all its remaining arrears with the IMF (SDR 39 mn) and prepaid its December obligations, and has settled \$76 mn out of \$103 mn arrears to the IBRD.

Southern Europe

27 In Greece the overshoot of the \$1.7 bn target for the current account deficit is now expected to be limited to around \$100 mn, because of oil price weakness. Non-oil imports have continued to rise, however, and the stabilization policy appears to have led to little structural reform so far. Despite indications that several of the performance targets for 1986 attached to the granting of the second half of the ECU 1.75 bn Community Loan have been missed, EC Finance Ministers have agreed to its release, following indications from the Greeks of further progress in dismantling export subsidies and import deposits and assurances that further expenditure and monetary policy measures would be taken if necessary.

Sub-Saharan Africa

28 Following the agreement of a term sheet with the commercial banks, the Nigerians embarked on a short roadshow in the first few days of December. The Fund Board approved Nigeria's SBA in principle on 12 December for 30 days. The Nigerians were commended on their adjustment programme, although some concern was expressed at the recent operation of the second tier foreign exchange market. The Paris Club agreed a rescheduling of \$7-7.5 bn of official debt on 16 December.

29 The upsurge in disinvestment by foreign companies from South Africa is causing concern in the country, although in many cases links are not being totally severed. The decision of Barclays to sell its remaining 40.4% stake in Barnat has created fears that further widespread UK disinvestment is likely. On the domestic front, the authorities expect growth of only 1% in 1986; their priority in 1987 is to achieve growth of between 3% and 4%. Despite the favourable balance of payments outlook, the South Africans may seek to limit resources available for the 1987 debt negotiations so as to allow for higher growth. A possible linkage between the amount on offer and the gold price has been mooted.

30 On 29 October, Zaire announced that it intended to restrict its debt service payments to 10% of export earnings or 20% of the domestic budget. It is unclear whether this policy stance is negotiable, but it is understood that discussions with the Fund are continuing over the old 22-month Standby, seven months of which have been completed. Zambia's external position has now become critical. The latest figures indicate that at least SDR 270 mn is required in new aid pledges to close the combined 1986 and 1987 financing gaps. A Paris Consultative Group is scheduled to meet on 16 and 17 December, but this may well be too early unless donors can focus very quickly on the problem. Bridging finance to clear Fund arrears

(currently SDR 104 mn and rising to SDR 135 mn at end-December 1986) is unlikely to be available until prospects for closing the financing gaps have substantially improved. Fund management is at present considering whether to revive the current programme or negotiate an entirely new one. Both options carry substantial risks, but negotiating a new programme would allow the current level of non-Fund arrears to be reduced over time; revival of the present SBA would involve these arrears being paid off. Moreover, after recent food riots the authorities have rescinded measures designed to reduce subsidies, thereby increasing the country's financing problems. Sudan continues to face intractable problems. Mahdi's government has, so far, been unable to resolve the damaging civil war or take firm action on the economy. Sudan remains ineligible to draw from the IMF and arrears continue to mount.

Middle East & North Africa

31 In Egypt, negotiations with a visiting IMF mission on a Standby arrangement were first delayed by President Mubarak's dismissal of Prime Minister Lutfi's administration (and the resignation of Central Bank Governor Negm) and then concluded at end-November without agreement on a Letter of Intent. It remains uncertain whether a viable programme can be put in place even with considerable exceptional assistance. The programme proposed by Fund staff, which assumed such assistance and further large accumulation of debt, conceded that the balance of payments would almost certainly not be viable over the medium-term; but the proposals were not acceptable to the Egyptians, who put forward their own much more gradual adjustment package. In an informal meeting on 4 December, Fund Executive Directors - including those from the G5 apart from the UK - encouraged the staff to adopt a softer approach, despite the wider ramifications for the Fund. In Iraq, the problems of Rafidain Bank remain unresolved. Some progress has, however, been made in bilateral rescheduling talks and some letter of credit payments are now reportedly being made. Iran is now facing an increasingly serious foreign exchange shortage, following Iraqi strikes on oil export facilities at Kharg Island and Larak which have significantly reduced Iran's oil exports (in October to around half the July level). The strains in the domestic economy, notably manufacturing industry, have become more severe.

32 In Morocco, the authorities have agreed a draft Letter of Intent with the IMF for a new SDR 230 mn Standby, but one precondition was an agreement in principle with banks on rescheduling 1985-7 maturities and closing the 1987 financing gap. In the event the banks agreed on 15 December to reschedule 1985-88 maturities over

10 years with 4 years' grace at LIBOR +1 3/16, and to re-reschedule also previously rescheduled 1987 and 1988 maturities. Outstanding bankers' acceptances and trade arrears are also being rescheduled. The Steering Committee have telexed the IMF, saying that the 1987 financing gap should now be closed. In Algeria, the external position is under growing strain - despite prompt adjustment - because of the low prices for oil and gas exports. Algeria's latest approaches to the market have been poorly received, and heavy amortisation payments are due in 1987. Increasing payment delays have been reported. The Omani economy has moved into recession with recovery unlikely before 1989. Sizeable fiscal and external deficits are in prospect this year and next; and further market borrowing may be sought to smooth difficult adjustment decisions.

INDEBTEDNESS AND BRITISH EXPOSURE

CONFIDENTIAL

\$ billion

	Total external debt	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1986*	End-June 1986	End-September 1986 [2]	End-September 1986 [3]
<u>Latin America</u>				
Argentina	51	2.8(0.2)	0.2	0.2
Brazil	104	6.3(1.4)	1.0	1.8
Chile	19	1.4(0.1)	-	0.1
Colombia	15	0.5(0.1)	0.1	0.1
Ecuador	9	0.5(0.1)	0.1	0.1
Jamaica	4	- (-)	-	-
Mexico	103	6.2(0.5)	0.6	1.2
Peru	14	0.3(-)	0.1	0.2
Uruguay	4	0.3(-)	-	-
Venezuela	35	2.1(0.1)	-	-
<u>Far East</u>				
Indonesia	42	0.7(0.3)	0.8	1.6
Malaysia	21	1.2(0.3)	0.1	0.1
Philippines	27	1.4(0.1)	0.1	0.2
Thailand	18	0.3(0.2)	0.1	0.1
<u>Eastern Europe (convertible currency)</u>				
Hungary	14	0.4(-)	-	0.1
Poland	34	0.5(-)	1.2	1.3
Romania	6	0.2(-)	0.3	0.4
Yugoslavia	19	0.9(0.1)	0.7	0.9
<u>Southern Europe</u>				
Greece	18	1.3(0.1)	0.2	0.3
Turkey	27	0.5(0.2)	0.2	0.5
<u>Sub-Saharan Africa</u>				
Cote d'Ivoire	8	0.2(-)	-	0.1
Nigeria	21	1.1(0.1)	2.2	3.1
South Africa	20	3.6(0.4)	0.8	2.5
Sudan	10	- (-)	0.2	0.2
<u>Middle East and North Africa</u>				
Algeria	23	0.3(0.1)	0.2	0.4
Egypt	45	0.2(0.2)	0.3	1.2
Israel	30	0.4(0.1)	0.1	0.2
Morocco	17	0.2(-)	0.2	0.3
Saudi Arabia	n/a	0.6(0.4)	0.2	0.3

[1] 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. Other portfolio investments in these 29 countries amounted to \$21 million at end-June 1986.

[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

OVERDUE FINANCIAL OBLIGATIONS TO THE FUND*

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding (SDR mn)
Kampuchea	13 March 1975	28.9#
Guyana	31 May 1983	46.3#
Viet Nam	6 February 1984	60.1#
Sudan	12 July 1984	323.8#
Liberia	25 January 1985	97.5#
Peru	9 September 1985	131.9#
Jamaica	15 April 1986	61.5
Zambia	30 April 1986	<u>104.0</u>
		<u>854.0</u>

NB The above figures are derived from Fund papers issued with respect to individual country complaints. There will have been further overdue obligations falling due subsequently, so the figures are not completely up-to-date. A Fund source indicates that total arrears were 886.4 mn as at 17.11.86 but this figure is not divided country by country.

* for members with at least one obligation with respect to repurchases or charges overdue for more than one month.

Guyana, Viet Nam, Sudan, Peru and Liberia are ineligible. Kampuchea is out of contact with the Fund.