



ccpc
②

Treasury Chambers, Parliament Street, SW1P 3AG

01-270 3000

10 February 1987

Charles Powell Esq
10 Downing Street
LONDON
SW1

Prime Minister

CDP
19/2

Dear Charles

INTERNATIONAL FINANCIAL SCENE

I attach the regular report on developments in the international debt scene.

My letter of 22 December noted that the world economic outlook for 1987 was somewhat gloomier than it had seemed at the time of the Bank Fund meetings. The institutional response to this outlook combined with signs of both creditor and debtor fatigue has been to generate suggestions from various quarters for studies/new debt relief initiatives. The ECLAC Conference in Mexico was safely negotiated on this score but the underlying note was one of threat. Later this year, debt and development issues may take the centre stage in UNCTAD while there are proposals for studies of the debt problems of the poorest (mainly African States) from Ripert at the UN and Stern at the World Bank.

As foreshadowed in our December report, there is now evidence (eg the Mexican and Nigerian packages) of great reluctance by commercial banks to participate in packages involving the contribution of new money.

The easing of conditionality, in the shape of weak Fund programmes for Mexico, Egypt and Jamaica, has been given a new and worrying dimension by the Paris Club's breach, in the case of Brazil, of its previous refusal to reschedule without a Fund programme. As with the earlier Fund cases, the main responsibility for this weakening of conditionality lies with the US. The way in which the Brazilian negotiations were conducted with the 11th hour change of position by the US in response to Brazilian threats underlines the need for senior creditors to align their positions in advance. We shall be working on ways of improving procedures.

On individual countries, Brazil has dominated the scene and is likely to continue to do so. Although the Paris Club agreement last month broke unwelcome ground in allowing Brazil to reschedule without a Fund programme, the rescheduling of maturities in the first half of 1987 is conditional on a letter of support from the Managing Director on the basis of



an Article IV discussion. On present form it seems unlikely that such support will be forthcoming. The latest indications are that the Brazilian economy continues to deteriorate on both the domestic and external account; the effective collapse of the Cruzado Plan has confirmed our earlier caution. The default threatened by the Brazilian negotiators at the Paris Club negotiations may come about in any event if the Government fails to take necessary adjustment measures fast enough. Ministers will be consulted shortly about the question of ECGD cover in these very difficult circumstances. The attitude of the commercial banks remains unclear: they seem to be waiting for a Brazilian initiative. The rollover of 1986 maturities expires at the end of March and there are reports that the Brazilians may want new money and a bank MYRA.

The next major debtor in the queue is Argentina. An outline agreement has been reached between Argentina and the IMF for an SBA and a CFF drawing. A hopeful indication is that the SBA has been agreed without a Mexican-style trigger clause. We will need to look carefully at the programme and, more especially, the prospects for its implementation. In the meantime the new Fund Managing Director has asked Executive Directors to participate in a \$700 million bridging loan. The UK has refused to take part and it is not clear that sufficient support can in fact be secured from other countries.

On a brighter note, the Chilean, Colombian and Uruguayan economies have generally been performing well. A number of oil exporters, such as Algeria and Indonesia, have also taken significant adjustment measures to try to maintain their creditworthiness.

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

Yours ever,
Tony Kuczys

A W KUCZYS
Private Secretary

INTERNATIONAL FINANCIAL SCENE

1 Heightened concern over the prospects for handling international debt derives from three interrelated factors: the increasing difficulties in maintaining a co-operative approach amongst banks and other creditors, the apparent easing of conditionality in some IMF programmes and Paris Club reschedulings, and the deterioration in economic performance in some debtor countries.

2 Regarding the first of these factors, there has been little progress in recent weeks in securing the remaining commitments to the Mexican new money package. Whilst around 95% of the required new money has so far been committed, well over 100 banks have to date not agreed to participate. It remains to be seen whether Chairman Volcker's appeal to the recalcitrant US regionals earlier this week has any significant effect. The fact that such an appeal has been delayed so long may well serve to blunt its efficacy. For the Nigerian package, critical mass on the agreement was not achieved in time for the IMF's revised completion date of 26 January; most Japanese banks, in particular, have been very reluctant to participate, especially on the new money element. Whilst these two packages may well yet be successfully put together (the Nigerian SBA was in the event made effective on 30 January on the existing level of commitments), the unprecedented difficulties involved - and the hostility of the banks more generally now to new money packages - suggest that Advisory Groups and debtors will be reluctant in the future to devise agreements which include significant conventional new money elements. At a time when several important debtors are about to begin discussions with banks in which a need for new money has been identified - Argentina, for example, is expected to seek \$1-\$1.5 bn in its prospective negotiations - this reluctance is likely to cause particular difficulty, and can only serve to undermine the credibility of the Baker Plan.

3 Partly because of the severity of the economic conditions facing some debtors, but partly because of political pressures, the Fund has in a number of recent cases endorsed strategies which imply a significant weakening of its conditionality.

and staff have been instructed by the Board to work on a programme for Egypt which is expected to leave the country's current account position at the end of the programme as weak as at present; and Fund staff have backed away from insistence on an immediate devaluation for Jamaica. In response to pressure from the US, the Paris Club has in the case of Brazil broken from its practice of requiring an IMF Standby to be in place before it will reschedule official debt: on 21 January it agreed to reschedule 1985-86 arrears and principal of 1987 H1 maturities; Brazil at this stage is committed only to "enhanced contacts" and to a favourable outcome from Article IV Consultations with the Fund.

4 Meanwhile, for the first time since 1983, there are no clear "success cases" amongst the major debtors. Brazil's economic position, in particular, deteriorated rapidly in the last months of 1986; although the authorities have taken measures to reverse the weakening on the external account, it seems that the anti-inflationary benefits of the Cruzado Plan have been dissipated and will be difficult to recover. In Mexico the authorities continue to struggle with the 60% reduction in export revenue in 1986 as a result of the oil price fall, although recent economic data suggest that the picture may well not be as gloomy as had earlier been expected. In Argentina the current account deficit more than doubled last year (to \$2.7 bn), and the country continues to suffer from the decline in the prices of its commodity exports. Amongst other major debtors, the problems of Egypt look intractable. A number of fora, including the Paris Club, have started considering new ways of handling the debt of the poorest countries.

5 Against these trends, there have been positive developments in some countries. After considerable delays, Morocco completed a rescheduling agreement with the banks and agreed an SBA with the Fund in mid-December. (Even so, there are already indications that a performance criterion on external arrears has not been met.) The Chilean, Colombian and Uruguayan economies have generally been performing well. A number of oil exporters, such as Algeria and Indonesia, have taken significant adjustment measures to try to maintain their creditworthiness in the markets. And, despite some rhetoric in individual countries about imposing limits on their debt-servicing payments, there has been little indication of any concerted attempt by debtors at an alternative strategy for handling debt problems.

6 The spot price of oil has risen from under \$15 pb at the end of November to approaching \$18 pb now, largely as a result of the December OPEC agreement. Meanwhile, non-oil commodity prices have continued to decline. In the eight weeks ending 27 January, the Economist all items index fell about 2% in SDR terms

(although it rose 2% in \$), so that prices are now 14% below their level at the end of 1985. Once again, the heaviest falls in the most recent period were in food prices (-4.7%), with industrial raw material prices stable. Major falls included coffee (-15%), maize (-16%) and beef (-12%). Coffee prices are now almost 50% below their level at the end of 1985, and close to their 1985 trough. Sugar prices rose 16%, because of lower estimates for output this year, after initial falls following the announcement that the US would cut its preferential import quotas for 1987 by 41%: these cuts will mainly affect Caribbean and Philippine producers.

7 In the wider economic sphere, developments have been mixed. Eurodollar interest rates fell slightly in early January, but have since recovered (six-month eurodollar rates are around 6 1/4%). Most debtors benefit from the continued decline of the dollar: in effective terms the dollar had by February 5 fallen over 5% since the beginning of December, leaving it 17% below its level at the start of 1986, and around its level of early 1981. However, the beneficial effects on the US trade account are slow in coming through: although on preliminary estimates the trade deficit for December fell to \$10 bn (cf \$19.2 bn in November), there are no clear signs yet of a sustained improvement in the trade deficit. Without such a reduction, protectionist pressures are unlikely to abate: whilst these pressures are at the moment directed principally at the EC, at Japan, and at some East Asian NICs, the threat to the LDC debtors remains real. Prospects for growth in the major industrialised economies are becoming slightly more gloomy, with forecasts edging down below 3% for the coming year - the West German official forecast has been revised down from 3% to 2 1/2%, and there are fears that activity could be weak in the US in the current quarter.

8 Since the beginning of December, there have been 11 market borrowings, totalling \$682 mn, for LDCs: within this, China borrowed a total of \$188 mn, whilst India borrowed \$125 mn. Jordan has arranged a syndicated credit for \$150 mn. Hungary was the only East Bloc borrower active in this period. The National Bank raised a \$200 mn syndicated credit and the Central European International Bank arranged a \$40 mn uncommitted NIF.

Further details on individual countries are given below.

Latin America and Caribbean

9 Little progress has been made with Mexico's financing package since the critical mass was achieved in November: commitments are only just over 95% and many small banks have yet to participate. Furthermore, a number of banks have committed on a

sis smaller than that requested by the Advisory Committee. It is thus unclear when disbursements will begin: the banks were originally expected to disburse \$3.5 bn by end-1986. The Advisory Committee met Mexican Finance Ministry representatives on 13 January to review the status of responses and, in a subsequent telex to the banking community, stressed the importance of full support from all banks and urged the recalcitrant banks to commit to the package. Against this background, economic performance continues to improve. All end-September performance criteria were met, releasing SDR 225 mn from the SBA in mid-November, and it seems that the end-December criteria will also have been met. The current account deficit during January-September was \$1.7 bn (cf \$2.7 bn expected in the Fund programme). The end-year trade surplus was \$3.9 bn, with oil exports down 63%, but non-oil exports up 33%; imports fell by 12%. (Non-oil exports exceeded oil exports for the first time for a decade.) Gross reserves fell \$1.3 bn in the nine months to September, but Finance Minister Petricioli indicated that at end-1986 gross reserves were slightly higher than at end-1985, largely because of private capital inflows of \$1.5 bn during the year. Consumer prices rose by 106% in the year to December (cf 115% forecast in the SBA), the highest on record. Nevertheless, the government is continuing its policy of raising public sector tariffs and prices to realistic levels and has undertaken to depreciate the peso in line with inflation: for a short period during December the controlled market rate was actually above the free market rate. Minimum wages were raised by 23% on 1 January.

10 Mexico has been repaying its official bridging loan on schedule; the whole of the first tranche (\$750 mn) has been repaid, and the remaining \$248 mn is to be repaid by 13 February. However, a request to defer repayment of the banks' bridging loan from 30 January until 30 April has been granted. The IMF have held discussions with Mexico to establish detailed performance criteria for 1987; their report will be scheduled for Board discussion before the end of March. Meanwhile, the IDB Board approved a loan of \$100 mn for tourism development on 2 December and the World Bank Board approved a \$250 mn second Export Development Project loan on 20 January.

11 The overheated Brazilian economy (which experienced real GDP growth of more than 8% in 1986) has run into serious liquidity difficulties. Concern about external performance has led the authorities to seek a rescheduling of Paris Club maturities, and they are now reported to be looking also for up to \$4 bn in new money in 1987 (including \$1.3 bn from IFIs) and possibly a commercial bank MYRA. At its meeting on 17-18 December the Paris Club agreed to discuss terms for a short-term

rescheduling of Brazil's \$3.2 bn 1985-86 payments arrears, provided 1987 payments were kept current. However, on 6 January, the Brazilians made a counter-proposal for rescheduling of the arrears plus 100% of 1987 principal and interest over 10 years (5 grace). After lengthy discussions at the Paris Club on 19-21 January - which included threats of default from the Brazilians and considerable pressure to reach agreement from the US - the Paris Club agreed to reschedule 1985-86 arrears over 6 years (3 grace), for moratorium interest to be repaid in three semi-annual instalments from June 1988, and (if a letter of support is received from the Managing Director of the IMF by 15 July on the basis of an Article IV discussion) for the principal on 1987 H1 maturities to be rescheduled also over 6 years, with 3 years' grace. The commercial banks have given no clear reaction to the Paris Club agreement, with its weak conditionality. Some reports suggest that discussions on a 6-month extension of the rollover of 1986 maturities to end-March will begin shortly, but that the banks will be unwilling to grant new money in the absence of a full IMF programme. UK banks appear fairly content with the Paris Club rescheduling of 1985-86 maturities, and take some comfort from their view that official creditors have kept a relatively tight rein on Brazil over 1987 maturities.

12 The Brazilian authorities remain under domestic pressure to avoid a Fund programme, but their room for manoeuvre has been curtailed by continuing poor trade figures and lack of liquidity. Commentators have suggested that the Brazilians would impose a temporary moratorium in the first instance if liquidity is exhausted, rather than go to the Fund immediately. The trade surplus in Q4 1986 was \$460 mn (cf \$3.4 bn Q4 1985), bringing the yearly figure to \$9.6 bn (cf \$12.8 bn in 1985), and unconfirmed reports suggest that there was a trade deficit in January. However, the authorities have indicated that they expect the trade surplus to recover to its Q1-Q3 1986 monthly average level of \$1 bn in the second half of 1987. The current account is reported to have recorded a deficit of \$2.8 bn (1.5% of GDP) in 1986, and the authorities forecast a \$1.7 bn deficit in 1987. Gross international reserves were estimated by the Central Bank to have fallen to \$5.3 bn at end-1986, although other estimates have put the level considerably lower, and the likely further drawdown since then suggests cash reserves may now be no more than \$2 bn (2 months' imports). On the domestic side, the Sarney administration, still feeling the after-effects of the unfavourable reception given to Cruzado II, has relaxed the price freeze by approving rises in a range of items in the face of continuing supply shortages and labour disputes. As a result the narrow official inflation rate rose to 15% in January, and the authorities expect a rate of 17% in February. The position of Finance Minister Funaro looks insecure.

13 Outline agreement has been reached between Argentina and the IMF on a 15-month SBA for SDR 1.1 bn and a CFF drawing of SDR 390 mn. Board approval is likely by end-February. Contrary to earlier reports, and in spite of strong Argentine pressure, the IMF has not agreed to a Mexican-style 'trigger clause'; however, the outline agreement provides that the country's growth performance and terms of trade will be 'taken into account' in setting future performance criteria under the programme. It also provides that Argentina may draw more under the CFF if its terms of trade deteriorate further and other normal CFF conditions are met. The programme is based on a projected real GDP growth rate of 4% in 1987 (cf growth of 5 1/2% last year); in addition, Argentina hopes to reduce inflation to an annual rate of about 40% in 1987 (cf 82% in 1986). Having already reduced the PSBR from 6.3% of GDP in 1985 to 3.6% last year, the authorities are aiming at a further reduction to 2.5% of GDP in 1987. They also intend to relax progressively the existing wage and price controls as and when conditions allow. It remains to be seen whether the government can carry through its adjustment programme in the face of opposition from the Peronist - dominated trade union movement, and in view of the gubernatorial elections due to be held in November. Doubts about the administration's policies were reflected in the increase in the parallel exchange rate premium to nearly 45% in early January.

14 Argentina continues to be seriously affected by the fall in commodity prices and the loss of the Soviet grain market. Exports for the first eight months of 1986 were \$4.9 bn, down 18% from the same period in 1985, whilst imports were \$3 bn (up 11%). It now seems that the 1986 current account deficit could be as high as \$2.7 bn (cf \$1.3 bn in 1985). The capital account surplus could be about \$700 mn, after allowing for the repayment of \$1.2 bn of arrears to external creditors during the year (which has reduced the total outstanding to \$500 mn). For 1987 the Fund Staff has identified a \$3.25 bn financing gap. They have suggested that \$1.2 bn of this could be met by a Paris Club rescheduling of 1986 and 1987 maturities, with an additional \$200-300 mn in the form of additional export credits, mainly from Japan. The commercial banks will probably be asked to supply the balance of \$1.85 bn. Argentina's liquid reserves fell to about \$1.5 bn (4 months' imports) at end-1986 and, with a \$300-400 mn bond repayment falling due shortly, could fall by a further \$1 bn in 1987 Q1. Because negotiations with bank and official creditors are progressing only slowly, the IMF MD has canvassed support for an official bridging loan to be arranged under the auspices of the BIS. The UK does not propose to participate (the UK did not take part in two earlier bridge loans for Argentina), but will not stand in the way of its arrangement.

15 The Advisory Committee failed to reach agreement with the Venezuelans by the end of 1986 over the proposed amendments to the MYRA covering \$21.2 bn of public sector debt. Instead, the banks granted a 90-day deferral on all payments due in Q1 1987, in order to allow more time to reach a satisfactory agreement; but the Advisory Committee insists that agreement must be reached by end-March. The Venezuelans have requested a one year grace period (1987) on their MYRA repayments, and much reduced payments in 1988 and 1989; they have also requested a reduction in the interest rate spread from 1 1/8% to 3/8% above Libor. The banks have yet to reach agreement amongst themselves how to respond, but the \$750 mn downpayment necessary to activate the MYRA has been made. Meanwhile, although the private sector debt scheme has now become law, many banks still feel that some of the issues have not been settled satisfactorily. Talks are continuing between the Central Bank and Advisory Committee representatives, but the banks are likely to have to accept the scheme as it stands. The Venezuelan authorities announced that real GDP growth was a rather surprising 3.1% in 1986, following the IMF projection (in June) of nil economic growth and their own forecast (made in November) of 0.8%. Inflation in 1986 was 11.5% (cf the IMF target of 11.9%). Oil export revenues fell by \$5.5 bn to \$7.2 bn in 1986; non-oil export revenues were up 13% on the previous year. A current account deficit of \$2.3 bn was recorded in 1986 compared with a surplus of \$2.9 bn the year before. Gross reserves fell to \$9.85 bn at end-1986 (cf \$13.75 bn at end-1985), of which \$4.3 bn are regarded as operating reserves. Even with the proposed amendments to the MYRA, the Venezuelans are forecasting overall balance of payments deficits of \$3.6 bn in 1987 and \$1.5 bn in 1988; allowing for a reduction in reserves, they are forecasting a financing requirement of \$3.5 - \$4 bn for the 1987-88 period.

16 There still appears to be a stalemate between Peru and the banks' Advisory Committee. The Committee remains unwilling to negotiate until the authorities make a payment equivalent to 10% of outstanding interest arrears (some \$650 mn at end-1986), and has discussed cutting short-term trade and working capital lines (\$320 mn, on which Peru has remained current) to put further pressure on the authorities. The latter have reiterated their policy of limiting debt service payments on medium- and long-term debt to 10% of export revenue, but are seeking to reach agreements whereby up to an additional \$240 mn would be repaid in goods this year. Most creditors have shown little interest, although four agreements have been reached with Soviet bloc countries. On the domestic front, a surge in domestic demand boosted real GDP growth in 1986 by 8% (1.5% in 1985) and the PSBR remained between 4-5% of GDP, excluding arrears. Higher domestic demand and the over-valued exchange rate have, however, weakened the trade balance, which may

Register a deficit for 1986, and gross international reserves were a reported \$2.2 bn at end-November (11 months' imports, cf \$2.5 bn at end-1985). There were no new IDB loans to Peru in the year and the IBRD is reported not to be planning any new lending at the moment.

17 No significant progress has been made in Cuba's negotiations with external creditors. On 26 December, the government announced an austerity package aimed at improving the country's hard currency position in 1987. The main measure was a sharp increase in fuel prices to reduce domestic consumption. Ecuador will be having discussions with the banks about easing the repayment schedule on the banks' \$4.7 bn MYRA (signed in December 1985). The country's official MYRA is also off-track, and at some stage the Ecuadoreans will have to renegotiate. Meanwhile, the country is close to agreement with the IMF to extend the SBA to the end of 1987. However, recent events (the kidnapping of President Febres Cordero and its consequences) underline the weakening position of the government. This raises considerable doubt about the future effectiveness of economic management and will render debt negotiations much more difficult. The Guyanese authorities have been continuing talks with the Fund about an SBA. However, before the Board can approve an adjustment programme, Guyana will have to eliminate its SDR 50 mn of arrears to the Fund; the Fund will also need to be satisfied that the overall financing gap (estimated by the IBRD at \$157 mn in 1987 and \$100 mn per annum in 1988-90, after rescheduling) can be met from external sources.

18 Negotiations continue between Chile and the commercial banks about covering \$650 mn of the \$1.2 bn financing gap: the banks have suggested that they provide only \$450 mn with the Paris Club providing \$150-\$200 mn. The Paris Club has expressed its unwillingness to agree a second rescheduling, given its exceptional undertaking to maintain cover in its previous rescheduling agreement with Chile in July 1985. However, the Chilean authorities have indicated that they will have to approach the Paris Club again. The IBRD is reportedly considering various co-financing mechanisms to try to break the deadlock. All IMF targets for 1986 are likely to have been achieved. Real GDP growth in 1986 was 5% (cf an IMF target of 3-5%), whilst the public sector deficit was on target at 2.2% of GDP (cf 2.6% in 1985). The trade surplus may exceed the target of \$1 bn (it was \$946 mn up to mid-October). Inflationary pressure has been increasing, and the year-on-year rate in December was 17.4% (but still just within the IMF target range of 15-18% for 1986 as a whole). On 2 December the IDB approved a \$319 mn loan for Chile for a hydro-electric project.

19 Jamaica and the IMF have reached agreement on a new 15-month SBA for an estimated SDR 110 mn. Targets under the agreement include the reduction of inflation from a projected 12% in FY 1986-87 to 7% in FY 1987-88; the reduction of the central government borrowing requirement from 6.4% of GDP in FY 1986-87 to 3.3% in FY 1987-88; and a 10% ceiling on annual wage rises. The programme does not include a devaluation (which had previously been urged by the Fund and had been a major stumbling block) at this stage, but the government has introduced a tax rebate scheme to encourage exporters. The Fund Staff hope to bring the SBA (together with a CFF request) to the Board in late February. Meanwhile, Jamaica cleared its SDR 50 mn of outstanding arrears to the Fund on 13 January from the proceeds of forward sales of bauxite. Agreement with the Fund on a new SBA will enable Jamaica to draw on recently-agreed IBRD loans totalling \$60 mn.

20 The Colombian economy performed well in 1986. Real GDP grew by an estimated 5%, whilst inflation fell to 21% (cf 22.5% in 1985). The PSBR fell from 3.7% in 1985 to 1.7% of GDP in 1986. Shortly before Christmas, the Colombians drew \$318 mn of the final \$361 mn tranche of the \$1 bn commercial bank loan. The IMF "enhanced monitoring" arrangement expired at end-1986 and will not be renewed. The Uruguayan economy also generally performed well, achieving a 1986 trade surplus of \$234 mn, with exports of \$1,056 mn (up 25% on 1985) and imports of \$822 mn (+15%). Foreign exchange reserves grew strongly and GDP growth was about 5%. The Advisory Committee met the Bolivians early in January to discuss the possible repurchase by Bolivia of its commercial bank debt; they are shortly to telex all banks requesting their approval of an amendment to the original loan agreements to allow repurchases. The source of finance for the repurchases has yet to be resolved.

21 The December meeting of IDB Governors to discuss the 7th Replenishment agreed that the lending programme would be between \$20-25 bn, up to 25% of which would be allocated to sector lending. The precise size of the Replenishment and the voting structure within the Board of Governors are expected to be decided at the next meeting (in Washington on 17-20 February). Loan approvals in 1986 amounted to only \$3 bn, the lowest annual level since 1982, bringing the total under IDB-6 (1983-86) to \$12.7 bn.

South and East Asia

22 The negotiations between the Philippines Government and its major commercial creditors scheduled for 6 January were postponed at the last minute. Both sides seemed to accept that another meeting would prove futile at that time since there

was no apparent compromise available. The banks, however, agreed to another 90-day standstill on repayment of debts maturing from 1 January 1987, and to extend the \$4 bn trade facility for another 6 months. The banks also ruled that a prospective agreement would be retroactive to 1 January 1987. With the constitutional Plebiscite now out of the way, a meeting is being arranged for later this month. Meanwhile on 22 January, the Paris Club agreed to reschedule 100% of principal and 70% of interest on \$870 mn of Philippine debt over 10 years with 5 years' grace. During this period, the Government has been adopting an aggressive stance on debt. Finance Minister Ongpin has intimated that legal sanctions may be applied against Citibank in retaliation to its stand at the abortive negotiations in November, and stated that the Philippines would discuss joint action on debt with Brazil and Argentina. Real GDP is estimated to have grown by 0.1% in 1986, following the sharp falls in the previous two years, and the Government is aiming for a growth rate of around 6% in 1987. However, a level of 3-4% (roughly in line with the IIF's recent forecast) seems more likely.

23 Malaysia's latest figures show a trade surplus of US \$2.3 bn in the first ten months of 1986 (cf US\$3.4 bn for 1985 as a whole). However, the outlook for 1987 appears relatively gloomy, despite the recent recovery in oil and tin prices. Real GDP is set to increase by no more than 2%, following only 0.5% growth in 1986. In Indonesia the 1987 Budget was presented on 6 January. Real government expenditure was cut by an estimated 4% in rupiah terms, although the decrease was nearer 17% in US dollar terms. On the assumption of an oil price of US\$15 pb, the budget deficit is expected to widen to Rp 5.5 bn (6.9% of GDP), compared with Rp 3.6 bn (4.5% of GDP) in 1986. The budget is regarded by bankers to be as austere as is politically possible. Nevertheless, concern is mounting about the debt-service ratio, now variously estimated at between 35% and 40%. A US\$350 mn syndicated loan was agreed before Christmas with an 8-year maturity, a 5-year grace period and a 5/8% spread for the first 6 years and 3/4% for the remaining two. An initially lukewarm response put paid to suggestions that the authorities would seek to raise the amount to US\$400 mn.

24 In marked contrast, a US\$300 mn syndicated loan for Thailand, proved so popular that the amount was increased to \$350 mn. Meanwhile a new US\$30 mn "Thailand Fund" has been launched to channel foreign investment into the Thai Stock Exchange. This comes shortly after Merrill Lynch doubled the size of its Bangkok Fund to US\$30 mn. GDP growth is set to increase to 5 1/2% in 1987 following the 4 1/2% recorded in 1986. South Korea's prospects continue to appear very promising. The current account surplus of US\$4.5 bn in 1986 enabled Korea to achieve a cut in its

foreign debt, from US\$46.8 bn in December 1985 to just under US\$46 bn at the end of last year. Assuming that Korea achieves a projected US\$5 bn current account surplus in 1987, the Finance Ministry expects external debt to fall to US\$42.3 bn by the end of the year. GNP growth is forecast at 7.5% in 1987 after an exceptional 12.2% in 1986.

Eastern Europe

25 The Poles met official creditors in Paris on 23 January but failed to reach agreement. The Poles indicated that they expected to have around \$325 mn available for official creditors in 1987 as a whole, compared with the Paris Club's expectations of around \$550 mn in the first half of the year. At the end they were handed a letter setting out the Paris Club's proposals for consolidating arrears and payments due under various arrangements, but requiring the Poles to implement in full the 1981 agreement. A visit to Warsaw by Whittome (IMF) earlier in the week had revealed sharp differences over the timescale of economic adjustments the Poles were to make. Nevertheless, the IMF will return to Warsaw in the Spring to begin exploratory discussions on a Standby. Hungary's performance in 1986 was dismal, with a convertible currency current account deficit expected to be well in excess of \$1 bn (4% of GDP). Banks (which may not be aware of the size of the deficit) still do not seem very concerned; however, although the \$200 mn 8-year credit currently being arranged has been fully underwritten, the general syndication may prove more difficult because of the aggressive terms (Libor +1/4%). Yugoslavia's poor economic performance in 1986 gives cause for serious concern; the surplus on the convertible currency current account is unlikely to have reached \$400 mn. Despite earlier reports that the financing gap appeared to have been closed with the aid of substantial unidentified capital inflows, and no reports of any arrears, new balance of payments and national accounts data show substantial revisions; these indicate a much less favourable picture than seemed likely even at the time of the Fund Article IV mission in December. The Article IV report will have to be rewritten, and Fund discussion postponed. This casts doubts over the implementation by governments and banks of the next stages of their respective rescheduling packages. The outlook for 1987 is not good, with the Fund projecting a financing gap of around \$0.8 bn.

26 Romania on the other hand appears to have ended the year relatively well. The current account surplus appears to have exceeded the target of \$1.2 bn, enabling the clearing of arrears with both the IMF and IBRD (reports of new arrears with the IMF in January probably only reflect normal Romanian practice of late payment) and some

recovery in reserves. Following rejection of their earlier request to official creditors to reduce interest margins, the Romanians have informed them that they want to prepay the remaining balances under the 1982 and 1983 rescheduling agreements (around \$340 mn, of which some \$150 mn is due this year). If the Romanians proceed along these lines it will imply a very tight liquidity position throughout 1987. The move would be very unpopular with the banks, who would be bound to see the relief given by their agreement of last September to re-reschedule \$750 mn as having been used to pay out the official side, and the banks could be expected to be correspondingly reluctant to lend further support should the Romanians seek it in the future.

Southern Europe

27 In Greece the current account deficit last year was reduced to \$1.8 bn (4.6% of GDP) from \$3.3 bn (10% of GDP) in 1985, but the near-achievement of the \$1.7 bn target was only as a result of weaker oil prices and increased transfers from the EC. The import deposit scheme is to be completely removed by end-April, and export subsidies are to be phased out gradually by means of a substantial reduction this year and further annual steps to complete removal by the beginning of 1990. Following the EC Finance Ministers' agreement in December, the second half of the ECU 1.75 bn Community Loan is expected to be disbursed in March or early April, but the progress of the Greek economy is to be monitored on a quarterly basis by the Monetary Committee.

Sub-Saharan Africa

28 Nigeria's 1987 budget, announced on 2 January, maintains the tight fiscal policies required under its structural adjustment programme. The government's announcement of its intention to limit debt service to 30% of export earnings is thought to be only for domestic political consumption. Meanwhile, the authorities have reduced the amount of foreign exchange available at the weekly auction, and the rate is moving towards N4=US\$1 (having earlier rebounded to N3=US\$1). However, the country failed to secure critical mass (now defined as 90%) of commitments from the banks within the 30 days given by the approval in principle of the SBA. A two week extension was agreed to 26 January, but responses have been slow. A particular difficulty has been the reluctance of the Japanese banks to participate in the new money element of the package. The SBA was nevertheless made effective by the IMF Board on 30 January on the basis of commitments received (about 87%), but there are likely to be further difficulties over Nigeria's failure to make the payment of

interest (about \$30 mn) due on 5 January to holders of promissory notes under the scheme to reschedule uninsured trade arrears; discussions of detailed proposals of a revised payments schedule are expected to begin shortly.

29 The South African Standstill Co-ordinating Committee has been touring Europe and the US to see the major creditor banks. The commercial banks in the Technical Committee see advantage for themselves and South Africa in starting negotiations for the next roll-over of commercial bank debt ahead of the scheduled meeting in April (which could clash with the planned general election for the White electorate). The SCC has yet to give its response to the idea. However, some banks appear to have been irritated by the SCC's tactics of trying to play off the banks against each other. Despite further consultations in November between Fund staff and the Sudanese authorities, there is no sign that the two sides are any nearer to reaching agreement on a Fund-backed adjustment programme. The Article IV discussion revealed little progress.

30 Zambia continues to face serious financing difficulties. The Zambians are actively seeking bridging finance to cover IMF arrears (which currently stand at SDR 130 mn), so that either their Fund programme can be re-instated or a new programme can be negotiated. Commercial bank bridging finance to clear the arrears may be obtainable, but only if the banks can be assured that a viable Fund programme can be put in place. For their part, Fund staff have drawn up a scenario for 1987 which - even assuming disbursements from the Fund and World Bank as well as generous Paris and London Club reschedulings - still leaves a financing gap of SDR 57 mn. Zaire has recently improved its relations with the IMF and IBRD, despite the announcement last October of a debt servicing ceiling. The engineered depreciation of the zaire by 11.6% in January appears central to this improvement, and negotiations on a new IMF programme are expected to begin soon. On the IBRD side, the first tranche of an industrial Sector Adjustment Loan, agreed last June, now been disbursed.

Middle East & North Africa

31 Following the informal meetings of the Paris Club and of IMF Executive Directors to discuss Egypt, on 17 and 22 December respectively, official creditors and the Fund have embarked on a course which they privately acknowledge has little prospect of success in the medium term. A Fund Mission arrived in Cairo on 15 January with instructions to agree a Letter of Intent, despite the authorities' continuing reluctance to accept Staff recommendations for early corrective action on exchange

rates, energy prices and, in particular, interest rates. An exceptionally generous Paris Club-style rescheduling is expected which, for political reasons, is likely to be dealt with outside the Club. A meeting of a consultative group of donors, probably to be chaired by the IBRD, is also envisaged to ensure that the prospective external financing gap will be closed for at least the period of the initial eighteen-month Standby.

32 Consequent upon the banks' signing of an agreement on 15 December with Morocco, to reschedule their 1985-88 debt, the IMF approved a 16-month SDR 230 mn Standby arrangement the next day. The first review under the Standby, which is scheduled for mid-February, seems likely to reveal that the Moroccans failed to meet the stipulation that external arrears should be reduced to a maximum of SDR 375 mn by end-December 1986. Syndication of Algeria's latest loan (progressively scaled down to \$250 mn) arranged by BNP, proved difficult, but the deal was eventually signed on 19 December. The authorities are reported to be seeking further borrowings via a £75 mn bankers' acceptance facility for the state oil company and a \$100 mn credit for the state-owned commercial bank. Against the background of growing external difficulties, the authorities continue to demonstrate the will to adjust: they have announced a budget for 1987 which envisages a deficit of some \$2.5 bn (5% of GDP), \$500 mn less than the revised figure for last year, and a further 17% reduction in imports.

33 Iraq's payments problems continue, with latest reports indicating that the vast majority of letters of credit remain unpaid, including a number payable through Rafidain's London branch. A recent report has estimated that Iraq's total indebtedness was (mid-1986) at least \$55 bn, and, more importantly, that debt other than that to the Gulf Co-operation Council may be \$26 bn (including \$19.4 bn of trade credits).

INDEBTEDNESS AND BRITISH EXPOSURE

\$ 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]
Latin America				
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)	-	-
Far East				
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
Eastern Europe (convertible currency)				
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
Southern Europe				
Greece	18	1.3(0.1)	0.2	0.3
Turkey	27	0.5(0.2)	0.2	0.5
Sub-Saharan Africa				
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
Middle East and North Africa				
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
Oman	3	0.1(-)	0.7	1.9
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	50.3#
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#
Zambia	30 April 1986	140.0
Somalia	29 October 1986	3.2
Romania	6 January 1987	34.0
		<u>869.7</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 972.1 mn as at 12.1.87 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.

Econ Pol

INTERESTEDNESS

P76

