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Dear Charles

INTERNATIONAL FINANCIAL SCENE

... I attach the regular report on developments in the international debt scene. This report sets out the background to the Interim and Development Committee meetings early next month in Washington, which will have debt issues on their agenda.

The meetings will take place against a growing perception amongst creditor governments, except the US Government, that the position of problem debtors is not yet improving despite the efforts made - on both sides - since 1982. The outlook on debt remains very difficult, although the systemic risks for the banks have clearly receded since the onset of the crisis and there has been some modest growth in schemes, such as debt/equity swaps, to value debt more realistically through the secondary markets.

The outlook for the world economy is for continued moderate growth. Most industrialised countries are implementing prudent macro-economic policies, and inflation has been reduced significantly. But the fall in oil prices has not boosted growth of output and trade as much as was hoped. There is therefore unlikely to be any major improvement in the external environment facing debtors (unless commodity prices recover sharply). There is also increasing recognition of the weaknesses in the implementation of the present strategy to which our earlier reports have drawn attention: uneven conditionality; differences between creditors; difficulty in assembling bank packages; more confrontational negotiations; and an increasingly intractable problem in sub-Saharan Africa.

Against this background, the Washington meetings seem likely to be dominated by the problems of individual countries. The meetings may see the start of attempts to reshape some aspects of the present strategy particularly in relation to sub-Saharan Africa.

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Our last report noted that Brazil was likely to continue to dominate the scene. That has proved to be the case. The Brazilians announced, on 20 February, a moratorium on interest payments to commercial banks on medium and long term debt and an effective freezing of principal on short term debt. These measures follow a rapid deterioration in economic performance since summer last year, reflected in a much reduced trade surplus and accelerating inflation. There are as yet no signs that the Brazilians are prepared to contemplate the necessary corrective action. On the bank negotiations themselves, the position remains fluid and no formal proposals have been put forward. Funaro's attempt to politicise the negotiations, through visits to capitals, has largely misfired. The general message he received was that governments would not put pressure on the commercial banks and that policy improvements were necessary. In the main governments were unwilling to provide new export credits before Paris Club consideration of an IMF report in July.

The banks have had to accept the Brazilian measures as a fait accompli and are likely to have to roll over for a further period the payments under the existing rollover due on 31 March. In the wider context they have responded by a deliberate effort to speed up negotiations with a number of debtor countries, thus reducing the risk of contagion. Agreements have been reached with Chile and Venezuela in the past few weeks whilst faster progress has been made in the negotiations on the Argentine and Philippine packages.

Recent developments in Mexico have been relatively encouraging, although it is not yet clear whether signature of the long delayed commercial bank package is going ahead as planned. Economic developments have been generally favourable. The current account deficit was lower than expected in 1986 with the reduction in oil receipts offset in part by a 33 per cent rise in non-oil exports. However, the outlook remains uncertain and heavily dependent both on the oil price holding up and on adequate fiscal targets being agreed and implemented in a pre-Election period.

The current picture on Nigeria is less encouraging. The stand-by arrangement has run into trouble with the discovery that some 20 per cent of oil revenues have been dedicated to a number of major industrial projects thereby reducing the amount of foreign exchange available for debt service and imports. It is not yet clear whether the Government will take effective steps to dismantle these arrangements. In the meantime, ECGD are due to start their bilateral negotiations with a Nigerian team this week. Satisfactory completion of these is the key to activation of the promised export credit package.



Still more discouraging is the outlook on Egypt. Although a formal letter of intent with the IMF has now been agreed, a financing gap remains even after very generous rescheduling. The medium term balance of payments prospect is so poor that the Fund Managing Director has asked Executive Directors to consider guaranteeing repayments by Egypt and offering concessional interest rates on rescheduling. We have very serious reservations about both these suggestions. Informal discussions are still going on in Washington and the subject will inevitably be discussed by Finance Ministers during the Spring meetings.

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
Private Secretary