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Dear Charles

INTERNATIONAL FINANCIAL SCENE

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

2. Since the last such report, after the Washington Interim and Development Committee meetings, the Venice Summit has taken stock of the debt situation and generally endorsed the present strategy for handling it. The Summit communique recognised the particular problems of the poorest, most heavily indebted countries in Sub-Saharan Africa to which the Chancellor's initiative at the Washington meetings was directed. Although the communique fell short of endorsing our proposals on concessional interest rates, it is being interpreted as a clear signal to press on with the necessary work to provide the countries concerned with debt relief. The next step will be an informal meeting, jointly organised by the Bank and Fund in early July for G10 members, to discuss the various initiatives in this area, including the treatment of debt owed to the international financial institutions and M. Camdessus' proposal for a significant increase in the resources of the Structural Adjustment Facility. It will be followed by a further Paris Club meeting in late July. Although the communique only talks of a conclusion within the year, we shall be pressing for decisions by the time of the Autumn Bank/Fund meeting.

3. In the meantime, the discussions in Venice should be helpful in dealing with the debt issue at UNCTAD. They will also provide a basis on which we and others can reply to the now traditional pre-Summit letter from the Cartagena Group of countries.

4. On the general scene, there has been little change in the economic outlook, whether for debtors or for creditors, although the rise in dollar interest rates is clearly increasing debtor anxiety. The most important new development is the move by Citicorp followed by a number of other US banks to increase its loan loss reserves by \$3 billion, equivalent to



providing against 25 per cent of its sovereign debt exposure. The scale of increased provisions by US banks has swiftly been overtaken by the decision announced earlier this week by Natwest to increase its provisions from 13 per cent to close on 30 per cent. These are long looked for moves in the direction of greater realism by the commercial banks, away from the orchestrated world of crisis management, and should be a healthy development for the longer term. The expectation of such decisions has been a central element in the debt strategy of buying time: the banks' moves have been welcomed in the market and reflected in strengthened share prices. It is possible that in the shorter term, say the next twelve to eighteen months, debt negotiations could be more difficult in some cases. Commercial banks may negotiate more toughly, be less prepared to make concessions or to provide new credit, and more prepared to risk defaults. Debtors could react by agreeing to quicker settlements, seeing little gain from holding out and risking breakdown: alternatively, some at least may see the balance tipped towards default. An increased risk of non-payment would also affect government creditors and export credit agencies.

5. Turning to individual countries, of the three major Latin American debtors, only Mexico is making satisfactory progress. Brazil remains the major problem; with political uncertainties compounding a poor economic outlook - very rapid inflation, lax fiscal policy and a trade balance only benefiting from recession. The new economic team have introduced an interim package of anti-inflation measures, including a further devaluation, a short-term wage and price freeze and cuts in public spending. A comprehensive macro-economic plan is still said to be in preparation. In the meantime, Brazil has asked the Paris Club for postponement of deadlines in the January rescheduling agreement. There will be difficult decisions about how far to go along with Brazilian requests for more time without a clearer idea of Brazilian intentions.

6. The situation in Argentina also gives cause for concern. Economic performance is moving away from the IMF programme on a number of fronts and the programme could be off track by the time the critical mass of commercial bank financing is secured.

7. Elsewhere further action is still needed in Nigeria before the first review of its IMF programme can be completed. In Zambia, President Kaunda has broken with the IMF and abandoned the IMF adjustment programme. Among Francophone countries, the Cote d'Ivoire, an earlier successful rescheduler, has suspended debt servicing. On the other side of the coin, following approval of Zaire's SBA, SAF and CFF despite reservations, the Paris Club agreed a rescheduling over 15

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years - a partial implementation of one of the elements in our Sub-Saharan African initiative. Similar treatment may be offered to other African countries whose rescheduling requests come before the Paris Club this week.

8. Finally, problems over implementing the second stage of the Yugoslav MYRA seem to have been resolved. Doubts about whether the Yugoslavs are taking sufficient action remain but creditors, on the basis of a cautious assessment from the Fund Managing Director, seem likely to let Stage 2 go ahead and to focus on tightening conditionality for Stage 3.

9. I am copying this letter to Tony Galsworthy, Tim Walker and John Footman.

Yours ever,

Tony Kuczys

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INTERNATIONAL FINANCIAL SCENE

1 On 19 May Citicorp (with \$11.6 bn exposure to Latin America the international bank most exposed to the region) announced that it intended to increase its loan loss reserves by \$3 bn, leaving it with a net loss of \$2.5 bn for 1987 Q2. Citicorp reported that the addition to its reserves meant that it had now provided against 25% of its sovereign debt exposure. To some extent this merely represented a continuation of the trend of the past couple of years towards banks making themselves less vulnerable to losses on their sovereign debt: in 1986 Citicorp itself had boosted its primary capital by 24% to \$13 bn, and had increased its loan loss reserves by 37%. It may also have represented an attempt by Citicorp to improve its tax position in future quarters. Nevertheless, the magnitude of the increase in reserves was unprecedented, and created expectations that other heavily exposed banks would take similar action. On 27 May Chase Manhattan, the fourth most exposed bank to Latin America, and the second most exposed of the major US banks in relation to its equity capital, announced that it intended to increase its reserves by \$1.6 bn in the second quarter, leaving it with a loss for the quarter of \$1.4 bn. (Chase followed Citicorp in announcing that it would maintain its dividend for the quarter.) Some other banks, amongst them most notably Bank of America, the second most exposed bank and generally considered one of the weakest of the major banks, have also followed Citicorp in announcing large increases in their loan loss reserves. On 20 May the Bank of England issued a notice to the Press, reflecting discussions the Bank had held with the major British banks over the previous few months, declaring that the Bank expected to see British banks make sizeable increases in their provisioning against sovereign debt.

2 Market sentiment has been broadly in favour of Citicorp's move, and the bank's share price rose after the announcement, suggesting that the market had already largely discounted the fall in the underlying value of the sovereign debt, and was now regarding Citicorp's announcement in effect as a better recognition of reality. Citicorp's move was prompted in part by the moratorium on interest payments imposed by Brazil (claims on Brazil are a higher proportion of claims on problem debtors for Citicorp than for any other major international bank), but reflects also the increasing availability of secondary markets and of equity conversion schemes whereby a bank can dispose of, or transform, its existing

Portfolio: Citicorp has indicated that it intends to remove \$5 bn of LDC loans from its books using these activities. Whilst the strengthening of banks' positions is undoubtedly a step towards the resolution of the debt problem, it is also likely to lead to a hardening of banks' negotiating stances in future financing packages, making the completion of these packages rather more difficult. Citicorp itself was in recent months prepared to stand out for several weeks against the Advisory Group consensus over the Philippines and Chile, and further moves in this direction would provide a serious undermining of creditor cohesion. On the other hand, Citicorp (and latterly also Chase) have indicated that they intend to play their full role in continuing to handle problem sovereign debt; and, since the announcement of its increases in reserves, Citicorp has led the Advisory Committee (which includes Chase and Bank of America) in signing up for the financing package for Argentina. Nevertheless, the announcement of increased reserves may exacerbate debtors' reluctance to continue with the rescheduling process, thus perhaps increasing the risk of some form of default.

3 In addition to Argentina, progress has been made between debtors and the Advisory Groups over a number of other bank financing packages. The Advisory Groups have now agreed the documentation for the Venezuelan package, and have agreed to move on to the second stage of the Yugoslav MYRA. On the other hand, progress has been slow in getting full bank participation for packages agreed with Advisory Groups, for example for Chile, Morocco and Nigeria, and it remains to be seen how effective the incentive of the higher fee for early signature for the Argentina package will be. Nevertheless, at least as far as the major banks are concerned, most of the major financing packages have essentially been completed, in advance of expected negotiations with Brazil. These may begin by the end of June, and banks are likely to be asked for new money perhaps substantially in excess of the \$4 bn that was earlier expected for this year.

4 Economic developments in debtor countries remain mixed. Adjustment measures in Indonesia and Malaysia seem to be proving sufficient to maintain the countries' creditworthiness in the markets despite the adverse economic shocks of last year. External economic performance continues to be strong in Mexico. Colombia and Venezuela are making tentative returns to market borrowing (although Colombia never rescheduled and Venezuela never had new money, so they may not necessarily provide pointers for the return of other debtors to the market). On the other hand, inflation seems to be rising dangerously, virtually throughout Latin America. The position in Brazil remains particularly worrying and uncertain: inflation in April

as over 20% and for May could have risen to 30% (an annual rate of over 2000%). Investment has reportedly come virtually to a halt. The Brazilian trade surplus, although in April at \$500 mn well above the very low levels of the turn of the year, remains well below the level needed to meet the officially projected \$8 bn surplus for the year as a whole. Meanwhile, Zambia has decided to break its links with the IMF after ten years of co-operation, and has abandoned economic reforms introduced over the last 18 months, revalued its currency and set a limit on its debt-servicing.

5 Spot commodity prices have been rising in recent weeks and the Economist index is now almost 3% higher in SDR terms (and in dollars) than five weeks ago. In SDR terms the index has returned to its mid-1986 levels, whilst in dollar terms it is back to its level of mid-1984. All of the Economist sub-indices strengthened during the past weeks. Food prices rose over 4%, largely because of lower estimates for this year's crops: vegetable oil seed prices were particularly buoyant (some rising almost 10%) although grain and coffee prices also strengthened. Among industrial raw materials, agricultural non-food prices picked up more strongly than metals (2.2% and 0.5% respectively in SDRs). Lead and zinc prices have led the metal recovery, with industrial action threatening supplies in the shorter term. With many users now maintaining lower stock levels, fears of even temporary supply shortfalls have produced sharp rallies in prices. The rise in agricultural raw material prices has been led by textiles where the recovery in demand from last year's very low levels has coincided with lower production estimates. Cotton prices rose over 15%. But it is much too early to say whether these rises represent a lasting reversal of the trend of the past few years. Most of the rises seem to stem from temporary factors - industrial action, crop shortfalls - and there is little evidence that there will be much of a shortage of supply at current real prices in the medium term. Nevertheless, the recent price rises will have brought at least a temporary respite to many commodity exporters.

6 Prospects for growth in the industrial world remain relatively gloomy, with growth expected to be no more than 2 1/4% this year and 2 1/2% in 1988. There are concerns about an economic slowdown in each of the G3 economies; apparently largely in response to external pressures, the Japanese have announced a programme of increased public expenditure which they claim will add almost 2% to the country's growth for the year, but some observers have questioned the size of the impact. Meanwhile, the dollar has been relatively stable: it rose by over 1% in effective terms during May, but remains 6% below its level at the beginning of the year, and roughly back at its level of 1980. However, efforts to restrain the fall in the dollar have contributed to a rise in dollar interest rates. US Prime now stands at

1/4%, compared with 7 1/2% last autumn, and the six-month eurodollar rate is now around 7 1/2% compared with about 6% around the beginning of the year. During the last period of sustained rises in interest rates, in 1985, debtor reaction was very strong, with heightened talk of interest capitalisation and limitations on debt servicing. The Argentine authorities have been quick to point out that the benefits of the lower spreads in their recent bank agreement have already been largely eroded because of the general rise in interest rates. The Presidents of Argentina, Brazil, and Uruguay met on May 27 to discuss possible responses to the rises in interest rates. Officials from the Cartagena Group of countries met at the end of May, and announced plans to hold a meeting of Finance Ministers, the first such meeting for over a year.

7 After the April 24 meeting of the Paris Club on the Chancellor's Sub-Saharan Africa initiative, lobbying has been taking place to enlist the support of those countries (especially the United States) which are not yet ready to accept all the proposals, in particular the call for concessional interest rates. The initiative is likely to be taken forward through a meeting to be called by the World Bank in the fringes of the July Paris Club meetings. In the meantime, one of the less controversial parts of the initiative - the lengthening of repayments periods on rescheduled debt - has been partially implemented by the Paris Club, which agreed to reschedule Zaire's debt over 15 years.

8 Developing country borrowers have since the middle of April raised just over \$2 bn, three quarters of which was in the form of syndicated loans. China took the largest share of this with various government borrowings: the largest of these was a \$200 mn floating rate note at 1/16 over 6 month LIBOR, substantially cheaper than recently arranged syndicated credits. India's National Aluminium Co arranged its third syndicated loan of this year, for \$250 mn, but with a spread of about 1/4 over LIBOR, against LIBOR flat for the previous issues. There were several South Korean borrowings including \$125 mn for Hyundai and \$100 mn for Electric Power Co.

Further details on individual countries are given below.

Latin America and Caribbean

9 In Brazil there have been indications that the authorities may be moving closer to some kind of arrangement with the IMF, although the political obstacles to a formal agreement remain serious. The new Finance Minister, Bresser, held talks in

May with both the Article IV mission and a World Bank team, and has reportedly put a series of adjustment measures to the Cabinet. While no formal announcements have been made by either the Fund or the authorities, Bresser's statements on economic policy, the recent cruzado devaluation and the limit on price increases suggest that Brazil is moving towards a policy package which the IMF could endorse. Both the IMF and IBRD teams are planning to return to Brazil for further discussions. Any arrangement could be expected to facilitate discussions with commercial bank creditors, negotiations with whom might begin in late June if the economic plans outlined by the Finance Minister are introduced in time. It is, however, becoming clear that Brazil's financing requirements in 1987 will be substantially larger than the \$4 bn originally mentioned, since the \$8 bn trade surplus on which this figure was based does not seem likely to be achieved. The Brazilians claim that if their proposals on debt are accepted they would be ready to start paying interest on half their foreign bank debt (the rest to be refinanced) but would seek to refinance all the interest due on official debt.

10 Although the behaviour of the monetary aggregates and retail sales in Q1 reinforce reports that demand has been cooling, both retail prices and interest rates rose sharply in April, partly as a result of speculation in anticipation of a new price freeze. The CPI is reported to have risen 21% in April, bringing the rise since end-1986 to about 80%, while overnight interest rates have fluctuated wildly, rising to 45% a month in mid-May before falling back to 28% a month. The authorities announced on 15 May that retail price rises would be limited to 80% of the previous month's inflation, but there is still no indication that they are prepared to take action to control real wage increases or to eliminate the wage indexation trigger. After the 7.5% devaluation announced on 30 April the authorities are expected to continue with the current policy of crawling-peg depreciation, although Bresser himself appears willing to countenance implementing a larger devaluation if he is allowed to do so. The trade surplus for April was \$520 mn, the highest level since September 1986, bringing the 1987 surplus so far to \$1150 (cf \$3750 mn in January-April 1986). Non-oil imports were the lowest this year, although still higher than the 1986 monthly average. Exports were the highest since September 1986, but still 23% below the April 1986 level. Prospects for external performance for the remainder of 1987 are at present therefore unclear, and the announcement in May that the 1986 trade surplus was only \$8.4 bn, rather than the \$9.5 bn earlier reported, indicates that any 1987 figures should be treated with caution. Creditor countries will shortly face difficult decisions over Brazil as the country is unlikely to meet its formal requirement to the Paris Club to be current on payments by 1 July. Meanwhile, President Sarney's authority has been badly affected by the economic crisis, the administration's inability to tackle it,

and the President's lack of a popular mandate. While pressure is mounting for early direct elections, possibly in 1988, Sarney has announced that his term will be five years - that is until early 1990 rather than the six years until 1991 stipulated under the present constitution - with elections in late 1989.

11 Signature of Mexico's bank financing package was completed in mid-April with commitments at \$7.787 bn, compared with the \$7.7 bn required and \$8.5 bn requested. The first \$3.5 bn tranche was drawn on 30 April and the \$0.5 bn bridging loan was repaid simultaneously. The \$0.5 bn growth contingency mechanism has been triggered as real GDP, which declined by 3.8% in 1986, seems to have been at best flat in 1987 Q1, but it is not certain that Mexico will make any drawings. Mexico met all the quantitative performance criteria for 1987 Q1 under its SBA, and targets for 1987 have been agreed. The external economy's performance, in particular, continues to be good. In 1987 Q1 a trade surplus of \$2.2 bn was recorded: exports were \$4.9 bn, reflecting continued growth of over 25% pa of non-oil exports, while imports were only \$2.7 bn (\$3.0 bn in Q1 1986), reflecting the continued recession in the domestic economy. The April trade surplus was \$1.3 bn. Tourism earnings in Q1 were over \$750 mn, up 36% on Q1 1986. Reserves rose to over \$13 bn in early June, the highest level in the country's history. The major threat to the success of the programme continues to be inflation. Consumer prices rose by 44% during January-May, bringing the year-on-year rate to 125%; the programme target of 80% year-on-year at end-1987 seems increasingly unlikely to be met.

12 The terms sheet for Argentina's 1987-1989 financing package was sent out to creditor banks on 30 April and the roadshows took place during May. A critical mass of commitments to the package is being sought by 17 June, in accordance with the terms of the IMF SBA, with banks being offered higher fees if they commit before this date. The package also includes a scheme of exit bonds, allowing banks to exclude the first \$5 mn of their Argentine debt from the base for new money, by accepting a bond paying 4% pa. The base has been reduced overall to \$21.7 bn from the \$25 bn level used in 1985; the new money package represents a 50% increase on the new base. The authorities also have obtained a rescheduling of Paris Club debts: the Paris Club agreed on 19-20 May to reschedule 100% of principal and interest due 1 May 1987 - 30 June 1988 and 100% of principal and interest on arrears as at 30 April 1987 over 10 years (5 grace). "Late interest" accrued as at

30 April 1987 is to be repaid in four equal half-yearly instalments between 31 July 1989 and 31 January 1991. The Argentine request for a rescheduling of previously rescheduled debt was refused. The deal is worth about \$1.9 bn, and will be triggered by the entering into force of the SBA; a side letter to the agreement draws attention to new commercial guaranteed credits of \$400 mn in 1987 which are included in the balance of payments projections in the SBA. The IMF programme on which the package is based would commit the authorities to a tighter fiscal policy in 1987, holding the PSBR to 2.5% of GDP (3.6% in 1986) and reducing year-on-year inflation to 42%. However, this programme seems seriously threatened by the continuing high rate of inflation (4.2% in May, bringing the year-on-year rate to 103%) and there are serious concerns about prospects for the economy. In order to combat inflation the authorities have allowed the exchange rate to become overvalued, which will in turn further damage the already weak trade balance. The trade surplus for January-April was only \$325 mn, 70% below the 1986 level, largely because of weak exports. The authorities' projection for 1987 has been reduced from \$2.5 bn to \$1.7-\$2.0 bn, and even this may prove optimistic.

13 The documentation for Venezuela's rescheduling agreement with the banks was finalised in late May. Following the Argentine agreement in April, which included a spread of 13/16% compared with the Venezuelans' 7/8%, the authorities indicated that they would not seek to reopen their own negotiations, provided that the Philippines were not also offered a lower spread and that Venezuela attained access to voluntary finance. Finance Minister Azpurua is reported to be talking to US banks about the possibility of new money: a medium term loan, reportedly for \$100 mn, is being discussed with Morgan Guaranty. Reserves remain high, around \$9.5 bn. However, inflation is rising: the CPI rose 6.2% in Q1 (2.8% in Q1 1986), bringing the year-on-year rate to 18.9% (15% at end 1986). The introduction at the beginning of May of "compensation bonuses" for private and public sector employees, can be expected to provide a further boost to inflationary pressures. The increasing lack of confidence has shown up in further speculation against the free-market bolivar, which has dropped by more than 15% against the dollar since the end of March despite the establishment in mid-April of an additional 200% excess reserve requirement for Venezuelan commercial banks.

14 Despite Chile's agreement with the Paris Club in early April, progress with its financing package with the commercial banks has been slow since the agreement in principle reached in February: by the beginning of May only 82% of banks (by exposure) had committed to the package, although signing is expected to begin in mid-June. Consumer prices rose by 7.9% in the first four months of the year

iving a year-on-year increase at end-April of 18.8% (cf 17.4% at end-1986 and the IMF target of 13% for 1987). On the external side, the trade surplus for the first quarter of 1987 was \$217 mn (cf \$299 mn for the same period in 1986).

15 Colombia successfully syndicated an IDB complementary financing loan in London and New York at the end of April. Like the euromarket issue in March, the IDB loan carries a relatively high spread (1 1/8% over LIBOR for the first four years and 1 1/4% thereafter) although the risk to the banks to whom participations are sold is minimal because of the IDB guarantee. A further yen or eurodollar issue for the equivalent of \$60-70 mn is reported to be planned for later in the year. On the domestic front the rate of inflation appears to have stabilised: prices rose 19.8% in the year to end-April, compared with 20.6% at end-1986. Nonetheless, the effect of weak coffee prices on fiscal revenue and on the trade balance may still jeopardise recovery, and, in the longer term, Colombia may need to seek more concerted external borrowing from 1988 onwards as the maturities fall due on the large commercial bank loans taken up in 1981-82. Uruguay is expected to seek enhanced surveillance after completion of the Article IV consultation on 29 June, and the World Bank Board will discuss a request for a SAL for \$80 mn on 16 June. Exports, which prospered last year because of strong demand in Argentina and Brazil and because of the Uruguayans' competitive exchange rate, are beginning to fall.

16 Ecuador's economic decline has been exacerbated by domestic financial speculation following the earthquake in March. A contraction of GDP in 1987 of between 4-7% (cf an increase of 1.7% in 1986) is expected. Prices rose 4.7% in March, despite an attempted price freeze, bringing the year-on-year inflation rate to 29% (cf 26% in the year to end-February). Limited oil production has resumed following the opening of the Colombian pipeline link on 8 May, and it is hoped that production and transport through the main oil pipeline may restart in late July or August. The World Bank has provided \$80 mn for the emergency petroleum reconstruction project. However, little progress has been made towards meeting the 1987 external financing requirement, now estimated to be \$950 mn. Negotiations with commercial banks have been brief and superficial, and discussions with the IMF on a follow-on programme and emergency assistance are not yet completed.

17 Contacts may be resuming between Peru and the IMF. The Peruvian authorities have held a number of meetings with Fund Staff in Washington since February, and have indicated their willingness to have an Article IV mission in mid-year; the Fund Board hopes to conclude the consultation by 14 September. The Peruvians' change in attitude may have been triggered by the continuing fall in liquid reserves

(to \$850 mn at end-March), which has in turn caused an apparent tightening of the debt service policy to include restrictions on payments due to official creditors: as a result of the accumulation of \$57 mn in arrears the World Bank suspended disbursements from 5 May. Debt to commercial banks has been unilaterally rolled over for another three months from 4 May. UK banks detected some softening in the authorities' stance with the announcement of the formation of a National Council for External Debt, but negotiations are unlikely to begin for some time. Meanwhile supply shortages have begun to slow the growth of output and to boost inflationary pressures, while the fall in reserves indicates that the external trade account has continued to deteriorate. From 21 April the authorities suspended foreign sales of silver by the state mineral company to try to boost the price on world markets.

18 Full commercial bank support for Bolivia's debt buy-back scheme was expected to be obtained by 22 May; two banks have yet to support the scheme, but are expected to do so shortly. The IMF has been asked but has yet to agree the nature of its involvement in the scheme. As a minimum the banks want the Fund to monitor the scheme to ensure that Bolivia uses only voluntary contributions from other governments to buy back debt, rather than deploying its own reserves; ideally, they would like the Fund to operate it. Costa Rica opened negotiations with the banks on 4 June. The country is seeking to reschedule all debt over 20 years (7 years' grace) and \$100 mn new money or interest capitalisation for 1987. Discussion of the SBA is postponed until agreement is reached with the banks. Jamaica's 1987 commercial bank rescheduling agreement was signed on 5-6 May. Both the external account and the fiscal side performed better than expected in FY 1986/87, and economic recovery is expected to continue in FY 1987/88, when the authorities expect output to increase by 4.6%. There are indications that Cuba is seeking to normalise trading relations with western creditors. A rescheduling mission arrived in the UK on 25 May. The Paris Club Task Force originally due to visit Havana at the end of May has been postponed until late June.

19 Agreement on the IDB's Seventh Replenishment of Resources now looks unlikely before the autumn, although a Governors' meeting is planned for late June. The IDB's lending in 1987 will thus be financed entirely from resources left over from IDB-6. The US authorities have indicated that, if the regional borrowing members do not agree to the organisational changes the US is seeking, the appropriations which would have provided for a substantial increase in lending may be diverted to the IBRD while the IDB receives only a minimal replenishment with no new paid-in capital. Officials from the Cartagena group of eleven regional debtor nations met on 28-29 May at Guanajuato, Mexico. They are reported to be arranging a meeting of

their finance ministers, the first such meeting since February 1986. The Presidents of Argentina, Brazil and Uruguay met in Montevideo on 27 May and discussions focussed on debt: the possibility of a meeting of the Cartagena group at Presidential level before the end of the year is under consideration. The Organisation of American States has, at the instigation of Alva Castro, the Peruvian Finance Minister, invited major creditor banks to Latin America to meet in Washington on 29-30 June to discuss links between exports and the region's debt servicing.

South and East Asia

20 In the Philippines, increases in exports are helping to foster the economic recovery first detected in 1986 Q3, and an overall increase of 10% in export earnings appears likely for 1987. However, with imports forecast also to rise, there is likely to be an increased trade deficit. The official target of real GDP growth of between 6% and 7% appears optimistic, although a 4% increase is possible. The Government has signed an agreement with Japan's Exim Bank which will provide \$300 mn in untied loans for development projects. Finance Minister Ongpin, who had earlier said that he intended to reopen his rescheduling package with the banks in the light of the better terms obtained by Argentina, appears now to be more reluctant to do so.

21 In Indonesia there was a sharp fall in the trade surplus, from \$5.8 bn in 1985 to \$1.8 bn last year. However, the authorities are confident that firmer oil and commodity prices, together with the present competitive exchange rate and increased receipts from tourism will significantly reduce the current account deficit in 1987. A CFF for SDR 462.9 mn was agreed at the beginning of May; the Indonesian authorities remain wary of a possible SBA on the grounds that it may discourage potential commercial lenders.

22 In Malaysia modest improvements in the prices and export volumes of palm oil, tin and rubber have coincided with a firming of the oil price to boost export earnings from the depressed levels of 1986. Overall, the trade surplus is expected to be in the region of \$3.6 bn in 1987, an increase of \$1 bn on the 1986 total. Official estimates for real GDP growth for 1987 are now 2%. However, domestic demand is still depressed, and doubts persist about the commitment to economic adjustment, following the almost successful challenge to Prime Minister Mahathir from within the ruling party and the dismissal of seven ministers who had supported the challenge. Meanwhile, a \$60 mn Malaysia Fund is being launched on the New York

Stock Exchange: the International Finance Corporation will underwrite half the fund, with the remainder underwritten by Merrill Lynch Capital Markets, Morgan Stanley, and Arab-Malaysian Merchant Bank.

Eastern Europe

23 Little further progress has been made on reaching an agreement with Poland. The creditors' proposals for an interim agreement covering all arrears from 1986 and payments falling due in 1987 have been met with a counter-proposal expressing readiness to agree an interim settlement if the cut-off date is extended to end-March 1988; interest due under the 1981 agreement would be honoured only if bilateral reductions in the relevant interest rates were agreed. The Fund staff have completed work on the measures they would look for in the prospective SBA. In Frankfurt on 13-14 May the banks' steering committee confirmed the banks' unwillingness to re-reschedule beyond 1989 and to lower the margin below 1 3/8% (the Poles are seeking 0.6%); they were, though, open to the possibility of repayment terms beyond 10 years.

24 Yugoslavia's external performance so far this year has been better than expected. The trade deficit for 1987 Q1 was only \$316 mn (43% down on 1986 Q1 and 45% below target) and the current account deficit only \$27 mn (cf \$366 mn in 1986 Q1 and a target of \$260 mn). Nevertheless, there are serious doubts as to whether the Yugoslavs' targets for the year (including a current account surplus of \$810 mn) can be achieved. Yugoslavia had been pressing hard for the automatic implementation of the second stage of its official MYRA (to end-March 1988) as provisionally agreed in Paris on 31 March. Major creditors, however, insisted on a formal discussion in the Paris Club on 20 May, and after great initial reluctance the Yugoslavs did provide letters setting out in more detail certain policy measures to be taken within the next year. Even on the basis of these letters the Club could not agree to implement the second stage: the correspondence was referred to the Fund MD for his personal assessment, at the insistence mainly of the US, who are anxious to strengthen the concept of enhanced monitoring given that it may soon be applied to Brazil. On the basis of the MD's cautious assessment, the US is now likely to let Stage 2 go ahead; the next stage will be to tighten conditionality for Stage 3. The banks had earlier granted the waivers necessary to allow the second stage of their MYRA to proceed on the revised date of 27 May.

5 Hungary met some market resistance to the terms it hoped to secure on the National Bank's latest syndicated euro-credit: it is now seeking \$400 mn at a margin of 3/8% (compared to the \$500 mn at +1/4% originally hoped for). It is also believed that the authorities are close to deciding to seek a new IMF Standby in the autumn; a final decision is expected to be taken in mid-June.

Southern Europe

26 In Greece first quarter data have confirmed the doubts, expressed by the EC Monetary Committee amongst others, about the likelihood of meeting the government's economic performance targets this year. Public finance, consumer price inflation and current account developments are all giving rise to concern, and the last will be adversely affected by the dismantling at end-April of the import deposit scheme, imposed in October 1985, and the reduction of export subsidies.

Sub-Saharan Africa

27 The Chancellor's proposed initiative to help the poorest and most indebted countries comprises the conversion of old aid loans into grants (Retrospective Terms Adjustment), the acceptance of longer repayment periods and grace periods when rescheduling other official loans, and the granting of concessional interest rates on rescheduled debt. All elements would have to be firmly linked to debtors' implementation of appropriate reform policies. The announcement of the initiative in Washington on 9 April was followed by an informal Paris Club session on 24 April. RTA presented no problems, and most creditors were ready to move immediately to rescheduling over 20 years with up to 10 years' grace for suitable cases. Progress was made over agreeing the list of countries standing to benefit from the initiative. However, it has become clear that intensive lobbying, aimed particularly at the US, will be needed to reach a consensus on softening interest rates; only Sweden was ready to follow the UK's lead on this particular part of the initiative. The initiative was discussed at the Venice summit, and is likely to be taken forward at a meeting to be convened by the World Bank in the fringes of the July meeting of the Paris Club with the aim of having definite proposals in place by the time of the Annual Meetings. The Fund MD wrote to the Chancellor, and to other participants at the Summit, asking for the political commitment to, at a minimum, triple SAF reserves to SDR 9 bn, with financial resources being committed commensurate to countries' resources and international responsibility. The Fund has been in intensive negotiations with the Japanese, who might contribute \$3 bn.

8 On 1 May President Kaunda announced that Zambia had decided to break its links with the IMF and abandon its IMF-backed adjustment programme. The authorities are developing their own adjustment package, and a ceiling on external debt payments equivalent to about 5 per cent of export earnings has been imposed to free foreign exchange for investment. Most visible among the measures already announced is the decision to abandon the foreign exchange auction and fix the exchange rate at US\$1=8 kwacha compared to the last auction rate of US\$1=21 kwacha. The decision will inevitably lead western donors to reassess their policies towards the country. Already the World Bank has ceased disbursements because of mounting arrears. On 22 May the IMF Board agreed that Zambia would be declared ineligible at the end of July without further review unless there were clear signs in the meantime that the authorities were willing to re-open a meaningful dialogue with the Fund. At the end of May, Cote d'Ivoire announced that it was unable to meet its servicing obligations, because of the decline in prices of its commodity exports. Other countries in the region will be watching developments closely.

29 Zaire's SBA, SAF and CFF were approved by the Fund Board on 15 May. The UK, joined by Australia and the Nordics, abstained, and a number of others expressed serious reservations about the strength of the adjustment effort and the weak Fund programme. At the Paris Club creditors agreed on 18 May to reschedule all medium term maturities in arrears at 31 March 1987 or falling due between April 1987 and May 1988. Debt previously rescheduled at Zaire's first six Paris Clubs was further rescheduled, but not that falling under PC VII. The UK was prepared to reschedule over 20 years with 10 years' grace, but with other creditors not prepared to go as far a compromise of 15 years with 6 years' grace was agreed.

30 The latest IMF mission to Nigeria was encouraged by the evidence of the authorities' commitment to policy reform, but further action is still required before the first review can be successfully concluded. The reluctance of the Japanese banks to participate in the new money package remains the major stumbling block to the conclusion of the commercial bank agreement, and signature now seems unlikely before September at the earliest. Despite the issue of an additional \$1.5 bn of promissory notes in early April and the expectation of a further modest issue shortly, the majority of uninsured creditors still have a large proportion of their debt unverified and are unlikely to consider rescheduling proposals until the verification process becomes more rapid. Despite optimistic reports from the authorities, Sudan is still some way from an agreement with the IMF on an adjustment programme. The main stumbling blocks remain the exchange rate and arrears to the Fund. A Fund team arrived in Khartoum on 10 May to continue negotiations, but was forced to postpone talks because of the dissolution of the cabinet on 13 May.

Middle East & North Africa

31 The Executive Board of the IMF approved Egypt's request for a SDR 250 mn Standby on 15 May with the Nordics and the Iranians abstaining. Many Executive Directors noted that the programme was weak and the risk of failure high; further adjustment measures were urgently required. The Egyptians have now promised to strengthen the programme (notably in the key areas of interest and exchange rates) before the first review is completed in November. Due to domestic political considerations, these promises have not been made public. In early May energy prices were increased (though remaining well below world levels) and the first stage of exchange reform was introduced. As expected, the Paris Club, meeting on 21-22 May, agreed to provide Egypt large-scale debt relief (over \$7 bn) on generous terms. However, the present and prospective balance of payments position remains fragile; a deficit of \$3.9 bn on the current account is expected in FY 1986/87 (ending June) and deficits of similar size are expected to persist into the 1990s.

32 Elsewhere, Algeria continues to experience domestic and external economic difficulties despite the more settled outlook in the oil market. Real GDP growth is unlikely to rise above last year's 2% level. Banks remain very cautious about lending to Algeria, and with amortisation payments of around \$4 bn falling due and an expected current account deficit of \$1 bn to be financed, payment arrears have arisen and more formal rescheduling requests cannot be ruled out. In Morocco, the authorities continue to be assisted in their adjustment efforts by favourable exogenous factors; the IMF programme is still on track (although a modification has been agreed). In addition, contingency measures have been prepared against expected revenue shortfalls to ensure that the key SBA target for the fiscal deficit is met. No firm date has yet been set for signing the rescheduling agreement with the banks but June/July now looks likely. Despite agreeing bilateral reschedulings with a number of countries, Iraq continues to experience payments difficulties. Negotiations with West Germany about guaranteed debt have stalled and new arrears to UK creditors are being reported.

OVERDUE FINANCIAL OBLIGATIONS TO THE FUND*

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding as at 31. 5.87 (SDR mn)
Kampuchea	13 March 1975	29.9
Guyana	31 May 1983	56.5
Viet Nam	6 February 1984	72.1
Sudan	12 July 1984	425.7
Liberia	25 January 1985	144.7
Peru	9 September 1985	258.4
Zambia	30 April 1986	181.0
Sierra Leone	16 January 1987	<u>5.8</u>
		1,174.1

NB The above figures are derived from the Fund's latest six monthly Report on Overdue Financial Obligations.

* 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. Zambia will be declared ineligible at end-July unless it has given firm indications of an intention to clear arrears in the interim.

INDEBTEDNESS AND BRITISH EXPOSURE

CONFIDENTIAL

	Total external debt \$bn	British-owned banks' exposure[1]	\$ billion ECGD amounts at risk	
	End-Dec 1986*	End-Dec 1986	End-March 1987 [2]	End-March 1987 [3]
<u>Latin America</u>				
Argentina	51	3.0(0.2)	0.2	0.2
Brazil	111	6.6(1.4)	1.0	1.9
Chile	19	1.3(0.1)	-	0.1
Colombia	15	0.6(0.1)	0.1	0.1
Costa Rica	5	0.1(-)	-	-
Ecuador	8	0.5(0.1)	0.1	0.1
Jamaica	4	- (-)	-	-
Mexico	98	6.3(0.7)	0.7	1.3
Peru	15	0.3(-)	0.1	0.2
Uruguay	4	0.3(-)	-	-
Venezuela	36	2.1(0.1)	-	-
<u>Far East</u>				
Indonesia	42	0.8(0.3)	0.9	1.8
Malaysia	21	1.1(0.3)	0.1	0.1
Philippines	29	1.3(0.2)	0.1	0.2
<u>Eastern Europe (convertible currency)</u>				
Hungary	15	0.3(-)	-	0.1
Poland	34	0.6(-)	1.3	1.4
Romania	6	0.2(-)	0.3	0.4
Yugoslavia	19	0.8(0.1)	0.7	0.9
<u>Southern Europe</u>				
Greece	18	1.2(0.2)	0.1	0.3
Turkey	31	0.5(0.3)	0.2	0.6
<u>Sub-Saharan Africa</u>				
Cote d'Ivoire	9	0.3(-)	0.1	0.1
Nigeria	20	1.3(0.2)	2.5	3.5
South Africa	22	3.6(0.6)	0.9	2.5
Sudan	11	- (-)	0.2	0.2
<u>Middle East and North Africa</u>				
Algeria	27	0.4(0.1)	0.2	0.4
Egypt	45	0.2(0.2)	0.3	1.3
Iraq	55[4]	0.1(-)	0.6	1.6
Israel	31	0.4(0.1)	0.1	0.2
Morocco	17	0.2(-)	0.2	0.3
Oman	3	0.1(0.1)	0.7	1.9
Saudi Arabia	14	0.6(0.2)	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 31 countries amounted to \$9 million at end-December 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.

[4] Includes \$30 bn from Arab countries.

* Current estimate.

INDEBTEDNESS AND BRITISH EXPOSURE

CONFIDENTIAL

	Total external debt \$bn	British-owned banks' exposure[1]	\$ billion ECGD amounts at risk	
	End-Dec 1986*	End-Dec 1986	End-March 1987 [2]	End-March 1987 [3]
<u>Far East</u>				
China	27	0.4(0.9)	0.2	3.0
India	38	1.0(0.4)	0.5	1.8
South Korea	46	2.4(1.0)	0.4	0.7
Thailand	17	0.2(0.1)	0.1	0.1
<u>Eastern Europe</u>				
Bulgaria	5	0.3(0.1)	0.0	0.1
GDR	17	0.5(0.1)	0.1	0.2
USSR	35	0.7(0.1)	0.6	0.8
<u>Southern and Western Europe</u>				
Denmark	36	2.1(0.5)	0.1	0.1
Finland	34	1.6(0.4)	0.1	0.1
Iceland	2	0.1(-)	-	-
Ireland	17	2.5(0.4)	0.2	0.3
Italy	62	7.5(1.5)	0.2	0.3
Norway	38	1.3(0.8)	0.5	1.2
Portugal	17	0.9(0.2)	0.2	0.2
<u>Australasia</u>				
Australia	72	6.2(1.9)	0.5	1.0
New Zealand	15	1.2(0.6)	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 16 countries amounted to \$113 million at end-December 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.