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31 July 1987

Dear Charles

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INTERNATIONAL FINANCIAL SCENE

...I enclose the usual 6-weekly report from the Interdepartmental Debt Group. This will be the last report before the summer holiday: the next one, in early September, will be an extended report setting the scene for the Annual Meetings of the IMF and IBRD, which this year will focus very largely on debt problems.

Economic activity in the main industrial countries in the early part of this year was running about $2\frac{1}{2}$ per cent up on a year earlier, and we expect a similar figure for the year as a whole. The slightly gloomier note struck by the OECD in their latest economic outlook is not being echoed elsewhere. In Japan, for example, partly because of the fiscal package, quite strong growth of domestic demand is expected to continue. And there has been a distinct stiffening in commodity prices, especially in metals and oil, in recent months. So there are reasonable prospects of growth in 1988 at about, or perhaps a bit above, the $2\frac{1}{2}$ per cent mark.

The report deals with current proposals for enlarging the Structural Adjustment Facility of the IMF, and with the Chancellor's debt-relief proposals for Sub-Saharan Africa. There is not much support for the latter yet; as the Chancellor said in his speech to the All-Party Development Group last week, most creditors are taking a very short-sighted and unrealistic view of the problem. The joint IMF/IBRD meeting in Paris on 10 July was very disappointing; so was the follow-on discussion in the Paris Club. The Chancellor is currently considering how best to take this forward in the remaining weeks before the Annual Meetings, and will be making direct approaches to some of the key Finance Ministers concerned.

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The other main development since our last report has been the continued move towards greater provisioning by the Commercial Banks against Third-World debt. The big four London clearing banks have now followed the lead of Citibank and other major American banks. This change of policy by the British banks is of course welcome, and in line with the greater realism which the Chancellor has urged for some time.

Turning to the position of the largest debtors. Mexico seems at present to be in a fairly healthy state with very high reserves and rising exports (even before the recent increase in the oil price). No new debt negotiations are due this year.

Argentina is in a much more unhappy situation. Although the banks have recently completed an agreement covering 1987 maturities, the IMF programme has gone badly wrong and has been revised. The UK has reluctantly supported a new and weaker programme, warning however that we shall not be prepared to support any further waivers if the new targets are not met. The tactics of the Fund, and indeed of the banks, appear to be to settle the Argentine problem and isolate it from the case of Brazil. Here there are serious difficulties ahead.

Brazil declared a moratorium on payments to the banks in February, which has recently been extended to the government creditors in the Paris Club. Although informal talks with the IMF have begun, and a major new economic reform programme has just been announced, it is not clear yet whether this will be acceptable to the Fund (or to major creditors like the UK), or that the Brazilian government will be prepared to go back on political opposition to a drawing from the Fund. However, the banks are reported to be pressing for a Fund agreement as a precondition of any new debt settlement, and the Paris Club creditors have agreed to stand firm on the same demand. Meanwhile most (but not all) government creditors have suspended export insurance cover in an attempt to persuade Brazil back to the negotiating table.

Among the medium-sized debtors, the Nigerian programme is showing signs of strain, and we may need to exert some diplomatic pressure on the government there to reinforce it.

Yugoslavia is belatedly recognising that foreign exchange problems are not merely short term cash flow ones but reflect deeper structural difficulties. They have suspended repayment of debt to the banks, and seem likely to ask the Paris Club for further relief too. Once again, the UK (with support from most other creditors) will be seeking to steer Yugoslavia to the IMF.

The Polish problem is as intractable as ever. The US has just changed its position, opening up the chance of a negotiation

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covering all debt maturities up to the end of 1988 (ie after the US Presidential Election). But this has taken so long that the banks seem likely to steal a march on government creditors and sign an agreement in September which will take up most of the funds Poland has available for debt service. In the longer term, we see the only solution to the Polish economic problem as lying in a strong IMF adjustment programme. The US, for what appear to be domestic political reasons, is strongly opposed to such a programme and as a result the IMF is dragging its feet. The UK, with support from France and Germany, is mounting a diplomatic campaign to persuade the US to modify its opposition.

Finally, Turkey, which has been a model debtor in recent years, is showing signs of returning strain. Inflation is increasing and foreign earnings coming under pressure. There are reports of corrective economic measures about to be taken, but until there is hard evidence of these, we shall have to watch fresh lending to Turkey with great care. The possibility of a further debt restructuring begins to look a real one.

I am sending copies of this letter to the Private Secretaries to the Foreign Secretary, the Secretary of State for Trade and Industry, the Secretary of State for Defence and the Governor of the Bank of England.

Yours sincerely
J M G Taylor

J M G TAYLOR