



Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

21 September 1987

C Powell Esq
10 Downing Street
LONDON
SW1

Dear Charles

INTERNATIONAL FINANCIAL SCENE

I attach the regular report on developments in the International Debt Scene. This report is intended as background for the Autumn series of international meetings - Commonwealth Finance Ministers, Annual Fund and Bank meetings and Commonwealth Heads of Government. An important theme of discussion at the annual meetings will be how to help the poorest indebted countries, especially those in sub-Saharan Africa.

The meetings are taking place at a time when the debt strategy remains under strain. However, unilateral action by the debtor countries to restrict debt servicing has so far been limited, tactical and unconcerted. This year's meetings will provide an opportunity for a major push to increase the resources available to the poorest and most heavily indebted African countries. An important element in this is the Chancellor's own initiative, together with the complementary proposals from the Fund and Bank. We are, however, unlikely to get agreement on the essential interest relief component of the Chancellor's scheme this time round. The proposals remain an important factor in our ability to manage this part of the debt problem.

In order to keep the focus clearly on sub-Saharan Africa, it will be necessary to ensure that the difficulties and problems of middle income debtors are not allowed to dominate the discussions. The UK line on middle income debtors will be, as it was at the April meetings, the continuation of the case by case strategy, emphasising the need for conditionality (additional creditor support linked to appropriate adjustment programmes) and for debtors and banks to work out market-related solutions.

The economic background as it affects the evolution of the debt problem has shown little change over the past two months. There is some improvement in the prospects for LDC exports,



together with a slight strengthening of non-food commodity prices, compared with the very low levels of last year. On the other hand dollar interest rates have strengthened recently and further increases could well be needed if the US stands by the Louvre agreement to maintain the dollar at around present levels.

On individual countries, there are few bright spots. The performance of Mexico and some smaller Latin American debtors continues to be encouraging. On the other side Brazil remains the major problem. As the report notes the radical Brazilian proposal that one half of its commercial bank debt should be securitised (on terms which represented a significant discount on face value and would have led to wide spread write downs) was withdrawn following intervention by US Secretary Baker. He apparently said, in persuading the Brazilians to retreat, that new bank lending to cover interest arrears could become available without Brazil's acceptance of an IMF programme, although such a commitment would still be required for any rescheduling by Government creditors in the Paris Club and for any further "new money" from the banks next year. This, if true, would be an unwelcome weakening of the present strategy. It remains to be seen what the banks make of this. For the moment they (and the UK banks in particular) seem set on a harder line requiring a Fund programme for the arrears, and the Chancellor does not believe we should lean on the UK banks to soften whatever line they believe right to take, even though the US is likely to press us to do so. Brazil's intentions in relation to the Fund remain unclear. The Managing Director's summing up of the recent Article IV discussion of Brazil clearly amounted to a negative assessment of current economic measures but the latest indications are that Bresser Pereira has been persuaded to go for an IMF Standby. New formal debt proposals will be presented to the banks on 25 September.

Despite the signature of the commercial bank lending package in August, developments in Argentina have been adverse. The country is off track on its new, weaker Fund programme and following the Peronist victories in the elections, a more confrontational aspect to debt issues seems to be emerging. On 9 September Alfonsin announced a decision to seek the "freezing of interest rates at historic levels". This appears to be a warning shot for the future rather than an immediate attempt to unpick the commercial bank package.

Elsewhere, there are a number of countries in Eastern Europe (Yugoslavia, Poland and Hungary) where an improvement in deteriorating economic performance depends on negotiations for a Fund programme. The Hungarians hope to negotiate a sizeable programme to reassure their creditors and to avoid rescheduling. Government creditors will make a new Fund



programme for Yugoslavia a precondition of further rescheduling. Such a programme remains a precondition for any long term approach to Polish debt problems, but is not an immediate prospect, so that an interim settlement is needed and now seems likely.

In Africa, the Nigerian position has deteriorated. The present programme is now effectively dead, although the Fund are formulating a new programme for next year. This could cause financing difficulties if it delays disbursement under the commercial bank package and negotiation of a further World Bank loan. Among Commonwealth countries in Africa there are a number (eg Tanzania, Ghana) who have Fund programmes and are therefore candidates for the Chancellor's sub-Saharan initiative. Others, like Malawi and Sierra Leone, could become so were they to reach an agreement with the Fund. Zambia, on the other hand, for the moment looks set to remain outside the fold.

Finally, the Egyptians, surprisingly, seem to have met IMF requirements at the first review of their SBA in September. However there remain very serious doubts about the Egyptian ability to strengthen the programme as promised.

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

Yours sincerely

Jonathan Taylor

J M G TAYLOR
Private Secretary

CONFIDENTIAL

INTERNATIONAL FINANCIAL SCENE

1 Debt discussions at the forthcoming IMF/IBRD Annual Meetings will be taking place at a time when the current strategy is under strain. Creditors' confidence in the ability of major debtors to adopt and sustain appropriate economic policies has been sapped, and the banks' reluctance to provide new money appears to be growing as their balance sheets strengthen. Most debtors still see their long term interests as being best served by accommodation with their creditors, and unilateral action to restrict debt servicing has, so far, been limited, tactical and unconcerted. There is, nevertheless, a perception among borrowers that they are being required to bear an unfair share of the costs of a solution. They see a disproportionately large part of their future output being committed to debt servicing, seemingly for years ahead. Moreover, growing trade surpluses, partly necessitated by a much reduced scale of external inflows, represent a net transfer of real resources to creditors which has been largely matched internally by cuts in investment that are likely to restrict future debt servicing capacity. The continuing Brazilian moratorium is the clearest sign of the gulf between the two sides.

2 With apparently irreconcilable issues of principle at stake, there seems little prospect of the complex problems faced by middle income debtors and their largely commercial bank creditors being resolved in the near future. In contrast, the chances of achieving a consensus among official creditors on the need to grant significant, but conditional, debt relief to the poorest debt-distressed countries, particularly in sub-Saharan Africa, may be improving, although difficult negotiations lie ahead. While the direct financial costs of such relief will be relatively small, the UK and other creditor governments, with an eye to the reaction of middle income countries, will be anxious to quash any move to make concessions to any but the most deserving cases.

3 The signing of the Argentina debt package on 21 August, within 4 months of agreement in principle, contrasts favourably with the prolonged negotiations with other major debtors (eg Mexico and Nigeria) over the past year. While the relatively swift completion of the agreement owes much to the flexibility and innovation of the "menu" offered to creditors and to the smaller number of banks

involved, pressure to complete before the commencement of negotiations with Brazil, which promise to be much more difficult and protracted, has also been an important factor. Argentine and Brazilian authorities were in close contact throughout. Overall, the record of commercial debt negotiations since the Baker initiative has not, however, matched earlier hopes. Although most of the Baker 15 have successfully rescheduled, new money has been agreed in principle in only 6 cases. On the basis of IMF figures, ldc's with debt problems made net repayments of \$11 bn to banks in 1986, including net repayments of \$3.5 bn by the Baker 15.

4 Recent developments in the run-up to the banks' negotiations with Brazil emphasise that country's pivotal role. Posturing by both sides prior to the commencement of negotiations was only to be expected, but attitudes have, if anything, hardened in recent weeks, with the Brazilians refusing to make a token payment of interest arrears. Brazil's radical proposal that one half of its commercial bank debt should be securitised on terms which represented a significant discount on face value and which would have led to widespread write-downs, met a cool response from the banks and was effectively withdrawn after only a week following discussions with the US Treasury. (What now remains of the plan appears to be merely the inclusion of Argentina style exit bonds in the "menu".) The US authorities, while persuading the Brazilians to retreat, indicated that they would not stand in the way of any agreement between the banks and Brazil to provide new money to cover this year's interest arrears which did not require Brazil's acceptance of an IMF programme. Such a commitment would still be required in any approach to the Paris Club and for any further "new money" from the banks next year. The banks, however, appear to be sticking to their insistence on a full programme in order that the financing burden be more evenly spread.

5 On 20 August interest payments on Brazilian debt fell more than 180 days overdue. If there is no change in the position by late October US regulators may classify these loans as "value impaired", requiring the banks either to establish special "Allocated Transfer Risk Reserves" (ATTRs) or to write down the value of their loans using loss reserves such as those substantially boosted by provisioning in the second quarter. Either course of action has the effect of reducing a bank's primary capital, but it also renders losses on such lending eligible for tax relief. Although US banks' capital asset ratios have risen significantly since the early eighties, Citibank, again stealing a march on its competitors, announced a common share issue intended to restore its common equity:assets ratio. Canadian banks, who had already established 15% mandatory reserves against problem ldc loans, have now been required to raise their provisioning to 30-40%. In the UK, all the major clearing banks have now announced increased provisions against ldc loans which

● cumulatively now amount to about 30% of their exposure to problem debtors.

Supervisors have circulated banks with details of a matrix of factors which they will use to judge the adequacy of provisions. The Inland Revenue has also advised the banks that, while its general policy regarding the tax treatment of loan losses remains unchanged, it will regard the matrix methodology as relevant in determining the extent to which specific loss provisions against sovereign loans are tax deductible, with the caveat that the level of provisioning allowable for tax may be somewhat lower than that recommended by the supervisors.

6 After being declared in formal default on loans of US\$750 mn last month - the first such instance in recent times - North Korea has now agreed to sign a debt rescheduling accord with two bank syndicates led by Morgan Grenfell and the ANZ Banking Group. This will spread debt repayments over twelve years with four years' grace.

7 US regulators have relaxed limitations on investment by bank holding companies in non-financial companies in ldc's. The lifting of rules which restricted such investment to 20% of a holding company's capital is likely to boost demand for debt:equity swaps. Although much has been made of the contribution these transactions can make to restructuring debtors' external liabilities, debt conversions since mid-1984 total only around \$4.5 bn, or about 2% of the commercial bank debt of countries with active conversion schemes. (Chile has, however, converted around 13% of its debt.) While Citibank has recently announced its intention of swapping a third of its \$1.5 bn of Argentine loans for equity over the next 1 1/2-2 years, it is difficult to see how conversions by all banks on this scale could be absorbed. Banks with large exposures will remain reluctant to participate if, following the sale of loans at a discount, accounting rules require them to "mark to market" the remainder of their portfolio. Widespread conversions would tend to depress prices in the secondary market where turnover, expected to rise to \$10-\$15 bn this year, still remains small in relation to the value of debt outstanding. Recent sharp falls in secondary market prices following second quarter provisioning (which raised expectations that banks would significantly increase the supply of loans) are shown in Chart 1. Both demand and supply to the market are heavily influenced by technical factors and trading is thin. Most transactions are in the obligations of Mexico and Chile which have active conversion programmes. Currently, monthly trading in Brazilian debt is thought to be as little as \$20 mn.

8 Close co-operation between Argentina and Brazil apart, recent efforts by debtors to establish a united front have met with little success. At UNCTAD VII, Brazil, Venezuela and others who had been seeking a radical change in the debt strategy,

including a commitment to a larger volume of non-conditional finance, were unable to enlist the support of the poorer countries who did not wish to prejudice progress on the various initiatives to alleviate the acute debt problems of sub-Saharan Africa. The text of the conference's Final Act presented few problems for creditor governments. A call by some African countries at the OAU summit (where the UK initiative was well received) for a limitation on debt servicing was similarly deflected, although the Organisation still plans to hold a conference in December to establish a common negotiating position. In a recent national address the Mexican President rejected "populist measures that postpone effective progress", an apparent dismissal of Peru's unilateral limitation of debt servicing, and also suggesting a reluctance to follow any radical moves from Brazil.

9 The joint IMF/IBRD initiative to expand the resources available to the poorest debt distressed countries, including an expansion of the SAF, additional multilateral disbursements and cofinancing, and interest relief, is currently being discussed with major creditors. Support for the Chancellor's initiative is also being actively canvassed in G10 capitals and with the French in particular. While there is a consensus that special action is required, potential donors remain divided as to which form this should take. The IBRD hope to call a meeting in October to co-ordinate progress.

10 An important element in the current strategy is an expanded role for the World Bank and regional development bank (MDBs). The Baker plan called for MDB lending additional to previous plans, of \$3 bn per annum to highly indebted countries over 1986-88. In 1986 gross MDB lending to the Baker 15 rose \$1.9 bn (World Bank +\$1.7 bn), and between FY1985 and FY1987 IBRD commitments to these countries have risen \$2.2 bn, with quick-disbursing policy based loans accounting for more than a third of the total. Co-financing commitments by MDBs, however, fell sharply in 1986. The importance attached to MDB financing in the debt strategy was reaffirmed at the Venice summit with support for the IBRD's General Capital Increase (GCI). While most countries support an increase at the top end of the \$40-\$80 bn proposed, opinions differ as to the size of the paid-in component. While Congressional support for IDA's Eighth Replenishment and the GCI may be forthcoming, the US Administration's continuing difficulties with Congress over appropriations to MDBs have led to delays in the payment of US subscription to IDA and IFC, thereby holding up disbursements as well as encouraging late payments by other donors. The issue of voting rights and concerns over the effectiveness of lending policies have also led the US to take a hard or critical line in negotiations for the IDB's Seventh Replenishment, the fourth GCI for the African Development Bank (agreed in June), the fifth replenishment of the African Development Fund, and the forthcoming fourth GCI for the Asian Development Bank.

11 Japan has announced details of its \$20 bn recycling scheme to follow its \$10 bn programme last year. Apart from a build-up of oda, \$8 bn will be made available through MDBs, \$9 bn through the OECF (Overseas Economic Cooperation Fund) in the form of direct lending and co-financing, and \$3 bn in the form of direct lending by Japan's EXIM bank. The size of the contribution expected from Japanese commercial banks to the package remains unclear.

12 Recent economic developments in the major debtors have been mixed. Trade surpluses, with some exceptions, have been strengthening, with an encouragingly strong non-oil performance by Mexico. This trend represents the fruits of more realistic exchange rate policies and supply side reforms as well as what may prove to be only a temporary surge in non-food commodity prices. Doubts remain, however, about the sustainability or adequacy of fiscal and financial policies in a number of countries (eg Brazil and Argentina), and in most countries inflation rates have begun to rise again.

13 During most of August spot prices for non-food commodities continued to rise strongly. More recently, however, metal prices have begun to fall back as supply disruptions have eased. The recovery of industrial material prices this year may largely be in reaction to sharp falls in the latter part of 1986 which appeared to be overdone in relation to the underlying supply/demand balance; low stock levels may also have heightened the response of prices to temporary shortfalls in supply. If this is the case, further increases are likely to be limited as underlying demand growth is probably modest while supplies are thought to be plentiful. Food prices, important to many ldc exporters, have not shared in the recovery. Oil prices have fluctuated in sympathy with tensions in the Gulf. Evidence of production well in excess of OPEC quotas led to a \$2 pb decline in spot prices which have since stabilised on news that OPEC's price monitoring and production committees would meet to try to restore OPEC discipline.

14 Demand and activity in the main markets for ldc exports recovered strongly in Q2, with signs of further growth in Q3, especially in the US and Japan. The recent weakness of the US dollar, in combination with the recovery in commodity prices, has revived inflation expectations leading to some strengthening of US interest rates. The relative strength of the DM and Yen has, however, led to some reversal of earlier upward pressure on long rates in Germany and Japan.

15 Since mid-July, capital market borrowing by ldc's has been largely confined to Asian borrowers. After some months of relative inactivity, S Korea returned to the market with borrowings by industrial and commercial companies of \$850 mn including an FRN issue with a finer spread than of late. Three borrowings by Taiwan totalled

\$510 mn, including two in the form of Euro-commercial Paper Programmes (ECPs) for banks. ECPs were also arranged for Korea's Goldstar and ICICI, India's Industrial Credit and Investment Corporation.

16 On 2 September, judgement was given in the High Court in favour of Libyan Arab Foreign Bank in its action against Bankers Trust to recover \$292 mn frozen in London and New York following President Reagan's blocking of Libyan assets in January 1986. The judge ruled that LAFB's London account was governed by UK law and LAFB was entitled to payment of \$131 mn blocked in London in cash, either in US dollars or in sterling. LAFB was also entitled to payment of \$161 mn of which should have been transferred, under a cash management facility, from New York to London immediately prior to the freeze order on 8 January 1986. The verdict, which sets a significant precedent for the conduct of banking in London and has important implications for the Euro-dollar market, is likely to be appealed.

Further details on individual countries are given below.

Latin America and Caribbean

17 The IMF Board discussed Brazil's Article IV report on 14 September. While the report was generally favourable as regards the direction of economic policy, it expressed clear concerns over the adequacy of the measures taken, particularly the control of public sector finances [the PSBR in H1 amounted to 13-14% of GDP (1.9% operational)] and was not presented as the basis of a formal Fund programme. The MD's summing up is not thought to have been sufficiently positive to be taken as the "seal of approval" required by the Paris Club as a condition for rescheduling principal due in H1 1987. The Brazilians' attitude to the Fund remains ambivalent; there are signs that they would eventually be prepared to accept some form of monitoring. Brazil will be discussed among Paris Club creditors at the end-September meeting although no formal arrangements have yet been made for a meeting with the Brazilian authorities. Negotiations with Brazil's commercial bank creditors are due to begin on 23-24 September, following the Fund Board's discussion. A series of informal meetings to present the authorities' macroeconomic plan to creditor banks took place in early September. Brazil proposed the securitisation of half its debt at a discount reflecting the level of provisioning recently made by the banks but following discussions with the US Treasury the plan has been dropped. (See also para 4 above.) US commercial banks' attitudes to Brazil are thought to have hardened recently as a result of the Brazilian authorities refusing to make even a token interest payment before 20 August, the date on which interest on medium and long-term debt fell 180 days

overdue. UK banks also continue to take a firm line, stressing the need for Brazilia to seek a fully funded IMF programme to ensure that the financing burden is shared with official creditors.

18 Despite the freeze introduced in mid-June, prices rose 3% in July and by a reported 6.4% in August. Overnight interest rates have risen from 10% a month at end-July to 13% at end-August, and the real test of whether inflationary pressures have been significantly dampened will come as price controls are eased from end-August. It does not seem likely that additional fiscal measures announced at end-August will have much impact. There are more encouraging signs on the external front. The cooling-off of the domestic economy, and a more competitive exchange rate policy, have limited import demand and freed resources for exports: a July trade surplus of \$1.42 bn, the highest ever, brought the total for January-July to \$4.9 bn (cf \$7.2 bn January-July 1986). If this performance continues the authorities will meet their \$8.6 bn target for the annual trade surplus comfortably.

19 The final stage of Mexico's 1986-87 financing package was reached on 14 August with the start of the signature of the \$9.7 bn FICORCA private sector restructuring arrangement. The terms are as for the public sector debt (20 years/7 grace, Libor +13/16%). It is now unlikely that the remaining \$2.5 bn commercial bank financing for 1986-87 will be drawn because of the high level of gross reserves (an estimated \$15 bn at end-July, cf \$7 bn at end-1986). The preliminary trade surplus in H1, at \$4.8 bn, was \$200 mn higher than that for the whole of 1986, and strong oil prices have so far also precluded the need to draw on the banks' \$1.2 bn oil contingency loan. In addition, non-oil exports have also performed well, rising 24% in January-May compared with January-May 1986. The H2 trade surplus is likely to be lower in response to the short term adverse impact of trade liberalisation, a slower rate of exchange rate depreciation and rising domestic demand. Although industrial production for January-May was 2.6% lower than in the first five months of 1986, manufacturing output has shown signs of a revival, with a 4.2% year-on-year rise reported for June. While the authorities appear to be united in the view that economic growth must come second to the control of inflation, the fiscal deficit (16.6% of GDP forecast for 1987) remains a major influence on inflation despite a sharp recovery in oil revenues, and the current policy stance seems unlikely to bring any immediate benefit. Prices rose 133.3% in the year to July (126.6% in the year to June), although an 8.1% rise in July is likely to have reflected the raising of the minimum wage level by 23%.

20 Commitments to the full \$1.95 bn of the new money loan for Argentina were received by 20 August, allowing the deal to be signed on 21 August. The package comprises a \$1.05 bn medium-term loan, a \$0.5 bn cofinancing with the IBRD, and a \$0.4 bn trade credit and deposit facility; in addition there is a \$2 bn money market standby facility and a \$30 bn restructuring of public sector and private sector debt. A few of the smaller banks have still not agreed to commit new money on the basis of their fair share, and the revised exit bond scheme, which permits banks to convert up to \$30 mn into bearer bonds at a 4% interest rate, has attracted take-ups by only 3 banks. However it appears that some banks (with, perhaps, Citibank taking the lead), will take advantage of the debt-equity conversion scheme in the package. The achievement of the critical mass of commitments for the bank package activated the SDR 1113 mn SBA, which had been approved in principle in February. By July, however, Argentina was significantly off track under the original programme and a revised programme for 1987, with substantially weaker targets for inflation and the PSBR, was approved by the Fund Board on 23 July. Recent economic developments have continued to be discouraging and the end-August performance criteria are almost certain to have been breached. Prices rose 13.7% in August, bringing the year-on-year inflation rate to 126.4% (cf the revised IMF target of 90% by end-year). An economic package introduced on 20 July to restructure public sector finances has met with little enthusiasm, with even those who support the package being sceptical about the authorities' will and capacity to implement the measures envisaged. Doubts will have been reinforced following Peronist gains in the September elections and by a hard line speech directed against the IMF by President Alfonsin shortly afterwards in which it was suggested that Argentina might seek a "cap" on real interest payments. However, the authorities subsequently sent telexes to the banks confirming that they will continue to service their debts normally, pending further negotiations. The external trade account continues to be adversely affected by an overvalued exchange rate: the trade surplus in H1 1987 was only \$610 mn (cf \$1.4 bn in the same period in 1986).

21 Against a deteriorating economic background, Venezuela continues to make slow progress towards signing the \$21.1 bn commercial bank MYRA. The cabinet and central bank have approved the amendment to the MYRA and the Advisory Committee and the authorities began signing on 18 September, with other creditor banks due to sign in time for the new October deadline for signature to be met. The authorities have had some minor success in obtaining new credits when, in July, Banco Indosuez headed a syndicate of mainly French and Spanish banks which provided Alcasa (the state aluminium entity) with a \$30 mn loan to prefinance imports; the loan was, however, associated with a major export credit package. Rumours that US banks are putting together a \$2 bn new money package for Venezuela seem unfounded, although the

authorities held preliminary discussions with banks in August on the possibility of financing on this scale following the signature of the MYRA. The Article IV mission, which visited Venezuela in June under the enhanced surveillance agreement, has not yet presented its report to the Board; it was concerned, however, about the direction of economic management and will be holding further talks with the authorities. Prices rose by 5.2% in July, despite the 120-day price freeze on essential goods introduced in May, bringing the cumulative increase in the first seven months of the year to 24.2% and the year-on-year rate of inflation to 31.8% (cf 10.1% at end-1986). Stronger domestic demand, particularly following wage increases in May, has more than offset the beneficial impact of high oil prices on the trade balance. Overall, reserves have fallen \$0.9 bn to \$8.6 bn since end-1986.

22 Chile's satisfactory economic performance under the IMF EFF continues, and the July review was successfully completed with all criteria having been met. In August, a World Bank mission visited Chile to study patterns of savings and investment in advance of negotiating a third SAL which would be scheduled for disbursement in November. Meanwhile it appears that buoyant domestic demand has led to a rise in inflation to 20.8% at end-August compared with the IMF's projection of 16% for end-1987. The tightening of controls on bank credit and the rise in domestic interest rates imposed at end-March has yet to curb demand pressures. The upturn in demand has, moreover, already been reflected in the external trade accounts. Imports in H1 at \$1.9 bn, were 35% higher than in H1 1986. Thus despite the rising price of copper, which contributed to a 14% increase in exports in H1 1987 compared with H1 1986, the H1 trade surplus was only \$530 mn, (cf \$730 mn in H1 1986).

23 When Ecuador's SBA was cancelled in June because of a failure to meet performance criteria as a result of the earthquake, the authorities stated their intention of negotiating a new Fund programme. Finance Minister Espinosa held informal meetings with Fund staff in Washington in August and formal discussions have just started. Negotiations with the banks are now expected not to begin before early October. Oil production and exports have resumed. In compensation for output losses between March and August, OPEC has agreed to allow Ecuador to produce up to 320,000 bpd until end-1987 rather than the revised H2 production quota of 210,000 bpd. The authorities have also requested an extension to the payback period on oil loans from Venezuela and Nigeria to twelve months from December 1987 instead of seven. Meanwhile domestic inflation continues to rise, reaching 30.3% year on year at end-May (cf 27.3% at end-1986).

24 On 31 July the IMF completed its third review of Peru's arrears, which have now risen to SDR 306 mn, an increase of SDR 92 mn from the 13 February review. Debt service arrears to other creditors rose \$1.2 bn in H1 1987 to \$5.9 bn at end-June. Although an IMF mission visited Lima in early June, and the Fund hopes for an early completion of Article IV consultations, the authorities seem unlikely to agree to a rapprochement in the near future. Arrears to the World Bank reached \$69 mn in July. Disbursements ceased earlier this year when payments fell more than 90 days overdue, and, after a lapse of 180 days, loans were placed a non-accrual basis on 3 August. Signs that creditor bank cohesion is crumbling have begun to appear, with Midland Bank announcing a countertrade agreement with Peru which is intended to clear \$9 mn of the bank's exposure to Peru. President Garcia has adopted a significantly tougher stance towards the private sector and foreign creditors. His perception of the alleged unwillingness of the private sector to support plans for investment outside Lima is believed to have been behind the announcement of the nationalisation of the financial sector. Although legislation has been passed by the Chamber of Deputies and is currently with the Senate, an interim Presidential decree to intervene in the banks was ruled unconstitutional. Foreign banks are not at present included, but legislation could be amended to affect them too and Chase, one of six with local operations, had already begun negotiations to close its office. Political violence has increased further, and the President's nominee for Central Bank President was assassinated in August.

25 Although Colombia's trade balance has been affected by weaker international coffee prices, an increase in nontraditional exports has in part compensated. On the domestic side inflation has shown a slight upturn, to 26.7% year-on-year at end-July (cf 14.1% in July 1986) largely because of rises in prices of agricultural products. The authorities have reached an agreement in principle with a group of commercial bank creditors on the terms of a new money loan of \$1.06 bn for 1987 and roadshows to market the loan were held in mid-September. The banks have asked for the release of the Fund's Article IV consultation documents. The IMF Staff, currently in Bogota, regard the general direction of policy as remaining acceptable. Bolivia's poor economic performance in H1 1987 prevented the authorities from making the last two purchases due under the SBA which expired in July. However, following an IMF mission to La Paz, a Letter of Intent forming the basis of an SBA or EFF has been agreed. There has been little progress on the commercial bank debt buy-back scheme, as the Fund has yet to agree to its involvement and most creditor governments remain reluctant to commit themselves. Uruguay's economic performance continues to be stable, and in July the IMF approved a request for enhanced surveillance in support of its MYRA until end-1989. Inflation remains the major domestic problem: although the rate of increase slowed

during the first half of the year, the IMF target of 50% by end-1987 is still in jeopardy. Despite the downturn in demand in Brazil and Argentina, export revenues are up on last year. Commercial banks have requested a postponement of Costa Rica's refinancing talks until after the Annual Meetings in order to have more time to consider the authorities' "menu" of options, which includes variable annual amortisation and interest capitalisation. IMF Staff are considering a request for an SBA before the conclusion of an agreement with the banks.

26 In early August the IMF Board discussed Jamaica's first review under the SBA. Although all performance criteria were met, those for public sector finances were close to the target ceilings and the Fund has agreed to modifications of the programme to allow increased capital spending. Prime Minister Seaga's debt plan announced in March, which primarily targets reductions in the debt service ratio for small, middle income debtors and calls for an enhanced role for the IBRD, may be tabled at the meeting of Commonwealth Finance Ministers meeting in Barbados. A Paris Club task force visited Cuba from 9-12 July to prepare a draft economic report in preparation for the next round of rescheduling talks. The report is generally gloomy and detects few signs of structural adjustment.

South and East Asia

27 In the Philippines, output continues to recover with a year-on-year increase in H1 of 5.1%, a significant improvement on last year's 1.5% and an 11% fall between 1983 and 1985. The official growth target for the full year has, nevertheless, been scaled down to 5.8% from an ambitious 6.8%, and even this could prove to be optimistic given heightened uncertainty following the latest coup attempt. All the cabinet has offered its resignation and Ongpin has been replaced as Finance Minister by Vicente Jayme, also thought to be a moderate on the debt issue. The current account moved into a deficit of \$230 mn in the first half of 1987 compared with a surplus of \$435 mn in the comparable period last year. Higher imports combined with lower services receipts appears to be the main explanation. A recent IMF mission agreed to recommend to the Board that year-end targets for reserves and the current account surplus be scaled down. The inauguration of the new Congress has been marked by hawkish statements on the debt issue by both the President and some members of the pro-Aquino majorities in both Houses, and at least three draft bills proposing either selective repudiation or limitation of service payments have been tabled. Barclays has been singled out for particular criticism following its insistence that commitments by the Marcos regime to debts incurred by a fertiliser company, Planters Products Inc, be honoured.

28 Firmer oil and commodity prices, combined with an increase in exports of manufactures, are helping to foster a tentative recovery in the Malaysian economy. Current estimates point to trade surplus in the order of \$4 bn in 1987, compared with a \$3.3 bn surplus in 1986. The current account may be in balance, or even register a small surplus in 1987 - the first in 8 years. Although projections for GDP growth in 1987 have been revised upwards to 3%, this compares poorly with the 8%-9% average for the 1960s and 1970s.

29 Despite higher oil prices and some evidence of successful diversification into non-oil exports, external prospects for Indonesia remain fragile. A drastic liquidity squeeze initiated to stem capital flight has apparently succeeded in attracting back about half the outflow that took place between May and early July. Indonesia remains, nevertheless, vulnerable to panic outflows and reserves are now 1/3 lower than at end-1986.

Eastern Europe

30 Poland has reached agreement with its commercial creditors on the broad outlines of a six year, two stage MYRA which will consolidate all of its medium and long term commercial debt under one agreement and reschedule it over fifteen years at Libor +15/16%. The banks have also agreed to extend the final maturity of the \$1 bn revolving credits by two years to 1991. Official creditors, who have indicated their willingness to reschedule all arrears outstanding and all payments due until end 1988, hope that the Poles will attend the Paris Club in October.

31 Confronted with an external financing gap in excess of \$1 bn in 1987, and the prospect of a very tight liquidity position in 1988, Yugoslavia has concluded that it cannot continue to service its external debt and has decided to develop a programme for longer term stabilisation of its external payments position. Following a 90 day moratorium on the payment of \$240 mn principal to the commercial banks, negotiations were originally due to recommence in September but have been postponed to October. Initial approaches to major official creditors have already been made, and a formal approach to the Paris Club is expected in October. Neither set of negotiations is likely to be successful without an IMF standby. Although the IMF is due to return to Belgrade in September to discuss a package of adjustment measures, it is by no means certain that the government will be reconciled to a Fund programme. Creditor confidence will have been further dented by the financial scandal over Agrokomerc, the 24th largest company in Yugoslavia, which has been found to have issued illegally up to \$500 mn or more of uncovered promissory notes, affecting 63 banks across the country. Though similar practices are widespread

throughout Yugoslavia, this scandal has implicated leading politicians and businessmen and led to the resignation of the country's Deputy President, while the National Bank is apparently prepared to let a small local bank at the heart of the matter go bankrupt.

32 Hungary's economic performance remains poor and the policy response by the authorities continuing to be disappointing. The convertible-currency current account deficit in H1 is estimated at \$0.8 bn, some \$50 mn less than H1 1986, but there are signs that easy access to the capital markets is ending - the latest \$400 mn credit experienced difficulty in syndication despite the higher margin (Libor +3/8% against Libor +1/4% in February). At Hungary's request, an IMF mini mission visited Budapest in mid-August and formal discussions on a SBA are expected to begin in September. The banks' steering committee has reached agreement with Romania on a reduction in the spread on the 1986 re-rescheduling agreement (from Libor +1 3/8% to Libor +7/8%) and hope that they can proceed with selling the agreement now that arrears to the IBRD have been reduced.

Southern Europe

33 In Greece disappointing economic performance in the first half of the year has led to a pessimistic revision of targets for inflation and the current account deficit. The authorities have acknowledged the need to continue the austerity policy into next year. A \$100 mn credit was raised at the end of July by the Public Power Corporation on slightly finer terms than for a comparable loan last year, and was followed by a DM 150 mn bond in September by the same borrower.

34 Developments in Turkey continue to give some cause for concern. A high level of inflation persists and the likelihood of measures to restrain the rapid expansion of the economy in the run up to the election called for November is remote. Whilst in the six months to June the trade balance had shown some improvement, July's outcome eliminated earlier gains with a substantial leap in imports and weaker exports. Despite improved invisible receipts, it now seems unlikely that Turkey's current account this year will show any significant improvement over the \$1.5 bn deficit in 1986.

Sub-Saharan Africa

35 The Nigerian financing package is under considerable strain. A recent IMF mission was unable to complete the already delayed SBA review because of slippages in fiscal policy. The Fund staff will concentrate on formulating a new programme for next year. Foreign exchange market reforms have had, however, some success.

Negotiations for the World Bank's Trade and Investment Loan have been held up for lack of an effective programme and signature of the commercial bank 1986/7 rescheduling agreement has been delayed. The situation has been additionally complicated by Nigerian proposals for rescheduling promissory notes. The proposals include the immediate termination of the verification process and terms which, in the opinion of LDTC, will be unacceptable to the noteholders it represents. LDTC has responded with counter-proposals and awaits the Nigerian reply. There is a risk that trade creditors who have not yet received promissory notes in respect of their claims will take legal action. This could trigger a parallel response from noteholders which in turn could lead to a seizure of assets as well as potentially triggering cross-default clauses on bank loans.

36 The moratorium in Cote d'Ivoire shows no immediate sign of easing. The August meeting with the London Club went badly with no definite date being set for new negotiations. The timetable for a Fund Board discussion on a new SBA (including a CFF and possibly a SAF) has now slipped to 10 December and any eventual programme still seems likely to be a soft one. The Ivoriens do not seem to be unduly perturbed and may well be awaiting the outcome of events in Brazil. Meanwhile economic conditions continue to deteriorate. Although the dollar/CFA Franc rate has stabilised, cocoa and coffee prices remain weak. Recent figures show that the trade surplus shrank by a third in the first eleven months of 1986 whilst real GDP is expected to fall by one percent this year. In mid-August the authorities in Zambia finally announced their much-delayed alternative New Economic Recovery Programme (NERP). While the programme aims to achieve growth from Zambia's "own resources", it remains heavily dependent on assumed capital inflows from donors. The programme seems doomed to failure. Ingredients include an exchange rate of \$1=K8 (over K4 below the mines' current break-even point), production and growth targets which are clearly optimistic, unsustainably high levels of investment with a misplaced emphasis on industry rather than agriculture, and no measures to reduce the budget deficit.

37 In Zimbabwe, the budget for 1987/88 fails to address major problems. The budget assumes no growth (in contrast, local Zimbabwean sources expect GDP to fall by 3%-4%) and aims for a virtually unchanged deficit (11% of GDP in 1986/87). Its measures fall well short of those envisaged by the IMF in the recent Article IV discussions as necessary for medium-term sustainable growth.

The economic recovery in South Africa is not continuing as strongly as first hoped. The Reserve Bank has said that GDP growth in 1987 is unlikely to reach the government's target of 3% - the third year in which growth targets have not been reached.

38 After more than two years of inconclusive contacts, Sudan and the IMF have reached agreement on adjustment policies which could provide the basis for an IMF programme. The draft programme includes the reduction of domestic subsidies, devaluation, exchange rate unification and parastatal reform. However, many details have yet to be worked out, not least the substantial assistance which will be required from donors to repay IMF arrears (now over \$500 mn), reschedule official debt, finance immediate supplies of essential commodities, and provide new money to meet large financing gaps in 1987 and beyond. There are also uncertainties about Sudan's ability to carry out the politically very sensitive adjustment measures, particularly given the serious dissensions within the coalition government.

Middle East & North Africa

39 As expected, Egypt is likely to have considerable difficulty in meeting IMF requirements at the first SBA review in September. Credit ceilings have probably been breached and the budget for FY87-88 lacks credibility in the absence of further, revenue-raising measures. While reforms to the exchange system have increased the flow of foreign exchange through official channels, the new regulations have effectively prevented branches of foreign banks, including Lloyds, from doing business, and the authorities have yet to respond to their complaints. Questions remain over the financing of the SBA and little, if any, progress has been made in bilaterals under the May Paris Club agreement. IMF staff are doubtful of Egypt's ability to strengthen the programme as earlier promised. Morocco's IMF programme still appears broadly on track, although the delay in signing the banks' rescheduling agreement - not now expected until October - may require a further waiver on external arrears. Algeria has continued to benefit from firmer oil prices and has managed to secure new official and commercial credits. But banks remain cautious, and further substantial inflows are still needed if Algeria is to honour amortisation payments of around \$4 bn this year as well as finance its current account deficit.

INDEBTEDNESS AND BRITISH EXPOSURE

\$ billion

	Total external debt \$bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1986*	End-Dec 1986	End-March 1987 [2]	End-March 1987 [3]
<u>Latin America</u>				
Argentina	52	3.0(0.2)	0.2	0.2
Brazil	110	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	4	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
Pakistan	15	0.2(0.2)	0.1	0.1
Philippines	29	1.3(0.2)	0.1	0.2
<u>Eastern Europe (convertible currency)</u>				
Bulgaria	5	0.3(0.1)	-	0.1
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	20	1.2(0.2)	0.1	0.3
Turkey	31	0.5(0.3)	0.2	0.6

[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 36 countries amounted to \$8.9 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.

* Current estimate.

INDEBTEDNESS AND BRITISH EXPOSURE

\$ billion

	Total external debt \$bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1986*	End-Dec 1986	End-March 1987 [2]	End-March 1987 [3]
<u>Sub-Saharan Africa</u>				
Cote d'Ivoire	9	0.3(-)	0.1	0.1
Kenya	4	0.1(0.1)	0.2	0.5
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
Zambia	6	0.2(-)	0.2	0.2
Zimbabwe	2	0.2(0.2)	0.2	0.3
<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	32	0.4(0.1)	0.1	0.2
Morocco	18	0.2(-)	0.2	0.3
Oman	3	0.1(0.1)	0.7	1.9
Saudi Arabia	14[5]	0.6(0.2)	0.2	0.3

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

[5] Excludes unguaranteed non-bank claims.

OVERDUE FINANCIAL OBLIGATIONS TO THE FUND*

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding as at 14.8.87 (SDR mn)
Kampuchea	13 March 1975	30.3
Guyana	31 May 1983	59.9
Viet Nam	6 February 1984	73.7
Sudan	12 July 1984	481.1
Liberia	25 January 1985	151.4
Peru	9 September 1985	305.8
Zambia	30 April 1986	242.4
Nicaragua	15 September 1986	0.3
Sierra Leone	16 January 1987	12.3
Somalia	2 July 1987	<u>6.6</u>
		1,363.8

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 SDR 1,380.3 mn as at 24.8.87, 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.

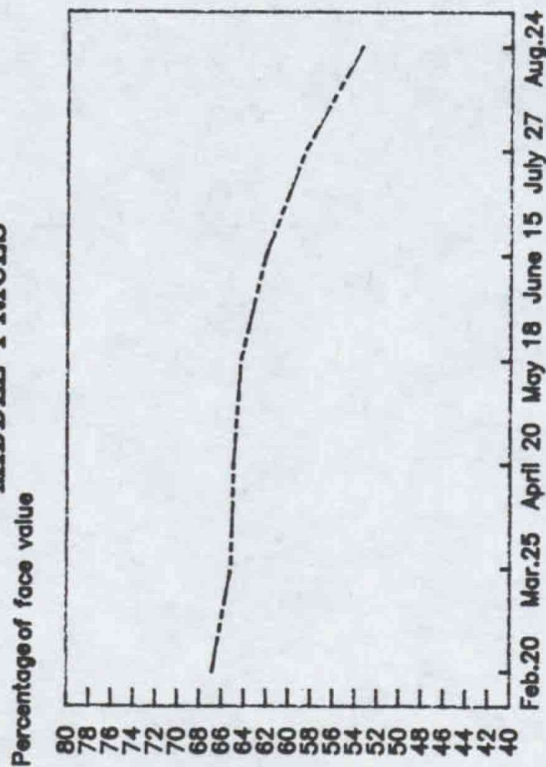
Guyana, Viet Nam, Sudan, Peru and Liberia are ineligible. Kampuchea is out of contact with the Fund. Zambia will be declared ineligible at end-September unless it has given firm indications of an intention to clear arrears in the interim.

CHART 1

SALOMONS SECONDARY MARKET PRICES

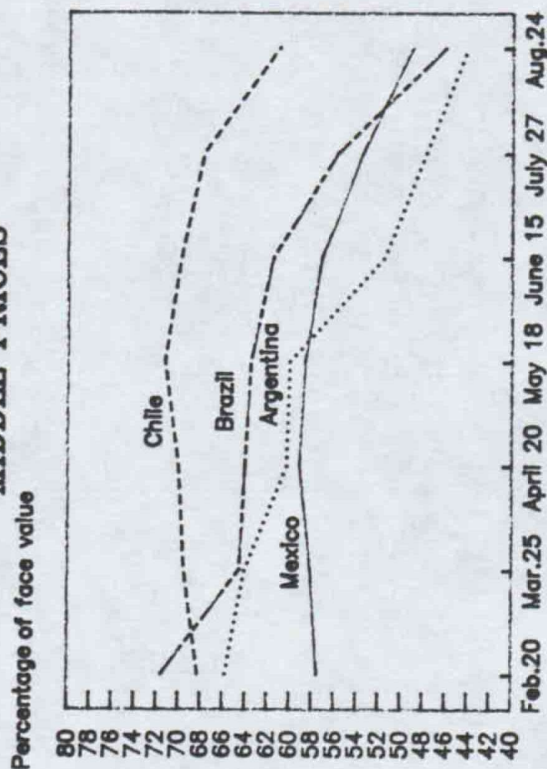
ALL IDR COUNTRIES (WEIGHTED AVERAGE)

MIDDLE PRICES

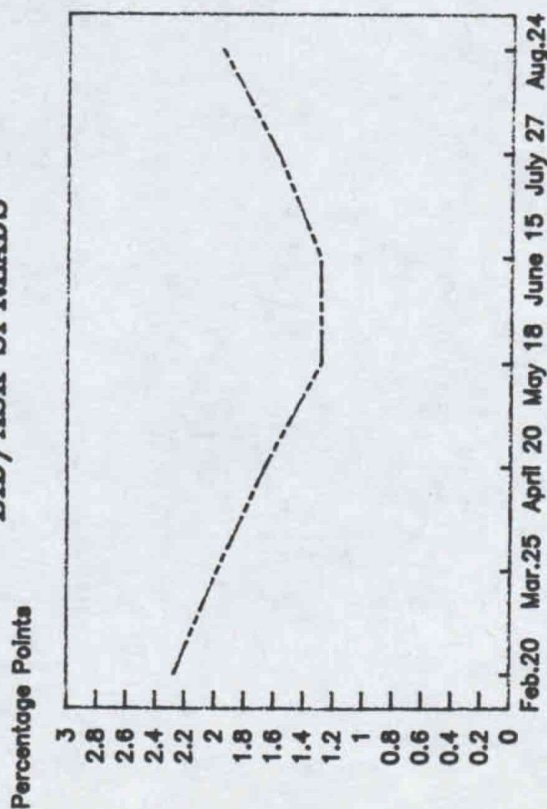


SELECTED MAJOR DEBTORS

MIDDLE PRICES



BID/ASK SPREADS



BID/ASK SPREADS

