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Prime Minister (2)
Despite a lower dollar, lower interest rates and lower oil prices, debt problems remain.
AT 17/6

Treasury Chambers, Parliament Street, SW1P 3AG
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A Turnbull Esq
10 Downing Street

14 June 1985

Dear Andrew,

INTERNATIONAL FINANCIAL SCENE

I enclose the latest assessment of developments on the international financial scene which has been discussed in the Treasury's International Debt Group. Brian Unwin had an opportunity to discuss the main issues with his G5 Debt Deputy Colleagues in London on Thursday last.

2. The Bank's paper notes the rather gloomier picture that is emerging, where in a number of key problem countries a continuing lack of adequate internal adjustment has been accompanied in the first part of 1985 by disappointing trade accounts. These worries are offset only partially by better signs on interest rates and, in some countries, on competitiveness. The continuing attempts to put together bridging support for Argentina have been reported separately in my letter of 7 June. (The attached assessment records the position as at last weekend.) Although Mrs Case's minute of 10 June (copied to you) reported information we had received that agreement had been reached on a bridging facility, this has yet to be publicly confirmed. We will report further if and when it is finalised.

3. There are three other key areas to draw to your attention. First, Peru. This was also the subject of my letter of 7 June. The economic adviser to the President-elect was in London this week and called on the Treasury (as well as on Lady Young, and at the Bank of England). First indications are depressing. The new regime seems set on a showdown with the IMF. We are discussing the problem with other creditors and will report again soon. If there are new developments, for example in the form of decisions by US bank regulators, we will report further.

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4. Second, Poland remains a major concern. Ministers have recently decided (following the Chancellor's minute of 10 May to the Foreign Secretary) that there is no case for extending substantial new credits to Poland; a decision parallelled by most other creditor governments. Our continuing aim is to keep the Poles in play in rescheduling negotiations and avert the slide from a de facto moratorium of debt service into an outright default. The next step will be the Paris Club meeting at the end of this month when it is hoped the Poles will sign the draft 1982-84 rescheduling agreement. Creditors have said they would understand if the Poles wished at the same time to make an oral statement about the difficulties they will face in honouring it. The state of these negotiations remains fragile and the Poles could yet decide to break off talks. An informal meeting between the G5 and the Polish negotiators has been arranged ahead of the Paris Club session.

5. On the Cartagena front, Chancellor Kohl has now replied on behalf of all the Summit participants with a skilfully worded letter which needs no amplification by his Summit partners. So far, it has not led to any further group action by the Cartagena countries. Though we have had reports of their continuing dissatisfaction, they have yet to find sufficient further identity of interest to undertake a new demarche. Nevertheless departments are, on a contingency basis, reviewing the range of demands the Cartagena Group might make if they were to renew pressure.

6. I am copying this letter to Len Appleyard (FCO), John Mogg (DTI) and John Bartlett (Bank of England).

Yours ever

Rachel.

MRS R LOMAX
Principal Private Secretary

INTERNATIONAL FINANCIAL SCENE

Although recent developments have not all been unfavourable, sentiment about the debt situation generally continues to be gloomy. As noted in the last Report, attention is turning increasingly to the lack of adequate internal adjustments within several debtor countries. In addition, results on the external side - the success story of 1984 - have for a number of countries been rather disappointing so far this year. Partly as a result of these factors, problems may be arising even for some debtors that either have so far not been in difficulties or that seemed to have already overcome the worst of them. Also, and perhaps most worryingly, increasing difficulties in filling the expected financing gaps, particularly so far for some middle-sized debtors, suggest that there may be renewed pressures to go beyond the established framework - rescheduling maturities and providing new money in exchange for external surveillance - that has successfully contained the debt crisis over the last three years.

These developments have occurred against a world environment that, for the debtors, has recently appeared to be improving. Although GDP growth in the US decelerated to only 0.7% (annual rate) in the first quarter, and industrial production actually fell in April, the US current account deficit has continued to rise: in the first quarter of this year the deficit is likely to have been over $30 billion compared with less than $20 billion in the corresponding period of 1984. In response to the domestic slowdown, the discount rate was cut on 17 May by 1/2 percentage point to 7 1/2%, its lowest level since August 1978. Three month eurodollar rates have fallen by over 1 1/2 percentage points since March and are now below 8%. The recent depreciation of the dollar (on 7 June it was 7 1/2% in effective terms below its March peak) will also be helping to reduce debt-service burdens. Over the longer term, the adverse effects of the falling dollar on the

competitiveness of some of the debtors may cause them difficulties in achieving their external targets; but the threat that the US would introduce comprehensive new protectionist measures, which seemed very real at the beginning of the year, seems now to have faded slightly, although increased protection may yet affect individual sectors.

To judge by the rather sluggish performance of exports and/or rapid increase in imports in a number of debtors in the first quarter of this year, the period of continuous over-achievement of debtors' external targets appears in any case to have come to an end. To some extent a reduction in the size of the trade surpluses from last year's levels was to be expected; but creditors are in no mood to give a debtor the benefit of the doubt over what constitutes a satisfactory performance (particularly where, as in the case of Brazil, a small current account shortfall, and an apparent unwillingness to draw down reserves, may mean that new money will be required in 1985). Indeed, export shortfalls in the first quarter of the year in South Korea, which so far has not experienced any debt servicing difficulties, were reportedly causing some banks to re-evaluate their exposure to that country.

The IMF programmes for two of the three largest debtors - Brazil and Argentina - as well as a number of smaller debtors remain in abeyance, because of the debtors' conspicuous failure to achieve internal targets. To safeguard its own credibility and, indeed, to get such countries back on track, the IMF seems less willing than it was earlier to accept target overruns and missed criteria. Yet the internal adjustment necessary to restore relationships with the Fund is likely to prove politically difficult for a number of countries. One such case is Peru where the President-elect, in considering how to resolve the impasse over his country's debt problems, has declared that creditors should accept that Peru's debt payments should be limited to a set proportion (maybe 20%) of the country's export earnings, and that the IMF's prescriptions are unacceptable.

On the other side of the coin, however, there are some brighter areas. Several bank and official reschedulings have recently been signed; the first official MYRA - for Ecuador - has been agreed. Venezuelan performance appears to support its official statements that its debt problems are now largely behind it. Resistance to currency depreciation seems to have weakened in some countries, for instance Mexico and Argentina, in that they have increased the rate of depreciation of their currencies (although in neither case has the rate of depreciation yet caught up with their inflation differentials against the United States). Most debtors now at least recognise the need to deal with their internal problems. The continuing weakness of the oil price, and the possibility of further falls in interest rates, will assist the debt servicing of most countries. And, perhaps most importantly, forecasts (most recently the IMF's World Economic Outlook) continue to suggest that growth in industrial countries will continue to exceed the critical 3% annual rate that will be necessary if debtors are gradually to reduce their debt burdens.

The Interim/Development Committees meetings on 17-19 April were designed as a response to debtors' demands for dialogue. The "Cartagena Consensus" countries put forward a moderate paper, and the meetings passed off without any major confrontation. No plans have been made to continue the dialogue. The Consensus countries, however, were not satisfied by these meetings, and sent a message to this effect to the recent Bonn Summit; Chancellor Kohl has sent an anodyne but skilful reply on behalf of the Summit countries. Although the Cartagena countries have not yet formally re-grouped, the ideas of the Cartagena Consensus continue to be discussed in other fora: for instance, the new Finance Minister of Uruguay recently re-stated the demands at a meeting of the UN Economic Commission for Latin America and the Caribbean in Santiago.

More details on the major debtors are given below.

(i) Latin America

Although monetary and exchange rate policies have been tightened in the last month or so, Argentina will have to act also on fiscal policy before the IMF will agree to reinstate the SDR 1.4 bn Standby programme which collapsed in March. President Alfonsin told his population on 26 April to expect 'wartime economy' measures as part of the attack on inflation, which rose to 939% in the year to end-April; but these measures have yet to be announced. With the public sector deficit in the first quarter running at the equivalent of 10% of GDP - more than double the IMF target for the year - strong action will be required. If and when it does come, it will take place against a background of worrying instability in the financial system. The financial sector was shaken by reforms introduced in April designed to permit more market determination of interest rates; the extent of the sector's difficulties was highlighted by the Central Bank's announcement of the liquidation of the country's eleventh largest bank (Banco de Italia y Rio de la Plata, which owes $230 mn to commercial bank creditors) and the introduction of emergency measures to safeguard the financial system on 17 May. The Working Committee of commercial banks are becoming increasingly frustrated by the Argentinians who, in spite of making a $50 mn payment on 3 May, are now over 180 days overdue on interest payments.

In an attempt to stop the US Regulators, who are meeting on 10 June, from downgrading Argentine debt, the US Treasury are attempting to put together bridging finance, possibly of as much as $670 mn, to enable Argentina to bring down interest arrears to less than 90 days. The bridging loan depends on a statement (which apparently will be forthcoming) from the Fund MD supportive of a new Letter of Intent. But the decision of the Regulators remains in doubt. In the meantime, the UK Argentina Paris Club bilateral took place on 15-17 May, and some progress was made. Talks were to resume in Madrid on 5 June to resolve outstanding issues, notably on interest rates, but have been postponed until late June. Argentina is, however, still refusing to enter into parallel discussions on the ending of commercial restrictions between the two countries.

In Brazil, the death of President-elect Tancredo Neves has brought fresh uncertainty into the negotiations with the IMF and the commercial banks. The new economic team is determined to lower the public sector deficit as the cornerstone of its anti-inflation strategy, but is still debating as to whether to do it by cutting spending or raising taxes. Following the breakdown of Brazil's IMF programme at the beginning of the year, talks are continuing with the IMF, and it now seems probable that the EFF will be set aside and a new 12-month Standby put before the IMF Board in the summer. On the commercial bank front, Finance Minister Dornelles continues to affirm that Brazil will need no new money in 1985 and that he is keen to complete negotiations on the bank MYRA and a parallel Paris Club deal; but, with this year's trade surplus now expected to fall below the level achieved last year, and with Brazil apparently unwilling to draw down its reserves to meet a shortfall, a request for new money later in the year cannot be ruled out. Dornelles has stated that he will not seek to renegotiate the key elements of the MYRA, although he might well wish to obtain some changes so that he can present the MYRA to the Brazilian Congress and people as 'better' than the preliminary agreement reached by his predecessors. In the meantime, the Advisory Committee agreed to recommend a 90 day extension of the trade and interbank lines which expire at end-May, and has obtained a supportive message for the banks from the MD of the IMF offers.

As a refreshing change, Venezuela's economic performance, internal as well as external, has exceeded expectations, and agreement on the terms of a MYRA was reached with the banks' Advisory Committee on 16 May. Under the agreement, $21.2 bn of public sector debt falling due before end-1988 will be rescheduled over 12 1/2 years from end-1984 at LIBOR + 1 1/8%. The IMF will make half-yearly reports available to the banks so that they can monitor Venezuela's economic policies during this period. Roadshows will start in Tokyo in the first week of June, although final signature of the agreement is not expected until September; some banks have already stated that they will not sign the agreement until the Venezuelans have completed the process of registering private debt (not covered by the MYRA).

Given the seriousness of its underlying problems, Mexico's performance too continues at the moment to be reasonably reassuring, but there are rumblings of policy disagreements within the Government about whether the present course should (or can) be held especially in the context of the forthcoming Congressional elections in July. But with its MYRA having been signed at the end of March, uncertainties over Mexico's debt burden have been substantially reduced. However, Mexico's current account surplus in the first quarter of the year was below the level achieved in the same period last year, and while the authorities have now again increased the daily rate of depreciation against the dollar, this still is not quite sufficient to maintain the country's competitive edge.

In April Ecuador was granted a Paris Club three-year MYRA. The deal covers principal only (100% of arrears and 1985 maturities, 85% of 1986 maturities and 70% of 1987 maturities), restructured over 8 years with 3 years' grace. This is less generous than the terms for official rescheduling (85% of principal and interest) which the Steering Committee of the commercial banks had made a precondition of a bank MYRA; how the banks will react is not yet clear. Meanwhile, efforts are being made to bring in the remaining commitments to the $200 mn of new money requested by Ecuador from the banks for 1985. Colombia is edging its way towards an agreement with the banks for nearly $1 bn of project-related new money in 1985/86, with disbursements to be linked to IMF enhanced surveillance of quarterly economic targets. A $300 mn IBRD loan designed to strengthen Colombia's export sector and reduce import restriction has been approved by the IBRD Board.

By contrast, considerable anxiety surrounds developments in Peru and Chile. In Peru, Sr Alan Garcia, leader of the centre-left opposition party, APRA, won the first round of the presidential election on 14 April and, having won the second round at the beginning of this month, will take office in July. Statements by Garcia and his supporters have been very critical of the IMF, and indicate that Peru might seek more generous terms for refinancing its debt, including the limiting of debt service payments to 20%

of export revenue. Garcia also says he wishes to negotiate directly with the banks without IMF involvement. However, these statements may be electioneering rhetoric rather than a considered negotiating position. The FCO is trying to persuade Garcia to visit London before he assumes office, so that Garcia can hear the UK's point of view. Peru paid $16 mn to the banks early in May to reduce interest arrears, on the strength of which a two-month rollover of maturities falling due since March 1984 was agreed. Nevertheless, it is believed that interest arrears to the banks are over the crucial 180 day threshold. US Regulators may therefore downgrade the status of Peruvian loans when they meet on 10 June. In the case of Chile, a programme for a SDR 750 mn 3-year EFF has been provisionally agreed with the IMF, but the financing requirements that remain, even allowing for a small CFF and a large IBRD contribution, imply more new money from the banks in 1985/6 than they are presently prepared to contemplate. A novel proposal worked out by the banks and the IBRD management for bridging the difference, whereby the IBRD would have guaranteed the principal on an additional tranche of bank lending, seems to have been shelved, but a B-loan co-financing for $150 mn is likely to be arranged instead. Despite Government fears that an approach to the Paris Club would either be rebuffed or would bring Chile no benefit because the creditors would remove export credit cover, Chile has reportedly agreed to seek a $150 mn public sector debt rescheduling - although it intends to maintain a pretence that this will not be negotiated within the formal Paris Club arrangements. The UK had already said that, for its part, were Chile to reschedule public sector debt, it would be prepared to resume limited cover quickly, as long as an IMF programme was in place.

(ii) Far East

The commercial bank package for the Philippines was finally signed by the major lenders on 20 May. However, in its first review of the Philippines' SDRs 615 mn Standby the IMF has found that the majority of the performance criteria have been breached. In response, rather than abandoning the facility, the IMF is proposing a restructuring of the remaining disbursements and the introduction of amended performance criteria.

Despite South Korea's disappointing export performance in the first quarter, and reports suggesting that some banks were becoming concerned at their exposure to the country, the Korea Development Bank's recent $600 mn eurocredit was received well by the markets. Finance Minister Kim recently visited major European financial centres, and appears to have reassured the commercial banks that all was well. The authorities are understood to be seeking a further IMF Standby arrangement.

Indonesia's current account deficit in FY 1984/85 was considerably smaller than expected, down to $1.7 bn from $4.2 bn in FY 1983/84. The Inter-Governmental Group on Indonesia (IGGI) is scheduled to meet on 4-5 June, when it is hoped that at least $2.4 bn in official assistance will be pledged for FY 1985/86 (the same level as FY 1984/85).

(iii) Eastern Europe

Poland remains in a very grave condition, but discussions over its debt continue. In order to encourage Poland to sign the 1982-84 agreement, official creditors, meeting in Paris on 17 May, proposed that signature be accompanied by an oral statement to the effect that Poland foresaw difficulties later in the year and might at that point seek further discussion with official creditors. Meanwhile there was agreement, ad referendum, on the main elements of a generous 1985 rescheduling package. However, signature and implementation of these agreements remain in doubt given uncertainties about the balance of payments and the pressures within the Polish leadership. Nothing has yet been heard from Warsaw, and the Chairman of the Paris Club intends to contact the Poles now to establish their position. The IMF Standby arrangement for Yugoslavia was approved on 29 April, but the second drawing has been made conditional on a satisfactory rescheduling agreement being reached with commercial banks by 30 August. Some progress was made at talks with the banks on 22-23 May, but differences over pricing and monitoring arrangements remain. Meanwhile, official creditors signed their multilateral rescheduling agreement on 24 May.

Elsewhere in Eastern Europe the situation is mixed. Bulgaria and Czechoslovakia have returned to the market, for the first time since 1979 and 1983 respectively, for a $100 mn credit each. The Bulgarian credit is for seven years, at Libor + 3/8 for the first four years and + 1/2 for the last three. The latter credit, for eight years, is finely priced, at Libor + 1/4 for the first two years rising to 3/8 for the remaining years. The GDR has returned again for a $200 mn 8-year credit on improved terms of Libor + 3/4 and prime +3/8.

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Romania - which was able to avoid rescheduling in 1984 and hoped to do so again in 1985 - has been forced to approach the four leading banks in the Steering Group for emergency finance in order to help meet the first repayment of principal under its 1982 rescheduling agreement. The banks agreed to advance a credit of $80 mn maturing on 15 October. The Romanians, who blamed the severe winter for their difficulties, expect a further $70 mn shortfall when the November payment falls due; the banks are insisting that all of the Steering Group now be brought in to work out a medium-term solution.

(iv) Southern Europe

An IMF review of Portugal's recent Standby has commented favourably on the success of the external adjustment, but expressed concern at the fiscal position and urged prompt corrective measures. Although an increase in the current account deficit to $0.9 bn is officially forecast for this year, early indications are that domestic demand may be weaker than expected and hence the balance of payments stronger than assumed in the Government's economic programme. A political crisis has been prompted by the decision of the Social Democrats to withdraw from the Government in mid-June after Portugal signs the Treaty of EEC accession.

(v) Africa

Delays in reaching final agreement on commercial bank rescheduling did not prevent Morocco completing all purchases under its $300 mn Standby arrangement with the Fund. Nigerian economic performance remains severely affected by the austerity policies of the military government. Import cutbacks have caused output and employment to fall, and inflation to rise. The IMF's recent Article IV appraisal highlights the need to combine effective demand management with measures to achieve long-term structural adjustment. A UK-initiative is being pursued to try to resolve the long-standing deadlock between Nigeria and the IMF over Nigeria's unwillingness to accept a devaluation of the currency as a key part of any Fund programme, but has so far prompted no reaction from Nigeria. There is no evidence that the Nigerians have modified their stance against the key elements of the Fund strategy. Given this, it is difficult to see how the Nigerians can get through the next few years without rescheduling and/or new money. Meanwhile, official credit agencies continue to insist that insured trade arrears be restructured within a multilateral framework and be conditional on an agreement with the IMF. Full settlement of interest due to official creditors on the debt that has so far been reconciled was made in April. The final tranche of six-year promissory notes - agreed last year as the means for rescheduling uninsured trade arrears - has been delayed until June/July, pending completion of the process of reconciling exporters' claims. In the Sudan, the military coup which overthrew the Numeiri Government has delayed the clearing of Sudan's arrears to the Fund which will be necessary before relations can be normalised. The US is reportedly urging Sudan to use a $50 mn disbursement from AID as bridge finance to reduce arrears to the Fund. A Paris Club meeting has been set for July.

(vi) Other

Turkey's discussions with the IMF on a new Standby arrangement have been abandoned until late summer, pending an evaluation of the effects of current policies. Following a resurgence of inflation in Israel the authorities have announced a number of new

measures designed to contain government expenditure and strengthen the external position. The IMF staff, in their recent consultations paper, are highly critical of Israel's economic management, notably the lax fiscal discipline and the increasing resort to exchange restrictions and multiple exchange rate practices.

Bank of England

7 June 1985