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→ Robin Butler

Prime Minister ②

To see

MCS 23/9

MCS 20/9

Treasury Chambers, Parliament Street, SWIP 3AG
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M C Scholar Esq
10 Downing Street
London SW1

19 September 1983

Dear Michael,

INTERNATIONAL FINANCIAL SCENE

I enclose the latest assessment of the international financial scene by the Bank of England, which the Treasury have discussed with the Bank and other Departments. The Prime Minister may find it useful background for her forthcoming visit to Canada and the United States.

2. The general tone of this latest assessment is little changed from the last assessment in July. The Chancellor has however asked me to draw attention to the following particular points which arise from our consideration of the assessment.

3. On the positive side, the Bank's note points to the improvement in economic activity in the major industrial countries, particularly in the US, which is of direct help to many of the major debtors. This more optimistic tone, as regards the US economy at least, has been reflected in the recent IMF World Economic Outlook paper.

4. The outcome of the conference on debt held by the Organisation of American States in Caracas from 5-9 September was better than anticipated. Speeches by the delegates were on the whole moderate, and there was no call for a debtors' cartel. Ministerial sessions at the end of the meeting endorsed a factual paper analysing the present position on international debt. Attempts to agree a draft resolution on policy were abandoned. It is encouraging that the Brazilians and Mexicans took a particularly moderate line in the discussions.

5. On the debit side, it is still not clear how the wrangle in Congress over the IMF quota legislation will be resolved. Sittings of the Conference Committee of both Houses have now begun but are not expected to be completed for some weeks. The odds still are that the legislation will go through, subject to a number of restrictive provisions. But meanwhile the uncertainty also casts a shadow over operational decisions on such issues as IMF access limits, and hence over the forthcoming IMF/IBRD Annual Meetings.

6. On individual countries Brazil remains the main focus of concern. The assessment does not on this occasion include a detailed section on Brazil, in view of the Prime Minister's discussion with the Chancellor and the Governor earlier this week. It is, however, worth reporting that at a meeting of G5 deputies in Paris this week our representative, with strong support from his French and German colleagues, made it clear to Beryl Sprinkel that we were not prepared to go further than support through the Fund and official (Paris Club) rescheduling. Sprinkel will report this back to the Fund Managing Director. We shall let the Prime Minister have up to date briefing on Brazil before her visit to the US.

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7. Of the other countries, the Philippines are becoming a bit worrying, given the political tensions. A JIC assessment is in preparation and the Fund have promised an assessment for the informal group of G5 officials.

8. I am sending copies of this letter to Brian Fall (FCO), John Rhodes (DTI) and John Bartlett (Bank of England).

Yours ever,

John Kerr.

J O KERR

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INTERNATIONAL FINANCIAL SCENE

General Situation

1 There seems, in so far as one can generalise, to have been marginally encouraging progress on the international debt scene over the past two months, evident most noticeably in Mexico and Chile, helped by - on balance - more favourable developments in the world economy, Fund programmes and domestic retrenchment. However, the Brazilian situation remains on a knife edge. The problems of the Philippines have been rendered more acute by political uncertainties and differences with the IMF over the standby arrangement; and a few more countries have applied for debt relief (eg Morocco) or are preparing to do so (Liberia). Although their problems add little to the size of the global debt problem they do contribute to the cumulative impact on banks' reluctance to lend more to ldcs.

Economic background and interest rates

2 The pick up in economic growth in the major industrial countries overall is proceeding a little faster than seemed likely earlier this year. Certainly this is true in the United States where GNP grew at an annual rate of more than 9% in the second quarter. This exceptional pace may now be slackening but growth of 5-6% in the year to 1983 Q4 now seems likely compared to the US Administration's January forecast of 3%. Renewed growth is also evident in Canada and Japan, both of which are benefitting from the US upturn. In Europe the recovery is less impressive: the positive growth of around 1/2% now forecast in Germany for 1983 as a whole is an improvement on the earlier forecast GNP decline, but France and Italy have yet to show much sign of a sustained revival. The improvement in the industrial world generally is directly helping a number of major LDC debtors, particularly in Latin America, where one-third of exports go to the United States. The impact is likely to be felt not only in improving export volumes terms but also in their terms of trade: the Economist index of dollar commodity prices, for example, has risen by 25% since its October 1982 trough.

3 Against this, however, US short-term interest rates touched a peak for 1983 in August, although they have since eased somewhat; and high US interest rates and the strength of the dollar remain, for countries whose debt is largely dollar-denominated, a major impediment to any more significant improvement in the general debt situation.

Lending attitudes

4 Another adverse factor for ldcs is the continuing slowdown in international lending. The interbank market has shared in this slowdown but major difficulties in it have been avoided. Nevertheless there is evidence that some as yet credit-worthy developing countries are finding it more difficult to obtain financing needed for imports.

Problem countries (other than Brazil)

(i) Latin America

5. The atmosphere surrounding Venezuela's negotiations with creditor banks has worsened significantly. The talks continue to be hampered by substantial interest arrears (some $600 mn) leading to a growing gulf between the Venezuelan authorities and creditor banks, and some banks are taking legal action. The authorities have ruled out an approach to the IMF prior to December's elections and although this will jeopardise the Venezuelan's chances of reaching an outline agreement with the banks by end-September, a further 90-day extension of the existing moratorium appears inevitable. Final agreement on a rescheduling is thus unlikely to be reached until next year.

6. In contrast, Mexico's position continues to improve. IMF targets are being met and the first three rescheduling agreements were signed on 26 August. Mexico's liquidity is underlined by a surplus on current account in the first half of the year which has notably led to a punctual repayment of the outstanding balance of the BIS facility. There are signs of improvement also in Chile where access to IMF resources is restored, agreements have been reached with the banks for new medium- and short-term credits and reserves seem to have stabilised after earlier dramatic losses.

7. In Argentina, the IMF's approval of the steps taken by the authorities to remove discriminatory restrictions against the UK, has paved the way for the release of the final tranche of the banks' bridging loan and agreement over the $1.5 bn new money loan. The Department of Trade continues to monitor Argentina's fulfilment of her commitments to ensure that restrictions are not reimposed. The banks, meanwhile, have delayed disbursement of the new loan because of the discriminatory interpretation of the Bankruptcy Law by an Argentine judge. More seriously, the IMF fears that the standby agreement programme for Argentina may be under strain because of increasing pressure on the Government to ease wage restraint, accelerating inflation and an increase in the public sector deficit.

8. Elsewhere refinancing agreements have been signed for Peru (Paris Club) and Uruguay (commercial banks) whilst the rescue package for Ecuador has been effectively finalised apart from a few relatively minor difficulties. This should be completed in the near future.

(ii) Eastern Europe

9. Recent developments in Eastern Europe suggest slow and patchy progress. Official creditors have agreed in principle to resume rescheduling negotiations with Poland in October and the commercial banks have agreed in principle to reschedule 1983 maturities, but the underlying situation offers little ground for optimism. The 1983 international support package for Yugoslavia is nearly complete. Signature of the commercial bank element is proceeding and disbursement is now expected before the end of October. As soon as the IMF have been advised of the availability date for the first advance of the commercial bank agreement the Fund will be able to release the blocked drawing of $110 mn originally scheduled for 15 August. Disbursement of the $200 mn gold-backed tranche from the BIS (which had as an interim measure postponed the repayment due in August) now seems imminent following the waiver of a negative pledge clause by a Kuwaiti-led syndicate. The Bank of England's participation has been eliminated by the second instalment of HMG's loan. With the assistance of international agencies Hungary appears to be having success in raising sufficient new funds to meet 1983 debt maturities but there is concern for 1984 when commitments are set to rise. Timar, President of the National Bank of Hungary, who met the clearers on his visit to London, looked for their support in the smaller syndicated loans which the Hungarians hoped to raise towards the end of this year or in early 1984. There has been no confirmation of earlier reports that the GDR has opened bilateral negotiations with a number of (unnamed) creditors to reschedule some of its maturing debt.

(iii) Southern Europe

10. Several countries in this area are faced with uncomfortably large borrowing programmes to refinance their continuing external deficits and although none seems likely to run into debt difficulties in the foreseeable future their position needs watching. Portugal has recently concluded talks with the IMF on terms for an 18-month \$480 mn standby arrangement which should assist market sentiment towards an expected approach in the autumn. In the meantime there are reports of an approach to the BIS for a \$300 mn gold-linked loan in addition to the facilities arranged in March and June. Growing concern is being expressed about Greece as poor export performance and reduced invisible earnings have led to a widening of the current account deficit and placed increased strain on already sharply reduced foreign exchange reserves. Although Spain seems potentially a larger problem because external earnings have been growing more slowly than the rising service on external indebtedness and progress in improving the current account is slow, the recently concluded \$750 mn loan suggests continued market confidence. Although sheltered by financial support from the United States, increasing awareness of the weakness of the Israel economy has prompted introduction of a number of measures including a 7.5% devaluation and public sector expenditure cuts. If a period of political instability follows Begin's resignation the external situation could deteriorate further.

(iv) Far East

11. There have been no major developments in the economies of the Far Eastern problem countries. In the Philippines, however, the assassination of the prominent opposition politician Aquino, and renewed speculation about the health of President Marcos, by raising concern about the prospects for political stability, may further weaken international banking confidence. The Philippines' chances of avoiding rescheduling, in the short-term, remain delicately balanced, but Indonesia and South Korea look reasonably placed at least for the remainder of the year.