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Prime Minister

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New Richard,

INTERNATIONAL FINANCIAL SCENE

... The Chancellor has asked me to send you the enclosed further assessment by the Bank of England of the international financial scene. Attached to it is a table showing the total indebtedness of the countries concerned in Latin America and Eastern Europe, and the exposure of British banks and ECGD to these countries. As you suggested in your letter of 1 February, I am not including detailed annexes on particular countries.

As you will see, the Bank's note was prepared before the recent OPEC agreement on oil prices and production quotas. If the price remains near its new level the fall could prove helpful to oil importing countries while not sufficient seriously to undermine the situation for those of the main problem countries that are oil exporters.

The Chancellor has asked me to draw your attention to the following points which arise from the attached assessment:-

- a. On the two largest debtors - Mexico and Brazil - the speedy preparation of the large and complex financial assistance packages has been impressive and encouraging. But it would be premature to conclude that we are yet out of the wood on these countries. There is a real possibility that one or both could require further funding later this year.
- b. There are emerging problems in a number of other South American countries - Venezuela, Chile, Ecuador, Uruguay and Peru - which individually are not large debtors but in aggregate involve debts of the order of Brazil or Mexico. One

/disturbing feature



disturbing feature is that all but one of those countries are oil producers. In the case of Venezuela, there is a danger of defaults arising from the administrative incompetence of the authorities there. However, it is encouraging that in most of these countries the IMF is continuing to give a positive lead to the commercial banks, which have had to bear the brunt of the rescue packages, by making support conditional on the banks providing a specified level of new money. This should help counter the defensive behaviour of the banks referred to in paragraph 4 of the report.

- c. The banks' experiences in Latin America and Eastern Europe could have implications for their attitude to countries in South East Asia like Indonesia and South Korea. We propose to examine this in our next report.
- d. The continuing stalemate on the rescheduling of Poland's officially guaranteed debts is most unsatisfactory. While the Americans are said to be reviewing their policy towards Poland, there are no signs yet of a change in their position on rescheduling. But there is now agreement within the EC on a more positive line, and this will be followed up when the matter is discussed again in Paris next month.
- e. We shall be keeping a careful eye on the progress of proposals that have been put before the US Congress to place new restrictions on international lending by US banks. We understand that these proposals are not at present supported by the Administration, and that, as currently drafted, their imposition would be at the discretion of the Fed.

Two of the remits from the February Interim Committee to the Fund's Executive Board (access limits, SDR allocations) could have a bearing on some of these issues.

Copies of this letter, and the report, go to Brian Fall (FCO) and John Rhodes (DOT), and Tim Allen (Bank of England).

*Yours
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INTERNATIONAL FINANCIAL SCENE

1. Main developments since January

Developments since the end of January incorporate a mixture of good and bad, but on balance progress has been made. On the positive side, signatures have been put to medium-term loans for Mexico (\$5 bn) and Brazil (\$4.4 bn) and to a rescheduling agreement for the latter. Increased resources have been agreed for the IMF which has continued to take a firm lead in rescue operations for other countries in difficulty. Further official assistance has been provided recently by the US Treasury (to Brazil and Peru) and the Commodity Credit Corporation (to Mexico).

On the other side, Brazil is still experiencing liquidity problems and the number of problem countries encountering difficulties has increased as a result of the drying-up of credit facilities in the international market. Discussions with banking advisory groups about rescheduling 1983 maturities and the provision of new money have been set in train for Chile, Uruguay and Peru, while Venezuela's seeming paralysis of will gives increasing concern. Looking ahead, and notwithstanding some encouraging indicators in the United States, prospects of only a gradual world economic recovery on the one hand and uncertainties in the oil market on the other (which could also affect smaller banks in the United States) suggest that the existing financial arrangements put in place for Brazil and Mexico (to take the two largest problem countries) may require some reinforcement.

2. Latin America

The Brazilian projects for new money and rescheduling have been signed with the banks and the first drawings have been made on the loan and also under the IMF agreement, which came into effect on 28 February. Full restoration of short-term banking facilities has not been achieved, however, and Brazil continues to suffer acute liquidity difficulties and is incurring arrears on payments due. Poor trade performance in January and February and concern about the exchange rate forced a major devaluation last month whose effects have yet

to feed through. The US Treasury have accordingly given additional short-term assistance, the banks have deferred half (\$1.1 bn) of the repayment of their bridging loan and Brazil is asking the BIS for further short-term help. Even if these immediate liquidity problems can be managed, the months ahead are likely to be difficult and a Brazilian request for further finance later in the year seems probable. A major step forward for Mexico was the signing of the medium-term loan on 3 March. Creditors are now absorbing Mexico's complicated proposals for rescheduling maturities due up to end-1984. Though the package for Mexico is the most firmly bedded-down of those that are in train, the adjustment effort required will be harder to achieve if the OPEC market price should fall further.

Like Brazil, Mexico could well need more assistance before the end of 1983. Argentina is moving slowly towards agreement on its medium-term loan and rescheduling needs. Successful outcome there depends mainly on the political will of those in power, although there are also some administrative and technical problems still to be overcome. Elsewhere in Latin America, the number of countries in difficulties is increasing as a result of the drying up of credit. Chile, Ecuador, Uruguay and Peru are in various stages of talks with advisory groups of banks and the IMF. The arrangements for Peru, the most recent, have got off to a good start with a sensible, diplomatic presentation of the country's proposals to creditor banks carrying the backing of the IMF and other international financial organisations. By contrast, Venezuela gives increasing cause for concern as the authorities fail to get to grips with a fast-deteriorating debt servicing problem brought about largely by administrative incompetence. There is the danger that creditor banks will lose patience and be unresponsive to requests to assist with Venezuela's needs. This country presents the greatest danger of falling into widespread default.

3. Eastern Europe

Progress towards a restructuring package for Yugoslavia continues; the elements provided by governments and international institutions are now largely agreed, and the banks made further progress at a meeting in London last week. It may, however, be necessary to extend the temporary moratorium on debt repayments which expires

on 31 March. The Poles have been procrastinating over discussions with bank creditors following changes in their negotiating team which may reflect a changing stance towards their debt. When they meet the banks (now planned for 21 March) they are likely to press for even greater relief over a much longer time-scale than in previous agreements. The GDR and Hungary are managing with a struggle to meet their commitments, but eventual reschedulings cannot be excluded. On the other hand, Romania has reached agreement in principle with a Steering Group of banks for rescheduling its 1983 maturities (it can afford slightly more repayments than in 1982) and has made overtures to the Paris Club for parallel relief.

4. Changing attitudes of banks and borrowers

In the aftermath of the major rescue packages, the international banks seem to be bracing themselves for a succession of much smaller, but similarly structured, packages for the countries mentioned in 2. This is leading to defensive behaviour by the banks and counter-defensive behaviour by the borrowers. It is preventing a return to a more normal relationship between the lending banks and the sovereign borrowers or the overseas agencies of the banks from these countries. This is a less favourable outcome than we had originally hoped, reflecting the doubts about the longer-term adequacy of the packages for Brazil and Mexico, but also the sheer time and effort needed to complete the negotiations. The defensive behaviour by the banks consists mainly of seeking to cut their exposure to countries likely to face a debt crisis soon, and a growing reluctance to commit new loans to so far creditworthy countries like Colombia, Indonesia and South Korea; the result is a rise in the margin needed to obtain full subscriptions to new Euro-market credits. The counter-defence of some borrowers, such as Chile and Uruguay, has been to freeze repayment of short-term debts ad interim. This seems to be a cat-and-mouse game as the Mexican and Brazilian precedents show that the exposure of each bank at some benchmark date is used to calculate "fair shares" of rescue packages. Naturally, the banks seek to reduce their level in advance of that, which can lead first to the threat of a liquidity crisis for the borrower and then to a refusal to allow any further outflows until new agreements can be reached.

5. Conclusions

The resilience of the international financial system has been further tested since January. A mechanism has evolved, particularly for Latin America debtor countries, with the IMF taking a strong lead in forging interdependence between its own facilities and programmes and the provision of assistance by the commercial banks. For their part, albeit with the change in attitude noted in paragraph 4 above, the commercial banks have shown themselves able to respond within days to the call to form suitable advisory groups for new countries joining the rescue queue. With support from central banks and governments implied if not always necessarily openly voiced, greater confidence in the system on the part of the banks has probably been felt.

Looking ahead in 1983, the international financial system is likely to have to face up to further challenges: the possibility of a continued increase in the number of countries needing help; conceivably, the spread of the problem (eg to Asia) whether because of the withdrawal of short-term funds or more fundamental economic causes; the risk that Argentina, Brazil or Mexico may not meet the targets set in IMF programmes or, by contrast, in the case of Yugoslavia, that the programme may not be adequate to deal with the problems faced by the country; and the growing likelihood that, for different reasons, Brazil and Mexico at least will return for more money.

The climate of uncertainty is increased by legislative proposals currently before the US Congress to apply limits to and/or restrictions on the price charged for international lending by American banks. Though the sponsors of this legislation are well aware of the acute problems of many debtor countries and their effect on the international financial system, there is always some risk that Congress as a whole will be less sensitive. It may therefore be that restrictions of this type could make it more difficult for the authorities and the banks together to manage the slowdown in lending to the developing countries in an orderly way - which has so far been one of the main aims of the rescue packages.

Whilst, therefore, a pragmatic response in the last eight months has so far successfully coped with three of the largest debtors in the Western world, it cannot be asserted with certainty that the worst is now behind the system and that the formula that has so far stood the test will continue to work smoothly for the increasing number of countries that are indenting for assistance, even though each on its own is less heavily indebted in absolute terms, and notwithstanding the successful outcome of last month's Interim Committee meeting.

Bank of England

March 1983

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INDEBTEDNESS AND BRITISH EXPOSURE

£ billion

	<u>Total external debt</u>	<u>British banks unguaranteed claims</u>	<u>ECGD amounts at risk*</u>
<u>Latin America</u>			
Argentina	39	2.4	0.4
Brazil	81	3.7	1.8
Chile	18	1.0	0.06
Ecuador	6	0.5	0.1
Mexico	83	5.3	1.7
Peru	12	0.4	0.1
Uruguay	4	0.3	0.01
Venezuela	30	2.3	0.09
<u>Eastern Europe</u>			
East Germany	16	0.9	0.2
Hungary	7	0.5	0.06
Poland	25	0.5	1.3
Romania	11	0.4	0.6
Yugoslavia	20	0.9	1.2

* Because of differences in definition the ECGD exposure figures in the final column are not directly comparable with the figures in the other two columns.

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