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Prime Minister (2)

Summarised in the Treasury cover note, though the table at the end is worth noting

AT 17/9

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

14 September 1984

Andrew Turnbull Esq
10 Downing Street
London SW1

Dear Andrew

INTERNATIONAL FINANCIAL SCENE

I attach the latest report by the Bank on developments on the international financial scene, which has been discussed in the Treasury's international debt group. Many of the issues discussed in the report will be raised in the forthcoming Toronto and Washington meetings.

Among the general issues it is worth noting the positive benefits of the multi-year rescheduling agreement reached in principle between the commercial banks and Mexico. Its successful completion, so soon after the London Summit's recommendation of this approach, is encouraging and should reduce the ability of the more extreme Latin American debtors to win over the moderates on arguments about lack of response by the industrialised countries.

On individual countries, Argentina remains the main problem. There has been some recent indications, eg from the Fund Managing Director, of greater optimism about the prospects for early agreement with the Fund; but previous history suggests it would be right to be very cautious indeed - not only about the prospects for such an agreement but also about the prospects of Argentina sticking to any agreement reached. Although the $750 billion bridging loan which falls due on 14 September will almost certainly be rolled over again, the commercial banks are currently taking a robust attitude towards Argentine demands and the next crunch point will come at the end of October when the US Regulators meet.

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They could decide to downgrade Argentina's credit rating requiring the banks to write-off some 10% of their outstanding loans. In advance of that we shall be taking a fresh look at our own contingency planning and concerting the plans with our US and other G5 colleagues.

Of the other countries Nigeria remains the most worrying. There is still no sign of the Fund agreement which must precede a multilateral agreement to reschedule her debts. In the meantime, the Nigerians are contemplating a unilateral offer to insured creditors extending to them the benefits of the agreement already reached with the uninsured. We shall be giving further thought to the handling of this in the light of discussions this week in the Paris Club.

I am copying this letter to Len Appleyard (FCO), Callum McCarthy (DTI) and John Bartlett (BOE).

Yours ever,
David

D L C PERETZ
Principal Private Secretary

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INTERNATIONAL FINANCIAL SCENE

Uncertainties about the course which Argentina will eventually follow continue to be a major concern for the markets. Meanwhile, a number of negotiations in train elsewhere - notably Mexico - appear to be making progress, while others remain deadlocked. Against this background, regional co-ordination of debt strategies is again under discussion in Mar del Plata (the follow-on to Cartagena).

The economic background to the debt problem remains mixed. On the one hand, unexpectedly strong growth in the major industrial economies over the past few quarters has helped to boost exports by developing countries; combined with enforced cutbacks in imports, this has significantly narrowed the trade deficits of these countries. On the other hand, dollar interest rates, which have changed little over the past few weeks, remain obstinately high and the exchange rate strong. At the same time, commodity prices, after strengthening during 1983, have weakened so far this year, particularly in the second quarter. Moreover, although the outlook in North America and Japan remains generally favourable, there is continued concern about the pace, and even perhaps the durability, of sustained recovery in Europe.

Figures of international bank lending in the second quarter - when the problems at Continental Illinois surfaced - are not yet available. In the previous three months, a rise in lending to non-oil developing countries was more than accounted for by the involuntary $3 bn loan to Brazil. Over the same period, these countries increased their balances with banks abroad by a further $4 bn, of which nearly half was by Latin American countries.

Negotiations between Mexico and the Advisory Group of banks on a multi-year rescheduling have now been completed. It would clearly be beneficial from many points of view if the Mexican package could be quickly put in place. The deal is predicated on new money requirements being met on a voluntary basis and, as such, can be regarded as a notable effort towards re-establishing normality for

Mexico - although it remains to be seen whether the projected amount of voluntary lending by banks (averaging $2 1/2 bn per annum between 1985-1990) will be forthcoming. It is likewise welcome that a mechanism for IMF monitoring has been devised, which takes account of Mexico's unwillingness to submit to further IMF conditionality after the current EFF expires at end-1985, and at the same time satisfies the banks' insistence on IMF monitoring "with teeth". As regards burden-sharing, it is a disappointment to British banks that most members of the Advisory Group were not in favour of an approach to the Paris Club, even though it was widely recognised that Mexico would set a precedent for subsequent multi-year rescheduling negotiations. But this perhaps serves to reinforce the validity of the case-by-case approach: there was no immediate and obvious need to restructure official trade credit in the Mexican case, although there certainly is such a need for other countries eg Brazil. In this context, the growing willingness of creditor governments to renew (limited) cover for certain countries in the event of a rescheduling, is particularly timely and welcome.

Meanwhile, the regional co-ordination of debt strategies takes a further step forward on 13/14 September, when Foreign and Finance Ministers of the eleven Latin American countries represented at Cartagena in June re-assemble in Mar del Plata (Argentina) to review developments over the last few months. When the agenda was discussed in August, it was agreed to invite major creditor countries to attend a summit on Latin American debt. This reflected a general view that creditors had not responded adequately to the "restraint and maturity" demonstrated at Cartagena. Following the August meeting, several Latin American countries have asked the Summit Seven and other OECD countries how they would react to a proposal for some kind of high level, political meeting with the Latin American debtors. We, together with our principal Summit partners, dislike the idea of a high-level political meeting because we think it could lead to public confrontation and damage the prospects for making practical progress in handling debt issues. Some of the Latin American countries evidently share this concern. We have therefore told the Latin Americans informally - having previously ascertained that our principal Summit partners generally agreed -

that we were sceptical of the value of such a meeting and thought the Mexican idea of using the IMF/IBRD Development Committee seemed more practical. The Mar del Plata meeting this week will be considering, in the light of these exchanges, how to carry forward the idea of a political dialogue with the creditors; and the question will no doubt be discussed during the IMF/IBRD annual meetings later this month.

As regards the specific Cartagena proposals for debt relief, a committee has been formed by the Latin Americans to study a system of compensatory credits to offset high international interest rates. The scheme, if agreed by Ministers, would be submitted to the IMF/IBRD Annual Meetings later this month.

Turning to some of the main problem countries, the Philippine authorities have now accepted virtually all of the IMF's proposals for a programme, but progress on a bank financing package is being delayed by wrangling over the Citibank Manila question. In Nigeria, talks with the Fund remain deadlocked, and the Nigerians are meanwhile endeavouring to by-pass official credit agencies and settle insured arrears directly with suppliers. On the other hand, banks have implemented a multi-annual rescheduling agreement for Poland, and the Poles have made a move to break the deadlock in official negotiations. Brazil, which is shortly to begin Phase III negotiations, has met all the IMF's performance criteria so far this year, but is faring much less well with its targets for inflation and the monetary aggregates. The picture in the smaller Latin American countries is mixed (see following section). But Argentina continues to be the most intractable problem: substantial differences remain with the IMF, and the time is rapidly approaching when the Argentines must decide whether to go it alone or accept Fund conditionality. Meanwhile, it remains very doubtful whether Argentina will meet its next repayment obligation on 14 September.

More detail about the position in major debtor countries is given below.

(i) Latin America

Argentina is still the major source of concern. Although recent discussions with the Fund staff have produced a broad measure of agreement on the overall policy objectives of a new Standby programme, there is still a wide gap between the two sides. This prompted creditor banks to refuse an Argentine request to roll over the end-June bridging loan of $125 mn when it fell due on 15 August, and repayment was accordingly made. The next major deadline for the banks is 14 September, when Argentina is due to repay the $750 mn outstanding from the 1982 bridging loan of $1.1 bn. But there is little prospect of the country being able or willing to repay this amount from its own resources, and the banks will almost certainly have to agree to a further roll-over. The precise terms will no doubt depend on the degree of progress which the Argentines have made in their talks with the IMF. The protracted negotiations with the IMF may well not continue much beyond the forthcoming IMF Annual Meeting: the size of Argentina's external financing requirement (officially forecast at $11 bn in 1984-85) and the continuing deterioration in the economy are putting pressure on the authorities to settle their differences with the Fund. Furthermore, the IMF has its own credibility to consider: it will be difficult for the Managing Director or his Deputy to go on being a party to statements that progress is being made if, in fact, two or more of the original stumbling-blocks remain in place. Perhaps around the end of this month, therefore, Argentina may have to decide whether to go it alone or accept the IMF's prescriptions: some indication of its thinking may emerge after Mar del Plata.

Against this background, Mexico has reached a timely agreement in principle with the Advisory Group of banks on a multi-year rescheduling of some $48 bn of public sector debt falling due between 1985 and 1990. The restructuring is effectively split into two tranches, with repayments extending up to 1998; implementation of the second tranche will depend on favourable Fund reports in 1987 (see below). The average spread is 1 1/8% over LIBOR or cost of funds: the prime rate option has been eliminated. No restructuring fees are to be charged.

The IMF will - subject to formal approval by the Board which has not yet been given - assess targets set by the Mexicans, and monitor progress, as part of the annual Article IV Consultations; and will also conduct mid-year reviews. The reports will be made available to the banks: if the Fund indicates dissatisfaction with Mexico's performance or targets, the banks may decide to call an event of default.

LBI and other British banks were strongly in favour of an approach to the Paris Club, but found little support from most other members of the Advisory Group, and the idea was eventually dropped.

The draft agreement contains a provision for non-US banks to switch a proportion of their dollar lending into local currency, subject to approval by the respective central banks.

Details of the draft package were finalised on 8 September and circulated to creditor banks early this week.

As attention begins to focus on Phase III of Brazil's debt rescue package, the authorities have indicated a desire to complete the new round of negotiations - including the question of a multi-year rescheduling - before next January's Presidential election. However, because of the political uncertainty surrounding the elections, the banks may seek an interim agreement to reschedule maturities only in 1985, while deferring discussion on a multi-year arrangement until the new Administration has been installed. An IMF team recently reached agreement with the authorities on performance targets for the second half of 1984, which should pave the way for signature of a sixth Letter of Intent later this month.

Elsewhere in Latin America, formal bank rescheduling negotiations with Venezuela began on 25 July, and reasonable progress has reportedly been made on the three basic issues of IMF monitoring, private sector debt, and interest arrears. Once these are resolved, negotiations will begin on terms: initial positions are some way apart - the Venezuelans have requested the rescheduling, over 15 years, of all public sector maturities between 1983 and 1992 - and the authorities appear optimistic in expecting to have reached agreement by the end of this month. Although Chile comfortably met all IMF performance targets at the end of June, the Fund consider that further measures of restraint will be required if the annual

targets are to be met. The Advisory Group of banks meets later this month to discuss strategy for 1985 and beyond: the possibility of a multi-year rescheduling is likely to be considered.

Peru's Standby agreement seems certain to require renegotiation in a few months' time. While second quarter performance targets may have been only slightly exceeded, a much larger overshoot is expected in the third quarter. Meanwhile, final agreement on the $2.5 bn commercial bank refinancing package, covering maturities in 1984/85, has been further delayed. In Ecuador, the Febres Cordero Administration, which took office on 10 August, has already initiated talks with the IMF on a new Standby, with a view to obtaining a new money loan from banks before the end of the year. In early August, the banks signed an agreement to reschedule $348 mn of public sector debt falling due in 1984. Colombia's economic and financial position continues to deteriorate; and recent evidence that private sector debt is being rescheduled in a piecemeal fashion is likely to weaken confidence even further and make foreign banks less willing to undertake new lending.

(ii) The Far East

In the Philippines, the government has now accepted the Fund's proposals for a Standby programme almost in their entirety: the measures would be implemented largely as prior action in support of a SDR 615 mn eighteen-month Standby to end-1985. The Fund staff hope to put the proposals to the Board by end-October, but disagreement between banks on the Citibank Manila question might lead to serious delay in assembling the new money package.

Elsewhere in the Far East, Indonesia and South Korea continue to command relatively favourable spreads in the euromarkets.

(iii) Eastern Europe

In a move to break the deadlock in official negotiations, Poland has offered to meet Paris Club requirements in respect of non-consolidated 1981 debt and interest arrears; and attention is now turning to

Poland's application in 1981 for IMF membership, which had earlier been blocked by NATO sanctions. The governmental Task Force is due to meet in Paris on 14 September to discuss economic developments.

Meanwhile, the commercial bank multi-annual rescheduling agreement (for 1984 to 1987) signed in London in July has been implemented, even though the associated amount of new money was below the target threshold. The banks are expected to meet the Yugoslavs in October to discuss their 1985 financing requirements: a multi-annual rescheduling agreement is likely to be raised. A further waiver of performance criteria under the SDR 370 mn Standby was approved on 31 August. Elsewhere in the region, the GDR has obtained a DM 950 mn ($330 mn) loan from West German banks, on the same terms (1% over Libor) as the DM 1 bn credit raised in June 1983; and Romania has indicated that it will not seek a further IMF programme.

(iv) Southern Europe

Portugal's external balance is responding well to the IMF-supported recovery programme, and the current account deficit is expected to be within the Fund's target. But longer-term prospects are less favourable, with a debt service ratio of around 30% projected for the remainder of the decade, leaving little or no scope for relaxation of adjustment policies. The Greek current account deficit in 1984 is still forecast to be around $2 bn - much the same as last year. There is no indication of any further strengthening in the adjustment programme. Nevertheless, a $200 mn loan by the Public Power Corporation of Greece was favourably received, and the amount was increased in response to oversubscription. In Israel, attention continues to focus on resolving the political stalemate which followed the general election. Meanwhile, the interim government is unable to implement further measures to check the recent rapid decline in the economy.

(v) Africa

Nigeria has made no further progress in negotiations with the IMF on a three-year EFF. Meanwhile, trade credit agencies remain insistent

that a multilateral restructuring of trade arrears must be conditional on agreement being reached with the IMF. This has prompted the Nigerians to plan the issue of promissory notes to individual companies on similar lines to those already agreed for companies with uninsured arrears, thus bypassing trade credit agencies. Morocco's rescheduling negotiations with commercial banks remain deadlocked, but the IMF have allowed two drawings under the Standby to be made by 30 November.

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INDEBTEDNESS AND BRITISH EXPOSURE

$ billion

	Total external debt End-Dec 1983 (except where stated)	British-owned banks' exposure [1] End-Dec 1983	ECGD amounts at risk[2 End-June 1984
Latin America			
Argentina	46	2.5	0.2
Brazil	92	6.1	1.9
Chile	19	1.3	0.1
Colombia	12	0.7	0.2
Ecuador	7	0.6	0.1
Mexico	91	6.3	1.4
Peru	12	0.4	0.1
Venezuela	34	2.4	-
Eastern Europe (convertible currency)			
East Germany	13-14	0.7	0.2
Hungary	8	0.5	0.1
Poland	27	0.5	0.8
Romania	9	0.3	0.5
Yugoslavia	19	0.9	1.2
Southern Europe			
Portugal	14	1.4	0.3
Greece	12	1.6	0.4
Spain	40	2.8	0.1
Far East			
Indonesia	31	0.8	1.5
Philippines	25	1.4	0.3
South Korea	40	2.6	0.9
Other			
Morocco	12	0.1	0.3
Nigeria	20	1.3	3.3
Israel	29	0.6	0.2

[1] This column now shows exposure defined as consolidated external claims, adjusted for certain inward and outward risk transfers in respect of guaranteed loans, plus any net claims on local residents in local currency.

[2] Excluding claims paid (net of recoveries). Because of differences in definition, these estimates are not directly comparable with the figures in other columns.