PO-CH/NL/0104
PART A

Chex
Lawson

PART A

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PO -CH /NL/0104
PART A

CHANCELLOR'S MEETINGS WITH THE INTERNATIONAL MONETARY FUND (IMF), THE GROUP OF SEVEN (G7) AND THE ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT (OECD)

with

d OECD

DD: 25 years

Begins: 17/1/85
Ends: 3/4/85 (CONTINUED)

5/9/95

PO -CH /NL/0104
PART A

A

GRS 350
UNCLASSIFIED
DESKBY 180445Z
FM WASHINGTON 172315Z JAN 85
TO IMMEDIATE FCO
TELEGRAM NUMBER 152 OF JANUARY

FROM LITTLER FOR NO. 10 DUTY CLERK

FOLLOWING IS TEXT OF ANNOUNCEMENT ISSUED TO PRESS BY DON REGAN IMMEDIATELY AFTER G5 MEETING THIS AFTERNOON.
BEGINS

THE MINISTERS OF FINANCE AND CENTRAL BANK GOVERNORS OF FRANCE, GERMANY, JAPAN, THE UNITED KINGDOM, AND THE UNITED STATES ANNOUNCED TODAY THAT THEY HAD MET TO DISCUSS A RANGE OF INTERNATIONAL ECONOMIC AND FINANCIAL ISSUES. THE MEETING, PART OF A REGULAR SERIES OF CONSULTATIONS AMONG THESE COUNTRIES ON ECONOMIC AND FINANCIAL MATTERS OF MUTUAL INTEREST, ALSO INVOLVED IMF MANAGING DIRECTOR DE LAROSIERE FOR A DISCUSSION OF THE ECONOMIC POLICIES AND PROSPECTS OF THE MAJOR INDUSTRIAL COUNTRIES.

THE MINISTERS AND GOVERNORS, NOTING THE RECENT DEVELOPMENTS IN THE EXCHANGE MARKETS, EXPRESSED THEIR COMMITMENT TO WORK TOWARD GREATER EXCHANGE MARKET STABILITY. TOWARD THIS END, THE MINISTERS AND GOVERNORS:

--REAFFIRMED THEIR COMMITMENT TO PURSUE MONETARY AND FISCAL POLICIES THAT PROMOTE A CONVERGENCE OF ECONOMIC PERFORMANCE AT NON-INFLATIONARY, STEADY GROWTH:

--STRESSED THE IMPORTANCE OF REMOVING STRUCTURAL RIGIDITIES IN THEIR ECONOMIES TO ACHIEVING THE OBJECTIVES OF NON-INFLATIONARY, STEADY GROWTH AND EXCHANGE MARKET STABILITY, AND EXPRESSED THEIR INTENT TO INTENSIFY EFFORTS IN THIS AREA: AND

--IN LIGHT OF RECENT DEVELOPMENTS IN FOREIGN EXCHANGE MARKETS, REAFFIRMED THEIR COMMITMENT MADE AT THE WILLIAMSBURG SUMMIT TO UNDERTAKE COORDINATED INTERVENTION IN THE MARKETS AS NECESSARY.

/THE

attached

THE MINISTERS AND GOVERNORS BELIEVE THAT THIS APPROACH WILL PROVIDE A SOLID FRAMEWORK FOR SUSTAINING RECOVERY, REDUCING INFLATION, INCREASING EMPLOYMENT, AND ACHIEVING GREATER EXCHANGE RATE STABILITY.

ENDS

FCO PLEASE PASS IMMEDIATE DESKBY 04.45Z TO NO. 10 DUTY OFFICER AND TO PS/FOREIGN SECRETARY.

AND DESKBY 08.00Z TO PS/CHANCELLOR, SIR P. MIDDLETON, MR. CASSELL, MR. LAVELLE (HM TREASURY), PS/GOVERNOR, MR. LOEHNIS, MR. GAILL AND MR. BYATT (BANK OF ENGLAND)

WRIGHT

FINANCIAL

ERD

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320.64

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

Mr J J M Exeter
First Secretary (Economic)
British Embassy
3100 Massachusetts Avenue NW
Washington DC 20008
USA

30 January 1985

Dear Julian,

I should be grateful if you could forward the enclosed letter from the Chancellor to Mr James A Baker III.

Yours sincerely,

Philip Wynn Owen.

P WYNN OWEN
Assistant Private Secretary

320.63

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

James A Baker III
Secretary US Treasury
WASHINGTON

30 January 1985

Dear Mr Baker

I wanted to write straightaway to congratulate you on your installation to the office of Secretary of the US Treasury.

Let me at the same time welcome you to the band of Finance Ministers. You will quickly discover the considerable camaraderie that exists between its members: reflecting our efforts in a common cause in a not unremittingly appreciative world. I hope to see you very soon in one or other of the several groups in which we both participate.

Yours sincerely

Nigel Lawson

NIGEL LAWSON

THE SECRETARY OF THE TREASURY
WASHINGTON, D. C. 20220

~~6/f 20/3 pl~~

6/f 3/4 pl

February 20, 1985

C.
~~To see. No response necessary.~~

IMF folder

Rwo 4/3

Dear Nigel:

Thank you for your congratulatory note on my new responsibilities as Secretary of the Treasury. Please accept my apologies for the delay in responding, but, as you might imagine, my schedule has been quite hectic lately.

I look forward with great enthusiasm to assuming my new position. The Department of the Treasury has a long and proud tradition as one of the finest executive branch agencies. I look forward to contributing to the continuation of that fine tradition.

With thanks and best regards,

Jim

James A. Baker, III

The Right Honorable Nigel Lawson, M.P.
Chancellor of the Exchequer
London, United Kingdom

P.S. I'm looking forward to seeing you soon.

SAVINGRAM

~~b/f 1/4 pt~~

BY BAG

FROM UKDEL IMF/IBRD WASHINGTON

~~b/f 4/4 pt~~ FOR FOLDER

~~b/f 21/3 pt~~

RESTRICTED

TO FCO SAVINGRAM NO 78 OF 12 MARCH

IMF: UNITED KINGDOM - 1984 ARTICLE IV CONSULTATION

1 On 6 March, the Executive Board completed the 1984 Article IV consultation with the United Kingdom (SM/85/44 and Supplement 1, and SM/85/54). Before the discussion, I circulated buff 85/44.

2 Ismael (Indonesia) opened the discussion, followed by Alfidja (Francophone Africa), Bush (US), Zhang (China), Fujino (Japan), Pickering (Canada), Grosche (Germany), Blandin (France), Nimatallah (Saudi Arabia), Zecchini (Italy), Polak (Netherlands), Perez (Spain), Lundstrom (Nordics), Rye (Australia), Abdallah (Kenya), de Groote (Belgium), Jayawardena (Sri Lanka) and Finaish (Libya).

3 A summary of the discussion is contained in our telno 23 of 6 March.

Individual Interventions

4 Ismael said that the UK's performance in 1984 had been mixed. Productivity, profitability and investment had all improved; but there were several areas of concern. The single most important challenge facing the authorities was to reduce real wages in order to tackle the dual problem of unemployment and the poor performance of the external sector.

5 On fiscal policy, the authorities had not made much progress towards their objectives. Government expenditure had increased as a percentage of GDP, and the reduction in the PSBR had been largely due to the windfall factors of oil revenues and asset sales. All this added up to a temporary solution to the fiscal problem; he urged the authorities

to strengthen expenditure control, and felt that it was not an appropriate time to reduce taxes.

6 Monetary policy had been too loose in 1984; the authorities should take much more notice of the supplementary indicators. Indeed, lax fiscal and monetary policies had probably contributed to the fact that inflationary expectations had not yet been removed from the economy, which, as the staff pointed out, had led to relatively high real wage increases.

7 Ismael concluded by expressing concern at the intensification of protectionist pressures, especially non-tariff barriers and voluntary export restraints.

8 Alfidja said that the authorities had met their major objectives of maintaining growth and reducing inflation, but high and rising unemployment called for urgent corrective measures. Expenditure overruns by local authorities were a concern; he welcomed the authorities' long term fiscal objectives. Finally, it was disappointing that ODA continued to decline as a percentage of GDP.

9 Bush said that the UK had had some success in bringing down monetary growth and the PSBR, and the increases in investment and the real rate of return were positive signs. However, there were strong pressures to relax policies given the high level of unemployment, and some evidence of this was beginning to be apparent. She warned that the hard won progress already made could be very quickly reversed if the adjustment efforts slackened.

10 Bush made the same points as Ismael on fiscal policy, noting that the slippages this year reduced the chances of tax cuts. On monetary policy, with sterling M3 growing at around 10 per cent there was little downward pressure on inflation.

11 The level of real wages was a serious problem, partly due to the persistence of inflationary expectations. Bush added that the

non-oil trade balance had steadily worsened, and that the UK continued to lose market share. This partly reflected the fact that the present level of competitiveness was still below that of the late 1970s. The UK had succumbed "to some extent" to protectionist pressures; it was disappointing to see that the authorities appeared to be somewhat reluctant to have a further round of multi-lateral trade talks.

12 Zhang felt that the most important problem in the UK economy was unemployment, although the staff had also offered some useful advice on monetary targetting. The size of the PSBR was now a less urgent problem.

13 Zhang made a number of detailed (and correct) criticisms of the staff's assumption that the yield differential on index and non-indexed bonds could be equated to inflationary expectations in the labour market. Finally, he expressed concern at the shrinkage of the UK's export base.

14 Fujino, like Zhang, felt that unemployment was the most important remaining problem. As inflation stabilised, the expectations gap should disappear. More generally, he stressed the importance of adapting to changing circumstances, and the recent coal strike suggested how difficult this could be in the United Kingdom. The Government could have a role to play in facilitating such adjustment.

15 On fiscal policy, Fujino noted the spending overruns in the local authorities. On monetary policy, he detected a general reluctance to see interest rates rise, which had perhaps led to a sharper depreciation in the exchange rate. Finally he urged the authorities not to yield to protectionist pressures.

16 Pickering emphasised the need to improve the competitiveness of manufacturing industry, noting the decline in the non-oil trade deficit.

17 His authorities had had some concern that the momentum behind the MTFS might be weakening, and the UK authorities would be well advised

not to understate the fiscal stimulus of the past few years. If there were to be tax cuts, strong expenditure restraint would be necessary.

18 On monetary policy, he agreed with the staff that the targetted inflation reduction over the next two years was unambitious. He agreed that more weight should be placed on supplementary monetary indicators, and warned that overfunding could lead to a discrediting of the monetary targets. He concluded by warning that a "quick fix" approach to dealing with the problem of unemployment must be resisted.

19 Grosche said that while the results in the United Kingdom had been broadly favourable, they had fallen short of what might have been achieved. The miners' strike showed very clearly how difficult industrial relations in the United Kingdom could be, and what effect they had on the overall performance of the economy.

20 Monetary policy in 1984 had been loose. He urged the full use of supplementary indicators, and welcomed the January rise in interest rates. On fiscal policy, he made many of the same points as did Ismael, urging decisive action on expenditure.

21 In conclusion, he expressed concern about the level of real wage rises, and their effects on the balance of trade. The authorities should redouble their efforts to implement their financial policies.

22 Blandin saw the UK as an economy of contrasts; good GDP growth but high unemployment; high business investment with little effect on the labour market; high unemployment and low inflation but high wage increases; and generally favourable economic results but a weak pound. He noted that the average duration of unemployment had worryingly increased. Manufacturing competitiveness was threatened by the high rise in unit wage costs, and continuingly high inflationary expectations perhaps indicated the underlying lack of self-confidence.

23 On financial policies, monetary policy should be a little more ambitious, and adequate expenditure restraint would be necesssary if

there were to be tax reductions. He asked that the best wishes of his French authorities be passed to the UK authorities.

24 Nimatallah said results in the UK economy had been generally favourable, and emphasised the importance of supply-side measures and competition.

25 Zecchini said that the first five years of the British experiment showed that the Government's goals on inflation had been completely achieved, those on the public finances largely achieved, but the cost involved had been higher than expected. The current policy stance would not provide a sufficient stimulus to maintain the recovery. He added that the UK authorities' statement that they had no intention of changing their economic policies suggested a rather negative approach to surveillance.

26 Zecchini went on to argue that unemployment in the United Kingdom was partly classical (too high real wages) and partly Keynesian (lack of demand). Therefore an expansionary demand policy combined with wage restraint was called for.

27 Polak said that in many respects the United Kingdom strategy was not living up to expectations. He was not surprised that the staff reported a perception that priorities have changed, and warned that easing fiscal and monetary policy was unlikely to achieve the Government's policy objectives. He was not impressed by the "idyllic" scenarios for 1993/94. Six areas in particular worried him;

(a) the growth in the ratio of government expenditure to GDP;

(b) the fact that the reduction in the PSBR had been wholly due to transitory factors;

(c) inflation was now edging upwards;

(d) real wages and umemployment were increasing;

(e) monetary expansion had been generous;

(f) the appreciation in sterling was now feeding inflationary pressures.

28 On monetary policy, the authorities had not taken sufficient account of Goodhart's Law. PSL2 had been growing rapidly, and sterling M3 targets had been met only through overfunding.

29 He had reservations about the staff's theory that umemployment was in part due to inflationary expectations; the staff should give greater weight to structural rigidities.

30 On the external policy, the authorities' view that an exchange rate target and monetary targets were incompatible seemed to imply a permanent rejection of the EMS. If so, there would be little prospect of attacking the fluctuations in exchange rates in the longer term.

31 Perez disagreed with the staff that the present policy stance was unambitious. While inflation was a prime target, the authorities had to give enough attention to the social problem of uemployment. Local authority expenditure was worrying, and it would be unwise to give any tax reductions. On wages, he wondered if there was any scope for a policy of social consensus perhaps involving ceilings on nominal wages increases.

32 Lundstrom said that the reduction in inflation had been achieved at great cost. Both OECD and the NIESR had rejected a further tightening of economic policy, and the EEC had pointed out that the UK was one of the few OECD countries that had sufficient room to apply a fiscal stimulus.

33 On the staff's theory of wages and inflationary expectations, the tax system was not neutral between indexed and non-indexed bonds, and anyway, expectations in the labour market and the financial markets had different timeframes.

34 Since unemployment had continued to increase while inflation fell, he questioned the authorities' "categoric belief" that their

objectives on inflation and unemployment did not conflict. He emphasised there should be no tightening of fiscal policy.

35 On protectionism, his constituency was concerned that state support to certain industries appeared to have become more or less permanent; he regretted that ODA had now fallen below the DAC average.

36 Rye felt that the staff appraisal accessed the UK performance more against recent successes rather than world conditions.

37 On monetary policy, overfunding appeared to encourage disintermediation, and it was not clear that it ensured the maintenance of tight monetary conditions. He questioned the statement in my buff that "monetary conditions were now tight by any measure". He detected in the papers a strong hint of interest rate targetting - taken too far this could become inconsistent with monetary targetting.

38 The high level of real wages remained a major problem, and he expressed concern at the overshoot in public sector pay awards.

39 On protectionism, his constituency was grateful to the United Kingdom for its efforts to reform the CAP.

40 Abdallah said that there should be some easing of financial policies in order to tackle the problem of unemployment. Protectionist pressures should be resisted, and the reduction in ODA was "deplorable".

41 de Groote observed that the United Kingdom was like Belgium in a number of ways. He made Ismael's points on fiscal policy, and expressed concern that the recent rise in interest rates could affect investment.

42 Jayawardena said that he endorsed Pickering's comments. Increasing protectionism was inconsistent with the authorities desire to promote competition. Structural rigidities could prove the achilles' heel of the adjustment effort. He was concerned at the decline in ODA, but noted that it stood at a high level compared with other countries in similar situations. He hoped it could be increased again later.

43 Finaish felt that a large part of the umemployment problem was not so much a lack of demand as the level of real wages. But there was some scope to modify the rate at which the Government reduced the PSBR while moving towards its medium-term objectives.

44 Schmitt (European Department) said that monetary policy was certainly tighter after the 4½ per cent increase, but the staff felt that caution was still necessary. Real interest rates were probably excessively high, due to the need to provide a firm signal to financial markets. In response to a question of Grosche's, he said that sterling M3 was now such a venerable indicator that it would be difficult to stop targetting it. But it might be an idea to include building society deposits in the definition of sterling M3, since these had been rising very rapidly.

45 Schmitt remarked that any relaxation of fiscal policy had a very quick effect on expectations; the authorities perhaps should not rush into giving tax relief too quickly at this stage. North Sea Oil and asset sales gave the authorities a period of opportunity to make needed changes in the tax system.

46 Schmitt agreed that rigidities in the labour market were the major reason for unemployment. But it should also be noted that employment in a number of areas had continued to fall. This suggested that real wage increases were still too high; and if one assumed that workers did not want to price themselves out of jobs, one had to look for further explanation. The staff believed that much of the answer lay in high inflationary expectations being built into wage increases ex-ante (although he admitted that the differential between the yield on indexed and non-indexed bonds was not a perfect indicator of this expectations gap).

47 In reply to the discussion, I began by assuring Zecchini that the fact that the fact that my authorities had expressed their

determination not to waiver from their economic strategy did not indicate that they would take no notice of the discussion in the Board. Indeed, it was rather the reverse; my authorities wished to assure the Board that they would continue to follow the policies that had been endorsed by the Board in previous years.

48 My authorities were determined to continue with their medium-term financial strategy, and two events in particular underlined their resolve. First, the recent 4½ per cent increase in interest rates; and second, the fact that my authorities had fully supported the efforts of the National Coal Board to allow the closure of unprofitable pits, despite the long and difficult coal strike.

49 On monetary policy, I agreed that the growth of PSL2 had been high. But this in part reflected a movement out of building society term shares, which were not included in PSL2, and which would not have any fundamental effect on monetary conditions.

50 Like other Directors, I had some doubts about the staff's calculations of inflationary expectations from the yield on indexed gilts.

51 Finally, and in answer to Bush's point, I quoted the Prime Minister's statement to the joint session of Congress stating that we fully supported President Reagan's initiative for a new GATT round.

52 The Managing Director's summing up will follow by bag.

WICKS

MONETARY
ERD.

1b

OK.
Concorde approved
r.

C.

To see, esp for the timetable. All flight arrangements are subject to my minuting Sir P.Middleton and making a case for proposed Concorde trips. But you might care to approve the team and provisional timetable now.
OK?
RW 25/3

FROM: A B MILLIGAN

DATE: 21 March 1985

1. MR LITTLER
2. CHANCELLOR

cc: Sir P Middleton
Mr Unwin
Mr Lavelle
Mr Mountfield
Mr Sedgwick
Mr Shields
Mrs Diggle
Mr Dennison
Miss Lyons
Mr Wicks (UKdel/IMF)

IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS

This minute seeks your approval for the composition and travel arrangements of the Treasury Team to the Spring meetings in Washington on 17-19 April. A timetable and agenda for the meetings is attached.

TREASURY TEAM

2. I recommend that this includes:

Chancellor, ~~Mrs Lomax~~*, Mr Culpin, Mr Littler, Mr Lavelle.

Sir Crispin Tickell will attend the meetings, with Mr Braithwaite (FCO) in support. In view of the limitations on numbers in the afternoon sessions of the Interim and Development Committee meetings, Sir Crispin Tickell should be considered part of the Treasury Team so that he can sit in on meetings as necessary.

3. The Governor of the Bank will be attending with Mr Loenhis and Mr Gilchrist.

TRAVEL ARRANGEMENTS

4. A G5 Ministers' Dinner will take place on Tuesday evening 16 April, probably preceded by a meeting involving a presentation by the IMF Managing Director. The most suitable flight for you to take for this meeting will be Concorde, departing 1300, arriving 12.15. I suggest the Chancellor, Mrs Lomax* and Mr Littler fly out

* Mr Wynn Owen instead.

on Concorde, whilst Mr Lavelle and Mr Culpin will follow on a later BA flight.

5. The Spring Meetings will end shortly after noon on Friday 19 April, with a press conference chaired by Mr DeLarosiere, Mr Clausen, Mr Ruding and Mr Kahn. There seems no need for you to attend this. I suggest you and Mrs Lomax* return to the UK on Concorde, departing 1300 arriving 2200. If the meetings do run over a little in the final drafting of the Development Committee communique Mr Littler can tie up any loose ends. Mr Littler, Mr Lavelle and Mr Culpin will return on the Friday evening BA flight, after a Sherpas meeting that afternoon.

ACCOMMODATION

6. The Chancellor will be staying at the Ambassador's Residence as usual, with ~~Mrs Lomax~~. Mr Wynn Owen

CONCLUSION

7. If you are content with the proposed travel plans and composition of the Treasury Team, we will finalise the necessary arrangements.

Andrew Milligan
A B MILLIGAN

25/3

BTW

TIMETABLE OF IMF/IBRD INTERIM/DEVELOPMENT COMMITTEE MEETINGS

Tuesday 16 April

Flights to Washington - Concorde BA 189 dep. 1300 arr. 11.15
(Chancellor, Mrs Lomax, Mr Littler)

- BA 277 dep. 15.30 arr. 17.40
(Mr Lavelle and Mr Culpin)

4.00 pm (app) G5 meeting, followed by dinner.

Wednesday 17 April

8.30 am G10 Ministers meeting (the Chancellor will be Chairman)

9.30 am Interim Committee - plenary session

1.00 pm Chairman's lunch for Interim Committee members

Afternoon Interim Committee - informal session

8.00 pm Chairman's dinner for members of the Interim and Development Committees

Thursday 18 April

8.45 ~~7.30~~ am James Baker III Bilateral — US Treasury.

9.30 am Development Committee - plenary session

1.00 pm Chairman's lunch for Development Committee members

2.00 pm Development Committee - informal session

Evening Chairman's dinner for Interim Committee members to discuss communique
(there will be a separate dinner for other participants)

Friday 19 April

8.30 am Interim Committee - plenary session to approve communique

9.30 am Development Committee - informal, and then plenary sessions, to discuss and approve communique

Noon (app) Joint press conference by Chairmen of the Development and Interim Committees, President of the World Bank and Managing Director of the IMF

Flights to London - Concorde BA 188 dep. 13.00 arr. 23.00
(Chancellor and Mrs Lomax)

- BA 276 dep. 20.20 arr. 9.30 Saturday
(Mr Littler, Mr Lavelle and Mr Culpin).

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

ICMS/Doc/85/1

February 19, 1985

INTERNATIONAL MONETARY FUND

INTERIM COMMITTEE OF THE BOARD OF GOVERNORS
ON THE INTERNATIONAL MONETARY SYSTEM

There follows the provisional agenda for the Twenty-Fourth Meeting of the Interim Committee, which is to be convened at 9:30 a.m. on Wednesday, April 17, 1985, in the Meeting Hall at the Fund's headquarters in Washington, D.C.

PROVISIONAL AGENDA

1. Adoption of Agenda

2. Approval of Minutes of Twenty-Third Meeting (September 22, 1984)

3. World economy in the medium term
   (a) Developments and prospects
   (b) Policy issues

4. Question of allocation of SDRs - Report by the Managing Director on Executive Board consideration

5. Other business

6. Press communiqué

Note: The members of the Committee are invited to address in the morning session the various aspects of items 3 and 4 of the agenda. It is expected that the issues of policy arising out of paragraph 5 of the Interim Committee Communiqué of September 22, 1984, will be discussed more fully in an informal afternoon session. That paragraph reads, in part, as follows:

> It was agreed that, at its next meeting, the Interim Committee will discuss, in a medium-term framework and in the context of the global financial environment and the current approaches toward resolving debt problems, certain issues relating to the adjustment efforts and balance of payments prospects of member countries. These will include
>
> external indebtedness,
> international capital flows,
> trade policies, and
> the role of the Fund's surveillance in dealing with these issues.

In order to avoid duplication of the discussion that is expected to take place in the Development Committee on trade policies, it is suggested that this subject be dealt with primarily in the Development Committee.

JOINT MINISTERIAL COMMITTEE
OF THE
BOARDS OF GOVERNORS OF THE BANK AND THE FUND
ON THE
TRANSFER OF REAL RESOURCES TO DEVELOPING COUNTRIES
(Development Committee)

FOR OFFICIAL USE ONLY

DC/85-1

March 4, 1985

NOTICE OF MEETING

The twenty-sixth meeting of the Development Committee will be held on Thursday and Friday, April 18 and 19, 1985, commencing April 18 at 9.30 a.m. in the Meeting Hall at the International Monetary Fund, 700 Nineteenth Street, N.W., Washington, D.C.

PROVISIONAL AGENDA

1. Medium- and longer term setting for developing countries' growth, including, inter alia, global financial conditions and external indebtedness 1/

2. Policy issues related to medium- and long-term capital flows (including private direct investment and equity flows, ODA, export credit flows, and commercial bank flows)

3. Trade policy issues, protectionism and development

4. The Future Role of the World Bank and the nature and scope of its operations

5. Sub-Saharan Africa -- progress report on the World Bank's Action Program

6. Other business

1/ In order to avoid duplication in the proceedings, it should be noted that the subject of the world economy in the medium-term will have been discussed in the Interim Committee.

* * *

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Note:

The first three items of the agenda respond to the Development Committee's agreement in its meeting on September 23, 1984 that it will discuss in spring 1985 "within the context of a medium- and longer term framework and the current approach toward resolving debt problems, the structural and development aspects of the problems of developing countries in their efforts to achieve sound economic growth. These include, inter alia, external indebtedness, protectionism, commodity prices, interest rates, the structure of capital flows and obstacles to direct investment and equity capital flows."

The fourth item is in response to the Committee's agreement that it will "look forward at its next meeting to suggestions from the World Bank management concerning the future role of the Bank and the implications for longer term capital requirements, keeping in mind the need for a general capital increase."

The fifth item is in response to the Committee's request for the Bank to report to its next meeting "on the progress achieved in implementing the program" [Joint Program of Action for Sub-Saharan Africa].

176/68

Mr. Wynn-Owen (personal)

FROM: R G LAVELLE
DATE: 26 March 1985

To Sec, cp x1

MR SALLNOW-SMITH)
MR DENISON)
MR AARONSON) Copy to each
MR PICKFORD)
MR WALKER)

cc Mr Littler
Mr Mountfield
Mr Sedgwick
Mrs Case
Mr Beastall
Mr Shields
Mrs Diggle

SPRING MEETINGS

Mr Littler held a meeting yesterday to consider the preparations for the Spring meetings and to commission some further work. The meeting primarily addressed the Washington meetings and we are pursuing the preparation of speaking material for the OECD Ministerial meeting separately.

x 2. On timetable, it was concluded that we should aim to submit material to the Private Office by the Easter weekend.

3. Preparation of the background briefs was well advanced. Mr Littler suggested that it would be useful to ensure that in appropriate cases the briefs had quotes from the IMF/IBRD issues papers.

4. A steering brief would need to provide a conspective look at the run of meetings (G5, G10, Interim Committee and Development Committee), the objectives we had in mind, tactics etc. The Washington meetings would be the main subject for discussion at the ECOFIN meeting in Palermo. There would need to be a separate steering brief to cover this occasion noting the points eg possible orchestration of speaking, role of the World Bank which would need to be clarified.

5. As regards speaking notes for the Interim/Development Committee meetings, the background briefs had been prepared in a form for drawing upon as appropriate at the time. However some rather fuller notes seemed necessary as follows.

(i) Interim Committee: opening statement EF

The Chancellor would probably wish to make a short tone-setting statement, referring to the better general climate indicating that the industrial countries had done much of their part of the bargain; acknowledging difficulties; and referring to longer term solutions including the trade strategy. We would need to avoid overlap with the Managing Director and this might point to including some material on structural adjustment, the role of the Fund. We would need desirably to cover as much ground as possible, by assertion, so as to help provide a backing for material in the Communique.

(ii) Development Committee: opening statement Mr Aaronson

Mr Littler envisaged here that the Chancellor's remarks would be directed primarily to issues of capital movements. They would start with a look at the past pattern of capital movement and the present state. He would probably wish himself to add some material here on the particular role of private investment and techniques that might be developed.

(iii) Interest rate capping Mr Walker

This subject seemed likely to occupy a good deal of time and it would be helpful to have a thoughtful negative account of the case for a Fund facility and the attitude of commercial banks to propositions in this area.

(iv) Export credits Mr Sallnow-Smith

As discussed in recent minutes, the Chancellor might wish to make some reasonably positive comments on the paper in the World Bank series on this subject and the proposals in it for vetting of schemes.

(v) Trade Mr Pickford/EF

The background brief would need to disentangle the Community position, including the (essentially French) question of a change in Japanese import propensities, and the trade/monetary link, and the more positive UK approach. The speaking material would pick up the latter.

(vi) World Bank Mr Denison

We needed to take the Chancellor's mind on the line to be taken on the role of the World Bank and the extent to which it would be necessary to commit ourselves to a view about a future GCI. Speaking material would match this.

6. It would be helpful, if this is practicable, for first drafts of the speaking material above to reach me by the end of this week. The main speaking notes will probably need to be annexed to the steering brief. No doubt all the material will need to be adapted in the light of events but it would be helpful to have something reasonably fireproof with us. The main statements will themselves need to be only a little over five minutes in length and the others not more than a page in length.

R G LAVELLE

85-03-29 22:08
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CH/EXCHEQUER
REC. - 1 APR 1985
ACTION Mr Littler
COPIES TO Sir P. Middleton
Mr Mountfield
Mr Shields
Mrs Diggle.
PS/GOVERNOR.

Gov

US TREAS WSH
MSG PEF387
PIERRE BEREGOVOY
MINISTER OF ECONOMY AND FINANCE
FRANCE
GERHARD STOLTENBURG
MINISTER OF FINANCE
FEDERAL REPUBLIC OF GERMANY
NOBORU TAKESHITA
MINISTER OF FINANCE
JAPAN
NIGEL LAWSON
CHANCELLOR OF THE EXCHEQUER
UNITED KINGDOM

C.
To see. Sir Peter (see below) has agreed Concorde for you, Jeff Littler and me on the way and you and me on the way back. This fully justifies sending us out on Concorde.
PWO 1/4

DEAR COLLEAGUE:

IT IS MY PLEASURE TO INVITE YOU TO A MEETING AND WORKING DINNER OF OUR SMALL GROUP ON TURSDAY, APRIL 16, 1985 AT TAYLOE HOUSE, 721 MADISON PLACE, N.W., WASHINGTON, D.C. I PROPOSE THAT WE BEGIN THE MEETING AT 5:00 P.M., BREAK FOR COCKTAILS AT ABOUT 6:30 P.M. AND CONTINUE OUR DISCUSSION AT DINNER COMMENCING AT ABOUT 7:00 P.M.

IN LIGHT OF THE DISCUSSIONS BY OUR DEPUTIES, I SUGGEST THAT WE FOCUS ON THE FOLLOWING ISSUES:

1. INTERIM AND DEVELOPMENT COMMITTEE MEETINGS: TO COORDINATE POSITIONS FOR THE MEETINGS THE FOLLOWING DAY, INCLUDING THE COMMUNIQUE.
2. WORLD ECONOMIC OUTLOOK: TO REVIEW BRIEFLY CURRENT AND PROSPECTIVE DEVELOPMENTS AND THEIR IMPLICATIONS FOR DOMESTIC POLICIES.
3. G-10 MONETARY STUDIES: TO DISCUSS THE RIPORT BEING PREPARED BY G-10 DEPUTIES.
4. BONN SUMMIT: TO REVIEW PREPARATIONS FOR THE MAY 2-4 MEETING, FOCUSSING ON ECONOMIC ISSUES THAT ARE LIKELY TO ARISE.
5. RECENT EXCHANGE MARKET TRENDS.
6. WORLD BANK GENERAL CAPITAL INCREASE: TO REVIEW EFFORTS TO INCREASE THE EFFECTIVENESS OF LENDING AND THE NEED FOR A GCI.

I HAVE ASKED IMF MANAGING DIRECTOR DE LAROSIERE TO JOIN US AT THE PRE-DINNER MEETING FOR THE DISCUSSION OF AGENDA ITEMS 1 AND 2 SO THAT WE MAY HAVE HIS VIEWS ON THE INTERIM AND DEVELOPMENT COMMITTEE MEETINGS. I HOPE YOU WILL FIND THESE ARRANGEMENTS ACCEPTABLE. PLEASE INFORM YOUR CENTRAL BANK COLLEAGUE OF THIS INVITATION.

SINCERELY,

JAMES A. BAKER, III
19/3621/PF
NNNN*
262405 TRSY G..

FROM: P WYNN OWEN
DATE: 29 March 1985

cc Mr Littler
Miss S Lyons

MR BOARD

PALERMO AND WASHINGTON TRAVEL ARRANGEMENTS

Thank you for your minute recording Sir Peter Middleton's agreement to Mrs Lawson accompanying the Chancellor to the OECD meeting in Paris on 11/12 April. This minute seeks Sir Peter's agreement to the arrangements for the informal ECOFIN in Palermo and the Spring Meetings in Washington.

Informal ECOFIN

2. Mrs Lawson has been invited to accompany the Chancellor to Palermo. I believe that she went to the informal ECOFIN last year and that Lady Howe may well have accompanied her husband to similar meetings at an earlier date. Mrs Leigh-Pemberton plans to accompany the Governor. I should be grateful for confirmation that Sir Peter is content to give his permission to Mrs Lawson's travel expenses being met from public funds.

3. The trip from Paris to Palermo on a Friday evening and from there back to London on a Sunday evening is by no means easy. The flights we have currently booked, stopping at Milan on the way out and Rome on the way back are the only flights available, though we are exploring the possibility of travelling down direct to Palermo with other Finance Ministers.

IMF Spring Meeting

4. The Chancellor's first meeting in Washington is likely to be a G5 meeting on 4.00 p.m. on Tuesday 16 April. His last meeting is likely to end before noon on Friday 19 April. The proposed party consists of the Chancellor, Mr Littler, Mr Lavelle, Mr Culpin and myself.

5. Possible flight are:

	Departs London Heathrow	Arrive Washington
Tuesday 16 April	13.00 BA 189 (Concorde)	11.15
	15.30 BA 277 (Jumbo)	17.40

	Departs Washington	Arrive London Heathrow
Friday 19 April	13.00 BA 188 (Concorde)	23.00
	20.20 BA 276 (Jumbo)	09.30 (Saturday)

The Governor and Mr Loehnis are booked to fly out and back on Concorde.

6. The justification for flying out on Concorde rests on the fact that that is the only flight from London Heathrow that day which would get the Chancellor and Mr Littler to Washington in time for the likely G5 meeting at 4.00 p.m. I am not sure of the precedents concerning Private Secretaries flying Concorde and am thus double-booked both there and back. I should be grateful for Sir Peter's guidance on this point.

7. The justification for travelling back on Concorde rests on the fact that all the Chancellor's business would be over by noon on the Friday and it is the first plane out. Messrs Littler, Lavelle and Culpin, however, will probably have to stay on for the final Development Committee press conference, for which the Chancellor is not required. BA 276 goes overnight and we have been unable to obtain first class sleepers on it because it will be full of 18 Generals from the US High Command! The Chancellor attaches great importance to returning on Concorde on the Friday, rather than getting in Saturday morning after half a day doing nothing in Washington and a long, uncomfortable overnight flight.

8. I understand from Miss Lyons that the current cost of various return flights is as follows:-

Concorde	£2,724
Jumbo First Class	£2,266
Jumbo Club Class	£1,089

This implies that Concorde one way and Jumbo Club Class the other would cost £1,907. I understand from Miss Lyons that these prices may shortly be increased.

9. You agreed to show this to Sir Peter Middleton and to tell me as soon as possible what flight arrangements he thinks would be sensible, and whether he is happy with the Palermo plans.

PWO.

P WYNN OWEN

X today pl

From: D R H BOARD
Date: 1 April 1985

PS/CHANCELLOR (MR WYNN OWEN)

cc Mr Littler
Miss S Lyons

Sir Peter Middleton has seen your minute to me of 29 March.

Informal ECOFIN - Palermo

2. Sir Peter Middleton is content for you to seek the necessary permission from No 10 for Mrs Lawson to travel to the informal ECOFIN at public expense (your paragraph 2)*.

IMF Spring Meeting - Washington

3. Sir Peter is clear you should accompany the Chancellor throughout. On the outward journey, Sir Peter is content for Mr Littler to join you and the Chancellor on Concorde if this is absolutely essential. On the return journey he concludes it does not appear to be necessary for anyone other than yourself to accompany the Chancellor back on Concorde.

4. On the question of using Concorde, Sir Peter thinks it might save time in future to establish now in what circumstances it would not be considered necessary for the Chancellor to travel by Concorde? Perhaps we could have a word about this.

Douglas Board

D R H BOARD
Private Secretary

* I understand now Mrs Lawson will not be going to Palermo (or Paris).

ADVANCE COPY

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TO IMMEDIATE F C O
TELEGRAM NUMBER 37 OF 3 APRIL
AND TO UKREP BRUSSELS.

DI) 01/4/84

RC
Hd ERD
PS/Chancellor of the Exchequer
Mr Littler
Sir C Tickell ODA
Mr Gilchrist B/England
(x5)

C. Any views on X and Y? Rvo 4/4

X is OK: I will send a draft in good time. I will draw on comments which Herzog has done on Mexico! without going over the top. As for Y, OK only if there's time. P.M.

I.M.F./I.B.R.D.: SPRING MEETINGS

1. POLAK (DUTCH FUND EXECUTIVE DIRECTOR) TOLD ME TODAY THAT RUDING (DUTCH CHAIRMAN OF THE INTERIM COMMITTEE) WOULD BE GLAD IF THE CHANCELLOR WOULD SPEAK SECOND, AFTER SILVA HERZOG (MEXICAN FINANCE MINISTER), IN THE SECOND HALF OF THE INFORMAL AFTERNOON SESSION OF THE INTERIM COMMITTEE ON DEBT AND CAPITAL MOVEMENTS, WITH SPECIAL REFERENCE TO L.D.C. FINANCES. HERZOG WOULD, IT WAS HOPED, ENDORSE THE QUOTE CASE-BY-CASE UNQUOTE APPROACH BUT EMPHASISE THAT ADJUSTMENT COULD ONLY PROCEED IF FINANCE WAS ADEQUATE. RUDING HOPED THAT THE CHANCELLOR COULD MAKE A POSITIVE REPLY WHICH WENT BEYOND THE NEED FOR MORE PRIVATE DIRECT INVESTMENT, POINTING OUT THE POSSIBILITY FOR M.Y.R.A.S, REOPENING OF EXPORT CREDIT WINDOWS, AND SO ON. RUDING'S PLAN WAS THAT STOLTENBERG (GERMAN FINANCE MINISTER) WOULD JOIN THE DISCUSSION TOWARDS THE END TO EMPHASISE THE CONSTRUCTIVE POINTS MADE. THE CHANCELLOR WILL HAVE OPPORTUNITY TO DISCUSS THIS WITH RUDING AT THE O.E.C.D. MINISTERIAL MEETING AND THE FINANCE MINISTERS COUNCIL. BUT POLAK SAID IT WOULD NEVERTHELESS BE HELPFUL TO KNOW BEFOREHAND WHETHER THE CHANCELLOR WOULD BE WILLING TO TAKE THIS ON. X

2. POLAK ALSO TOLD ME THAT KHAN (CHAIRMAN OF THE DEVELOPMENT COMMITTEE) WOULD SHORTLY TELL GORIA (ITALIAN TREASURY MINISTER) AND DELORS (PRESIDENT, E.C. COMMISSION) THAT HE WAS NOT READY TO MAKE AN EXCEPTION FOR COMMISSION OBSERVERS TO ATTEND INFORMAL SESSIONS OF THE DEVELOPMENT COMMITTEE. TO INCLUDE THEM WOULD MEAN INVITING, E.G. U.N.C.T.A.D. KHAN'S LETTER WOULD, HOWEVER, IMPLY THAT THERE WOULD, OF COURSE, BE NO OBJECTION IF A COMMUNITY COUNTRY WISHED TO ALLOW A COMMISSION REPRESENTATIVE TO ATTEND, AND SPEAK, AS PART OF THEIR DELEGATION. RUDING WAS LIKELY TO FOLLOW THE SAME APPROACH IN RESPECT OF THE INTERIM COMMITTEE.

3. IN A SEPARATE TALK TODAY, FISCHER (EXECUTIVE SECRETARY OF THE DEVELOPMENT COMMITTEE), TOLD ME THAT KHAN WOULD WELCOME THE OPPORTUNITY TO TALK IN WASHINGTON WITH THE CHANCELLOR BEFORE THE DEVELOPMENT COMMITTEE. SHOULD I TELL FISCHER THAT HIS OFFICE SHOULD BE IN TOUCH WITH US ABOUT A MEETING AFTER THE CHANCELLOR'S ARRIVAL? Y

4. GRATEFUL FOR ADVICE ON THE POINTS IN PARAGRAPHS ONE AND THREE ABOVE.

5. F.C.O. PLEASE ADVANCE TO P.S./CHANCELLOR, LITTLER, TICKELL (O.D.A), TAIT (F.C.O.) AND GILCHRIST (BANK).

WICKS

171/34

CONFIDENTIAL

FROM: R G LAVELLE
DATE: 3 April 1985

CHANCELLOR

Thanks. I will take this to Paris.

cc Sir P Middleton
Mr Littler
Mr Unwin
Mr Mountfield
Mr Sedgwick
Mr Beastall
Mrs Case
Mr Shields
Mr Culpin
Mrs Diggle
PS/Governor) B/E
Mr Loehnis)
Sir C Tickell, ODA
Mr Braithwaite, FCO
Mr Williams, DTI

C/ The IMF/IBRD steering brief (without most of voluminous attachments for now!).

9/4

PS. See also note on federal taxes in US - separate string.

WASHINGTON SPRING MEETINGS: 16-19 APRIL

Schedule of meetings

The following are the main meetings you will be attending:

(i) **G-5:** 5pm, Tuesday 16 April. A meeting in the "surveillance" series and to coordinate positions for the meetings in the following days: with discussion of Summit prospects etc over dinner.

(ii) **G-10:** 8.15am, Wednesday 17 April - again to prepare for the forthcoming meetings. You have agreed to chair in place of the Japanese Minister.

(iii) **Interim Committee:** 9.30am, 17 April - a plenary session in the morning and an informal session in the afternoon focusing on the medium-term economic prospect, macro-economic aspects of adjustment and the role of the Fund.

(iv) **Bilateral with Secretary Baker:** 8.45am, Thursday 18 April - essentially an opportunity to get more closely acquainted and gain an informal insight into US attitudes on current issues.

(v) **Development Committee:** 9.30am 18 April - again a plenary session in the morning and informal session in the afternoon focussing on developing countries' growth, capital flows, trade and the role of the World Bank.

(vi) **Interim and Development Committee:** 8.30am, Friday 19 April (until approximately lunchtime) - a final plenary session of the Interim Committee followed by concluding sessions of the Development Committee: to be followed by a joint IMF/IBRD press conference.

A detailed schedule of IMF/IBRD meetings and functions is at Annex A. BUT SEE DIARY for fuller programme at the time.

2. This note provides a broad conspectus of the main issues for discussion over the run of meetings. There are two separate attachments. First, a clutch of speaking notes is being worked up, covering possible prepared interventions in different sessions. These will need to be refined in the light of the preparatory discussions and at this stage are mainly illustrative of possible themes. Secondly, a set of operational (and background) briefs has been put together, matching the main items in the agendas, in a form lending itself to use as a quarry in debate. The folder has a guide to the more important briefs on top. A large number of long background papers have been issued by the Fund and Bank and discussed in the Executive Board. The Treasury briefs are self-contained and in some cases contain quotable extracts from these background papers. However a few of the papers themselves are worth glancing through to get a general flavour of the issues as seen by the agencies or because they are of good quality. A modest selection of these is attached at the end of the dossier.

Antecedents and agenda

3. The idea of a special meeting on the problems of developing countries emerged at the London Summit partly as a technique for accommodating pressure for a new Bretton Woods. Later it had appeal as a means of diverting Latin American pressure for

a debt summit. It was sufficiently good an idea for Secretary Regan to decide to hijack it last September although the Americans have subsequently played a generally unhelpful role in preparations.

4. The agendas for the Interim and Development Committees are attached at Annex B. In principle, these reflect the respective responsibilities of the two committees in relation to the prospects for the developing world with the Development Committee having the larger part of the proceedings. In broad terms the Interim Committee discussion will set the macro-economic context and review surveillance issues. The Managing Director will no doubt introduce discussion but is not planning to circulate any linking paper of his own*. His summings up of earlier Executive Board discussion are in the briefing where appropriate. The Development Committee will be the prime forum for discussion of the policy implications in terms of capital flows, trade policy, the role of the World Bank and the problems of particular areas, notably Africa. The IBRD President has recently circulated a report reviewing the issues in all these areas: as the most comprehensive single paper it is placed first in the selection of papers in your background dossier.

5. The Washington meetings fall between the annual OECD Ministerial meeting and the Bonn Summit and are recognisably self-contained with their emphasis on development issues. OECD will be more concerned with the macro-economic responsibililties of industrial countries, structural reform and trade negotiations. The OECD meeting will therefore set the climate for the general discussions especially in the Interim Committee but will feed through primarily to the Bonn Summit. The latter also expects to take on board the judgements on debt etc issues reached in Washington.

General assessment

6. As noted above a formidable number of background papers have been prepared by the staff of the IMF and IBRD and discussed

* a round-up paper of Fund-related issues has, however, just been circulated as background to the Development Committee discussion.

in the Executive Board. Even allowing for the anaesthetic effect of Washington on the developing country conscience these papers seem to have been received calmly, discussed soberly but not generated a great deal in the way of new insights. This implies no disrespect to any of those concerned. But it in general suggests that the development prospect looks sombre but manageable in systemic terms ~~but sombre;~~ and that there are no fancy new solutions though some helpful evolution of existing policies may be envisaged.

7. Turning to the meetings of the Interim and Development Committees themselves, these will be special meetings in the sense that there has never before been provision for a protracted seminar. In general it must be said that the omens for such a debate are not good. Past meetings of the committees have all too often taken the form of set speeches with executive decisions reached over meals. This time no executive decisions are in view. There is provision for restricted discussion in the afternoon to facilitate genuine debate. But it is an open question at this stage whether even with stage management this will lead to a genuine exchange of views or provide an adequate opportunity to blow off steam.

8. What are the chances of a "successful" meeting? There are a number of favourable indications.

9. First, the central judgement of both agencies is that provided in particular the industrial countries can maintain 3 per cent growth and there is some gradual easement in real interest rates the world will be able to grow away from the debt problem. There look to be rather more downside risks than upside opportunities to do better: hence the need for responsible policies by all and the need to develop existing policies further to ameliorate the prospect. But it looks just about manageable. Alongside this prospect the current easing in the dollar is certainly a plus. It will do something to ease existing debt export ratios. But beyond this it represents a helpful distraction not least since US interest rates have not, at any rate yet, hardened significantly. It may not represent a new

dawn but it is certainly a new talking point: and it will tend to undermine the more extreme views about surveillance, interest capping etc.

10. Alongside this general prospect there are a number of participants who have an interest in making the meetings a success. The Americans ought to see it this way, having allegedly sponsored them. The agencies themselves and the two chairmen (fortunately both able) have something at stake. The Germans have the Summit to worry about. Even the Japanese have their modest burden as current G-10 Chairman to bring the reform studies to fruition. As regards the developing countries, it looks as if most of the Latin Americans (perhaps not Argentina) have decided to lie low and keep their bid for a political summit under wraps. More generally there is no natural set of issues, except possibly the unpromising area of IMF conditionality, round which the developing countries can naturally unite. The interests of the major debtors, the oil producers, the Indians, the successful NICs and the Africans are all significantly different. And there is no pool to scoop.

11. Finally, on the plus side, there are a few areas where it seems possible that the meetings could lead to a genuine evolution of thought of a positive kind. These are primarily recognition of the problems of Africa; of the need for an enhanced role for the IBRD (and the establishment of a new multilateral investment guarantee agency); some genuine advance in terms of understanding of the role of direct investment; and a further step along the anti-protectionist road.

12. Against this there are a number of negative elements in the prospect. Thus far, the US have taken a pretty negative line on some of the major issues, notably an enhancement of the role of the World Bank. They also have shown themselves less than constructive in contemplating a communique which might reflect a growing consensus or contemplating any follow-up action. Amongst the industrials, the French are always liable to court developing country opinion by a range of mischievous comment from the case for an SDR allocation to the need to link trade and monetary progress together. While as noted above there

are major differences between the interests of developing countries, and they may develop a sense that these divergent claims can only be met by an orderly queue, the unknowns in the world prospect are quite sufficiently daunting to bring forth a number of extreme claims for debt relief, global solutions and the like. They will have had six months to compose some of the begging letters.

13. The moral of all this is that the industrial countries will have to get their act together. It will be important to get the initial debate off on to a good footing by a sober but effective analysis of the world prospect which recognises the uncertainties while firmly putting down devices such as a new interest rate facility in the Fund. It will be necessary to make the most of the achievements eg to recognise the commercial MYRAs and the general easement in debt rescheduling terms rather than bemoan the absence, as yet, of any official MYRA. It will be necessary to make the most of the potential developments discussed above. Finally it will be necessary to conduct a successful public relations operation through the communique and follow-up arrangements. Agreement on a follow-up discussion of itself implies that the present meeting has made progress. The identification of elements in the current discussion to be carried forward, within existing institutions, would be a useful supplement to that.

Speak to Jeff

Tactics

14. The analysis above suggests the following very broad tasks for the preparatory meetings and the UK role in the main meetings themselves:

Palermo

A fairly dull EC statement has already been worked through by the Monetary Committee for circulation to the Washington meetings. This will need to be cleared at Palermo. This procedure should at least help to ensure that the Community adopt a reasonably sensible common approach. It will be helpful to establish that the French and the Italians in particular are not going to break ranks. A specific need will be to restrain the French from taking too forward a position on the World Bank and so upsetting the Americans and the chances of a reasonable consensus. It could be helpful to establish some lead speakers on individual aspects of the discussion.

G5

The Fund have not yet circulated any surveillance paper. Provisional briefing for this part of the discussion is at Annex D. As regards the other main items for discussion - the Managing Director will still be present and his assessment will be valuable - the main problem may be to get the Americans into line, and especially to be prepared to accept reasonably forthcoming language on the role of the World Bank even though the time for decisions on a general capital increase is some way in the future. We will also need to try to persuade them of the case for a reasonably full communique. It would be useful to use this occasion to sound out opinion on the response to any approach by the Cargagena Group for a political dialogue with Summit countries after the Washington meetings. A minor task will be to agree who is to record the state of play in the G-10 discussions in the main meetings, so that these can represent a modest potential plus without leading to actual debate. As (involuntary) chairman of the G10, you might wish to do this. Alternatively the Germans have an interest, given this input into the Summit. A point to settle with Stoltenberg perhaps.

G10

This has sometimes been a rather unsatisfactory meeting. This does not matter of itself. But the time might be more usefully (and pleasantly) spent if there were concentration on one or two themes. Most present will in fact be sensitive to the need to make the main meetings a success. A tour de table looking for a consensus on positive themes might be a possible procedure. Given

Ruding's interest as Chairman of the Interim Committee, you might wish to take an opportunity to consult him on this or other approaches.

UK role

For a variety of reasons, the UK have tended to be looked to to provide a constructive lead in general debate in the IMF/IBRD committees. It will probably be helpful for the UK to support and follow up the Managing Director's remarks in the first (formal) session of the Interim Committee. In the plenary session of the Developing Committee your statement might in particular relate to the question of capital flows on which you have already set out some ideas in Fund speeches. It may be helpful in the informal sessions to intervene in particular on such matters as interest rate capping, resumption of export credit, the need for a new trade round and the role of the World Bank. The Treasury briefs are all prepared in a way which lends to their use as necessary in general debate. As noted earlier, rather fuller speaking material is being worked up on the specific topics identified above although this will need to be amended in the light of developments.

The communique

As you know, we gave thought to the possible content of a communique some time ago. Mr Littler has subsequently developed these themes and circulated possible language to G-5 Deputies (see Annex D). The Americans remain adamantly opposed, at official level, to anything other than a formal and perfunctory communique from each of the committees. The other participants, notably the Germans, were very much more positive with the Japanese (in line with their industrial practice) moved to circulate a slight variant as their own. It might be useful to instruct Nigel Wicks to be in touch with the Secretariats and offer his assistance in any contingent drafting work.

R G LAVELLE

ANNEX A

INTERIM COMMITTEE AND DEVELOPMENT COMMITTEE
Schedule of Meetings and Functions
April 1985

See your diary for full timetable.

Wednesday, April 17

8.15	G10
9:30 a.m.	Interim Committee Plenary Session, Fund Meeting Hall
1:00 p.m.	Chairman's Luncheon for Members of the Interim Committee, Managing Director's Dining Room
Time to be anounced	Interim Committee Informal Session, Fund Executive Board Room, Room 12-120
8:00 p.m.	Chairmen's Dinner for Members of the Development Committee and the Interim Committee, Mayfair Room, Regent of Washington, 2350 M Street, Northwest.

Thursday, April 18

8.45	Baker
9:30 a.m.	Development Committee Plenary Session, Fund Meeting Hall
1:00 p.m.	Chairman's Luncheon for Members of the Development Committee, Fund Dining Room No. 5
2:00 p.m.	Development Committee Informal Session, Fund Executive Board Room, Room 12-120
7:30 p.m.	Dinner for Participants, World Bank Auditorium, H Building, entrance on G Street between 19th and 20th Streets (Entry by meeting identification badge)
Time to be announced	Chairman's Dinner for Members of the Interim Committee, Managing Director's Dining Room

Friday, April 19

8:30 a.m.	Interim Committee Plenary Session, Fund Meeting Hall
9:30 a.m.	Development Committee Informal Session, Fund Executive Board Room, Room 12-120
Skip × Time to be announced (approx. noon)	Development Committee Plenary Session, Fund Meeting Hall
Skip × Following Adjournment of Committee Meetings	Joint Press Conference by Chairmen of the Development and Interim Committees, the President of the Bank and the Managing Director of the Fund, Fund Meeting Hall

G5 SURVEILLANCE

A short surveillance session with the IMF's Managing Director is planned for the evening of 16 April. In view of the limited discussion time there is some doubt whether the MD will produce a paper.

2. The previous surveillance session was held on 17 January in advance of the President's announcement of the US budget for fiscal 1986. The MD summed up the discussion highlighting three points:

- the need for smooth, progressive reductions in US fiscal deficits;

- the need to reduce European rigidities and recognise that the scope for tax cuts depends at least in part on market conditions;

- scope for greater domestic expansion in Japan based on readily available savings.

3. All three points could usefully be endorsed this time.

US Developments

4. The President's fiscal 1986 budget seeks cuts of $50bn to reduce the Federal deficit to $180bn (including off-budget items) next year. No significant defence cuts or tax increases are proposed but there are expenditure reductions or freezes across virtually all other areas. Progress in Congress has been slow. The Senate Budget Committee's package of cuts worth $55bn seems unlikely to succeed as it asks for a defence freeze in real terms against President Reagan's original request of 6 per cent real increase - though recent press reports suggest Reagan may after all be willing to compromise. Without cuts the Congressional Budget Office sees the Federal deficit approaching $300bn by 1990 and averaging 5 per cent of GNP in the intervening years.

5. In mid-February Fed Chairman Volcker announced that the progressive easing in policy begun late last year had been brought to an end. He confirmed the provisional 4-7 per cent of M1 target but raised those for some of the broader aggregates. Elsewhere monetary targets have generally been reduced this year - the German CBM target of 4-6 per cent may turn out to be tighter than intended if activity is more rapid than the 2½ per cent plus growth forecast by the authorities.

6. After edging up earlier this year US short term interest rates have eased in recent weeks as markets seem to have become less concerned over an immediate tightening in the Fed's policy stance - despite the dollar. Some increase in interest rates later this year is still likely if growth and hence credit demand continue growing strongly.

7. The dollar has eased since early March partly reflecting concern over the problems of US banks as well as signs of a less buoyant economy. It is too early yet to say whether there has been any major shift. But the emergence of the US as a major international debtor could weaken confidence. It underlines the risk of a sudden possibly precipitous fall in the dollar.

Europe

8. For this year most forecasters expect growth to average 2½ per cent with slightly lower inflation (under 7 per cent) but no significant fall in unemployment. The key to improving European performance is greater structural adjustment.

9. The US are pushing for more work on structural adjustment both at the last G5 - though this was not taken up - and more generally within the OECD. We can welcome such efforts to improve the working of markets ~~but are concerned lest the efforts of the US merely serve to deflect criticism of their own macro-economic imbalances.~~

10. The European Council on 29-30 March urged further work to solve structural rigidities in Europe and adopted the PM's initiative to reduce the administrative burdens on businesses.

Japan

11. The Japanese authorities' fiscal objective is to achieve current budget balance for central government by 1990. Its main problems are a large structural deficit and a high debt/income ratio. The tight fiscal stance pursued in recent years has probably held back domestic activity in the short term and Japan's recovery, as in the past, has relied too heavily on export growth.

12. The last G5 reminded the Japanese authorities of their concern over the pace at which the medium term objective is being met. The high level of personal savings in Japan helps reduce credit market pressures and should allow the government some flexibility in its fiscal stance in the short term. The latest income tax cuts did little to offset fiscal drag and were financed by higher indirect and corporate taxation.

Concerted Intervention

13. The last G5 issued a statement on concerted intervention (attached) which reaffirmed the original Williamsburg commitment. There have been bouts of concerted intervention since then on a number of occasions. Experience suggests such intervention can be successful in achieving its limited objectives. Since early March when the dollar began to ease further interventions have been regarded as unnecessary.

ANNEX D

TELEX TO: Dr. Hans Tietmeyer, Bundesministerium der Finanzen, D-5300 BONN 1. Telex No. 003 886645

COPIED TO: Mr. Tomomitsu Oba, Vice Minister of Finance for International Affairs, Ministry of Finance, TOKYO. Telex No. 007 72 24980.

Mr. Beryl Sprinkel, Under Secretary ofthe US Treasury, US Treasury Department, WASHINGTON, DC20220. Telex No. 007 230 248492

M. Daniel Lebegue, Directeur Du Trésor, PARIS. Telex No. 0022 220962

FROM: Mr. J.G. Littler, HM Treasury, LONDON, SW1.

DATE: 13 March, 1985

TEXT AS IN ATTACHED SHEETS PLEASE

TEXT BEGINS:

Dear Hans,

At the last meeting of our small group I promised to circulate before our next meeting a note of points which might be suggested for concluding statements of the two Committee meetings in April. To avoid overlap, I have constructed a series of headings, which would split fairly naturally between the two Committees, with the last one perhaps appropriate to both.

2. The following is my draft.

World Economic Activity

- Welcome progress made in 1984 and prospects of sustaining recovery for some time ahead. A much better climate for all countries than was frequently predicted. Particularly gratifying that resumed growth of activity has been accompanied by continuing reduction of inflation rate for industrial countries as a whole.

- Acknowledge some disequilibria: need for further action, in a medium-term timescale, to facilitate adjustment; need to persevere with strategy to sustain growth and create conditions for more stable and open markets.

- Strategy requires all member countries, in framing domestic economic policies, to keep three objects in view: to combat inflation; to reduce public deficits; to improve functioning of markets.

Interest Rates

- Acknowledge that level of real interest rates remains very high, particularly comparing long-term rates with hopes for future reduced inflation. Such rates add to burdens of debtor countries ~~for~~ and all countries in need of borrowed capital from abroad and ~~for full~~ impairs vigour of expanding investment in industrial countries.

- At the same time acknowledge that real interest rates should be positive: the negative rates in some of the last decade were a symptom of unsustainable policies.

- The key to more moderate rates can only lie in effective pursuit of the strategies outlined above, with particular responsibilities in this respect resting on industrial countries.

Exchange Rates

- Large and rapid movements have reflected disequilibria in a period of severe adjustment. Future uncertainties must be recognised.

- Possible reference to G.10 studies expected to be concluded this summer and to be offered for discussion to the wider IMF membership.

- Key to more stable exchange rates between major currencies is less divergent policies and performance.

External Indebtedness

- Experience of individual debtor countries has been uneven; but progress - often painful - has been made, helped by an improved world economic climate. (IMF analysis should illustrate).

- Wide variety of circumstances of individual debtor countries means that continued case-by-case management is essential. In spite of all the difficulties, some basis of common understanding has been developing, in the approach, procedures and requirements for dealing with individual problems.

- Vital importance of a continuing background of sustained world economic expansion. Lower interest rates, nominal and real, would ease the problem, but they must be sustainable and this underlines the need for sound financial policies. Similarly, less turbulent foreign exchange markets would be helpful. And it is vitally important to maintain open trading systems.

- But the adjustment efforts of each individual country are vital. They should be encouraged - as has been recognised in practice as well as in words, by: willingness of creditors to reschedule and refinance debts on realistic terms over several years

- Readiness of industrial countries to continue to provide export credit

- Encouragement of new sources of finance, and willingness to use them.

<u>SDR and Global Liquidity</u>

- [? No significant change of positions.]

Role of IMF

- Emphasise the importance of the IMF, past and future, particularly in relation to: surveillance in respect of major industrial countries and the rightness and compatibility of their policies and performance; continued advice and monitoring of debtor countries and others in balance of payments difficulties, encouragement of structural adjustments which are needed; cooperation with the World Bank Group.

International Capital Flows

- Stress the need for capital as an essential part of the process of development. It is important: (1) that all potential sources should be tapped; (2) that a realistic judgment should be taken of the limits on some traditional or recent channels; (3) that other and newer channels need to be explored and fostered.

- Note the broad categories of capital which could be drawn upon: official development assistance; trade finance; commercial bank lending; other private investment from abroad in all forms; and capital generated domestically.

- Needs of individual countries vary greatly, and some will need more access to one kind of finance than another. But they should be as uninhibited as possible in their choices.

- Industrial countries should be urged to help maintain and expand capital flows. Realism requires us to recognise that growth of official development assistance, trade finance and future commercial bank lending will be constrained. It is the more important that industrial countries should remove barriers to outflow of private capital.

- It is even more important that countries in need of capital should remove barriers to its inflow, and take appropriate steps to encourage such inflow. They should also focus particularly on the importance of retaining their own domestic savings, and seek ways in which they would encourage this process over the medium-term.

- There could be scope for future study of ways in which foreign private investment could flow to countries in need of it, in ways which need not provoke hostility, taking advantage of the increasing variety of forms and instruments of investment, encouraged by judicious receptive attitudes on the part of potential host countries, and helped by the valuable role which the World Bank Group can play in encouraging the process.

Trade Policy Issues

- Draw attention to the importance of access to export markets world-wide. This applies both to and from - and between - industrial and all other countries.

- Urge action on as wide a basis as practical in the appropriate fora.

World Bank Group

- Encourage the World Bank Group, particularly the IFC, in their role as catalyst in attracting private direct and portfolio investment.

- Encourage the World Bank Group and countries generally to foster the development of financial markets and mechanisms for attracting capital to countries in need of it.

- Possible favourable mention of the principle of the proposed MIGA. Multilateral Investment Guarantee Agency

- Encourage the World Bank to extend its role in on-the-spot coordination of aid, particularly in the poorer countries.

- Note that it will be appropriate to discuss over the coming year or so the possible future need to expand the capital of the World Bank.

- Encourage coordination with the IMF by the World Bank and closer attention to structural policies in developing countries.

Sub-Saharan Africa

- Welcome the progress made in establishing the new Fund.

- Encourage the coordinated action intended and its focus on medium-term structural improvement.

Future

- Opportunity for exchange of views in some depth could usefully be repeated from time to time.

- Possibly suggest somewhat similar meeting in spring of 1986.

- A few particular subjects arising in discussion (e.g. assessment of future capital availability and exploration of new channels) might be subject of special study and reports by the institutions for such a future meeting.

Copies go to our three colleagues. I look forward to seeing you all next week.

Yours

Geoffrey

TEXT ENDS

DEVELOPMENT COMMITTEE: PLENARY SESSION

Statement on capital flows

[Opening courtesies]

Current pattern of world capital flows most unusual. Historically, industrial countries have exported capital to developing countries. In the wake of oil crisis this role passed temporarily to oil exporters but this did not persist. Since 1982 large deficit has emerged in industrial countries - quite unrelated to oil. Counterpart is major reduction in deficit of NODCs. Recognise statistics not perfect in this field but believe trends undeniable.

2. Note that current net flow of capital to NODCs less than net payments of interest. Thus outward resource transfer, in contrast to inward flow, supplementing domestic savings in financing of investment, many countries have become used to. This outward transfer adding to pressure on domestic consumption and investment created by need to restrain demand as part of adjustment programmes.

3. How should we respond to this problem? Correct response requires correct diagnosis. Always difficult to tell if such changes originate in current account - changes in exports or imports - which then forces capital account to adjust, or in capital account - diversion of funds from one area to another - which then forces current account to adjust.

4. Probably a mixture. Clearly fears about creditworthiness have led to cutback in lending to some debtors by industrial country creditors, and inappropriate policies by debtors have deterred direct investment. But US fiscal deficit, leading to bidding for funds in world capital market, also had effect, if only by bidding up interest rates, which made adjustment an urgent priority for many debtors.

5. Do not believe right solution is multilateral action to change direction of capital flows. In the end, capital will flow where market sees best returns. But need to counter factors distorting world capital markets. Classify US Governments present claim on world savings as one of these. But many others in LDCs themselves. Private investors need to have confidence in borrowers economic policies. Adherence to Fund adjustment programme secures this.

6. Particularly important to encourage equity flows as opposed to debt. This requires relaxation of rules on foreign ownership, through direct investment and through stock exchange. Foreign ownership does not mean licence to multinationals to behave as they wish: necessary controls do not require local ownership. Multinationals operating in UK comply with UK laws.

7. Restrictions on repatriation of profits, dividends or even interest deter investment. Correct response to balance of payments deficit is devaluation, not exchange controls. Other distortions in economy can deter investors in what would otherwise be profitable projects.

8. If progress made on all these fronts, confident that world payments flows would return to more typical pattern, because LDCs potentially offer high returns. But must work with market, not try to override it. Renewed lending without adjustment recipe for new debt crisis.

IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS
17-19 APRIL 1985

Draft Speech Material

Discussion in the preparatory meetings (EC, G5, G10) may bear on themes to stress, lead speakers for particular agenda items etc. An allied point is the objectives seen for the communique.

2. Subject to this, the draft speaking notes below provide a possible basis for reasonably full opening statements in the two plenary sessions and shorter interventions for the afternoon sessions, under the main agenda items, as follows:

(i)	Interim Committee	: Plenary Session
(ii)	Interim Committee	: Interest rate capping/surveillance
(iii)	Development Committee	: Plenary Session (capital flows)
(iv)	Development Committee	: Export Credit
(v)	Development Committee	: Trade
(vi)	Development Committee	: Role of World Bank.

INTERIM COMMITTEE

Interest rate capping/surveillance

Present high level of real interest rates - although there has been significant easing from the levels of 1984 - involve significant burden on debtor economies, hampering adjustment and delaying recovery. But necessary to deal with cause of problems, not symptoms. [As made clear in opening session] No realistic alternative to sound mix of fiscal and monetary policies conducive to non-inflationary growth, particularly in the larger industrial economies, especially in the US.

2. Many rate-capping ideas in circulation. Fall into three main groups.

3. First, interest forgiveness as it is called. This would impose costs on banks or export credit agencies out of any proportion to the benefits to debtors. It has been calculated [by Williamson, Cline and Bergsten of the Institute for International Economics] that forgiving half the interest due from Brazil, Mexico and Argentina would eliminate over half the equity of eight major banks. A theoretical counterpart would be a one-off rise in GDP by debtors: but the reality would be that any prospects of new money would be severely impaired.

4. Secondly, there are interest compensation schemes. It has been suggested that the IMF could operate an interest capping facility like the oil facility it operated in the seventies in response to the first oil shock. But, in contrast to the oil price relief scheme, an interest scheme would represent a very substantial open-ended commitment. It would imply a potentially enormous drain on the IMF's limited resources. And with no certainty that it would be temporary, allowing Fund resources to revolve. A predetermined time limit would not necessarily postpone the problem to a more hospitable season for adjustment, as the WEO makes clear. And meanwhile fundamental adjustment problems could go untackled.

5. The third category is interest deferral. As said earlier this idea less topical than when US interest rates were rising in 1984 H1. Some versions of this approach were thought even at that time to pose problems for regulators in relation to performance obligations. A particular problem as it seems to me is practicalities. On the whole commercial creditors do not like automatic formulae. They prefer to negotiate ad hoc solutions. But there would be also difficult problems in setting the cap. For example are you dealing with real rates or nominal rates? If real, should the cap be adjusted for changing world conditions? One thing seems certain: by the end of that sort of discussion world conditions would have changed.

6. I come back to where I began. We have already begun discussion of the question of IMF surveillance and how symmetrical or otherwise it is in practice. Can we make progress in dealing with the origins of high interest rates? [possible reference to G10 studies]. I think we can. It may not be - perhaps it cannot be - a matter of sanctions. But we can provide for effective analysis and effective international debate: and an effective demonstration that - over time - no country will gain from imbalances and misalignment.

DEVELOPMENT COMMITTEE

Export credit

1. I welcome the ideas outlined in the President's speech, and developed more fully in the Bank paper on role of export credits in promoting development. I foresee possibilities here to the benefit of borrowers and lenders: borrowers would receive an additional source of funding (some of it at concessional rates subject to the Consensus), lenders would benefit from expanded markets for their goods.

Resumption of cover

2. The UK last year took a decision to be ready to resume cover on a modest scale to countries in payments difficulties - provided adequate adjustment programmes were underway. I note that some other lenders are moving cautiously in the same direction. And I welcome the move to improve co-ordination of this process already underway in the OECD Group on Export Credit Guarantees through regular exchanges of views.

IBRD involvement

3. As the Bank paper points out "the quality of individual projects in aggregate is a critical determinant of a country's debt servicing capacity". If satisfactory arrangements could be worked out through which the World Bank could do more to identify suitable projects, it could help to unlock larger flows of credit. They will need to be of clear developmental benefit and able to generate export earnings (or import savings) at least equal to the service of new debt incurred. In that way, new lending by way of export credits would not add to the net debt burden. A supporting project appraisal by the World Bank would also be a notable comfort to the lender by helping to confirm the prospect of its viability.

Information flow

4. I note also the suggestions made in the papers for better provision of information. This seems well worth pursuing. The UK would be glad to participate in any further work.

Risk Standards

5. I must add a note of caution here. While improvements in the developmental quality of the use of export credit would be a valuable step forward, it will not, and should not, enable Export Credit Agencies to relax their risk assessment standards. The Bank rightly notes that "export credits are not an aid instrument". Increased credit flows can only be justified if moves to encourage developmentally effective investment can substantially improve the prospects for the recipient economy. A return to full creditworthiness can only be achieved following a sustained effort of adjustment. Ensuring the most effective use of the limited export flows that will be available is only one step in the right direction. But its a crucial step if that adjustment is to succeed. The UK is ready to try to take it.

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DEVELOPMENT COMMITTEE

Trade

Case for liberal trading system is clearcut. Protectionism imposes costs on importers as well as exporters - patterns of trade and production are distorted. Understandable that rapid changes in technology and relative costs should generate calls for protection from sectors affected, because industrial adjustment has undoubted transitional costs. But casting industrial structure in stone is no answer.

2. Improving debtors' access to industrial countries' markets will ease debt problems. But liberalisation not just for the industrial countries to take part in. IBRD paper demonstrates that liberalising their own trade policies is in the developing countries' own best interests. Believe they will wish to play constructive role in new GATT round.

3. Although it would often pay individual countries to scale down protection on their own, benefits far greater if trading partners act in concert to reduce trade barriers. Economic benefits of multilateral moves are multiplied; and political realities mean that a far greater degree of liberalisation can be achieved by acting together.

4. Benefits of a new GATT round are obvious. So too are dangers if no agreement - slide into bilateral agreements and increased tolerance of NTMs, grey area measures. This would endanger very existence of system. So status quo is not realistic choice: alternatives are positive action to roll-back existing protection within multilateral framework, or world economy moving to increased protection in increasingly damaging forms.

5. All the main IFIs have a role to play in this process. It is right that all should be concerned about trade policy; no coincidence that all have produced papers, from slightly different angles, expressing hope for action but fear of inaction.

6. As well as increasing awareness of the problem, they all have a role to play in achieving positive action. [As clear in discussion earlier in week] Fund should continue giving more prominence to trade matters in programme design and, particularly, surveillance. Bank right to encourage liberalisation as a spur to development process. GATT have main role [refer to Dunkel Statement] in improving policing of agreements; increasing coverage of liberal trade agreements; and in making progress for a new round.

DEVELOPMENT COMMITTEE

Role of the World Bank

I recognise the importance of the World Bank's work in fostering developments in the LDCs and channelling finance to them. I welcome the paper which has been put to us presenting the results of the World Bank's review of its future role. I would like to express my appreciation of the valuable work that has been put into it.

2. The Bank is already taking a significant part in some of the most immediate and urgent issues facing the developing countries, most notably the problems of sub-Saharan Africa. In its activities both alongside other donors, and in coordinating the overall approach, we welcome the resources and experience the Bank can bring to bear.

3. The Bank's prime objectives, though, must continue to extend over much longer timescales. As the World Bank President points out in his report to the Committee "the Bank - as a long-term development institution - has a responsibility to look beyond current crises and to address those investment and institutional development issues that are crucial for sustaining progress in the longer-term" [para 87]. This is the traditional strength of the Bank. It is here that it can make its own unique contribution while its approach can continue to evolve to reflect the long term needs of its borrowers and can, I suggest, be reinforced by giving attention as appropriate to overall country assessments in conjunction with the continuing project-based scrutiny and assessment.

4. As part of the Bank's new role, I particularly support the concept of increased flexibility for the Bank in responding to the difficut situations facing many of its borrowers. The Bank will always remain primarily a project lender. However, other lending instruments, such as structural adjustment and sector loans, which support policy and institutional reform are likely to have an increasing role in promoting development over the longer term. It is important that the LDCs play their full part in the policy dialogue, and that the Bank's programmes should be well designed and effectively monitored. As the World Bank paper says, "the

Bank's assistance plans need to be fimrly anchored in the borrowing country's own medium-term development strategy, and these plans should be the subject of a continuing two way dialogue".

5. Similarly, it is more than ever important that the Fund and Bank work closely together to co-ordinate their respective interests. I would hope to see this given increasing practical effect in the future.

6. At a time when resources for bilateral and multilateral aid are inevitably constrained, it is more than ever important to stimulate and encourage prudent and well-based lending by the commercial banking sector. The World Bank has an important role here. It can add a multiplier to its own loans by co-financing - an instrument which the UK strongly supports. I am glad British banks have been active in this sector. The World Bank can also provide moral support for additional bank lending to projects which form part of a well-thought out investment programme designed with World Bank help, especially where these are consistent with or build on IMF-supported adjustment programmes. It may also be possible to stimulate more direct investment through multilateral investment guarantees. We have been studying management's proposals for a MIGA with great interest. Although I cannot announce our final decision today, I am certainly attracted to any scheme which can be shown to lead directly to an increased flow of private funds.

[Insert passage on export credit here if desired.]

DEVELOPMENT COMMITTEE

Role of the World Bank

None of this, of course, detracts from the Bank's central role as a major lender in its own right. The question of a capital increase is not an immediate issue at our discussions here today. But I can confirm that the UK stands ready to participate, at the appropriate time, in a general capital increase to support the Bank's operations in furthering its future role. It will, of course, be essential to demonstrate a clear requirement for a new capital and to address a range of isssues including the size and timing of a GCI and the appropriate size of the paid-in element. We will be happy to consider this further at Seoul in the Autumn.

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SPRING MEETINGS OF INTERIM AND DEVELOPMENT COMMITTEES 1985: READING GUIDE

Several inches of background papers have been issued by the Fund and Bank for the meetings on 17-19 April. It is not strictly necessary to read any of these, though for a general flavour of the issues and their handling it is worth looking at:

The IBRD President's report to the Development Committee (flag A)
(now plus a background paper on Fund-related issues);

the IMF's World Economic Outlook: Prospects and Issues (flag B);
- policy discussion pages 13-27

the IBRD's From Recovery to Sustainable Long Term Growth (flag C).

2. Among the other papers, if time permits, it may be worth glancing at:

the IBRD's Coping with External Debt in the 1980s (flag D)

the IMF's surveillance review (flag E)
- proposals discussed on pages 29-37.

and possibly

the IMF's trade paper (flag F)
- issues headlined.

See 2nd folder for these lettered IMF/IBRD papers

3. The briefs are arranged roughly in the order of the Interim and Development Committee agendas, though there is some overlap because of the common ground between the meetings. Each brief covers a single topic in a self contained way, with references to the relevant IMF and IBRD papers and in some cases quotable extracts from them. Where the IMF Board has had a preparatory discussion, the Managing Director's summing up is also included.

4. For preparatory reading the key briefs are

(1) World Economic Outlook

and (5) Debt

The agendas for the Interim and Development Committees are only a starting point for discussion, but they suggest that the next most important briefs are those on

(3) surveillance

(9) IBRD

(6) aid

(8) trade

and (7) export credit.

5. The others are primarily background briefs, involving issues which may be raised in the margins of other meetings or in bilaterals. They include notes on all the main problem debtor countries (13), together with material on Commonwealth countries facing economic difficulties (14), particularly those in Africa (12).

INTERIM AND DEVELOPMENT COMMITTEES

17-19 April 1985

WORLD ECONOMIC OUTLOOK

References: IMF-WEO-EBS/85/47-50 and SM/85/70-80

Objectives

(a) Welcome marked improvement in world economy: better growth, lower inflation in industrial countries; further adjustment in debtors. Strike cautiously optimistic tone on prospects but recognise problems remain.

(b) Get continuing adherence to firm medium term counter inflationary policies and greater commitment to structural adjustment policies in both developed and developing countries.

(c) Stress dangers from emergence of US as net debtor and importance for medium term world economic prospects of convincing and progressive reductions in the US Federal deficit.

(d) Emphasize need for all countries, especially reserve currency bloc, to take full account of international repercussions of domestic policies. Debtors will have to make further adjustment.

Line to Take

(a) World trade up 9 per cent last year, industrial countries' output up about 5 per cent - fastest growth since 1976. Inflation in industrial countries cut sharply in last 3 or 4 years and kept down. Investment recovering. Basis for sustainable growth being laid.

(b) Agree Fund's forecast of slower but continuing world growth, in 1985 and beyond, no acceleration in inflation, easier interest rates but no significant drop in unemployment.

(c) Lower inflation major contribution to recovery, explanation for continuing high European unemployment is largely the result of structural rigidities and hence further adjustment efforts required. Trade liberalisation useful component of structural reform (see trade brief 8).

(d) Without firm counter inflationary commitment, inflation likely to accelerate again as in previous cycles, undermining progress so far.

(e) US fiscal position unsustainable. Threat to dollar and risk of higher interest rates and protectionist pressures undiminished. Hope for quicker progress in agreeing President's budget proposals.

(f) Some progress with debt problems since 1982 although situation remains fragile. Confirms existing strategy. Key is medium term commitment to adjustment (see debt brief 5). No quick way out for debtors.

Others' Objectives

(i) US:

- Stress gains to world economy from US growth.
- Minimise detriment of high Federal deficit.
- Emphasise dollar's strength a reflection of higher relative rates of return on investment in US.
- Suggest European growth faster if structural rigidities eliminated.

(ii) Some European (eg France):

- Seek some co-ordinated expansion, amongst industrials especially UK and Germany, to tackle unemployment.

(iii) Debtors

- Get lower interest rates/easier trade access in industrial countries.
- slower adjustment via weaker conditionality.

- Urge special measures (eg interest-rate capping) to limit negative resource transfers.

Responses

(i) US:

- Policy mix, leading to overvalued $, clearly unsustainable.
- But adverse impact on world of high real US interest rates - which must reflect high deamnd for credit by public sector - and strength of dollar. Now concerned with medium term world prospects rather than last year's performance.
- Stress Fund's analysis of dangers if action not taken to reduce US Federal deficit.
- Accept argument that structural rigidities impeding European growth. Tackling problems earnestly eg last European Council.

(ii) Other European:

- Expansionary policies in Europe singly or collectively, tried and failed. Collective reflation may reduce individual budgetary and exchange rate risks, but would increase world inflationary pressures. Real interest rates already high. Note danger that reemergence of inflation could lead to unfavourable resource allocation between public and private sectors - in some cases fiscal discipline already allowing scope for tax cuts.

(iii) Debtors:

- Best way to ease interest rate pressures is through cutting budget deficits, especially in US.
- Sustained adjustment still optimal approach for debtors. Resumption of borrowing would merely reawaken inflationary pressures. Can't insulate debtors completely from effects of previous borrowing.

BACKGROUND

The IMF Staff have produced a useful set of medium term forecasts up to 1990 under a number of different scenario.

2. The central projections - the baseline - assume the continuation of existing macro and structural policies. On the US Federal deficit the Staff assume action which lowers the deficit relative to current services by 1 per cent of GNP in 1990 - a compromise allowing for roughly half of the US Administration's latest budget proposals. Elsewhere restrictive fiscal policies are assumed to continue. The Fund assumes a constant nominal dollar exchange rate (as at November 1984) up till end-1986. For 1987-90 the real effective dollar rate is assumed to decline by 5 per cent a year - both later and more modest than other forecasts.

3. The main features of the forecast are given in annex A. Activity in industrial countries slows this year reflecting more moderate US and Japanese growth. As a result the growth differential between the US and Europe narrows though European recovery remains modest. The unexpectedly slow "flash" estimate of US GNP growth of 2 per cent (annual rate) in the first quarter is more in line with the Fund's US forecast of 3½ per cent growth than the Administration figure of 4 per cent.

4. The Fund's baseline scenario sees growth in the industrial countries averaging 3 per cent a year until 1990 but no significant reduction in unemployment. The forecast of a slight but continuing decline in inflation rests on the assumption that counterinflation policies will continue.

5. On the Fund's figures this background is consistent with indebted developing countries' growth averaging 4½ per cent over the rest of the decade. But the external environment for debtors is unlikely to be so favourable in the years ahead as it was in 1984. Slower but continuing export growth (down from 12 per cent in 1984 to about 7 per

cent pa) will probably be offset by more rapid import growth and with little change in their terms of trade no further improvement overall is expected in their current account position. A falling dollar together with falling dollar interest rates would however ease the burden of those with mainly dollar denominated debt.

6. The papers show the position of oil exporters improving rather more slowly - the Staff assumes unchanged dollar oil prices implying a 7 per cent reduction in the real price of oil by the end of 1986. If the oil price were to fall further than the WEO assumes, (as we would expect) those debtors for whom oil represents a large share of total exports would find it very difficult to service their debt without further reductions in imports and consumption.

7. Even for net oil importers the prospects are clouded by adverse domestic developments. The prospects for continued orderly servicing of debt depend as much on the debtors' own economic policies as on the world environment. Debtor countries have so far been more successful in adjusting their balances of payments than in tackling domestic problems such as excessive government deficits, lax monetary policy, inflation and structural distortions caused by price controls, subsidies, import quotas and the like (eg spiralling inflation in Brazil, Mexico and Argentina). Until these problems are solved the improvement secured on the external side cannot be regarded as lasting.

8. There are disturbing signs that some major debtors are not prepared to tighten fiscal, monetary and wage policy sufficiently to ensure a lasting solution to their problems. There are strong pressures on debtor governments to permit some increase in real wages and consumption after the austerity of recent years (in some countries real wages have been cut by up to 30 per cent). But servicing their debt - even with substantial rescheduling - will require them to make outward resource transfers, which means they will have to hold domestic demand below domestic output. After many years of inward resource transfers from the

developed world the flow halted in 1983 and was reversed in 1984. On the assumptions of our own forecast (which require either substantial further rescheduling or large amounts of new bank lending) the outward resource transfer will equal some 6 per cent of exports of goods and services between now and 1988. Thus a resolution of the debt problem will only be achieved if the Governments of debtor countries succeed in maintaining austerity for a sustained period. Some have made a start but are wavering, others have yet to begin. It seems all too likely that balance of payments and debt servicing difficulties will re-emerge in at least some major debtors, and that creditors will be obliged to reschedule existing debts and provide new money via concerted lending for many year to come. (See also debt brief 5).

9. The variants to the Staff's central forecast are based on either "better" or "worse" policies in the developed or developing countries. This produces four scenarios (see annex B):-

(i) Better policies in industrial countries

More restrained US fiscal policy plus effective structural policies in other industrialised countries.

(ii) Worse policies in industrail countries.

No significant fiscal adjustment - no measures to cut US budget deficit. More inflationary monetary policies and increased protectionism.

(iii) Better policies in developing countries

The strongest economic policy that the Fund could decently envisage - fiscal deficits fall to less than half their baseline levels and their real exchange rates as a whole are 9 per cent lower by 1990.

(iv) Worse policies by developing countries.

The abandonment of the intensified adjustment efforts undertaken since 1982.

Note that when the policies of one group of countries alter, those of the other group are assumed to stay unchanged.

10. Annex B shows that growth rates vary more than do debtors' current accounts. This is partly because the latter are constrained by the availability of finance. This is the reason why current account deficits are larger under better policies than under worse policies. It is also because under better policies some current account improvement will be traded off for higher growth. Similarly, debt ratios improve little with better policies, since these enable more debt to be taken on to match the increase in exports. A curious feature is that better policies require higher real interest rates to ensure monetary targets are met. A conclusion not shown in the table is that "economic developments in the major borrowers, are relatively more sensitive to policies in industrial countries, while development in those countries that rely on official financing are more responsive to changes in their own policies.". (EBS/85/47 p12).

Recent Developments

11. In mid-February Volcker announced that the progressive easing in policy begun last year had been brought to an end. He confirmed the provisional 4-7 per cent of M1 target but raised those for some of the broader aggregates. Elsewhere monetary targets have generally been reduced this year - the German CBM target may turn out to be tighter than intended if growth is more rapid than the authorities forecast.

12. The easing of the dollar since early March may be an encouraging feature though it partly reflects problems with US banks. It is still too early to judge whether it amounts to a major shift. Most forecasters expect US interest rates to increase again later this year though in 1985 on average rates could still be lower than in 1984. The emergence of the US as an international debtor and the slow

progress on the President's fiscal 1986 budget proposals underline the uncertain financial prospect.

13. The compromise agreement between the White House and Senate Republican leaders reached in early April suggests the President may be prepared to accept a much lower real increase in defence expenditure (around 3 per cent) in fiscal 1986 than he asked for and less than full indexation for social security. Both represent significant concessions from Reagan's January budget proposals. But the full Senate has yet to agree this package and the House will probably have alternative views. Some deficit reduction package now seems reasonably likely to be agreed but there is a long way to go yet. In most other countries fiscal deficits need to be reduced further but in Japan and Germany there is at least room for debate over how fast their budget consolidation objectives should be achieved.

14. Annex C gives quotations from the WEO papers.

15. The IMF Executive Board discussed the world economic outlook in early April. The Managing Director's summing up of the discussion is at annex D.

IMF: WORLD PROJECTIONS (BASELINE)

Percentage change unless otherwise stated

	1967-76 (average)	1982	1983	1984	1985	1986	1987-90 (average)
World trade volume	7.7	- 2.2	2.2	8.9	5.2	5.3	5.3
Industrial countries							
GNP growth	3.7	- 0.2	2.6	4.8	3.2	2.9	3.1
Of which: US	2.8	- 2.1	3.7	6.9	3.6	2.9	2.9
GNP deflator	6.7	7.2	4.9	4.1	3.8	3.8	3.7
G7 unemployment (percentage rate)	3.8	7.9	8.3	7.6	7.5	7.4	7.2
3-month LIBOR rate (percentage)							
- Real	1.9	7.0	5.7	6.7	5.0	5.0	3.9
- Nominal	7.5	13.0	9.5	10.5	8.6	9.0	8.4
Indebted Developing Countries							
GNP growth	5½	2.0	1.8	3.9	4.2	4.6	4.8
Current account deficit ($bn)	-	103	60	88	38	37	-
(As per cent of exports)	(-16)	(-20)	(-12)	(- 7)	(- 7)	(- 6)	(- 7½)
Long and short term external debt ($bn)	-	747	791	828	865	896	-
(As per cent of exports)	(127)	(148)	(158)	(151)	(149)	(142)	(108)

MEDIUM TERM SCENARIOS: 1987-1990

	1984	Worse policies by Industrial countries	Worse policies by Developing countries	Baseline scenario	Better policies by Industrial countries	Better policies by Developing countries
Industrial countries						
Growth of real GDP (per cent)	4.8	2.0	3.1	3.1	3.5	3.1
GNP deflator - industrial countries	4.1	3.7	3.7	3.7	3.7	3.7
3-month LIBOR in fiscal terms	6.7	5.0	3.9	3.9	3.5	3.9
Indebted developing countries						
Growth of real GDP (per cent)	3.9	2.3	3.7	4.8	6.4	5.7
Ratio of current account to exports (1988)	-6.9	-3.5	-6.6	-6.5	-7.4	-6.5
Ratio of debt to exports	151.3	127	105	107.7	106	104
Debt service ratio	22.5	26.5	21.4	20.5	19.9	19.7
Growth of exports (per cent)	10.8	3.25	4.5	5.6	6.9	6.7

Note : Growth rates are averages for 1987-1990; ratios are 1990 figures.

Annex B

ANNEX C: extracts from WEO documents

Industrial countries

"A significant shift in European countries' fiscal policy, such as to make a sizeable dent in existing unemployment levels, would rekindle longer term fears about the trend in debt and the dangers of monetization. A small shift, on the other hand, might avoid such fears, but would have only marginal direct impact on activity, and could well undermine credibility in (sic) the longer term constancy of policy." (p15, EBS/85/47).

"Domestic policies among the major countries should be formed so as to avoid, as far as possible, exchange rate movements that are associated with such large imbalances in payments positions. No one country is solely responsible.... The solution requires a consistent approach to policy formation .... to ensure that interactions in policies among countries operate to strengthen the prospect of attaching sustainable growth and financial stability." (p20, EBS/85/47).

"Reduction or elimination of regulations may be expected to improve productivity and efficiency without imposing severe costs on consumers." (p3, SM/85/77).

"Wage increases in excess of productivity growth cannot lead to universal gains in living standards and in the end will serve only to perpetuate inflation and reduce international competitiveness." (p6, SM/85/77).

Developing countries

"One encouraging feature .... is the strengthening in the external position of the indebted developing countries. This .... exceeds earlier expectations by a substantial margin and has gone a long way toward restoring a current account position .... sustainable in the medium term." (p6, EBS/85/47).

"The macroeconomic performance of many developing countries in recent decades has been characterised by demand management policies that have frustrated energetic supply policies." (p16, SM/85/78).

Policy interactions

"Industrial countries bear a significant responsibility not to take actions that undermine the well-conceived structural policies of developing countries." (p24, EBS/85/47).

"Unless or until US national saving/investment relationships can be adjusted in a way that permits a higher propo r tion of domestic capital investment to be financed from domestic sources, the prospects for expansion of net capital movements from industrial to developing countries will tend to remain limited." (p2, SM/85/79).

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IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS

17 - 19 APRIL 1985

Brief 2: SDR ALLOCATION

References: IMF - SDR review paper - SM/85/50
- reserves (paper for G10) - SM/84/269

A **Objectives**

(a) Avoid commitment to resumption of SDR allocations.

B **Line to Take**

(a) Do not accept case for SDR allocation can be substantiated on grounds of long term global reserves inadequacy. Reserves growth still roughly keeping pace with trade. Global reserves in relation to trade now close to 1970s average.

(b) Important to assess overall supply of international liquidity in broad terms: not just reserves, but also swap lines with other central banks, IMF credit and bank lending. Likely that need and demand for reserves have fallen, with most major currencies floating, and many others less irrevocably pegged than in the 1960s.

(c) Expect demand for international liquidity to grow roughly in line with trade. Experience suggests that operation of international capital markets can supply requirements of multicurrency reserve system. Prospects depend on macro-economic policies in major countries, especially the US.

(d) Commitment in IMF Articles to promoting SDR as reserve asset does not require creation of SDRs either continuously, or just at the moment. Better to strengthen and liberalise operation of international financial markets to improve their efficiency.

C **Others' Objectives**

(i) US, Germany, Japan and Australia: to resist renewed SDR allocations.

(ii) Canada, Netherlands: modest annual allocations of SDR 4-5 bn.

(iii) France, Italy, Belgium, Spain, Anglophone Africa: SDR allocations of SDR 10 bn a year in 1986 and 1987.

(iv) Others (most developing countries): substantial allocations (SDR 15 bn a year or more).

(v) Belgium (possibly with support from France and elsewhere): to get agreement that any SDR allocation should be at least partly conditional, ie weighted in favour of developing countries.

D **Responses**

(i) Accept some developing countries' reserves are still low in relation to their trade. But on average they grew vigorously last year (up 22%, though admittedly from low base) outstripping trade to reach equivalent of 2.8 months of imports.

(ii) Reserves shortages in individual countries usually reflect need for adjustment to restore credit worthiness, which will pave the way for resumption of more normal financial flows, including direct investment. Supplying unconditional liquidity through SDRs is not a durable solution. Nor is it appropriate to meet specific needs by global allocation.

(iii) Admit that composition of reserves shows undesirable reliance on borrowed resources. But note that using SDRs would involve liability to IMF charges.

(iv) Oppose making any SDR allocation conditional. IMF not short of resources. Depending on nature of scheme, could count as public expenditure for creditor countries.

E **Background**

Definitions

1. The SDR is a composite currency unit defined in terms of 5 international currencies (dollar, DM, yen, franc and sterling). So far SDR 21.4 bn has been issued. (SDR 9 bn during 1970-72; SDR 12 bn during 1979-81). The IMF's accounts are also maintained in SDR units. Issues are in proportion to IMF quotas. On the present distribution, 65 per cent of any new allocation would go to developed countries, 26 per cent to non-oil developing countries. Private use of the SDR as a unit has not taken off after a modest start in 1981.

[Cri]teria for allocations

2. The IMF's Articles require SDR allocations to be justified by long term global need for reserves. Judgement of reserves adequacy is inevitably contentious. Current reserve levels are close to the 1970s average in relation to trade and external debt. 1984 saw significant recovery in the reserves adequacy of the developing countries, reflecting both compression of their imports and more vigorous world trade:

	average 1970's	ratios, %, end year 1982	1983	1984
<u>Reserves: imports</u>				
all countries	22.3	20.6	21.1	20.7
non oil ldcs	22.7	19.7	20.9	23.2
<u>Reserves: trade imbalances</u>				
all	129.8	108.5	106.1	
no ldcs	101.5	79.6	66.2	[at least 80]
<u>Reserves: external bank debt</u> (H1)				
all	-	15	15	15
no ldcs	-	11	12	13

3. These figures suggest that present levels of reserves are not inadequate. It is certainly true that some developing and debtor countries have very low reserves and their access to borrowed reserves via the capital markets is restricted by limited creditworthiness. Proponents of SDR allocations urge the liquidity needs of these countries. But they do not justify greater <u>world</u> liquidity. Rather they illustrate need for adjustment of domestic economies and for non debt creating financial flows, such as direct investment and aid. As the Fund's analysis points out (SM/85/50, p10):

> "...balance of payments problems and reserve shortages that reflect inappropriate macroeconomic policies followed in the past can only be corrected by effective adjustment programmes."

Recent developments

4. The UK has consistently rejected the case for allocations in recent years on these grounds: see annex A for the Chancellor's most recent speech.

The recent IMF Board meeting also concluded against allocations: see annex B for the Managing Director's summing up.

5. The IMF's recent paper for G10 on reserves and liquidity shares the theme of this extract that the role of reserves has changed (SM/84/269, pp10, 9):

> "...the question of reserves adequacy cannot be treated in the same way in the current [international monetary] system as in the Bretton Woods system" and

> "...unlike the gold exchange standard system, the present [international monetary] system does not contain a systematic constraint on the policy choices of the reserve currency countries in the form of a convertibility obligation. For this reason, Fund surveillance over the policies of reserve-currency countries should reflect the special obligations of these countries in the present system."

Options

6. SDR allocations have so far taken place in basic periods normally of 5 years. The two phases of allocation have each lasted 3 years. The present basic period, the 4th, ends in 1986. So far it has been empty.

7. Any decision to allocate could apply just to 1986, the last year of this 5 year cycle. Or a new cycle could be started in 1986, not necessarily of 5 years.

8. Proponents of large allocations sometimes suggest revival of reconstitution as a way of helping limit the initial economic impact of potential SDR use. Until 1981 this practice required IMF members to maintain a minimum average level of SDRs. This restricted the SDR's liquidity, though limiting the impact of SDR use on industrial countries' reserves.

Conditional Allocations

9. It is sometimes suggested that the benefit of an SDR allocation to developing countries should be increased by skewing the distribution to favour countries with IMF programmes. The basic idea is that industrial countries would lend some or all of their allocation to developing countries alongside Fund programmes. There are Belgian and French schemes, the latter a non-starter because it would count as public expenditure, at least in the UK. Neither scheme is necessary in that the IMF is not short of resources (see brief 11).

Potential effect on the UK

10. The UK's low holdings of SDRs (SDR ½ bn or 27 per cent of cumulative allocation) means that, despite our low reserves, we are designated to receive some 30 per cent of the SDRs which other countries want to exchange for hard currencies, currently amounting to a flow of some SDR ½ bn a year. So an SDR 5 bn a year allocation might require us to exchange a further SDR ½ bn or so annually. Though our total reserves would also rise (by SDR 0.35bn) it would put an unwelcome strain on our liquid foreign currency reserves. Experience suggests that over the longer term we should be able to dispose of unwanted SDRs by sales to other IMF members (cf designation of SDR 622 m in the year to February 1985 was nearly matched by voluntary sales of SDRs of SDR 514 m).

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EXTRACT FROM THE CHANCELLOR'S SPEECH TO THE INTERIM COMMITTEE, 22 SEPTEMBER 1985

I now turn to the question of SDRs.

2. I am not persuaded of the case for an allocation of SDRs on the criteria we are required to apply to this decision.

3. Nor am I impressed by arguments that are sometimes adduced to bolster in the case which rely on an outdated view of the role of the SDR in the system.

4. Moreover, I doubt if an allocation would have a helpful bearing on the real problems we have to consider. It could instead be an unhelpful distraction.

5. Let me explain briefly why I reach these conclusions.

6. First, the question of criteria. In an exchange rate system where the major currencies float, the requirement for reserves is less than it used to be. It is also the case - and the debt problem itself bears witness to this - that over the last decade potential sources of liquidity for creditworthy borrowers have increased begin square brackets last word underlined end square brackets. However, even without reference to these points I see no reason to believe that global reserves are inadequate. Non-gold reserves have increased by 12 per cent since the end of 1982. In global terms, present levels relative to imports are close to the average of the 1970s. Finally, we are also required to take a long-term view. The prospect for the period ahead is that Central Banks will have the opportunity to increase their holdings of dollars.

7. Second, the role of the SDR. An important element of the argument for an allocation has the flavour of giving the SDR the benefit of the doubt on some general philosophical grounds. But I think a fairer way of looking at it would be to recognise that the circumstances which led us to seek to develop the SDR no longer exist. The system we have is a multicurrency reserve system. That is one reason why I welcome recent moves to internationalise the Yen.

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8. Thirdly, the Distraction Point. An allocation of SDR will not solve the debt problem. It will not solve the problem of US interest rates. There are issues there which we need to tackle. If debtor countries can recover creditworthiness, and if we are successful in encouraging new kinds of capital flows to them, this would deal with the reserve and other problems with which they are faced in an appropriate manner.

IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS

17-19 APRIL 1985

BRIEF 3: SURVEILLANCE

References: IMF - annual review of Surveillance SM/85/65
- supplement (including exchange rate annex).

A Objectives

(a) Encourage more effective surveillance:

- as a way of promoting non-inflationary growth through convergence;

- to demonstrate even-handed approach of IMF.

(b) Express cautious interest in further study of G10/IMF proposals to bring home and follow through conclusions of surveillance, including limited publicity.

B Line to take

(a) Endorse central importance of surveillance, primarily through Article IV analyses in IMF and multilaterally in G5 in conjunction with IMF Managing Director. Appropriate way of appraising international consequences of countries' economic policies. Important that interactions properly understood so that can feed through into domestic policy making.

(b) Value use of surveillance to foresee and where possible avert dangers ahead. Especially useful for heavily indebted countries.

(c) Support in principle use of low key publicity to promote wider appreciation of international interactions and repercussions, and to better inform credit risk analyses. Similarly encourage role of Institute of International Finance (IIF) in this field to improve commercial banks' information bases.

(d) G10 proposals: support experiment with limited statements by IMF Managing Director after Article IVs. Also important to ensure that surveillance conclusions followed up at appropriately senior level in countries studied.

(e) Encourage further work on how danger signals can be used to trigger exceptional surveillance activity, whether by G10 or IMF.

(f) Endorse use of enhanced surveillance technique in MYRAs - and otherwise if demand exists. But only appropriate for debtors/developing countries with good track record and firm commitment to adjustment.

(g) Whatever change is made, stress importance of frank dialogue in surveillance with unfettered assessments by IMF staff.

C Others' objectives

(i) US: maximum publication of Article IVs, but persistently avoiding taking to heart message of international surveillance of own economy.

(ii) Germany: against Article IV publication, preferring confidentiality to ensure frankness.

(iii) France: in favour of objective performance indicators, especially target zones for exchange rates.

(iv) Developing countries: concerned that discipline of surveillance should extend symmetrically to industrial and developed countries.

(v) Most: to use surveillance to criticise US policy.

D Responses

(i) Publicity: must strike right note, with particular attention to countries where policies in need of correction. Support routine publication of uncontroversial material (from Recent Economic Developments papers by Fund). Hope also that more timely comment can be made effectively.

(ii) Fund impartiality: agree equivalent stringency in surveillance, but important that process recognises and studies problems of each country sensitively. Slavish symmetry inappropriate.

(iii) Objective indicators: support experiment in Fund Article IV surveillance.

(iv) Even-handedness: recognise responsibility for major industrial countries to adopt sound economic policy mixes conducive to non inflationary global economic growth.

(v) US fiscal/monetary stance: agree inappropriate for countries with international reserve currencies to adopt mix of domestic policies which severely distorts world trade and interest rates.

E Background

Remit

1. The IMF's experience with regular surveillance activity dates only from 1979. Practice has evolved with time. It is hard to point to demonstrable benefits for the volume of international analysis and discussion. But there is a general perception that better understanding has improved policy making. A significant strengthening of the effectiveness of surveillance is now being considered.

Experience

2. The bulk of the IMF's surveillance workload is in annual country reviews undertaken under Article IV. Usually staff investigations lead to lengthy papers which are then discussed in meetings of the IMF Board. The formal responsibility for surveillance over exchange rate regimes is interpreted widely to comprehend virtually all aspects of economic policy which can have external impact. Fiscal and monetary policies, together with the role of exchange restrictions, have always been prominently covered. Recently more attention has been paid to structural issues and trade regimes, with particular effort to attempt medium term projections of external prospects and debt service. For debtors and developing countries, one of the more effective uses of the Article IV procedure has been to act as a stalking horse for programmes. Though

> "the Fund's powers of surveillance under current practices are limited to cogent analysis and effective persuasion" (SM/85/65, p7)

in practice, the Fund's influence can be considerable - for instance finance and economics ministries sometimes use it against their spending departments.

3. The quality of the Fund's work is generally pretty high, characterised by sound if not especially forthright judgements. Thoroughness of coverage sometimes leaves something to be desired, especially for OPEC countries, whose touchiness and arrogance can lead the Fund to extremes of tact. An element of sycophancy can also creep into the Fund staff's dealings with certain other powerful countries, such as the US, Japan and China. The main lacuna is insufficiently thorough coverage of the international repercussions of industrial countries' policies and dominant regional economies. Given certain industrial countries' unwillingness to heed the Fund's strictures unless they chime with their own intentions, this has led to persistent developing country criticism of the Fund's evenhandedness. The Fund staff therefore emphasise the importance of surveillance in developed countries:

> "The Fund has stressed that, while they should continue their adjustment efforts, developing countries had the right to expect developed countries - in particular the major industrial countries - to contribute to the global adjustment process in a major way. Developed countries should be especially aware of the implications of large fiscal deficits on interest rates and longer run economic growth." (SM/85/65, p5)

Proposals

4. The G10 monetary studies (see brief 4) include work on surveillance. Suggestions made there have been discussed in general terms by the Fund board and are to be considered further by a G10 Ministerial meeting in June. The outcome might include something on the following lines:

- experimental use of objective indicators to monitor performance between Article IVs;

- publication of uncontroversial background material prepared to support Article IV consultations;

- supplementary Article IV consultations for countries whose adjustment is inadequate, perhaps triggered by performance against pre-established objective indicators;

- effort to encourage dialogue between the Fund and finance ministers about the content and conclusions of Article IVs;

- (perhaps) limited public statements by the IMF Managing Director after selected Article IV discussions, particularly where the message is critical.

The IMF Managing Director's summing up at the recent IMF Board review of surveillance is annexed.

6. Recently proposals for enhanced surveillance have assumed some importance as a way of ensuring adjustment without a formal IMF programme. Agreement has been reached in principle to undertake 6 monthly surveys of Mexico and Venezuela, with the papers passed to commercial banks to underpin MYRAs. Similar arrangements may be agreed, perhaps on a quarterly basis, alongside a new money loan to Colombia (see brief 13). Many of the details of the enhanced surveillance technique remain to be clarified, including what happens if economic performance drifts off track (see also debt brief 5).

More general studies

7. The Fund's surveillance role has also included analytical research work transcending country boundaries. The most striking recent instance was a clutch of papers in early 1984 about the determinants of exchange rate policy and its international implications, prepared as input to the G10 debate. Another batch on the impact and effectiveness of Fund programmes is expected shortly. A note on the role of the exchange rate in adjustment has been made available for the Spring Meetings. This is a useful rehearsal of the importance of timely exchange rate change in economic adjustment, explaining its potentially favourable impact on the real economy:

> The wrong structure of prices leads to an inefficient structure of production and a decline in economic growth ... there are clear potential advantages of a policy of exchange rate adjustment as a means of restoring an appropriate cost-price structure in the face of inflation-induced distortions." (SM/85/65 Supp 1, p65).
>
> "An exchange rate adjustment produces an immediate correction of the price misalignment and permits adjustment to take place at higher levels of economic activity." (ibid p69).
>
> "The superiority of exchange rate policy as a means of correcting major price misalignments is likely to be empirically valid for all countries." (ibid p69).
>
> "....when there is a great need for enhancement of competitiveness, programmes that rely exclusively on demand management will involve heavier costs in terms of foregone output and unemployment over a prolonged period." (ibid p71).

IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS
17-19 April 1985

BRIEF 4: INTERNATIONAL MONETARY REFORM: G10 STUDIES

A Objectives

(a) to take credit for fact that full examination of international monetary system has been proceeding; but

(b) to fend off calls for new institutional initiatives or additional studies; and

(c) to avoid discussion of substance at this stage or creation of inflated expectations of outcome.

B Line to take

(a) Studies have been thorough and comprehensive.

(b) Look for practical improvements in operation in system rather than radical changes.

(c) Detailed discussion has to await completion of work in June; and then report to G10 Ministers, and Interim Committee.

(d) Improvements in system not to be achieved overnight: inappropriate to seek direct link with other international work eg trade negotiations.

C Others' objectives

(i) French are keeping threat of international conference in play as general bargaining counter eg in relation to GATT.

(ii) NAM and G77 have maintained bid for something akin to a new Committee of 20 process.

(iii) Developing countries generally look for greater symmetry in IMF surveillance partly because of high US interest rates.

D **Background**

2. The studies, proposed by President Mitterand at Williamsburg, have addressed four areas: exchange rates, surveillance, liquidity and the role of the Fund/Bank.

3. Drafting of a report by Deputies is now well advanced. A G10 Ministerial meeting to consider it is scheduled for 21 June in Tokyo, in line with the timetable envisaged at the London Summit.

4. The results of the exercise are likely to be modest: confirmation that no practical alternative to floating; some strengthening of IMF surveillance; clarification of the link between liquidity and creditworthiness - with the SDR on the back burner; need to safeguard the monetary character of the IMF but scope for improvement of coordination with IBRD.

Now more in harmony on US suggested meeting

5. Meanwhile the traditional disputes between the French and US could erupt at any time: they smoulder through any discussion of exchange rate mechanism or surveillance.

6. There will not be time for discussion of the G10 studies at the short Ministerial meeting scheduled for 17 April which the Chancellor has been asked to chair. Stoltenberg will be briefed by Dini and his own officials to pave the way for a suitable reference to this exercise at Bonn.

7. At the Summit itself the French may make mischief. But there is some expectation that they could be bought off by a special Interim Committee meeting in Paris, perhaps in January 1986.

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IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS

17-19 APRIL 1985

BRIEF 5: DEBT

References: most of the papers issued for the meetings, but especially

IMF:	Commercial debt	SM/85/61
	Official debt	SM/85/62
	WEO - overview	EBS/85/47
	- supplement 10 - capital flows	SM/85/79
IBRD:	Recovery to growth	DC/85-2
	Coping with debt	DC/85-3
	Direct and portfolio investment	DC/85-5

A Objectives

(a) Maintain agreement on persisting with case by case debt strategy, centred on Fund programmes, with rescheduling, new loans or aid as appropriate.

(b) Resist concessions toward demands for global solutions, especially expensive new facilities run by creditors or international institutions. Keep discussion to existing fora.

(c) More active IMF role in monitoring MYRAs.

B Line to take

(a) Welcome current account improvement by debtors. This initially based on import reduction, followed by export growth, in turn based on recovery in industrial countries. This has allowed recovery of imports and resumption of domestic growth. Prospects nonetheless fragile. Heavy debt service commitments for rest of decade require continued adjustment. Failure to maintain structural adjustment has caused some larger Fund programmes, eg Brazil, to falter recently.

(b) Strategy:

(i) Adjustment by debtors remains central. "The key factor that will influence future access to commercial bank financing and other private capital flows is the economic policies of developing countries. Progress toward a viable external payments position will be a prerequisite for improving these countries' creditworthiness" (IMF SM/85/61). Current emphasis is on ensuring sustainable strategy by structural adjustment to reduce inflation and lower budget deficits.

(ii) Developed countries have responsibility to pursue policies designed to keep down inflation and interest rates, create the conditions for sustainable growth, and resist protectionist pressures. The US must cut its budget deficit (see WEO brief 1).

(iii) More stable forms of finance should play increasing role in financing development. "Both direct and portfolio investment have the potential for covering a higher proportion of the funding needs of developing countries than they have up to now." Vital precondition for increased investment is that debtors reduce barriers and restrictions to create favourable climate. Not a complete nor an immediate substitue for bank lending though: "direct investment, which is undertaken by relatively few companies in a narrow range of countries, and industries, is likely to be relatively slow to respond". (IBRD: DC/85-5).

(iv) Support measured resumption of export credit coordinated with other creditors at an earlier stage than hitherto provided satisfactory adjustment well under way. Encourage association of World Bank with this process, through cofinancing and identification of projects of maximum development potential to ensure most effective use of scarce resources (see brief 7).

(v) Encourage multi-year rescheduling agreements (MYRAs) for countries with heavy debt service commitments and good recovery prospects. Prefer greater control provided by serial rather than block structure, with close supervision by IMF where official credit involved. Also scope for improving terms within traditional rescheduling - eg grace periods, repayment terms - to strike appropriate balance in each case.

(vi) Some scope for adapting bank lending and evolving instruments to provide finance more appropriate to debtors' needs.

(vii) Fund and Bank should co-operate in advising on adjustment/development problems, especially in poorer heavily indebted countries (see brief 10).

(viii) Accept, for lower income debtors with inflexible economic structuress, eg some in sub-Saharan Africa, the need for case by case extended official rescheduling on terms adapted to individual needs. This would informally be part of external financing packages conditional upon continued adjustment efforts.

(c) Procedure: no value in proliferating fora for discussion. Prefer instead to concentrate dialogue through existing channels. Constructive bilateral negotiations better than grandiose political 'solutions'.

C Others' Objectives

(i) Cartagena group:

- high level political dialogue

- easier debt repayment terms, including lower interest rates compensation schemes if interest rates remain high, ceiling on debt service/export ratio, etc

- generous universal rescheduling and new money, including export credit

- conversion of debt into local currency

- softer IMF conditionality (see brief 11)

- SDR allocation (see brief 2)

(ii) IMF: to promote orderly adjustment, but progressively to disengage from credit risk business, eg in MYRAs.

(iii) France (and some other creditors): to insist on tough terms for MYRAs, including IMF programmes.

(iv) World Bank: to get MYRAs for poor countries on back of expanded multilateral aid framework.

D Responses

(i) Cartagena proposals: welcome pragmatism of Santo Domingo meeting, which recognised success in debt rescheduling and acknowledged importance of IMF. But no realistic alternative to pressing on with existing strategy. Concessions by creditors would be self defeating: they would inevitably undermine the incentives to adjust and threaten sustained non-inflationary world growth on which debtors' recovery prospects ultimately depend. Easier repayment terms for all similarly dangerous: likely to harm debtors' credit ratings and delay the resumption of spontaneous new lending. Resist political dialogue: discussion best kept to existing fora.

(ii) MYRA eligibility: most should continue to rely on Fund programmes to sustain adjustment, accompanied by annual rescheduling where necessary. Do not rule out using enhanced surveillance alone, even for official MYRAs, where adjustment clearly well under way. Unsuccessful MYRAs would damage credibility of both debtors and creditors involved.

(iii) Role of Fund: dangerous for Fund to withdraw from process of establishing creditworthiness too soon, especially in case of official debt. Even where limited Fund resources are involved, important for Fund to continue to help debtors work towards restoring normal pattern of financial flow.

(iv) World Bank: agree provided other creditors also support and if such MYRAs were clearly distinguished from those for economies adjusting and recovering.

Background

1. The present position is discussed in Annex C, the Chairman's remarks at the March 20 Executive Board meeting. Although the debt crisis has so far been contained, the problems are far from resolved. Most of the major debtors are committed to adjustment through IMF programmes, but several have run into serious - superable - difficulty. A heavy burden of debt commitment overhangs the rest of the decade. Nevertheless cautious attempts are now being made to return to a more normal pattern of financial flows, underpinned by better credit risk analysis.

Recent performance and prospects

2. Since the nadir in 1981-82, debtors' economic performance has slowly improved, particularly on the external side. The aggregate current account deficit of non-oil developing countries (IMF definition) more than halved from $110bn in 1981 to $40bn in 1984. The deficit of the market borrowing economies ((at least two-thirds of 1978-1982 borrowings from commercial creditors) was a particularly reduced ($73.6bn in 1982 down to $8.4bn in 1984), owing to the scarcity of spontaneous commercial finance. This was initially achieved by severe import compression, but latterly export growth has taken over, reflecting recovery in the industrial countries (see WEO brief 1). Little further improvement in LDCs current account performance is expected over the rest of the decade.

3. The trade surge has spurred activity. After stagnating at less than 2% a year in 1982-83, real gdp growth in non-oil developed countries reached 4.2% in 1984 and should average

nearly 5% over the rest of the decade. Inflation performance, however, is less good. Though median rates continue at 10% (still more than double that of industrial economies), average rates have continued to climb, reaching 38% for all developing countries and 66% in Latin America.

4. The most encouraging aspect of recent performance is improvement in the debt indicators. Among non-oil developing countries, the debt/export ratio peaked at 158% in 1983, reaching 151% last year and is expected to subside gradually to 108% by 1990 (the parameters for Latin America show the same pattern writ larger: 294% in 1983, 270% in 1984, 176% in 1990). Debt service payments are also off the top. Ratio of debt service to exports (DSR) already down from 24.6% in 1982 to 22.5% in 1984, though there is still a worrying peak ahead (DSR's of about 25% 1987-88) before further significant decline can be expected to 20.5% in 1990.

5. Debtors will benefit if the dollar continues to be weak. Work by Cline comparing a 5 with a 15 per cent depreciation of the dollar over 1982-1986 found that for 19 major debtors, 1986 a 15 per cent depreciation produced a more favourable ratio of debt to exports (1.62 against 1.72) though with a 10% higher current account deficit and slightly greater total debt.

Risks

6. Despite the better than expected performance of the world economy as a whole over the last two years, significant downside risks remain.

(i) If the economic recovery in the industrial world, especially the US, slows more than expected, developing countries' external prospects would deteriorate. "Growth of 3 per cent in the industrial economies seems to be the minimum necessary to let the biggest debtor countries restore their debt-servicing capacity. Slower growth would pose new problems in expanding exports and could delay progress in debt restructurings. that, in turn, would impede flows of finance to developing countries. (IBRD: DC 85-3).

(ii) The burden of debt service payments would worsen if interest rates and/or the dollar (in which much debt is denominated) rose further.

(iii) Protectionism, especially in industrial countries, could also worsen (see trade brief 8).

(iv) Domestic social and political constraints could slow the pace of structural adjustment.

(v) The position of some of the smaller developed countries has deteriorated. Furthermore, the volume and terms of their borrowing imply that banks have failed to learn the lessons of the debt crisis.

(vi) Developing countries are expected to make significant net financial transfers to banks for the rest of the 1980s. This increases the attractiveness of debt repudiation.

7. As ever, aggregates conceal important variations among countries. Many of the major debtors - Argentina, Brazil, Peru, Philippines (see brief 13) - have recently hit difficulties in their Fund programmes. In addition many heavily indebted African countries (see brief 12) face crippling external problems, though small in global terms.

Strategy

8. Economic adjustment remains essential. If major debtors are seen to remain in difficulties even after Fund programmes, confidence in the case by case approach would be undermined. Normally a Fund programme is the trigger for rescheduling (both commercial and official) and new financial flows (bank loans and aid). The ending of the crisis phase for most countries has engendered greater attention to the structural content of Fund programmes, with a more prominent role for the World Bank (see conditionality section, brief 11). At the same time attention is focussed on reviving non debt creating financial flows, primarily direct investment. More receptive climate

through elimination of restrictive conditions on such investment vital part of process. In addition, there are cautious moves toward multiyear rescheduling for the more successful partly adjusted debtors, and limited multilateral resumption of export credit in cases where prospects look relatively sound (see brief 7).

Cartagena Group

9. A group of 11 heavily indebted Latin American countries meets periodically to co-ordinate their international position. The group's demands are ambitious, comprehending all aspects of international finance, but they have not recently been pressed immoderately, partly because of tensions within the group. The latest meeting, held at Santo Domingo in February, produced a relatively realistic statement. Extreme demands could however be reawakened either if the outcome of the Spring Meetings is not demonstrably constructive or if the current difficulties between Brazil and Argentina and the Fund are not resolved. A paper proposing a broad dialogue between debtors and creditors is promised for the Spring meetings, but has not yet emerged. While most creditor governments would prefer to avoid such a dialogue, the President of the European Commission is reported to have invited the Cartagena Group for discussions on debt.

MYRAs

10. In June 1984, the London Summit endorsed multi-year rescheduling arrangements (MYRAs) in appropriate cases, picking up a recommendation in a recent speech by the IMF Managing Director. Since then commercial banks have arranged two in principle, with Mexico and Venezuela, with a possibility of a third for Ecuador. Negotiations on Brazil's were stalled by the failure of its EFF. There have been no official MYRAs since the London Summit. There have been no negotiations with Brazil, while Yugoslavia was judged not yet suitable. There is a possibility that an official MYRA for Ecuador might be negotiated soon.

11. The criteria for official MYRAs will be stringent. Practice will undoubtedly develop by precedent, but the criteria

are likely to include: a good track record with the Fund and Paris Club, genuine need for rescheduling (usually a debt hump), no need to reschedule interest or previously rescheduled debt. Some flexibility on the last two should be possible, especially if the amount of rescheduling required diminishes over the MYRA consolidation period. No necessity is perceived for bank and official MYRAs to be negotiated simultaneously.

12. A recent feature of the banks' approach has been demands for Paris Club rescheduling at least 85 per cent of official debt (for Ecuador). Official creditors will want to resist the temptation for commercial banks' to use official rescheduling as a creditworthiness test: they should make their own judgements. However the Paris Club is likely to be content to accept a general degree of burden sharing when rescheduling does take place. This example points up the tension between terms offered by commercial banks and official creditors. The need is for general comparability of terms though not precise comparison.

13. In the case of bank MYRAs, countries without current IMF programmes are to undergo twice yearly surveillance under Article IV with the Fund, the staff reports being passed to the commercial creditors. So far the Fund have expressed willingness only to monitor against the debtor country's own programme. Similarly, Colombia has recently proposed enhanced Fund surveillance as backing for new money from the banks - see Briefs 3 and 13. Consequent risk that the country's economic policies could drift off the recovery path. For official MYRAs we want the Fund not only to monitor but also, where no Fund programme exists, to design a forward economic plan covering at least the consolidation period.

<u>Non debt finance</u>

14. The forms of direct investment and policies of developing countries towards it are discussed in Annex B. Satisfactory policies, while necessary, are not a sufficient condition of increased flows. Other factors include the availability in developed countries of resources for investment and the

perceptions of investors, which will inevitably change slowly, but which will be affected by the political stability of host countries. The change in investor perceptions applies also to portfolio investment. The potential of portfolio investment is now attracting attention (see IBRD: DC 85-5). This identifies restrictions which correspond to those on direct investment and also hinder flows, such as minimum time periods for which foreign portfolio funds must remain invested.

New approaches to bank lending

15. As the success thus far of the case-by-case approach has become apparent, the plethora of global solutions has been replaced by more limited proposals. Most of these are analysed in the recently published "Possible Modifications in International Bank Lending", by Williamson, Cline and Bergsten of the Institute for International Economics (IIE). The proposals are summarised in Annex A; those for interest rate capping, which also apply to official lending, are considered in more detail below.

Interest-rate capping

16. The many 'rate-capping' ideas in circulation fall into three groups:

(a) Those involving a permanent waiver of interest.

(b) 'special facilities' - usually a new "window" at the IMF to lend temporary finance as compensation for increased interest bills.

(c) those involving deferral of interest: capitalisation, "building society" rollovers, fixed annual payments (like one small World Bank Loan to Paraguay) etc.

17. The UK is firmly opposed to (a) and (b). Waiver would impose costs on banks or export credit agencies not matched by benefits to debtors. Williamson et al calculate that forgiving half the interest due from Brazil, Mexico and Argentina

would eliminate over half the equity of eight major banks, for a one-off 3 per cent rise in GDP by debtors, whose prospects of new money would be severely impaired.

18. Compensation could involve enormous sums - up to $3bn a year for each percentage point. It would weaken the pressure on the US to take measures to bring interest rates down. For the banks, it would tie them to a formula, removing their ability to make ad hoc decisions about new money in the light of prevailing conditions. For the IMF, it would go against the principle that use of Fund resources should revolve, since it would in practice be very difficult to ensure that such a facility would be temporary. The cost of such a scheme could also put a severe burden on the IMF's liquidity (see brief 13).

19. The UK recognises the possible need for some interest deferral in a few particularly difficult cases, but without going so far as automatic variation in response to subsequent interest rate movements. The main problem with automatic variation is setting the interest rate cap. A capped nominal rate could be made irrelevant by changes in world inflation. The burden of a capped real rate would depend on changing world conditions; for example, in 1984 strong world trade growth enabled debtors to cope with high real interest rates. Annual adjustment of the cap would be extremely complicated. More generally, there is no justification for protecting debtors against interest changes alone, given the many external factors that affect them.

ANNEX A

EFFECT ON

PROPOSAL	Debtor	Bank	"System"(1)	Williamson(2)	UK(2)
1. Reduced spreads & fees	Favourable	Unfavourable	Favourable	✓	✓
2. MYRA	Favourable	Neutral	Favourable* (3) (Problem of Conditionality)	✓	See paras 10-13 above
3. Longer maturities	Favourable	Unfavourable	Favourable	✓	✓
4. Currency conversion	Unfavourable	Neutral	Neutral	-	-
5. Private insurance	Favourable	Favourable	Favourable	✓	X
6. Official guarantees	Favourable	Favourable	Neutral* (Public resource costs)	✓	As part of cofinancing
7. World Bank Co-financing	Favourable	Favourable	Favourable	✓	✓
8. Marketability	Neutral	Favourable	Unfavourable* (Realistic valuation)	X	-
9. Exemption of trade finance from rescheduling	Neutral	Favourable	Favourable	✓	✓
10. Re-imbursable interest averaging cap	Favourable* (Pro-cyclical interest rates)	Unfavourable	Favourable* (Where to set cap?)	✓ Retro-spectively in contingency	X
11. Variable maturity loans	Favourable* (As 10)	Unfavourable	Favourable* (As 10)	✓	X

PROPOSAL	Debtor	Bank	"System"(1)	Williamson([illegible]	UK(2)
12. Fixed interest loans	Favourable	Unfavourable	Unfavourable	X	X
13. Zero coupon bonds	Unfavourable	Unfavourable	Unfavourable	-	-
14. Indexed loans	Neutral	Unfavourable	Unfavourable	-	-
15. Real interest rate cap	Favourable* (Ad hoc preferable to automatic solution)	Unfavourable	Unfavourable	X	X
16. Interest capitalisation instead of new money	Favourable	Unfavourable	Unfavourable	In contingency	X
17. Payments based on exports	Unfavourable	Unfavourable	Unfavourable	X	X
18. Exchange participation notes	Unfavourable	Unfavourable	Unfavourable		
19. Debt into equity	Unfavourable	Unfavourable	Neutral	X	X
20. Payment in local currency	Favourable	Neutral	Unfavourable	-	-
21. Exit bonds	Unfavourable	Unfavourable	Unfavourable	X	X
22. Interest forgiveness	Unfavourable	Unfavourable	Unfavourable	X	X
23. Debt forgiveness	Unfavourable	Unfaovurable	Unfavourable	X	X
24. Concessional restructuring through multilateral institution.	Unfavourable	Unfavourable	Unfavourable	X	X

NOTES: (1) i.e. The effect on the smooth functioning of international lending.

(2) / = Support proposal
X = Oppose proposal
- = Neutral

(3) * = UK disagreement with the analysis - UK view in brackets

(4) In current conditions, when $ expected to fall

(5) Except in circumstances where default is the only other option.

ANNEX B

Foreign Direct Investment

1. Direct investment in developing countries can take various forms, for example:

(i) the setting up by foreign companies of wholly-owned subsidiaries;

(ii) joint ventures with companies of the host country;

(iii) purchase by foreign companies of equity in domestic companies.

(iv) new forms such as schemes for the conversion of debt to equity, production or revenue sharing agreements, and exchange participation notes.

Advantages

2. The advantages to developing countries of direct investment compared with bank debt include, in particular:

(i) servicing of outflows more closely tied to domestic economic conditions;

(ii) profits may be reinvested rather than repatriated;

(iii) import of associated technical, management and marketing skills;

(iv) tends to be concentrated in export-orientated or import-substituting industries;

(v) if project fails, no cross-default clauses as with bank debt.

(vi) less exposure to international capital market fluctuations.

<u>How big a contribution could it make?</u>

3. Some indications of the role played by direct investment in recent years are as follows:

(i) between 1975 and 1981, a quarter of world foreign direct investment was in developing countries.

(ii) Comparing the aggregate flow of resources to developing countries in 1970-72 with 1981-83, the share of direct investment fell from 18 per cent to 12 per cent, while the share of private bank lending grew from 16 per cent to 30 per cent.

(iii) Direct investment <u>flows</u> were $9 billion in 1984, compared to long-term bank flows of $23 billion. In 1983, the <u>stock</u> of direct investment in developing countries was around $136 billion, while that of long-term bank debt was $220 billion.

(iv) Direct investment in developing countries is highly concentrated: the aggregate share of the five largest recipients had grown to 42 per cent by 1983.

4. In view of these figures, it is unrealistic to expect direct investment to play a very large role in resolving global debt problems. The attractiveness of direct investment is diminished in the short term as debtors tighten economic policies, and social and political strains mount. New projects have lead-times before capital is imported and earnings generated. The risk of continued foreign exchange shortages, making the importation of inputs and repatriation of profits difficult, is a deterrent.

What is being and could be done?

5. There is no shortage of techniques of encouraging direct investment, employed by both host and investing countries, in particular:

(i) investment promotion and protection agreements;

(ii) tax incentives;

(iii) tariff advantages;

(iv) freedom from exchange controls;

(v) raising limits on foreign participation;

(vi) offers for sale of equity in existing assets;

(vii) investment insurance schemes.

6. Some of these techniques - particularly (ii) and (iii) - may distort competition and not add to the total of direct investment. Others are counterproductive; for example, capital grants or allowances that reduce the relative advantage of low labour costs. An example of restrictions that may also prove counterproductive are those on remittances of profits and dividends that encourage practices such as transfer pricing.

7. But most important are host country attitudes and a favourable economic climate:

(i) Latin America has in the past received much foreign investment because foreign companies have been attracted by its natural resources, and so it has been able to afford until now to set relatively harsh entry criteria. Concentration of debt there now makes such an attitude inappropriate.

(ii) The poorest LDCs are often very receptive to inward investment to encourage development; but fail to attract it because of their lack of natural resources.

Sir C. Tickell
in support

SPRING MEETINGS OF INTERIM AND DEVELOPMENT COMMITTEES
17-19 APRIL 1985
BRIEF 6: OFFICIAL DEVELOPMENT ASSISTANCE

Reference: IBRD - aid - DC/85-6

A. **Objectives**

(a) Resist pressure to increase UK aid budget. (see Foreign Sec's letter under Flag 9 below!)

(b) Encourage co-ordination with other donors to improve effectiveness.

B. **Line to take**

(a) The UK believes that industrialised countries can make an important contribution to the economic development of the poorer countries by establishing conditions which help promote sustained growth of the world economy. To this end, the UK has continued to exercise strict control over public expenditure, including aid.

(b) Nevertheless, the Government continues to maintain a substantial aid programme - some £1,200 m in 1985-86.

(c) The programme's principal aim continues to be the encouragement of more rapid economic growth and the raising of living standards in the poorest countries. About two-thirds of bilateral aid allocations go to the poorest countries which have the greatest need for concessional funds. Over 90 per cent of bilateral aid is given as grants rather than loans.

(d) Our aid programme continues to reflect our close historical and cultural links with members of the Commonwealth. These countries received 73 per cent of our bilateral aid in 1983.

C. **Others objectives**

(i) Aid recipients are likely to urge more rapid progress towards the 0.7 per cent oda/GNP target set by the United Nations.

D. **Responses**

(i) Although official aid has a crucial role to play in the alleviation of the problems facing the developing countries, trade, external private investment and lending are also essential, as are the developing countries' domestic policies. The UK continues to be one of the major sources of private capital flows.

(ii) Net disbursements of official development assistance (oda) in 1983 totalled £1,058 m ($1,605 m), equivalent to 0.35 per cent of GNP. This is around the average for all DAC countries (0.36 per cent). We accept in principle the UN target but like previous Governments are not committed to a timetable for achieving it.

(iii) We shall continue to maintain a substantial aid programme. In 1985-86 the amount available for spending (the gross aid programme) is expected to total about £1,200 m (an increase of nearly 3 per cent in cash terms on 1984-85).

(iv) Our combined official and private flows consistently exceed the 1 per cent target for combined resource transfers set by UNCTAD in 1968; in 1983 the UK's flows totalled 1.25 per cent of GNP. Combined official and private flows were £3,776 m ($5,728m). We remain one of the larger sources of financial flows to the developing world.

(v) Other flows (see debt brief 5).

Background

Global Flows: patterns and trends

During the 1970s, the volume of official development assistance (oda) increased substantially. Of the overall increase of 6 per cent a year in real terms, aid from members of the Development Assistance Committee (DAC) of the OECD rose by 4 per cent a year and that by OPEC members by some 24 per cent a year. By 1980 the total stood at $39.5 billion.

2. In recent years, the trend of sharply accelerating oda growth has changed abruptly. Since 1980, the level of total net oda has declined by about 1.4 per cent a year in real terms. The small increase in DAC members' aid (some 2 per cent annually) over this period was more than offset by the decline in that given by OPEC countries (though oda still represents over one per cent of their GNP). For DAC members as a whole, the decline in the oda/GNP ratio from 0.38 per cent in 1982 to 0.36 per cent in 1983 was largely due to GNP rises.

3. Precise estimates of future oda trends are not possible because of the uncertain prospects for a number of major donor countries. For DAC countries

some further increase in oda in real terms is expected, though probably of the order of no more than 2 per cent a year. There is the possibility of a further decline in aid from non-DAC sources.

4. Recognising that aid growth in the 1980s will be much smaller than in the 1970s, donors are paying increased attention to ensuring that aid is being used effectively and that available resources are channelled to the most urgent priority needs. Improved policy dialogue with recipients and better co-ordination of programmes with other donors are important factors in realising these objectives. This is part of the search for more sustainable patterns of financial flows (see debt brief 5). There has been a growing concentration on low-income countries facing particularly difficult development problems, and on priority sectors such as agriculture, energy and human resources development.

5. The growth in multilateral concessional flows has slowed down considerably compared with much of the 1970s. However, the recently agreed World Bank's $1.2 bn Special Facility for Sub-Saharan Africa (see brief 12) will provide extra resources for quick-disbursing concessionary development finance to countries genuinely committed to policy reform.

6. As part of the drive towards qualitative improvements in aid, the Development Committee have set up a Task Force on Concessional Flows to examine the inter-related issues of the volume of aid, its effectiveness, and the support for development co-operation in donor countries. A report will be presented to the Development Committee in October.

UK aid policy

7. The basic aim of the aid programme remains to promote economic and social develoment, particularly in the poorest countries. We also give due weight in the allocation of our aid to political, industrial and commercial factors alongside the development objective. Aid efforts are being concentrated on the development of indigenous skills, on making institutions more effective and on developing selected economic sectors in particular countries. These policies are partaicularly relevant to many countries in Sub-Saharan Africa, where a further important element of our policy is to support IMF and World Bank-led Structural Adjustment programmes, with the provision of programme aid for essential imports of spare parts and other maintenance goods.

8. The balance of payments and debt problems of developing countries also

highlight the importance of attracting private flows. With this aim, further efforts are being made to interest British companies in investing in developing countries.

Distribution

9. In 1983 nearly 57 per cent of our official development assistance was disbursed as bilateral aid and of this amount (£645 m) 63 per cent went to the poorest developing countries.

10. New aid is invariably made available on grant terms to all countries with a 1981 GNP per capita of $790 or less. In 1983 about 94 per cent of gross bilateral expenditure was on grant terms.

11. Commonwealth countries received 73 per cent of our bilateral aid in 1983. The poorest countries, amongst which are many of the Commonwealth countries of sub-Saharan Africa and South Asia, benefit from our contributions to multilateral programmes including the European Development Fund, the International Development Association and those of the United Nations agencies.

IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS
17-19 APRIL 1985

Brief No 7: EXPORT CREDIT

References: IMF - SM/84/272 (Brau Report)
IBRD - DC/85-4

A **Objectives**

(a) To find opportunity for positive intervention on role of export credit in promoting development.

(b) To support need for closer relationship between Export Credit Agencies (ECAs) and World Bank, to enable ECAs to take fuller account of development priorities.

(c) To support Bank and Fund proposals for improved information flow between World Bank, ECAs, and borrowing countries.

(d) To endorse need for greater consistency of approach between Governments on export credit cover policies towards countries with payments difficulties, while avoiding pressure for complete harmonisation of export credit cover.

B **Line to take**

Role of Export Credit in Development

(a) Welcome Bank's ideas on role of export credits in promoting development. Potentially useful source of funding to complement aid flows, bank lending and direct investment. Some of it at concessional rates, subject to Consensus.

Resumption of cover

(b) UK ready to resume cover, on modest scale, to countries in payments difficulties - provided adequate adjustment programmes were under way.

(c) Welcome move to improve co-ordination in this field already underway in OECD Group on Export Credit Guarantees through regular exchanges of views.

IBRD involvement

(d) Support World Bank work to identify suitable projects, of clear developmental benefit, able to generate export earnings (or import savings) at least equal to service of new debt incurred. Appraisal by World Bank would be comfort to the lender by helping to confirm prospects of viability.

(e) Caution that this approach will not enable ECAs to relax their risk assessment standards. Increased credit flows can only be justified if these moves to encourage developmentally effective investment can substantially improve the prospects for the recipient economy. As Bank paper correctly notes "export credits are not an aid instrument".

(f) Useful progress might be made by greater involvement of ECAs in consultative groups and aid consortia and by expanded use of co-financing between World Bank and ECAs. As Bank paper says "may be scope with regard to low income countries to bring development priorities more explicitly under consideration".

Information flow

(g) Support suggestions in paper for better provision of information. UK would be glad to participate in further work. Both Bank and Fund can help here: the Bank on project appraisal and developmental strategy and the Fund by aiming to make more explicit underlying assumptions and parameters of their analysis. Accept Bank paper's offer "to make available to ECAs its knowledge of sectoral and project priorities in developing countries to assist ECAs in their project choices".

C Others' objectives

(i) Most: support for use of export credit cover to support adjustment and for earlier resumption of cover for rescheduling countries. But significant differences of emphasis.

(ii) France: distrusts co-ordination of export credit cover policies.

(iii) US: to avoid too central a role for the World Bank in concerting action on export credit, preferring sovereign country decisions in this field rather than multilateral judgements.

(iv) Developing countries: significantly more rapid and more extensive resumption of cover.

(v) France/Japan: to resist limitations on the use of mixed credits

D Responses

(i) Co-ordination: accept dangers of over-rigidity due to complete harmonisation. Sudden swings of cover availability could inhibit rather than assist the ability of the debtor country to adjust. Should aim for measured withdrawal and renewal of cover.

(ii) Concerting of action with, eg, World Bank: accept key decisions must remain sovereign ones but if considered decisions by individual countries are to be effective in supporting adjustment, co-ordination of approach and proper account of expert views on developmental worth is vital.

(iii) Pace of resumption of cover: recognise need not to overburden debtors but there is mutuality of interest in ensuring that adjustment process is sustainable. Measured re-introduction of cover and careful attention to developmental priorities are necessary conditions of sustainability. ECAs also need to rebuild reserves. It would benefit no one, debtors included, if ECAs were weakened so far that cover was inhibited even for good cases.

(iv) Mixed credits: Eliminating completely the mixing of aid with export credit may be impractical, at any rate in the short term. However, the cost-effective use of limited funds - to the benefit of lender and borrower - can only be helped by greater discipline (restraint in the use of mixed credits) and transparency (clear acknowledgement that aid is being used in this way).

E Background

1. The Spring Meeting will focus on the role of export credit in the debt crisis. This breaks down into 2 elements: the flow of export credit, in particular the withdrawal and resumption of cover for countries in payment difficulties, and the uses to which that credit is put. The IMF's Brau Report considered the first of these elements. The Bank paper the second.

Brau Report

2. Its key points are:

(i) the tendency to remain on cover too long should be counter-acted by better risk analysis and collaboration on sounder lending standards (resisting the contrary political pressures);

(ii) there is broad support for a more co-ordinated case-by-case approach towards the withdrawal and subsequent resumption of cover for countries taking their adjustment medicine;

(iii) there is scepticism of any formal pledging process;

(iv) debtors need a better awareness of the ground rules if resumption of cover is to be encouraged.

3. The UK originally attempted to prevent the study proceeding, doubting whether it would lead to policy recommendations. However we subsequently instigated discussion in both the G5 and the Paris Club (the multilateral negotiating forum for official creditors) on the need for greater consistency of cover policy towards rescheduling countries. The Fund report is consistent with that discussion.

4. Exchange of information The report has been quoted by the UK in arguing that the OECD ECG should institute a regular exchange of information on attitudes to countries in either the debt build-up or post-rescheduling phases to secure a more consistent approach. The implementation of this is causing some difficulties. The Commission argues that the EC line must be presented by the Commission itself, hampering the raising of countries of concern to the UK (this happened with Turkey) where others would prefer a lower profile. But the first exchange on views took place in March and the process will continue at subsequent meetings.

5. On resumption of cover, the Minister for Trade announced in December the UK's intention to allow ECGD greater flexibility so that, in appropriate cases, cover could be restored at an earlier stage after the rescheduling of officially guaranteed debts than has traditionally been the case (see annex for description of current practice). This is to be implemented on a selective basis and is only applicable where we are satisfied that the debtor country is taking appropriate action. It does not represent a relaxing of risk standards.

6. So far a decision to apply this flexibility has been taken for Brazil and Mexico only and only for small amounts of business. But it has not been possible to put this new cover into effect even for these two countries following their current difficulties with the Fund (see Brief 13). However, ECGD will process any applications received and are seeking to avoid publicity for the delay in introduction. So there is some sensitivity surrounding the limited nature

of the move, both with exporters and the debtor countries concerned. Nevertheless the decision in principle to resume cover at an earlier stage of the recovery process represents a positive step. The limited nature of the steps taken so far reflects the need to tie resumption of cover closely to the success of the adjustment process. Where this has faltered, cover has had to be held back.

IBRD Paper

7. Alongside the Fund work on the need for greater co-ordination of export credit cover policies, the World Bank have been urging better co-ordination between ECAs and development institutions like the Bank over the application of that cover to the right type of project.

8. The general approach is again commendable. ECAs financing development projects can benefit from World Bank advice on priorities. Conversely, debtor countries embarking on a developmental programme need to be aware of the best ways of tapping export credit flows. One way they can help themselves, as both Fund and Bank papers propose, is by providing accurate and realistic information to creditors about their economic prospects and plans.

9. We can also agree that co-financing of projects by the World Bank and ECAs can be beneficial, provided the independence of ECAs' risk judgement is not compromised and the essential discipline of economic adjustment not reduced in priority.

10. It is important that linkage of export credit to productive projects is of net benefit to the developing country's economy, and does not simply release other funds for wasteful purposes. To ensure this, ECAs risk analysis will need to continue to take full account of the prospects for the economy as a whole and not focus exclusively on the project concerned.

Debt

11. Export credit issues are interlinked with debt problems (see Brief No 5): both their genesis and their solution. Over the long term an orderly return to less constrained trading patterns should result from progressive elimination of debt difficulties.

12. The moves we can endorse on export credit - for better co-ordination in resumption of cover; and for greater IBRD involvement to encourage application of funds in productive projects - cannot solve the debt problem. They are moves at the margin. Nevertheless they do represent a positive element in the picture, to which the UK can hook a cautiously positive intervention as indicated in the line to take.

ANNEX

ECGD's COVER POLICY

1. ECGD underwrite sovereign risk by applying country ceilings, security requirements, and pricing of cover.

Restrictions

2. Generally, ECGD control exposure through country limits on their commitments. These can be strict ceilings or benchmarks, reviewable as exposure rises.

3. Cover is gradually cut back on certain very high risk markets where extensive transfer claims payments are being made or expected. As a last resort cover is withdrawn for any class of business rescheduled (usually medium/long term).

Security

4. Security is sought through irrevocable letters of credit (ILC), (here ECGD is looking to the buyer's Central Bank to control foreign currency allocations), or confirmed irrevocable letters of credit (CILC) (to remove the risk to the country of an acceptable confirming bank).

Pricing structure

5. Countries are classified according to risk, and rates for medium term business depend on the length of credit and the country risk grade. Premium for short term business is essentially flat rate.

6. ECGD is also participating in the initiative under the OECD Export Credit Group for exchange of information about credit policies (see main brief).

INTERIM AND DEVELOPMENT COMMITTEE MEETING
17-19 APRIL 1985

BRIEF 8: TRADE

References: IMF - Trade Policy Issues and Developments SM/85/60 + Supplement 1 & 2

IBRD - Trade, Protection and Development DC/85

GATT - Trade Policies for a Better Future (report of Leutwiler group)

A: Objectives

(a) Emphasise UK commitment to a more liberal, multilateral trading system, and declare readiness to participate in launching of a new GATT round.

(b) Encourage others to agree that a new GATT round should be launched as soon as possible, hopefully building on positive developments at OECD Ministerial.

(c) Welcome increased IMF/IBRD concern about trade policy, given relevance to international financial flows and prospects for debtor countries.

(d) Endorse specific proposals for increasing Fund overview of trade policy in surveillance exercises.

B. Line to take

(a) Liberalisation of trade is in interests of all countries, developed and developing alike. Within countries protectionism leads to inefficient resource allocation between different sectors; between countries it distorts the pattern of comparative advantage.

(b) Best way forward is a multilateral approach, based on mutual liberalisation, while recognising some need in particular circumstances for differential speed of liberalisation according to degree of development. Action on NTM's (non-tariff measures) particularly important. Drift towards bi-lateralism must be stopped by new and meaningful GATT round - inaction is likely to be actively damaging to multilateral relations.

(c) Desirable for developing countries, especially the more advanced, to be actively involved in new round and begin progressively to implement the full range of GATT principles. It would benefit their own growth prospects if NICs started to liberalise their own trade regimes. It is clear that outward orientation (liberal trading stance and emphasis on export industries) offers the best prospects for development and growth.

(d) Appropriate that the MFA should be considered as one element for discussion in any multilateral liberalisation.

(e) Welcome the Fund and IBRD papers on trade policy as timely interventions. It is correct that the Fund focus on the benefits from a more liberal trade regime for the world economy and world trade, while the IBRD concentrate more specifically on developing countries. Both of these are a useful addition to the work carried out in OECD which looks more at the developed countries.

(f) Fund and IBRD have a useful role to play in encouraging moves towards trade liberalisation, although need a clear distinction between roles of IMF/IBRD and GATT. Welcome increased emphasis on trade policy in surveillance (see brief 2), and endorse suggested improvements especially more comprehensive coverage in surveillance documents. Acknowledge liberalisation moves associated with adjustment programmes, subject of course to the overriding requirement for successful adjustment. Welcome greater collaboration between Fund/IBRD and GATT. Support strengthening of GATT discipline as recommended in Fund paper.

C. <u>Others' objectives</u>

(i) France (and others): stress need for improvement to international monetary system in parallel with progress on a new GATT round although earlier bids for a close link and on international monetary conference seem now to have receded.

(ii) US: (a) threaten recourse to bilateral (or plurilateral) negotiations if progress on a new GATT round, especially from LDCs, is not swift;

(b) increasing Congressional pressure for 'temporary' import surcharge, either global or targetted against Japan; although Administration opposed and President likely to veto;

(iii) LDCs: some e.g. ASEAN and Korea willing to accept new GATT round. Others e.g. Brazil remain suspicious and resist progress, seeking one-sided liberalisation in their favour by developed countries; they argue debt problems justify this demand.

(iv) Various: may attack developed countries' enthusiasm for new GATT round as inconsistent with past record on VRA's, grey area measures.

D: **Responses**

(i) International monetary reform: recognise importance and relevance of link with international trade. G-10 expected to report by mid-year (see brief 4). Counter-productive to make progress in one area conditional on progress in the other. "Solutions to imbalances whose origin lies in the monetary and financial areas cannot be found in trade negotiations" (FAC communique)

(ii) (a) Bilateralism: must be avoided - it is discriminatory, less transparent than measures applied to all countries, and would undermine the whole basis of the present GATT system. Need to identify areas of interest to NICs to bring them to negotiating table: threats are not enough.

(b) Import surcharge: would be wholly inappropriate. Its current account problems stem from the high level of the dollar, itself partly attributable to unbalanced domestic policy: urgent need to bring down the fiscal deficit but <u>not</u> by a temporary surcharge on other countries. Surcharge would almost certainly be in breach of GATT principles, bring the threat of retaliation, and jeopardise a new round.

(iii) Developing countries' problems: as IBRD paper points out, protectionism by developing countries is both higher and more variable than in developed countries. Short-term benefits from protectionism in terms of stimulating domestic output and employment, but at the cost of severe resource misallocation, insufficient emphasis in export performance, and overvalued exchange rates, usually exacerbating eventual adjustment problem. There is strong evidence that outward-oriented countries enjoy significantly faster economic growth than inward-oriented countries.

(iv) NTMs: admit UK's record on grey area measures not spotless, but better than some. UK has resorted to protectionist measures only in most difficult cases. Existence of the grey area demonstrates the urgent need for a workable GATT safeguard clause.

E. Background

GATT round

1. UK's support for a new GATT round was reiterated by the Prime Minister in her speech to congress on 20 February. Our main efforts devoted to ensuring that the EC echo our strong support. (EC would negotiate on our behalf within GATT, at least for trade in goods - competence on services is contentious). 18-19 March FAC declared EC's "readiness to participate in the launching of a new round ...subject to the establishment of an adequate prior international consensus on objectives, participation and timing"; and to "enlist the support of its trading partners".

2. UK objectives in a new GATT round are:

(a) liberalisation of trade in services;

(b) bringing trade in agriculture more fully under GATT disciplines;

(c) graduation of NIC's into acceptance of GATT obligations as well as rights;

(d) effective opening of to the Japanese market to imports of manufactures [Japanese package of market-opening measures announced 9 April described by EC (de Clercq) as "modest in scope with an uncertain effect."];

(e) reducing peaks in developed country tariffs.

3. To get developing countries to the negotiating table at all will require being prepared to make concessions, but the UK's position is to ensure broad reciprocity in liberalisation. Areas where we would consider liberalisation are:

(i) the MFA (the current version expires in July 1986 - a decision will be needed on whether to replace it by another by July 1985): as yet no agreed Community position;

(ii) improved safeguard provisions within GATT.

Both should appeal to developing countries, as would further liberalisation of products of interest to them e.g. tropical products.

Stance of IFIs

4. The Fund's Managing Director has adopted a strong liberal stance on protectionism, stressing:

(i) exercise of political will now be needed to progress with liberalisation, with multilateral route (especially through a new GATT round) the preferred way;

(ii) need for developed countries to lower trade barriers, to aid developing countries' external adjustment;

(iii) need for developing countries, especially the more advanced, to liberalise their own trade regimes.

His summing up of Executive Board discussion attached at Annex.

5. The IMF paper (SM/85/60) picks up these themes strongly:

..."trade expansion induced by an open trading system feeds back on the growth of output ...the effects of protection on efficient resource allocation have implications for the pace and pattern of world growth of output and trade." (p3).

"...industrial countries' willingness to absorb imports from developing countries in sectors where they have a comparative advantage will be critical, both in encouraging greater reliance by developing countries on private direct investment, and in reinforcing the pursuit of more open trade policies by developing countries." (p12).

"The scope for further trade liberalisation by developing countries ...remains considerable ...In some sectors some tariffs on nontariff restrictions may be redundant in an economic sense." (p10).

Also, from the World Economic Outlook (EBS/85/47):

"The medium term consequences of protectionism rapidly overwhelm any temporary advantages that measures of protection may bring to the countries that adopt them." (p27).

6. The IBRD paper (DC/85-) also urges early anti-protectionist measures as a means of promoting development:

"(NTMs) ...are an important source of economic distortions reducing efficiency and longer term growth in developing and industrial countries alike." (p2)

"Protection usually involves overall net losses both for the importing and the exporting country and transfers from consumers to producers in the importing country." (p15)

"The consequences of these [protectionist] policies, especially in developing countries ...have been highly detrimental to sound growth... The ...evidence indicates that economies ...not biased against exports succeeded in maintaining higher gdp growth both before and after the external shocks." (p20).

"Trade liberalisation would improve the prospects of indebted countries by encouraging the supply of direct investment and commercial bank funds to export-oriented industries." (p22)

"To the extent that protection in industrial countries forces developing countries to bear the burden of adjustment primarily through reductions in economic activity, or, worse, additional protection to restrict imports, this has further adverse effects on industrial countries' export and output growth". (p22)

7. The GATT paper, while not formally on the agenda, contains a number of useful recommendations for strengthening existing GATT procedures, widening its scope to cover agriculture and services more effectively, and curbing NTMs. Its analysis stresses the limited benefits and large costs from protection:

"...protection cannot protect jobs for long. Indeed in many cases protectionist measures actually eliminate jobs. Jobs which are "saved" from the competition of imports are preserved only at the expense of jobs lost in the same country's export sector." (p8)

"...developing countries ...have gradually been placed in a separate and supposedly privileged category from which they have in fact benefitted little." (p20)

The paper's conclusions and recommendations are generally helpful. But it also "urge(s) the IMF Interim Committee to meet at regular intervals with both trade and finance ministers in attendance." This could be cumbersome and time-consuming. It would be better to avoid changing the monetary focus of the Interim Committee, leaving trade detail to be discussed in GATT.

Other

8. The OECD Ministeral (11-12 April) also produced a strong statement against protectionism, reflecting the favourable reception at an ad hoc EPC to the Secretariat paper (now published) on the "Costs and benefits

of protectionism" (the Michalski report). The communique calls for a new round starting "as soon as possible (some felt this should be in early 1986)". This reference to 1986 reflects US preoccupations and goes further than the EC position. This communique also proposes "a preparatory meeting of senior officials..... in GATT before the end ofthe summer to reach a broad consensus on subject matter and modalities."

9. The Bonn Summit in June will provide an opportunity to swing the major industrial countries behind concrete action for further liberalisation, following up the statements of the Williamsburg and London Summits.

SPRING MEETINGS OF INTERIM AND DEVELOPMENT COMMITTEES
17-19 APRIL 1985, WASHINGTON

BRIEF 9: WORLD BANK GROUP

Reference: IBRD - The Future Role of the Bank - DC/85-9

A **Objectives**

(a) Support World Bank's central role in development.

[(b) Support GCI and work for start on process at Annual Meetings.]*

B **Line to take**

(a) Recognise importance of Bank's work in fostering development and encouraging finance. Welcome flexibility in responding to difficult situations facing many of its borrowers.

(b) Lending instruments, such as structural adjustment and sector loans, which support policy and institutional reform have an increasingly important role. Important that LDCs recognise this and play full part in the policy dialogue, and that programmes should be well designed and effectively monitored.

[(c) Concerned at possibility of negative net transfers by Bank towards end of decade. UK stands ready to participate in General Capital Increase (with low paid-in position) when time comes. Happy to consider this further in Seoul. But quality of Bank lending must not be diluted.]*

(d) Bank/Fund collaboration more than ever important. Would like to see this given greater practical effect. (See brief 10).

[(e) Prepared in principle to participate in a Multilateral

* These sections assume the Foreign Secretary's agreement to the Chancellor's minute of 3 April.

Investment Guarantee Agency (MIGA), subject to agreement on detailed arrangements, and on widespread support from other countries including the developing countries.]*

(f) Support any moves to make International Finance Corporation (IFC) more effective, including new ways of fostering private investment in Africa.

(g) Privately, with Mr Baker (US Treasury Secretary) express interest in the successor to Mr Clausen when his Presidency expires in June 1986. Suggest it would be well-received if he talked over the possibilities with G5 Finance Ministers.

C Others objectives

(i) US (and others): to secure "root and branch" review of future IDA operations.

(ii) US: still reluctant to concede need for a GCI.

D Responses

(i) Agree IDA 7 mid-term review in July 1985 is a suitable starting point for considering IDA's operations under the next replenishment.

(ii) GCI is important gesture to recognise developing countries' long term needs.

(iii) Need to consider GCI soon, given usual long lead times.

(iv) Size, timing, and paid-in portion of GCI are matters to be determined in relation to Bank's need.

(v) Concern of all members, not least USA and UK, to secure lowest possible paid-in element compatible with financial market perception of member governments' support for the Bank.

E Background

General Capital Increase

1. Bank staff are conducting a review of the Bank's future role. Yet to be published, but Executive Board has discussed major issues (Paper Sec 85-247). Review originally designed to lay foundations for next General Capital Increase. United States never fully supportive; events have moved in US favour as Bank's lending programme in FY85 expected at $10.5 billion - $11.5 billion, against target of $12.3 billion. Constraints facing some of Bank's largest borrowers seem likely to continue in FY86; borrowing level might therefore remain static. Need for GCI has receded. Situation adversely affects resource transfers since, even if Bank achieved an annual $13 billion lending programme over next few years, net transfers to borrowers would decline from $3 billion in FY85 to $0.7 billion in FY88, with negative transfers thereafter. A 10% growth in annual lending (requiring a GCI) would slow the sharp decline in net transfers, but they would still fall to $0.2 billion by FY90. IBRD Management aiming to have initial consideration of resource requirements at the Annual Meetings in Seoul in October, leading to firm proposals at the Spring 1986 Development Committee Meeting.

2. This timing would probably require formal Bank Governors' approval during calendar year 1986 with a five year period for share take-up commencing from 1 July 1987 (ie the start of Bank Financial Year 1988).

3. A GCI will imply increased IBRD borrowing on world capital markets in the future (with the main impact in the 1990s). The US have expressed doubts over the willingness or capacity or capital markets to meet rising World Bank demands for medium and long-term fixed rate credit on the scale required and argue that this must act as a constraint on the size and timing of a GCI. We accept

that there must inevitably be uncertainties about future market conditions and capacities (though we would expect substantial growth as the world economy expands): but we would not accept that this should be a factor in the timing of a GCI and believe that continuing diversification of the World Bank's borrowing strategy, in terms both of markets and instruments, will give adequate flexibility to meet shifting circumstances. The growth in the World Bank's requirements and US reluctance to see their domestic markets used as the residual market will require other countries to show greater willingness to allow the World Bank access to their own markets. The statement of the European Community to the Interim Committee contains such an undertaking, in conjunction with strong support for a GCI.

Future Role of Bank

4. Debate on the Bank's future role has concentrated on its activities in assisting adjustment process in borrowing countries. Foremost issues are

a. balance between investment lending and non-project lending, where we would support increased flexibility to allow an expansion of non-project lending (and associated conditionality) as appropriate, while recognising that the traditional project lending remains the Bank's main business.

b. implications for the relationship between the Bank and its borrowers on policy reform lending, where prospects may depend on some reduction in LDCs resistance to Bank conditionality.

c. Fund/Bank cooperation, where we would hope to see continuing improvement (see brief 11).

5. Some consensus exists among major shareholders on the following points: the quality of Bank loans must not

be diluted to achieve lending targets; lending operations covering structural adjustment should be continued (some, including the UK, agree level could be slightly expanded) but the necessary conditionality should be well designed and closely monitored; a proper balance (unspecified) should be struck between traditional project investment and non-project lending, the latter by its nature being limited; and the lip service paid to IMF/IBRD collaboration by both bodies should be given more practical reality.

International Finance Corporation

6. The 1984 $650 million capital increase cannot become effective without the United States vote in the Board of Governors. This is now expected in October 1985, to coincide with Congressional approval of the necessary appropriation to cover the cost of the US share. UK Parliamentary approval cannot be sought before then but the UK vote has already been cast in support (subject to that approval). Meanwhile, IFC's management structure is being rigorously reviewed; the Corporation has begun to borrow directly from the financial markets on its own account; and new ways are being examined to foster private investment in Africa.

Multilateral Investment Guarantee Agency

7. The Bank has reviewed the idea of a scheme for multilateral investment insurance to promote direct private investment in the LDCs by offering insurance against political risks - primarily war, expropriation and inconvertibility. The proposed vehicle, a Multilateral Investment Guarantee Agency, would be separate from the World Bank and have its own capital. OECD countries have discussed a draft convention, but there are many doubts: (i) the need for another arrangement alongside national agencies; (ii) whether a MIGA would attract additional investment; (iii) whether developing countries really are committed to private investment; and (iv) whether the proposed modalities, particularly voting rights, are generally acceptable to those who will have to subscribe

the most capital.

8. Most developing countries appear to favour a MIGA in principle. The proposal has strong US backing, although Washington's views on the details, including dilution of the Bretton Woods system of voting relative to shares, are still unclear. UK Ministers have yet to be consulted and Departmental responsibility determined, particularly for the expected UK $5 million paid-in capital plus $45 million callable.

IDA: Seventh Replenishment

9. IDA7 became effective at the end of 1984 for advance contributions. UK has formally notified its 6.7% £401.5 million contribution, and has deposited with IDA Management the first of three Promissory Notes. A formal review of IDA is expected in the IDA 7 mid-term review in July 1985. We shall be represented. The pattern of resource allocation and IDA terms of lending are expected to be discussed, and a number of donors, particularly the US, wish to tackle IDA flows "root and branch". We would not see this as a conclusive meeting since firm decisions on these subjects are for the Executive Board and not IDA Deputies, but it provides the opportunity to begin the process of considering IDA's future direction under the 8th replenishment.

10. Ability of UK (and doubtless other countries) to contribute to supplementary financing for IDA7 has been pre-empted by the Bank's Special Facility for Sub Saharan Africa, under which some $1.2 billion has so far been pledged (see brief 12).

Presidency of the World Bank

11. Mr Clausen's term as President expires in June 1986. There is no enthusiasm for his renomination. But within the Bank, it is thought that he might seek reappointment

(for at least 2 years until he is 65), that this might be preferable to any new US nominee, and that the US authorities might accept such an extension. The appointment is, in effect, in the US gift and is likely to be decided by Mr Baker, taking advice as appropriate. (The convention is that the President of the Bank is an American but that the Managing Director of the Fund is a European). There are no obvious successors. Names which have been floated include Mr Bill Simon, Mr Beryl Sprinkel, Mr Paul Volcker and Mr Ernie Stern (the present Senior Vice President, Operations) and Mr Lewis Lehrmann (who was narrowly defeated a year or so ago for the Governorship of New York).

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TELEGRAM NUMBER 43 OF 10 APRIL

IMF/IBRD DEVELOPMENT COMMITTEE: WORLD BANK ISSUES

CURRENT BANK THINKING HERE IS AS FOLLOWS:-

WORLD BANK GENERAL CAPITAL INCREASE (GCI)

2. IBRD WILL BE SEEKING AGREEMENT AT THE DEVELOPMENT COMMITTEE TO MOVE ON TO A DISCUSSION OF RESOURCE ISSUES. WHILE IN DEFERENCE TO THE US THIS WILL INCLUDE OPTIONS OTHER THAN A GCI (E.G., LOAN SALES), MANAGEMENT ARE FOCUSSING ON A PROPOSAL TO INCREASE SHARE CAPITAL BY 50 PERCENT (AROUND DOLLARS 40 BILLION) WITH 5 PERCENT PAID IN. THIS WOULD SUPPORT LENDING PROGRAMME INCREASES OF 10 PERCENT A YEAR IN NOMINAL TERMS OVER A 5 YEAR PERIOD. THEY ARE AIMING AT POLITICAL AGREEMENT ON GCI AT THE SPRING 1986 DEVELOPMENT COMMITTEE AND FORMAL ACTION BY THE GOVERNORS AT THE 1986 ANNUAL MEETING. SUBSCRIPTIONS WOULD BE DUE FROM BANK FISCAL YEAR 1988.

3. PAPER TO THIS EFFECT LIKELY TO GO TO BOARD IN JUNE IF DEVELOPMENT COMMITTEE GIVES NECESSARY SIGNALS.

FUTURE OF IDA

4. THIS TOPIC IS UNLIKELY TO COME UP AT DEVELOPMENT COMMITTEE ITSELF BUT AT QURESHI'S DINNER FOR SELECTED SENIOR OFFICIALS ON 19 APRIL. PAPER ON FUTURE OF IDA IS PLANNED FOR JULY IN PREPARATION FOR IDA DEPUTIES MEETING IN SEOUL ON EVE OF ANNUAL MEETINGS IN OCTOBER. BANK IDEAS ARE STILL FLUID, BUT FUTURE LENDING TO ASIAN BLEND COUNTRIES (CHINA, INDIA, PAKISTAN, SRI LANKA) CLEARLY ONE KEY ISSUE. SOME STAFF ARGUE FOR INTEREST SUBSIDY MECHANISM, OTHERS FOR HARDER TERMS IN EXCHANGE FOR KEEPING SIGNIFICANT PORTION OF NEXT IDA AVAILABLE FOR THESE COUNTRIES. GENERAL PESSIMISM THAT US WILL GO ALONG WITH AN IDA 8 WITHOUT SOME SIGNIFICANT MOVEMENT IN THIS AREA. QURESHI DINNER PROVIDES OPPORTUNITY FOR US TO MAKE ANY PRELIMINARY COMMENTS ON FUTURE ARRANGEMENTS FOR IDA.

IBRD BORROWING ACCESS

5. GIVEN IBRD'S PROBLEMS LAST YEAR OVER US WISH TO REDUCE THEIR ACCESS TO US MARKET, QURESHI MAY ALSO SEEK AT DINNER ON 19 APRIL SOME ASSURANCE THAT BANK'S ACCESS TO MAJOR CAPITAL MARKETS WILL NOT BE UNREASONABLY CIRCUMSCRIBED. IT WOULD BE USEFUL IF SIR C. TICKELL WAS BRIEFED BY BANK OF ENGLAND ON THIS ASPECT.

6. FCO PLEASE PASS ADVANCE COPIES TO TAIT (ERD), TICKELL AND ARBUTHNOTT (ODA), BEASTALL (TREASURY) AND GILCHRIST (BANK OF ENGLAND)
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WICKS

(ADVANCED AS REQUESTED)

MONETARY
ODA

MEETINGS OF INTERIM AND DEVELOPMENT COMMITTEES
17-19 APRIL 1985

BRIEF 10: IMF/IBRD CO-OPERATION

References:	IMF - Issues	SM/84/242
	- Progress report	SM/84/210
	IBRD - Review	R85-30

A UK Objectives

(a) Reinforce international commitment to strengthening co-operation between IMF and IBRD.

(b) Get agreement on practical measures to promote and facilitate co-ordination in practice.

B Line to Take

(a) Vital that economic stabilisation and development objectives are pursued simultaneously. Fund and Bank should concentrate on different but complementary aspects of the same process in harmonious fashion.

(b) Support practical proposals put forward by UK ED in Fund Board last November and by France in discussion in G10 Deputies: harmonising policy diagnoses, mutual recognition of each institution's contribution, collaboration on mobilising resources, and a host of practical measures.

C Others' Objectives

(i) US, Germany and Japan:

- against turning Fund into aid institution;
- containment of non project loans in Bank.

(ii) Developing countries: resistant to cross-conditionality (ie, usually, enforcement of Fund prescriptions through Bank programmes); and to increased Bank conditionality in itself.

(iii) Fund and Bank managements: concerned not to jeopardise independence, and therefore reluctant to change working practices.

D Responses

(i) Fund: agree essential character should be protected and that financial assistance should be temporary. But still appropriate to maintain enlarged access for time being.

(ii) Bank: favour cautious enlargement of Bank's non-project lending provided lending quality maintained through well designed conditionality and effective monitoring.

(iii) Conditionality: Fund and Bank should concentrate on the aspects of the adjustment/development problem where they can contribute most effectively. Fund should work primarily (but not solely) on macroeconomic policy, Bank on complementary microeconomic/structural issues.

(iv) Co-operation in practice: some progress made in co-ordinating working arrangements but scope for plenty more, especially in formulating consistent policy analyses and prescriptions.

E. Background

1. Guidelines on IMF/IBRD co-operation were originally adopted by both Boards in 1980. They have recently been endorsed. The G10 Deputies have also focussed on Fund/Bank co-operation as one of their topics for study (see brief 4). There is a widespread perception, especially among developed countries, that really effective co-ordination is still some way off. Instances of conflicting policy advice (eg, recently, in Kenya and Uganda) persist though they have become less frequent and less glaring. Sometimes coherent assistance is achieved to good effect: eg in Ghana, where the Fund's series of SBAs has been complemented by a variety of Bank facilities, including a reconstruction import credit and an export rehabilitation scheme as well as project loans in the transport and petroleum sectors.

2. The need for Fund/Bank co-operation has become more pressing over the past few years because of the emergence of debt problems among most developing countries. Such countries face heavy debt

service commitments for the foreseeable future in combination with severe development needs. Sustained adjustment effort as well as developmental progress is therefore required. The timescale needed to resolve their problems has lengthened as their debt burden has grown more onerous and their capacity to service it has not in general kept pace. The biggest debtors (Brazil, Mexico, Argentina, Philippines, Korea) are likely to recover reasonably durable external viability primarily through balance of payments adjustment such as that promoted by the Fund. So the need for a joint approach is strongest among smaller, heavily indebted non-oil developing countries primarily in Africa (eg Malawi, Zambia and many more) but also in the Caribbean(eg Jamaica) and Asia (eg Sri Lanka).

3. There has been some progress in achieving a coordinated approach to international assistance in such cases. The techniques used include a longer term perspective for Fund programmes and more structurally directed lending by the Bank. Both institutions have stressed the structural content of policy requirements, essentially by encouraging diversification, better production and marketing, often through improved competition and more open trading arrangements. These pragmatic trends have evolved the two institutions some way from their original roles. It is important that they should not go too far. Some safeguards have already been introduced in the Fund, where guidelines on prolonged use of Fund resources were adopted last autumn (see brief 11) to prevent the enlarged access policy facilitating continuous use of Fund resources. In the Bank better arrangements to enforce policy pledges under non-project loans are under consideration.

4. Typically, complementary advice from the Fund and Bank is especially important for:

(a) prices - balancing fiscal and import implications of subsidies against agricultural policy needs;

(b) balance of payments - matching exchange rate policy with appropriate trade regimes, including the tariff structure;

(c) investment - reconciling development priorities within a level consistent with fiscal requirements;

(d) tax strategy - ensuring acceptable fiscal balance wi[illegible] collectable taxes allowing adequate incentives.

5. Practically, the difficulties of promoting Fund/Bank co-operation include:

(i) different timescales - Fund lending is essentially short term, negotiated quickly; whereas Bank programmes are more considered, long term affairs, continuously updated;

(ii) different (though not necessarily conflicting) priorities - the Fund concentrating on external stabilisation, through appropriate domestic policies; the Bank aiming for an improved level of social welfare via durable non-inflationary growth;

(iii) practical difficulties - operating arrangements in the two institutions differ; staff reluctance to sacrifice independence; the Executive Board's greater effectiveness in the Fund than in the Bank.

6. The annex lists measures proposed by the UK ED in the IMF Board last autumn. They reflect consensus among the G5, with particular support from France.

ANNEX

EXTRACT FROM MR WICKS' BUFF, NOVEMBER 1984

1. The following are some specific procedures, which might be instituted or strengthened in furtherance of the process described in paragraph 7 above:

- where appropriate, shared preparation of and participation in missions as normal practice;

- better coordination in the programming of missions where the above is not possible or appropriate;

- the preparation of a consistent country economic analysis, as a basis for:

  Article IV reports (for Fund Board) giving more extensive discussion of the objectives, time-frame, and progress of Bank programs, and

  country assessments (for Bank Board) examining the overall impact of Bank involvement in a country,

  program proposals by both institutions;

- participation by senior staff of one institution at reviews prior to Board discussions in the other;

- regular review in the Bank Board of the overall performance and objectives of Bank programes in a particular country;

- close contacts between each constituency's Bank and Fund Executive Directors;

- appointment of Executive Directors of one institution as temporary Alternate Directors of the other, to allow observation of and participation in discussions;

- attendance at Board discussions in each institution of appropriate staff member(s) from the other; and

- informal joint meetings or seminars of the two Boards.

2. In addition to these steps relating to the analytical and lending functions of the Fund and the Bank, it may be helpful to implement a number of other changes in "domestic" arrangements. For example:

- closer coordination of training activities of Fund and Bank educational institutes, through, for example, exchanges of teaching staff;

- closer co-ordination of research programs and more joint research projects;

- amalgamation of activities on debt statistics and associated advisory services;

- expansion and closer co-ordination of technical assistance programs to avoid overlaps and to secure more effective implementation of Fund/Bank programs;

- "cross-training" of each institution's staff in the other;

- longer-term personnel exchanges between the two institutions; and

- a joint report, perhaps annually, to the Interim and/or Development Committee, reviewing issues and progress on Fund/Bank co-operation.

INTERIM AND DEVELOPMENT COMMITTEE MEETING

17-19 APRIL 1985

BRIEF 11: IMF ISSUES

This is primarily a background brief, covering recent and prospective business in the IMF. There are no points for decision or which need specifically be raised.

A Line to take

(a) Access: Content with application of guidelines on IMF lending. Believe staff carrying out spirit of Interim Committee's decision to ensure that borrowing from Fund is genuinely temporary.

(b) Conditionality: Endorse present mix of policies. Support greater emphasis on supply side adjustment as need for medium term perspective appreciated to be more generally necessary. Welcome commitment by many debtors and developing countries to sustained adjustment in order to carry through recovery to achieve external viability within reasonable timescale.

(c) Programme design: Some concern about effectiveness of Fund programmes, which tend to turn around external accounts without remedying underlying domestic rigidities and structural imbalances. Recent acceleration of inflation in countries following programmes a particular worry. Recognise that typical adjustment timescales now longer after oil and debt shocks of past decade. Important that this is reflected in commitment to sustained and effective adjustment.

(d) IMF resources: Fund's relatively liquid resource base means no need for further borrowing initiatives in the near future if present policies continue. Accept case for extending loan agreement with BIS to end 1985 to avoid early emergence of over-commitment of borrowed resources.

But if Fund were to adopt universal compensation scheme (eg interest rate cap), resurces drain could be unsustainably large.

(e) Arrears: Regret increasing emergence of overdue payments owed to IMF. Emphasise importance of maintaining Fund's financial integrity. Support measures to enforce prompt payment, including automatic interruption of right to make use of Fund resources and (where necessary) formal ineligibility procedures.

(f) Staff pay: Concerned that staff (and executive directors') remuneration should not outstrip comparators. Case for some real reduction in average current level of staff pay, though recognise importance of maintaining adequate compensation packages for key staff.

BACKGROUND

Access

Since the quota increase at the beginning of 1984, the IMF's enlarged access policy has been gradually wound down, reflecting the intention to manage without Fund borrowing and return to quota finance. The access limits for 1985 are:

	% quota	
	Normal	Exceptional
Annual	95	115
3 year	280	345
Cumulative	408	450

In practice the exceptional limits, intended for countries in severe need undertaking very strong adjustment, have not been tested; while the normal annual limit has been touched only once (for Argentina, whose programme was agreed at the normal 1984 annual limit of 102 per cent of quota).

2. There are, however, a fairly large number of countries whose outstanding debt to the Fund is heavy enough to threaten the cumulative limit. Assuming continuation of programmes currently in force, there are 25 countries whose present or prospective use of Fund resources will take them to above 200 per cent of quota, with 7 of these likely to use more than 300 per cent of quota. Programmes in the pipeline could soon boost the latter group to 9, while the former could easily approach 30 by the end of the year. The proportionately heaviest debtors to the Fund are listed below:

	Use of IMF credit at end of programme (or present use) as % quota	Programme expires
Jamaica	376	June 1985
Turkey	336	April 1985
Yugoslavia	326	April 1985
Ivory Coast	320	May 1985
Mexico	310	Dec 1985
Brazil	307	Feb 1986
Sudan	(303)	-
Uganda	285	-
Morocco	279	March 1986
Malawi	260	Sept 1986

3. The access limits are set year by year. A decision will be needed at the Annual Meetings in the Autumn to set the access limits for 1986. Clearly there will be only limited scope for reduction in the cumulative limit if the position of most of the countries in the table above is not to be seriously prejudiced. It may be possible to agree on some further decline in the annual limits without much practical damage to chronic Fund clients. That is the minimum the US, Germany and Japan will all want. The developing countries will resist this strongly, even though a further small reduction would probably make little difference in practice to the size of new Fund programmes awarded.

4. This is because Fund lending is governed by guidelines adopted at the beginning of 1984. These stressed that Fund lending should be temporary, pitched at generous levels only in support of strong adjustment programmes. The guidelines have been amplified by the adoption of understandings about prolonged use of Fund resources and the phasing of drawings. It is now standard practice for countries whose existing borrowings from the Fund are substantial, or which are expected to need to draw on the Fund for a continuous period of several years, to get programmes involving loans of no more than 50 per cent of quota a year, and sometimes less. For some this may mean that the Fund is demanding substantial net repayments even though the adjustment process is far from complete.

Conditionality

5. Over the last three or four years, since the emergence of severe debt difficulties, on average some 35-40 members of the IMF have been borrowing on conditional terms at any one time, often with another dozen or so in active negotiation on programmes (see annex for list of current programmes). The result is that the Fund has supervised adjustment in most debt-ridden economies, particularly those in Latin America and Africa. With the passing of the most urgent initial response to the debt shock, Fund lending has dropped back significantly - a net SDR4.8bn in 1984, less than half the record SDR10.6bn disbursed in 1983. Net loans will probably fall further, to about SDR4.3 bn in 1985.

6. The adjustment problems faced by IMF clients fall loosely into two groups:

(a) those with reasonable hope of relatively rapid recovery, eg Mexico;
(b) those with simultaneous development needs, protracting the recovery horizon, eg Jamaica, Zambia and many others.

Increasingly, countries in the first group - like Venezuela and Colombia (see brief 13) - are trying to manage without Fund programmes. The latter group, by far the larger, need the Fund badly as other sources of finance, both commercial and concessional, usually require the Fund's guarantee. Such countries are particularly dependent on exogenous factors, notably activity in their export markets and commodity prices. Despite the prospect of several more years of austerity, most of these countries seem prepared to persist with adjustment, faut de mieux. There are now relatively few of them - Sri Lanka is an exception - where negotiations with the Fund are stalled.

7. Consequently the Fund is increasingly being forced to engineer adjustment programmes for countries whose recovery prospects are relatively remote - 5 years or more. This contrasts with traditional Fund practice, which usually relied on short sharp one or two year programmes to achieve external viability. As the typical recovery horizon recedes, 3 year programmes under the extended financing facility (EFF) have become less appropriate, although isolated instances such as the prospective arrangement for Chile do occur. Instead countries in this position tend to get a series of loosely related shorter programmes in close succession. Conditionality in such circumstances inevitably needs a strong structural and development flavour, and is usually undertaken in concert with World Bank lending programmes, often including SALs (cf brief 10). In recognition of the frequency of relatively long term relationships with clients, the Fund has recently adopted rules about the phasing of loans to better ensure implementation of agreed conditionality.

Programme design

8. Among the more spectacular large Fund programmes, a disturbing trend has emerged. Initial adjustment measures typically include devaluation and raising domestic commodity prices toward international levels as well as fiscal and monetary restraint. External confidence can then rebuild rapidly, especially if the trade account revives fast through

import compression. At this stage adjustment may drift off track, as the current account improves, perhaps dramatically, and previous flight capital returns, putting pressure on the monetary aggregates. Thus the inflation hike induced by the initial price measures may not be temporary, especially if the inflation rate has been driven up so far as to encourage indexation, and if action to tighten fiscal policy is less determined than action to improve the balance of payments.

9. In different guises this kind of difficulty has arisen in Brazil, the Philippines and Yugoslavia, to name but the most obvious. The Fund staff are worried about it. A Fund paper discussing it has been held up for weeks.

10. No ready solution is immediately apparent. The problem might be averted by settling for gradual adjustment, but the external finance available is rarely adequate to permit that luxury. The danger, of course, is that the deflation required to overcome the inflation induced by the cure for the external problem (or by insufficiently supportive fiscal policy) will prove politically intolerable, especially coming after a period of initial austerity. So far none of the larger debtors has been tempted to default because of this predicament. Fund programmes are still generally seen as a least worst outcome.

<u>Liquidity</u>

11. The IMF is in a comfortable resources position. Since the quota increase in early 1984, and the SDR6 billion borrowing agreements with SAMA and BIS, a number of factors have conspired to reduce net flows out of the Fund. Access limits have been somewhat lowered. Criteria for use have been tightened. A number of large programmes (eg the Philippines and Argentina) took longer to negotiate than expected. Some seem unlikely now ever to be arranged (eg Nigeria, Venezuela). Generally, the strength of the world recovery has enabled the Fund's potential clients to manage with less, or even without, Fund resources. The low rate

of depletion of the Fund's resources seems likely to continue. Even if some of the delayed programmes were to be agreed, this would remain true:

IMF LIQUIDITY (SDR bn)

	1984	1985	1986
Uncommitted resources available for lending at start	32.7	32.3	29.8
of which borrowed	4.2	2.7	1.3
New commitments	5.7	5.8	5.8
Gross lending	8.0	7.8	7.3
Repayment to the Fund	1.2	3.5	6.2
Uncommitted resources at end	30.6	28.5	28.4
of which borrowed	2.7	1.3	- 0.4*

* overcommitment of borrowed resources.

12. The SDR3 billion loan from developed countries agreed last spring was originally to be available for drawdown only until the end of April. So far only 20 per cent of this (and the corresponding SDR3 billion loan from SAMA) has been drawn. The Fund may not in practice need to draw the remainder in full, but would like to keep the option open until the end of the year. The BIS guarantors are expected to go along with this but may not agree firmly until the BIS meeting on 15 April.

13. It is possible that the Fund might face heavier demands for resources over the period to the next quota increase in early 1989. The chances of managing without further borrowing look reasonably good, however, though much depends on the success of debtors' and developing countries' adjustment efforts. On the Fund's over-cautious estimates, present available borrowed resources should last until at least mid-1986. Significant repayments to the Fund, averaging

some SDR6½ billion a year, are expected over the rest of the decade. Rolling these over (on average) by awarding new programmes would still leave the Fund's liquidity position quite comfortable, even taking account of the need to repay existing Fund borrowing. But if demand for significant net transfer of resources developed (eg by way of interest rate capping or other extravagant schemes - see debt brief 5), it might be necessary to contemplate further Fund borrowing, though probably no sooner than early 1987. At that stage it might be right to consider recourse to the so far unused GAB facility for lending directly to the Fund, though this would undoubtedly be contentious.

14. In the meantime, the Fund will need to consider whether and how its internal accounting should be adapted to take account of lower reliance on borrowed finance. At present quota financed and loan financed lending by the Fund are made on different terms (both interest rates and repayment periods). The mix between the two will need to be adjusted.

Arrears

15. A worrying manifestation of the impact of debt problems has been the emergence of arrears owed to the Fund. Minor delays have always occurred but recently the record has worsened appreciably. Over the last couple of years arrears have increased more than sixfold to reach some SDR225 million. Much of this is fairly short term, but a handful of countries have emerged as persistent offenders. Of these by far the most serious in financial terms is Sudan, with arrears of some SDR115mn. The amounts outstanding can no longer be regarded as insignificant compared to the Fund's financial flows and reserves.

16. The IMF Board has therefore instituted tougher procedures to encourage prompter payment:

(a) emergence of any arrears now automatically precludes continuation of a conditional lending agreement, or negotiations toward one;

(b) countries with significant arrears for more than six months will normally be formally prohibited from using Fund resources under Rule K, a slightly more formal version of (a);

(c) for particularly intractable cases, formal ineligibility under Article XXVI will be invoked.

These steps amount to successively stronger sanctions. So far only the first two of these have been necessary, with Vietnam, Guyana and Nicaragua being identified under Rule K. A number of other countries risk similar procedure unless repayments are made fairly soon. These include Tanzania, Sierra Leone and Sudan. Ineligibility procedures (c) are likely to be applied shortly to Guyana and Nicaragua.

17. In addition, consideration is to be given to:

(d) limited publicity for countries subject to ineligibility (c), with the inevitable consequence that most other sources of finance will automatically dry up; and

(e) penalty charges for countries with significant arrears.

18. It will also be necessary to put at least the worst arrears on a non-accruals basis in the Fund's accounts, requiring:

(f) increased provisioning in the Fund's reserves;

(g) higher IMF interest rates generally to compensate for lower income flows.

19. The trend is not yet near crisis proportions. The emphasis in the Fund's deliberations has rightly been on safeguarding the Fund's financial standing.

IMF Interest Rates

20. Since 1981, the interest rate on SDR holdings has been pitched at the average of Treasury bill rates in the G5 countries. Following an agreement in early 1984, the rate of remuneration, ie the interest rate paid on the IMF's use of its creditor members' currencies, is projected to rise to the same level by early 1986 provided that market interest rates do not rise too quickly. So far the rate has reached 90 per cent of the SDR rate. At end March 1985, the rates in force were:

SDR rate:	8.64 per cent
Rate of remuneration:	7.78 per cent.

Staff Pay

21. The 1984 pay review in the IMF (and IBRD) awarded increases of 5½ per cent, roughly in line with inflation. Together with the US, Germany and some others, we opposed. Comparability studies showed clearly that IMF staff were on average paid some 14 per cent more than people doing similar work elsewhere. Only core staff, ie those involved in the vital work of economic analysis and programme design, were not paid significantly more than their comparators.

22. A career streams exercise is now in progress to adjust pay scales to achieve more appropriate relativities. A study of the pay determination mechanism is also under way. It had been hoped that their results would be ready in time to inform the 1985 pay review, but their report is not expected until August. In the meantime Fund and Bank management may try to secure an interim pay award in line with the general comparability review, which suggests across the board increases of some 3 per cent (less than US inflation).

23. On executive directors' pay the 1984 outcome was more acceptable, with the 4½ per cent increase recommended by a 3-man commission (including Sir Douglas Wass) being narrowly rejected. The team is to reconvene again for 1985.

Once again we shall want to see that remuneration levels - some $80k taxfree - are not out of line with salaries for comparably responsible posts.

Forthcoming business

24. Over the next few months the IMF Board will need to consider the following issues:

- the compensatory financing facility (CFF), due for (partial) renewal in May. It would be sensible to make the criteria for eligibility more precise, as they, have recently allowed some loans subsequently found to be poorly justified;

- membership applications from Kiribati, Poland, and Tonga with decisions on quotas;

- the valuation method for the SDR, due for review in May. The appreciation of the dollar means that it now accounts for more than half of the value of the SDR unit. It would seem appropriate to remedy this, with some slight relief for developing countries whose repayments to the Fund are denominated in SDRs;

- (perhaps) the modalities for the relatively new technique of enhanced surveillance (see brief 3), which may be associated with MYRAs or unspontaneous new lending (see brief 5).

25. Among the conditional programmes for IMF member countries expected soon are the following (see also brief 13):

- (probably) a new one-year SBA programme for Brazil to replace the final year of the now broken-down EFF;
- a three-year EFF programme for Chile;

- a first programme for Mozambique, which joined the Fund last autumn;
- potentially, a one year SBA programme, giving a eighth year of support for Turkey;
- a one year SBA programme, giving a seventh consecutive year of support for Yugoslavia.

26. In addition, the IMF Board will need to begin enhanced Article IV surveillance procedures for Mexico, Venezuela, (probably) Ecuador and (possibly) Colombia (see brief 13).

Annex

Stand-By and Extended Arrangements in Effect as of February 28, 1985
(thousand SDRs)

Member	Date of Arrangement	Expiration	Amount Agreed	Undrawn Balance
Stand-By Arrangements				
Argentina	Dec. 28, 1984	Mar. 27, 1986	1,419,000	1,182,500
Belize	Dec. 3, 1984	Mar. 31, 1986	7,125	4,750
Central Afr. Rep.	Jul. 6, 1984	Jul. 5, 1985	15,000	7,000
Dominica	Jul. 18, 1984	Jul. 17, 1985	1,400	430
Gambia, The	Apr. 23, 1984	Jul. 22, 1985	12,830	10,200
Ghana	Aug. 27, 1984	Dec. 31, 1985	180,000	120,000
Haiti	Nov. 7, 1983	Sept. 30, 1985	60,000	39,000
Ivory Coast	Aug. 3, 1984	May 2, 1985	82,750	41,370
Jamaica	Jun. 22, 1984	Jun. 21, 1985	64,000	36,000
Kenya	Feb. 8, 1985	Feb. 7, 1986	85,200	55,400
Korea	Jul. 8, 1983	Mar. 31, 1985	575,775	—
Liberia	Dec. 7, 1984	Jun. 6, 1986	42,780	34,280
Madagascar	Apr. 10, 1984	Mar. 31, 1985	33,000	—
Mali	Dec. 9, 1983	May 31, 1985	40,500	6,500
Morocco	Sept. 16, 1983	Mar. 15, 1985	300,000	—
Niger	Dec. 5, 1984	Dec. 4, 1985	16,000	12,800
Peru	Apr. 26, 1984	Jul. 31, 1985	250,000	220,000
Philippines	Dec. 14, 1984	Jun. 13, 1986	615,000	530,000
Senegal	Jan. 16, 1985	Jul. 15, 1986	76,600	66,000
Somalia	Feb. 22, 1985	Feb. 21, 1986	22,100	22,100
Sudan	Jun. 25, 1984	Jun. 24, 1985	90,000	70,000
Togo	May 7, 1984	May 6, 1985	19,000	3,000
Turkey	Apr. 4, 1984	Apr. 3, 1985	225,000	56,250
Uruguay	Apr. 22, 1983	Apr. 21, 1985	378,000	226,800
Western Samoa	Jul. 9, 1984	Jul. 8, 1985	3,375	843
Yugoslavia	Apr. 18, 1984	Apr. 17, 1985	370,000	90,000
Zaïre	Dec. 27, 1983	Mar. 26, 1985	228,000	30,000
Zambia	Jul. 26, 1984	Apr. 30, 1986	225,000	145,000
			5,437,435	3,010,223
Extended Arrangements				
Brazil	Mar. 1, 1983	Feb. 28, 1986	4,239,375	1,496,250
Malawi	Sept. 19, 1983	Sept. 18, 1986	100,000	66,000
Mexico	Jan. 1, 1983	Dec. 31, 1985	3,410,625	1,203,745
			7,750,000	2,765,995
		Totals	13,187,435	5,776,218

SPRING MEETINGS OF INTERIM AND DEVELOPMENT COMMITTEES
17-19 APRIL 1985

BRIEF 12 : SUB-SAHARAN AFRICA
(including World Bank Special Facility)

Reference: IBRD - Sub-Saharan Africa - DC/85-7

A. Objectives

(a) To show constructive and sympathetic approach to exceptional problems of SSA.

B. Line to take

(a) Greatly disturbed by the scale and severity of the famine afflicting some of these countries, and by the signs that for them a food emergency will continue throughout 1985. Nevertheless, it is encouraging that some previously drought-striken countries are now receiving good rains.

(b) Apart from emergency aid which is essential at the present time, we can best assist by ensuring that we contribute to world economic recovery, to the growth of international trade, and to the reform programmes for longer-term development of these countries.

(c) The IMF and IBRD have our full support in their attempts to help countries to pursue policies of growth with stability through adjustment programmes. Close co-operation between the Bretton Woods institutions, and between them and African Governments, donors and creditors is essential if these programmes are to work and there is to be a sustained recovery.

(d) On the World Bank's Special Facility for Sub-Saharan Africa, welcome its successful launch.

C. Others' objectives

(i) IBRD/other Special Facility for Africa contributors: to criticise those countries, including UK, which refused to make a direct contribution and in the UK's case, to criticise the amount of aid which we are associating with the Facility (£75 m over 5 years).

(ii) SSA debtor countries: to seek more generous rescheduling terms, in some cases of short-term as well as medium term debt; possible demands for more multi-year reschedulings (see debt brief 5).

(iii) Some countries negotiating IMF programmes: to seek our help in negotiations with the Fund with a view to softening the extent and speed of adjustment measures.

D. Responses

(i) World Bank Special Facility: Regret that the UK aid budget could not accommodate a direct contribution. The UK is supporting the objectives by pledging up to £75 m in untied bilateral grant aid to be used in close support of the Facility.

(ii) Debt: must treat countries individually ie keep to case by case strategy.

(iii) Paris Club: We are prepared, as we have shown, to give sympathetic treatment to countries seeking rescheduling of their debts. We seek to preserve a flexible approach, with generous terms where necessary.

(iv) IMF programmes: sympathetic but impartial UK approach to adjustment measures.

General economic overview

Although the recovery in the industrialised countries is now spreading to developing countries, there is relatively little impact on the countries of Sub-Saharan Africa (SSA) where growth averaged only 1.5 per cent in 1984, though this masks wide variation. The World Bank believes SSA now faces "a catastrophe of unprecedented proportions" (para 1).

2. The underlying structural problems have been aggravated by drought which has reduced agricultural productions and necessitated greatly increased imports of food. The long-term problems are many; they include inappropriate agricultural pricing, poor marketing arrangements, inefficient parastatal monopolies, population growth outstripping economic growth, over-valued exchange rates and a general lack of effective management. To these must be added overreliance on relatively few primary commodities which makes these countries particularly vulnerable at times of low commodity prices.

3. For the medium term the position of many of these countries remains precarious. Economic growth is expected to be below the average of developing countries generally. With the high rate of population growth, the prospects

of any increase in per capita income for some countries remain extremely poor. There is no prospect of a miracle panacea in the shape of rapid increases in world market prices for the region's primary commodity exports and of dramatic terms of trade gains. It is critical to maintain the flows of imported inputs needed to maintain and operate existing assets, as well as to build up foreign exchange earning capacity. They are also necessary to ensure that the existing debt servicing burden does not preempt too great a proporption of resources.

4. Solutions will require sustained commitment by donors and sympathetic treatment by creditors, matched by genuine commitment to adjustment and policy and institutional reform by African countries themselves. The Bank notes international consensus:

> "all major donors basically agree on the diagnosis of African economic problems and on measures needed to address them." (para 10)

But:

> "The problems of a decade cannot be solved instantly. It will require the sustained efforts of African governments and donors to improve the productive environment, to recover from the impact of the drought, and to restore growth..... If we fail to focus on ..... basic development problems, we will fail to reap the benefits of the sacrifices involved in the stabilisation and adjustment programmes now being undertaken." (para 14).

5. The debt problems of Sub-Saharan Africa are not on the same scale, nor pose the same threat to world financial stability as those of Latin America (cf debt brief 3). However, they are, if anything, more intractable for the debtor countries themselves. The problems are notable not so much for their magnitude in global terms as for their number and the likely persistence of some of them. They are worsened because so much of the debt is owed to the multilateral institutions which cannot, and OPEC countries which will not, (in general) reschedule. In 1982 the IMF was owed 2.2 per cent of total SSA debt.

6. The 1970s also saw imprudent borrowing on non-concessional terms by African governments, much of it on the back of export credits. As elsewhere, the majority of debt problems started to appear towards the end of the decade following the oil shock, the recession and consequential terms of trade loss. This change in external economic circumstances, the failure to make prompt adjustment and

the effect of rising interest rates precipitated rescheduling and led to accumulation of arrears. Debts are high in relation to GDP, and the servicing of debt in the past few years has imposed an unsustainable burden on budgets and foreign exchange resources.

7. For commercial bank creditors, the amounts at risk are, by world standards, small but the debt burden is a matter of concern to multilateral agencies. With the notable exception of Nigeria, fourteen countries have rescheduled (some more than once) their official debt service payments at the Paris Club, while thirteen have rescheduled their commercial debt through the London Club. There are a further fourteen others with a very high debt service ratio (ie over 25 per cent).

8. In some countries, even after restructuring, debt service has remained unprecedently high in relation to exports of goods and services eg Zambia. The economic outlook gives grounds for some pessimism about the management of Sub-Saharan African debt and for a number of countries (eg Zambia, Zaire), rescheduling is expected to be necessary into the next decade. Most commodity prices for African countries are expected to remain considerably lower in real terms for the rest of the 1980's than in the 1970's. Increased export earnings must thus come from increasing existing export volumes and diversifying exports. Drought has materially affected the ability of some countries to service debts. However, on the positive side, there is now a greater awareness on the part of African governments of the need to adjust promptly to external checks and to adopt policies to encourage export promotion, whilst creditors have shown increasing flexibility in dealing with SSA debts.

IMF programmes

9. The IMF has shown a heavy commitment to Sub-Saharan Africa's adjustment efforts over the past few years. Some 40 per cent of these countries currently have Fund programmes and others are under negotiation. The Fund can certainly claim a measure of success in halting economic and financial decline by having secured some implementation of more realistic pricing policies including exchange rates, and of measures to curb budget and balance of payment current account deficits. And most African countries now seem prepared to acknowledge the Fund's advice.

10. For the IMF, the priority remains the correction of unsustainable external payments imbalances. Relatively long term assistance will be required to deal with the deep seated and intractable problems faced by some countries. The Fund's

lending policy requires it to ration loans to countries likely to need Fund support over a sustained period (see IMF brief 11). Heavy existing borrowing from the Fund therefore means that scope for significant further resource transfers is limited (eg Zambia, Zaire). So closing balance of payments financing gaps will increasingly require the Fund to employ a mixture of bullying, cajoling and bluff to persuade multilateral and bilateral creditors and donors to assume a reasonable share of the burden.

11. 1984 saw, in general, a rise in the terms of trade. More African countries are now committed to austerity programmes, though some, particularly anglophone countries (Uganda, Sudan, Gambia, Sierra Leone and Zimbabwe), have experienced more difficulty than others in maintaining a strict fiscal posture; this is despite substantial external assistance. Factors adding to their problems include peaking – debt service obligations (arising in part from the recent heavy use of IMF resources, the continuing strength of the US dollar, high interest rates, and the sharp decline in net capital flows where there is no debt rescheduling. For some countries (Tanzania, Nigeria) negotiations with the IMF have been protracted because of differences of view about the extent and speed of adjustment measures.

12. The exchange rate, particularly the scale and timing of devaluations, has long been an area of difficulty between the Fund and SSA countries. Recently certain currencies have successfully been floated (eg Zaire) and others have been flexibly adjusted (eg Ghana). Nigeria and Tanzania are now publicly the most reluctant to devalue. Achievement of fiscal and credit targets in Fund programmes is another testing area for SSA countries (in fact, the main area of programme breakdown, as happened in Zimbabwe last year). Despite the very real political and social difficulties involved, some countries (eg Zaire) have made sacrifices to implement adjustment measures. But there are others which have shown insufficient genuine commitment to tackling basic problems, such as (in the case of Senegal, for example) an overlarge and inefficient public sector.

13. Since 1981 the World Bank has produced three reports analysing the problems of Sub-Saharan Africa; a substantial measure of agreement between donors and recipients has now been reached on these.

14. The World Bank's paper (DC/85-7) takes the form of a progress report on the implementation of the Joint Programme of Action for Sub-Saharan Africa proposed in their most recent report "Toward Sustained Development in Sub-Saharan Africa", the conclusions of which were endorsed by the Development Committee last September.

There is now widespread consensus on the Bank's analysis amongst not only aid donors, but also the African nations themselves. The accent is on trade and price liberalisation; less Government interference in the economy, efficiency and accountability reforms in public expenditure and the public sector, and more judicious public expenditure planning.

15. It is the Bank which has sought to bring the continent's problems and the need for structural adjustment to the centre of international attention over the past year. Most notably this has involved the establishment of the Special Facility for Sub-Saharan Africa which was agreed in principle at a donors meeting in Paris in January. This multilateral fund has attracted contributions totalling \$1.2 bn which will offer quick-disbursing concessionary development finance to countries seen to be committed to genuine adjustment. The extra resources will be deployed in support of structural adjustment, sectoral policy reforms and rehabilitation projects.

16. The UK aid budget could not accommodate a direct contribution to the Facility without further significant cuts in bilateral aid. Instead, it was decided that bilateral aid of up to £15 m a year would be given in association with the 5 year programme, giving a total of £75 m. However, since we have waived the normal requirement that bilateral aid should be tied to UK procurement, British firms will have procurement access to the whole facility. Germany, Japan and Switzerland are similarly allocating bilateral aid, while other OECD countries are contributing some \$750 m directly. The US is completely outside the Special Facility and is taking separate action.

17. Meanwhile the Bank Group has altered the focus of its structural adjustment lending from economy-wide programmes to include less ambitious but more thorough-going sectoral rehabilitation and development credits.

18. There is now widespread recognition of the importance of aid co-ordination, and the need to give great weight to policy dialogue with African countries. Here the World Bank is taking on an increased role, as part of which new Consultative Groups are in the process of being formed. The Development Committee's Task Force on Concessional Flows which is not due to report until the autumn will be examining the effectiveness of some of these developments. The expected finding is that so far there has been more rhetoric than any real improvement in communication either between bilateral donors, or between donors and recipients.

19. The Bank's paper concludes that while progress has been encouraging, it will take sustained efforts by African governments and donors to put right the problems of a decade.

UK aid to Africa

20. For UK aid volume and policy, see Official Development Assistance. A substantial share of the British bilateral budget goes to African countries for longer-term development - over £200 m in 1983. The principal aim is to lay a sound foundation for future growth, with particular emphasis on manpower development, public administration, infrastructure and agriculture. Balance of payments assistance is focussed on countries which accept financial disciplines with sound development priorities. Policy reform should generally include agricultural revival, greater export orientation, improved public sector efficiency, more effective maintenance of capital resources, and attempts to tackle population growth.

21. In 1984-85 we provided over £100 m in emergency relief and food aid to help refugees and drought victims. Much of this was provided through international and voluntary agencies. In 1985-86 the UK expects to spend at least £60 m on emergency aid, of which at least half will be bilateral and the rest through the European Community.

22. Briefs on countries of UK interest in Sub-Saharan Africa follow:

Kenya
Sudan
Tanzania
Uganda
Zambia
Zimbabwe

KENYA

1. Kenya's fiscal and current account deficits have been successfully reduced to more sustainable levels with Fund help. But the economy continues to suffer from worrying structural imbalances. Recent progress has been undermined by the onset of widespread drought in 1984. Disagreement with the IBRD has not helped.

Relations with IMF

2. Kenya's latest IMF programme, a 1 year SBA for SDR 85m, was approved in principle in January on condition that the 1985 financing gap of SDR 93m was bridged. The Fund mismanaged the parallel finance, first acquiescing in a eurocurrency borrowing and then urging concessional finance because of Kenya's heavy debt burden. In the event the programme was activated in February; the financing gap was largely filled through a combination of increased donor support and improved BOP outturn. The problem was exacerbated by the Fund's policy disagreement with IBRD, which led to the World Bank's refusal to chair a donors' co-ordination meeting.

3. The programme aims to contain the adverse effects of the drought without undermining the basic strengths of the economy. It is hoped that rainfall in 1985 will be normal. If not, the 4% growth in GDP forecast for 1985 will not be attainable. The drought will inevitably continue to have significant financial implications throughout 1985, as the bulk of drought related grain imports will take place this year. The medium-term BOP outlook remains viable although further structural adjustment is needed.

UK aid and other creditors

4. Kenya has been unable to negotiate a third IBRD SAL because of policy disagreements between the IMF and World Bank. Kenya is the largest African recipient of UK aid, second only to India overall, £31 m in 1984-85, £30 m in 1985-86.

TANZANIA

1. The Tanzanian economy is characterised by serious BOP and fiscal imbalances, an inappropriate exchange rate and an unsustainable debt burden. Inadequate producer prices have led to a crisis in the agricultural sector, which provides some 70% of export earnings, threatening to halt economic development. Persistent current account and overall BOP deficits have been financed by increased external arrears ($450m in 1983). External debt now stands at $2.9b, with debt service pre-empting 75% of 1984 export earnings.

Relations with IMF

2. Despite desultory negotiations, there has been no Fund programme since 1980. There are signs (for instance the 1984 devaluation and proposals to increase producer prices) of growing rapprochement with the IMF. However many uncertainties remain and the most recent Fund mission to Tanzania in March ended without agreement. Nyerere's philosophical mistrust of the market orientated approach of the IMF leads him to reject Fund policies, though other Ministers are less intransigent. His successor, who will take power at the end of the year, may be willing to negotiate more seriously with the Fund.

Prospects

3. Given the imbalances in the Tanzanian economy, any Fund assistance must be based on strong adjustment measures to justify a relatively high level of access to Fund resources. A weak programme would leave a large, probably unbridgable, financing gap. Any programme will need generous donor and creditor support. Despite the potential for economic growth, Tanzania's long-term prospects are not good without several years of sustained structural adjustment.

UK aid

4. £15m in 1984/85; £11.5m in 1985/86, which would be increased to £16.5m if agreement is reached with the Fund.

SUDAN

Inevitably, following the coup of 6 April, there is now considerable uncertainty about Sudan's position. The demonstrations and general strike which preceded Nimeiri's downfall seem to have ceased but there remains the possibility of further unrest. Despite Sudan's perilous economic state, the new regime is giving priority to the internal political situation, including the transfer of power to a civilian government. At present there is no real indication of their attitude towards the IMF and economic reform; it is, however, believed that the new regime intends to maintain Nimeiri's pro-Western policies.

2. Sudan's economy remains in a perilous state despite a long series of Fund programmes and successive reschedulings. The main weaknesses have been Sudan's expansionary financial and monetary policies, poor producer incentives and heavy external borrowing, compounded by lack of political will to implement IMF adjustment measures and sudden ill-prepared institutional changes, eg Islamisation. External debt amounts to some $8b, including arrears of some $260m.

Relations with IMF

3. An IMF programme agreed only with great difficulty last May broke down within weeks. Arrears to the Fund are mounting (SDR 115m now) and a formal decision to prevent further borrowing from the Fund was taken under rule K. Sudan's arrears are serious enough to threaten the Fund's financial affairs, as they could exceed net income this year (see brief 11). Nevertheless, an IMF mission had concluded in March that planned economic measures, including fiscal and exchange rate action and price increases, justified a qualified endorsement of Sudan's policies. The Fund's Managing Director urged donors to provide urgent assistance in support, stressing that the outstanding arrears would have to be cleared before a new programme could begin.

4. The coup was apparently precipitated by measures taken

under this agreement, including devaluation resulting in increases in the price of bread and petroleum. But it reflected widespread dissatisfaction with the Nimeiri regime. It remains true that Sudan's best hope of attaining economic viability rests on agreeing a Fund programme of radical economic measures, although any monies disbursed under a new programme would be heavily outweighed by scheduled repayments due from previous programmes. Donors would then be under pressure to release aid sufficient, with debt relief to enable Sudan to clear its arrears to the Fund and underpin the programme. The gap could be some $400m.

5. The proposed meeting of Ministers on 18 April (UK to be represented by Sir Crispin Tickell) to appraise them personally of IMF-Sudan relations may now be replaced by a meeting between the Fund and Saudi Arabia. The IBRD's meeting of donors to Sudan, planned for the end of April, may be cancelled.

Debt rescheduling

6. Sudan has had 4 Paris Club reschedulings since 1979, under which the UK is owed £173m including arrears. No further official debt relief will be agreed until an IMF programme is in place. There have been several London Club reschedulings of other debt, and the banks are considering the terms of a further rescheduling.

Aid

7. Prior to the coup there was general agreement among G5 members that a firm line should be taken to link future aid to a Fund programme. As far as the UK is concerned, we still intend to continue with existing projects and programmes, totalling some £23m in 1985-86, but will not at present be pledging any new aid. The US has, however, already told the new regime that it will honour the promise made recently to Nimeiri to release $180m in aid for developmental purposes. It is not clear whether the link to adjustment will be maintained.

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FM UKDEL IMF/IBRD WASHINGTON 120045Z APR 85
TO IMMEDIATE F C O
TELEGRAM NUMBER 44 OF 11 APRIL
INFO KHARTOUM

IMF: MANAGING DIRECTOR'S MEETING ON SUDAN
ODA MODEV 57 OF 11 APRIL

1. THE MANAGING DIRECTOR'S OFFICE HAVE TOLD US THAT FORMALLY THE MEETING IS STILL ON, BUT THAT IT IS LIKELY TO BE CANCELLED AT LEAST IN ITS PRESENT FORM. (WE BELIEVE IT MAY BE RECONSTITUTED TO INVOLVE ONLY THE US AND THE SAUDIS). WE ARE ASKED NEVERTHELESS TO MAKE SURE THAT OUR REPRESENTATIVE IS STILL AVAILABLE UNTIL A FINAL DECISION IS TAKEN, PROBABLY AT THE BEGINNING OF NEXT WEEK. Sir C. Tickell

2. THE WORLD BANK NOW CONTINUE TO PREPARE FOR THE PLANNED DONORS' MEETING IN PARIS (SCHEDULED FOR 30 APRIL) BUT IT AGAIN SEEMS DOUBTFUL WHETHER THE MEETING WILL TAKE PLACE.

3. FCO PLEASE ADVANCE TO PS/CHANCELLOR, LAVELLE AND DIGGLE (HMT), PS/TICKELL AND COX (ODA), WARE (B O E) AND TAIT (ERD).

CLARK (ADVANCED AS REQUESTED)

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TO IMMEDIATE FCO

TELEGRAM NUMBER 35 OF 2 APRIL

AND TO PRIORITY KHARTOUM

TALK TO SIR C. TICKELL'S OFFICE

b/F 15/4 pl

IMF: SUDAN

SUMMARY

1. FUND MANAGING DIRECTOR (MD) COMMENDS SUDAN'S BOLD ECONOMIC MEASURES AND CALLS UPON DONORS TO PROVIDE URGENT ASSISTANCE AS A BASIS FOR SUDAN'S SETTLEMENT OF OUTSTANDING ARREARS TO THE FUND AND A NEW FUND PROGRAM.

DETAIL

2. THE MD REPORTED TODAY ON LATEST FUND DISCUSSIONS WITH SUDAN TO EXECUTIVE DIRECTORS REPRESENTING THE NORDIC, ITALIAN, SAUDI ARABIAN, FRENCH, UNITED STATES, CANADAN, JAPANESE, GERMAN, BELGIAN, DUTCH, LIBYAN AND UK CONSTITUENCIES. HE SAID THAT THE SUDANESE AUTHORITIES HAD NOW TAKEN ''BOLD AND COURAGEOUS'' MEASURES:

- A 48 PER CENT DEVALUATION, WITH RESULTING PRICE INCREASES OF 33 PER CENT FOR BREAD AND 60 PER CENT FOR PETROLEUM:
- AGREEMENT IN PRINCIPLE FOR PEGGING THE CURRENCY TO A BASKET SO THAT COMPETITIVENESS WOULD BE MAINTAINED:
- ALLOWING THE BANKS TO OPERATE WITHOUT INTERFERENCE IN THE FOREIGN EXCHANGE MARKETS:
- A CUT IN THE BUDGET DEFICIT FOR 1984/85 OF SOME 6 PER CENT OF GDP.

3. THESE PRIOR ACTIONS LAID THE BASIS FOR A NEW 1985 PROGRAM, PROVIDED THAT SUDAN SETTLED ITS OUTSTANDING ARREARS. THESE NOW AMOUNTED TO SDR 115 MILLION, WITH AN ADDITIONAL SDR 35 MILLION ACCRUING BY THE END OF THE YEAR. THE MD CONCLUDED BY SAYING THAT HIS MESSAGE TO DONOR GOVERNMENTS WAS THAT THE SUDANESE AUTHORITIES HAD DONE ALL THAT THE FUND HAD ASKED THEM TO, NOTHING MORE WAS FEASIBLE AT THIS TIME, AND THAT DONORS SHOULD NOW HELP SUDAN WITH THEIR FINANCIAL PROBLEMS.

4. SHAALAN (DIRECTOR, MIDDLE EASTERN DEPARTMENT) THEN PRODUCDED TABLES (BY FAX TO MRS. DIGGLE, TREASURY), SHOWING THAT EVEN AFTER CASH AND COMMODITY AND PROJECT AID OF DOLLARS 678 MILLION IN 1985, SUDAN WOULD HAVE A RESIDUAL FINANCING GAP OF DOLLARS 398 MILLION. THE DOLLARS 678 MILLION INCLUDED AN ASSUMED CONTRIBUTION OF DOLLARS 10 MILLION FROM THE UK WHICH, FUND STAFF EXPLAINED, REPRESENTED 80 PER CENT OF THE SUDANESE EXPECTATION OF DISBURSEMENTS IN 1985. NIMATALLA (SAUDI ARABIA) WONDERED WHETHER THE SAUDI CONTRIBUTION SHOULD BE NEARER DOLLARS 40 MILLION RATHER THAN DOLLARS 110 MILLION SHOWN IN THE TABLE. DALLARA (US) CONFIRMED PRESS REPORTS THAT THE US WOULD NOW DISBURSE SUMS HELD BACK FROM 1984 OF DOLLARS 40 MILLION FOR THE PETROLEUM FACILITY AND DOLLARS 27 MILLION FOR THE COMMODITY IMPORT PROGRAM. A FURTHER DOLLARS 40 MILLION FOR THE PETROLEUM FACILITY AND DOLLARS 70 MILLION FOR COMMODITIES WOULD BE AVAILABLE FOR 1985, IN CONJUNCTION WITH THE EFFORTS OF OTHER DONORS AND SATISFACTORY IMPLEMENTATION OF SUDAN'S ECONOMIC MEASURES (THOUGH CONTACTS WITH USAID SUGGESTED THAT THESE TWO CONDITIONS MIGHT, IN PRACTICE, NOT BE PRESSED). JAYCOX (VICE PRESIDENT, EASTERN AND

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/SOUTHERN

SOUTHERN AFRICA REGIONAL OFFICE, WORLD BANK) REPORTED THAT THE BANK PLANNED TO CALL A DONORS MEETING, PROBABLY IN PARIS, FOR APRIL 29, AS A ''GAP FILLING EXERCISE'', WITH A FULL CONSULTATIVE GROUP MEETING TOWARDS THE END OF 1985.

5. THE MD THEN SAID THAT HE HOPED THAT SUDAN COULD SETTLE THEIR ARREARS SO THAT THE FUND BOARD COULD AGREE A NEW PROGRAM IN JUNE. ENSUING DISCUSSIONS AMONG EDS DID NOT EXPLAIN WHERE THE REQUIRED SDR 150 MILLION WOULD COME FROM. NIMATALLAH INSISTED THAT THE SUDANESE SHOULD FIND SOME FOREIGN EXCHANGE THEMSELVES AND NOT RELY ENTIRELY ON DONORS. JAYCOX DOUBTED THAT THIS WAS POSSIBLE. DALLARA AND GROSCHE (GERMANY) WONDERED WHETHER AID DONORS COULD MOVE THIS QUICKLY. ONE POSSIBILITY MIGHT BE FOR THE SUDANESE TO BORROW FROM BANKS USING THE COTTON CROP AS SECURITY. THE MD AGREED THAT MEDIUM-TERM BALANCE OF PAYMENTS VIABILITY DEPENDED ON EXPLOITATION OF THE SOUTHERN OIL FIELDS, BUT HAD NO NEWS THAT THE SECURITY SITUATION WOULD PERMIT THAT.

6. THE MD THEN CONCLUDED THE MEETING BY URGING DONORS TO COME FORWARD QUICKLY IN RECOGNITION OF SUDAN'S BOLD STEPS. THIS WAS PROBABLY THE LAST POINT IN TIME FOR AN EARLY SETTLEMENT OF THE COUNTRY'S ARREARS TO THE FUND. HE PLANNED TO CALL A MEETING OF MINISTERS DURING THE SPRING MEETINGS TO APPRAISE THEM PERSONALLY OF THE SITUATION. THE MD'S OFFICE HAVE NOW TENTATIVELY SUGGESTED A BREAKFAST MEETING AT 08.15 ON THURSDAY, APRIL 18 (THE CHANCELLOR ALREADY HAS A MEETING AT 8.45 ON THAT MORNING WITH SECRETARY BAKER). GRATEFUL FOR ADVICE ON OUR REPLY.

COMMENT

7. THE MD'S TIMETABLE FOR APPROVAL OF A NEW FUND PROGRAM LOOKS VERY OPTIMISTIC. IT IS UNCLEAR TOO HOW DONOR AID CAN BE UNLOCKED SO QUICKLY AND HOW SUDAN CAN FIND THE MEANS TO SETTLE OVERDUE OBLIGATIONS. THE MD'S PRESENT APPROACH MAY WELL RESULT FROM UNITED STATES PRESSURE, BUT HE IS ALMOST CERTAINLY RIGHT IN MAINTAINING THAT THIS IS THE LAST TIME FOR AN EARLY SETTLEMENT OF THE ARREARS. DESPITE THE BOLDNESS OF THE MEASURES, SUDAN'S MEDIUM-TERM BALANCE OF PAYMENTS VIABILITY DEPENDS ON EXPLOITATION OF THE SOUTHERN OIL DEPOSITS, AND A NEW FUND PROGRAM WOULD BE DIFFICULT TO JUSTIFY, ON NORMAL CRITERIA, WITHOUT SOME ASSURANCE THERE. IN ANY EVENT, A PROGRAM SHOULD BE ON A NET REPURCHASE BASIS.

8. FCO PLEASE ADVANCE TO BUIST (ODA), DIGGLE (TREASURY), GILCHRIST (BANK OF ENGLAND), AND TAIT (ERD).

WICKS

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UGANDA

1. After a decade of continuous deterioration, Uganda's economy began to improve after 1981 with Fund help. Real GDP growth revived and the BOP position improved. Since mid-1983 though fiscal performance has deteriorated, causing inflation and the current account to worsen. No early agreement on a new IMF programme is in sight.

Relations with IMF

2. A 1 year SBA for SDR 95m, approved in September 1983, broke down in June 1984 with the final tranche of SDR 30m outstanding. The end of June targets for total domestic credit were exceeded as the government resorted to unprogrammed domestic borrowing from the public enterprise sector. Discussions have begun on a replacement programme but with elections due in Uganda later this year, agreement will not be easily reached, particularly on fiscal and monetary policies.

3. A new programme should concentrate on correcting the severe fiscal imbalances, containing inflationary pressures, sustaining external adjustment and strengthening the productive sectors of the economy, particularly agriculture. Such measures will be difficult to negotiate, but unless a programme is agreed soon, any progress achieved so far will fast evaporate.

Developments

4. Uganda's economic position is increasingly fragile. The relatively favourable current account position achieved in 1984 is forecast to deteriorate over the medium-term. Since the breakdown of the Fund programme, fiscal and monetary policy has been relaxed further, for instance public sector wages have been increased fourfold, with serious consequences for inflation (300% and rising). The weakness in the economic outlook is worrying as Uganda needs to generate substantial BOP surpluses over the next few years to repay the IMF, eliminate arrears and strengthen reserves. IBRD collaboration with the Fund in the adjustment and rehabilitation process is thus essential.

UK aid

5. £6 m in 1984/85; rising to £7.5 m in 1985/86.

ZAMBIA

1. Zambia's poor economic performance has been characterised in recent years by an acute shortage of foreign exchange and an excessive role for the public sector. The economy remains over-reliant on copper exports (over 90% of export earnings) and is burdened by a chronic level of debt service, which will require rescheduling into the foreseeable future. The political commitment to adjustment has not been sufficiently strong and the earlier decision to finance the balance of payments deficit through import reductions and the accumulation of arrears has exacerbated an already difficult situation. On the domestic side, aggregate demand remains at an artificially high level, sustained through excess misapplied deficit spending.

Relations with IMF

2. Zambia's 21 month SBA of SDR 225m agreed in July 1984 recently broke down after SDR 80m had been drawn. The first review at end-September 1984 required a waiver of the performance criterion relating to external arrears; other criteria have since been breached. Rather than resuscitate the programme, discussions are concentrating on a new SBA, including a major reform of the exchange rate system, with a large devaluation to make copper exports competitive.

3. Zambia's high level of debt to the IMF suggests that any new programme will involve net repayments to the Fund. Rapid agreement with the Fund is nonetheless critical to creditor confidence and donor support. It is hoped that a new programme can be agreed by mid 1985. Despite the need for long-term IMF support, rapid stabilisation in the short-term will be the pre-requisite, leading to medium term structural adjustment. Exceptional complementary support from creditors and donors is likely to be neccessary.

Rescheduling

4. Zambia has defaulted on its 1984 Paris Club rescheduling obligations and has asked for re-negotiation. An agreement rescheduling bank debt falling due 1983-86 was signed in January this year, but implementation is conditional upon a Fund programme being in place. The authorities are actively considering schemes to eliminate the pipeline of commercial arrears, estimated at over $600m. Meantime arrears continue to mount, eg on oil imports.

UK aid

5. £15 million in 1984-85, split equally between capital, programme and TC.

ZIMBABWE

1. An initial burst of growth after independence in 1980 was stemmed by 3 years of drought, depressed world commodity prices, and shortage of foreign exchange; by 1984 Zimbabwe's real output was only 3% above 1980 levels. The drought has now ended and prospects are good for a bumper grain harvest in 1985 and a return to self-sufficiency in May. Nevertheless, Zimbabwe badly needs to reach early agreement on a Fund programme, given a heavy short-term debt service burden (around 30% of export earnings in 1985/87) and the underlying weak balance of payments. Agreement seems politically impossible before the elections in June.

Relations with IMF

2. Sporadic discussions on a new programme have taken place, following the suspension of Zimbabwe's last SBA in March 1984. The breakdown was precipitated by the introduction of exchange controls on current transactions (including remittances to expatriates living in the UK) and the publication of a mini Budget to finance additional public expenditure from the banking system. The Fund and authorities have reached broad agreement on most of the measures of a new programme, but Ministers wish to delay decisions until the elections.

3. The programme is expected to concentrate on fiscal adjustment, with the aim of reducing the budget deficit to a sustainable level through real reductions in expenditure on subsidies and on some social programmes, (education and health expenditure have risen rapidly). Exchange rate reform may also feature, to correct any appreciation of the Zimbabwe dollar, particularly against the rand.

Prospects

4. Domestic prospects are poor. A rapid expansion of the public sector to meet post independence expectations and the consequent large budget deficit (about 10% of GDP in 1984/85) have led to rapid money supply growth. Inflationary pressures have been exacerbated by the authorities' decision to impose strict import controls. The high budget deficit will inevitably constrain growth and investment prospects. While the economy has good long-term prospects, deregulation and liberalisation are needed to remove bottlenecks to growth.

UK aid

5. The UK has pledged £113m aid since independence; UK aid totalled £14m in 1984/85, and will rise to £18m in 1985/86.

726/3

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INTERIM AND DEVELOPMENT COMMITTEES

17-19 APRIL 1985

BRIEF 13: PROBLEM COUNTRIES

This is a background brief, comprising summaries of the key economic and financial facts on:

Argentina
Brazil
Chile
Colombia
Israel
Mexico
Nigeria
Peru
Philippines
Poland
South Africa
Turkey
Venezuela
Yugoslavia

There is also a list of external debt owed by sovereign debtors, together with ECGD exposures.

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INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1984	End-June 1984	End-Dec 1984 [2]	End-Dec 1984 [3]
Latin America				
Argentina	48	2.5	0.2	0.3
Brazil	100	6.6 (0.5)	0.7	1.7
Chile	19	1.3	–	0.1
Colombia	12	0.7	–	0.2
Ecuador	7	0.6	0.1	0.1
Mexico	95	6.2 (0.6)	0.5	1.2
Peru	14	0.4	0.1	0.1
Venezuela	35	2.3	–	–
Eastern Europe (convertible currency)				
East Germany	13	0.6	0.1	0.1
Hungary	8.5	0.5	–	0.1
Poland	27	0.5	1.0	1.1
Romania	8	0.3	0.2	0.4
Yugoslavia	19	0.9	0.7	1.1
Southern Europe				
Greece	12	1.5	0.2	0.4
Portugal	15	1.3	0.2	0.3
Spain	41**	2.8 (1.0)	0.1	0.1
Far East				
Indonesia	35	0.9	0.7	1.4
Philippines	26	1.3	0.2	0.2
South Korea	43	2.7 (0.7)	0.4	0.7
Africa				
Morocco	13*	0.1	0.1	0.2
Nigeria	21*	1.2	1.5	3.0
South Africa	24	4.9	0.6	2.9
Sudan	8*	–	0.1	0.2
Other				
Israel	30**	0.6	0.1	0.1
Turkey	20	0.3	0.2	0.3

[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] Defined as unrescheduled principal disbursed, plus political claims paid and claims under examination.

[3] Defined as guaranteed principal and contractual interest, plus political claims paid and claims under examination.

* Estimates for end-December 1984 ** End-June 1984

ARGENTINA

Argentina arguably now faces the severest challenge of any of the big debtors. The young civilian government may feel constrained in implementing austerity policies by democratic pressures. Although the trade balance has improved, inflation continues to escalate and the IMF programme has broken down after a single drawing. Argentina's self sufficiency in food and energy gives grounds for concern about potential default. External debt is the third biggest at $48 bn, 65% gdp.

IMF programme

2. The Alfonsin government, which came to power in December 1983, initially resisted an approach to the IMF but was forced into a more realistic stance by the gravity of Argentina's problems. Generous IMF loans worth SDR 1.7 bn were agreed at end 1984. The parallel commercial package included $4.2 bn of new money for 1985, rescheduling of $16.6 bn of public and private sector maturities falling due between 1982 and 1985 and maintenance of short-term credit lines. Shortly afterwards the Paris Club agreed on rescheduling of official debt (including that owed to the UK).

3. The economic programme underwriting all this is very ambitious. It envisages a sharp drop in inflation from 700% (September 1984) to 150% by end 1985, with a halving of the public sector deficit to 5% gdp, reinforced by tax increases, cuts in capital spending and a tighter wage policy. Taken with the active exchange rate policy introduced last September, (under which the real effective rate dropped 14% in Q4 1984), these policies should go a good way toward correcting Argentina's economic problems. The political will to implement them has always been uncertain.

Relations with the banks

4. The SDR ¾ bn drawn from the IMF in January was used to repay a $0.5 bn bridge lent by the US Treasury in December. Along with a $100 m loan from Mexico, this had been used to reduce commercial bank arrears so as to persuade US regulators to upgrade loans to Argentina from the substandard classification applied in November and to encourage commercial bank commitments to the $4.2 bn package of new money. But this is still short of some $50 m of commitments.

Latest developments

5. The IMF programme has already broken down. Despite emergency price controls, inflation accelerated to 804% at end February, the performance criteria for the next IMF drawing have been widely missed. Real wage increases of 6% last year were not allowed for when the 1985 budget was drawn up and it is not clear how far the budget

can be achieved. It is possible that recent supplementary tax measures may allow the IMF programme to be renegotiated, or perhaps replaced. That would permit the banking package to proceed. If further bridging finance is needed, the US and Mexico have privately made it clear that they will not lend further interim support in the absence of an agreed programme.

6. The recent reshuffle of economic and financial portfolios is expected to bolster the administration's resolve to persist with adjustment, though the replacement of the highly respected Garcia Vasquez by the lightweight Alfredo Concepcion as President of the Central Bank initially caused consternation in banking circles. Bernardo Grinspun and Juan Sourrouille have switched jobs to become respectively Planning and Economy Ministers.

BRAZIL

Despite the largest international debt burden of $100 bn (44% gdp), Brazil has achieved a rapid turnaround in external trade under two years of IMF support. But serious doubts about the sustainability of adjustment have recently emerged as domestic imbalances, including inflation, continue intractable. The IMF programme has consequently been interrupted, causing negotiations on the commercial bank MYRAs to be suspended. The new civilian government may be able to get adjustment back on track within a few months, but the continuing serious illness of the President elect Tancredo Neves is not encouraging.

The IMF programme

2. Brazil typifies our worries, apparently shared by Fund management, about programme design. Import compression, helped by import substitution (eg for oil), together with a highly successful export drive, have pushed the trade surplus up to a $13 bn in 1984, ($1 bn in 1982). Exports were buoyed by US import demand and real growth surged to 4%. Yet, inflation remains chronically high, rising from 180% at end 1983 to 210% at end 1984. The escalating monetary base (up 244% in 1984 cf target of 95%) suggests an accelerating trend, reflecting both inadequate fiscal control (significant real public expenditure cuts in early 1984 were not enough to offset soaring debt service costs) and unexpectedly rapid reserves growth directly caused by the recovery of the external account. The trade surplus itself is now faltering, (18% down on 1984 in Q1 1985), reinforcing doubt about the sustainability of the adjustment effort.

3. The persistence of inflation prevented the March IMF drawing (SDR 374m). There have been two previous very significant waivers of the performance criteria of this 3 year programme, which expires in February 1986. The electoral process has effectively forestalled corrective action for several months. The sensible and moderate new team seems aware of the urgency of remedial action, though the weak political base of the acting President Sarney may prevent radical reform. The new finance minister Dornelles has already introduced tough measures, including a 10% cut in public spending. Even so, it is unlikely that the IMF programme's status can be clarified before May. One option then may be to replace the EFF by a shorter (1 year?) SBA.

Rescheduling

4. The banks' Advisory Committee was close to agreement on a MYRA covering $45 bn due between 1985-91 when the news about the EFF broke in February. The Paris Club was expected to be willing to reschedule official debt in parallel - this would have been the first official MYRA. Further progress on both reschedulings will have to wait for agreement with the IMF. In the meantime, and with the support of the IMF Managing Director, the Advisory Committee has agreed to extend trade credits ($10 bn) and interbank lines ($6 bn) to 31 May. Further rollover may be necessary if the Fund programme cannot be swiftly revived. Rumours of the need for further unspontaneous loans of up to $3.5bn could complicate the negotiations.

Chile suffers from twin problems of high debt ($19 bn or 88% gdp) and heavy dependence on a single commodity, copper. The military government is persisting with adjustment. A new Fund programme should begin shortly.

Relations with the IMF

2. A one year standby arrangement (SBA) was completed successfully in January. Gdp was up 5.9% in 1984, though the trade performance was less vigorous than expected (a surplus of $0.35 bn cf target of $1 bn) because of declining world copper prices. In consequence, and also because of high interest rates, the current account deficit worsened to $2.1bn (10% gdp).

3. Deteriorating prospects in the second half of the year led to a September package, including a 19% devaluation, an increase in import tariffs to 35% and public expenditure cuts. With the replacement of the somewhat liberal finance minister Escobar by the economically more conservative Hernan Buchi in February, this paved the way for agreement in principle on a three year programme under the extended fund facility (EFF) for SDR 0.75 bn. Preconditional actions have included reducing import tariffs and relying instead on a further 8% devaluation coupled with a tighter monetary policy. The earthquake in March has already caused the fiscal target to be relaxed from 3% to 3.5% gdp (cf 4.7% in 1984). The Fund believes undue fiscal tightening would be counter productive as Chile's problems cannot be attributed to weak control of public finance. Because of the weak copper price, no rapid external improvement can be expected. Formal agreement in the Fund Board is expected shortly: Fund management are waiting for adequate parallel finance.

Other sources of finance

4. Meanwhile, negotiations with the commercial banks, have just begun. Chile has requested a one-year rescheduling, and $1.1bn of new money. The commercial banks are reluctant to offer more than $800 m of new money. Chile has applied for an SAL from the IBRD to develop non-traditional exports, and has suggested a scheme to convert debt into equity. Emergency loans from IBRD and IADB have also been arranged to help finance a $100 m earthquake relief programme. The authorities continue to rule out any rescheduling agreement with official creditors, though a bilateral approach to the US is possible. Substantial further loans in 1986 and 1987 are likely to be necessary.

COLOMBIA

Like Venezuela, Colombia is attempting to cope with debt difficulties without a formal IMF programme, relying on a mostly good track record to 1982 as well as recently discovered oil and coal resources. Despite attempts at controlling the cocaine industry, the black market narcotics trade clearly contributes significantly to activity and government revenue. Banks' reluctance to finance such a strategy may in the end force Colombia toward a full IMF programme. External debt amounts to $12 bn (23% gdp).

Recent economic developments

2. Some external progress was achieved in 1984, with a reduced trade deficit ($1/3 bn cf $1.3 bn in 1983) and modest recovery in activity to 3% growth, partly on the back of a 49% increase in foreign investment. But inflation has risen (20% in February), progress on reducing the fiscal deficit has been slow and the peso remains uncompetitive. Recent fiscal and monetary corrective measures seem appropriate.

Relations with the IMF

3. Colombia's Article IV consultation was recently brought forward as an aid to commercial negotiations. Given broad IMF endorsement of their policies, Colombia (with US support) is now pressing the Fund for enhanced surveillance (see brief 3) as an alternative to an IMF programme. So far the IMF Board's response has been cautious. Many details remain to be resolved.

Debt

4. Negotiations on a new money package worth $500m, but without rescheduling, are well advanced. So far agreement has been reached on maintaining short term credit lines but the banks are insisting on an IMF programme if substantial new money is to be involved. Discussions are to resume on 16 April.

5. In the meantime there have been some encouraging signs. An $80 bn IADB cofinanced loan was oversubscribed and several Colombian banks have persuaded their foreign bank creditors to convert short term lines into medium term loans.

ISRAEL

Israel's widening current account deficit, falling reserves and spiralling inflation led to general decline in confidence in economic management by the time of the last election in July. Measures taken by the Peres Government and the counter-inflationary package deals with the unions and manufacturers have restored a degree of domestic confidence and stability. The position remains fragile. Little progress has been made towards implementing the necessary longer-term structural adjustments, in part due to opposition to increased unemployment.

Relations with the IMF

2. Political sensitivity in the IMF (including Saudi Arabia's potential concern) has prevented recourse to the IMF despite very large external debt, equivalent to some 130% of gdp. US willingness to supply capital has so far not provoked serious consideration of this option, but further aid could be conditional on the implementation of further austerity measures, possibly a formal Fund programme. The IMF would undoubtedly require severe fiscal measures, and probably further depreciation of the shekel.

External position

3. Despite some improvement in the deficit on goods and services ($4.9 bn in 1984, $5.1 bn in 1983) due to strong export performance, Israel's external solvency remains dependent on US and other aid. A continuing decline in the level of foreign exchange reserves (from $2.8 bn at end-November 1984 to $2.2 bn at end-February 1985) prompted a request for supplementary US economic aid for US fiscal 1985 - as yet no decision has been made. Israel's external debt totalled $29.9 bn at end-September 1984.

MEXICO

Mexico's $95 bn international debt (61% gdp) became unsustainable in 1982 as s result of an overvalued exchange rate and lax fiscal policy. Adjustment under a Fund programme agreed in late 1982 has been very good, though it has now shown domestic weakness. The first stage of a commercial bank MYRA has now been put in place.

Relations with the IMF

2. The first two years of the EFF have accomplished remarkable external improvement. A record current account surplus of $5.5 bn in 1983 was followed by a surplus of around $4 bn in 1984. This has allowed rapid rebuilding of reserves, which now stand at over $8 bn. Within a trade surplus last year of $12.3 bn, imports were up by nearly 40% and non-oil exports by nearly 30%. To maintain the impetus of non-oil exports, the daily rate of depreciation of the peso was accelerated in December and again in March, to reach a rate equivalent to 38% in a full year. After real effective appreciation of some 30% over 1983-84, the real rate may still be increasing.

3. On the domestic front, performance has recently been less successful after a dramatic reduction in the fiscal deficit in 1983. The public sector deficit overshot the Fund's target for 1984 of 5½% gdp by ¾ percentage point; and the rate of inflation, which had been projected to slow to 40% by December (from 81% at end-1983), was a disappointing 59%. This reflected some monetary relaxation. But gdp growth resumed after two years of contraction.

4. The 1985 budget is projected more generously than the Fund wants, with a deficit of 5.1% gdp as against the EFF's target of 3½%. However, spending cuts of $1.3 bn in February, more than accommodating the oil price cut, together with a privatisation campaign encompassing 235 state owned companies, now seem set to reduce the deficit to 4.1% gdp. Taken with the pledge not to increase real wages (down by a third since 1979), the Fund seems prepared to accept this.

Commercial banks

5. The first phase of a MYRA covering over $48 bn of public sector debt, agreed in principle last September, was signed in March. It includes restructuring of $19.8 bn due between 1985 and 1990, $23.6 bn of previously rescheduled debt, and $5 bn of new money (advanced in 1983). The IMF have agreed to underpin the process by twice yearly enhanced Article IV surveillance, making reports available to banks (see briefs 3 and 5).

NIGERIA

Line to take

(a) Bilaterally: encourage agreement with the IMF on an economic programme including devaluation, competitive internal pricing structures for petroleum products and agriculture, and tariff reform.

(b) With other creditors: hold fast to principle that rescheduling of insured arrears can only be reached multilaterally following agreement on a Fund programme.

(c) IMF negotiations: no question of UK's (sympathetic) impartiality. Nigeria must negotiate bilaterally.

Background

Because of the abrupt weakening of world demand for oil, Nigeria slipped into substantial current account deficits during 1981-1983, financed by drawing down reserves and accumulating trade arrears. Buhari's military government, which took power in early 1984, has had some limited success in turning the economy around by dint of more stringent and effective implementation of the austerity programme first initiated in 1982. Internally, the budget deficit was halved to some $4 bn and externally a small surplus on current account was probably achieved. But compression of imports essential to industry has caused widespread disruption in manufacturing, whose 1984 output may have fallen to 30% of capacity. Employment fell and the rate of inflation rose to over 50% last year, as shortages of imported goods pushed up their prices.

2. Nigeria's present policy mix, relying on import controls, contrasts sharply with the Fund's preferred course, devaluation. This would more efficiently ration scarce imports and so set the right price signals for non-oil exports and industries using domestic materials. But in fact, because of domestic inflation, the real exchange rate for the naira rose over 50% in 1984, to a level 150% above its 1980 value.

External debt

3. Although medium and long term debt of some $14 bn has continued to be serviced satisfactorily, Nigeria has outstanding arrears on short term debt of some $6 bn, including an estimated $2½ bn of officially insured arrears. ECGD expect to meet claims on insured debt to UK exporters of some £450 m in 1984/85 and 1985/86. Agreement on a formal rescheduling of insured arrears on the lines of that reached with uninsured creditors in April 1984 is held up pending agreement between Nigeria and the IMF on a programme. Though the Fund endorsed some aspects of Nigeria's existing austerity measures at the routine Article IV consultation in January, there was no sign of compromise over the further necessary adjustment measures, notably devaluation, which the government judge political suicide. The current strengthening in the oil market (however temporary) may encourage Nigeria to manage without IMF assistance.

PERU

Adjustment is stalled at least until elections in May, which the present government expects to lose. Arrears are accumulating. Further rescheduling will be necessary on external debt of $14 bn. (77% gdp).

Relations with the IMF

2. After a hesitant start, the SDR ¼ bn SBA agreed last April broke down very quickly, preventing implementation of agreements reached with the commercial banks and Paris Club. The government has refused to take unpopular remedial measures because of the elections. The programme is now irrecoverably off track: the 1984 fiscal deficit surged to 10% gdp (cf target of 4.1%), and inflation has reached 100%.

3. Early in 1985, the new Economy Minister, Garrido Lecca, introduced a limited package of austerity measures. It includes revenue measures worth 1% gdp in the next six months, spending cuts of 1.6% gdp and faster depreciation. The Fund will require stronger measures still for a programme. Firm political management will be necessary. If the opposition Apra party wins the elections, negotiations threaten to be very difficult.

Debt

4. The deterioration in the public sector balance was partly financed by building up arrears to foreign creditors. These had reached $200 m on commercial bank debt by January, when pressure from the IMF and banks forced an agreement on limited debt servicing so as to keep arrears within the 180 day threshold, which is important for US banks and US bank regulators. This has not been achieved though some $76 m of payments persuaded the banks to agree to roll over maturities due in mid January to mid March. Provided payments on account continue, the banks seem prepared to continue this lenient treatment until the new government takes power in July.

5. Delays in servicing official debt have recently emerged. The Paris Club will probably be satisfied with payments of interest only for the time being, expecting to reschedule formally, on the strength of an IMF programme, later in the year. Barter contracts with the USSR, reportedly worth up to $200m, may help bridge the gap until then.

The Philippines' persistent adjustment difficulties derive from over-expansionary policies and inefficient management. External debt now stands at $25 bn (73% gdp). The latest of a long line of IMF programmes has just run into trouble. President Marcos' (perhaps terminal) illness may exacerbate policy irresolution.

Relations with the IMF

2. After the Aquino assassination and banking crisis of 1983, it took a long time to negotiate the necessary austerity programme with the IMF, partly becasue the extent of the crisis was initially understated. The SBA for SDR 615 m agreed in December was predicated on substantial prior action including both demand management measures and structural reforms. This helped overcome scepticism about the Marcos' government's political commitment to reform.

3. So far only a single drawing under the SBA has been made. Restoration of external confidence caused the end December monetary target to be overshot because of remittance inflows not offset by sufficient sales of government debt. It is not clear whether the end March criteria were met. However, inflation is turning out better than expected - already down to 40% from its 70% peak in October. The external account has been stabilised by import restraint, including oil substitution, but at the cost of restricting inputs for domestic industries. As a result real GNP fell 6% in 1984. Meantime the peso is floating upwards, despite a little help from intervention. It may be possible to get the programme back on track, but further challenges undoubtedly lie ahead, not least political ones.

Other creditors

4. Agreement has been reached in principle to reschedule $5.9 bn of commercial debt and in the Paris Club $1 bn of principal and interest. Despite the lukewarm response of non-US banks, the banks are to maintain a revolving trade facility of $3 bn and interbank lines, together with $925 m of new money. There are no arrangements yet for the rescheduling of private sector debt. These deals could be jeopardised if the IMF programme is not resuscitated soon. A 90 day moratorium on debt service was recently declared.

Prospects

5. Whilst the 1986 external payments gap can probably be covered by official credit, gross inflow requirements of $2.2 bn pa for 1987-88 may require $700 m pa of commercial bank funding. Thus further rescheduling and/or involuntary new lending looks inevitable. External confidence may not be regained until the end of the decade, or later if non-traditional exports fail to take off. Lack of access to foreign capital will severely constrain investment and it is difficult to see private domestic savings rising to meet the envisaged gap. Major structural reform will be necessary if the overly protected industrial infrastructure is to make a sustainable contribution to restoring the external account.

POLAND

Line to take

(a) IMF membership: support application to rejoin Fund provided Poland prepared to comply with responsibilities of membership (eg data). Borrowing from Fund will depend on willingness to undertake adjustment.

(b) Paris Club rescheduling: no question of new credits until 1982-84 rescheduling agreement signed and track record established.

Background

After rapid growth in the 1970s on the back of heavy foreign borrowing, Poland's debt became unsustainable in 1980 as short term bank credit was cut. Official export credit was suspended when martial law was imposed in December 1981. The US embargoed Poland's IMF application and official debt rescheduling negotiations were broken off. With a debt/export ratio of over 5, Poland faces one of the heaviest debt burdens.

2. After three years of sharp decline, the economy showed some growth in 1983 and 1984, although Net Material Product is still 20% below 1979 levels and the dollar value of imports is about half the 1979-80 average. The trade balance improved from a deficit of $2.2 bn in 1979 to a surplus of $1.5 bn in 1984. (Polish data showing a growing current account surplus neglect substantial arrears of unpaid interest). The scope for a further increase in the trade surplus seems limited given the ageing capital stock, the demoralised workforce, and the poor prospects for coal exports.

Relations with the IMF

3. Poland's application has been revived on the dropping of US opposition because of more liberal political developments. The aim of membership by the annual meetings in October seems possible. Poland's main motive for joining is to qualify for Fund credit, unlocking other sources of finance. It is unlikely that a Fund programme could be in place before late 1986. Polish expectations of the scale of Fund lending will need to be deflated.

Debt

4. Western sanctions in 1982 led to interruption of payments due to Western governments. Negotiations were resumed in late 1983, and in November 1984 agreement was reached in principle on a generous rescheduling of 1982-84 arrears of principal and interest, and on bringing up to date arrears under the 1981 agreement, the net effect of which would require limited payments to Western governments. Progress since

t[illegible] has been slow because of Polish demands for substantial new credits. This is out of the question until the latest agreement is signed - and even then such credits would almost certainly be minimal. Other governments, including Germany, are taking a similar line, despite recent press reports. The next Paris Club meeting is scheduled for 26 April.

5. Western banks have negotiated four rescheduling agreements since 1981, the last of which, for 1984-87, virtually completed the rescheduling of the original stock of debt. The banks have not rescheduled any interest payments as such, but have provided new money as 6-month revolving credits amounting to some $800 m. A little cautious spontaneous lending has resumed.

Outlook

6. Overall, the prospects are bleak. Poland is still in current account deficit, and the economy's structural problems give little hope for rapid improvement. Poland is unlikely to be able to meet debt service due under current rescheduling agreements (including the 1982-84 Agreement with Western Governments) without the provision of new credits, and it is far from clear where these could come from.

SOUTH AFRICA

Poor fiscal and monetary control, coupled with the decline in the gold price, caused South Africa's economic performance to deteriorate again after a gentle rally in the year to mid 1984. Drought forced maize imports. Confidence has been further shaken by resistance to apartheid, both domestic and international. Debt amounts to 30% gdp.

Recent economic performance

2. South Africa's economy has traditionally followed a counter cyclical path because of its gold resources. The current account swung sharply into deficit in Q4 1983 and the rand depreciated rapidly in July 1984. Immediate interest rate action has been bolstered by the recent budget, which tightened the fiscal deficit (projected at 2.2% gdp cf 3.2% in 1984-85). With a small current account surplus Q4 1984, the situation has now stabilised, though inflation (now 16%) could rise a little further.

3. However, the external position continues weak. The 1984 gold price averaged the lowest level ($360/oz) since 1979 while depreciation of the rand has increased the cost of debt service. The weak current account surplus seems sustainable in the short term: the lower level of domestic activity has reduced import demand while this year's maize crop is likely to meet domestic requirements.

Debt

4. South Africa's external debt burden worsened rapidly (by $5½ bn) to finance the 1981 and 1982 current account deficits. Since then an unhealthy dependence on short term borrowing has developed. There are as yet no indications of unwillingness to roll over the debt, though the brutal events in the Eastern Cape could provoke punitive action.

Prospects

5. Beyond 1985 the balance of payments position will depend heavily on the behaviour of the gold price and on the extent to which the expected pick-up in the level of economic activity results in a higher import bill. Surges in the monetary aggregates (M3 up by 20% in 1984) may indicate inflationary pressures. Over the medium and long term South Africa could face substantial fiscal demands as the government faces increased expenditure because of the new constitution and the need to improve the conditions of the black majority; in any case the international community may be under increasing pressures to withhold loans on political grounds. It is very unlikely that South Africa could borrow from the IMF again given US legislation effectively preventing US support.

TURKEY

Despite seven years of IMF programmes and three major debt reschedulings (1978-80), Turkey's economic situation is still weak. The new civilian Government which took office in November 1983 is attempting to introduce a more open and market-oriented economy, but has neglected straightforward demand management. Another IMF programme is being negotiated and further rescheduling cannot be ruled out. External debt amounts to $20 bn (36% gdp).

Relations with the IMF

2. Turkey has had Fund support continuously since 1978. After some progress on reducing inflation, public sector borrowing and the current account deficit 1980-82, but with poor commitment to structural reform, the adjustment effort faltered in 1983. Recently the Ozal government has concentrated on external liberalisation, privatisation and deregulation. These policies have had only limited success so far given relatively lax fiscal and monetary policies. The high growth strategy (gdp up 5.7% in 1984), combined with deregulation has fuelled inflation (50% in 1984) and import growth, leaving the trade deficit unchanged despite a 24% increase in exports.

3. The current SBA expires in early April. If Turkey is willing to accept tough fiscal and monetary policies, another could be in place by about mid June. Because of Turkey's already heavy borrowing from the Fund, it is likely to involve very little (if any) net transfer of resources.

External position

4. On a revised presentation, the balance of payments was in current account deficit of $1.4bn in 1984, a drop of $0.4bn on outturn for 1983, although there was no improvement on the former presentation. Turkish projections suggest a deficit of some $1bn in 1985 on the new basis. Taking into account medium and long-term debt maturities of over $2 bn a year, the annual financing requirement is likely to exceed $3 bn for some years ahead - together with rolling over short-term obligations, currently estimated at $4 bn and growing at $1 bn a year.

5. The heavy prospective financing requirement reflects expiry of grace periods from previous reschedulings. Maintenance of creditor confidence will be crucial. Although both banks and export credit agencies have resumed spontaneous lending, their attitude remains cautious. Unless the external position is strengthened, another round of rescheduling and/or unspontaneous new credit cannot be ruled out.

VENEZUELA

With substantial oil-derived reserves, Venezuela is trying to weather debt servicing problems without a Fund programme. A commercial bank MYRA is to be underwritten by enhanced Fund surveillance. External debt amounts to $35 bn (41% gdp).

Recent economic performance

2. After two years of expansion, both monetary and fiscal policy were tight during 1984, the latter scoring a 7% public sector surplus (cf 4% deficit in 1983). On the external side, the trade account surplus increased to $8.7 bn ($8 bn in 1983), with the current account surplus at $3.8 bn ($3.6 bn in 1983). The $0.5 pb oil price cut agreed with OPEC in February should reduce the projected $1.9 bn current account surplus for 1985 to perhaps $1.7 bn. Substantial public expenditure cuts are intended to neutralise its fiscal impact. Austerity measures continue to be introduced, eg the recent cuts in food subsidies.

Debt

3. The banks agreed on a MYRA provisionally last September. It covers $22 bn of public sector debt due over 1983-88. Progress on finalising the deal has been hindered by accumulation of more than $1 bn private sector interest arrears. Delay in finalising a registration scheme could hold up full agreement on the MYRA until mid year. The first Article IV enhanced surveillance review to underpin the MYRA (see brief 3) is due shortly.

4. The Paris Club is concerned about arrears of some $800-900 m of private sector debt owed to official creditors. It is intended that unrescheduled Paris Club debt will be registered in the same way as bank debt and thus enjoy a preferential (ie government subsidised) exchange rate for debt service.

NB. See Line to Take on P.2. You may be approached by unhappy Yugoslavs. Rud 8/4

YUGOSLAVIA

After five years of IMF support and two debt reschedulings, Yugoslavia has made some progress towards external equilibrium, though structural reform has been less thorough than desirable, partly because of the fragmented political system. The prospective financing gaps are still wide. Further reschedulings for 1986-88 seem inevitable. A new Fund programme should be approved in late April. Convertible currency external debt amounts to $19 bn.

Relations with the IMF

2. Yugoslavia has been operating under IMF programmes almost continuously since May 1979. The pace of adjustment has been slow. Much structural change is still required. The removal of subsidies has lifted inflation back to over 60%, jeopardising the positive real interest rate target. Despite further falls in real earnings and gross fixed investment (down 8% last year), real gross social product grew by 2.1% in 1984, with industrial output rising by 5.5%, largely through stockbuilding and increased exports. Further modest expansion is planned for 1985 (GSP up 3%, industrial production up 4%), but inflation is still likely to be in the 40-50% range by the year-end.

3. IMF staff are sceptical of the value of further Fund support but are negotiating another SBA to start shortly after the present one expires in mid April. Because Yugoslavia already has substantial debt to the Fund, net transfer of resources is likely to be minimal.

External position

4. Yugoslavia exceeded the Fund's target current account surplus in 1984 ($0.8 bn cf $0.5 bn) and hopes to achieve about $1 bn a year from now on. Nevertheless financing gaps of some $3 bn a year are likely 1985-88, with only limited scope for refinancing to help bridge them. Therefore it is imperative Yugoslavia takes measures to boost confidence and encourage spontaneous capital inflows.

Debt

5. Yugoslavia is trying to negotiate a commercial bank MYRAs for 1985-88, intending to guarantee creditworthiness after 1985 by enhanced surveillance rather than further Fund programmes. Relief is sought on principal only, with no new money element. The banks may be willing to agree on rescheduling of two years initially with two annual reschedulings thereafter (ie 2+1+1). Official creditors have agreed to reschedule for 1985 with a goodwill clause for subsequent years.* This could be linked to enhanced surveillance from 1986 rather than a Fund programme.

* See attached note on Yugoslavia's dissatisfaction with this

YUGOSLAVIA : DEBT RESCHEDULING

Background

Last month the Paris Club agreed terms rescheduling Yugoslavia's debt. The terms were generous (90% of principal due, over 9 years with 4 years grace) but only covered maturities due up to May 1986 (when the new SBA will expire). The Yugoslavs wanted a MYRA covering 1984-88. But the agreement contained only a "goodwill" clause, undertaking to consider rescheduling of future years' maturities but without commitment to the terms.

2. The Yugoslavs have complained publicly and privately about their creditors' failure to give them a MYRA, claiming to have been led to expect better. They affect to believe there is political malevolence behind this.

3. In fact during months of contacts before the Paris Club, the Yugoslavs were told plainly not to expect more than they were ultimately offered. We also made it quite clear that the rejection of a MYRA was solely a financial/economic judgement and had no political overtones.

4. You may however be lobbied in Washington by either Klemencic (Federal Secretary for Finance), Makic (Governor of National Bank) or Ajanovic (Assitance Federal Secretary responsible for Economic Relations).

Line to take

(i) Pleased Paris Club reached a successful agreement.

(ii) Believe the terms are generous to Yugoslavia and take account of both her achievements and prospects.

(iii) No political content in decision not to offer a MYRA.

(iv) Collective decision of all the creditors, not just UK.

(v) Does not mean future years' debt will not be rescheduled. Agreement contains clauses recognising that this is likely to be needed, in the context of Yugoslavia's medium term economic programme, which the UK strongly supports.

(vi) But before deciding the terms of any future rescheduling, important to see how the needed reforms in the Yugoslav economy progress.

(vii) Nothing sinister about this; purely a financial judgement.

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CONFIDENTIAL

INTERIM AND DEVELOPMENT COMMITTEES

17-19 APRIL 1985

BRIEF 14 : COMMONWEALTH COUNTRIES

This is a background brief, summarising recent economic developments and the IMF's relations with certain Commonwealth countries.

Guyana

India

Jamaica

Sri Lanka

GUYANA

1. The Guyanese economy is in crisis, due to a combination of gross economic mismanagement, low world sugar prices, weak bauxite demand, and widespread gold smuggling. President Forbes Burnham has retained power largely through patronage, but as the country moves slowly towards a subsistence economy opposition is growing, even within his own party and the security forces. Lack of a Fund programme has led him to flirt with Eastern Bloc countries for financial assistance, with little success. Without a determined effort at adjustment, prospects for Guyana are bleak.

Relations with IMF

2. Guyana has been in arrears with the IMF for two years (now around SDR 20m). Unless they are eliminated by 15 May, (unlikely) it is expected that Guyana will be declared ineligible to use Fund finance and could subsequently face expulsion. Discussions on a possible Fund programme have taken place intermittently. The Guyanese reject the Fund's prescriptions (reducing the public sector deficit, devaluation and rehabilitating the main export industries) on the grounds that the changes would be too drastic, and the harshness of the measures would not be matched by the funds made available. The present size of the black market, (estimated at over 50 per cent of GDP), primarily from gold smuggling, would hinder the success of any programme.

Recent developments

3. The current account deficit was 37% of GNP last year. The Guyanese dollar remains overvalued despite recent devaluations. Fiscal policy is in total disarray; the PSBR was over 60 per cent of GNP last year, and the 1985 Budget forecasts a broadly similar deficit for this year.

UK aid

4. Guyana has been in default on aid loan repayments for some time, and now owes UK £9.3m. £3.3m of existing loans remains uncommitted and the aid programme suspended pending agreement with the IMF.

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INDIA

1. Rajiv Gandhi has inherited a reasonably strong economic position 4% growth in 1984/85, inflation falling to 5% pa and a current account deficit of only 1.6% of GNP. Substantial adjustment is required in many areas though to improve growth and exports if India's medium term debt service burden is not to become too heavy.

Relations with IMF

2. India cancelled a 3 year Extended Fund Facility (EFF) for SDR 5bn in 1984 with SDR 1.1bn undrawn, largely for political reasons in an election year. Significant structural adjustment is still required, particularly to correct the large fiscal deficit and poor export performance, and improve competitiveness.

Economic performance

3. The fiscal deficit is likely to remain at 10% of GDP in 1985/86. There is considerable room for fiscal reform curbing the black economy, and reducing states' and government corporations' deficits.

4. Although there has been considerable export diversification exports still account for only 5% of GNP. India has been losing market share and improved competitiveness is necessary to keep to the 20% maximum debt service ratio target desired by the authorities and maintain a reasonable (5%) rate of economic growth. IMF projections show that to meet this target, either imports must grow by only 3% pa (difficult if industry is to expand) or export volume by 7% pa (implying a 2% increase in market share).

5. Gandhi is responding to the overwhelming mandate for change in last year's national elections. A series of measures are in hand or under consideration, to open up the economy to foreign competition, revitalise the nationalised industries and liberalise the banking system. These should help remove the structural bottlenecks to faster growth.

6. India has taken some 30% of the IBRD group's annual lending, but this should decline in future as economic prosperity improves, and China has greater access to the IDA funds. Accordingly, India has approached the ADB (but met US opposition) and expressed interest in gaining access to EIB funds (unlikely). India is largest recipient of UK aid, £135m in 1984/85.

JAMAICA

1. Despite nearly continuous Fund support since 1977, Jamaica is far from external viability. The present SBA is in danger of breaking down, partly because of exogenous factors, and negotiations on a successor will be extremely difficult.

Relations with IMF

2. An ambitious 1 year SBA for SDR 67m was agreed last June to diversify the economy and tackle the fiscal and BOP imbalances from past economic mismanagement; if completed, Jamaica will be the heaviest debtor to the Fund (use of credit 376% of quota). The SBA's objectives include halving the PSBR to 7½%, an improvement of some $200m in net reserves, and elimination of arrears. The programme has run into difficulties over the arrears targets, partly due to delays in disbursing external loans, though it always looked very optimistic. Another programme is expected to follow when the present one expires in June. The formidable fiscal problems and the high level of Fund support will hinder negotiations.

Recent Developments

3. A recent major setback occurred in the bauxite industry, the major foreign exchange earner. Alcoa and Alpart are to close their Jamaican operations about a year after Reynolds took a similar step, and Alcan is threatening to leave unless relief is granted from the bauxite levy. A waiver is expected shortly for the current SBA, but the forecast 25% fall in government revenue in 1985-86 and loss of some $200m foreign exchange earnings will pose serious challenges for a successor programme. A financing gap of some $60-80m is likely to emerge requiring exceptional donor assistance. In the meantime a 50 day moratorium has been declared, and further rescheduling (possibly involving a MYRA) has been requested. A donors' conference, chaired by the IBRD, is planned for late May.

Prospects

4. Prospects for Jamaica are poor. Inflation has accelerated to 35% and unemployment is around 27%. A further fall in GDP is in prospect this year. Structural diversification is essential to medium term viability. Dependence on the US, already heavy at $170m a year, may have to increase in the short term. Seaga's popularity is beginning to wane; he has ruled out any prospect of early elections (due by 1988) despite growing pressure from the Socialist PNP Party.

UK aid

5. £21.5m committed since 1980; latest £2.5m loan agreed in October 1984; 1985/86 aid will be £4m including carryover from last year.

SRI LANKA

1. Structural problems continue to plague Sri Lanka: growing budgetary deficits, rising inflation and a mounting debt service burden. However the BOP has improved, (surplus $260m this year) because of higher tea prices caused by India's partial ban. The long-term future will be bleak should tea prices decline. No Fund programme is currently in prospect.

Relations with the IMF

2. Poor performance in implementing a series of IMF programmes has led to an uneasy relationship with the Fund. The last SBA was halted in 1984 after the authorities failed to agree to the proposed performance criteria for the second half of the programme. Since then high tea prices have reduced BOP pressure, enabling Sri Lanka to manage without Fund support. Intermittent discussion has continued on a new SBA but the authorities, preoccupied with their internal political strife, have not yet adopted a comprehensive macro-economic programme which could be supported by the IMF.

Economic performance

3. Ability to postpone adjustment continues to depend on high revenues from tea, so that the sharp fall in prices in early 1985, although in part seasonal, is worrying. The suppression of indigenous Tamil insurgency in the North continues to disrupt tourism (worth $150m pa before the troubles) and fishing, and given the failure of recent political initiatives will continue to be an economic depressant for some time. The growth in mainly concessional debt to $3b gives cause for concern, with the debt service ratio rising from around 10% in 1979 to 22% in 1983.

Aid

4. Sri Lanka's aid inflows have remained buoyant and they are reportedly the largest per capita aid recipients in the world. $580m was pledged in 1983/84, 11% more than the previous year, meeting about a quarter of Sri Lanka's current account deficit. UK bilateral aid will total £15m in 1984/85. After final disbursement of aid for the Victoria Dam project in 1985/86, this will revert to more normal levels of £8-10m pa.