PO-CH/NL/0326 PT A

Part A.

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Begins: 14/3/86.
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PART A

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PART A

Chancellor's (Lawson) Papers:

INITIATIVES FOR RELIEVING INTERNATIONAL DEBT IN AFRICA

DD's: 25 Years

[signature]

1/11/95.

2569/26

From: P MOUNTFIELD
Date: 14 March 1986

CHANCELLOR

You may be appearing before the TCSC on 26 March. EST?
D 17/3

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Lavelle
Mr Fitchew
Mrs Case
Mr Pitcairn

Yr PSC n

NIGERIAN DEBT

The Nigerian Finance Minister may be in London on 26 March. Would you be willing to see him then?

2. Background. A Nigerian team is scheduled to visit London just before Easter, for talks with the banks. As you know, Warburgs represent Nigeria in London. Barclays have been given the mandate to organise an international negotiation committee of banks. The talks will be exploratory. There is no question of an immediate settlement.

3. Similar preparatory talks are going on among government creditors. The Nigerians have been invited to a Paris Club meeting in the week of 14 April. We have made it clear, however, that we are not prepared to reach any agreement until an IMF programme is in place.

4. The Nigerian team was originally to have been led by the Permanent Secretary, Ministry of Finance (Bello) and the Governor of the Central Bank (Ahmed). But I have just heard from Warburgs that the Minister (Ojunkwo) may be coming as well.

5. If he does, I very much hope you will be prepared to see him, however briefly. As you know there are divided councils in Nigeria about the advisability of devaluing and accepting the IMF terms. The officials we talk to are all more or less converted. The job is to persuade the politicians (and the military). A high level message from you, preferably delivered personally, would be useful. If you cannot manage it yourself, perhaps the Economic Secretary could: or perhaps you could authorise Sir Geoffrey Littler and me to convey your own personal message.

PM

P MOUNTFIELD

SAVINGRAM

BY BAG

FROM UKDEL IMF/IBRD WASHINGTON 261430

RESTRICTED

TO FCO SAVINGRAM NO 55 OF 26 FEBRUARY 1987

1 Chancellor
Bijorn [?]
Low [?] the
Article IV discussion
post-Budget.
2. PS [?] inform
Mr Clarke's
PS of X,
as I am
sure he
would be
pleased to
know.

IMF: UK - 1986 ARTICLE IV CONSULTATION

Summary

See my telno 51. (below – you have seen)

Detail

2. On 24 February the Executive Board completed the Article IV consultation which had been delayed by one day due to the closure of the Fund on 23 February because of a major winter storm. Before the meeting, I circulated Buff 87/27. A copy of the Deputy MD's summing up is attached.

Individual Interventions

3. Masse (Canada etc.) opened the discussion. Like virtually every other speaker he started by applauding the overall achievements resulting from our policies in terms of fostering renewed growth and reducing inflation. Nonetheless, he noted some concerns. Domestic investment was weak. The monetary situation was difficult to interpret. While he could understand the eclectic approach taken to monetary management, wage and price pressures and the rapid growth of credit were somewhat worrying. He was unsure whether monetary policy was really tight enough. M0 had accelerated and although real short-term interest rates appeared high, this might partly reflect higher inflationary expectations. There appeared to be little room for any easing of monetary policy at present.

4. On fiscal policy, he stressed the importance of continuing to reduce the PSBR. The PSBR adjusted for asset sales and the non-permanent component of oil revenues was the appropriate indicator. The fiscal stance should be tightened in 1987/88. Only the permanent component of the currently buoyant revenues should be used to reduce tax rates.

5. Further improvements in the competitiveness of the non-oil sector were needed. In this light, any upward pressures on the exchange rate should be resisted; instead, reserves should be built up. Depreciation however would

/NOT

not be advisable as it would be likely to feed through to the domestic price level. In general, wage pressures should not be validated by the exchange rate. Rapid wage growth at a time of higher unemployment was puzzling and might be due to the segmented nature of the labour market where the long-term unemployed had little influence on wage bargaining. He commended the Restart programme and suggested that a thorough-going reform of the rented housing sector was required. He commended the UK's commitment to free trade.

6. Ploix (France) noted that the economy's performance had improved but that important structural rigidities remained. 1986 had been a good year but there were signs that the economy might be overheating. There was no room for fiscal relaxation. Rapid wage growth was a source of concern and, in the light of the authorities' decision to eschew wage controls, public sector pay policy must set an example.

7. Monetary policy appeared to be broadly appropriate given the present uncertainties. Nonetheless, domestic liquidity was high and the balance of payments weakening. It was essential to control domestic costs. The process of medium-term fiscal consolidation must continue and it was important that there were no further slippages in expenditure control.

8. Ismael (Indonesia etc.) thought that 1986 had been a satisfactory year apart from the continuing high level of unemployment. Policies generally appeared appropriate although he had some reservations particularly concerning the monetary stance. He felt that the rapid growth of sterling M3 was an important sign that monetary policy was too loose. The underlying PSBR was also still too high and arguably there were signs that the economy was overheating. Now was not the time for tax reductions and greater expenditure control efforts were required. Structural policies in the labour market were in the right direction but tighter control of public sector pay was needed. Excessive social security benefits seemed to explain part of our high unemployment. He suggested that in future the Article IV should take place after the budget and that the staff this year should circulate a note on the budget measures as soon as they were announced.

9. Kafka (Brazil etc.) was worried about the rapid growth of wages. Further structural reform measures in the labour market were needed particularly in the area of housing policy. He understood the difficulties of controlling local authority expenditure but stressed the importance nonetheless of taking resolute measures in this area. The current uncertanties concerning monetary policy were an area of concern. The UK's commitment to open trade was good although our aid performance was disappointing.

10. Sliper (New Zealand etc.) was worried about the rapid rate of domestic demand growth. Any available fiscal adjustment should be used to reduce the PSBR. Monetary policy was not tight enough at present and he was concerned about the rapid rate of cost increases. Continued resolve on expenditure control particularly in the field of public sector wages was essential. The UK's commitment to reforming the CAP was very welcome.

11. Grosche (Germany) felt that generally policies had been in the right direction. Unemployment remained high and the rapid rate of wage increase was surprising but appropriate measures were being taken. He was concerned about the strong growth of sterling M3 and the perception that monetary targetting was being abandoned. Reduced exchange rate volatility would help the private sector and joining the ERM would enhance the authorities' credibility. He suggested that the fiscal position should be tightened in 1987/88 and greater efforts made to control expenditure growth. Only the permanent component of recent revenue increases should be used to reduce tax rates.

12. Ortiz (Mexico etc.) asked to what extent the recent falls in unemployment reflected people being taken off the unemployment register by administrative and other changes. He noted recent press reports which suggested that there had been eighteen changes in the way the unemployment figures were calculated since 1979 and that seventeen of these had had the effect of reducing the unemployment count.

13. He noted what he saw as the difficulties fiscal adjustment had encountered in the UK. By implication, he suggested that it was not surprising that adjustment efforts faced similar difficulties in the ldcs.

He noted that the underlying PSBR had not been reduced all that much and that expenditure had proved difficult to reduce - a common problem in many countries. He noted that the UK had moved away from what he described as the "monetarist dogma" of earlier years. It was, in his opinion, a pity that this had not happened before. The main lesson that he drew from the existence of hysteresis was that governments should seek to avoid sharp fluctuations in output. In this light, he thought that it was now clear that policies in most of the major industrialised countries had been too tight in the early 1980s. He commended the UK's commitment to free trade.

14. Yamazaki (Japan) spoke at length but made few substantive points. He accepted that an incomes policy would probably not be effective but thought that it was therefore important to keep demand policies tight. There were signs that the economy was heating up. Social security benefit levels should be reviewed. The rapid growth of credit was a source of concern as was the weakening of the balance of payments. A persistent weakening of the current account should be avoided. Greater efforts to control expenditure and to reduce the PSBR were needed. He expressed approval for the recent US/UK agreement on banking supervision.

15. Salehkhou (Iran etc.) saw the higher level of unemployment as resulting from structural problems. Further efforts to improve the flexibility of the labour market were thus required and he commended the concept of profit sharing. Joining the EMS would help to improve confidence. Fiscal targets could be more ambitious. The UK had substantial trade restrictions of varying sorts which were damaging to the interests of the ldcs. In this connection, the Exchange and Trade Relations Department should have been represented on the Fund's mission. ODA was too low.

16. Mawakani (Francophone Africa) noted that unemployment remained high due to structural factors. Regional pay settlements would be helpful. He welcomed the apparent undershooting of the PSBR this year and thought the target for next year should be reduced. The UK should join the EMS. ODA remained too low.

/17.

17. Posthumus (Netherlands etc.) felt that more needed to be done on the fiscal front. The monetary situation was a slight cause for concern and there was no scope for relaxation at present - indeed a tightening might be in order. Any further appreciation of the exchange rate should be resisted. ODA was too low.

18. Nimatallah (Saudi Arabia) thought that policies were basically on the right track. He approved in particular of using the nominal framework to set policies. More generally the UK and other industrialised countries should recognise that high unemployment rates were not going to go away on their own and should seek to impose more far-reaching measures aimed at tackling this problem in conjunction with the social partners.

19. Zecchini (Italy etc.) stressed the need to reduce the PSBR. Nonetheless, he saw the recent increases in planned local spending as being helpful as they should lead to higher capital expenditure which he felt had been reduced excessively in recent years. The growth of sterling M3 in itself was not a major source of concern but monetary conditions generally were worrying in the light of trends in unit labour costs and house prices. Reform of the rental housing market was needed to increase mobility. Profit-sharing was helpful and should be supplemented with an incomes policy. The UK should join the ERM.

20. Sengupta (India etc.) thought that 1986 had been a fairly favourable year. Nonetheless, GDP growth had somewhat undershot earlier expectations and had mainly come from consumption rather than investment. Private investment growth needed to be strengthened. In this connection, the apparent slowdown in productivity growth and pressures on profitability from the high cost of capital were worrying. The existence of a strong trade union movement should be welcomed. An incomes policy could play a useful role in reducing wage pressures.

21. Interpreting monetary conditions had been difficult and he wondered how long financial innovation would continue. He speculated that targetting M0 alone might be sufficient. Non-tariff barriers were too high and were to the detriment of the ldcs. ODA had apparently increased

/SOMEWHAT

somewhat but needed to rise further. The Article IV discussion should have been held after the budget.

22. De Groote (Belgium etc.) reiterated suggestions made in previous years by Polak (the retired Dutch Director) that the UK should have invested some of the proceeds of North-Sea oil in offshore accounts. Credit ceilings were needed. The PSBR should be reduced. Tax reform to reduce higher marginal tax rates was required but this should not be at an overall revenue cost. Joining the ERM would help to improve confidence. The ERM had coped well with the sort of pressures that the UK felt made its participation inappropriate. Interest rates were high but there was little scope at present for reducing them. The current unemployment problem was far different from that experienced in the 30s and needed to be tackled by wage restraint. The public sector had an important leading role here. The recent Paris accord, in his opinion, reflected a recognition by the UK of the need for stable exchange rates and was thus a step towards joining the ERM.

23. Jiang (China) stressed the need for structural reforms to tackle unemployment. Regional pay settlements would be useful. He was concerned about the apparent decline in the manufacturing sector. ODA should be increased.

24. Lundstrom (Nordics) noted that inflation was still relatively high and that the gap between the UK and the other major countries had widened. Real interest rates appeared to be high but this might reflect inflationary expectations. Developments in the labour market suggested that the natural rate of unemployment was not much below current unemployment levels and this was concerning. The existence of hysteresis underlined the importance of avoiding demand shocks and continuing to pursue structural reform efforts. Further efforts to reduce the PSBR over the coming years were needed. Unit labour costs needed to be reduced. He asked about the UK's attitude to the EMS following the Paris Agreement. A non-accommodating exchange rate policy continued to be important. ODA should be increased.

25. Bush (US) endorsed the broad approach of the MTFS. This had helped to foster steady growth although the rate had declined somewhat in 1986. The

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economy appeared at present to be near the natural rate of unemployment and this underlined the importance of constructing a more specific plan to tackle the problem of unemployment. This should include more far-reaching structural measures including reform of the rental housing market, greater flexibility of pay settlements and granting tax incentives for profit sharing agreements. Recent increases in planned expenditure were disappointing and greater efforts were needed. Serious consideration should be given to a tax reform package to reduce the high marginal rates facing many individuals. Current revenue buoyancy suggested that the supply side effects of the recent corporate tax reforms had been larger than had initially been expected.

26. She was not overly concerned about the rapid growth of M3. The current level of the exchange rate appeared appropriate but wage growth needed to be restrained. Too much confidence should not be put in the large stock of external assets as these could be run down quickly. The recent efforts to deregulate the financial markets were welcome as was the privatisation programme. The UK's positive attitude to trade liberalisation was commendable.

27. Donoso (Chile etc.) thought that policies should aim to maintain a current account surplus. This implied reducing the PSBR by using any available fiscal adjustment. Monetary policies appeared to be broadly appropriate. The UK should continue to push for reform of the CAP.

28. Archibong (Anglophone Africa) welcomed the measures being taken to tackle the serious problem of structural rigidities. Asset sales should be excluded from the definition of the PSBR used for monitoring purposes. The UK's trade record was good but the aid performance left something to be desired.

Staff Replies

29. De Fontenay (Division Chief, European Department) explained that although the economy had grown at a rate of about 3% for a prolonged period, the staff continued to believe that productive potential was about 2%. The faster growth, in their opinion, stemmed largely from the catch up from the severe recession following the second oil price shock.

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He noted suggestions that the Article IV discussion should be held after the budget and said that the staff would consider this although they would be reluctant to move the timing of the Article IV mission itself as they felt the traditional timing fitted in well with the budget cycle. The staff would circulate a note on the budget measures.

30. On labour market issues, he agreed with Ortiz that the changes in the unemployment definitions over recent years had substantially reduced the unemployment count. Conditions in the labour market did seem to have tightened however and there was continuing evidence of a shortage of skilled workers. On monetary policy, he noted that there were some signs of looseness. Nonetheless, real interest rates were very high and the yield curve broadly flat which suggested that inflationary expectations had not risen sharply. The Big Bang and the effects of privatisation had both increased credit demand. The latest monetary figures suggested that monetary growth might now be slowing in response to the increases in interest rates in the latter part of 1986. In the light of the current weakness of investment, it seemed appropriate that fiscal rather than monetary policy should be tightened. M0 had tracked developments well but had suffered from the disadvantage that few in the city had confidence in it. Relying on M0 also threatened to give the impression that the authorities were indifferent about the growth of credit.

31. On fiscal policy, he noted recent developments suggested that revenue had been very buoyant although in the staff's view this was largely a cyclical phenomenon. In underlying terms, there had been some tightening of fiscal policy this year but on current plans that was likely to be reversed in the coming year. He found it difficult to estimate whether the real exchange rate had fallen sufficiently to ensure medium-term balance of payments viability but in any case he thought that the exchange rate should not be allowed to rise again. Ideally competitiveness should be improved by reducing costs. The issue arose however as to what to do should this not prove possible. The staff were of the view that in these circumstances some further fall in the nominal exchange rate would be inevitable.

32. Replying to the discussion, I noted that most Directors had broadly approved the current stance of policies. The prospects for continued

 /STEADY

steady and more broadly based growth in 1987 appeared good. The outlook for manufacturing output and for investment was better and non-oil exports had picked up strongly in the second half of 1986. We were more optimistic than the staff about the outlook for the balance of payments in 1987 but in any case the very substantial accumulation of net overseas assets provided some room for manoeuvre.

33. We had allowed the exchange rate to fall in response to the drop in oil prices but believed that it was not appropriate to allow any further significant depreciation at present. Further depreciation was unnecessary and would pose unacceptable risks for inflation. We had continued to keep the question of membership of the ERM under close review. In some ways, the arguments for membership had strengthened. But we had still concluded that now was not the appropriate time to join.

34. On monetary policy, I said that we had no intention of abandoning monetary targetting. M0 had been a reliable indicator and we had made considerable efforts to convince the financial markets of this. I did not think that credit ceilings could have a useful role to play as they would run counter to the liberalisation being undertaken in the financial markets. On the whole, we believed that the overall stance of monetary policy had been right.

35. Some Directors felt that the underlying progress in reducing the PSBR had not been sufficient but they ought to bear in mind that both in adjusted and non-adjusted terms the PSBR GDP ratio had been reduced substantially in recent years, and the fiscal out-turn for 1986/87 was likely to be well within the Budget estimates. We were committed to making further progress in strengthening the fiscal position over the medium-term. Public expenditure had inevitably proved difficult to contain but it was important not to underestimate what had been achieved. The growth of expenditure had slowed sharply over the past 4 years compared with the 1970s. The government would continue to maintain tight control over public sector salaries but, here again, it was important to recognise that public sector wages growth had been significantly below that in the private sector in recent years. We were committed to making further progress in reducing marginal tax rates.

36. We were continuing with our efforts to strengthen the performance of the labour market and were seeking to convince others of the importance of regional wage settlements and of the potential benefits of profit-sharing. An incomes policy was most unlikely to work: it had been tried in the past and failed. I noted that high unemployment was in part the counterpart of the strong productivity growth of recent yeras. (After a slowdown in late 1985, the latter had picked up again in 1986). But employment had risen substantially since 1983 and unemployment had also now begun to fall. We had made various alterations to the unemployment count but we believed that these had helped to achieve a more accurate measure of the real unemployment situation. In this connection, I pointed out that - contrary to what was said in the Staff Report - only a very small number of those not turning up for Restart interviews had been taken off the register.

37. On trade policy, I noted our commitment to free trade and to reforming the CAP.

X 38. Finally, I said that we would be at least willing to consider changing the timing of the Article IV discussion but that we would not want to move the timing of the staff mission as this fitted in well with the timing of our preparation for the budget.

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ATTACHMENT

The Acting Chairman's Summing Up at the Conclusion of the 1986 Article IV Consultation with the United Kingdom
Executive Board Meeting 87/32 - February 24, 1987

Executive Directors commended the U.K. authorities for achieving over a period of years a marked reduction of inflation and a prolonged economic recovery. They reiterated their support for the Medium-Term Financial Strategy (MTFS), which had helped secure a deceleration in nominal GDP growth, and welcomed the improvements in efficiency and productivity in the economy as a whole. Directors noted that prospects were favorable for an extension of the economic recovery, that corporate profits continued to improve, and that private investment was forecast to become more buoyant as capacity utilization increases. Some Directors saw emerging capacity constraints, and all speakers expressed concern over the prospects for inflation, pointing to the recent widening of the inflation differential vis-à-vis the main partner countries against the background of rapid expansion in the monetary and credit aggregates, strong growth in domestic demand, and sustained rates of increase in real wages in excess of those abroad and unwarranted by productivity gains. Directors urged the authorities to give high priority to their commitment to a further deceleration of inflation.

Continued high rates of unemployment were also seen as a difficult problem facing the authorities. While recognizing the efforts made to date, Directors encouraged the authorities to intensify their search for solutions. They agreed with the staff that these efforts should continue to focus on improving the functioning of the labor market, and that stimulating demand through financial policies would be inappropriate. In current conditions such stimulus was likely to be dissipated into inflation and a worsening of competitiveness, instead of securing lasting output and employment gains. Directors supported the emphasis on profit-sharing arrangements, greater regional differentiation of wages, training programs, and measures to improve labor mobility. Directors also urged the authorities to exercise their moderating influence in the negotiation of wage contracts in the public sector.

Directors commented at length on the stance of fiscal and monetary policy. With respect to fiscal policy, Directors commended the authorities for maintaining their target for the public sector borrowing requirement (PSBR) in the current fiscal year, despite the loss of oil revenue, but they strongly argued that the buoyancy of non-oil revenue and the need to shift resources into net exports called for a greater reduction in the PSBR in relation to GDP for the next fiscal year than foreseen in the MTFS. Several Directors observed that a tighter fiscal policy in 1987/88 would strengthen confidence in the financial markets and would help to reduce interest rates and to revive private investment. Speakers generally urged the authorities to cut the share of government spending in the economy as a whole and thereby to create room for income tax reductions. Otherwise, income tax reform should be largely revenue neutral in the current circumstances of the U.K. economy. With respect to tax reform, some Directors encouraged the authorities to reduce high marginal tax rates, including those rates affecting low incomes.

On monetary policy, Directors appreciated the difficulties in assessing velocity behavior and hence in setting targets for monetary aggregates. Some of them expressed the view that despite these difficulties, the policy of announcing targets for monetary aggregates should not be abandoned. Reliance on narrow money as an indicator of the appropriateness of policy stance was not sufficient, many Directors commented; they considered that developments in broad money and credit also had to be closely monitored. In this respect, speakers generally expressed concern over the current rapid build up of liquidity and the high rates of real credit expansion; a number of Directors argued for a tightening of monetary policy, and others stressed that there was certainly no room for relaxation of policy. Directors agreed that, given the widening inflation differential vis-à-vis other industrial countries, prospects for lower interest rates were dependent on progress on price and cost inflation, and on greater fiscal restraint.

Directors recognized that in the face of the fall in oil prices, the decline in the effective exchange rate of the pound sterling over the past year had been appropriate. They agreed with the staff that it was important to consolidate the resulting improvement in competitiveness in order to broaden the base of output growth, enhance employment prospects over the medium term, and check the recent deterioration in the external current account position. They stressed in this respect the need for lowering markedly the rate of growth in unit labor costs so that it does not exceed the rate prevailing in the main trading partner countries. In this regard, some Directors asked if full membership of the European Monetary System (EMS) might not facilitate monetary policy and reinforce the authorities' efforts to limit inflation. At the same time, it was recognized that participation in the exchange rate mechanism of the EMS would be more demanding with respect to underlying conditions. In addition, some Directors wondered whether full membership of the EMS might be seen as a way of reinforcing broader cooperative efforts to strengthen the stability of exchange rates, in line with the statement of Ministers of Finance and Central Bank Governors of six major industrial countries made in Paris on February 22, 1987.

Directors welcomed the continued liberalization of financial markets and supported the authorities in their efforts to ensure effective market supervision. More broadly, Directors commended the authorities' intention to persevere with a range of measures to improve efficiency in labor and product markets generally. They commended the authorities for their support for foreign trade liberalization, and urged them to step up the implementation of initiatives, both on their own behalf and within the European Communities, to achieve that goal. On official development assistance (ODA), and while recognizing the highly concessional character of ODA and its focus on poorer countries, Directors expressed the hope that the decline in the ODA/GNP ratio which was foreseen on current plans for the period ahead could be reversed.

It is expected that the next Article IV consultation with the United Kingdom will be held on the standard 12-month cycle.

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If this can happen, its only a matter of time before everything collapses. I think we have contingency plans to deal with the consequences. A.

MY TELNO 174: IMF: NIGERIA

SUMMARY

1. SERIOUS OVERSPENDING BY THE NIGERIANS. CONTINUATION OF IMF STANDBY ARRANGEMENT AT RISK.

DETAIL

2. ALLEN, HEAD OF THE VISITING IMF TEAM, INFORMED US ON 25 FEBRUARY ON THE OUTCOME OF HIS DISCUSSIONS SO FAR WITH THE NIGERIANS. CONTRARY TO THE FAIRLY SANGUINE CONCLUSIONS WHICH HAD BEEN REACHED EARLIER BY THE WORLD BANK AND REPORTED IN TUR, ALLEN SAID THAT THERE WAS STILL A MAJOR PROBLEM ABOUT OVERSPENDING BY THE NIGERIANS. THE MAIN DIFFICULTY CONCERNS THE DEDICATION BY THE NIGERIANS OF ABOUT 20% OF THEIR OIL REVENUE (US DOLLARS 1.2 BILLION) TO SOME MAJOR INDUSTRIAL PROJECTS (SEE MY TELNO 1125 OF 29 DECEMBER). THESE ARE THE AJAOKUTA STEELWORKS AND CERTAIN DOWN-STREAM OIL-RELATED ACTIVITIES. THESE ''DEDICATED'' ACCOUNTS APPEAR TO HAVE BEEN ESTABLISHED BEHIND THE BACKS OF THE FINANCE AND PLANNING MINISTRIES, AND ARE NOT (NOT) THEREFORE TAKEN INTO ACCOUNT IN THE 1987 BUDGET (JENNINGS' LETTER OF 12 FEBRUARY TO WAD). INDEED, OKONGWU, FINANCE MINISTER HAD TOLD THE IMF AND THE WORLD BANK THAT THIS PRACTICE HAD BEEN ELIMINATED. ALLEN BELIEVES THAT HE DID SO IN GOOD FAITH, BUT HAD SUBSEQUENTLY BEEN OVERRIDDEN.

3. THE NET EFFECT OF ALL THIS IS THAT THE NIGERIANS NOW NEED TO PRUNE THEIR SPENDING BY OVER US DOLLARS 1 BN THIS YEAR IF THEY ARE TO STAY WITHIN THE FINANCING ARRANGEMENTS AGREED WITH THE INTERNATIONAL INSTITUTIONS AND THE CREDITORS. ALLEN IS SEEKING TO CONVINCE NIGERIAN ECONOMIC MINISTERS AND OFFICIALS OF THE NEED TO ELIMINATE THE DIVERSION OF OIL REVENUES IN THIS WAY OR OTHERWISE ABSORB FUNDING, ALBEIT SCALED-DOWN, FOR THE PROJECTS CONCERNED INTO THE NORMAL BUDGETARY PROCESS. HE RECOGNISES THAT THIS REQUIRES TOUGH DECISIONS, BUT SAYS THAT ESSENTIALLY THE NIGERIANS HAVE NO CHOICE.

4. ALLEN IS ALSO CONCERNED ABOUT OTHER ASPECTS OF NIGERIA'S ECONOMIC PERFORMANCE, EG THAT THE CREDIT SQUEEZE HAS BEEN INSUFFICIENTLY EFFECTIVE (WITH A 17% INCREASE IN THE AVAILABILITY OF CREDIT IN 1986), THAT FUNDING OF SFEM HAS ON A NUMBER

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RF OCCASIONS EXCEEDED THE US DOLLARS 50 MILLION PER WEEK WHICH THE IMF BELIEVE IS ALL NIGERIA CAN AFFORD IN HER CURRENT ECONOMIC STATE, AND THAT THE AMOUNT WHICH INDIVIDUAL BANKS CAN PURCHASE FROM THE SFEM HAS NOT BEEN INCREASED. HE IS ALSO CONCERNED ABOUT THE SIZE OF THE PROJECTED PUBLIC SECTOR IMPORT BILL OF US DOLLARS 2.9 BILLION. HE INTENDS, THEREFORE, TO LEAVE OKONGWU WITH A LIST OF THE STEPS WHICH NEED TO BE TAKEN IF THE IMF STAFF ARE TO BE ABLE TO RECOMMEND CONTINUATION OF THE SBA. HE WOULD THEN PLAN TO RETURN TO NIGERIA IN ABOUT APRIL ONCE HE HAD SEEN EVIDENCE THAT THE NECESSARY ACTION WAS BEING TAKEN. IF, ON THE OTHER HAND, THE NIGERIANS WERE NOT PREPARED TO TAKE THE NECESSARY DECISIONS, THE IMF WOULD HAVE TO WITHDRAW THE SBA, WHICH WOULD IN TURN AFFECT THE CONTINUED PROVISION OF MONEY FROM OTHER SOURCES, INCLUDING WORLD BANK LOANS AND EXPORT CREDIT AGENCY (ECA) BACKED LINES OF CREDIT.

5. ALLEN SAID, HOWEVER, THAT HE DID FEEL THAT THE ISSUES WERE NOW AT LEAST BEING SERIOUSLY DISCUSSED WITHIN THE GOVERNMENT. HE UNDERSTOOD THAT THERE HAD BEEN A NINE HOUR MEETING OF THE NATIONAL SECURITY COUNCIL, WHICH COMPRISES THE CHIEFS OF STAFF AND THE ECONOMIC MINISTERS WITH THEIR SENIOR OFFICIALS, ON 23 FEBRUARY, TO CONSIDER THE SITUATION. HE WOULD HIMSELF BE STAYING IN LAGOS UNTIL 4 MARCH TO CONTINUE IMPRESSING UPON THE NIGERIANS THE SERIOUSNESS OF THEIR POSITION, AND WOULD AIM TO BRIEF THE TREASURY, BANK OF ENGLAND AND BARCLAYS (FOR THE LONDON CLUB) THE FOLLOWING DAY IN LONDON. FOR THE TIME BEING, ALLEN FELT THAT THE ECA'S SHOULD MAKE RESTORATION OF CREDIT COVER DEPENDENT UPON THE SATISFACTORY RECEIPT OF INTEREST PAYMENTS THROUGH THE SPECIAL ACCOUNT ESTABLISHED WITH THE BANK OF ENGLAND. IT MIGHT ALSO HELP TO PERSUADE THE NIGERIANS TO END DIVERSION OF OIL REVENUES TO PARTICULAR PROJECTS IF THE ECA'S WERE ABLE TO OFFER THE PROSPECT OF CREDIT COVER FOR SPECIFIC PROJECTS THAT WERE JUDGED VIABLE AND ECONOMICALLY SOUND. HE THEREFORE VERY MUCH WELCOMED ECGD'S INTENTION OF SEEKING WORLD BANK ENDORSEMENT BEFORE SUPPORTING NEW PROJECTS.

6. PLEASE SEE MIFT FOR COMMENT ON THE IMPLICATIONS OF THIS FOR OUR BILATERAL DEBT RESCHEDULING NEGOTIATIONS AND FOR OUR WIDER RELATIONS WITH NIGERIA.

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MIPT: IMF: NIGERIA

SUMMARY

1. ALLEN'S ACCOUNT OF FURTHER FINANCIAL BACKSLIDING BY THE NIGERIANS SHOULD CLEARLY BE TAKEN INTO ACCOUNT IN OUR BILATERAL NEGOTIATIONS ON THE ECGD COVER DUE TO START ON 9 MARCH, BUT I THINK THE TALKS SHOULD STILL CONTINUE AS PLANNED.

DETAIL

2. CLEARLY ALLEN'S ACCOUNT HAS IMPLICATIONS FOR OUR OWN BILATERAL RESCHEDULING NEGOTIATIONS AND THE RESTORATION OF ECGD COVER, AND INDEED FOR OUR OVERALL BILATERAL RELATIONS (ALREADY UNDER STRAIN BECAUSE OF THE CLOSURE OF OUR VISA OFFICE IN LAGOS BY THE NIGERIANS).

3. ALLEN'S REPORT INDICATES SOME DISARRAY WITHIN THE GOVERNMENT, WITH THE ECONOMIC MINISTERS SEEMINGLY BEING OVERRULED BY THE MILITARY HIERACHY, AND A DISTURBING FAILURE TO LIVE UP TO COMMITMENTS MADE TO THE INTERNATIONAL INSTITUTIONS AND OFFICIAL AND COMMERCIAL CREDITORS. IT APPEARS THAT THE NIGERIANS WILL HAVE TO FURTHER PRUNE THEIR SPENDING PLANS IN ORDER TO BE ABLE TO MEET THEIR DEBT SERVICING OBLIGATIONS POST-RESCHEDULING. IT MAY BE THAT ONCE PRESIDENT BABANGIDA RETURNS THE NECESSARY PAINFUL DECISIONS WILL BE TAKEN, BUT WE CANNOT COUNT ON THAT AND DO NOT KNOW WHEN HE WILL BE ABLE TO RESUME CONTROL.

4. WE ARE IN A PARTICULARLY EXPOSED POSITION, HAVING SUPPORTED THE NIGERIAN CASE WITH THEIR CREDITORS AND INTERNATIONAL FINANCIAL INSTITUTIONS, AND BEING FIRST IN LINE FOR BILATERAL RESCHEDULING. WE COULD AT THIS STAGE CONSIDER POSTPONING OUR RESCHEDULING TALKS UNTIL THE IMF ARE SATISFIED WITH NIGERIA'S PLANS, OR UNTIL SOME OTHER CREDITORS HAVE HELD THEIR NEGOTIATIONS. BUT THE NIGERIANS WOULD BE VERY LIKELY TO SEE A POSTPONEMENT (UNLESS ALL ECAS WERE TO TAKE THE SAME POSITION) AS A POLITICALLY MOTIVATED REACTION TO THE PROBLEMS THEY ARE CAUSING US OVER THE VISA OFFICE. THIS COULD HAVE AN IMPACT IN COMMERCIAL AREAS AND GIVE AN ADVANTAGE TO OUR COMPETITORS. AT PRESENT THE FRENCH ARE DUE TO BEGIN THEIR TALKS ON 12/13 MARCH.

5. MOREOVER, IT HAS TAKEN A LONG TIME TO GET THE NIGERIANS TO AGREE THE WEEK OF 9 MARCH FOR THE BILATERAL RESCHEDULING TALKS, AND TO SUGGEST A POSTPONEMENT NOW MIGHT BRING A FURTHER VERY LONG DELAY. ALLEN'S DISCUSSIONS WITH THE NIGERIANS ARE CONTINUING, AND THERE IS JUST THE POSSIBILITY OF HIS SUCCEEDING BEFORE HIS VISIT'S END IN EXTRACTING SOME MORE HELPFUL REASSURANCES. IN ANY CASE, THE IMF ARE UNLIKELY TO TAKE ANY IMMEDIATE ACTION, BUT WILL RATHER GIVE THE NIGERIANS A MONTH OR SO TO GET THEIR ACT TOGETHER.

6. I VERY MUCH HOPE, THEREFORE, THAT WE WILL PROCEED AS PLANNED. I ASSUME IT WOULD BE POSSIBLE FOR US TO SUSPEND ANY ARRANGMENTS AGREED, SHOULD THE IMF BE EVENTUALLY UNABLE TO CONFIRM CONTINUATION OF THE SBA.

EWANS

YYYY

LAHPAN 8905

MONETARY
WAD

Cl/49/ph

CONFIDENTIAL

FROM: A W KUCZYS
DATE: 2 MARCH 1987

MRS CASE

cc PS/Economic Secretary
Sir G Littler
Mr Lavelle
Mr Mountfield - o/r
Mr Pitcairn

IMF: NIGERIA

The Chancellor has seen the attached telegram from Lagos. He has particularly noted that dedicated accounts have been established behind the backs of the Finance and Planning Ministries. He has commented that if this can happen, it is only a matter of time before everything collapses. He trusts we have contingency plans to deal with the consequences?

AWK

A W KUCZYS

GRS 750

CONFIDENTIAL

CONFIDENTIAL

FM LAGOS

TO IMMEDIATE FCO

TELNO 276

OF 261130Z FEBRUARY 87

INFO IMMEDIATE HM TREASURY, BANK OF ENGLAND, DTI, ECGD, ODA

INFO IMMEDIATE UKDEL IMF/IBRD WASHINGTON

INFO SAVING KADUNA

If this can happen, its only a matter of time before everything collapses. I think the Nigerians plan to deal with no consequences. M.

MY TELNO 174: IMF: NIGERIA

SUMMARY

1. SERIOUS OVERSPENDING BY THE NIGERIANS. CONTINUATION OF IMF STANDBY ARRANGEMENT AT RISK.

DETAIL

2. ALLEN, HEAD OF THE VISITING IMF TEAM, INFORMED US ON 25 FEBRUARY ON THE OUTCOME OF HIS DISCUSSIONS SO FAR WITH THE NIGERIANS. CONTRARY TO THE FAIRLY SANGUINE CONCLUSIONS WHICH HAD BEEN REACHED EARLIER BY THE WORLD BANK AND REPORTED IN TUR, ALLEN SAID THAT THERE WAS STILL A MAJOR PROBLEM ABOUT OVERSPENDING BY THE NIGERIANS. THE MAIN DIFFICULTY CONCERNS THE DEDICATION BY THE NIGERIANS OF ABOUT 20% OF THEIR OIL REVENUE (US DOLLARS 1.2 BILLION) TO SOME MAJOR INDUSTRIAL PROJECTS (SEE MY TELNO 1125 OF 29 DECEMBER). THESE ARE THE AJAOKUTA STEELWORKS AND CERTAIN DOWN-STREAM OIL-RELATED ACTIVITIES. THESE ''DEDICATED'' ACCOUNTS APPEAR TO HAVE BEEN ESTABLISHED BEHIND THE BACKS OF THE FINANCE AND PLANNING MINISTRIES, AND ARE NOT (NOT) THEREFORE TAKEN INTO ACCOUNT IN THE 1987 BUDGET (JENNINGS' LETTER OF 12 FEBRUARY TO WAD). INDEED, OKONGWU, FINANCE MINISTER HAD TOLD THE IMF AND THE WORLD BANK THAT THIS PRACTICE HAD BEEN ELIMINATED. ALLEN BELIEVES THAT HE DID SO IN GOOD FAITH, BUT HAD SUBSEQUENTLY BEEN OVERRIDDEN.

3. THE NET EFFECT OF ALL THIS IS THAT THE NIGERIANS NOW NEED TO PRUNE THEIR SPENDING BY OVER US DOLLARS 1 BN THIS YEAR IF THEY ARE TO STAY WITHIN THE FINANCING ARRANGEMENTS AGREED WITH THE INTERNATIONAL INSTITUTIONS AND THE CREDITORS. ALLEN IS SEEKING TO CONVINCE NIGERIAN ECONOMIC MINISTERS AND OFFICIALS OF THE NEED TO ELIMINATE THE DIVERSION OF OIL REVENUES IN THIS WAY OR OTHERWISE ABSORB FUNDING, ALBEIT SCALED-DOWN, FOR THE PROJECTS CONCERNED INTO THE NORMAL BUDGETARY PROCESS. HE RECOGNISES THAT THIS REQUIRES TOUGH DECISIONS, BUT SAYS THAT ESSENTIALLY THE NIGERIANS HAVE NO CHOICE.

4. ALLEN IS ALSO CONCERNED ABOUT OTHER ASPECTS OF NIGERIA'S ECONOMIC PERFORMANCE, EG THAT THE CREDIT SQUEEZE HAS BEEN INSUFFICIENTLY EFFECTIVE (WITH A 17% INCREASE IN THE AVAILABILITY OF CREDIT IN 1986), THAT FUNDING OF SFEM HAS ON A NUMBER

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Tel

RF OCCASIONS EXCEEDED THE US DOLLARS 50 MILLION PER WEEK WHICH THE IMF BELIEVE IS ALL NIGERIA CAN AFFORD IN HER CURRENT ECONOMIC STATE, AND THAT THE AMOUNT WHICH INDIVIDUAL BANKS CAN PURCHASE FROM THE SFEM HAS NOT BEEN INCREASED. HE IS ALSO CONCERNED ABOUT THE SIZE OF THE PROJECTED PUBLIC SECTOR IMPORT BILL OF US DOLLARS 2.9 BILLION. HE INTENDS, THEREFORE, TO LEAVE OKONGWU WITH A LIST OF THE STEPS WHICH NEED TO BE TAKEN IF THE IMF STAFF ARE TO BE ABLE TO RECOMMEND CONTINUATION OF THE SBA. HE WOULD THEN PLAN TO RETURN TO NIGERIA IN ABOUT APRIL ONCE HE HAD SEEN EVIDENCE THAT THE NECESSARY ACTION WAS BEING TAKEN. IF, ON THE OTHER HAND, THE NIGERIANS WERE NOT PREPARED TO TAKE THE NECESSARY DECISIONS, THE IMF WOULD HAVE TO WITHDRAW THE SBA, WHICH WOULD IN TURN AFFECT THE CONTINUED PROVISION OF MONEY FROM OTHER SOURCES, INCLUDING WORLD BANK LOANS AND EXPORT CREDIT AGENCY (ECA) BACKED LINES OF CREDIT.

5. ALLEN SAID, HOWEVER, THAT HE DID FEEL THAT THE ISSUES WERE NOW AT LEAST BEING SERIOUSLY DISCUSSED WITHIN THE GOVERNMENT. HE UNDERSTOOD THAT THERE HAD BEEN A NINE HOUR MEETING OF THE NATIONAL SECURITY COUNCIL, WHICH COMPRISES THE CHIEFS OF STAFF AND THE ECONOMIC MINISTERS WITH THEIR SENIOR OFFICIALS, ON 23 FEBRUARY, TO CONSIDER THE SITUATION. HE WOULD HIMSELF BE STAYING IN LAGOS UNTIL 4 MARCH TO CONTINUE IMPRESSING UPON THE NIGERIANS THE SERIOUSNESS OF THEIR POSITION, AND WOULD AIM TO BRIEF THE TREASURY, BANK OF ENGLAND AND BARCLAYS (FOR THE LONDON CLUB) THE FOLLOWING DAY IN LONDON. FOR THE TIME BEING, ALLEN FELT THAT THE ECA'S SHOULD MAKE RESTORATION OF CREDIT COVER DEPENDENT UPON THE SATISFACTORY RECEIPT OF INTEREST PAYMENTS THROUGH THE SPECIAL ACCOUNT ESTABLISHED WITH THE BANK OF ENGLAND. IT MIGHT ALSO HELP TO PERSUADE THE NIGERIANS TO END DIVERSION OF OIL REVENUES TO PARTICULAR PROJECTS IF THE ECA'S WERE ABLE TO OFFER THE PROSPECT OF CREDIT COVER FOR SPECIFIC PROJECTS THAT WERE JUDGED VIABLE AND ECONOMICALLY SOUND. HE THEREFORE VERY MUCH WELCOMED ECGD'S INTENTION OF SEEKING WORLD BANK ENDORSEMENT BEFORE SUPPORTING NEW PROJECTS.

6. PLEASE SEE MIFT FOR COMMENT ON THE IMPLICATIONS OF THIS FOR OUR BILATERAL DEBT RESCHEDULING NEGOTIATIONS AND FOR OUR WIDER RELATIONS WITH NIGERIA.

EWANS

YYYY

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FM LAGOS
TO IMMEDIATE FCO
TELNO 277
OF 261237Z FEBRUARY 87
INFO IMMEDIATE HM TREASURY, BANK OF ENGLAND, DTI, ECGD,
INFO IMMEDIATE UKDEL IMF/IBRD WASHINGTON
INFO SAVING KADUNA

MIPT: IMF: NIGERIA

SUMMARY

1. ALLEN'S ACCOUNT OF FURTHER FINANCIAL BACKSLIDING BY THE NIGERIANS SHOULD CLEARLY BE TAKEN INTO ACCOUNT IN OUR BILATERAL NEGOTIATIONS ON THE ECGD COVER DUE TO START ON 9 MARCH, BUT I THINK THE TALKS SHOULD STILL CONTINUE AS PLANNED.

DETAIL

2. CLEARLY ALLEN'S ACCOUNT HAS IMPLICATIONS FOR OUR OWN BILATERAL RESCHEDULING NEGOTIATIONS AND THE RESTORATION OF ECGD COVER, AND INDEED FOR OUR OVERALL BILATERAL RELATIONS (ALREADY UNDER STRAIN BECAUSE OF THE CLOSURE OF OUR VISA OFFICE IN LAGOS BY THE NIGERIANS).

3. ALLEN'S REPORT INDICATES SOME DISARRAY WITHIN THE GOVERNMENT, WITH THE ECONOMIC MINISTERS SEEMINGLY BEING OVERRULED BY THE MILITARY HIERACHY, AND A DISTURBING FAILURE TO LIVE UP TO COMMITMENTS MADE TO THE INTERNATIONAL INSTITUTIONS AND OFFICIAL AND COMMERCIAL CREDITORS. IT APPEARS THAT THE NIGERIANS WILL HAVE TO FURTHER PRUNE THEIR SPENDING PLANS IN ORDER TO BE ABLE TO MEET THEIR DEBT SERVICING OBLIGATIONS POST-RESCHEDULING. IT MAY BE THAT ONCE PRESIDENT BABANGIDA RETURNS THE NECESSARY PAINFUL DECISIONS WILL BE TAKEN, BUT WE CANNOT COUNT ON THAT AND DO NOT KNOW WHEN HE WILL BE ABLE TO RESUME CONTROL.

4. WE ARE IN A PARTICULARLY EXPOSED POSITION, HAVING SUPPORTED THE NIGERIAN CASE WITH THEIR CREDITORS AND INTERNATIONAL FINANCIAL INSTITUTIONS, AND BEING FIRST IN LINE FOR BILATERAL RESCHEDULING. WE COULD AT THIS STAGE CONSIDER POSTPONING OUR RESCHEDULING TALKS UNTIL THE IMF ARE SATISFIED WITH NIGERIA'S PLANS, OR UNTIL SOME OTHER CREDITORS HAVE HELD THEIR NEGOTIATIONS. BUT THE NIGERIANS WOULD BE VERY LIKELY TO SEE A POSTPONEMENT (UNLESS ALL ECAS WERE TO TAKE THE SAME POSITION) AS A POLITICALLY MOTIVATED REACTION TO THE PROBLEMS THEY ARE CAUSING US OVER THE VISA OFFICE. THIS COULD HAVE AN IMPACT IN COMMERCIAL AREAS AND GIVE AN ADVANTAGE TO OUR COMPETITORS. AT PRESENT THE FRENCH ARE DUE TO BEGIN THEIR TALKS ON 12/13 MARCH.

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OF 090858Z MARCH 87
AND TO IMMEDIATE DTI, ECGD, BANK OF ENGLAND, TREASURY, ODA
INFO IMMEDIATE UKDEL IMF/IBRF WASHINGTON

MY TELNO 306

IMF AND THE NIGERIAN ECONOMY

SUMMARY

1. AT THE END OF THEIR VISIT THE IMF TEAM TELL US THAT THEY BSLIEVE THEY HAVE PERSUADED NIGERIAN MINISTERS THAT FURTHER SEVERE ECONOMIC MEASURES ARE URGENTLY REQUIRED TO KEEP THE ECONOMY ON COURSE.

DETAIL

2. THE THE WORLD BANK REPRESENTATIVE HERE, HUSAIN, TOLD HEAP (MINISTER) ON 6 MARCH THAT OUR REPORTS (TELNOS 276 AND 277) ON THE VIEWS OF MARK ALLEN OF THE IMF ON THE NIGERIAN ECONOMIC SITUATION HAD CAUSED HIM SOME DIFFICULTIES: HE SUSPECTED THEY HAD PAINTED AN OVER PESSIMISTIC VIEW. HEAP TOLD HIM THAT HE HAD NOT BEEN PRESENT AT THOSE REPORTED CONVERSATIONS WITH ALLEN, BUT HAD NO REASON TO DOUBT THEIR ACCURACY, BUT SAID HE WOULD ARRANGE A FURTHER MEETING WITH ALLEN BEFORE HIS DEPARTURE TO GET HIS CONSIDERED VIEW ON THE RESULT OF THE IMF MISSION. CONSEQUENTLY HEAP AND I SAW ALLEN ON 7 MARCH.

3. ALLEN TOLD US THAT HE STOOD BY WHAT HE HAD TOLD MY COMMERCIAL COUNSELLOR EARLIER, ALTHOUGH THOUGHT WE HAD PERHAPS INDICATED DIFFERENCES BETWEEN THE WORLD BANK AND IMF WHICH DID NOT EXIST. (HE SAID HE HAD NOT SEEN OUR TELEGRAMS BUT CLEARLY HAD A DETAILED KNOWLEDGE OF THEIR CONTENTS AND SAID ''EVERYONE ELSE HAD SEEN THEM''.).

4. ALLEN LEAVES FOR LONDON TONIGHT 7 MARCH AND EXPECTS TO HAVE MEETINGS IN LONDON ON 9 MARCH. SINCE HE WILL NO DOUBT REPEAT HIS FINDINGS AT THOSE MEETING WHAT FOLLOWS IS ONLY AN OUTLINE OF HIS COMMENTS.

5. HE SAID THEY HAD FOUND A SERIOUS SITUATION IN WHICH THE NIGERIANS WERE USING UP THEIR FOREIGN EXCHANGE FASTER AND MORE WASTEFULLY THAN PLANNED. HE HAD HAD SESSIONS THE PREVIOUS EVENING WITH OKONGWU, FINANCE MINISTER, AND LUKMAN, OIL MINISTER, AND BELIEVED HE HAD CONVINCED THEM THAT DRASTIC MEASURES HAD TO BE TAKEN AT ONCE (A) TO REDUCE THE FOREIGN EXCHANGE AVAILABLE TO THE PRIVATE SECTOR, ESPECIALLY THROUGH THE SECOND TIER AUCTIONS (HE CLEARLY THOUGHT THAT THE US DOLLARS 75 MILLION IN THE WEEKLY AUCTIONS TOO MUCH, AND WAS HAPPIER WITH US DOLLARS 50 M) AND (B) TO REDUCE PRIVATE SECTOR FOREIGN EXCHANGE EXPENDITURE, OVER WHICH CONTROLS WERE MUCH TOO LOOSE. HE SAID THE IMF AND WORLD BANK HAD ALREADY JUST ACHIEVED THE CLOSURE OF THE DEDICATED ACCOUNTS BY WHICH 20% OF OIL REVENUES HAD BEEN GOING DIRECTLY TO THE AJAOKUTA STEEL PROJECT AND A RANGE OF NNPC OIL RELATED PROJECTS. ALL THESE REVENUES WOULD NOW BE GOING INTO THE CENTRAL BANK. SOME EXPENDITURE ON THESE PROJECTS WOULD CONTINUE, SINCE TO RUN THESE DOWN WOULD TAKE LONGER. ALLEN SAID THAT UNLESS THESE AND THE OTHER TOUGH MEASURES WERE TAKEN VERY QUICKLY THE NIGERIANS WOULD NOT BE ABLE TO START THEIR RESCHEDULED REPAYMENTS IN APRIL, WITH THE TOTAL LOSS OF CONFIDENCE THAT WOULD BRING. HE WAS NOT TOTALLY PESSIMISTIC. HE THOUGHT THE NIGERIANS COULD BE KEPT ON COURSE: THE MAIN PROBLEM WOULD BE TO GET THE AGREEMENT IN PRINCIPLE ACHIEVED WITH MINISTERS TRANSLATED INTO EXECUTIVE ACTION.

6. FOR THE FUTURE ALLEN SAID OKONGWU AND AHMED, GOVERNOR OF THE CENTRAL BANK, WOULD BE REQUIRED TO GIVE AN ACCOUNT OF THEIR STEWARDSHIP TO THE IMF IN WASHINGTON IN EARLY APRIL, WHICH, IF ALL WENT WELL WOULD BE FOLLOWED BY A RETURN OF AN IMF TEAM TO LAGOS IN MID APRIL, WITH A VIEW TO CONFIRMING THE IMF STANDBY ARRANGEMENT THEREAFTER.

EWANS

YYYY

LAHPAN 9142

MONETARY DIST.
WAD

COPIES TO:
DTI, VICTORIA ST.
ECGD.
BANK OF ENGLAND.
HM TREASURY.
ODA.

B/F 10/3

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Kuczys → Case 2/3

IMF: NIGERIA

3601/032/bc

FROM: P T SHERIDAN
DATE: 10 March 1987

1. SIR G LITTLER
2. CHANCELLOR

cc: Sir P Middleton
Sir T Burns
Mr Evans
Mr Walsh
Mr Lankester - UKDEL

OK

IMF: UK ARTICLE IV CONSULTATION

Mr Kuczys' note of 6 March recorded the Chancellor's comment on savingram 55 that he had no objections to moving the Article IV Board discussion until after the Budget.

2. In the Board discussion on the UK Article IV on 24 February the Indonesian and Indian EDs suggested that in future the Article IV discussion should take place after the Budget. In reply, Mr Lankester stated that we would be willing to consider changing the timing of the Board discussion but that we would not want to change the timing of the staff mission. This now takes place in late November, just after the Autumn Statement, a very convenient time for us; a later date eg. just before Christmas or in the New Year would not be at all suitable.

3. Under the Fund's rules an Article IV discussion must take place within three months of the consultation. If we wish to retain the late November consultation date, a post Budget discussion would fall outside the three month rule and require a Board waiver. In effect, the UK would need to apply for a waiver annually or else seek some special standing dispensation. Either would be likely to attract embarrassing comment and possibly lead others to ask for similar treatment. It would also run counter to our oft stated policy of urging timely Article IV discussions for other countries.

4. UKDEL's initial view is that there is no way round this problem. Since the current timings suit both the staff and us well and since it is only two ldc EDs suggesting a change, it might be best if, after suitable consideration, both the staff and the UK agree to continue with the present arrangements.

P T SHERIDAN

CONFIDENTIAL

Thanks. We clearly need to watch this with hawk-like eyes. [illegible] within:

FROM: P MOUNTFIELD
DATE: 10 March 1987

CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Lavelle
Mr H P Evans
Mrs Case
Mr Pitcairn

NIGERIA

You commented, in connection with Lagos Tel No 276 of 26 February reporting the progress of the IMF team's talks on the SBA review, that if dedicated financing accounts were established without the knowledge of the Finance and Planning Ministries it could only be a matter of time before everything collapsed and asked about contingency plans. We have deferred a reply until we had the chance (yesterday) to talk to the IMF Mission Chief, Mark Allen, (a British national) as he returned from Lagos to Washington. (See also further telegram from Lagos, below) AWK

Present situation

2. Mr Allen confirms the worries reported in the telegram. However, in the light of his subsequent talks in Lagos, he believes that provided the Nigerians take further difficult decisions, as they say the intend to do, Nigeria can be kept on track. That view is apparently shared by the IBRD.

3. The main problem is overspending of foreign exchange. The culprit is the dedicated accounts which finance certain dubious projects, including the Ajokuta steel complex and certain oil industry projects. These would account for some $1.2 billion of expenditure at an annual rate. The existence of these accounts was well known and the Fund staff thought that there was an

assurance in the Letter of Intent that these expenditures would be incorporated in the 1987 Budget. The Finance Minister appears to have been unable to deliver this. In addition foreign exchange resources have also been strained by overspending in the public sector and by overfunding of the foreign exchange market. There are also problems on other aspects of the programme eg petroleum subsidies, monetary policy and some technical aspects of the auction system. One problem seems to be that the provisions of the Letter of Intent agreed with some secrecy at Finance Minister level have not filtered down to lower levels in the Ministry of Finance.

Next Steps

4. The Nigerians have now wasted the breathing space between agreeing the SBA (in December) and resumed debt service (in April). However, the Fund Mission believe that the seriousness of the position has now been taken on board, not just by the Finance Minister and Central Bank Governor, but also by the acting President and Oil Minister and that with the return to Lagos of the President, the position can be turned round. They left behind them a list of measures to be taken which will involve drastic cuts in spending and will want to see evidence of these measures being taken before they complete the SBA review. Unless that review is satisfactorily completed, there will be a hold up in disbursements of both IBRD and commercial bank money. In the interim the Nigerians may be looking to creditor countries involved in the dedicated account projects to provide further export credit. (The UK is not among these.) Assuming the Nigerians can report progress at the time of the Interim Committee meetings, the Mission would return to Lagos in April for completion of the review.

Our Assessment

5. We remain very nervous about the Nigerian programme. If the military government does all the things recommended by the

So do I

IMF and IBRD, there is a chance that the economy will turn around; that the non-oil export sector will expand; and import-substitution (like a revived agricultural sector) take some of the strain off the current account. It will take a long time; oil is still over 95% of total exports. If the oil price softens further in the next few months, Nigeria will be in real trouble again; most of the margin afforded by conservative budget estimates has already been used up. In the longer term, we are really buying the Nigerians time until the oil price recovers. If the military government does not return very quickly to the programme, the dangers of default become much greater. The UK has a major economic stake to protect, and on balance we judge it is still worth staying with the programme and encouraging the Nigerians to carry it through. But it would be unrealistic not to recognise that this is a high-risk policy, which may need to be reviewed later in the year.

<u>UK Action</u>

Ch/He is seeing Peter Mountfield today (Wed)

6. We shall take the opportunity of Governor Ahmed's visit this week to say how strongly we support the IMF team's recommendations. We don't yet know if he will visit the Bank but we expect them to say much the same. The Nigerians refused at the last moment to come to London this week for bilateral negotiations on restructuring ECGD guaranteed debt; but after protests they have now agreed to come to London on 23/24 March. Unless you are still tied up in the Budget Debate, we hope you can find time to see Okongwu then. It will be the first opportunity for Treasury Ministers to encourage him to restore the programme; and a better chance than the Washington meetings in April. In the meantime there can be no implementation of our promised package of credits which depend on signature of the bilateral. From the point of view of protecting ECGD, this is advantageous, and we may be able to wait until the SBA review is complete before reopening cover.

Ch
Late morning on the 24th looks possible

Will. 23rd if possible.

7. You have also agreed to the refinancing rather than rescheduling of some £500 million of ECGD guaranteed debt covered by last December's Paris Club agreement. We do not suggest this should be reconsidered for the time being, although we would clearly need to do so should the Nigerian package collapse.

8. As to "contingency plans", there is little that can realistically be done in advance, other than avoiding putting more at risk. The commercial banks have already sought to protect their position in the rescheduling/new money package to the maximum extent possible (British owned banks' exposure $1.1 billion). It is difficult to foresee quite when a collapse might come about. There is not much cushion ~~is~~ if the oil price weakens. Depending on the form and circumstances, we like other creditors would have to decide whether there was any alternative to taking the consequences on the chin.

PM

P MOUNTFIELD

CONFIDENTIAL

FROM: A W KUCZYS
DATE: 11 March 1987

MR MOUNTFIELD

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Lavelle
Mr H P Evans
Mrs Case
Mr Pitcairn

NIGERIA

The Chancellor was grateful for your minute of 10 March. He has commented that we clearly need to watch this with hawk-like eyes. Like you, he remains very nervous about the Nigerian programme.

2. As for seeing Okongwu, the 23 March is impossible for the Chancellor (he is speaking in the Budget Debate). But late morning on the 24th looks possible. Will you follow this up with Mrs Lester?

AWK

A W KUCZYS

CONFIDENTIAL

FROM: MRS A F CASE
DATE: 23 March 1987

1. MR ~~LAVELLE~~ Agreed in draft
2. CHANCELLOR OF THE EXCHEQUER

cc
Mr Evans
Mr Mountfield
Mr Peretz
Mr Culpin
Mr Pitcairn
Mr Lankester - Washingto

Copies attached for:

Chief Secretary
Financial Secretary
Sir P Middleton
Sir G Littler

INTERNATIONAL FINANCIAL SCENE

I attach the usual letter to No 10 following the meeting of the Lavelle your Group on Wednesday.

AFC

MRS A F CASE

Ch
OK for me to write as below?
AWK
23/3

OK as [illegible]

Pl type for my sig

CONFIDENTIAL

~~DRAFT~~ LETTER TO CHARLES POWELL - No 10

INTERNATIONAL FINANCIAL SCENE

I attach the regular report on developments in the international debt scene. This report sets out the background to the Interim and Development Committee meetings early next month in Washington, which will have debt issues on their agenda.

2. The meetings will take place against a growing perception amongst creditor governments, except the US Government, that the position of problem debtors is not yet improving despite the efforts made - on both sides - since 1982. The outlook on debt remains very difficult, although the systemic risks for the banks have clearly receded ~~somewhat~~ since the onset of the crisis and there has been some major growth in schemes to value debt more realistically through the secondary markets, such as debt/equity swaps,

3. The outlook for the world economy is for continued moderate growth. Most industrialised countries are implementing prudent macro-economic policies, and inflation has been reduced significantly. But the fall in oil prices has not boosted growth of output and trade as much as ~~expected~~ was hoped. There is therefore unlikely to be any major improvement in

the external environment facing debtors, (unless commodity prices recover sharply). There is also increasing recognition of the weaknesses in the implementation of the present strategy to which our earlier reports have drawn attention: uneven conditionality; differences between creditors; difficulty in assembling bank packages; more confrontational negotiations; and an increasingly intractable problem in sub-Saharan Africa.

4. Against this background, the Washington meetings seem likely to be ~~somewhat introspective and perhaps~~ dominated by the problems of individual countries. The meetings may see the start of attempts to ~~refurbish~~ redesign ?
reshape/ some aspects of the present strategy particularly in relation to sub-Saharan Africa.

5. Our last report noted that <u>Brazil</u> was likely to continue to dominate the scene. That has proved to be the case. The Brazilians announced, on 20 February, a moratorium on interest payments to commercial banks on medium and long term debt and an effective freezing of principal on short term debt. These measures follow a rapid deterioration in economic performance since summer last year, reflected in a much reduced trade surplus and accelerating inflation. There are as yet no signs that the Brazilians are prepared to contemplate the necessary corrective action. On the bank negotiations

themselves, the position remains fluid and no formal proposals have been put forward. Funaro's attempt to politicise the negotiations, through visits to capitals, ~~seems to have~~ has largely misfired. The general message the message was that governments would not put pressure on the commercial banks and that policy improvements were necessary. In the main governments were unwilling to provide new export credits before Paris Club consideration of an IMF report in July.

6. The banks have had to accept the Brazilian measures as a fait accompli and are likely to have to roll over for a further period the payments under the existing rollover due on 31 March. In the wider context they have responded by a deliberate effort to speed up negotiations with a number of debtor countries, thus reducing the risk of contagion. Agreements have been reached with Chile and Venezuela in the past few weeks whilst faster progress has been made in the negotiations on the Argentine and Philippine packages.

7. ~~On the other major debtors~~ Recent developments in Mexico have been relatively encouraging, although it is not yet clear whether signature of the long delayed commercial bank package is going ahead as planned. Economic developments have been generally ~~positive~~ favourable. The current account deficit was lower than expected in 1986 with the reduction in oil receipts offset

in part by a 33% rise in non-oil exports. However, The outlook remains uncertain, ~~however~~ and heavily dependent both on the oil price holding up and on adequate fiscal targets being agreed and implemented in a pre-Election period.

8. The current picture on <u>Nigeria</u> is less encouraging. The ~~SBA~~ stand-by arrangement has run into trouble with the discovery that some 20% of oil revenues have been dedicated to a number of major industrial projects thereby reducing the amount of foreign exchange available for debt service and imports. It is not yet clear whether the Government will take effective steps to dismantle these arrangements. In the meantime, ECGD are due to start their bilateral negotiations with a Nigerian team this week. Satisfactory completion of these is the key to activation of the promised export credit package.

9. Still more discouraging is the outlook on <u>Egypt</u>. Although a formal letter of intent with the IMF has now been agreed, a financing gap remains even after very generous rescheduling. The medium term balance of payments prospect is so poor that the Fund Managing Director has asked Executive Directors to consider guaranteeing repayments by Egypt and offering concessional interest rates on rescheduling. We have very serious reservations about both these suggestions. Informal discussions are still going on in Washington and the subject will inevitably be discussed by Finance Ministers during the Spring meetings.

~~10.~~ I am copying this letter to Tony Galsworthy (FCO), Tim Walker (DTI) and John Footman (Bank of England).

CONFIDENTIAL

FROM: M I PITCAIRN
DATE: 23 March 1987

1. MR MOUNTFIELD
2. CHANCELLOR

cc PS/Chief Secretary
PS/Economic Secretary
PS/Sir P Middleton
Sir G Littler
Mr Lavelle
Mr Evans
Mrs Case
Miss Higgins

VISIT BY NIGERIAN MINISTER OF FINANCE, Dr OKONGWU

Dr Okongwu, Nigeria's Minister of Finance is to call on you at 11am on Tuesday, 24 March. Dr Okongwu is leading a team of officials, including representatives from the Central Bank of Nigeria, for negotiations on the draft bilateral agreement with ECGD to implement the 16 December Paris Club minute. The team includes Central Bank Governor Ahmed, Mr Animashawun from the Central Bank and from the Ministry of Finance, Mrs Fashanu, Mr Ayanlowo and Mr Ogba, Special Assistant to Dr Okongwu. The team are in London for two days before flying to Paris on Wednesday to hold similar discussions with the French authorities.

2. There is a difference in approach between ECGD and other export credit agencies which has been explained to the Nigerians but which still seems to leave Central Bank of Nigeria officials puzzled. ECGD's strategy is to obtain a signature to the formal bilateral agreement followed by technical discussions at a later date on agreeing the debt list for which there are over 25,000 items. For the other ECAs, agreement to the debt list precedes signature of the formal agreement.

3. There are a number of pieces of the Nigerian jigsaw that have to be put in place before the various financial packages under discussion with the commercial banks ECAs and the IBRD become effective and new credits begin to flow. There

There is a very serious possibility that timing delays in the disbursement of new credits will cause problems later in the year for Nigeria's management of its foreign exchange balances as debt service commitments begin to fall due for payment in April.

4. Of most immediate concern is the IMF Stand-by Arrangement which is in difficulties and is in abeyance pending finalisation of discussions on the first review which could not be completed when the latest Fund Mission was in Lagos (16-27 February). The Fund have left the Nigerians with a series of tough decisions to be taken if the SBA is to continue. Assuming these are taken, a Mission will go back to Lagos in April to finalise a Policy Letter for the first review. This will go before the Board in May when hopefully certification of drawing will be given in respect of the second drawing that was due on 15 February.

5. Nigeria has maintained the line that it does not intend drawing under the IMF Stand-by Arrangement but it is the implications for confidence in the Nigerian economy that are all important. There are no signs that the banks are getting worried as yet. Government creditors are still at the stage of having to negotiate and agree bilateral agreement and debt lists with the Nigerian authorities before resuming cover. The Fund and the Bank are both alarmed by the slippage that has occurred in implementing the terms of the SBA programme. Provided Nigeria takes the necessary corrective action the Fund staff believe the problem is soluble and that the programme can be kept on track.

6. The Fund staff's main concern with Nigeria's management of the economy and implementation of the SBA centres on overspending of foreign exchange. The culprit is the dedicated accounts in which a lot of political capital is tied up in projects overwhich the IBRD has its doubts in a number of cases. Unbeknown to the IMF and possibly even to Dr Okongwu, 20% of Nigeria's oil revenues have been siphoned off into dedicated accounts to meet cash payments on these projects

of some $1.2 billion at an annual rate. The existence of these accounts was well known to the Fund staff who thought that there was an assurance in the letter of intent that these expenditures would be incorporated in the 1987 budget. Dr Okongwu whose grip over the Ministry of Finance is not strong appears to have been unable to deliver this. There is no doubt about the Minister's commitment to the SBA programme though the commitment of his three Permanent Secretaries is variable. In addition there are defects in other areas of the programme where Nigeria has failed to honour its commitments. Foreign exchange resources have been strained by overspending in the public sector and by overfunding of the foreign exchange market. There are also problems on other aspects of the programme eg petroleum subsidies, monetary policy where credit has expanded too rapidly and some technical aspects of the auction system. One problem seems to be that the provisions of the letter of intent agreed with some secrecy at Finance Minister level have not filtered down to lower levels in the Ministry of Finance which caused difficulties in drawing up the budget.

7. The Nigerians have now wasted the breathing space between agreeing the SBA (in December) and resumed debt service (in April). However, the Fund Mission believe that the seriousness of the position has now been taken on board, not just by the Finance Minister and Central Bank Governor whose support for the programme has been undoubted, but also by the oil Minister who wields considerable influence in the Government and that with a return to Lagos of the President, the position can be turned round.

8. The working of the SFEM (Nigeria's weekly foreign exchange auction), whose adoption was the last remaining obstacle to an agreement with the IMF last September, is seen as a barometer of Nigeria's intention towards the economic reform. Late January and early February, when Dr Okongwu and Central Bank Governor Ahmed were absent from their posts on holiday, coincided with a period of government intervention in the SFEM. In late January the Government made available $75 million a week

(as against $50 million a week recommended by the IMF) to prevent further large falls in the value of the naira. Then in mid-February the Government made an unprecedented intervention by ordering the Central Bank to revalue the naira. But within hours the Government overturned the decision and declared that "as much as possible, market forces should be allowed to determine the exchange rate". Since the first round of bidding in September the naira has been devalued by 70%. The naira's first tier value used for official purposes has declined gradually by 42%. Unification of the two rates is expected mid-year.

9. In common with the problems associated with the new money package for Mexico, there are still a number of Nigeria's creditor banks who have yet to signify their acceptance to the terms of the rescheduling and new money package. The Fund SBA became effective on 30 January on the basis of 87% of new money commitments from commercial banks. The level of commitments currently stands at 90.2% with Japanese banks who account for some 4% of exposure yet to signify their acceptance. The commercial bank package is contingent upon the SBA programme being in place. The commercial banks are unaware that the SBA programme is in abeyance. The banks' advisory committee has a month or so to get the remaining 6% of banks on board.

10. The last remaining area of contention concerns the registration of Nigeria's pre-1984 trade debts. These are variously estimated at between $5.5 to $9 billion of which only $1.5 billion have been translated into promissory notes. For the insured creditors that is creditor government export credit agencies there is no problem now that Nigeria has agreed to accept debt lists provided by the various ECAs. However the problem of the uninsured trade creditors is not so satisfactory. We have consistently urged the Nigerian authorities Governor Ahmed in particular to make conciliatory moves towards the group of uninsured trade creditors. At the moment the interests of the promissory note holders are protected by having the Law Debenture Trust Corporation acting

as trustee. This still leaves those trade creditors that have not had their debts registered, unrepresented until such time as the Nigerian authorities announce a further new issue of promissory notes. The Central Bank has been claiming for some time that a major issue of promissory notes is imminent. While the interests of the uninsured trade creditors are not directly our concern this body of creditors does include a number of prominent UK companies to whom substantial amounts are owed. We should urge the Nigerian authorities to do the right thing by the uninsured creditors by calling a meeting with the Law Debenture Trust Corporation who are about to appoint a negotiator to represent the interests of the promissory note holders. You should also stress upon Dr Okongwu the importance of meeting the 5 April interest payment to existing promissory note holders. Nigeria failed to make an interest payment on 5 January, citing the Paris Club as reason for non-payment which was technically correct, though much goodwill was lost as a result.

Your brief consists of:

(i) Objectives and Line to Take;

(ii) Chronicle of recent events;

(iii) Background notes on (a) the economy
(b) ECGD cover arrangements
(c) Trade
(d) Aid

(iv) Personality Note on Dr Okongwu

12. A call by Dr Okongwu provides the opportunity to steer Nigeria back on track to full and proper implementation of the SBA programme and to show our support for the IMF staff's recommendations.

13. The President's absence through illness in February also led to a large upset in bilateral relations with the

MEA peremptorily forced the closure of our new visa office (re-opened on 20 March under deadline to close on 31 May). Negotiations are active to lift deadline by Foreign Secretary who believes that Dr Okongwu should be advised that the problem if it continues to be fuelled by MEA could do damage over whole range of relations.

14. Mr Mountfield and I will support you at the meeting.

M I PITCAIRN

STEERING BRIEF

NIGERIA VISIT BY DR OKONGWU, MINISTER OF FINANCE

Steering Brief

Objective

(i) To emphasise our support for Nigeria's economic recovery programme; to encourage Dr Okongwu to stick to this and to repeat our commitment to help where possible.

(ii) To express our strong support for the recommendations made by IMF to restore the SBA programme.

(iii) To stress the importance attached to commercial relations and maintaining our market share; to encourage creation of suitable conditions for British businessmen and investors to work effectively in Nigeria.

Points to make

(i) Enquire about health of President Babangida who has recently returned to Lagos from receiving medical treatment abroad.

(ii) Comment on successful visit by Mrs Chalker to Lagos in January.

(iii) Late disclosure of financing gap to the Paris Club and IMF in December had the very unfortunate effect of loss of confidence. Failure to complete second review of IMF SBA in February could have similar implications if IMF staff review not completed in April. Where do you see the position now?

(iv) We have been concerned by slow progress of short term debt reconciliation exercise affecting pre-1984 debts owed to trade creditors.

(v) How does Dr Okongwu assess progress under SFEM? What will be the level of funding in future? When will unification of the first tier/second tier take place.

(vi) Maintaining our position as Nigeria's main trading partner is a high priority for UK Government and British business.

(vii) As a major foreign investor in Nigeria, UK has a vital interest in Nigeria's progress and prosperity.

(viii) Problem about our visa office in Lagos blown out of all proportion through a series of misunderstandings. Foreign Secretary hope soon settled. Goodwill on our side but genuine practical difficulties over meeting MEA deadline for final closure of 31 May. In light of all our efforts to improve relations and extent of UK investment, hope it will go no further to damage interest of both sides.

The Nigerians have said they will raise this. See backgd note on ~~Aid~~ Aid

(ix) [If raised] Aid - Britain has no plans to reintroduce a capital aid programme but we are a strong contributor to multilateral funds. Very heavy pressure on aid programme. Britain will continue to provide a substantial technical co-operation programme.

(x) [If raised] ECGD support for UK exports to Nigeria has continued notwithstanding Nigeria's economic problems and substantial ECGD claims payments:-

(a) Short Term cover available on cash terms secured by irrevocable letters of credit;

(b) ECGD continues to allow disbursements of monies under substantial extant Medium Term loans.

(xi) [If raised] <u>New Credit Package:</u> ECGD has indicated willingness to support new credit package - to include relaxation of short term cover and resumption of new medium term cover PROVIDED:-

(a) IMF Stand-by Arrangement in place;

(b) UK/Nigeria bilateral rescheduling agreement signed; and

(c) an acceptable level (to ECGD) of Short Term trade arrears reconciled and verified by Nigerian authorities.

But <u>avoid</u> being drawn on figures! PG.

CHRONICLE OF RECENT EVENTS

NIGERIA - CHRONICLE OF EVENTS

September 1986

Weekly foreign exchange auction introduced. Up to end-December 1986 80% of foreign Exchange allocated to manufacturers for import of raw materials and spare parts.

15 November

Commercial banks' advisory committee recommend rescheduling package, including $320 million of new credits in 1987 - contingent upon IMF programme being in place.

12 December

IMF SBA for SDR650 million approved in principle.

16 December

Paris Club agreement signed.

1 January 1987

Firm but realistic 1987 Budget announced, giving further impetus to reform. Emphasis placed on revitalising agricultural sector; industrial rehabilitation; tax and tariff reform; encouragement of overseas investment; budget revenues include $13pb oil price assumption.

5 January

Nigeria fails to make interest payment ($30 million) due to promissory noteholders - Nigeria cites comparability of treatment clause in Paris Club minute as reason for non-payment which is technically correct - though much goodwill lost as a result.

30 January

IMF SBA becomes effective on the basis of 87% of new money commitments from commercial banks. This in turn triggers Paris Club agreement.

15 February

Nigeria fails first IMF review - SBA in abeyance - IMF staff concerned with foreign exchange cashflow; general overspending by public sector; overfunding of SFCM; domestic petroleum prices; monetary policy.

BACKGROUND NOTES

THE ECONOMY

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NIGERIA - THE ECONOMY

Estimated gross external indebtedness increased by over $1.0 bn to $22.7 bn from end 1985 to end 1986 (from 163% to 335% of exports of goods). The current account swung into a deficit forecast at $1.5 bn in 1986 from a surplus of $0.7 bn in 1985. Visible import cover extended to 1.4 months at end 1986.

Nigeria has suffered a serious worsening of its external and fiscal position. Export earnings were $6.7 bn in 1986 (compared to $12.5 bn in 1985) and are not expected to increase significantly in 1987. Visible imports fell some 35% to $5.4 bn in 1986 from $8.3 bn in 1985. The projected import bill in 1987 is still uncertain, but is expected to increase to around $6.0 bn. Since oil provides 70% of federally retained revenue, budgetary expenditure has also been severely constrained.

The 1987 budget, announced on 2 January, maintains tight fiscal policies required under the structural adjustment programme. The government's re-iteration of its intention to limit debt service to 30% of export earnings is thought to be only for domestic political consumption. Meanwhile the authorities have reduced the amount of foreign exchange available at the weekly auction, and the rate is moving towards N4 = US$1 (having earlier rebounded to N3 = US$1). The authorities have continued to depreciate the first-tier rate which now stands at N2.6 = US$1. Unification of the first and second tier rates is expected mid-year.

On the external front there is still some way to go before Nigeria's 1986-87 debt rescheduling is completed. Following board approval in principle of a SBA in early December, a Paris Club rescheduling was agreed on 15-16 December. The eleventh-hour Nigerian revelation that the 1987 import bill was understated by $1.3 bn has however set back the bilateral timetable and shaken official creditor confidence. Further investigations by the World Bank revealed the figure to be nearer $0.8 bn, of which $0.4 bn represent cash arrears and $0.4 bn public sector letters of credit. The SBA finally became effective on 30 January on the basis of commercial bank commitments received (about 87%), although this strictly fell short of critical mass (90%). The level of commitments currently stands at 90.2%. A particular difficulty has been the reluctance of the Japanese banks to participate in the new money package, and who represent more than a third of the remaining commitments outstanding. The banks are awaiting the reaction of the Japanese banks to the two-day roadshow in Tokyo which took place on 3 and 4 March, headed by Governor Ahmed. The commercial banks' package is contingent upon the SBA programme being in place. However, the SBA has run into difficulties. The latest Fund mission (16-27 February) was unable to complete the first review and recommend the programme's continuation mainly because of excessive foreign exchange expenditure. Most importantly, the Nigerians have dedicated around 20% of their annual oil revenue (US$1.2 bn) to a number of major industrial projects, unknown to the IBRD, IMF and Nigeria's creditors, and apparently Okongwu himself. As a result, the amount of foreign exchange available in 1987 to service post-rescheduled debt and finance the projected level of imports as agreed with Nigeria's creditors, will be lower by the same amount. If they are to stay within the financing arrangements agreed with the international institutions and creditors, the Nigerians will have to cut their spending by over $1 bn this year. Other aspects of economic performance have also concerned the Fund including: increased credit expansion, overfunding of the SFEM, continued restrictions on the amount individual banks can bid for, and the size of the public sector import bill. The Fund have left the Nigerians with a series of tough decisions to be taken if the SBA is to continue. Assuming these are taken, a mission will travel to Lagos in April.

As part of the overall rescheduling exercise the Nigerians requested the rescheduling of promissory notes issued under the 1984 scheme to reschedule uninsured trade arrears. The first principal payment of the promissory notes was due on 6 October 1986 but the Nigerians deferred the payment date. Creditor unease further increased when the Nigerians without prior notice missed the first of the interest payments due in 1987, (quarterly interest had until then been assiduously paid). The Nigerians legitimately claimed that the interest payment was missed on the basis of Paris Club comparability. (The same argument could be used if the next interest payment due in April is also missed.) Discussions have been held between the trustees of the promissory note scheme and the Central Bank of Nigeria (CBN) in establishing an agreed framework for the negotiations, which will include an independent adviser to represent the many (and geographically widely spread) creditors. A circular to the noteholders explaining the appointment of an adviser is expected soon. Under the terms and conditions of the commercial bank agreement, a resolution must be reached by 31 May. Although substantial progress has recently been made, this deadline may well not be strictly met. It will be preferable that negotiations are completed as close to the deadline as possible, but the commercial banks appear willing to tolerate a slight slippage in the timetable, so long as they are assured that the uninsured trade creditors receive broadly the same terms as the insured trade creditors at the Paris Club (ie, over 7 1/2 years with three years' grace, with interest payable during the grace period). The CBN expects to issue shortly a further $1.4 bn of new notes, but wish to reschedule the arrears of interest payable on the issue of these notes. This will create negotiating difficulties. Under the original scheme it was agreed that such arrears would be paid on issue. Until now this has been honoured and a variation of the existing provisions would lead to different interests between the holders of existing and new notes.

BANKING ASPECTS

BIS area claims (end-September 1986)	$9.4 bn	(1.4%)
UK-registered banks' consolidated lending (end-June 1986)		
- gross claims	$2.6 bn	(3.5%)
- exposure	$1.3 bn	

BIS area claims fell by $214 mn (exchange rate adjusted) in the 12 months to end-September, despite an increase of $184 mn in the third quarter. The consolidated claims of UK-registered banks rose by $121 mn in the first half of 1986.

At end-December 1986 ECGD had an estimated $3.3 bn at risk (of which $0.9 bn was undrawn).

NIGERIA - ECGD COVER ARRANGEMENTS

ECGD COVER

BACKGROUND NOTE (Please protect commitment levels)

Cover Arrangements

1 At present ECGD cover is available only for Short Term business under the Section 2 (National Interest) Account for existing ECGD policyholders trading with their established buyers on cash terms of payment secured by irrevocable letters of credit.

Commitments

2 As at November 1986 ECGD had the following commitments:-

	£m
Short Term	110
Medium Term	1630
Total	1740
Short Term Arrears ie Pre January 1984 business (against which ECGD have paid claims of £400m; Central Bank of Nigeria have verified around 40% of such claims)	780
Medium Term Arrears	60
Total ECGD Exposure	2580

Future Cover Proposals

3 ECGD has outlined to the Nigerians a package of new credits which would become effective once the following criteria have been satisfied:-

3.1 an IMF Stand-By Arrangement in place;

3.2 an agreement with the Paris Club on debt restructuring and signature of a UK bilateral agreement and

3.3 satisfactory progress being made on the reconciliation of short term trade arrears; in effect this means that all transfer claims paid by ECGD (total to date £400m) are recognised as debt eligible for rescheduling.

New Credit Package

4 Once the above criteria have been fulfilled ECGD would be prepared to offer support in the following areas:-

4.1 Short Term business: increasing commitment levels and relaxing payment terms from cash to up to 180 days secured by irrevocable letters of credit for the same policyholders as now; later to include new buyers and new policyholders. Cover would be for goods such as raw materials, spare parts and pharmaceuticals. On this basis ECGD exposure could increase to £250m turned over twice a year to produce an annual rate of business of £500m.

4.2 Medium Term business: cover by means of ECGD guaranteed lines of credit to the Nigerian Government for industrial and agricultural rehabilitation; goods would include machinery and equipment to refit and expand Nigeria's industrial and agricultural productive capacity. No figures have been fixed as yet but a starting figure of £200m may be possible.

4.3 Existing Projects: new credit (up to £100m), on a case by case basis, for existing ECGD supported projects which have slowed down or stopped due to lack of funds. ECGD would work in conjunction with the Nigerian authorities and the World Bank to establish whether continuation of work would be appropriate.

4.4 New Projects: cover on a case by case basis for projects approved by and preferably co-financed with the World Bank. Such potential projects could include NEPA but would likely exclude Abuja given that neither the World Bank, the IMF nor the export credit agencies consider Abuja to be of high priority in the context of Nigeria's economic recovery.

5 All new Medium Term credit would be subject to and fall within ECGD Section 2 DX criteria; ie the business to be supported would need to illustrate that it contributes directly to the foreign exchange earnings capacity of Nigeria.

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UK/Nigerian Trade

£'s million

	1982	1983	1984	1985	Jan-Oct 1985	Jan-Oct 1986
UK Exports	1,225	798	768	961	817	473
UK Imports	357	388	376	660	543	298
Balance	+868	+410	+392	+301	+274	+175

TRADE

Nigeria is our largest market in tropical Africa. We are the principal supplier providing nearly 26% of Nigeria's imports in 1985 (£961m); our exports in 1986 are down by 38% over 1985 figures at £473m (Jan-Oct). But we believe that our main competitors who are the USA, FRG, France and Japan, are suffering similarly.

Over dependent on oil. Due to the fall in oil revenues and the growth of Nigeria's debt problems Nigerian imports fell back sharply in the first ten months of 1986. The Nigerian Government recognise the need to put the economy on to a sound footing.

Short Term Debt - TRADE CREDITORS

Nigeria's total external debts are estimated at between $18-22 billion. Many, if not most, UK exporters trading with Nigeria have substantial sums outstanding. Short term trade arrears accumulated before 1984 are the subject of a reconciliation exercise being co-ordinated by the Chase Manhattan Bank to substantiate (match) and register claims. US$ interest bearing promissory notes are to be issued to creditors. These debts total some $7.5-9 billion, $4.5 billion of which is owed to unsecured creditors. The lengthy process of reconciling debts has caused resentment and in some cases hardship for British exporters. The need for progress has been emphasised repeatedly to Nigerian Ministers and senior officials, both bilaterally and through the Paris Club. The Nigerians are aware that there will have to be significant movement on this issue particularly in respect of claims already recognised and met by the ECGD and the other export credit agencies before new export credits can be put in place. Agreement reached on these points at Paris Club meeting on 15/16 December.

To date we believe that debts amounting to $4.9bn have been reconciled by Chase Manhattan, but only $1.9bn worth of promissory notes have been issued. In a circular dated 29 September, the Central Bank informed promissory note holders that it was not in a position to make payment of principal due on 6 October. The Central Bank has been claiming for some time that a major issue of promissory notes is imminent but it seems likely that this will be delayed until a meeting of note holders which the Bank intends to convene in London in mid January to consider proposals (details of which are to be circulated) which would have the effect of deferring payment of principal according to an agreed schedule.

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Terms agreed at Paris for the insured trade arrears will, because of the need for comparability between creditors, be essentially those put before the uninsured creditors. The Nigerians are seeking to reschedule insured short term trade arrears at Paris over 10 years with 5 years grace. Anything approaching these terms will not be popular with the uninsured creditors and makes it all the more imperative that a substantial volume of uninsured claims are recognised.

Investment

The UK is the largest single foreign investor in Nigeria, covering all areas of economic activity (oil, banking, insurance, construction, manufacturing and distribution). Investments total about £1.6 billion; 40% of all foreign investments.

NIGERIA - AID

AID

ESSENTIAL FACTS

1. When Nigeria became a major oil producer, it was decided in 1974 we should discontinue Capital Aid and that Nigeria should contribute towards the cost of Technical Co-operation. However, with the decline in oil revenues it was decided in 1984 to resume fully funding the TC programme.

2. TC expenditure is expected to be about £3.6m in 1986/87. The Aid Framework provides for it to rise to £4.575m in 1989/90. Most assistance is channelled through the British Council.

3. In 1985 there was a Review of our Manpower and Training Aid. The principal recommendations were that in accordance with ODA's manpower policy aid to Africa:

i. aid should be provided in the form of projects (rather than ad hoc initiatives and programmes of general support);

ii. projects in the education sector of 3-5 years duration incorporating training and books etc should be worked out and implemented in the areas of secondary teacher training and materials production, particularly in science, and institutional and development for polytechnics and universities.

4. The TC programme comprises:

i. Training in Britain. About 500 places costing £2.2m a year for Nigerians approved by the Federal authorities. (There is pressure for more awards but first we need to be sure the existing programme is really effective.) Majority of trainees are in agriculture, public administration and technical and industrial subjects.

PERSONALITY NOTE

OKONGWU, Dr. CHU S P

Minister of Finance

Born 23 September 1934 in Enugu.

Attended Government College, Umuahia. Dennis Memorial Grammar School, Onitsha. First Degree in Economics, Boston University 1961. PhD Harvard, 1965. Taught at University of Nigeria, Enugu, from 1965. Worked with United Nations Centre for Development Planning Projections and Policies. Returned to Nigeria 1972, to join East-Central State Agricultural Development Corporation. Chairman of committee for re-constituting the Institute of Management and Technology (IMT), Enugu, before resigning from the Civil Service in 1975 to head Multivar System, a consultancy firm. Appointed Minister of National Planning September 1985; swapped with Dr. Kalu I Kalu (qv) to become Minister of Finance, January 1986.

Was unimpressive in first months as Finance Minister, verbose but with little grasp of the difficult economic issues facing the country. Has improved in recent months, and has been obtaining a good press through his sustained efforts to achieve agreements on the rescheduling of Nigeria's debts and the provision of new money. But much of the credit for this in fact belongs to the more pragmatic Alhaji Ahmed, Governor of the Central Bank.

Hobbies include chess, cooking, the study of history and mathematics, squash, cycling.

Married; four sons.

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FROM: P MOUNTFIELD
DATE: 23 March 1987

MOUNTFIELD CH/EX 23/3

1. SIR G LITTLER 23/3
2. CHANCELLOR

What [illegible] the proposals?

cc attached for:

Chief Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Tyrie
Mr Ross-Goobey

cc Mr Lavelle
Mr Cassell
Mr H P Evans
Mr Turnbull
Mrs Case
Mr Walsh
Mr P Davis
Mr Culpin
Mr Pitcairn

SUB-SAHARAN AFRICAN DEBT

I attach a paper on this problem, which is a companion-piece to Mr Evans' more general paper on debt. It would be convenient to discuss the two at the same time - well ahead of the Spring Meetings.

The differences are:

- Mr Evans' paper is mainly about the big debtors who pose a systemic threat; this one is about a smaller (but probably more intractable) one

- his is mainly about debt owed to banks; this is mainly about government creditors

- his is about a problem which could be solved, given cooperation and political will; this is about a problem which (on the whole) will go on getting worse unless we tackle it soon;

- his is about a problem governments can affect only indirectly; this is one which creditor governments, if they agree, can tackle on their own

On the other hand

- his is about a problem we can't afford to ignore; this is one we could leave to tick over for years. (But my guess is that it will eventually explode, with much noise and not much damage)

- his is about a debate which has hardly started yet; this is about an argument which is already running internationally, and with increasing speed.

The present paper has been discussed extensively with other departments and the Bank (though not agreed with them line-by-line; important differences of emphasis remain, like 'who pays'). It draws on several recent discussions in the Paris Club and with the World Bank. These have so far been only exploratory and non-committal; we shall soon have to show the UK hand. So we need Ministerial instructions anyway; and if the Chancellor decides we should make a move, he may want to start the process at the Spring Meetings. The debate is already starting at home: see the attached piece in the FT of 20 March (which, incidentally, we did not inspire!)

Unlike Mr Evans' paper, this one involves several other government departments - ODA, ECGD (whose money is mainly at stake), FCO and also the Bank. I have tried to reflect their views in the paper.) If the Chancellor wants to carry these ideas further, the next move will be to write to other Ministers and the Governor. I can draft a letter following his meeting.

The paper only lists 'options for discussion', and I am not sure that there is complete unanimity even in the Treasury. My own view is that:

(a) The present position is unsustainable, and a new approach is needed;

(b) Simply extending the debt over time doesn't help (except possibly for one or two debtors); some form of interest relief is needed;

(c) As argued in the paper, this will have to be tightly-conditioned and carefull ring-fenced;

(d) The 'costs' - rising to £35/£40m a year - are more apparent than real; in practice they will arise anyway and the real question is whether we recognise them now or later. My vote goes for doing it now.

But see Andrew Turnbull's riposte AWK

(e) Since the costs reflect mistakes in the past, not new decisions to allocate additional recourses, they should not score as public expenditure (and the PSBR effects are allowed for up to 1991 anyway).

(f) There is some advantage in taking the lead ourselves, or at least joining the vanguard. This points to a pretty positive passage in the speech at the Spring Meetings.

PM

P MOUNTFIELD

Lombard

Sub-Saharan Africa's agony

By Michael Prowse

MENTION Third World debt at a dinner party and two misconceptions are likely to surface immediately. The first is that the crisis centres on Latin America and, at present, Brazil in particular. The second is that the principal villains in the debt morality play are hard-nosed commercial bankers like Mr John Reed at Citicorp. The truth is that the real debt crisis lies in Africa while the real villains are politicians and civil servants.

The impression that Brazil is facing intractable difficulties has been created by the media's indulgence of Mr Dilson Funaro's recent fist-waving world tour. The fulminating Finance Minister knows perfectly well that Brazil, by Third World standards, is rich and can readily service its debts if it avoids the sort of consumption binge he unleashed last year. If Brazil defaults, it will be a matter of choice not necessity.

What about the John Reeds of this world? True, they do not come across like Salvation Army bandmasters. But then their shareholders pay them to be profit-seekers. The world would be in a sorry state if bankers stopped behaving like bankers and began to ape Oxfam representatives. It is quite legitimate for commercial bankers to play a vigorous game of bluff and counter bluff with their formidable adverseries in the big middle income debtor nations. Tightfistedness now may prove a commercial misjudgment, but that is another matter.

If criticism is due, it should be directed not at cogs in the banking system but at the politicians (and to a lesser extent civil servants) who theoretically have the power to change the rules of the debt game. The charge that might be levied against, say, the Group of Five finance ministers (who effectively dictate the policies of the IMF and World Bank) is lack of leadership and lack of humanity. If a prosecuting counsel wanted to guarantee a verdict of guilty he would direct an international jury's attention not to Latin America but to Sub-Saharan Africa.

There are two reasons for this. In the first place, almost all the debt is owed to governments and supranational institutions rather than commercial banks. Politicians thus cannot pretend solutions are the private sector's responsibility.

Equally important, the region — unlike rich Brazil — genuinely deserves the First World's sympathy and cash. Many of the countries are quite desperately poor and face quite impossible debt repayment schedules. Zaire, for example, is poorer than it was a generation ago and has well under a tenth of the per capita income of Brazil. The World Bank calculates that the 12 African countries most plagued by debt now face scheduled repayments more than four times higher than the sums they could not manage in 1983-85.

Paris Club negotiations on African sovereign debt have descended into farce. There have been 88 reschedulings in the past decade. Payments due on previously rescheduled debt are having to be rescheduled. The cycle of arrears and rescheduling looks endless and it all reflects the meanness of First World lenders and donors.

The problems are magnified by what one senior official dubs the "unconscionable" attitude of the IMF, which is proving every bit as inflexible in Africa as the commercial banks have been in Latin America. Like them, it lent heavily on the wrong terms to the wrong countries and it is now refusing to bend its own rules. It wants the money back, come what may. Roughly half of the total debt repayments being made by the most heavily indebted countries are going to the Fund.

Something clearly has to give. Virtually every development economist openly admits that debt forgiveness is unavoidable in Sub-Saharan Africa. The absolute sums at stake are not large. A political initiative at the highest level is required to sort out the muddle and to mobilise more resources. It may be that the Fund's rules will have to be amended. The sooner politicians stop worrying about Brazil and start worrying about Africa, the better.

EXTRACT FROM LOMBARD BY MICHAEL PROWSE

INTERNATIONAL DEBT: POOREST COUNTRIES

Note by the Treasury

This subject will be on the agenda of a number of international meetings later this year. It is widely (but not universally) accepted that for some of the poorest developing countries, especially in Sub-Saharan Africa, the service of their existing debt is no longer possible without some form of relief, going beyond traditional "rescheduling" packages. This note considers the prospects for international agreement, and the options open to the UK. It ends by seeking Ministerial agreement on the line to be taken.

NOTE BY THE TREASURY

The Scale of Debt

2. Throughout their paper, the IMF's definition of Sub-Saharan Africa is used. This definition does not include Nigeria or South Africa. Although Sub-Saharan Africa's debt of $82bn is not large (about 80% of either Brazil's or Mexico's), the region has had serious difficulties in meeting its commitments. The first table sets out the region's debt, exports and debt servicing ratios over the recent past, and the IMF's estimates for 1986 and 1987.

Sub-Saharan Africa

Table 1	1980	1982	1984	1986	1987
Debt (US$Bn)	44	54	58	76	82
Exports of Goods and Services (US$Bn)	30	25	26	27	29
Debt/Exports (%)	146	214	223	284	265
Interest/Exports (%)	7	10	11	11	12*

Source: Draft IMF World Economic Outlook, February 1987

* payments due.

Over the last seven years, debt has risen by over three-quarters, while exports have declined. Although 12% of export earnings are due to be paid as interest, it is unlikely that actual payments will be much greater than 10%. Arrears continue to accumulate.

3. The next table sets out OECD's estimate of the debt portfolio of the region.

Sub-Saharan Africa - External Debt (end 1985) (US$Bn)

MDBs	IMF	Banks	Governments (mainly ECAs and ODAs)	Others	Total Debt
18	7	14	30	13	82

4. $5bn of bank debt and $2bn of ECA debt is short term and trade-related. Much of the debt from the multilaterals and from ODAs is concessional in nature. The IMF and the multilaterals have priority over bank and ECA debt, so that not only are ECAs the single largest source of credit, they are also among the first to suffer if service payments are delayed. The World Bank estimates that about half the debt service due in 1986 and 1987 by the poorest countries in Africa is to official creditors, the largest proportion of which is owed to ECAs. This has been reflected in the large numbers of Paris Club reschedulings for countries in the region. Other creditors, particularly the IMF, are also facing difficulties in having their repayments made on time. The IBRD can expect growing problems in the next few years as the level of repayments grows, following on from the increased level of disbursements earlier in the decade. It should be noted that the aggregate figures disguise wide variations in the relative importance of the various debtors on a country basis.

5. Although it is unwise to see the 41 countries that make up SSA as an homogeneous grouping, they are generally poor,

with GNP/head less than$300 on average, and comparatively heavily indebted, with debt per head of about £230. Much of the labour force is employed in agriculture. Total population is about 320m, and is growing rapidly, although population density is still low. Economic growth is sluggish. A growing number of African countries have recognised the need to follow more sensible structural economic policies, and are working more closely with the IMF and the IBRD, but progress is likely to be slow. There are other countries elsewhere in the world which share many of the same characteristics, particularly in South Asia.

6. The reasons for Sub-Saharan Africa facing a major problem in servicing its debt are complex, but from a Western Government creditor perspective, it seems clear that a good part of the finance provided by ECAs has not been well invested, and has not shown a worthwhile rate of return. It also seems clear that the blame for this poor performance has to be shared between creditors and debtors; past lending for dubious prestige projects or arms sales, or even for consumption, under pressure from Western suppliers, has failed to generate the funds needed to cover repayment.

The problem

7. Essentially the problem is that the debt is mounting faster than Africa's ability to service it. Each time a country runs into a balance-of-payments gap, the creditor governments (meeting in the Paris Club) 'reschedule' the debt, postponing repayment for ten years, usually including a five-year grace period. Often the Club reschedules interest as well as principal. This newly-consolidated debt carries interest (technically called 'moratorium interest') at a market rate, often replacing the concessional rate on the original loan. (The OECD Consensus on Export Credit subsidies, which allows concessions, does not apply to rescheduled debt). When that burden in turn becomes too heavy, the debt is rescheduled yet again. So the debt is compounding itself

at 8 or 9% a year (on average) while the debtor's exports are growing, with luck, at 4 or 5%. Most of these countries are primary producers whose commodity prices have been depressed in recent years, with little chance of early recovery. The debt is mounting far faster than it can be paid.

International Debate.

8. Sweden and France have taken the lead in raising this problem in the Paris Club, where it is generally recognised that the problem will have to be tackled soon - in 1988 if not in 1987. There has been less discussion in development circles. The Nordic countries have given notice that they want to place this item on the agenda for the April Meetings of the Interim/Development committees. This will probably be in very general terms. The French are pressing for a more substantive declaration in the Venice Summit communique. The World Bank want more work done on the technical aspects during the Spring. It is likely to feature at UNCTAD. The UN Secretary General is to appoint an 'expert panel' to produce a report in time for the General Assembly in September or October. The whole topic will feature largely at the Annual Meetings of the IMF and the IBRD in late September. The World Bank hope this would lead to agreement on a new 'framework' for handling the problem, within which individual negotiations would proceed 'case by case' in the Paris Club. (It would be important to keep this 'framework' fairly flexible, to avoid over-generous treatment of over-mechanical rules.)

Attitude of other creditor governments

9. Most Paris Club creditors recognise that there is a problem. Many of them see the need for some new initiative to deal with it. As yet there is no consensus on the form that this special treatment should take. There remain those who are opposed to any special treatment. The Australians argue that the debts

will never be repaid anyway, so it is enough to go on rolling over the principal. Japan has argued that it would be perverse to reduce interest rates for the poorest countries when their lower credit rating should require them to pay a higher rate of interest; to write off part of their existing debt would cut them off from future international lending and make them wholly dependent on aid. The US have said that they would have very serious problems in getting appropriations to soften interest rates in the present congressional climate. Sweden is prepared to consider proposals that not only lengthen the repayment period and grace periods but also incorporate concessional rates of interest. France seems more prepared to lengthen the maturity and grace periods but is also looking at the possibility of concessional interest rates. FRG is also prepared to lengthen the repayment and grace periods but has more difficulty over concessional interest rates, for which Parliamentary approval would be needed (as it would, presumably, for the two minor FRG proposals noted below, in para 14g ~~above~~). Canada has argued for a nil rate of interest, arguing that this made it easier to ringfence the poorest countries and avoid the spread of concessional interest rates to Latin American borrowers; and is also prepared to consider offering a moratorium of ten years on the payment of interest; but no final decisions have been taken. The World Bank, which has recently sent a mission round European capitals to explore this problem, reports that FRG France, Italy and Sweden are all studying the question, and that France may produce some proposals fairly soon.

The case for action

10. The present arrangements for rescheduling this debt are becoming increasingly unrealistic. Elaborate negotiations provide debt relief for a further 12/18 months, based upon IMF adjustment programmes which at best cannot produce results for several

years; but the deferred debt, often including capitalised interest, is simply added to the normal maturities of other debt in future years to produce repayment profiles which simply cannot be met, and which in practice, is just rescheduled again and again (nine times for Zaire, for example). In some cases debtors cannot even pay 'moratorium interest' (that is, interest on the reconstructed debt) in full because it approaches their total export earnings and leaves nothing to finance imports. Such agreements give the debtor country no incentive to adjust, because the whole benefit of adjustment is seen to accrue to the creditor. Eventually, for many debtors there will be no alternative to default. Creditors are not being paid, in full or on time; and the costs are already being met by ECAs when they pay claims from exporters or banks. Default must look increasingly attractive to some debtors. The case for action is therefore:

(a) to improve the chance of eventual recovery of part of the debt;

(b) to give the debtor an incentive to adjust (the so-called 'light at the end of the tunnel' argument) - which is in the interests of the creditor;

(c) to recognise that some of the loans made in the past are in practice irrecoverable, and substitute more realistic valuations in the books of creditors;

(d) to get away from the charade of repeated annual rescheduling negotiations which impose a heavy administrative burden on debtors and creditors without improving the prospects of recovery;

(e) to win some political advantage along the way as a useful by-product.

However, there is no overriding reason of ECGD (or ODA) management for changing present policy. Indeed ECGD would argue that it is best to leave these debts on their books at full value so long as there is any prospect of eventual recovery. (While building up prudent provision against the risk of eventual non-payment.)

Objectives of any change of policy

11. It would be generally recognised among creditors that any new policy must:

(a) Not distract the developing countries from necessary adjustment measures.

(b) Not 'reward failure' while penalising those who have already adjusted.

(c) Avoid creating difficult precedents for Latin American and other major debtors.

(d) Limit the cost to creditor governments.

(e) Where possible, require comparable efforts by other creditors: banks; IFIs; and non-OECD governments.

(f) Not close the door to new cover by ECAs.

Coverage and Conditionality

12. Most Paris Club creditors agree that if there is to be a scheme at all, it would have to be confined to the 'poorest' debtors. There is as yet no consensus about what is meant by this term. We have considered various definitions including "IDA-eligible" (ie $790 per capita income or less in 1983) and the very poorest "LLDC" (which takes into account per capita income of about $400 but also the degree of industrialisation

and literacy). The World Bank has suggested limiting the operation to those countries already eligible for their special Facility for Africa. For the sake of this paper we have chosen an identifiable group of the "29 poorest countries in Sub-Saharan Africa" which is a World Bank definition. It is useful to confine this to Africa, though in time, the case by case approach might extend to other deserving countries outside Africa. Even the most restricted definition contains countries that have managed to avoid rescheduling their debts. There will need to be a second test of debt service capacity to establish need. Since it is assumed that principal repayments are in any event to be rescheduled, an interest payment to export ratio is perhaps the most relevant. An interest to export ratio of 10% has, on average, been all that African countries have been able to pay in recent years with generous capitalisation of interest. A table showing those of the "29 poorest countries in Sub-Saharan Africa" with interest/export ratios greater than 15% is shown in Annex 'C'. This is not necessarily the only definition to use (ODA have recently proposed a different test: a $400/head income figure and a total debt service/equity ratio of 40%). More work needs to be done in the UK and internationally before final decisions are taken on coverage.

13. It is common ground that any special treatment would be highly-conditional; otherwise automatic relief to heavily-indebted countries would only 'reward failure'. This is not going to be easy. Many of the countries concerned have tried to implement IMF programmes in the past, without much success so far. Creditors have very few sanctions, since refusal to reschedule merely invites outright default, and there is not much by way of aid flows or of new investment to withhold. But we must try. The normal requirement for any Paris Club rescheduling is the existence of a current IMF SBA at the time of signature. But this only runs 12 or 18 months forward; a SAF would normally run only 3 years forward. Efforts to apply conditionality will have to be attempted over a period of many years. Such longer-term engagement points to either interest relief or phased

writedown. The IBRD has suggested debt agreements covering three years at a time, linked to IBRD-approved adjustment programmes, and renewable if performance criteria are met; they assume interest-relief would be a major element. This seems a reasonable approach, though it would be important to associate the IMF with the programme as well as IBRD.

Options for Creditor Governments

14. In ascending order of difficulty, these are:

(a) Do nothing; let the debt accumulate, but postpone action for some years, in the hope that at least some of it will be paid off eventually;

(b) Conversion of existing aid loans into grant (RTA). The UK and FRG have a good record in this regard, others, including France, less so. But to urge this course would require the UK to continue the process, notably with Zambia. ODA argue that continuing grant aid, with conditions attached, is a more potent instrument than once-for-all RTA, where conditionality can be imposed only at the point of conversion. Future RTA could however be given in tranches subject to conditionality, as Canada apparently intends to do.

(c) Extending rescheduling terms. Current practice is to reschedule debt over about 10 years, including 5 years grace (though there have been slightly longer terms granted). There is a general readiness to extend these terms in appropriate cases. This brings considerable immediate relief to debtors, like Tanzania, with a high proportion of debt maturing in the next 10 years. But it assumes that such countries will eventually be able to grow out of their difficulties, and resume service of the debt in the future. It may cause particular problems for the US, who would require fresh congressional action. (However there is now a large pro-African lobby in Congress which may make this easier.) As with RTA, there are problems about applying conditionality, once the initial conversion has been made. Although leverage continues (in the sense that the original payments schedule can technically be restored if the debtor fails to meet IMF or other conditions) this is in practice unenforcable.

(d) Capitalisation of interest. Although this has been done in the past for many of these debtors, it is seen as an interim measure, which does not help in the longer term. The total debt increases by compound interest at a rate faster than the debtor's capacity to pay, thus pushing a mounting 'bow-wave' of debt into the future.

(e) Softening interest terms. There has been no multilateral agreement to do this since Indonesia (1972). Technically, the Paris Club leaves interest to be determined bilaterally 'on the basis of the appropriate market rate'. The UK reschedules old aid loans on the basis of the original concessional rate, but export credit is rescheduled at a rate which will leave ECGD without a loss (in practice, they seek a margin of 0.5% over LIBOR (a rough approximation to their own cost of funds) but do not always get it). The Paris Club Secretariat have made some calculations illustrating the effect of halving the average interest rate charged on reschedulings: this demonstrates a considerable extra relief, which bridges most of the financing gap for selected debtors. If such a concession were agreed in principle, it would have to be closely defined: the effects on creditors vary greatly, depending on whether the interest rate is cut by a fixed proportion; by an equal number of percentage points; or to a flat rate. The first and third of these devices would place an undue burden on high interest rate countries like the UK. All three pose the same problem of conditionality, though a concession made in one year can be withdrawn in a later year for non-performance.

(f) Partial or total write-off. A write-off of part of the debt has the same effect on cash flow as a reduction in the interest rate charged. (Technically, the amount to be written off would be the discounted present value of the future stream of interest payments forgiven.) Most government creditors could be indifferent between these two techniques, (although for ECGD they have very different accounting implications, explained below). A once-for-all write-off carries weaker conditionality, though it is probably a fairer presentation of the real position of the debtor.

(g) A variation under study in the FRG, which involves elements of each, is not to charge moratorium interest on capitalised overdue interest. This helps to avoid expanding the overall indebtedness of a debtor by only charging interest on the principal amount outstanding. A further refinement is an FRG proposal to use all receipts of interest to reduce the principal of the debt outstanding. This is in effect a write off of interest. But by classifying it as an interest payment the creditor is able to charge the debtor, and the debtor pay interest to the creditor, which if it were termed a principal repayment would not be allowed while principal payments remained the subject of rescheduling agreements. Neither of these proposals seems to help very much.

(h) Additional aid flows. It is unrealistic to expect this to help much. For all government creditors except perhaps Japan, Italy and Sweden, aid flows are constrained. OECD/DAC has calculated that total bilateral and multilateral aid flows will increase, on average, by only 2% per annum in the next 5 years - not enough to allow the poorest countries to service their debt, even if Africa gets a larger share than in the past.

(To put this in context, it is also assumed that inward investment and new bank lending to the poorest debtor countries is unlikely to rise significantly in the near future.)

IFIs

15. The main contribution of the IFIs will be additional lending, mainly by the IBRD, which is useful in resource terms but also helps to enforce conditionality. But debt already owed to the IFIs is also part of the problem; much of it falls due for repayment in the next few years, it takes precedence over other debt and is exempt from rescheduling. In the UK we think that IBRD loans should continue to be exempt, so that IBRD can go on borrowing on fine terms in financial markets. That means that other sources (bilateral aid, new IBRD loans, and rescheduling of official debt) have to be used to repay the IBRD. (Net transfers on concessional terms will continue to be made by the IFIs through 'soft funds' like IDA.) But we think it may be possible to roll over some of the very short-term debt due to the IMF or to turn it into more-concessional lending; these options are under separate study.

Commercial Banks

16. They have a comparatively small stake in the total problem. Governments cannot dictate terms to them. But certain options are open:

(i) negotiate appropriate solutions jointly with banks: this could encourage them to join in any writedown/interest relief:

(ii) make known government/IFI position: and 'expect' banks to play part:

(iii) make known government/IFI position: declare that bank debt is a matter for negotiation between banks and debtors; but recognise that if major debt relief is on offer for 80 per cent of debt, this would make it easier for countries to service bank debts, and at the same time would put pressure on banks to join in.

No immediate decisions are needed on these options, but if governments eventually agree on a debt-relief plan, a concerted approach to the banks will have to be agreed.

Official Debt: Who Pays?

17. Although there does not have to be international agreement on this before concessions are made to debtors, no government is going to sign up without reaching internal decisions on this point. For most creditor governments, the problems are the same. Aid budgets are constrained; export credit agencies, supposed to operate on a commercial remit, will be badly-hit by any reduction in debt service; and there are varying constraints on the ability of central exchequers to take the costs. (There do not appear to be any problems under the OECD Export Credit Consensus. In any case, if the creditors collectively decide on a new policy on debt, they will be able to amend the Consensus as necessary. The same governments are involved.)

UK Departments: Bearing the cost

18. Nearly all the debt in question is owed to ECGD. Its total exposure to Sub-Saharan Africa (excluding Nigeria and South Africa is some £1.932 billion, £509 million of which represents debt owed directly to ECGD following claims already paid, mostly following rescheduling agreements. For the 29

poorest countries in Annex C, the figures for ECGD would be £918 million and £451 million. The remainder is owed to banks and exporters under ECGD guarantee and is a contingent liability of the Department. Much of it falls due in the next few years and will have to be rescheduled. Any new terms would apply to most of it (though not of course automatically; 'case by case' treatment based on need would apply). Any extension of the repayment period (option c. above) would not in itself create a new burden for ECGD. Although the debtor would be given longer to pay, the full face value of the debt would be retained in ECGD's balance sheets, on the assumption that the debt would eventually be honoured. As ECGD's forecasts take into account non-payment (especially of Sub-Saharan debt), this is already reflected in ECGD's projected call on the PSBR up to 1991. This also covers the cost of any new interest relief (option e. above) in the same period. But <u>any</u> interest relief must eventually represent a call on the PSBR and a cost to ECGD. Assuming an average interest rate of 9½% charged to debtors in Annex C than halving the interest rate to 4¾% would entail 'forgiveness' of £44 million in a full year on ECGD's total exposure of £918 million. Although not all of this will necessarily have to be rescheduled it would be prudent to assume that the annual cost might eventually be in the range £35-40m.

19. The question is whether this is an additional cost, and who should pay it. The answer depends on whether we regard the costs as losses which have been incurred already, or as new resource transfers to be added to public expenditure.

(i) <u>ECGD: Deferred write-off</u>

ECGD will pay claims to banks which receive only a proportion of interest they are due. It will also receive somewhat less moratorium interest on debt already rescheduled or to be rescheduled in the future. Both would add to the PSBR. One solution is simply to acknowledge that losses have been incurred through excessive credit in the past, which must eventually be written off. There would be no need for immediate action. ECGD's (notional) borrowing from the Consolidated Fund would increase, to the point where ECGD could no longer pay interest in full. There is very little scope for recouping the cost from ECGD's customers through increased premium. At that stage part of ECGD's debt to the Consolidated Fund would have to be written off; this would require retrospective adjustment of past years' public expenditure figures, so as to record the losses in the years in which the loan concessions were originally granted. This solution sounds attractive; but it piles up trouble for the future; leaves ECGD to defend a deteriorating financial position; and could lead to Parliamentary criticism that the true facts were being obscured.

(ii) <u>ODA</u>. Alternatively, the concessions could be viewed as 'aid' and met by ODA who would reimburse ECGD its losses. (It is unlikely that, internationally, the DAC will agree to count them as aid. This doesn't stop the UK from so regarding them for domestic purposes, but complicates the presentation.) ODA could not afford to find up to £40/50 million a year from the existing aid framework. If Ministers chose this route, they would have to sanction additional public expenditure to be met from the Reserve. (Because the costs have largely been allowed for in the PSBR already, the addition to PSBR would be much smaller.)

(iii) <u>ECGD: Additional public expenditure</u>. Another solution is to recognise the costs as public expenditure, as they arise and meet them from an ECGD public expenditure programme (which at present covers interest make-up under the Fixed Rate Export Finance scheme). This would be a demand-led programme without a cash limit, and no offsetting savings are available, so this would be a net addition to public expenditure and met from the Reserve.

(iv) ECGD: Progressive write-off. A final approach would be to regard the losses as already incurred, but to 'forgive' ECGD part of its debt to the Consolidated Fund year by year, as the costs of interest-rate concessions worked through. (Technically this would require the calculation of the net present value of the stream of interest payments foregone by ECGD.) Since ECGD's Trading Account is non-statutory, this can be done without legislation, though Parliament should be informed. This could be scored as public expenditure, affecting past years' figures retrospectively (and they would have to be revised each year). That would be somewhat complicated, and would be difficult to present coherently. A better course might be to regard the costs as past, and to ignore the write off for public expenditure purposes since no new resource transfer is involved.

Issues for Ministers

20. (a) Has the time come to recognise that, for certain African debtor countries, permanent debt relief (rather than postponement) is now needed? Or should the problem be left over for the moment?

(b) Should the UK join in any international consensus of this kind?

(c) Should the operation be ringfenced: to the 29 poorest countries in Sub-Saharan Africa with an interest/exports ratio above 15%, or to any alternative formula? (No immediate decision on method is needed on this, if Ministers accept the need for ringfencing in principle.)

(d) Which course should we advocate: longer term rescheduling; interest rate concessions; or absolute write-off?

(e) On whom should costs fall - on ODA; on ECGD customers; on the Exchequer: and if the latter, should the costs be scored at the point of decision, or retrospectively adjusted, or regarded as past losses not needing further additions to public expenditure.

(f) Should the UK make a virtue of necessity by advocating treatment of this kind, taking a new, if limited, initiative at the Spring Meetings? Or should we simply go with any emerging consensus?

ANNEX A

The 29 Poorest Countries in Sub-Saharan Africa

	Exports (US$Bn)	Total External Debt (US$Bn)	Debt to Exports Ratio	Population (1984)	GNP/Head (1984) (US$)	GNP (1984) (US$Bn)	Interest Assessed (US$Bn)	Interest/ Exports (%)
Benin	0.2	0.8	4.5	3.9	270	1.1	0.0	22
Burkina Faso	0.3	0.6	2.3	6.6	160	1.1	0.0	8
Burundi	0.2	0.5	3.2	4.6	220	1.0	0.0	11
Central African Re	0.1	0.3	2.6	2.5	260	0.7	0.0	10
Chad	0.1	0.2	1.1	4.9	80	0.4	0.0	4
Ethopia	0.6	2.0	3.3	42.2	110	4.6	0.1	14
Gambia	0.1	0.2	2.3	0.7	260	0.2	0.0	11
Ghana	0.6	2.5	4.0	12.3	350	4.3	0.1	19
Guinea	0.0	1.4	0.0	5.9	330	1.9	0.1	
Guinea-Bissau	0.0	0.3	42.2	0.9	190	0.2	0.0	185
Kenya	1.6	4.1	2.6	19.6	310	6.1	0.2	13
Lesotho	0.4	0.2	0.4	1.5	530	0.8	0.0	1
Liberia	0.5	1.4	2.8	2.1	470	1.0	0.1	15
Madagascar	0.4	2.6	7.4	9.9	260	2.6	0.1	38
Malawi	0.4	1.0	2.7	6.8	180	1.2	0.0	11
Mali	0.2	1.5	6.9	7.3	140	1.0	0.1	28
Mauritania	0.3	1.5	5.2	1.6	450	0.7	0.1	27
Mozambique	0.1	1.4	15.0	13.4	380	5.1	0.1	85
Niger	0.3	1.1	3.8	6.2	190	1.2	0.1	19
Rwanda	0.2	0.4	2.1	5.8	280	1.6	0.0	6
Senegal	0.5	2.7	5.3	6.4	380	2.4	0.1	29
Sierra Leone	0.2	0.7	2.9	3.7	310	1.1	0.0	15
Somalia	0.0	1.7	40.2	5.2	260	1.4	0.1	186
Sudan	0.8	6.4	8.1	21.3	360	7.7	0.3	44
Tanzania	0.4	3.4	8.2	21.5	210	4.5	0.2	38
Togo	0.3	1.0	4.1	2.9	250	0.7	0.1	22
Uganda	0.4	1.1	2.8	15	230	3.5	0.1	13
Zaire	2.0	5.9	2.9	29.7	140	4.2	0.3	17
Zambia	1.0	4.5	4.5	6.4	470	3.0	0.3	25
TOTAL	12.2	51.2	4.2	270.8	240	65.2	2.6	21

ANNEX A

ANNEX. B

Other African Countries

	Exports (US$Bn)	Total External Debt (US$Bn)	Debt to Exports Ratio	Population (1984)	GNP/Head (1984) (US$)	GNP (1984) (US$Bn)	Interest Assessed (US$Bn)	Interest/ Exports (%)
Angola	2.0	1.4	0.7	9.9		0.0	0.1	5
Botswana	0.9	0.4	0.4	1	960	1.0	0.0	2
Cameroon	2.5	3.6	1.4	9.9	800	7.9	0.2	8
Cape Verde	0.0	0.0	6.8	0.3	320	0.1	0.0	41
Comoros	0.0	0.1	16.9	0.4		0.0	0.0	60
Congo	1.1	2.8	2.6	1.8	1140	2.1	0.2	16
Djibouti	0.1	0.2	2.6			0.0	0.0	15
Equatorial Guinea	0.0	0.1	7.4	0.4		0.0	0.0	45
Gabon	1.9	1.9	1.0	0.8	4100	3.3	0.1	6
Ivory Coast	3.0	7.2	2.4	9.9	610	6.0	0.5	16
Mauritius	0.5	0.6	1.2	1.0	1090	1.1	0.0	7
Reunion	0.0	0.1	0.0			0.0	0.0	
St-Helena	0.0	0.0	0.0			0.0	0.0	
Sao Tome and Princ	0.0	0.0	4.3	0.1	330	0.0	0.0	15
Seychelles	0.1	0.1	1.3	0.1		0.0	0.0	7
Swaziland	0.4	0.3	0.7	0.7	790	0.6	0.0	4
Zimbabwe	1.4	2.1	1.5	8.1	760	6.2	0.1	9
Total	13.9	21.0	1.5	44.4	640	28.2	1.3	9.5

Other Low Income Countries

	Exports (US$Bn)	Total External Debt (US$Bn)	Debt to Exports Ratio	Population (1984)	GNP/Head (1984) (US$)	GNP (1984) (US$Bn)	Interest Assessed (US$Bn)	Interest/ Exports (%)
Nigeria	12.0	22.0	3.1	96.5	730	70.4	1.8	15
Bangladesh	1.3	5.8	4.5	98.1	130	12.8	0.3	23
India	12.6	30.3	2.4	749.2	260	194.8	1.6	13
Pakistan	3.6	12.5	3.5	92.4	380	35.1	0.6	17
Sri Lanka	1.6	3.4	2.1	15.9	360	5.7	0.2	13
China	29.2	19.3	0.7	1029.2	310	319.1	1.0	4

Sources; "External Debt Statistics",OECD 1987, "World Development Report 1986", World Bank, IFS and IMF Article IV papers.

ANNEX B

ANNEX B

ANNEX C

THOSE OF THE "29 POOREST COUNTRIES" IN SUB-SAHARAN AFRICA WITH AN INTEREST/EXPORT RATIO OF 15% OR MORE

Country	Interest/Export Ratio %	ECGD Claims paid £m	ECGD contingent liabilites £m
Benin	22	26.1	38.5
Ghana	19	23.1	132.5
Guinea Bissau	185	.1	-
Liberia	15	10.9	43.2
Madagascar	38	9.3	3.7
Mali	28	3.9	12.5
Mauritania	27	3.4	3.9
Mozambique	85	31.3	17.2
Niger	19	3.4	3.8
Senegal	29	9.1	13.0
Sierra Leone	15	1.0	0.5
Somalia	186	12.3	0.8
Sudan	44	122.1	4.7
Tanzania	38	74.2	34.8
Togo	22	15.1	7.4
Zaire	17	41.9	3.7
Zambia	25	64.2	73.4
Total		451.4	467.0

Note:

a. Outstanding aid loans to Zambia, Senegal and Liberia are estimated at £64.5 million.

b. The total of 'ECGD paid' (£451.4m) includes £35.1m of buyer claims - ie companies which have defaulted or gone bankrupt - irrelevant to the present argument.

ANNEX C

CONFIDENTIAL

From : H P Evans
Date : 20 March 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Byatt
Mr Cassell
Mr Lavelle
Mr Monck
Mrs Lomax
Mr Mountfield
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Culpin
Mr Matthews
Mr Walsh
Mr Carpinter
Ms V Life
Mr Cropper
Mr Ross Goobey

Mr A Loehnis)
Mr P Kent)Bank
Mr L Price)of
Mr R G Ware)England

Mr Lankester -
UKDEL/IMF

Ch
This, and Peter Mountfield's companion paper on sub-Saharan debt, is to be discussed at your meeting on Thursday
A K
24/3

EVANS
→ CHX
20/3

INTERNATIONAL DEBT

I attach an analysis of international debt problems. This minute highlights the main points, lists some key questions, and suggests the next steps together with a line to take for the forthcoming Washington meetings.

Summary of Paper

2. There are many accounts of events leading up to the debt crisis of 1982 and a plethora (95 at the last count) of "solutions". This paper concentrates on developments between 1982 and now, in order to assess the progress made by creditors and debtors.

3. The position of the main creditors, the commercial banks, has strengthened very considerably relative to their exposure compared to 1982, although a number of US banks, and a few UK banks, are still heavily exposed. But the financial position of the great majority of debtors has worsened : they are now further away from creditworthiness than four or five years ago. This conclusion emerges whether we look at the Baker 15 grouping, sub-Saharan African countries, or a wider grouping of problem debtors.

4. There are of course some developing countries (a substantial majority in terms of income and population and trade) which borrowed prudently, and to good effect. But of the group of countries which emerged in the early 1980s as problem debtors have mostly been in the IMF/World Bank/Paris Club sick bay ever since, we have been able to identify only Korea (and the earlier case of Turkey) as clear examples of successful adaptations to large debt burdens. (They were arguably special cases and not the result of the successful application of the present strategy.)

5. We do not draw the conclusion that the present case-by-case strategy has been wrong. On the contrary, it can claim some successes :-

i) creditor countries, and banks in particular, have bought time since the original crisis broke in 1982, when collapse would have been much more damaging to the banking system;

ii) the world economy (and especially the UK) is in a healthier position than four or five years ago;

iii) a number of debtor countries have put in place sensible macro policies, with realistic exchange rates and real interest rates and other forms of structural adjustment;

iv) nobody has offered an alternative strategy, even in retrospect, which would clearly have served us better over the last few years.

6. But the stronger creditor and weaker debtor positions are creating obvious strains in the handling of debt problems. Thus far the effects have been most evident in the reluctance of banks to sign up on new money packages, and the efforts of the US to protect its weakened banking system by coralling other banks, Paris Club creditors and the IMF into going along with weak programmes - essentially spreading the costs that should fall hardest on US banks over all creditors. These efforts have successfully averted a major default and thus pressure on the banks for the time being.

7. We have not tried to apportion responsibility between the frequently perverse domestic policies of debtors and the undoubted deterioration of the world economic environment that had taken place by 1982. But we do look at the prospects for the world economy and conclude that taking three key elements together - real interest rates, the growth of markets in industrial countries, and commodity prices - we cannot count on a major improvement in the external environment over the next four years from the situation today.

8. We look at the conditions for a sustainable position in the longer-term. The current approach emphasises growth oriented adjustment programmes imposed by the creditor governments through IMF and World Bank conditionality. The banks and export credit agencies have taken their cue mainly from the IMF. Recent experience makes us very doubtful whether conditionality imposed in this way is leading towards a sustainable position. The alternative, making less use of the IMF and World Bank, is to restore decision-making powers to the market place, above all for middle income debtors. Greater use of financial markets could relieve creditor governments of some disagreeable and difficult choices, and restore greater responsibility to debtors.

9. There is a group of low income countries in sub-Saharan Africa which have never been market borrowers on any scale and where the range of problems including debt are massive in relation to their resources. Their debt is not large in relation to the total and is mainly held by governments and IFIs and not banks.

Mr Mountfield will be submitting a separate paper on the problems of sub-Saharan Africa and the policy choices, inviting you to circulate to colleagues and agree a line before the Spring Meetings.

10. We look at the debt problems of the large middle income debtors and examine three broad approaches :-

a) continuation of the present approach, in the hope that reform programmes will bear more fruit, that the world environment will improve, and that creditors, especially banks, will in time be in a position strong enough to be able to withstand either default or substantial reductions in interest payments should either of these occur.

b) reinforcement of the existing strategy by encouraging debtors to implement more effective reform programmes by a combination of stronger pressure from creditors and additional financial inducements. The converse would be that for those countries not prepared to implement programmes with a reasonable prospect of medium-term viability, there would be less access to external finance.

c) a shorter route to a market solution by encouraging the marketability of debt.

Key Questions

11. The key questions raised by the paper are as follows :-

i) is the conclusion accepted that debtors are further away from creditworthiness than they were in 1982?

ii) is it right to base the debt strategy on the expectation that either debtors' performance or the world environment or both will improve significantly?

iii) is it accepted that the long-run aim should be a bigger role for markets and a lesser role for governments and IFIs?

iv) is there a sufficient constituency for stronger reform programmes coupled with more finance among creditors and debtors?

v) if not, and if it is accepted that there will at some stage be some kind of partial default, do we want to :-

How to do it?

a) offer stronger inducements for reform programmes, eg by including in IMF packages phased and conditional forgiveness of debt; or

clearly much easier (political & practical)

b) leave such decisions as far as possible to the markets and to commercial bank/debtor negotiations?

vi) even if it is recognised that at some stage there is the likelihood of default, should we seek to continue with the present approach as long as possible in order to gain yet more time?

Answers to Key Questions

12. Our paper concludes that debtors are indeed further away from creditworthiness than in 1982, that a debt strategy should not be based on the expectation of significant improvement in the world environment and that marketability of debt should be the long-term aim.

13. These views are not universally held. For instance Volcker told the Senate recently : "debt burdens are tending to move lower relative to exports or other measures of capacity to pay". Baker has been making similar noises.

14. The Bank of England, who have been extremely helpful in the preparation of this paper - though they would not want to be associated with all its conclusions - agree that the debtors are further away from creditworthiness and that present trends in the debtors and in the world economy do not give grounds for optimism. The Bank are pessimistic on whether in the longer-term we can and should look to markets to impose conditionality on debtors. They also feel that there is unlikely to be a sufficiently large constituency among creditors or debtors for the stronger reform programme/more finance route. In particular they believe that this route, if it is to be viable, will need to be buttressed by some form of debt relief rather than by adding to existing debt, in the context of conditionality agreed with the IMF.

15. I have some considerable sympathy with the expectation that there will at some stage or other be partial default by some major debtors : we need to do more work on our response to that, on the menu of options facing debtors, and on the influences creditors can bring to bear in order to influence those debtors considering default.

The Next Steps

16. In considering whether a constituency exists for reform plus finance, we have to recognise the implications for the UK and our relationships with other creditors and with debtors. The present strategy is broadly agreed between creditors; major changes would also need to be agreed.

17. Politically it is not on for the UK constantly to act in splendid, and arguably futile, isolation : but in order to persuade other creditors that we are serious we would need to be prepared, on at least a few occasions, to say something in public and to abstain or cast a vote against in the IMF or World Bank Boards. Tactically we would try and get in as early as possible at the formative stages (as perhaps we should have done in the case of Egypt, though the outcome could well have been the same) and seek to persuade other creditors (and debtors) that it is in

no one's long-term interest for weak programmes to go ahead - as we are trying to do on Yugoslavia and have failed to do on Jamaica.

18. The first step therefore would be to try to persuade other creditors to share our analysis. The march of events will always be the most powerful argument, but it would be helpful to circulate a version of this paper, at the level of officials not Ministers, among the more important creditors (and the Fund and World Bank Staff) as a discussion document, not as a statement of UK Government policy. Discussion at G5/7 Deputies and Ministers would be crucial; to be followed by statements at the Interim and Development Committees, at the OECD Ministerial in May and the Summit in June.

19. We have just received a paper by Canadian officials, described as an internal working paper and not necessarily reflecting government views. It notes a lack of progress over the past year and suggests the need for an urgent re-examination of the current approach to the debt problem, without however coming up with anything very new. The Canadians are considering whether to release the paper sometime in the next few months. Michael Wilson (Finance Minister) has been holding meetings with banks.

20. The analysis and policy implications of the problems of sub-Saharan Africa would need to be pursued in parallel.

Current Cases in the IMF

21. We need to look now at the cases current in the IMF, bearing in mind the serious deterioration in the quality of recent IFI programmes - to a point where there is scarcely a single major debtor which can be said to be implementing an adequate adjustment programme.

22. We ought to start with Egypt. The difficulty is of course that G5 countries are already informally committed to support an IMF programme. Perhaps the most that can be done is to avoid backsliding by the Egyptians, and to tell them when the programme

comes to the Board that no waivers (except technical ones) would be granted if targets are not met. We would need to implement this threat and of course not offer any contribution to the financing gap, nor pressure the World Bank to soften its line in order to do so. All this might help to torpedo the programme.

23. A list of countries where early breakdown of existing programmes might be expected (despite some adjustment effort) and where a tough policy on waivers might be justified is :-

Argentina
Jamaica
Mexico
Nigeria (probably)
Tanzania

24. It looks as though the Brazilians may be looking for major sector loans from the World Bank, rather than from the IMF, to support any adjustment programme. But the implementation of a return to conditionality would mean at least a structural adjustment loan from the World Bank, if not an IMF programme, for Brazil.

25. A tougher policy would also indicate no IMF involvement with Poland unless there were to be a radical change of direction. In addition there is Yugoslavia which has no SBA but is subject to "enhanced monitoring". Our leverage here is our refusal to go along with Paris Club reschedulings without major adjustment measures.

26. Almost certainly, all but a few sub-Saharan African countries should not go down the route of further standby agreements with the Fund, since they are mostly unable to make good use of finance at commercial rates.

Line for Spring Meetings

27. Even on the assumption that other creditors are going through the same process of examining the viability and sustainability of

the current strategy, and that this paper can make some contribution, it is unlikely that there will be anything like agreement on the analysis, let alone on courses of action, by the time of the Spring Meetings. But it would be worth considering the following Line to Take :-

i) Debt strategy put in place in 1982 has yielded some valuable results;

ii) Have to recognise however that for most debtors the capacity to service debt has not improved;

iii) Sterile to try and apportion responsibility between creditors and debtors, need to concentrate on next steps against a sober assessment of likely world developments over next few years;

iv) Long-term aim should be access to financial markets by all debtors;

v) Further major steps to reform economies need to be taken by debtors : emphasise growth orientated adjustment programmes that offer prospect of success. "The sensible fiscal management needed to restore creditworthiness in the international capital market is the same management needed for effective economic growth".

vi) Wrong to put all the blame on the banks for not lending more; wrong to put all the emphasis on the provision of finance - must emphasise need for policy changes in debtors and for creditor governments to play part by trade liberalisation etc.

vii) Poorest countries in sub-Saharan Africa face massive problems in development and extra assistance needs to be considered.

This line of policies doesn't follow the analysis.

Conclusion

28. It would be helpful to discuss this paper and especially the proposals in paragraphs 18, 22-27 of this minute.

Y. Engledow

p.p. H P EVANS

CONTENTS

INTERNATIONAL DEBT : PRESENT POSITION AND POLICY ALTERNATIVES

CONTENTS

INTRODUCTION AND SUMMARY

CONFIDENTIAL

INTERNATIONAL DEBT : PRESENT POSITION AND POLICY ALTERNATIVES

Introduction and Summary

Many developing countries continue to experience severe difficulties in servicing their debts and so are unable to raise market finance. The risk of default - illustrated by the large discounts in the secondary debt market - poses problems for the banks, export credit agencies, and the international financial institutions. Much sovereign debt is entered in the books at unrealistic values.

2. Debt problems are closely linked with other developments in the world economy. The problems that would anyway have arisen, caused by excessive borrowing and the misuse of resources, have been exacerbated by the big rise in real interest rates, major declines in commodity prices and reduced access, especially for agricultural products, to OECD markets. Even though liberalisation of trade and agriculture is now high on the international agenda, progress is bound to be slow. This paper therefore focuses specifically on debt against the existing world background. There is a long history of debt and default : the experience of the 1930s is summarised in Annex A.

3. The rapid build-up of debt from the mid-1970s to the debt crisis in 1982 was followed by a period of containment with what came to be called the case-by-case approach. This was strengthened, and made more appealing to debtors, in September 1985 when the Baker initiative was launched.

4. There are already clear signs of the strategy coming under strain. On the **creditors'** side, the commercial banks have not been lending voluntarily, while involuntary lending packages have become increasingly difficult to put together, as banks are now stronger. At the same time, it has become increasingly difficult to put in place adequate IMF programmes.

5. Many **debtors** have continued to resist necessary reforms and over the last year or so they have been encouraged by some major

creditors - notably the United States which, unwilling to put at risk any further its already weakened banking system, is encouraging IFIs, banks and the Paris Club to support weak programmes. Most recent agreements have been based on weaker conditionality, to the extent that in the case of Egypt (where US pressure was based more on political concerns) a programme is about to be launched with little hope at the outset of medium-term viability.

6. The successful resolution of debt problems is important for the UK because of our interests, both as a creditor and as a trading nation, in the prosperity and smooth running of the world's trading and financial systems. There are important implications for our commercial banks, our interest in the IFIs, and (partly through ECGD) for government expenditure and taxation.

7. This paper assesses the present approach and examines alternatives. **Section 2** analyses the progress made by the major debtors in recent years. Despite widespread adoption of IMF (and sometimes IBRD) inspired policy programmes in recent years, the bleak conclusion is that the scale of the problem, as viewed from the debtors, has been getting worse, though much more slowly than in the years leading up to 1982. This conclusion is based on the following pieces of evidence :-

i) the worsening of debt export ratios, together with poor growth performance;

ii) larger discounts in the secondary markets;

iii) declining ratings by agencies;

iv) continuing capital flight.

In consequence most debtors are further away from creditworthiness than they were in 1982.

8. But as viewed from the creditors, the scale of the problem has diminished appreciably. There has been only a small rise in

bank lending to problem debtors, and a large rise in banks' lending in other areas. Moreover banks have strengthened their capital bases and made further provisioning against bad debts. The burden of lending to problem debtors has been shifted towards the IFIs and to a lesser extent the export credit agencies - all of whose portfolios have deteriorated in quality.

9. **Section 3** looks at some possible consequences of partial default. We looked, in a highly stylised way, at the effects on debtors and creditors of a 30 per cent sustained reduction in interest rates by all problem debtors. The figure of 30 per cent is illustrative, but bears some relation to many of the discounts on debt in secondary markets, as well as being consistent in a qualitative way with experience from earlier decades of sovereign debt - experience which generally yielded a partial, but far from complete, default.

10. In practice, any reduction in interest payments, as with Brazil recently, is likely to be messy and uncertain, with effects that are very difficult to quantify. A reduction in interest payments has obvious attractions for debtors, but unless they used resulting savings to much better effect than in the past, the net gains could well be small. For creditors, we have quantified the losses that would be suffered by UK and US banks : provided the interest reduction was limited to 30 per cent by countries with debt servicing problems (rather than say 60 per cent) there should not be a serious threat to individual banks in the UK, nor to the world financial system.

11. **Section 4** is a reminder that sustainable solutions, involving full debt service, would require major and sustained changes in policies by debtor governments. There is a great degree of uncertainty over whether debtors are able and willing to make such changes in policies.

12. For one group of countries, most of those in sub-Saharan Africa, it is already clear that the present debt strategy is not sustainable : many of these countries have no hope of servicing debt fully within the next 10 years or beyond. A separate AEF

CURRENT SITUATION AND ASSESSMENT OF PRESENT APPROACH

paper will consider what can/should be done here.

13. For other countries, and especially the middle income countries of Latin America which form the bulk of the Baker 15, there is little doubt that these countries have the ability to service debt in full if they so choose.

14. **Section 5** looks at ways forward : continuing as at present, reinforcing the present approach or adopting market based solutions. It is likely that, despite the risks, the current approach will continue much as it is for the next year or so. But as Section 2 makes clear while the current strategy is based on firm conditionality, it is not being implemented in practice. There is therefore a case for encouraging debtors to implement more effective reform programmes by a combination of stronger pressure from creditors and additional inducements. Where debtors are not prepared to make the necessary adjustments however, creditor governments would not put pressure on the IFIs and banks to lend. An alternative would be to encourage early moves towards sovereign borrowers being able to rely for long-term finance on world capital markets, with a much smaller role for the IFIs and governments. Action by governments could include encouraging marketability of debt.

15. In order to implement any change of strategy we would have to start by convincing the major creditors (especially the United States) that the analysis and conclusions are correct.

2. CURRENT SITUATION AND ASSESSMENT OF PRESENT APPROACH

Introduction

16. It is worth emphasising at the outset that by no means all LDCs are problem debtors. Many have used the resources that they have obtained from world financial markets, IFIs and creditor governments wisely and productively, and have had little trouble in making sufficient return from their investments both to service their debt and to allow for rising incomes and consumption. The problem debtors, on the other hand, have not managed to earn

WORLD ECONOMIC
BACKGROUND

sufficient foreign exchange from their investments to service them fully, and have had to restrain living standards, in some cases sharply, in order to meet their commitments. There are about the same number of problems debtor countries as non-problem debtors, but the non-problem debtors include India and China, and have a very much larger population. (India and China between them have six times the population of sub-Saharan Africa).

Table 1: Characteristics of debtor groups

	Debt end-1986 $Bn	Debt/ export ratio 1986	Debt per capita 1986 $	GNP per capita 1984 $	Change in GDP per capita between 1982-86 %
Sub-Saharan† Africa	76	2.84	230	280	-3.8
Baker 15	437	3.43	820	1450	-3.7
Countries WITH recent debt-servicing problems	626	3.05	630	1020	-3.1
Countries WITHOUT recent debt-servicing problems	408	1.14	150	500	16.7

Sources: Draft IMF WEO, February 1987,
IBRD World Development Report 1986.
HMT estimates.

World Economic Background

17. This section looks at the impact that changes in the world economic environment have had on the debtors. Table 2 sets out the path of the main economic variables over the last twenty

† Annex B provides a full definition and list of countries in these categories. All figures in this report should be treated with caution: they are from the best available sources, but key statistics for many debtors are often little better than estimates. It should also be noted that estimates of debt prepared by the various sources quoted in this paper differ, mainly because of differences in coverage and concepts. In particular, IMF estimates do not include debt owed to the IMF.

years, and the Treasury and IMF forecasts of developments in the next four or five years.

TABLE 2

	1962-75	1975-82	1982-86	1986-90
<u>Annual average growth rate, %</u>				
Major 7 OECD GNP	4.5	2.3	3.5	3
Major 7 OECD Import volumes	7	4	7.5	4.5
Real Commodity Prices				
Oil	10	7	-15	-2
Non-oil	1	-3	-4.5	0
	1968-72	1973-82		
Capital Importing Countries' Terms of Trade	0.2	1.5	-2.6	0
	1963-75	1977-82		
<u>Level</u>				
Real six-month LIBOR*	2.4	2.8	5.7	3.2

Sources : HMT and Draft IMF WEO, February 1987

* 6 month LIBOR, deflated by US GNP deflator.

18. Debtors were undoubtedly hit by the sharp rise in both nominal andeal interest rates in the early 1980s, and by the slowdown in world growth and trade. But the picture since then has been one of falling nominal and real rates, and comparatively strong growth in OECD markets. However, falls in commodity prices in the recent past have on balance more than offset lower import costs for LDCs as a group. Prices have probably now stopped falling, but given the existence of high levels of stocks, and a

persistent tendency to over supply, there may be no substantial recovery.

19. Growth in the industrialised countries should pick up a little from the 2.5 per cent in 1986 and may average close to 3 per cent over the next few years. Developing countries' export markets could grow at some 4.5-5 per cent a year. But within this, US imports may grow very slowly with particularly serious consequences for Latin American countries' exports. Japanese and European markets should grow quite rapidly, but with NICs receiving much of the benefit.

20. The large current account imbalances among the industrialised countries pose a number of risks to this outlook, not least the possibility of protectionist legislation in the US and emulation/retaliation elsewhere. Table 3 gives an indication of the likely direct effects on the balance of payments of changes in the world economic environment.

Table 3 : Direct effects on NODCs* and major debtors current balances ($ billion)

	Interest rates - 1 point higher	Commodity **Community prices 1% lower**	Industrial countries' GDP - 1% lower	Oil prices 10% ($1.5 pb) lower
NODCs	-2½	-1	-10	0
Baker 15	-2	-0.3	-3	-1½

Source : HMT and Bank of England

* Non-oil Developing Countries

21. The discussion so far has been on the impact of the world economy on debtors. We now examine the reverse causality. It is often said that debt problems for the LDCs are holding back the growth of world trade. In fact, in 1986 imports of goods into countries with recent debt servicing problems totalled only $140 bn (down from $200 bn in 1981) out of a total world trade figure of some $2,100 bn, ie no more than 7%. It is true that had debtors' exports and imports been stronger, this would have been

better for both world trade and the debtors. But imports have to be paid for in a sustainable way ie by expanding export earnings.

22. Import compression in debtor economies has undoubtedly been damaging to them : when the capital inflows nearly dried up after 1982, this forced debtors to bring about major improvements to their current account. The legitimate worry is that far too much of this improvement was achieved by deflation and protection leading to import compression (which often damages investment and hence future output) and not nearly enough by expansion of export earnings (goods and services) and by creating the conditions for repatriation of flight capital, more direct investment etc. This comes back to the problem of too little of the right kind of adjustment by the debtors - in circumstances made much more difficult by the high level of real interest rates, the spread of protectionism (especially in agriculture) and the weaknesses in commodity prices.

23. There is little doubt that changes in the world economy played a major role in precipitating the initial stages of the debt crisis. But developments since 1983 have generally been more favourable to the debtors, if not quite as favourable as had been expected, with falls in interest rates and in the value of their dollar denominated debt. Growth in export markets has more or less offset the impact of falling commodity prices. The outlook for the next few years is for no more than slight declines in real interest rates, more stable commodity prices and slower growth in export markets, the net effect of which would be to leave the external environment much as it is at present.

The Present Approach

24. The essence of the present case by case approach is :-

i) <u>debtors</u> are provided with new money and rescheduling of existing debt if they adopt measures aimed at returning to long-term creditworthiness and (the new emphasis laid by Baker) on securing medium-term growth;

ii) creditors in response to agreement by debtors and IMF (or IBRD) on adjustment programmes are encouraged to lend new net money and reschedule.

25. The present approach is based on the implicit assumption that debtors are merely illiquid and not insolvent. This implies an ability and a willingness within a few years to service their debt, ie to generate on a sustainable basis a sufficient surplus on trade or other external income in order to cover interest payments abroad (typically debtors as capital importers make no net repayments of principal, although individual loans can be repaid as they mature). A sustainable position can be consistent with rising debt, if the capacity to pay interest is rising at the same or faster rate.

26. It is increasingly being recognised, if not admitted in public, that for certain countries (eg countries in Sub-Saharan Africa) the problem is one of solvency rather than liquidity. They cannot pay the interest on their debt even if they wished to (although solvency and liquidity are defined relative to present commodity price and world trade assumptions and are rather imprecise concepts). But even for major debtors there are doubts about whether the countries concerned will be willing to take the measures necessary to return to creditworthiness. The essential elements of IMF conditionality, which are the most important aspects of debt relief packages, are conservative fiscal and monetary policies, combined with allowing relative prices (especially real interest and real exchange rates) to move to appropriate levels. This means there must initially be a fall in consumption, but if resources are successfully shifted to balance of payments, then there can be a sustainable growth in output, employment and consumption. As Charles Kindleberger said 20 years ago:

> "the sensible fiscal management needed to restore creditworthiness in the international capital market is the same management needed for effective economic growth".

INDICATORS OF PROGRESS

A fuller description of recent developments in conditionality is give in Annex C.

Indicators of Progress

27. We look at the following indicators of progress :

(a) statistical measures such as debt/GNP, debt/export, and interest/export ratios; and domestic economic performance indicators;

(b) market discounts on debt;

(c) ratings by banks and investing institutions of the creditworthiness of individual countries;

(d) capital flight.

The next section uses each of these indicators to assess progress. But before looking at the trends of the last few years, it may be useful to look briefly at some of the most important characteristics of representative debtors.

Table 4 : Characteristics of representative debtors

	External Debt ($Bn) (end 1985)	Debt/export ratio % (1985)	Market valuation of bank debt (%)
Brazil	107	420	74
Argentina	51	610	66
Mexico	99	450	57
Baker 15	438	285	60
Egypt	38	550	not quoted
Zambia	4	450	18

Sources: IMF, IFS, IMF "World Economic Outlook", World Bank "World Debt Tables", Federal Reserve Board.

28. Debt figures are uncomfortably high, debt to export ratios show both the vulnerability of the debtors and the medium term burden of servicing debt, and the secondary market discount indicates that financial markets do not feel that the present book valuation of bank debt is an accurate representation of reality.

29. In addition to flows, it is necessary to look at balance sheets. The debts in Table 4 are gross liabilities: they take no account of assets. Thus for example Argentina's external balance sheet includes the following elements.

Table 5 : Argentina: Balance sheet

	$ bn	$ bn
Liabilities	62	
of which banks		31
Assets	38	
of which reserves		2
accumulated capital flight		35
Net Assets	-24	
	(37% of GDP)	

Source : Citicorp and IMF

30. The liabilities are mainly governmental, the assets mainly private. In addition, Argentina has domestic assets (real estate, mineral rights) that could be transformed into external assets. Of course the figures are extremely crude, but they suggest rather strongly that the country of Argentina is not insolvent. By contrast, many SSA countries have much less in the way of accumulated assets overseas.

ASSESSMENT OF PROGRESS

Assessment of Progress

(a) The main debt ratios

31. In this section we look at the evolution of three key ratios : interest payments to exports, debt to GDP, and debt to exports. These ratios do not always tell the same story : we first consider why this is so.

32. Interest payments depend on the level of nominal interest rates which in turn is related to the level of inflation. A fall in nominal - but not real - interest rates does not reduce the real size of debt, but it does reduce annual debt servicing (and has the effect of lengthening the effective life of a loan). And a fall in nominal interest rates should be accompanied by a corresponding fall in the interest payments/export ratio. It is possible to look at the burden of debt in terms of the real interest rate, but it is simpler to focus on the stock of debt, in relation to GNP and exports. Neither of these ratios, unlike the interest payments/export ratio, are affected by the level of inflation.

33. GNP provides a measure of a country's total production of goods and services and therefore of its longer-term ability to generate resources for debt servicing. But it is hard to measure, especially in LDCs, conversion into dollars is very tricky (especially for economies with a large informal/barter element) and a country's ability to translate domestic output into exports may be limited especially in the short-term.

34. Export earnings have the advantage of being easier to measure and easier to express in dollars. They also tell us what is being earned in foreign currency, though not what could be earned if more resources were devoted to the export sector. We look at each of these key ratios.

Table 6 : Ratio of Interest Paid to Exports of Goods and Services(%)

	1980	1982	1984	1986
Baker 15	16	31	29	28
SSA	7	10	11	11
Countries with recent debt-servicing problems	13	24	23	21
Six month LIBOR ($)	14.0	13.6	11.3	6.8

Source: Draft IMF WEO, February 1987

35. Interest paid to export ratios have done little more than stabilise in recent years, despite the slowdown in the growth of debt, the big falls in nominal interest rates and the rescheduling of interest due to official creditors for much of SSA. These falls, especially when the fall in the dollar is also taken into account, should have led to a substantial reduction in the ratio if useful progress had been made. Instead the ratios have stayed at very high levels : the underlying problem has got worse.

Table 7 : Ratio of Debt to GDP (%)

	1980	1982	1984	1986
Baker 15	31	42	48	50
SSA	36	52	60	69
Countries with recent debt-servicing problems	34	46	52	56

Source: Draft IMF WEO, February 1987

36. The debt/GDP ratio, which provides a long term perspective of the debt burden in relation to total output in an economy, has risen more slowly in recent years, at least for the Baker 15, but is at a high level for all categories of debtors.

Table 8 : Ratio of Debt to Exports (%)

	1980	1982	1984	1986
Baker 15	167	270	272	343
SSA	146	214	223	284
Countries with recent debt-servicing problems	151	242	247	305

Source: Draft IMF WEO, February 1987

37. The debt/export ratio has continued to climb for all groups of debtors, reflecting increasing debt and static or falling exports. The sharper rise in the debt/export ratio than in the debt/GNP ratio reflects the falling share of exports in debtors' GNP (partly because of the fall in oil prices).

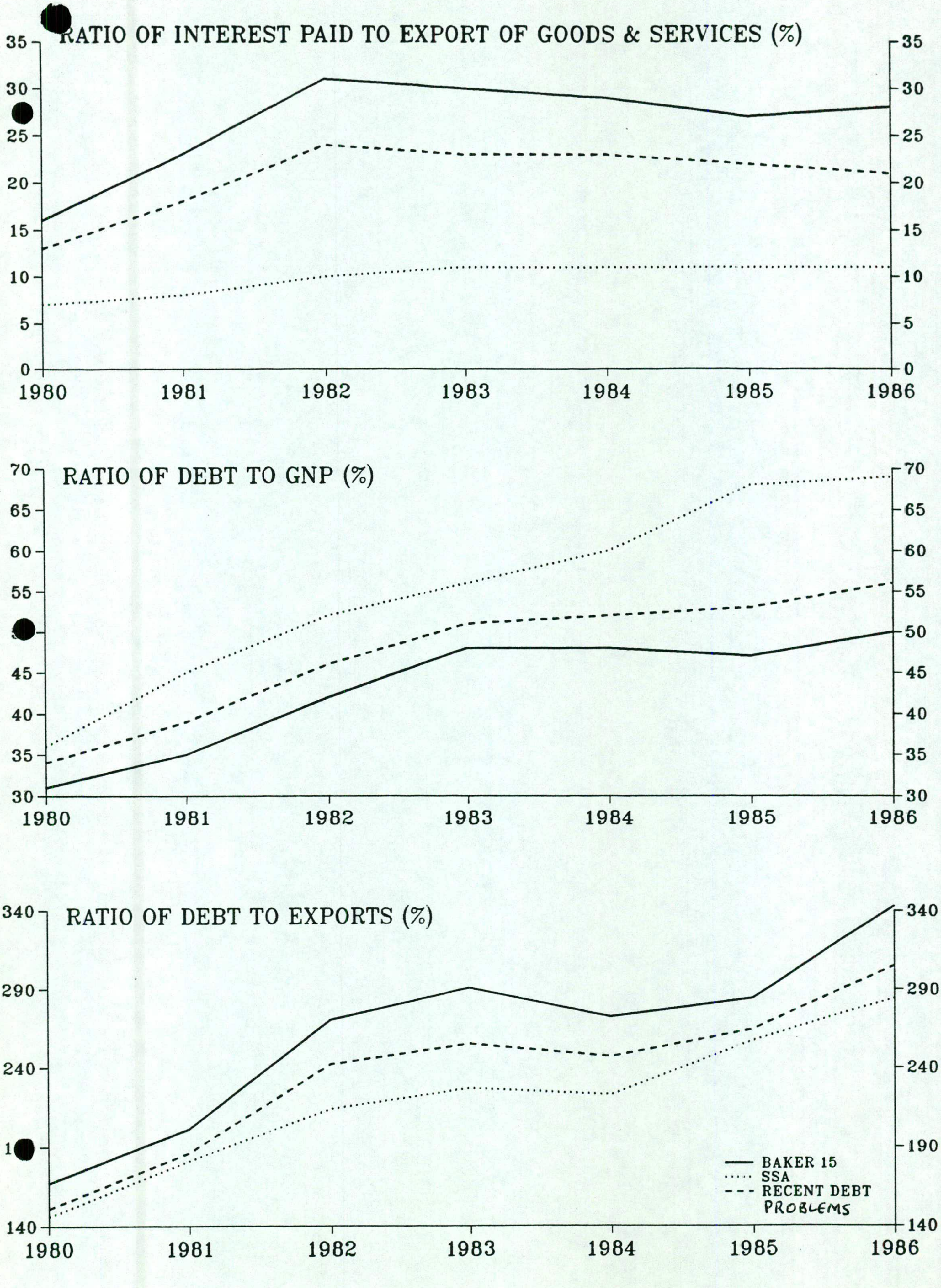
38. The attached charts overleaf show the evolution of these groups of indicators, while the domestic economic performance of the debtors is discussed more fully in paragraphs 44-48 below.

(b) Market discounts on debt

39. There are no reputable long term series available for the discount on debt available in the secondary market. Where figures are available, they need to be treated with caution because markets for many countries' debt are thin. The quoted figures which are available show large discounts for the bank debt of the main debtors, with some tendency for the discounts to widen over the last two years. Recent figures for some important debtors are shown in Table 4.

(c) Rating by agencies

40. A number of agencies and publications rate sovereign debt. One of the best known of these exercises is the regular six-monthly survey published by 'Institutional Investor', which aims at quantifying the market perception of different sovereign borrowers. Table 9 sets out this publication's rating of two important countries, some of the main debtors, and the average rating of the Baker 15, over the recent past.



SOURCE : DRAFT IMF WEO, FEB 1987

Table 9 : Institutional Investor Rating

	1981	1983	1985	1986
Japan	96	95	95	96
UK	89	89	88	87
Brazil	49	38	31	35
Mexico	69	34	39	31
Nigeria	55	36	25	23
Baker 15 (unweighted average)	49	33	26	26
All countries (unweighted average)	48	41	40	41

Source: Institutional Investor

41. Although there is no particular significance to the levels quoted, there is some in the reported changes in rating and in the comparison between countries. The fall in the average rating reflects the increased perceived riskiness of sovereign lending. The fall for the major debtors is much greater than the average, and shows little sign of being reversed.

(d) Capital Flight

42. The large inflows from banks to LDCs in the late 1970s and early 1980s were accompanied by, and indeed made possible, large scale outflows of capital from many LDCs - outflows seeking positive real interest rates, greater capital security, evading/ avoiding tax etc. A recent IMF Staff paper looks at various definitions of capital flight and presents the following estimates for countries with recent debt servicing problems :-

Table 10 : Capital Flight

	$ bn annual averages		increase from 1974 to 1985 in stocks outstanding $bn
	1979-82	1983-85	
Countries with recent debt-servicing problems	17	16	135

Source : IMF Staff

43. These estimates of capital flight are derived from figures of countries' stock of foreign assets not yielding a recorded inflow of investment income credits. The measures are obviously extremely crude, but they suggest that :

(a) there was some reduction in capital flight after the 1982 debt crisis;

(b) capital flight continues on a substantial scale (not surprisingly given the negative real interest rates and capital insecurity in many debtor countries);

(c) the scale is such that if it stopped entirely it would make a major contribution to reducing the debt problem.

Adjustment by Debtors

44. Table 11 sets out, in summary form, the progress the two main groups of debtors have made over the last eight years in economic terms.

Table 11 : Economic progress of debtors

	SSA		**Baker 15**	
	78-82	**82-86**	**78-82**	**82-86**
Growth Rates (p.a.)				
Real GDP	2.0	2.1	2.7	1.4
Real Per Capita GDP	-1.1	-0.9	0.5	-0.9
Inflation	24	22	51	99
Exports (vol)	1.5	4.1	0.1	2.7
Imports (vol)	-1.3	-2.0	0.7	-7.9
Terms of Trade	-3.4	-2.1	4.0	-4.9
Levels				
Current Account, % of GDP	-7.6	-5.7	-4.4	-1.7
Investment, % of GDP	17.3	15.5	24.0	17.3

Source: IMF World Economic Outlook, October 1986 and Draft IMF WEO, February 1987

45. Much of the adjustment that has taken place has been brought about by import compression and cuts in investment. Export growth has been slow (very slow in comparison with world trade and with the efforts of non-problem debtor LDCs) and structural imbalances have persisted. Living standards have declined.

46. The average member of the Baker 15 is a country with many of the following characteristics:

(i) Debt/GNP greater than 40%.

(ii) Rapidly rising real exchange rate between 1978 and 1981, before the onset of the debt crisis, with resultant increases in imports and reductions in exports.

(iii) High public sector deficits.

(iv) High inflation.

(v) Dependence on a small range of commodities for more than half of export earnings.

(vi) Slow average growth rates (often negative) in export earnings.

(vii) An uncompetitive industrial sector, protected by import licensing and/or high levels of tariffs.

(viii) A record of having a number of IMF programmes and debt reschedulings.

(ix) A rapid decline in domestic saving and investment ratios in the last five years.

(x) A sharp fall in living standards, with little prospect of recovery to 1980 levels before the end of the decade.

(xi) Capital flight on a substantial scale.

The very low income countries in SSA share many of the same characteristics, but have a large number of additional problems.

47. The differences between successful debtors and unsuccessful debtors are most marked in two areas:

(a) Successful debtors have, on the whole, run more conservative fiscal and monetary policies.

(b) The exchange rate and protective regimes of successful debtors have not discriminated against exports, while those of unsuccessful debtors, in the main, have.

These differences have been most graphically demonstrated in the relative external performance of the two groups, as set out below.

Table 12

	Export Volume Growth		Terms of Trade	
	1973-82	**1982-86**	**1973-82**	**1982-86**
Countries WITH recent debt-servicing problems	0.0	3.0	2.1	-3.6
Countries WITHOUT recent debt-servicing problems	6.6	10.5	0.6	-2.1

Source : Draft IMF WEO, February 1987

48. The export performance of the debtors was poor long before the debt crisis struck, and their relative position has not changed a great deal since, despite all the adjustment programmes aimed at increasing net foreign exchange earnings. The two groupings faced broadly similar trends in their terms of trade, so it seems internal rather than external factors bear the main responsibility for the debtors' poor export performance.

49. It is worth noting that some debtors (Chile and perhaps Uruguay) have now almost graduated from the ranks of the unsuccessful to the successful in the sense that they are close to being able to raise external finance from the markets spontaneously. Others (Korea, Turkey) arguably graduated some time ago although both encountered difficulties and both had implemented adjustment programmes before the onset of generalised debt problems in 1982. In all cases, success has been brought about only after considerable periods of adjustment, with adherence to consistent fiscal and monetary policies, and with careful attention being paid to exchange rate and trade policies.

Adjustment by Creditors

50. This section looks at the adjustment that creditors have made since the onset of the debt crisis in 1982. The most important changes are in the types of lending carried out, the reductions in NIC flows and strengthening of banks' balance sheets.

Table 13

Baker 15

Estimated Flows from Creditors, during the years 1983 to 1986 inclusive ($ bn.)

Net use of Fund Credit	13
Net Borrowings from MDBs	14
Other Official Borrowing (mainly ECA/OCIs)	14
Total net borrowing from Official Creditors	40
Commercial Banks	20
Other Private	-2
Total Net Private Flows	18
Total Debt-creating Flows	68
Net non-debt creating flows	18

Source : IIF, IMF

51. Table 13 illustrates the changes in lending over the last four years. The stock of debt increased only gradually over the period, from $410 bn. to $457 bn. (the difference between flows and the changes in stocks are due to changes in exchange rates and valuation of debt). The share of lending by banks has declined from 65% to 62%, while that of IFIs and creditor governments has increased. The rise of 12% in overall exposure should be set against an overall dollar inflation rate of about 13.5% over the same period.

52. Table 14 sets out the debt portfolio in slightly fuller form, as it stood at the end of 1986.

Table 14 : Debt Portfolios of the Main Groups of Debtors (end-1986) ($ bn)

	IMF	MDBs	Govts. (including ECA/OCIs)	Banks	Other Private	Total
Baker 15	20	39	78	287	38	462
SSA	7	18	30	14	13	82
Total	27	57	108	302	51	544
	(5%)	(10%)	(20%)	(56%)	(9%)	

Source : Baker 15, IIF, 1987 SSA, HMT estimate, based on IBRD, IMF, BIS and BIS/OECD reports.

(It should be noted that the Ivory Coast is in both groups of debtors, but the margins of error in the estimates almost certainly outweigh any over-estimate caused by adding the two categories together).

53. The main points are:

(i) 60% of external debt of the Baker 15 is owed to commercial banks;

(ii) over 70% of the external debt of SSA is owed to the bilateral and multilateral agencies and only 19% to banks.

54.. The multilateral and bilateral agencies are much more heavily exposed on a proportionate basis than are the banks in aggregate, although some banks' exposures are still high compared to their capital base.

55. Net flows from the banks to the debtors slowed during 1985. The Baker initiative, announced in September 1985, recognised the slowdown in flows, and called for increased lending by banks and IFIs to support growth in countries following IMF adjustment programmes. The next table sets out progress to date, compared with the amounts suggested by Baker.

Table 15 : Baker initiative

	Baker Initiative (1986-88)		**Actual Flows**	
	(in total)	**(pa)**	**1986**	
Gross Disbursements				
IBRD	19.5	6.5	5.7	
IADB	7.5	2.5	1.6	
Total	27	9	7.3	
Increase in net Banks lending	20	6.6	-2.6	year ending Sept 1986

Source: BIS, IMF.

56. Figures for the first full year of Baker are not complete but so far it appears that the amounts suggested by Baker have not

been forthcoming. The MDBs have come much closer than the commercial banks, although there are some large bank loans (eg Mexico) almost agreed but not yet disbursed.

57. As well as cutting back lending, banks have also increased their capital base, redirected their lending, and in varying amounts provisioned for doubtful loans. The US banks are by far the most important national grouping in terms of exposure, and their recent strengthening of capital ratios is summarised in Table 16 below. But the increased capital has to be seen also in the context of a worsening domestic loan portfolio: US banks have done very little specific provisioning against doubtful international loans. Against this, it is argued by Citicorp that "the debt problem has been largely discounted in the price of US bank stocks".

Table 16 : US Banks

	1982 ($Bn)	1986 (1st half) ($Bn)	Change ($Bn)	Change (%)
External Claims on Problem Debtors*	86.2	87.6	1.3	1.6
Total Assets	1261.0**	1545.0	284.0	22.5
Total Capital	70.6**	113.0	42.4	60.1
Claims as % of Assets	6.8	5.7		
Capital as % of Claims	81.9	129.0		

Source: Federal Financial Institutions Examination Council

*** net of risk transfers; problem debtors defined as Baker 15, Egypt, Poland and Sub-Saharan Africa (excluding Nigeria and Ivory Coast)**

**** figures for end 1982**

58. Table 17 provides a breakdown of developments in the UK banks, which have been similar to those in the US. However, UK banks' domestic portfolios are probably in better shape than those of US banks'.

Table 17 : UK banks

	£ million		
	1982	**1986 (end June)**	**Change (%)**
External claims on problem debtors	16.5	17.2	5
Total Assets	222.5	315.7	42
Total Capital	15.3	25.9	70
Claims as % of assets	7.4	5.4	
Capital as % of claims	92.7	150.7	

Source: Bank of England

59. Table 18 outlines the relative importance of problem debtors to the various UK banks; the reasonably comfortable average does disguise wide variations.

Table 18 : UK banks: Exposure to problem debtors in 1986 (end-June)

	All UK	**5 major clearers**		
	Banks	**Total**	**Highest**	**Lowest**
Claims as % of assets	5.4	5.9	9.1	3.2
Capital as % of claims	150.7	130.3	240.3	84.0

Source : Bank of England

60. Table 19 shows the progress in the main creditor nations in strengthening the position of the banks.

Table 19 : Capital asset ratios of banks in selected industrial countries

	1982	1984	1985
Germany	3.3	3.4	3.5
Switzerland	4.6	4.7	4.9
UK	4.1	4.5	5.5
US	5.6	6.5	6.9

Generally strengthening position

Source : IMF International Capital Markets, 1986

61. Although it is difficult to draw meaningful comparisons from this table between countries because of definitional differences most banks now have higher overall capital asset ratios than they had at the time the debt crisis originally developed, and are better equipped to deal with reductions in debt service.

62. Other creditors have also made some adjustments, although probably not to the extent that banks have. Little consistent data is available on the position of ECAs, but they have in general changed their operations and take a much more cautious view of trading opportunities with problem debtors. On the other hand the multilateral lending institutions have increased their exposure to the problem debtors, and this has probably had some impact on the strength of their portfolios.

Conclusions on Adjustment by Debtors and Creditors

63. Debtors have made a number of important changes to their economic policies and are now probably in better shape overall than at the outset of the debt crisis. But their performance in earning net foreign exchange has been disappointing, with far too much of the adjustment coming from reductions in imports and far

WHAT HAPPENS IF RISKS INHERENT IN PRESENT APPROACH MATERIALISE

too little from increases in export earnings. The lack of progress so far is reflected in :-

i) the worsening of the key debt ratios;

ii) the falling market valuation of their debt;

iii) the fall in the rating of debt by agencies;

iv) the almost total lack of access to spontaneous financial inflows;

v) the continuation, albeit at a reduced rate, of capital flight.

Part of the reason for this poor performance lies in external factors, but a good deal of the responsibility must lie with the debtors themselves. Creditors too have made adjustments, and most banks in particular are in better shape than four or five years ago.

64. With the benefit of hindsight, it is clear that both debtors and creditors made serious mistakes in the amount and type of lending carried out in the years before the onset of the debt crisis. The evidence suggests that the creditors may have made more progress in compensating for those mistakes than debtors (although, as noted above, a few smaller debtors are close to restoring creditworthiness).

3. WHAT HAPPENS IF RISKS INHERENT IN PRESENT APPROACH MATERIALISE?

65. Current levels of debt and debt interest payments and imports are summarised in Table 20 below. This paper concentrates mainly on the group of countries with recent debt servicing problems, but it should be noted that the level of imports into the group of countries <u>without</u> recent debt servicing problems is twice as big as in the other group.

Table 20

Developing Countries	Countries WITHOUT recent debt servicing problems	Countries WITH recent debt servicing problems	of which Baker 15 ($ bn)
Total debt (1986)	430	626	437
Interest payments	29	52	38
Imports of goods and services	329	154	90

Source : Draft IMF WEO, February 1987

66. The structure of external debt, interest rates and payments of Baker 15 and sub-Saharan African countries are shown in Table 21 below.

Table 21 : External Debt, Baker 15 and SSA ($bn) (end 1986)

	Banks	(o/w UK Banks)	ECA/ OCIs	MDBs	IMF	Other*	Total
Debt	302	(36)	65	57	27	93	544
Interest rates	8	8½	9½	8	6	6½	8
Interest payments	24	3	6	4.8	1.6	6	45

* non-OECD governments, private suppliers, ODA, and bonds

Debtor governments have direct responsibility for more than 80% of the debt, either because they contracted it themselves, or because they assumed responsibility for their private sector debt as the debt crisis developed in 1982 and 1883.

67. One way of looking at the risks involved in the debt situation is to ask what would be the consequences if problem debtors unilaterally reduced their payments of interest. We make the initial and crucial simplifying assumption that this happens only

to the group of countries with recent debt servicing problems : this assumes that other countries with substantial debts (but in general still with access to the markets, like India and Korea) do not follow suit.

68. As the current Brazilian affair demonstrates, cuts in interest payments could happen in many different ways, each of which would have a different impact on the markets and on the main creditors and debtors. In practice, action by debtors to reduce interest payments would be messy and confused, with great uncertainty about which debt and which debtors were involved, to what extent, and for how long. We cannot hope to capture much of this uncertainty and confusion in any figuring. Nor can we hope to capture the (possibly severe) losses of confidence in debtors and some creditors that would also occur.

69. What we can do, in the belief that this will throw light on some of the likely consequences, is to ask what would happen if :

i) all main (problem) debtors reduced their interest payments by 30 per cent to all creditors on medium and long-term debt;

ii) debtors maintain full servicing of short-term trade credit;

iii) creditors stop new medium and long term credit, accepting that this creates non-performing assets;

iv) creditors write down assets proportionately to non-performance.

70. For the purpose of this exercise, we assume that these changes in interest payments occur all at once, that the reductions are sustained at a constant and lower level, together with expectations that these lower interest payments will be sustained. In practice, a reduction in interest payments could well take the form of temporary suspensions, great uncertainty about long-term intentions, and consequent volatility of expectations.

The Debtors

71. The cut in interest payments for the group of debtors with recent debt servicing problems would amount to some $12 billion. With trade finance more difficult, debtors might well use the initial gains to build up reserves. If the extra $12 billion were all devoted to extra imports, this would allow the level of imports in goods and services to be higher by 6½ per cent. In practice :-

i) real exchange rates are likely to rise;

ii) the level of capital flight could well be increased;

iii) there could be a small rise in import prices as insurance cover becomes more difficult/more expensive.

72. 6½ per cent would be the maximum rise in imports : in practice it could well be only near half that. If the extra imports were used productively (and past evidence is not too encouraging) then the level of GDP, for countries where it is limited by a shortage of foreign exchange, could (on the basis of some Fund analysis) be 1½ per cent higher in the medium-term. Even this figure is likely to overstate the benefit since it takes no account of the lower investment that would follow from a lower capital inflow.

73. The effect of an extra 3 per cent say on imports into this category of debtors could raise the level of total world trade by 0.2 per cent (and then only after some delay caused by the rebuilding of reserves in these countries). UK exports might rise by a similar percentage.

Creditors

(a) Banks

74. Table 22 sets out income and capital losses for banks worldwide, in the US, and in the UK. The loss of income looks manageable; but the loss of capital if the writedown were applied

to the principal would be very large, especially in a UK context for two of the clearers. If the capital writedown were spread over say four years, it would be equivalent to a loss of profits of 35 per cent in each year. (Some special mechanisms might have to be created to allow the phasing of capital losses).

Table 22 **$ bn**

Commercial Banks

	Worldwide	**UK***	**US**
loss of income $bn	8	0.6	2½
as per cent of profits	na	12	30
loss of capital	80-100	7	23
as per cent of profits	na	137	300
as per cent of capital	na	15	na
as per cent of net worth†	na	25	na

* Major banks excluding consortium banks some of whom would be severely affected.

† Shareholders equity plus reserves.

75. Even so, these losses do not appear large enough to call into question the viability of the major UK banks, providing the markets do not react unfavourably. Some losses are already allowed for in the price of bank shares.

76. The market capitalisation of the four principal UK clearers and Standard Chartered is at present $15 bn. We do not know how far the effects of the scenario described have been discounted. Major UK banks' shares trade at less of a discount to net worth than, say, three years ago. Markets could also be assuming a measure of underpinning or supervisory relaxation by the authorities. For example, a Quilter Goodison survey of UK banks as investment prospects in March 1986 based its analysis on the following:

"While sovereign debt problems will be a worry for at least the next 20 years, we doubt that a crisis will ever be allowed to develop. In effect the world's banks will be able to 'grow around the problem', gradually reducing their relative sovereign exposure as their other business expands. Sovereign debt will probably be written down effectively to zero, over a very long period, with no overt admission as to what the banks are actually doing."

77. A collapse in share prices would leave banks exposed to take-over. In the circumstances, prudential controls on take-overs might be less easy to operate since some take-overs would probably clearly be in depositors' interests.

78. The prudential capital base of the four major clearers and Standard Chartered is $33 bn and their latest combined annual pre-tax profits was well over $4.5 bn. Against this the scenario implies a direct write-off of principal of $7 bn and an annual loss of $0.6 bn in interest income. The banks most heavily exposed to problem debt (some UK and many US banks) could expect to lose some competitive position. These problems would be exacerbated by worries that the reduction in interest payments could turn out to be greater than 30%.

(b) Export Credit Agencies

79. ECA/OCIs would suffer an income loss of about $2 billion per annum and a capital loss of about $20 billion after writedown. The ECGD's share of these losses could be about $0.2 billion per annum and $2 billion respectively. But a large part of the cash flow impact would have occurred anyway through continued refinancing/rescheduling.

(c) International Financial Institutions

80. The IBRD has net assets (reserves) of $14 billion. In addition, subscribed (but uncalled) capital stands at $70 billion. The income loss of interest (about $0.7 bn) could be sustained by the Bank's net income, though this would prevent the Bank from

building up reserves to a desirable level and from making transfers to IDA. The capital loss (about $10.5 bn in total) could be absorbed by reserves and paid in capital, although it is not certain whether the IBRD would actually be required to write this down in this scenario. If lending were to remain as planned, such writing down would require either a larger GCI (possibly with a higher paid in element to maintain market confidence) or some sort of burden sharing, or a charge levied on members. Other MDBs could expect to face similar problems.

81. The net assets of the Fund are now about $33 bn, mainly made up of gold, which is quaintly valued at SDR 35 ($44) per oz compared with a market value of around $400 per oz. The Fund could run a deficit for a short time, although it would ultimately have to protect its reserves by some form of increased burden sharing. Alternatively, the Fund's administrative expenses could be met by a voluntary levy, investment of its currency resources (up to the level of Fund's reserves), or selling gold and investing the profits (again up to the equivalent of the Fund's reserves). Gold sales, which might also finance concessional lending to the poorest countries, would in general require an 85% majority, giving the US an effective veto. Agreement on gold sales - if it could be reached - would probably be protracted. Furthermore, large Fund gold sales would depress the price, even if sales took place over an extended period. Proceeds would therefore be less than indicated above.

(d) UK Government

82. OECD governments would suffer reduced revenue from writedown relief and a fall in bank profitability. In the case of the UK, this could result in a loss of tax revenue of $0.1 billion-$0.2 billion per annum and much larger losses from writedown relief. The UK's capital contribution to the IFIs could total $1 billion. OECD governments would also have to absorb losses made by the export credit agencies, although, as already noted, it is not clear how much additional loss is involved in this scenario. The UK's total involvement in countries with recent debt

REQUIREMENTS FOR A SUSTAINABLE SOLUTION

servicing problems, through banks and through the ECGD, is in the region of £25 bn.

Conclusion

83. This is a highly stylised scenario: real life is much more messy and uncertain. For instance, debts are not being fully serviced now, and hence some of the consequences of this scenario are already in place. Most important of all, confidence in some banks could be badly shaken. **Debtors'** obvious gains from not paying part of interest payments are easy to quantify; the costs to debtors from loss of confidence by investors at home and abroad are impossible to quantify, but could be sizeable. Moreover, the experience of the last ten years suggests that a substantial part of the debtors' gains would be thrown away by bad policies.

84. **Creditors** would be required to face up to the reality of bad debts. If the reduction in interest payments was sustained at 30 per cent (rather than say 60 per cent) then UK banks should be able to survive by some margin. Some US banks would be in greater difficulties. Other creditors - export credit agencies and the World Bank - would be proportionately worse affected and governments would have to pick up the bill.

4. REQUIREMENTS FOR A SUSTAINABLE SOLUTION

85. A sustainable long-term position would be characterised by the following factors :-

i) confidence in financial markets that debtors will meet their obligations;

ii) interest rate differentials on new lending would give the correct signals to lenders and borrowers;

iii) assets and liabilities would be valued realistically by all debt holders, debtors, and regulators.

86. In a world in which sovereign borrowers relied for long-term finance on world capital markets, conditionality would be imposed by the market. This would entail a much smaller role for the IFIs and for creditor governments : the long-term goal would be some shift back in decision making powers away from the IFIs and politics to the market place, and the position pre-1982. There would also be a reversion to borrowing by individual entities other than sovereign governments within debtor countries.

87. While it is important to bear these desirable long-run results in mind, it is necessary first to deal with the present position. Despite extensive analysis, in this paper and elsewhere, of debt problems, there remains enormous uncertainty about whether and how far the present approach will work.

88. The analysis in Part 2 indicates that the present approach is not sustainable even with some reinforcement for poorer countries in Africa which have no hope of servicing debt fully within the next 10 years. A separate AEF paper will develop proposals for dealing with these countries. But experience in the 1930s was that, even though debt service on bonds was interrupted, in the end investors who bought Latin American bonds and held on received some return. And today banks are in general receiving substantial net flows. Middle income Latin American countries are without doubt capable of servicing all their debt in the longer-term if they so wish. The question is whether they wish to, given the structure of incentives that they face.

89. There are three main ways of treating the uncertainty over whether countries are willing/able to service debt :

i) defer problems by rescheduling, grace periods, and/or capitalisation of interest. These approaches recognise the inability of some debtors to service debt in full now, but assumes they will be able to do so in, say, 5 or 10 years' time.

ii) introduce or extend risk-sharing schemes under which debt service is in some way related to capacity to pay : debt

ALTERNATIVE APPROACHES TO A SUSTAINABLE SOLUTION

equity schemes, encouragement of direct investment, petro bonds for oil producers are all in this category.

iii) if some form of writedown is considered, consider phasing in order to allow both for longer-term conditionality and for uncertainty over future evolution of economic forces.

The uncertainty over the differences between countries emphasises the need to continue with a case-by-case approach.

90. The current approach seeks to close the gap between the face value of sovereign debt and its market value by imposing, mainly via the IMF, reform programmes designed to increase the market value of debt.

91. An alternative route to closing this gap would be to permit or encourage mechanisms to develop which allowed the face value of debt to fall.

5. ALTERNATIVE APPROACHES TO A SUSTAINABLE SOLUTION

Special Treatment for Poorest Countries

92. Because many very poor countries - mainly or exclusively in sub-Saharan Africa - have virtually no hope of viability and therefore of reaching the steady state outlined in Section 4 there is a strong case for special treatment if only to acknowledge reality. These countries typically have large (mainly official) debt problems, and qualification for special assistance could be decided by a combination of income per head and a measure of the debt service burden (eg the debt interest/export ratio). These criteria would have to be designed precisely in order that schemes of relief (whether by long-term reschedulings, debt forgiveness or lower interest rates) can be ringfenced against a) countries with higher incomes and b) countries with lower debt burdens. It might well help, as a matter of tactics, specifically to restrict eligibility for special relief to sub-Saharan Africa only.

[illegible]. For other debtors, especially the large middle income countries in Latin America, we look at three broad approaches :-

a) continuation of the present approach;

b) reinforcement of existing strategy;

c) market based solutions.

(a) Continue as we are now

94. While this carries obvious risks not least because present trends may not be sustainable, it is a likely outcome for the next year or so. The justification for it would be that while the creditor countries recognised the risks in the present approach, they can reasonably hope for a) a better performance by debtors and b) an improvement in the international economic environment. Major improvements in either are not our central expectation, but either are certainly possible. It will also be true that in a few years' time the problem, so far as the creditors are concerned, will have diminished further. Finally there are many worse courses of action : continuing as we are now is obviously better than either :-

i) heeding calls for more finance allied with weaker conditionality, or

ii) attempting a global scheme for large scale debt relief without differentiating between debtors or imposing effective conditionality.

(b) Reinforcement of Existing Strategy

95. The essence of this approach would be to encourage debtors to implement more effective reform programmes by a combination of stronger pressure from creditors and additional inducements. For those countries not prepared to implement programmes with a reasonable prospect of medium-term viability, there would be a number of disadvantages, mainly less access to finance. Ways of

inforcing the adjustment process include encouraging the spread of risk-sharing by :-

i) direct investment;

ii) portfolio investment;

iii) debt/equity swaps;

iv) commodity-related securities (eg petrobonds);

v) halting capital flight/repatriating capital.

Some of these reforms, eg debt/equity swaps, would accelerate the valuation of debt at market prices. (Ways of reinforcing adjustment are discussed in more detail in Annex D).

96. Since there is a limited amount that the IFIs and creditor governments can do, the main policy changes would have to be by the debtor countries.

97. For countries not prepared to put in place viable economic programmes the position of creditor governments would be as follows :-

i) they will not put pressure on IFIs to lend to a debtor when the programme does not have a good chance of success;

ii) they will not put pressure on the commercial banks to sign up to new money packages, leaving that to the banks' own judgements;

iii) they will no longer be involved in negotiations over individual financial packages;

iv) they will restrict export cover provided by their ECAs.

98. Banks would make their own decisions. There is already a noticeable breaking up in bank solidarity as their capital base strengthens and as the interests of banks of different sizes and nationalities increasingly diverge. That trend is likely to continue and accelerate - a view confirmed by a very recent survey by the Bank of the attitude of the commercial banks. The present cartel among banks in the area of problem debtors carries all the usual penalties : a market solution would favour the stronger banks against the weaker (ie those who overlent to LDCs, particularly the money centre banks). National authorities in individual countries would take whatever additional action that may be required to maintain the stability of their own financial systems.

99. There are two crucial questions raised by this approach :-

i) would additional creditor solidarity and determination, together with some financial incentives, be enough to persuade debtors that stronger adjustment programmes were needed, or would there need to be additional carrots in the form of debt forgiveness or interest relief? (For example it might be possible to use IFI conditionality in support of a phased forgiveness as an alternative to or supplement to new money and rescheduling);

ii) are creditor governments prepared, in the case of countries unable or unwilling to go along with a new tougher policy, to stand aside from the resulting problems?

(c) Market Solutions

100. Under this approach, governments would look for early moves to the kind of market solution envisaged as the steady state in paragraphs 85-86 above. This process could be started by encouraging the marketability of new and existing debt, and the valuation of debt at realistic levels. Accounting and regulatory obstacles to the sale of existing debt by banks, for instance, could be eased. Sovereign debtors could be encouraged to waive the restrictions which mean that their debt can usually only be on-sold

to other banks by the bank that initiated the loan. This would put market pressure on both creditors and debtors by creating substantially different interest rates for different kinds of sovereign debt and would :-

i) exert pressure on banks and ECAs not to lend to certain countries unless they were prepared to pay very high interest rates;

ii) penalise debtors with poor credit ratings and conversely reward those with satisfactory ratings (the opposite to present practice!);

iii) marketability could help the process of writing off some of the debt that will never be satisfactorily serviced; a resourceful debtor with a poor credit rating could buy up its own debt or devise schemes to swap it into equity at a discount in order to reduce its debt servicing burden. Chile has done this by debt/equity swaps and Bolivia may be in the process of achieving the same result by a debt buy-back scheme.

101. The aim would be to get back more quickly to a world in which sovereign lending went through the world capital markets with less involvement of governments and IFIs. It is quite possible that, given the past history of default and the difficulty/impossibility of collecting debts from sovereign borrowers, that sovereign lending will henceforward be regarded as relatively risky and therefore command higher interest rate spreads than has been the case with bank lending in the past.

IF1 Division
HM Treasury
20 March 1987

Annex A
Differences from the 1930s

ANNEX A

Sovereign Debt Problems - Differences from the 1930s

Sovereign debt problems go back one hundred years and more. The last major debt crisis arose in the 1930s, and it is worth looking at the major differences between then and now:-

(i) Debtor countries incurred fixed (nominal) rate liabilities mostly in the form of bonds distributed amongst a large number of private shareholders, and with active secondary markets, rather than in the form of bank borrowing;

(ii) There were many instances of outright defaults, but many creditors still got a return on their investments;

(iii) The Bretton Woods institutions (including the IMF as lender of last resort) did not exist: debts were often settled bilaterally between a debtor country and a committee representing the bondholders.

2. The main overall consequence of the switch from bond finance (1930s) to syndicated bank credit (now) is that rescheduling of debt has largely taken the place of default. Bank finance is also now buttressed by national central banks, the Bretton Woods institutions, export credit agencies, and (especially where bridging loans are concerned) the co-ordinating role of the BIS. There are now well-established arrangements for introducing conditionality in exchange for new finance whereas in the 1930s market discipline was almost the only factor (whether the newer arrangements are any more successful in imposing conditionality is of course arguable).

3. Despite the elaborate machinery now available to deal with debt, there were features of the situation in the 1930s which may have made the position in some respects somewhat easier for both creditors and debtors. Valuations could alter freely in the

secondary market while the effect was widely dispersed among holders of wealth. Creditors in default were, unlike the commercial banks now, not in the position where they had to keep on providing more finance to doubtful borrowers or else take the risk that they would have to realise losses on existing debt. Debtors' ability to raise new finance, where they were not actually banned from capital markets following a default, might actually have been enhanced when new potential investors took their lower debt servicing burdens into account. The blight caused by debt overhang is now an increasingly negative factor for new debtor borrowing. Defaulters in the 1930s, in contrast, eventually regained access to external funds. From the authorities' point of view, non-repayment of sovereign debt did not represent the systemic risk to the banking system in the 1930s that it does now.

4. Interest differentials between good and bad debtors on new lending may also have been larger in the 1930s than now, more accurately reflecting risk. Banks in the 1980s have tended either to refuse to lend or to lend involuntarily at interest rates largely unrelated to risk. The "herd instinct" of banks has also been much commented upon. They tended in the 1970s to all overlend at once, and then have tended to turn off the tap simultaneously in the most recent period - this might have created a discontinuity which was less prevalent in the 1930s when creditors were less tightly organised.

Annex B
Classification of Countries

ANNEX B

Classification of Countries

This paper uses three IMF classifications of debtors; countries with recent debt servicing problems, Sub-Saharan Africa excluding South Africa and Nigeria, and the Baker 15 group of highly indebted middle income countries.

2. There are some oddities in this classification. Colombia is a member of the Baker 15, but is not included in the list of countries with recent debt servicing difficulties. The Ivory Coast is included in both the Baker 15 and Sub-Saharan Africa. There are a number of low income countries which are not part of Sub-Saharan Africa.

3. Nevertheless, the groupings do allow the different natures of the debt problems of the very poor and the middle income debtors to be reflected in the analysis.

Countries with recent debt-servicing problems	**Sub-Saharan Africa**	**Baker 15**
Antigua and Barbuda	Angola	Argentina
Argentina	Benin	Bolivia
Belize	Botswana	Brazil
Benin	Burundi	Chile
Bolivia	Cameroon	Ecuador
Brazil	Cape Verde	Ivory Coast
Central African Republic	Central African Republic	Mexico
Chad	Chad	Morocco
Chile	Comoros	Nigeria
Congo	Congo	Peru
Costa Rica	Djibouti	The Philippines
Dominican Republic	Equatorial Guinea	Uruguay
Ecuador	Ethiopia	Venezuela
Egypt	Gabon	Yugoslavia
El Savador	Gambia	
Equatorial Guinea	Ghana	
Ethiopia	Guinea	
The Gambia	Guinea-Bissau	
Ghana	Ivory Coast	
Grenada	Kenya	
Guatemala	Lesotho	
Guinea	Liberia	
Guinea-Bissau	Madagascar	
(contd. over)	(contd. over)	

Countries with recent debt-servicing problems

Guyana
Honduras
Ivory Coast
Jamaica
Liberia
Madagascar
Malawi
Mali
Mauritania
Mexico
Morocco
Mozambique
Nicaragua
Niger
Nigeria
Panama
Paraguay
Peru
The Philippines
Poland
Romania
Rwanda
Senegal
Sierra Leone
Somalia
Sudan
Suriname
St Lucia
Tanzania
Togo
Uganda
Uruguay
Venezuela
Viet Nam
Western Samoa
Yugoslavia
Zaire
Zambia

Sub-Saharan Africa

Malawi
Mali
Mauritania
Mauritius
Mozambique
Niger
Reunion
Rwanda
St Helena
Sao Tome and Principe
Senegal
Seychelles
Sierra Leone
Somalia
Sudan
Swaziland
Tanzania
Togo
Uganda
Upper Volta
Zaire
Zambia
Zimbabwe

ANNEX C
EROSION OF
CONDITIONALITY

ANNEX C

Erosion of Conditionality

Conditionality is central to the IMF's role, and is increasingly important to the World Bank in connection with SALs in particular. It is vital in catalysing flows from commercial banks.

2. The erosion of conditionality at the IMF has to be seen against the background of the changing composition of its clients. In the 1950s and 1960s, lending was to relatively high income industrial OECD countries with temporary balance of payments problems. As recently as 1977 as much as 50% of total drawings of SDR 13 billion went to such countries. These countries were responsive to Fund prescriptions and adjustment policies stimulated genuinely spontaneous flows. But now Fund lending is almost entirely in concentrated in much poorer, less developed countries with chronic balance of payments problems. They have often been administratively incapable of implementing programmes and politically disinclined to do so. By 1980 protracted use of Fund resources with minimal adjustment was clearly emerging as a problem.

3. Under creditor pressure, and with strong leadership by Larosiere, Fund conditionality was tightened from 1981, and when the Mexican crisis struck in 1982, it was possible to put in place a range of reasonably robust programmes. To an extent they were successful, but import compression played the major part in bringing about the lower current account deficits made necessary by the big fall in the capital inflow and the necessary accompanying structural and liberalization changes were inadequately implemented. By 1985 it was clear that creditworthiness was further away for most countries. In consequence, and because of their strengthening capital base, commercial banks were increasingly reluctant to lend. On the debtor's side, too much of the adjustment had taken the form of import compression. Both debtors and creditors were showing signs of adjustment fatigue.

4. The response was the loosely specified Baker proposal which stressed growth objectives in the context of strong, comprehensive and sustained efforts directed at the underlying sources of imbalances in debtor countries. This meant a range of measures aimed at real exchange rates, real interest rates, pricing, and structural changes. While these measures took effect finance would be needed, not only from the IMF but also, and on a longer-term basis, from the World Bank and other creditors. In essence the Baker strategy was no more than a restatement of the traditional Fund medicine of tighter fiscal and monetary policies, external competitiveness, with an added emphasis on the growth that these policies reinforced by other structural adjustments, should bring about.

5. In fact matters drifted. Throughout the first half of 1986 a number of weak programmes were agreed (Zambia, Zaire, Ivory Coast, Argentina waiver) but Mexico with its innovative trigger mechanism was recognised to be a vital precedent. After the Mexican discussion, the Fund returned to the wider issue of the design of Fund programmes. There was a feeling that the major weakness in the Mexican programme had been its inadequate fiscal adjustment rather than its innovative features. Events, however, overtook the Board's deliberations as both Egypt and Jamaica will in practice be allowed programmes on the basis of thoroughly unsatisfactory adjustment.

6. In one case after another - Mexico, Egypt, Jamaica, Brazil - the US for political and/or systemic banking reasons, pushed the G5 into abandoning standard conditionality prescriptions.

7. The World Bank has a good record on projects and sector loans in holding firm to conditions. Despite politics, the Bank has so far for instance held firm on implementing energy price increases in Egypt before releasing funds under the recent energy sector loan. But it has been less successful in applying structural conditions for SALs. This is hardly surprising given their similarity to IMF loans and the erosion of conditionality there.

ANNEX D
WAYS OF
REINFORCING
ADJUSTMENT

ANNEX D

Ways of Reinforcing Adjustment

Halting Capital Flight

The stock of assets accumulated by capital flight is estimated by the IMF to be in excess of, perhaps well in excess of, $100 billion. Halting this outflow, and repatriating some of the existing stock, would improve the position of many debtors in Latin America. This would require further substantial policy changes in the debtors to ensure positive real interest rates a favourable tax regime and much greater capital security.

Increasing Direct Investment

2. Additional direct investment in developing countries is one way of implementing risk sharing (discussed more fully at paragraphs 8-11 below). But recent empirical evidence assembled by IMF Staff indicates that, while servicing of direct investment is more closely linked to the ability to pay than is debt finance, nevertheless this potential benefit is eroded as reinvested earnings rather than remitted profits have tended to bear the brunt of deteriorating performance. Nevertheless, more direct investment would be preferable to more debt finance. Encouraging an increased amount of direct investment is mainly in the hands of the LDCs themselves, most of whom have restrictions on foreign ownership, on majority holdings, on dividend and interest remittances, performance restrictions, high levels of protection and also restrictions on access to local capital markets. But it might be possible to use conditionality (eg by the World Bank) in order to get LDCs to drop some of these restrictions.

More Debt/Equity Schemes

3. It is already UK policy to encourage debt/equity conversion schemes. Limiting factors are the number of countries which offer schemes, the potential shortage of both buyers and sellers and the expansionary effects on debtors' money supply. Currently schemes

are in operation only in Mexico, the Philippines, Chile, Brazil, Costa Rica and Ecuador, although Argentina has proposed a new scheme. In the current climate not many companies wish to expand in problem debtors. On the sellers' side, many large banks have not made adequate provisions and do not wish to make provisions sufficiently large to take the loss in the secondary market price of their debt. The total amount of equity purchased under these schemes has been estimated to be about $4 billion. It is likely they will continue to make only a modest contribution to easing debt problems. Nor is portfolio investment in LDCs likely to make a major contribution. Stock exchanges in these countries are not highly developed and there are limits on the types of shares held, limits on capital repatriation, minimum holding periods and high tax rates.

Asset Sales

4. One way in which debtor countries could obtain more finance directly is through asset sales, for instance oil fields, land, housing, copper mines. The value of saleable assets is in principle very large even in relation to debts. But political difficulties are likely to preclude widespread adoption of this approach.

More Finance from the IFIs

5. For the IFIs, the main alternative would be more World Bank lending. It is not the case currently that overall resource constraints are limiting lending: rather it is the quantity of viable projects and policy lending proposals. If debtor countries were prepared to come forward with more policy based lending proposals then there would be a need to increase resources by a major GCI.

6. Another way in which the Bank could contribute more to further financing would be by increased use of guarantees of commercial bank lending. But this could considerably increase the Bank's exposure to risk.

Conditionality combined with new forms of help with debt burden

7. Another way of bringing in a greater financial contribution would be to use IFI conditionality in support of write down or interest reductions as well as new money and rescheduling. Banks could be given the choice as to the form their contribution should take. If the banks were to be willing to make such a contribution, it might be appropriate for governments and IFIs to show the same willingness to adopt new approaches. This could mean write down and interest relief from governments and rescheduling by the IMF. The latter would be a major change but should be considered.

Risk Sharing

8. Despite the prospect of more help with their debt burden, there might still an unwillingness among debtors to make sufficient policy changes in the face of uncertainty in the external factors which they have to face. One approach to this would be "risk sharing".

9. Risk sharing could be applied to income, to principal, or both. As applied to income the concept might be to have a reduced interest payout - with or without an ultimate repayment provision for the amount of the reduction below the amount of interest otherwise payable - in the event of an outturn which was below an agreed standard, or an extra payout if an outturn was above a certain standard. The "standard" could be the price (or total sales income) from a particular commodity, total gross or net export earnings, or some other measure of repayment capacity. Such risk-sharing would be similar to interest rate capping but in a symmetrical form.

10. But it would also be possible to formulate a true equity arrangement. Chapter XI of the US domestic bankruptcy code is sometimes put forward as a model under which the reorganisation of a company is permitted where creditors agree that debt claims can be converted into equities in order to avoid a liquidation.

Similar devices have often been used in corporate restructuring in the UK.

11. Mexico has already had some experience with petrobonds, where the repayment value of the bond has been related to the price of a contract for physical oil. Such collateralised equities would seem to be appropriate mainly for major commodity producers, since the commodity would have to be standardised: eg oil or copper. It is hard to envisage them being sufficiently attractive on a continuing basis to creditors such as banks except as a partial alternative to their equity investments which form a small proportion of their portfolios. They could have a role as a market security but, since LDCs are unlikely to provide <u>market-value</u> collateral to the <u>face</u> value of their debt, then they would need to be used in association with a writedown of bank assets.

Covering CONFIDENTIAL

EVANS → CH/EX 24/3

From : H P Evans
Date : 24 March 1987

CHANCELLOR

Rums de jour

cc Sir P Middleton
Sir G Littler
Sir T Burns
Mr Walsh
Mr Ross Goobey
Mr Hudson
Mr Culpin

WASHINGTON APRIL 8-10

At your meeting at 12 tomorrow (Wednesday), it would be useful to consider the issues likely to be raised at G5/7/10, and the themes for your interventions at the Interim and Development Committees.

G5/7/10

2. Sir Geoffrey Littler's minute to Alex Allan of 23 March (copy attached) covered the following points likely to be discussed in Washington :-

i) the future of the Louvre agreement;

ii) the G5/G7 argument;

iii) report to the Venice Summit;

iv) "indicators".

Interim Committee

3. The main items on the agenda are :-

i) world economic outlook and SDRs (in the morning) and

ii) indicators, surveillance and debt (in the afternoon).

4. You have been asked to speak for not longer than 7-8 minutes in the morning (you can of course circulate a fuller text). You will wish to cover the following subjects :-

(no longer have to do Presidency-speak, thank goodness).

i) the UK economy in the light of the Budget;

ii) the world economy : perhaps referring to the role of markets, structural adjustment, and policy changes by major countries (including a reference to the world current account discrepancy).

5. What you say at the informal afternoon session of the Interim Committee, covering indicators and debt, will depend on discussions the previous day in G5/7. On debt, my covering note of ~~19~~ 20 March on the general debt paper* proposed a line to take, which we could discuss at Thursday's meeting on debt.

*enclosed

Ch
I suggest you leave debt firmly for Thursday's meeting
AA

Development Committee

6. The agenda is as follows :-

1. Sustaining Growth in Developing Countries:

   a. Implementation of growth-oriented programs

   b. Poverty impact of structural adjustment and development programs

   c. Market prospects of raw materials, including consideration of the impact of industrial countries' agricultural policies on developing countries' economic prospects

   d. Overview of trends in the transfer of resources

2. Environment, Growth and Development

3. Progress Reports:

   a. Current international trade issues

   b. World Bank General Capital Increase (GCI), IDA and MIGA

4. Appointment of Executive Secretary

5. Other Business

7. The main element in your speech (again 7-8 minutes) could be world agricultural policies, and I attach a four page list of points to make which can be worked up into a speech. (Ch You may want to commission Robert — & Andrew — to work on this) AWK

8. Other subjects that should be covered are : poverty and the environment (both of these are on the agenda, and ODA are working up a paragraph on each); MIGA; General Capital Increase; and IDA.

Again, leave this till Thursday.

9. In the informal discussion in the afternoon, you could make an intervention on debt and perhaps on Sub-Saharan Africa. (Ch There is a separate paper, from Peter Mountfield, on the agenda for Thursday's meeting)

Briefing for Washington

10. IF1 is putting together the customary briefs on SDRs, IMF arrears and burden sharing, the ninth quota review, trade, problem countries, world economic outlook etc.

HPE

H P EVANS

sy2

DEVELOPMENT COMMITTEE, APRIL 1987 : AGRICULTURAL POLICIES

Last September, I said that perverse agricultural policies throughout the world "may well represent the greatest challenge of the next decade". Still true.

2. Agricultural policies in many countries are unsustainable. They represent an attempt on a massive scale to replace the market mechanism. Increasingly apparent that this attempt failing on a massive scale. Now increasing recognition of the costs that these policies impose :

i) in the EC, cost to each family maybe as high as $900 every year, in subsidies, higher taxation, and higher prices. Similar figures for Japan and United States. Inevitable consequence is fewer jobs and lower output in the non-farm economy;

ii) the EC and the US pay producers nearly three times the world price for butter. In Japan domestic prices are some nine times the import price for sugar, and rice, and six times world prices for wheat;

iii) some 50 per cent of the EC Budget is devoted to simply storing and dumping surpluses;

iv) the developing countries have to compete with highly subsidised products from the industrialised countries, while their domestic policies on exchange rates, market intervention and agricultural taxes undermine the price advantage of their own products. Developing countries could benefit to tune of $28 billion by removing border measures alone;

v) agricultural protection and subsidies a major threat to the multilateral trading system.

AGRIC-
ULTURE
POLICIES

3. Wrong to blame farmers for producing more; wrong to blame consumers for not demanding more; but right to blame governments for giving way to pressures to overrule markets. Verdict of governments instead of verdict of markets. Result, not only for agriculture but also for most other primary commodities, massive subsidies and artificially high prices. Meanwhile, huge waste of resources is tragic. But it can be avoided.

The Long-term Solution

4. Must move in direction of giving much bigger role to markets. All countries can gain from :

i) freer trade to exploit comparative advantage;

ii) bringing domestic prices much nearer to world levels;

Industrialised countries must reduce all forms of intervention, including subsidies, and move away from supporting rural communities in ways that stimulate production (eg should not link payments to output). **Developing countries** must reduce taxation of agriculture and intervention in markets.

5. No doubt about ability of many farmers to respond to a more competitive environment : farming (as recent OECD work shows) able to respond flexibly and quickly to a variety of signals. **No doubt that liberalisation of agricultural policies can be effective.** More flexible policies in **China** since 1977: growth of overall agricultural output 7 per cent per annum; cotton up by 23 per cent in first 3 years, and oilseeds up by 92 per cent. In **Ghana** reform of the marketing board system lead to significant increase in cocoa production.

UK Position

6. Within EC, UK has argued strongly and with some success for a lower level of CAP support prices. Over past three years real support price levels have been reduced by 10 per cent in UK. Even

so, for commodities such as **wheat, butter and sugar** prices remain as far as ever above world levels. Large falls in prices of agricultural land in UK : evidence of greater recognition that reform is inevitable.

7. UK attaches great importance to success of GATT round. Welcomed commitment at Punta del Este to special priority for tropical products. Has pushed for early start in agriculture negotiations on tackling causes not symptoms.

8. UK also taken unilateral action through new policies designed to encourage alternative uses of farm land and increased diversification.

9. UK also advocates tackling commodity problems generally by making use of market forces instead of trying to manage prices so making problems worse.

Need for Action

10. Growing consensus on need for long-term reform but need to agree on mechanisms.

11. Last year I called for multilateral disarmament among the subsidisers. GATT must play major role. But agricultural crisis will not wait for several years. Unless policies changed soon, real danger of further unwanted surpluses and costs.

12. **Industrialised countries** need to agree on quick action:

i) standstill on support measures;

ii) understanding on how to deal with the stock overhang;

iii) agreement on how unilateral reductions in support or other controls over supply should be treated in GATT negotiations.

13. **Developing countries** need to act to bring producer prices closer to world prices, and avoid overvalued foreign exchange rates which exacerbate the problem. Also important they get improved access to developed country markets for their food exports.

14. Need to build on Punta del Este agreement through negotiations on full range of domestic support and not just border measures. Commend contribution of OECD work on producer/subsidy equivalents as helpful benchmark in estimating size of problem.

Conclusions

15. Now worldwide acknowledgement of scale of problems. Must now agree that it is overall levels of assistance and intervention that are fundamental cause, and build on this common perception. Need to bring home to consumers and to taxpayers in industrialised countries and to producers in developing countries the scale of costs. Important to draw right conclusions, that markets, rather than governments, should provide the signals to producers and consumers. This means prices must not be set way above world prices (as in EC and Japan), nor heavily subsidised as in United States, nor set way below world prices as in many developing countries.

16. Much of OECD agriculture is now up to date flexible industry, which has demonstrated its ability to respond quickly to frequent changes in price and other signals. Potential for agricultural expansion in LDCs considerable. No doubt that agriculture will respond to the right signals in ways that will provide massive benefits to developing and developed countries alike.

3002/021

Alex – [illegible] with you

TURNBULL → MOUNTFIELD 24/3

FROM: A Turnbull
DATE: 24 March 1987

MR MOUNTFIELD

cc Chancellor
CST
EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Lavelle
Mr Cassell
Mr H P Evans
Mrs R J Butler
Mrs Case
Mrs Lomax
Mr Walsh
Mr P Davis
Mr Culpin
Ms Life
Mr Pitcairn
Mr Bush
Mr Carpinter
Mr Parkinson
Mr Cunningham
Mr Ross Goobey

Ch

Peter Mountfield's paper (below) is for discussion on Thursday. But you shd be aware of this disagreement between AEF + GEP

AWK 24/3

SUB-SAHARAN AFRICAN DEBT

You copied to me your submission of 23 March below in which you review the options for dealing with this debt and the public expenditure implications of each.

2. In paragraph 19(iv) you suggest that it might be possible to regard the costs of a debt write-off as bygones with no impact on public expenditure. This proposition was not considered in the discussions which AEF held with GEP and is not one that we think is valid.

3. The position as GEP see it is that loans which were originally made on commercial terms as part of ECGD's trading operations are now recognised as non-commercial, though there can be doubt about the precise moment at which this transition is realised. Your options discuss various ways of providing relief to the debtors. In our view, all these options should, at some point, be reflected in additional public expenditure, whether it is done by:

(i) rewriting history so that past public expenditure figures show what would have happened if losses had been acknowledged at the start (this process of retrospective adjustment being repeated in future years);

(ii) recording the interest concession as current public expenditure.

4. GEP have an open mind on which course is followed, though the second seems to reflect more clearly the method by which help is given. But it is undesirable on grounds of control for Government agencies to start out with commercial transactions and end up providing subsidised credit with no reflection of the resource costs of that anywhere in public expenditure. The improvement in control could in principle come in one of two ways:

(i) either ODA or ECGD have to find the money from within their programmes, or if that is neither possible (for ECGD) nor achievable (for ODA)

(ii) there is an addition to their programmes with a claim on the Reserve (or as a Survey bid for the years beyond 1987-88), with a tighter position for other programmes generally.

5. In practice, neither effect may operate strongly but scoring the change as an increase in public expenditure does at least provide a better description of what has been or is happening.

6. I do not think, therefore, that these proposals should be approached with the assumption that there is a free lunch. It would be helpful if, at the Chancellor's meeting on Thursday, the question of the public expenditure costs could be remitted for further study between GEP and AEF.

AT

A TURNBULL

CONFIDENTIAL

From : H P Evans
Date : 25 March 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Cassell
Mr Lavelle
Mr Mountfield
Mrs Lomax
Mr Walsh
Mrs Case
Mr Culpin
Ms V Life
Mr Carpinter
Mr Ross Goobey

Mr Loehnis - B/E

Press Briefing

Robin - prepare!

After Lancaster...

DEBT : UK INITIATIVE

You asked what a UK initiative on debt at the Spring Meetings might look like.

Major Elements in UK Statement

2. a) Long-term aim of debt strategy has always been to get problem debtors back into world financial markets;

b) But since debt crisis broke nearly 5 years ago the position of most debtors has worsened;

Message is : recognise this reality.

c) recognise that for many countries in sub-Saharan Africa, that aim is unattainable in foreseeable future. UK and some other countries already granting generous rescheduling and RTA ... need to look at long-term rescheduling ... even so, some countries need more ... UK therefore propose initiative/support initiative/join in study of debt problems in SSA.

Evans → CH/EX 25/3

Trade cycle not abolished

d) for other, mainly middle income, debtors, two major elements : first is policies pursued by debtors. Second is world environment, but wrong to count on sustained improvement here. Without further strengthening in debtors' policies, will be increasing questions about countries' ability/willingness to pay.

e) what can we (the creditors) do, in addition to attempting to liberalise trade, promote sustainable growth, to improve the prospects of debtors getting out of trouble? Options :-

- provide more finance : this is how problem arose, and no solution unless effectively deployed;

- urge more effective reform policies, with extra financial inducements; but urge no finance for countries not prepared to implement viable reform programmes;

- facilitate market-orientated solutions (increasing the marketability of debt, realising losses on existing debt, etc);

f) four main elements of UK initiative :-

  i) recognise reality (stronger position of banks, and especially worse position of debtors);

  ii) stress longer-term aim;

  iii) advocate positive action in sub-Saharan Africa;

  iv) further consideration/study of problems facing middle-income debtors, with UK favouring approach of early return to market-orientated solutions.

Settle Rue US!

Key Questions

3. i) how far do you want to go in advocating market-orientated solutions? Could the UK banking system cope?

ii) how far do you want to go in trying to secure creditor agreement (above all the US) before speaking in Washington? And how far are you prepared to go in standing alone?

Consultations

4. The Americans and the French, as last week's WP3 and G10 Deputies meetings in Paris showed very clearly, will be hostile to this line. But the Europeans and Japanese are much more sympathetic, though reluctant at the moment to say so. A UK lead could be very valuable : but there will need to be preparation of the ground, at bilaterals, at ECOFIN, G7, with colleagues and by circulating papers in advance of the Spring Meetings.

HME

HUW EVANS

*Later: you have asked us to fix a meeting with Sir G Howe. Does that mean you do not want to send a minute – or not just yet? AWK

CONFIDENTIAL

Ch/ Letter to issue?*

AWK 30/3

From: Sir G.Littler
Date: 30 March 1987

Sir G Littler → Chllor 30/3

CHANCELLOR

c.c. Chief Secretary
Sir P.Middleton
Mr F E R Butler
Mr Huw Evans
Mr Mountfield
Mr Walsh
Mrs R Butler
Mr Pitcairn
Econ. Secretary
Sir T.Burns
Mr Cassell
Mr Turnbull
Mrs Case
Mr P Davis
Mr Culpin
Mr Ross-Goobey
Mr Lankester (W'ton)
Mr. Anson

OK to send letter (as amended) now: I will have a word with SirGH just before Cab. ~~on Monday~~ on Thurs. NL

SUB-SAHARAN AFRICAN DEBT

At our meeting (Treasury and Bank) on 26 March you decided that you would open up in general terms an initiative on debt, which should encourage market approaches to the problem, reinforce the pressures and incentives towards better policies by debtors, and point towards some possible limited debt relief conditional on good performance. In the first instance you would signal at the forthcoming Washington meetings the possibility of debt relief for the poorest countries of the Sub-Saharan region.

2. You need to carry FCO, DTI and B/E colleagues with you, and I attach the draft of a letter you might send. We know that B/E officials will applaud this initiative. So also will the FCO - although it is important to get their and ODA acceptance that future "Retrospective Terms Adjustment" on aid loans should as in the past be carried by and within the Aid Programme. The draft mentions this last point.

3. ECGD may be more reserved, and the Chief Secretary, who was not present at the meeting last week, will want to know more of the problems arising on debt relief in relation to ECGD.

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4. Our starting-point is the acknowledgement that in practice we are never going to receive full payment on ECGD-guaranteed debt by the poorest countries. We are of course already in some cases receiving neither capital repayment nor interest, but accepting continuous rescheduling. All calculations show that the process of commercial rescheduling which we have been adopting creates an increasingly transparent fiction, with the burden of debt rising towards infinity. At some stage, default or deliberate relief is inevitable.

5. The argument for a measure of deliberate relief is that it would recognise reality, provide encouragement, and make possible conditions for improved policies which should make it much more realistic to hope for eventual servicing of the reduced burden of debt.

6. Given the starting-point, relief will not substantially affect the reality of our public expenditure and borrowing requirement, although the relief should be scored in the public expenditure figures and at least part of it will need to be financed from the Reserve. But the phasing of the amounts depends on the forms in which the relief is offered, and choices can be made about this. Within the Treasury, we are considering the options, in close consultation with Mr Butler, and will submit to the Chief Secretary shortly.

(Geoffrey Littler)

Pl type as a minute for CL's sig

CONFIDENTIAL

~~DRAFT LETTER TO:~~ Foreign and Commonwealth Secretary

~~c.c. Trade and Industry Secretary~~
~~Governor of the Bank of England~~
~~Sir Robert Armstrong~~

SUB-SAHARAN AFRICAN DEBT

Ahead of the forthcoming sequence of international meetings, from the IMF Interim Committee and Joint Development Committee meetings in Washington on 9-10 April to the Venice Summit, I have been considering the international debt problem on the basis of papers prepared by Treasury officials. Your officials have seen these, and indeed made valuable contributions. The papers have covered both the debt problem in general and the special problems of debt of the poorest countries of Sub-Saharan Africa in particular.

2. It is increasingly recognised that the management of debt problems is running into difficulties. ~~I have no doubt that~~ The strategy which has been followed so far has ~~been the best we could find, but equally it is clearly time,~~ served us reasonably well, but it is clear that after five years, ~~to take~~ it is reaching the end of its useful life. We need to take stock and to seek some way of giving new impetus and fresh hope.

3. Therefore I ~~am~~ propose~~ing~~, in my remarks at the IMF Interim Committee meeting in Washington next week, to outline some of the points which might form the basis for such a development of the strategy. I shall focus on the need to try to develop market arrangements which can, even if only marginally at first, begin to ease the problem: new market instruments and new forms of cooperative investment. But the main action here lies with the markets and with the willingness of debtor countries to open up to private investment. I shall stress the fundamental importance of sound policies by debtors - in their own interests -

if they are ever to restore their creditworthiness, and this must be backed by positive conditionality by both IMF and World Bank.

4. In the case of the poorest countries of Sub-Saharan Africa I believe we must go further. Many of these countries are within the Commonwealth. Most are not only extremely poor and heavily indebted (mainly official or officially-guaranteed debt rather than commercial bank debt), but they also face a whole range of other major problems: reliance on one or two commodities for their export earnings, weak administrations, the legacy of badly mistaken policies of industry, of agriculture, of urban subsidy. They have little realistic prospect ~~in any~~ for the foreseeable future of servicing their external debts or ever gaining and being able to afford access to commercial finance.

5. In my view the time has come for the UK to take the lead in advocating a new international approach ~~for~~ to the problems of these countries, which should include some limited and strictly conditional measure of direct debt relief. This should apply case by case and be conditional on the countries being ready and able to follow satisfactory policies with the approval and cooperation of either the IMF or the World Bank or both. In practice we must envisage policies developed over more than the usual short-term IMF horizon, so I envisage a major role for the World Bank. It is my impression that they would be willing to play this role, and are competent to do so.

6. In practical terms I have in mind three specific measures which we could advocate:

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- "Retrospective Terms Adjustment", which effectively converts old aid loans into grants, has been undertaken already by the UK for all except Zambia; but some other countries, including notably Japan and France, have not yet done so. they should come into line~~;~~.
- Long-period rescheduling of loans, with generous grace periods, is favoured by most Paris Club participants; the US may have objections, but I think we should push them and work to mobilise generous terms from all~~;~~.
- The relatively novel feature I propose is that we should agree - of course on the understanding that we can get all other major creditors to do the same - to some limited measure of debt relief: in advocating this I would not want to specify the form immediately, but it would probably have to be an element of abatement of interest.

7. Any arrangements under these headings should be structured in such a way as to give progressive benefit over several years, conditional on the maintenance of better policies. The details will need to be worked out between our officials, and of course among our fellow-creditors.

8. As far as costs are concerned, I would look to you to carry the RTA element (only for Zambia and over a period of years) on the existing aid programme, but I accept that other debt relief costs could not reasonably be charged within the existing allocations for that programme. As I see it, the justification for debt relief ~~would be~~ is that on ~~a~~ any realistic assessment full

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servicing is simply not achievable, so that to forego some of the payments due to us would do no more than recognise the reality, and should indeed make it more likely that some payments will eventually be received. I see no virtue in a policy of absolute self-delusion.

~~9.~~ The way in which any concessions are made and accounted for will need further consideration. I am asking my officials to explore the various options with ECGD colleagues. But we need not await the outcome before making a proposal in general terms internationally. The process of international agreement is bound to take some time, and any proposal at this stage obviously cannot be in specific terms. Indeed tactically it will be sensible to be able to make progress gradually over the series of international meetings which lie ahead.

~~10.~~ Before I take this further, I should like to know that I have your agreement, as well as that of Paul Channon and of Robin Leigh-Pemberton. I am copying this letter to them, and also to Sir Robert Armstrong.

(N.L.)

DEBT

CONFIDENTIAL

From : H P Evans
Date : 31 March 1987

EVANS → CHlex 31/3

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Lavelle
Mrs Lomax
Mr Mountfield o/r
Mrs Case
Mr Walsh
Mr Culpin
Mr Carpinter
Ms V Life
Mr Ross Goobey

Mr Loehnis) Bank of
Mr Price) England

UK DEBT INITIATIVE

I attach a rough draft of a speech on debt for Washington. Sir Geoffrey Littler minuted you yesterday on Sub-Saharan African debt (and you have sent the minute to Sir G Howe – below)

2. I see six main points to your initiative :-

i) analysis;

ii) role of markets;

iii) extending the role of risk-sharing;

iv) stronger IMF and Paris Club programmes for debtors prepared to implement reform policies; refusal of programmes for others;

v) float possibility of debt relief for some countries;

vi) positive action on sub-Saharan Africa.

3. The first point covers our motivation for looking afresh at the debt strategy in the light of five years' experience. It goes on to the conclusion that most debtors are further away from creditworthiness than in 1982. There will be a considerable measure of agreement with this conclusion in Europe, and among the banks - but strong disagreement from the United States if recent noises from Baker, Volcker and Mulford are anything to go by.

the better position (adjustment)

4. The second point re-emphasises the role of markets, particularly the secondary markets in debt. In the past, we have been unenthusiastic about the secondary markets on the grounds that they are often thin, to a considerable extent interbank, and somewhat distorted by differential tax treatment as between countries. But there is a positive role for markets - as indicators of progress of strategy, as a means of trading debt and so facilitating portfolio adjustment, and facilitating the conversion of debt into equity. The Americans, who have attacked the Japanese use of secondary market prices in the offshore Japanese scheme, will not welcome this.

5. The third point is the specific encouragement of various forms of risk-sharing : debt/equity swaps, direct and portfolio investment. No problem here with the creditors, only over the debtors' will to provide the right climate for these arrangements to expand.

6. The fourth point is the need for a stronger line in the Fund and elsewhere on conditionality. That may well be seen as a logical next step from our semi-public doubts about some of the weaker Fund programmes and the Paris Club battle over the Brazilian rescheduling. But this point will quickly lead on to questions about what we are proposing to do with countries like Egypt and Zaire (cited by Finch in his resignation speech) : any initiative on debt at the Spring Meetings will look rather empty if it is not followed up by action in the Fund Board, especially on Egypt with all the political difficulties that raises.

7. The fifth point is much the most contentious and potentially very high profile : this is the reference to the possibility of debt relief, on which see below.

8. Finally positive proposals on sub-Saharan Africa should get a general welcome, again perhaps excepting the United States.

9. The major question is this : do you want to refer (as paragraph 12(v) does now) to a "limited form of reduction in debt burdens"? This will be the first time that this proposition will have been put forward by a major creditor and it is likely to attract immense publicity. The Americans will dislike it intensely; and the banks will be highly suspicious, fearing the consequences for their profits and asset values. There will however be acceptance in many quarters that this is part of the process of facing up to reality. There will of course be delight in other quarters that the creditors are seen to be beginning to alter tack : you too may find yourself with a Guardian award! [illegible]

appalling prospect!

10. On the principle of whether or not to refer to some kind of debt relief/reduction in debt burdens, the case **against** is :-

i) even without any such reference, there is plenty of substance in the other points of the initiative and there will be other occasions this year (the Venice Summit, the Annual Meetings) at which the initiative could be developed further;

ii) the impact of debt relief (eg on banks) depends crucially on whether it takes the form of debt writedown or a form of interest relief that does not involve writedown and we are not yet at all sure of the consequences for UK banks;

Why not make clear?

iii) there could well be an adverse impact on some of the problem debtors whose cases are currently being finalised, eg Mexico.

11. The case **for** flows from the logic of the analysis and is essentially that of recognising reality. Sooner or later there is likely to be some form of substantial interruption of debt service : saying so in advance may help people to prepare for it.

12. If you do decide to float the general idea of debt relief then you will wish to consider the following arguments :-

i) you see this as something which is probably unavoidable, and certainly not something to be welcomed (though there will be many people who will ignore this distinction);

Janus - schizoid

ii) you will want to stress the damage that any form of debt relief will do to the creditworthiness of the country concerned;

iii) you need to decide how specific you want to be in the speech. The less said in the speech, the more there will be immediate demands for explanations and amplifications afterwards : what do you have in mind? for whom? how much? what is the Lawson scheme in detail? what are the regulatory implications for the banks? The Economic Secretary's view, which I share, is that if you do go down this road of floating the possibility of debt relief, you will need to do more in the speech than float a general concept : otherwise the whole burden of explanation and amplification will fall on press conferences.

13. In order to try and anticipate what sort of questions will naturally arise, Mr Walsh has put together the attached list of questions and answers. All references to debt relief outside sub-Saharan Africa are in square brackets.

14. In addition to the major question of whether or not you include the notion of debt relief outside sub-Saharan Africa, there are several other areas where there are still some question marks :-

i) are you content with the inclusion in paragraph 12(vi) of the reference to the possibility of rescheduling IMF debt in Africa? This is not the only way in which the problem of IMF debt can be dealt with, but it is an obvious one with some precedents

ii) Are you content that we should resist, even for Africa, any suggestion that World Bank debt should be rescheduled because this might damage the Bank's financial standing in world markets?

HPE

H P EVANS

DRAFT SPEECH

Ch
Needs rewriting, but important point for now is structure plus substance
AA

UK DEBT INITIATIVE

The debt crisis broke in 1982. Nearly five years later we are entering a new phase : this may prove the most challenging period of all.

2. At the start of the period the credit standing of many developing countries plummeted and international banking was under threat. Our aim was to enable debtors to restore their credit standing and so take advantage of burgeoning international capital markets. But that could not be achieved quickly : we had to buy time.

3. In some ways, this time has been well spent. The banking system has strengthened its capital base and raised provisions. Reform programmes have been put into effect in many debtor economies. There have been individual successes. All this despite the further pressures arising from oil price changes.

UK DEBT INITIATIVE

4. New policies have been put in place by the international agencies. The Fund has tried to give prominence in its programmes to the need to create the right conditions for economic growth. The World Bank's role and its rate of resource spend have been enlarged.

Sounds a bit odd - perhaps needs spelling out.

The World Environment

for whom?

5. Over this period the economic environment has improved, despite weakness in commodity price : the effect of this has been offset by a six point fall in interest rates; by GNP growth averaging $3\frac{1}{2}$ per cent since 1982; and by import growth into OECD countries averaging over 7 per cent. The depreciation of the dollar has meant a reduction for most in the weight of debt.

6. So we can take satisfaction both in the nature of the strategy that was adopted and from its case-by-case implementation. And the full effects of some policy changes introduced have yet to come through.

Analysis

7. But despite these efforts, we cannot avoid the major and unwelcome conclusion : most debtors are actually further away from creditworthiness than in 1982. This has been reflected in greater difficulty in the Fund's putting together programmes and in the banks' providing new money. The evidence is as follows :-

i) by 1986 the ratio of debt to exports in the Baker 15 group had risen from 270 per cent in 1982 to 343 per cent in 1986. The ratio of interest paid to export earnings has barely declined despite interest rates almost halving. The ratio of debt to GDP in the Baker 15 had risen from 42 per cent in 1982 to 50 per cent in 1986. The trends are the same for other groupings of debtors, and do not depend on the choice of particular years.

ii) capital flight, as a recent IMF paper showed, has probably been at a lower rate than in earlier years; but has continued in the years since 1982 at a high level.

iii) valuations placed on sovereign debt have continued to fall : this is true in the secondary markets for debt, and in the ratings by agencies.

The message from the markets and from the banks is that it is high time to look again at the implementation of the debt strategy.

8. What can we do? It is time to emphasise that this is a proper area for commercial and market judgements and realities. It is time to look for more ways of sharing the risk and opportunities. It is time to be more concerned with the quality of programmes. It is time to stop back seat driving the Fund. It is time to take the debt strategy out of the greenhouse. !!

(I dont keep my car in my greenhouse)

Distinguishing the Very Poorest

9. We need to distinguish carefully between the very poor countries, particularly of sub-Saharan Africa, and the middle

income debtors. Many countries in sub-Saharan Africa, apart from being extremely poor and heavily indebted, face a whole range of major problems : reliance on one or two commodities for export earnings, weak administration, the legacy of mistaken policies especially in industry and agriculture, and so on. Most of these countries, where the debt is mainly official and not to banks, have little prospect of servicing their external debt and ever gaining access to financial markets. Many are now implementing reform policies.

10. For larger, mainly middle income, countries the commercial banks are the largest creditors. In the longer-term, there is a feasible route back to high credit standing and spontaneous new finance - and this is what these countries need. This route - implementing reform policies and servicing debts - offers them the best prospect of sustained growth through full participation in the world financial and trading markets.

11. We have to recognise that even where reform efforts are being made, the markets are telling us that progress is too slow. The response cannot solely be new money - that is how the debt crisis arose. Nor should we rely on a further major improvement in the world economy.

Strengthening the Strategy

12. How then can we strengthen the debt strategy, building on what has already been achieved?

i) Make more use of market mechanisms. Although the secondary markets in debt are often thin, they serve to illustrate the gap between the face value of debt and reality. These markets, which allow claims to be redistributed, perform a useful function in trading financial assets. Greater securitisation of these assets is a desirable long-term goal, especially if it spreads sovereign debt risk outside the banking system.

ii) Look for more ways in which lenders and borrowers can share in the opportunities and risks in developing countries. Debt/equity swaps, direct investment, portfolio investment - all these are well worth encouraging.

In time these approaches will be able to make a major contribution. But they are not on large enough scale in short-term. We need therefore to go further in strengthening the debt strategy :-

iii) We have seen over the past year an insidious weakening of conditionality at the IMF. Some programmes are being put in place with poor prospects of medium-term viability for the balance of payments. This is simply not in the long-term interests of debtors themselves nor of the Fund. The creditors together must resist and reverse this trend. This means that : the Fund must not put forward weak programmes; the Fund Board must not support them; and the official creditors in the Paris Club must not reschedule without firm assurances. This would give a clear and positive signal to the banks, already worried about loss of conditionality. With stronger policies in place, banks would be more ready to lend money and creditor governments to play their part.

iv) Generally, we see a growing need to re-establish and strengthen incentives for strong reform policies in countries seeking Fund/Bank assistance. The obverse of this is that countries which reject such policies cannot expect to re-establish their creditworthiness with external financial help.

v) The time has come to examine how far further assistance should take the form of new money and hence of an increase in debt. There may be no realistic alternative to some limited form of reduction in debt burdens : rather than compounding debts yet further, it may be necessary to consider, for example, options which

New money or new terms??..

involve lower interest rates. One possibility is the suspension of some part of interest payments for a period, during which time debt is not built up further. This would need to be handled step by step, keyed to the implementation of strong and comprehensive reform programmes and case-by-case, tailored to the requirements of individual countries. Such an approach - and let there be no illusions about it - would seriously damage, and for an indefinite period, the credit standing of some borrowers. That is why maintaining full debt service on the route back to creditworthiness is so much better.

vi) Finally we need to recognise the enormous problems and special claims of sub-Saharan Africa. [I shall have more to say at Development Committee]. I propose that the main creditors, initially in the Paris Club, should consider changing their approach to a group of countries with both very low incomes and high debt ratios. For this group, there is a need to go beyond generous rescheduling, provided debtors co-operate with Fund/Bank. The process should start with conversion of aid loans to grants - process the UK has largely completed. Should also consider rescheduling on longer-term maturities. Consider reducing interest rates to well below market rates for official loans. Commercial banks will have to consider what line to take. Implement case-by-case on basis of appropriate IMF/World Bank programmes. [World Bank loans long term, and repayments not a problem, but we may need to consider, for this group of countries alone, special treatment of IMF debt, for example rescheduling].

Conclusion

13. Let us now examine together the debt strategy. Mistakes have been made by all parties and costs incurred. There are no easy solutions. These costs cannot be avoided - but they can be handled carefully, over a period, in ways which involve greater use of markets and in ways which strengthen the world economy. My proposals are based on these twin objectives.

Q&A BRIEF

1. Does this mean Baker approach is to be scrapped?

No alternative to existing case-by-case approach which has enabled us to avoid major breakdowns since 1982. But some recent adjustment programmes inadequate and debtors further away from creditworthiness than before. Difficulties in achieving the Baker target for new bank lending. Debtor and creditor fatigue. Strategy needs to be strengthened. Ultimate aim is still to restore debtor access to financial markets.

2 Is initiative in response to Brazilian suspension of payments?

No. Follows review of progress with debt strategy since 1982, which concluded that overall position of debtors is tending to get worse.

3. Weak IMF programmes: which countries are you referring to?

Particular worries about Egypt, but there are others. Need to forge new understandings in Fund that weak programmes are in nobody's long term interest.

Questions & Answers

4. How are reform programmes going to be improved?

This will be a matter for discussion in each individual case. But all will have to have real prospect of sustainable medium-term balance of payments position, while creating conditions for sustainable growth.

5. Will programmes qualifying for new approach have to be with IMF and not World Bank?

Normally expect Fund and Bank to be involved. But in any case qualifying programmes would have to restore a sustainable medium-term balance of payments position, and include any necessary measures such as control of domestic credit and reduction of fiscal imbalances. Monitoring requirements would be at least as rigorous as IMF monitoring.

6. Will Britain stand out alone in Fund and Paris Club?

Aim is to achieve widest possible measure of agreement.

[7. **Is official debt relief for large debtors contingent on parallel action by the banks?**

Yes. Most of the debt of large debtors is owed to the commercial banks so parallel action by them would be essential to the proposal.]

[8. **What form will official debt relief to large debtors take?**

To be considered in international discussion.]

[9. **What will be the form of debt relief given by the banks?**

Early days yet. Always made it clear that banks must take their own decisions. Discussions still to take place.]

10. **What are the views of other G7 creditors on UK proposals and did you consult first?**

Other countries also re-examining debt strategy; need to discuss, not only with the main creditors, but other countries and the banks. This we are now doing.

11. **What is the role of secondary markets in LDC debt strategy?**

Markets have three roles:-

(i) As indicators of progress of strategy they show how close market value of debt is to face value.

(ii) As means of trading debt amongst creditor participants to facilitate portfolio adjustment.

(iii) Facilitating the conversion of existing debt into equity investment in countries concerned.

12. **Role of private investment?**

In past ten years, too much lending to LDCs went through banks - better to diversify. Wish to encourage direct and portfolio investment in debtor countries. Can help themselves by removing restrictions on ownership, repatriation of profits, etc. Support Multilateral Investment Guarantee Agency to enable investors to insure against expropriation and other political risks.

13. **Does UK wish to increase banks' participation in concerted lending packages?**

Banks will continue to have role in debt strategy where debtors implement satisfactory programmes. It is for banks to choose between various options - new money, rescheduling, [debt relief,] etc.

14. **Is there a message that banks need to provision more?**
Yes.

15. **Budget change in tax treatment of banks' overseas lending?**
Doubt whether any significant impact on debtors.

16. **What form of debt relief for SSA?**
To be further considered. But have suggested rescheduling over longer maturities than now, conversion of aid loans to grants by all countries and possibly concessional interest rates for official loans (including ECGD) where there is a firm commitment to adequate reform programmes.

17. **Is debt relief for SSA countries contingent on parallel concessions from the banks?**
Most of their debt is official, but would look to other creditors to share burden. Banks have already rescheduled some SSA debt, and should consider any further concessions in the light of treatment of official debt for particular countries.

18. **Will not official debt relief for SSA simply lead to more debt service paid to the banks?**
No. Negotiations will take place with the government of the country concerned to ensure that the banks are not bailed out at the expense of creditor governments. This would be part of the conditionality for any debt relief.

19. **Is rescheduling of IMF debt going to be considered for SSA only?**
Proportion of debt burden accounted for by IMF debt highest in case of SSA; meeting repurchases on time poses considerable difficulties for countries concerned. Will be considering matter shortly in the Fund Board.

20. **What about poor countries outside Sub-Saharan Africa (SSA)?**
There is a growing international consensus that the problems of SSA - combined poverty and high levels of debt - are special and are spread throughout many African countries. This justifies a framework for debt relief relating specifically to SSA.

21. **Can UK unilaterally introduce any part of initiative?**
Have already implemented Retrospective Terms Adjustment (conversion of aid loans to grants) for most countries with lowest incomes. But debt relief can only be done on a multilateral basis including all main creditors.