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PART A

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PART A

Chancellor's (Lawson) Papers:

GROUP OF SEVEN MEETING
JANUARY 1989 TO DISCUSS
THE INTERNATIONAL
FINANCIAL SCENE

DD's : 25 Years

8/12/95.

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

13 December 1988

T Lankester Esq
Room 116/2
HM Treasury
Treasury Chambers
Parliament Street
London
SW1P 3AG

Dear Mr Lankester

WHITEHALL DEBT REPORT

I attach a copy of the final version of the Interdepartmental Debt Report for December, which takes account of revisions suggested by HMT and the Foreign Office.

Copies of the report go to other members of the Group.

Yours sincerely

pp CBlencowe

A R Latter

WHITEHALL DEBT REPORT

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COVERING CONFIDENTIAL

(Based on information as at 13.12.88)

INTERDEPARTMENTAL DEBT REPORT: DECEMBER 1988

Tables

INTERNATIONAL DEBT GROUP REPORT: DECEMBER 1988

Main points

- Brazil's bank package has been successfully completed, but its SBA is threatened by a loss of domestic financial control and hyperinflation.

- Controversial IBRD loans for Argentina have been approved; the banks remain distinctly cool to a new money request and a satisfactory IMF programme seems a distant prospect.

- Mexico's balance of payments and fiscal programme have been dealt a blow by the fall in oil prices. Reserves have been falling rapidly and the US has offered unconditional bridging finance.

- Following the offer of a substantial aid package, Nigeria and the IMF staff have been able to agree a programme.

- Poland has made an informal approach to the IMF for an SBA, but on the basis of an apparently inadequate adjustment plan.

- Iraq has approached HMG with a request for a bilateral rescheduling.

- There are increasing worries about the capacity of Jordan and Oman to meet their obligations.

- Little progress has been made in bank negotiations with smaller Baker 15 debtors.

- Secondary market prices of ldc debt have fallen sharply with widespread selling by smaller US and Canadian banks and with demand restricted by the suspension of debt:equity conversion programmes.

- The Paris Club has begun to reschedule the debt of the poorest countries on concessional terms.

- Creditor governments have agreed that greater emphasis should be given to debt reduction in the menu of options. Chile has bought back $300 mn of its debt.

International Financial Scene

World Economic Developments

1 Most projections point to a slowdown in OECD activity next year after the unexpected strength experienced since the crash, partly in response to the recent retightening of monetary policy and partly attributable to a more restrictive fiscal stance in Japan and Germany. Nevertheless growth should remain close to trend.

2 Market pressure, particularly intense since the US Presidential elections, is testing the willingness of the US authorities to accede to higher US interest rates (Chart 1) and/or dollar depreciation (the complexities of the twin deficit problem are being compounded by concerns over the future of the troubled savings and loan sector). A further rise in rates and depreciation does, however, seem probable. Recent commodity price movements (Chart 2) are giving conflicting signals: whereas metal prices have strengthened again (partly because of supply disruptions) having fallen back from peaks in the late spring, prices of other industrial materials are below their level at the end of last year. Oil prices have recovered somewhat following the latest OPEC accord but the $18 pb target looks a distant prospect. Food prices, while down from their drought-affected peak in July, remain well above mid 1987 lows although the recovery has not been shared by tropical beverages important to the export revenue of a number of heavily indebted ldcs.

3 Overall, these trends probably add up to a more difficult environment for servicing ldc debt in the year ahead.

IMF/IBRD

4 While repeating many of the familiar homilies, the Interim Committee communique also revealed increasing official acceptance that debt reduction will have a place in the work-out of middle income debt. While re-affirming the primacy of new money in financing packages, official creditors agreed that the menu approach be broadened to include "voluntary market-based techniques which increase financial flows and which reduce the stock of debt without transferring risk from private lenders". While such techniques would encompass self-financed buybacks such as the Chile and Mexican schemes, and buybacks financed by new private sector credits, the place of new official loans (or guarantees) is not clear. On a strict interpretation, official loans for buybacks would lead to a higher official share in the remaining debt. Nevertheless, the reduction in the debt could be sufficiently great that the

CHART 1

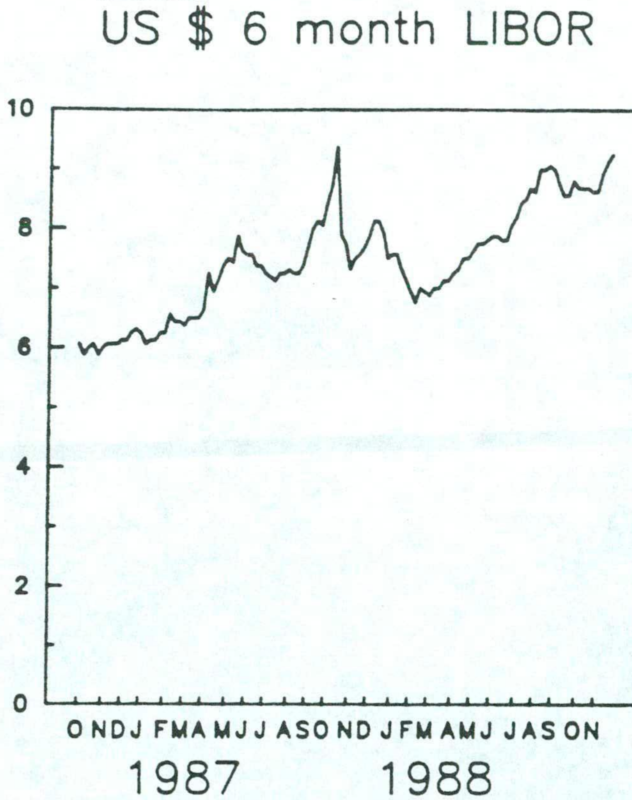
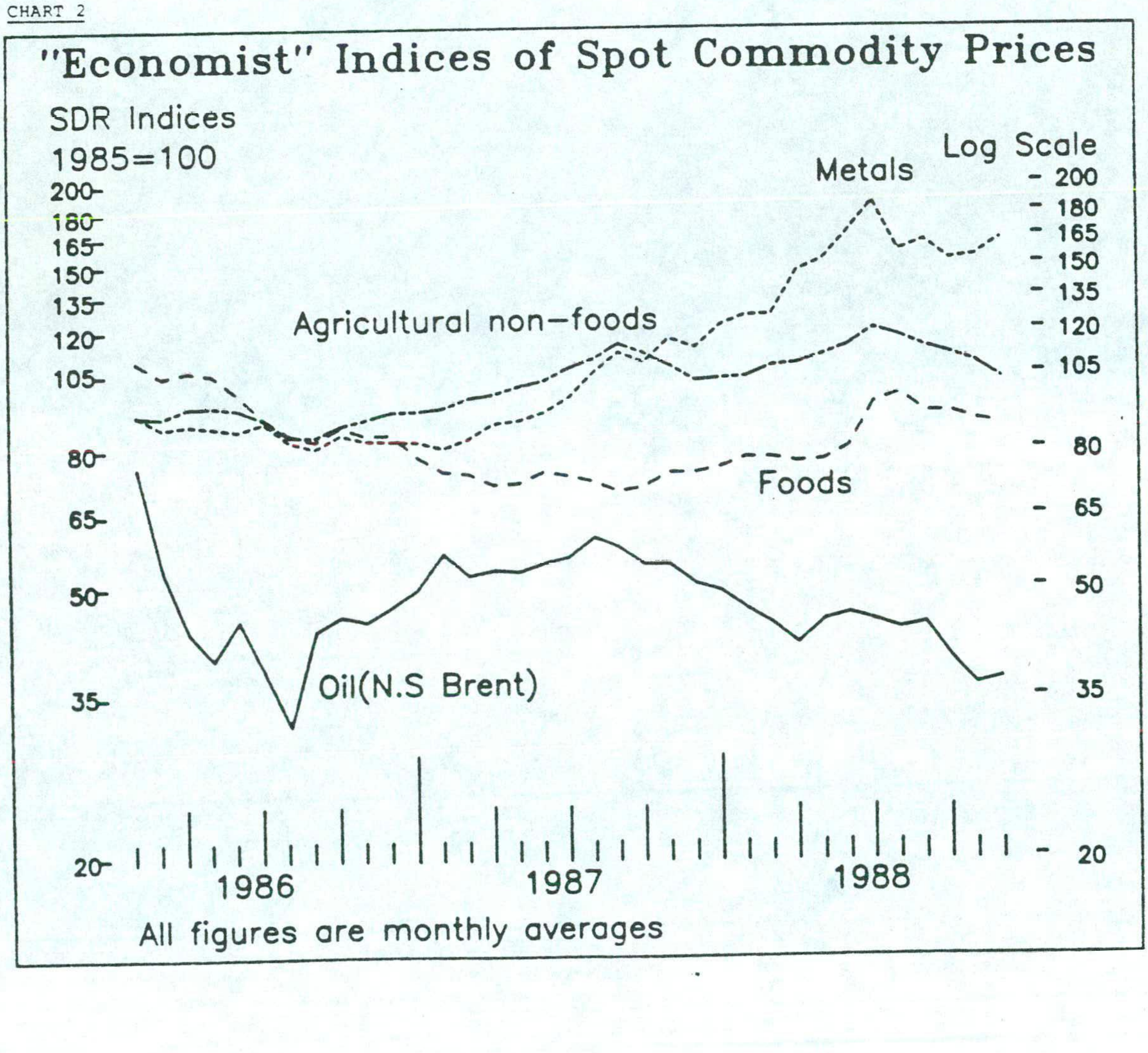
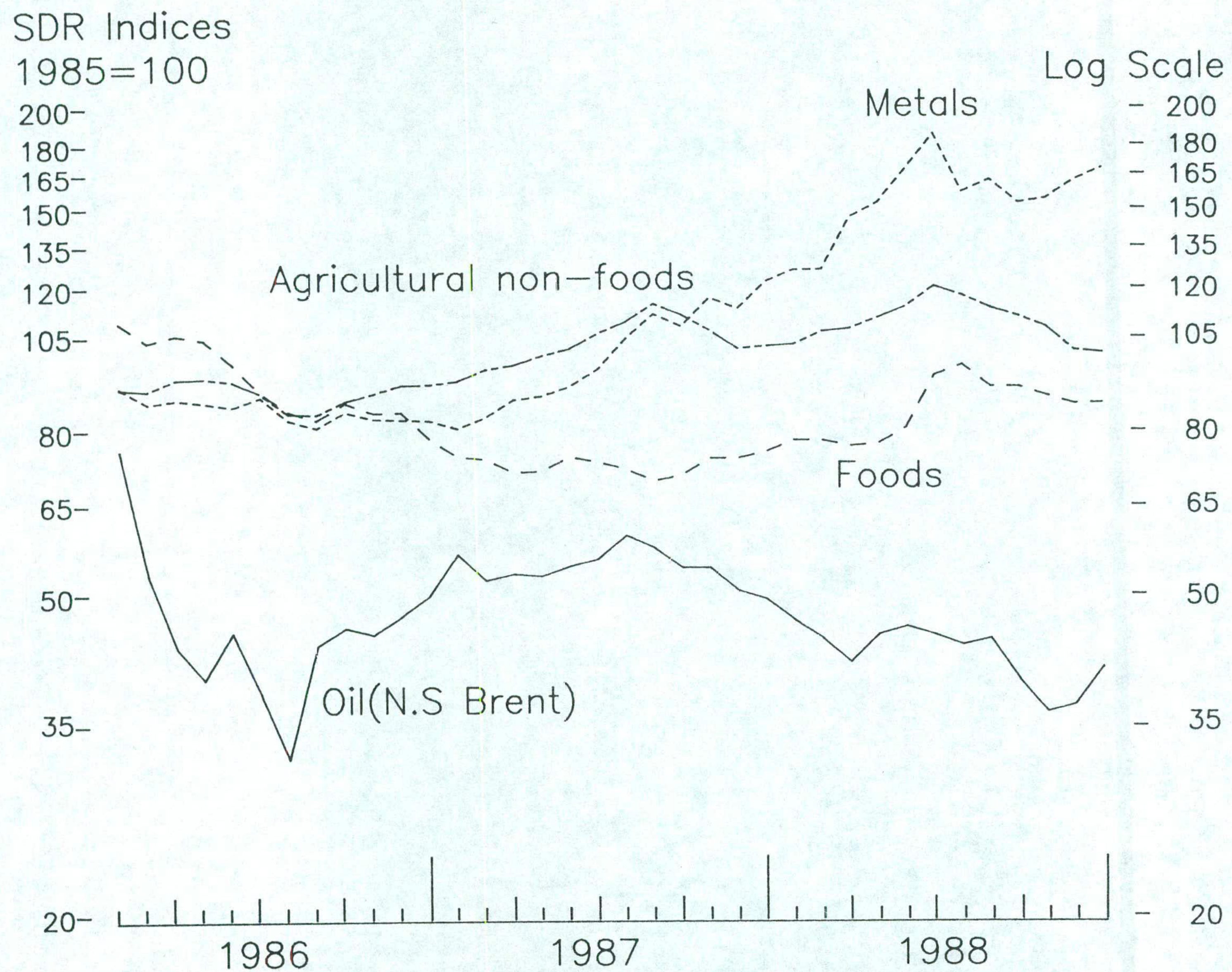


CHART 2



"Economist" Indices of Spot Commodity Prices



All figures are monthly averages, except December 1988 which is only the first week residual risk to official creditors, while rising proportionately to that of other creditors, would fall in absolute terms. Resistance to any suggestion from the banks that the public sector should be assuming the bulk of the risk on new lending (and therefore an increasing share of a growing stock of debt) is an essential part of the current strategy. Nevertheless, recent trends in net lending suggest that in practice a transfer of risk to official creditors has been taking place (see September WDR). The preferred creditor status of the Fund and Bank (although not inviolable) has given some protection, but Paris Club creditors have had to stand in line with (and in some cases behind) the banks.

5 The importance attached by official creditors to conditionality was rather undermined by the World Bank's announcement of new loans to Argentina on conditions that fall far short of the programme targets being sought by the IMF. (The disagreement may give new impetus to the G-10 study of the respective roles of the Fund and Bank in the debt strategy due to be completed next April.) The US administration's later offer of a bridging loan to Mexico without strings or an obvious take-out may only confirm the impression of the more cynical among debtors that, when it comes to the crunch, conditionality binds only the unimportant. The UK faces a similar, if not so acute, conflict of parochial with wider debt strategy interests in the case of Nigeria. There, offering the carrot of additional aid in exchange for the debtor's adherence to a reasonably strict Fund programme may nevertheless succeed in preserving credibility.

6 At Berlin, Japan announced a watered-down version of the Miyazawa scheme which in effect would offer the facilities of the Fund for mounting bond-for-debt (defeasance) swaps without official creditor guarantees. The offer of tied parallel financing to middle income debtors at below market rates with disbursements closely linked to a Fund programme is also on the table although the amounts available are unknown. The initiatives can be seen as part of a general attempt to broaden Japan's influence in international financial relations (viz, recycling, higher relative IMF quota). The ldc claims of Japanese banks, who, because of tax and regulatory constraints, have less scope for disposing of their portfolios than other banks, now represent an increasing share of total ldc debt, so the Japanese also have their own domestic interests in bolstering the existing strategy.

Debtor Concertation

7 In late October Presidents of Latin America G-8 countries* issued a "Declaration of Uruguay" calling for, inter alia, urgent talks on debt with the new US administration. A follow-up meeting of G-8 Finance Ministers has been held in Rio de Janeiro to prepare a new dialogue with creditors and to discuss intra-regional debt concessions. (Brazil is owed about $3 bn by other countries in the region and much of the debt is not being serviced. Brazil is seeking the consent of members of the Paris Club to be accorded preferred creditor status in Club restructurings involving other Latin America countries.)

8 The "Declaration" may well prove as toothless as the earlier "Commitment". Nevertheless, elections are producing a new crop of Latin American leaders who are committed to a tougher stand against creditors. In the face of a more difficult economic climate and with the prospect of voluntary access to overseas capital apparently no nearer, attempts to act in concert (for example the imposition of a unilateral limit on debt service so as to restrict outward resource transfers) cannot be ruled out.

Secondary Market

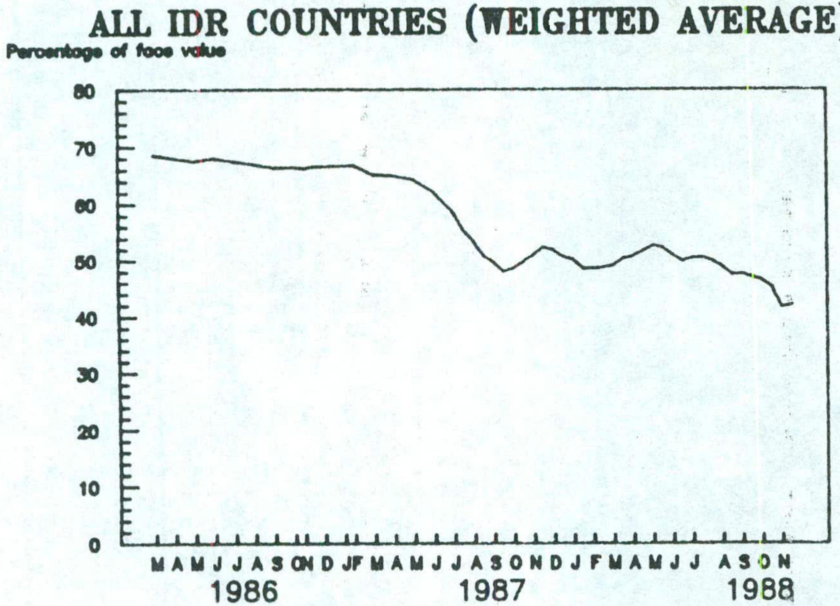
9 Prices have fallen sharply since the late summer (Chart 3). It appears that non-money centre banks in the US have continued to dump their relatively small exposures in order to boost the market price of their equity (Table 1). Heavy sales have also been made by some Canadian chartered banks ahead of their end-October fiscal year. Most recently, prices are reported to have fallen sharply in response to Irving Trust's indiscreet request for a valuation of its $500 mn portfolio of Latin American debt ahead of the bank's acquisition by Bank of New York. Demand for debt has also been reduced by the suspension of Mexico's debt equity programme. Brazil has also banned state enterprises from participating in informal swaps and the suspension or scaling down of its official auctions is also rumoured. Another factor apparently depressing prices was the emphasis given at the Berlin meetings to debt reduction.

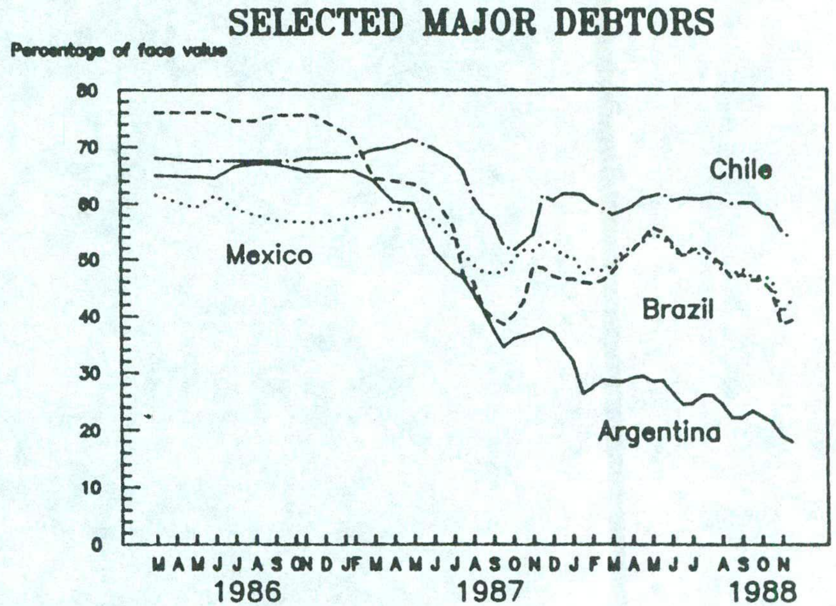
10 Having secured the necessary waivers from its bank creditors, Chile has used its own resources to repurchase about $300 mn of its debt at an average price of 56.3 c in the dollar, close to the prevailing market price.

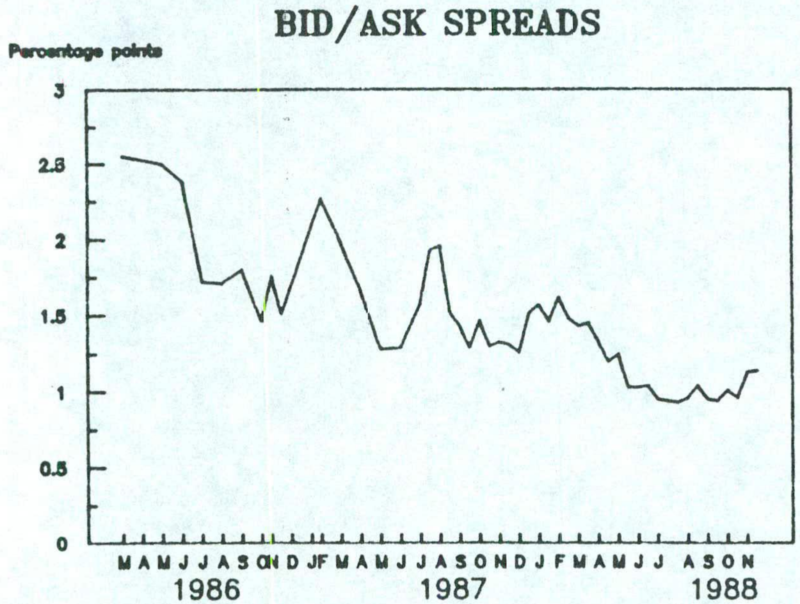
* Argentina, Brazil, Colombia, Mexico, Panama, Peru, Uruguay and Venezuela. Panama, however, did not attend. The Group first met a year ago, issuing their "Acapulco Commitment".

CHART 3

INDICATIVE SECONDARY MARKET PRICES(1)







(1) Source : Salomons, mid-point of bid-ask spread

Table 1

Change in US Bank Exposure to Brazil, Mexico, Argentina and Venezuala

(June 87 to Sep 88)

	Exposure as % of primary capital. * (31 Dec 1986)	Total LDC Exposure June 30 1987	Total LDC Exposure Sep 30 1988	Change $mn	Change %
New York Money Centre Banks.					
Citicorp	73	14600	12100	-2500	17
Manufacturers Hanover	124	9234	8688	-546	6
Chase Manhattan	96	8740	7950	-790	9
Chemical	96	5945	5900	-45	1
J.P Morgan	67	5400	4700	-700	13
Bankers Trust	74	4000	4000	0	0
Irving Bank Corp	91	1950	1890	-60	3
Other Banks					
BankAmerica	97	10354	9000	-1354	13
First Chicago	65	3120	2429	-691	22
Continental Illinois	N\A	2400	2000	-400	17
Mellon	54	1600	1386	-214	13
Security Pacific	35	2200	1260	-940	43
Bank of Boston	41	1400	1000	-400	29
First Interstate	38	1606	996	-610	38
Wells Fargo	43	1909	760	-1149	60
Valley National	22	155	62	-93	60
First Wachovia	16	212	8	-204	96
NCNB Corp	12	247	4	-243	98

* Primary Capital - equity plus preferential loan stock plus loan loss reserves.

Source: A Review of Bank Performance 1987, Salomon Brothers.
Keefe Nationwide Bankscan Nov 1988.

New Market Borrowing

11 A rare example of overseas non-bank private investors being prepared to buy a debt-troubled ldc's obligations has been provided by the issue of a DM 100 m 5-year eurobond by Venezuela. While the bond was primarily targeted at local financial institutions to help meet regulatory requirements, and to holders of previous debt that had matured, some private German investors were attracted by the very high spread (320 basis points over that paid by prime borrowers). By comparison recent $ issues by the Oil and Natural Gas Commission of India, and Turkey (in the latter case a 10-year bond) carry spreads of 114 and 183 basis points respectively over US Treasuries. (In February, a $100 mn 5-year issue for Venezuela carried a spread of 350 bp over Treasuries.)

12 Venezuela (which has never received new money from the banks in any post 1982 restructuring) is attempting to raise $1 bn of bonded debt secured by future oil sales. The bond is to be structured to avoid infringing negative pledge clauses and the implied subordination of existing creditors will be unpopular; but the banks (who have received principal repayments totalling $2 bn since 1982) have less of a stick to wield. If the issue goes ahead successfully, it may serve as a model for other debtors frustrated in their attempts to obtain new bank credits.

Debt of the Poorest

13 The menu of debt relief options has been agreed by the Paris Club and already implemented for Mali and Madagascar. The three main elements relating to debt on commercial terms are as described in the September WDR. Aid credits are being rescheduled over 25 years, 14 grace, at an interest rate at least as concessional as the original loan. The package reflects the pragmatic course steered by the Club's Secretariat. Relief will not necessarily be restricted to African countries and other qualifying criteria have not been precisely defined. (However, a Bolivian attempt to get at least Toronto terms was not conceded at the Club's November meeting.) Most countries (including the UK, Japan and Germany) have offered interest rate relief while France has effectively forgiven a third of its claims (debt service on these will be cancelled as they fall due). In both cases debt has been rescheduled over 14 years, 8 grace. The US, Spain and Belgium have opted for 25 year reschedulings with 14 years grace. The Netherlands also offered a longer rescheduling to Mali but may choose one of the other options for other countries.

US Elections

14 The election of Mr Bush and appointment of Mr Baker as Secretary of State should mean that there will be no radical change in US debt policies, in particular global schemes will continue to be off-side. The Omnibus Trade Law, signed by President Reagan in August, appears, however, to place the Administration under a number of obligations regarding debt. By end-February the Treasury must make an interim report on the feasibility of an International Debt Management Authority (intended as a self-financed body which would purchase debt at a discount), consideration has to be given to the efficacy of reducing debt through a one-off special SDR allocation (a report was due by 23 November of this year), and the three members of ICERC are obliged to conduct a study of the regulatory barriers to negotiated debt reduction by 23 February next year.

GATT: Uruguay Round mid-term review

15 An opportunity to earn trade surpluses is a basic requirement if LDCs are to service their debts. Progress on liberalisation at Montreal was disappointing. Although an agreement to reduce tariffs on tropical products was announced at the start of the meeting, implementation will be held up, effectively until a deal is struck between the US and EC on the pace of liberalisation of trade in temperate foods. The two sides remained deadlocked and in response Argentina (a major food exporter), supported by other Latin Amercian countries, threatened to withhold support for a programme of negotiations on trade services. The talks will resume in Geneva next April.

Assessment

16 Slower OECD growth, higher interest rates and lower commodity prices will aggravate debt servicing problems. Against this, a partial recovery of oil prices following the OPEC agreement will relieve more debt pressures than it will create.

17 The rapid conclusion of Brazil's bank package, the prospect of a reasonable Fund programme for Nigeria, and the early implementation of the "Toronto" menu for the poorest countries by the Paris Club, clearly score as among the successes of the last three months. Set against these, however, is the disagreement between the IMF and World Bank over Argentina, while negotiations with Egypt and smaller middle income debtors remain stalled. Trinidad has had to reschedule for the first time and may well be followed by Colombia. Attention may need to be focussed on a

number of countries not regularly highlighted in this report: there are growing concerns regarding Jordan and Oman, and domestic policies are uncomfortably expansionary in Greece and Turkey. The position in pre-election India and post-election Pakistan may require closer monitoring.

18 In discussions with the Paris Club in October, representatives of the major banks indicated that the limits of the "menu approach" were being reached and that it was becoming increasingly difficult to maintain cohesion within their group. There are already signs of debtor disenchantment with some of the menu options: debt-equity conversion programmes are in suspense in Mexico and may be halted in Brazil (see para 22 below), while resistance to on-lending proposals (increasingly seen as important for bank participation in reschedulings) has been met in Argentina.

19 Creditor governments face a number of challenges. Mexico, with a good recent adjustment record but now in difficulties, will be looking to all creditors for support. While the banks will be seeking credit enhancement (eg IBRD guarantees) those with the largest exposures cannot afford to walk away, at a time of pressure to maximise earnings and build up capital ratios. As in the case of Brazil, in the end they will probably stump up a reasonable share of total new money requirements. Similar arguments apply, if with less force, to Argentina and Venezuela. While uncertain, US official attitudes will, as usual, be crucial. In the face of pressing budgetary problems with the thrifts (a solution could cost US taxpayers $50 bn or more), and possible difficulties ahead with the banks' heavy LBO-related lending, the new Administration can be expected to offer stiff resistance to any suggestion of expenditure on ldc debt relief. Nevertheless, the response to Mexico's and Argentina's difficulties is indicative of the importance for the debt strategy of US foreign policy objectives.

20 In the case of the non-systemic middle income debtors (probably all but the four largest Latin American countries), the banks' position is, by definition, stronger. Recent experience suggests that new money will be conceded much more reluctantly, if at all; if need be the banks can afford to sit tight. Official creditors will be under pressure to take on an increasing share of the risk.

21 As the incentives for banks to contribute new financing have diminished, the ability of the IMF to co-ordinate debt negotiations in a way which achieves a satisfactory balance of the interests of all parties has been undermined. With fading expectations of support from private creditors, the Fund's financing gap calculations load an increasing burden on the debtor and official creditors. In

particular, the Paris Club is in danger of becoming lender of last resort. Improvements in a debtor's trade performance are tending to trigger less rather than more support from creditors at the next debt negotiation, the problem being aggravated by the independent approach of the various creditor groups each being understandably anxious not to lose out to the others.

22 As a greater share of the ldc risk falls on official creditors, their interest in maintaining effective conditionality ought if anything to be strengthened. Moreover, strong programmes are a pre-requisite not only for new official lending but for the stemming/return of flight capital and new equity inflows which offer the best potential for future private sector financing. The case for strong conditionality could nevertheless be reinforced by giving greater emphasis to providing shorter-term, tangible returns to debtors who accept the discipline. After six years the argument that higher debt service payments will bring their own reward in terms of restored market access is wearing thin: the efforts of one debtor to improve its market rating can be nullified by the failure of others. In any case, for some middle income debtors current levels of indebtedness are probably an effective bar to voluntary borrowing at an acceptable cost for the foreseeable future.

23 Greater co-ordination between creditor groups, coupled with some medium term agreement with the debtor on acceptable targets for both debt service and the distribution of unexpectedly high or low trade receipts, might be a solution (the 1986 Mexico agreement with the banks contained a contingency element). Such agreements would, however, be difficult to negotiate. It would be hard to convince the banks that they had much to gain from such burden sharing.

24 A more promising alternative might be to encourage a more vigorous exploitation of the opportunities provided by the secondary market for debtor buybacks. Banks would be more actively encouraged to sell out. Those that chose to would be forgoing their claim on future payments to which they attached a low probability of ever receiving. In return they would be released from any obligation to participate in future reschedulings. Losses would be realised but at a level many banks have demonstrated that they are able to sustain. Debtors and remaining bank and official creditors stand to gain from this process to the extent that sellers underestimate the potential of countries to service their debts in future, a potential which may be enhanced by a favourable impact on adjustment incentives of a

reduction in the face value of the debt*. However, for most debtors the financing of buybacks on a significant scale would require the injection of additional official funds or at least the diversion of money from more traditional forms of lending.

Further details on individual countries are given below.

LATIN AMERICA AND CARIBBEAN

Brazil

25 A strong trade and current account performance has been overshadowed by a deteriorating fiscal position and near hyperinflation. With domestic activity weak, maintenance of a competitive exchange rate has led to a trade surplus of $16 bn in the first 10 months of the year. Although recent figures suggest a slowing of export growth and a pick-up of imports (partly reflecting liberalisation), the surplus for 1988 as a whole should exceed IMF projections of $13 bn by a wide margin and should put the current account into a respectable surplus. The strength of manufactured exports has led to some recovery in industrial output since the early summer but, overall, GDP is likely to remain unchanged.

26 The domestic financial position has continued to deteriorate, with the 12 month rate of inflation rising to 812% in November after 5 successive monthly increases in excess of 20%. Inflation is being accommodated by a loose monetary policy and further fuelled by a growing PSBR (which itself largely reflects a sharp, inflation-related increase in debt service payments). Fears that the economy is heading towards hyperinflation triggered a flight from domestic currency in early October. The government has responded by negotiating a 60-day pact with business and labour to limit price and wage rises. To have any lasting impact, however, the pact will need to be bolstered by tougher fiscal and monetary measures. Mailson da Nobrega continues to battle against stiff political opposition to his plans for reducing the fiscal deficit. So far he has retained Sarney's support, not least because there is no obvious replacement.

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* It has to be acknowledged, however, that debt reduction could weaken adjustment incentives. The fact that Chile's self-financed buyback left the market price unchanged indicates a high degree of uncertainty as to which direction the balance of these opposing incentive effects could go.

27 Signature of the banks' financing package was completed on 2 November and Brazil is now current on its interest payments to banks. $1.2 bn of existing loans were converted into 25 year exit bonds with a coupon of 6% (about 4 percentage points below that presently being paid on the new money).

28 Official debt auctions have been held since March and total conversions have now reached $1.7 bn. Total swaps (including registered informal swaps) reached $5.3 bn in mid-November; some $2bn in informal swaps have still to be registered by the central bank (see box). Concern about round-tripping and monetary expansion led the central bank to ban parastatals from involvement in the informal market from late October. This move is expected to lead to a sharp reduction in conversions of bank debt, which may nevertheless reach $8 bn (or about 7% of the total outstanding) in 1988.

29 Four of the five SBA performance criteria are reported to have been met at end-September; no application for a waiver for the remaining criterion has yet been submitted to the Fund Board. Nominal end-December criteria will also be overshot because of the worsening domestic financial and inflationary position. Nevertheless, Nobrega has proposed an ambitious tax package aimed at securing a small operational surplus for the "central administration" sector; if implemented it would imply a smaller 1989 operating deficit for the public sector than the 2% target agreed with the Fund.

Argentina

30 Argentina's trade position has also shown a substantial improvement from last year's very poor outturn. Export volume has recovered sharply (including a strong growth in manufactured exports) while import volume has fallen. The terms of trade, having declined nearly 30% between 1984-87, have also partly recovered, assisted by much higher wheat and maize prices. In the first 8 months of the year the trade surplus was $2 1/4 bn (cf $0.9 bn in the same period of 1987) and the IBRD expect the surplus for 1988 as a whole to top $3 bn. The current account deficit is expected to decline to $2.3 bn (cf $4.3 bn in 1987) but to widen again in 1989 as higher interest payments more than offset a further improvement in the trade balance. As in Brazil, accelerating inflation has depressed real income, weakening domestic demand and imports.

0314u

Brazil: Unofficial swaps

The profitability of these transactions depends on the secondary market discount on the debt being greater than the discount on the parallel exchange rate in relation to the official exchange rate. Suppose the official exchange rate is Cr1 = $1 and the parallel market rate is Cr 1.65 = $1 (a discount of about 40%). In the secondary market a Brazilian public enterprise's external debt is discounted at 60%. The Brazilian borrower is due to repay $100 to a foreign bank. Normally it would pay the cruzado equivalent into the Central Bank which would assume responsibility for paying the lender under the terms of a rescheduling agreement. The payment of cruzados to the Central Bank would tend to depress the domestic money supply.

Instead the borrower effectively repurchases its debt through an intermediary (a local bank) using the parallel exchange market. It provides, say, Cr 90 to the intermediary which uses the proceeds to buy (roughly) $55 in the parallel market. The intermediary retains $4 as commission and buys the debt from the foreign bank for $50. The bank is happy to sell at this price which is well above that in secondary market, the buyer of cruzados gets them at the cheap parallel rate, the agent gets a commission, and the cost to the borrower of the repayment is reduced by 10%.

From the Brazilian authorities' standpoint, the transaction has a number of undesirable features. The transaction leaves the money supply unchanged rather than reducing it. (In effect cruzado deposits pass from the state company to the seller of dollars for cruzados in the parallel market.) Downward pressure is also exerted on the parallel rate. The Central Bank loses the opportunity to put the debt up for auction under the official scheme and realising the profit on any discount offered. While the cruzado counterpart of such official debt conversions will tend to boost the money supply, the effect will only exceed that arising in the case of unofficial swaps if the discount at the official auction is narrower than the margin (in the example 10%) earned by the borrower in undertaking the unofficial swap.

31 Industrial production in H1 was 4% below that a year earlier. The Plan Primavera (involving price and wage controls, and a variety of revenue raising measures) has had some initial success in reducing the monthly inflation rate (consumer prices rose 15.7% in November as against 27.6% in August) and the 12 month rate has fallen back to 372%. However, the Plan's success may be short-lived given its apparent reliance on administrative measures rather than substantive fiscal and monetary adjustment, and the lack of involvement by private sector unions.

32 Although figures since Q1 are unavailable, it appears that Argentina has been using its stronger trade position, together with a build-up in arrears to the banks (now over $1.3 bn), to bolster its reserves. New bank loans of $3.5bn are being sought for 1988-9, but the banks are only contemplating $2bn. Clear linkage with an IMF programme, a wide range of "menu" options and IBRD credit enhancement are likely to be needed to make the package at all attractive to a wide range of banks. The response so far has been distinctly lukewarm given Argentina's poor debt service record and weak economic programme.

33 The first tranche of the official bridge loan of $500 mn (no UK participation) became available from 15 November. The bridge will mature at end-February. On 27 October the World Bank Board approved four loans totalling $1.25bn: the UK voted against the two fast-disbursing loans that take out the bridge because there was no explicit linkage with a Fund programme. Several other EDs expressed concern about the adequacy of the economic programme but none voted against. The President agreed to supply an oral report on the macro-economic situation prior to disbursement of the second Trade Policy loan, which will not, however, require Board approval. The Fund is concerned about the IBRD's approach, the Bank's weak fiscal targets coming in for particular criticism. These include a PSBR of 4.6% for 1988 and 2.4% for 1989 compared with an original Fund target of 2.0% for 1988 and the elimination of the deficit in 1989. The deficit is likely to cause further problems as Argentina's draft Budget for 1989 reportedly envisages a deficit some 2.5 percentage points higher than that agreed with the World Bank. Moreover, tax measures needed to reduce the deficit in 1989 have to be approved by Congress and are unlikely to be implemented until 1989 H2.

34 Notwithstanding these IBRD credits (and the IADB is also to make 3 project loans totalling $459 mn), Argentina faces a large financing gap next year, and it is unclear how the remainder will be filled. Much will depend on agreement on a Fund

programme. This may unlock some new money from the banks and a further Paris Club rescheduling (although this may well be held up by the failure of the Argentines to complete their bilaterals on the earlier Club agreements). It is difficult to see how a package could be concluded without a disproportionate contribution from official creditors. ECGD met Argentine representatives in the margins of October's Paris Club and it was agreed that the 1985 bilateral could be signed. A timetable for signing the 1987 bilateral was not agreed but the interest rate was set at LIBOR+0.5%. Many governments report arrears on the 1985 agreement, but Germany, France and Switzerland have signed their 1987 agreements.

35 The third serious army mutiny in two years occurred in the first week of December. It is still not clear under what terms the rebels laid down their arms.

Mexico

36 The Economic Solidarity Pact (in place since December 1987) continues to squeeze both growth and inflation. Real GDP is expected to rise by only 0.8% in 1988. Annual inflation has fallen from its peak of about 180% in February to 81% in October: monthly increases have been less than 1% for the past 3 months. The Pact has been extended to end in December and has been supplemented by further spending cuts of 0.7% of GDP and an acceleration in the privatisation programme. Despite the fiscal restraint and the reduction of inflation, interest rates remain high and have changed little since July. From 1 January the pact will be replaced by the Pact for Economic Growth and Stability. The main features of the new pact will be a daily depreciation of the peso against the dollar, by one peso per day until the end of July, an 8% increase in the minimum wage from 1 January and increases in some public sector prices and tariffs (not petrol, bottled gas and electricity). With the real exchange rate likely to continue to appreciate under the new plan, interest rates will need to stay high to compensate for subsequent anticipated depreciation leading to a greater risk of renewed capital flight.

37 Despite the squeeze on the domestic economy, there was a trade surplus of only $2.5bn in the period January-August (cf $6bn for the same period of 1987) reflecting lower oil prices, import liberalisation and a sharp appreciation of the real exchange rate. International reserves have also come under increasing pressure as residents' outflows have accelerated, and had fallen to under $10 bn in October from their May peak of some $17 bn. The prospect of current account deficits aggravated by a further fall in oil prices and higher international interest rates led to a US Treasury/Fed announcement in October that they were prepared to extent an apparently unconditional $3.5 bn bridge loan.

38 The likely financing of next year's deficit has yet to take shape but is likely to require contributions from all classes of creditor. Given the stance of Mexico's policies it will be a test of the willingness of creditors to back adjustment efforts in the face of events largely beyond the debtor's control.

39 Carlos Salinas de Gortari was inaugurated as President on 1 December and has called for immediate talks with the incoming US Administration.

Venezuela

40 The external outlook has deteriorated with the fall of oil prices. Reserves have fallen rapidly and "operating reserves" (the bulk of the Central Bank liquid fx assets) were only $2.25bn at the start of November, as against $3.5bn at end-1987 (under the banks' MYRA they must not fall below $2bn). The decline in reserves forced the authorities into a liberalisation (and effective depreciation) of the exchange rate regime in late October along lines recommended by the Fund.

41 The financing gap for 1988 of some $2bn has still to be filled. The banks remain unwilling to provide new money and a rescheduling in 1989 looks increasingly likely. A loan of $1bn (in the form of bonds issued by two Venezuelan-owned US oil companies) secured against future oil sales, is being arranged. Commercial bank creditors are opposed to the loan, which would give the bond-holders preferred creditor status, and the deal may yet stall. In August and September a $500mn short-term loan was drawn from the BIS. At end-October a DM100mn, 8.25% eurobond was sold successfully.

42 On the domestic front annual inflation slowed to 23.3% in September, though it is still well above the target of 15% for the year. Prospects for containing inflation are poor: the main trade union is demanding wage increases of 30-40%, food prices look set to rise rapidly, and the recent exchange rate changes will increase import prices.

43 The presidential elections resulted in a win for the ruling Accion Democratica's candidate, Carlos Andres Perez, who will take office next February. The new President advocates a tougher stance on debt and will probably seek better terms than gained by Brazil and Mexico, but the officials who will deal with debt under the new Administration will probably seek consensus rather than confrontation. Unilateral action on debt in the short/medium-term is unlikely and Perez has already emphasised the need to develop Venezuela's non-oil economy to soften the impact of oil price movements.

Chile

44 Following Pinochet's defeat in the October plebiscite, the omens appear good for a fairly smooth transition to civilian government. The military government has announced it will take no direct part in the December 1989 Presidential and Parliamentary elections. Pinochet has said he will not himself contest the Presidential election. There seems to have been little loss of business confidence since the plebiscite, though investment is expected to slow in 1989. The economy continues to perform well. Demand is buoyant and real GDP rose by 5.8% in the 12 months to July. At present inflation continues to fall, (a 12 month rate of 11% in November cf 21.5% in December 1987) although real wage growth and rapid monetary expansion could reverse this trend. There was a trade surplus of $1.5 bn for January to September (cf $0.76 bn in the same period in 1987) partly reflecting higher copper prices. Following the amendments to debt contracts agreed with the banks in August, the Central Bank has purchased $299 mn of bank debt at an average price of 56.3 cents/$: annual interest payments will now be some $29mn lower. No further buybacks by the Central Bank are planned.

Peru

45 A watered-down version of the measures announced in early September (intended to reduce the fiscal deficit from 10% to 6% of GDP) was supplemented by a further package in late November. The latter included a 50% devaluation, further large increases in the prices of basic goods, and a 60% rise in the minimum wage. Interest rates will be more flexible but no real tightening of fiscal policy is implied. This change of tack appears to have only the half-hearted support of Garcia and a rapprochement with the Fund and World Bank still seems a long way off; in late November, Finance Minister Salinas resigned over the Government's failure to implement fully the measures he proposed. Although arrears to the IADB have been settled, it is by no means clear who will provide financing to clear huge arrears to the IFIs which would be a pre-condition for new Fund or Bank credits. Even more unclear is how Peru and its commercial bank creditors might be reconciled.

46 12 month inflation exceeded 1300% in November, the trade deficit has widened substantially, real GDP has fallen and cash reserves are all but exhausted. Against this unpromising background, a restricted debt:equity programme has been announced. The attempt to nationalise the banks is now dead.

Colombia

47 The trade surplus is likely to narrow this year (disease has affected coffee exports and oil exports have been disrupted by guerrila activity; imports have been boosted by stronger domestic demand and liberalisation). Inflation at 28% in the 12 months to November is above Fund projections.

48 A (first) rescheduling is now a distinct possibility. The $1.85 bn in new credits requested from banks has progressed only slowly ($1.4 bn has been offered in conventional new money, while about $200 mn may be provided in a range of market-based options).

Ecuador

49 The weakness of oil prices is particularly unwelcome at a time when August's emergency measures were beginning to show some effect. Inflation has slowed and the new government, despite hawkish statements during the election, appears to be intent on regularising relations with creditors and so releasing new IFI credits. Steps have been taken to settle arrears due to the IADB. A new SBA is under discussion. Formal discussions with the banks began in November and included a request for $1 bn to cover interest arrears.

Uruguay

50 The trade balance continues to improve despite weak regional demand reflecting sluggish domestic growth and a competitive exchange rate. Inflation, however, remains stubbornly high. At the end of November the authorities introduced some measures, including a freeze on investment spending, intended to reduce the fiscal deficit in 1989.

Bolivia

51 In October a scheduled meeting between the Bolivian authorities and Advisory Committee to discuss the future of the remaining bank debt was cancelled. No further meeting has yet been arranged. A request for a concessional rescheduling was rejected by creditors at November's Paris Club. Instead, the agreement reached rescheduled $230 mn principal and interest and arrears over 10 years/6 grace. Although the trade deficit has narrowed and reserves have risen, inflation, at 17.7%, is above target and some ESAF performance criteria could be missed.

Jamaica

52 General elections are constitutionally due by Spring 1989 but a date is expected soon. Recent polls point to a victory for Mr Manley's PNP. A Manley Adminstration would lengthen the odds against eventual economic recovery (and repayment of debts to the UK) and possibly strengthen the Jamaican links with Cuba and the Soviet Bloc.

53 The devastation caused by Hurricane Gilbert in mid-September had severely damaged economic prospects in the short-term. Aid commitments of some $520mn have been received so far (although much of this represents the re-allocation of existing commitments). Emergency assistance will also be provided by the Fund, IBRD and IADB. Prior to the hurricane the domestic economy had been performing well.

54 Although the Fund Board approved a new 14-month SBA on 19 September the programme's targets and performance criteria will have to be amended. A new Paris Club agreement was reached in October which rescheduled all principal and interest payments (including PRD) due June 1988-November 1989 over 10 years/5 grace. Debt due to banks is covered by last year's MYRA but Jamaica is to request a reduction in spreads to 0.875% from 1.25% over LIBOR.

Panama

55 US trade sanctions and the lack of overseas confidence continue to have a large impact on the domestic economy and the offshore centre. Offshore deposits have fallen 55% since end-1987, real GDP is expected to fall by nearly 20% this year and the fiscal deficit is expected to reach 9% of GDP. The reserves of Banco Nacional (the largest Panamanian bank) have dwindled to a few million dollars. Debt service payments to all creditors remain suspended and arrears of interest and principal (including amounts due to IFIs) are expected to reach $1.3bn by end-1988.

Costa Rica

56 In September Costa Rica failed to reach agreement with the Paris Club. Negotiations with the commercial banks have also made little progress since mid-August: a further meeting is planned for 30 November. Taiwan has offered to finance the purchase of 40% of debt owed to foreign banks, to be paid off with a soft loan of $300-400mn; in return Taiwan would obtain certain trade (mainly fishing) benefits. The IBRD Board is considering a SAL of $100 mn.

57 Provisional data show a January-May trade surplus of $23 mn (cf a small deficit in the 1987 period). Inflation continues to rise and reached a 12 month rate of 20.7% in July. The fiscal deficit so far this year is larger than targeted.

Guyana

58 Although a minor debtor, Guyana has become the first major test case for the new co-operative approach to the arrears problem agreed by the Interim Committee in September. As part of a rapprochement with the IFIs, a Policy Framework Paper was approved by both the Fund and Bank Boards in July. The medium-term outlook is made difficult by the need to close a large financing gap even after rescheduling. Extensive discussions have been taking place between the IFIs and creditor governments since August but little progress has been made; an inconclusive donors' meeting was held on 7 November. A "support group" has been established, with Canada in the chair, and hopes to have finalised a financing package by mid-January. However, a number of issues - eg whether there should be retroactive access to ESAF, the length of the shadow programme, the sequencing of clearance of arrears to IFIs - remain outstanding. The continuing delay in reaching a settlement with the IMF is causing political difficulties for Predient Hoyte. His Prime Minister and main political rival within the PNP, Hamilton Green, stands to benefit politically if Hoyte fails in his attempts to restructure the economy.

Trinidad

59 Trinidad is in the process of its first rescheduling of public sector debts and its first use of Fund resources. A further devaluation is expected soon. The Banks' Advisory Group (led by Bank of Tokyo) has agreed to reschedule most maturities due September 1988 - August 1992 (about $440 mn), over 12 years 4 1/2 grace at LIBOR +15/16%. (A rescheduling of Paris Club debts will be discussed in January.) The Fund Board approved a CCFF for SDR85 mn on 18 November; and a Letter of Intent has been sent as the basis for an SBA request for SDR 99 mn.

SOUTH AND EAST ASIA

Philippines

60 The Philippines has begun a fresh round of negotiations with the banks and IMF and has asked for new money totalling $3.11 bn over 3 years from 1988 to 1990. Both sides are currently considering their positions and another meeting will

probably take place in the New Year. Talks on a new IMF programme began with the Government aiming for an EFF and CFF but have been suspended. The Paris Club agreement has recently expired and the authorities have indicated that they will pay only 30% of interest due until a new multilateral is negotiated (unlikely before a new IMF programme is in place). After months of protracted talks, the US has agreed to pay a total of $960 mn for the use of Subic Bay and Clark Airbase over the next two years. Although this is almost three times more than the present level of compensation. In addition, the US will target $500 mn of Overseas Private Corp and EXIM assistance through 1991. However, the agreement has angered nationalists in the Filipino Senate. While the Senate has passed a bill which aims to limit debt service to 20% of exports, the move is unlikely to be supported in the Congress.

Malaysia

61 The Budget for FY 1989 is mildly expansionary. The budget deficit is now expected to rise by about 1 percentage point to just under 9% of GDP. Real GDP growth is officially forecast at 7.4% for 1988. The strong economic recovery has boosted import volume and the authorities now project a current account surplus of $1.2 bn in 1988 (cf $2.4 bn in 1987). However, the Government is continuing with its debt prepayment programme and expects to have prepaid $1 bn of foreign loans in 1988.

Indonesia

62 The Government has announced a fresh series of de-regulation measures focussing on the financial system and trade reforms. While the Government's aims are to promote competition and nurture the embryonic capital market, in the short term the measures have provoked capital flight and inter-bank overnight rates have risen from 18.7% to 31%. Rumours of an imminent devaluation do not appear to be well-founded and both the IMF and IBRD are satisfied that Indonesia can withstand the present vicissitudes in the oil market.

Pakistan

63 It is too early to speculate what implications the elections in Pakistan will have for economic policy, although negotiations with the IMF are at an advanced stage for a 15 month SBA worth SDR 273 mn and a 3 year SAF worth SDR 347 mn. If the negotiations reach fruition this implies that the new administration will have to implement a far-reaching adjustment programme whilst ensuring the military are still onside.

India

64 India's external debt continues to warrant close attention. At end-March 1988 it was estimated to have reached $52.3 bn (including IMF lending and deposits with Indian banks by non-resident Indians), up from $47.4 bn a year earlier, making it the largest debtor in Asia. The debt service ratio during FY1987/88 also stood at an uncomfortable 30.2%, although this was down from 31.8% a year earlier. Much of the rise in the DSR stems from a bunching of heavy IMF repurchases, which will fall from this fiscal year onwards.

EASTERN AND SOUTHERN EUROPE

Poland

65 While the new Prime Minister Rakowski shows some sign of trying to get to grips with economic reform, particularly the need to cut back heavy industry these efforts still fall far short of a coherent strategy and SBA new credits remain a distant prospect. HMG has made it clear that further UK credits and any long term debt rescheduling could not be considered before Poland has signed and adhered to an IMF programme. Disbursement of IBRD loans also awaits a more convincing economic programme. Some progress towards signing Paris Club bilaterals has been made; the Poles may have retreated a little from their tactic of demanding lower margins on earlier agreements.

66 Poland has made an informal approach to the IMF for an SBA on the basis of its still to be finalised Consolidation Plan. So far, there has been no formal response from the Fund, although versions of the Consolidation Plan seen to date do not constitute a sufficient basis for agreement.

Yugoslavia

67 The IMF mid-term review mission has been asked to approve the relaxation of some of the SBA targets because inflation has now reached 236% (against an SBA target of 95%). Drawing of the third tranche of the SBA, conditional upon Board discussion of the review, is now in doubt although Yugoslavia has no great need for it as the current account, unlike the domestic economy, is for the moment reasonably strong: the surplus in the first seven months of 1988 was $1.2 bn (cf $32 mn in the same period last year). Exports including tourism have been buoyant, while import

growth has not risen by as much as might have been expected given the liberalisation programme. Only the first tranche ($83 mn), of the BIS/US Treasury bridging facility of $250 mn was used, and it has been repaid. The Federal authorities are currently seeking to push through a number of supposedly wide-ranging and market-oriented reforms. Although the immediate effect of the reforms is likely to be limited, they mark an intellectual break with the past and could lead to important systemic changes. Fund Staff are to return to Belgrade again in December.

Hungary

68 The SBA mid-term review suggests that the economy remains more or less on target. The reshuffled Government under the new Prime Minister Nemeth has undertaken to push forward with market-oriented reform and shows greater signs of being prepared to tackle some of the more fundamental underlying problems of industrial reform (including the prospect of 150,000-200,000 job losses). A Fund mission has just returned to Budapest to consult and advise.

Romania

69 Agreement has been reached for the full repayment of the $1 bn of commercial bank debt still outstanding by end-June 1989 - 25% by mid-November and the balance in 8 equal monthly instalments. President Ceaucescu, in a speech to the Central Committee Plenary on 28-30 November, reaffirmed his belief in the central role of the Communist Party in all fields, including the economy.

USSR

70 Recent months have seen a spate of Western bank credit offers (mostly government-backed) to the concern of the more hard-line members of the US administration, Congress and media. The DM 3 bn FRG facility announced in May, and finalised during Kohl's visit to Moscow in October, has been followed by offers of ECU 680 mn from Italy, £1 bn from a consortium of UK banks, DFl 500 mn from the Netherlands and F Fcs 12 bn from France. US worries that such credits constitute a threat to Western security (because they could be diverted to the military sector or mean that defence spending need not be reduced so much) are without real foundation. Not only are the amounts involved - $5-6 bn over a number of years - minute compared with estimated annual defence spending of $400-500 bn, but also the credits are all tied to funding the development of the ailing agricultural, consumer goods and services sectors. In any case, the Soviet Union has historically been a

cautious borrower and it is most unlikely that it would wish to over-extend itself. At end-1987 it already had some $4.2 bn of undisbursed credits with BIS-area reporting banks (up $1 bn on end-1986). It is probable that the proposed £1 bn UK facility (which is still a long way from finalisation) is larger than could be utilised in the near future. Similarly, there are indications that drawings under the contracts already signed with the FRG are likely to be quite low. From the UK prudential angle, concerns that British banks might risk over-exposing themselves are misplaced since the lending would be 85%-guaranteed by ECGD. In any event Soviet creditworthiness remains sound, foreign trade is a very small part of the total Soviet economy and their debt service ratio is moderate (25% at end-1987). Current account developments will be monitored closely, however, given the slump in world oil prices.

Turkey

71 There is increasing concern at the direction the economy is taking. Inflation has now reached 86% and, with Ozal apparently still preoccupied with next March's local elections, the 1989 budget looks complacently optimistic. Although the current account is performing well this year, the deficit in the first eight months was only $131 mn (cf $502 mn in January-August 1987), and the 1988 foreign borrowing. programme is said to have already been completed satisfactorily, some OECD officials fear a rescheduling and/or Fund programme may be necessary by late 1989. Other voices have also been calling for an SBA but Ozal has vehemently denied the need for a Fund programme. A high-level mission visited Washington in mid-November to seek to reassure Fund/World Bank staff and a Fund mission later went to Ankara to continue the dialogue.

Greece

72 Shaken by the Koskotas financial scandal, and with elections due to be held by June 1989, the will of the Pasok Government to stabilise the economy is weaker than ever. Failure to keep to the tight conditions outlined in 1985 has created problems with both inflation and the PSBR.

73 The current account deficit for this year is projected to widen to $1.5 bn from $1.3 bn in 1987. However, non-debt creating capital inflows remain strong enough to ensure the financing of the deficit without recourse to net new external borrowing. Debt service costs, however, are estimated to rise by 31% next year and

will account for almost a quarter of public expenditure. With GDP growth likely to be the strongest this year since 1985, inflation and the PSBR will now certainly overshoot their budget targets.

SUB-SAHARAN AFRICA

Nigeria

74 The IMF Staff and Nigeria have reached agreement on the terms of a 15 month SBA - but only after promises of substantial concessional finance to which the UK will contribute $100 mn in 1989 conditional on the programme being approved and substantial sums (up to $400 mn) being provided by other donors. (Preliminary reactions from the US, France and others have been sympathetic without producing definite commitments.) The Nigerians will not be making a drawing on the Fund.

75 The programme is designed to strengthen recent efforts to control public spending (on and off budget) and bring about a major reduction in domestic imbalances. Consequently, the fiscal deficit for 1989 is now targeted at 8.4% of GDP. Domestic financing of the deficit will be reduced to 1.3% of GDP. Net domestic credit is programmed to rise by slightly over 9% in 1989 (against expected growth of 27% in 1988). Broad money growth is projected to be just under 11% in 1989 (against 33% in 1988). As regards exchange rate policy, the Nigerian authorities intend to unify the auction and interbank exchange rates and to manage the single rate through the interbank market.

76 A major effort on the part of creditors will be required to fill the financing gap (now estimated at $9.8 bn for 1989 on the basis of an average oil price of $14.50 pb). An IMF agreement will open the way for the disbursement of some $900 mn of gross new balance of payments loans from the World Bank, AfDB and Japan in 1989. The bulk of the rest of the financing will need to come from the Paris Club given that the commercial banks have adamantly refused to provide any new money as part of their rescheduling agreement. In its financing gap projections, the IMF is assuming that Paris Club creditors will reschedule 100% of original maturities, amortisation on previously rescheduled debt, and moratorium interest. This would provide debt relief of $4.5 bn in 1989. If non-Paris Club official creditors also reschedule on similar terms, the total debt relief resulting from rescheduling (commercial bank and official sector) in 1989 could amount to $8.6 bn. Allowing for all these sources of finance leaves a residual gap of $300 mn to be closed by the aid package.

South Africa

77 In the face of a rapidly deteriorating balance of payments position and buoyant private sector demand, the SARB has raised its discount rate by a further 2 percentage points. Increasing budgetary expenditure, however, threatens to undermine the effectiveness of this and other measures introduced earlier in the year.

Cote d'Ivoire

78 The unwillingness of the authorities to agree to a cut in cocoa produce prices is holding up the disbursement of IBRD loans and commercial bank agreement on a rescheduling. While some payments to official creditors have been made nothing has been paid to the banks since May 1987. Rumours of an agreement involving a private French company and the French Government to assist with the Ivorian stockpiling of cocoa have been denied by the French authorities.

Sudan

79 The recent floods have significantly worsened the already bleak prospects for the Sudanese economy. The Sudanese Cabinet endorsed the DUP/SPLA Agreement (one of the steps towards a ceasefire) on 1 December and the peace initiative is gathering momentum. Arrears now total \$5 bn (of which \$890 mn is due to the IMF). The authorities have, however, introduced a two-tier exchange rate system which has had some limited success in attracting inward remittances. They are also negotiating with the IMF on a possible shadow programme covering, inter alia, the exchange rate and subsidy reform. Even if agreement can be reached (which seems doubtful), a shadow programme is unlikely to be in place before April 1989. The floods have necessitated a major review of the budget and the authorities are reported to have secured \$300 mn for the Emergency Flood Reconstruction Programme at an end-November donors' meeting in Paris.

MIDDLE EAST & NORTH AFRICA

Iraq

80 Although no clear priorities have yet emerged for reconstruction, military expenditure, increased oil export capacity, major intrastructural projects and satisfying pent-up consumer demand are high on the list. The regime remains committed to economic perestroika and has introduced measures to promote privatisation and encourage private investment, but the legacy of war and centralised planning mean that the benefits of reform will take time to come through. Most industry remains Government-controlled. This sector is likely to benefit most from new credit. Foreign exchange to finance reconstruction is in short supply particularly as significant additional Arab aid looks increasingly unlikely (although Arab States are likely to write off Iraq's non-banking debt) (Neutral Zone war relief crude - worth around $1.1 bn a year at current prices - is to cease at the end of the year). Oil revenues are likely to remain uncertain. Prices could stay weak and Iraq is seeking a quota increase next year. Official and commercial borrowing may also prove difficult given the size of Iraq's outstanding debt and poor payment record. Iraq remains opposed to Paris Club rescheduling but most creditors can expect continued payment delays and reschedulings. Indeed Iraq has recently approached HMG with a request for a bilateral rescheduling. (The UK had only just agreed major new lines of credit worth £340 mn for 1989, double the 1988 total.)

Egypt

81 The IMF sees no prospect of an agreement with Egypt within the next six months. Negotiations remained deadlocked over the exchange rate, interest rates, pricing and fiscal policies. Egypt's external position is deteriorating, particularly as rising world commodity prices are pushing up the food import bill and oil prices remain depressed. The fiscal deficit target of 13% of GDP for 1988/89 is likely to be exceeded by a significant margin, and the recent riots in Algeria have reinforced the authorities' reluctance to reform subsidies. In the financial sector, a number of Islamic Investment Companies are reportedly bankrupt following failure to comply with new regulations by the November deadline. The final implications of this are not yet clear, but confidence in the financial sector could be seriously undermined.

Jordan

82 The economy faces serious problems. Structural weakness in the budget and BoP, both heavily dependent on declining flows of Arab aid and remittances, have been brought to a head in recent months by a succession of political and financial "shocks", culminating in the King's decision to disengage from the West Bank at end-July. This move halved remittance inflows in August/September and put new pressure on the dinar, which had already fallen sharply in May. In mid-October, the dinar was floated and immediately depreciated by 20%. Confidence has yet to be restored and the parallel market rate remains at a large discount. In November imports of certain luxury goods were banned and customs fees for non-essential goods, airport taxes and work permit fees were raised. A freeze on new development spending has also been announced. Despite these measures, Jordan's ability to service existing debt is in doubt. Although Iraq has repaid $100 mn of its trade debt to Jordan and new Arab money is being sought (the UAE recently pledged $100 mn), a $200 mn euroloan supposedly in the pipeline has not yet been agreed. Several Jordanian bankers and officials including the Crown Prince see no alternative to the IMF. Further corrective measures are promised in the forthcoming budet. It will be difficult to overcome the lack of public and business confidence in the economy, or to restore economic growth (although the Saudis would probably provide some aid in support of an IMF programme if they thought the alternative was instability).

Algeria

83 Economic prospects, already clouded by drought and lower oil and gas prices, have become more uncertain following the anti-austerity riots in October. The government is now pushing ahead with political and economic reforms but these will make it difficult to stabilise the fiscal deficit, reduce subsidies and compress imports this year as earlier planned. President Chadli Benjedid has now been able to set aside the objections of the hardliners within the ruling party and press ahead with economic and political reforms; it is however far from clear whether the population realise the depth of Algeria's economic problems or understand that increased austerity is inevitable. But even with the political endorsement gained in the recent referendum, and his expected re-election later in December, Chadli Bengedid may be tempted to back pedal on the introduction of necessary new austerity measures and will thus find it difficult to stabilise the fiscal deficit, reduce

subsidies and compress imports this year as he had earlier planned. Reported aid from Saudi Arabia and other sources has so far allowed the authorities to avoid rescheduling or going to the IMF (anathema to the Algerians) but payments delays are worsening. However, ECAs with large exposures are operating normally and some (including the Italians, Japanese and Americans) are considering additional credits. Some banks are showing concern but in general believe the present crisis is being weathered and the forfaiting market for Algerian paper remains active. As market perceptions of Algeria's creditworthiness have deteriorated over the year (reflected in higher spreads), the authorities have increasingly turned to the development banks, notably the IBRD, AfDB and Arab Monetary Fund.

Morocco

84 Following approval in August of a new SBA, a Paris Club deal was agreed in October to reschedule current maturities and (some) PRD due in the period July 1988 to December 1989. The Moroccans are now likely to seek a new commercial bank resheduling to cover 1989 and possibly 1990 maturities. The external position has improved significantly and Morocco intends to eliminate all remaining trade arrears by end 1988, but the fiscal deficit remains a problem reflecting a lack of budgetary control and the high cost of agricultural subsidies. Progress on privatisation has been very slow but may speed up in 1989.

Oman

85 Economic prospects have worsened significantly in 1988 with the downturn in the oil market. The IMF estimate that the current account deficit could rise to 8-11% of GNP in 1989/90 if oil prices are $12 pb. The fiscal position is already weak, with a deficit of $520 mn projected for 1988, due mainly to overruns on defence spending and uncontrolled expenditure by the Royal Diwan. The authorities intend to meet the deficits out of reserves but the drawdown could be very heavy if oil prices remain weak given the relatively high cost of Omani production. Additional external borrowing is also a possibility but the DSR is already set to rise to over 20% in 1989-90. A recent IMF report recommends new revenue-raising measures, higher interest rates and a more flexible exchange rate strategy to protect the reserves and avoid excessive borrowing.

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F[illegible]NT SOVEREIGN BORROWING BY LDCS

Date Announced	Borrower	Amount (mn)	Maturity/ Grace (years)	Spread or Fixed rate (%)
BANK BORROWING				
Africa				
16/7	Algeria - Banque Exterieure d'Algerie	$100	7/4	7/8
19/7	Madagascar - Banque Centrale de la Republique Malgache	$ 7	1	1 1/4
Asia				
16/7	Pakistan - Rice Export Credit Corp	$ 50	1	5/8
17/6	Thailand - Thai Airways International	$ 72.5	16	-
9/9	Malaysia	$350.0	10/6	1/8-1/4
30/9	India - Air India	$160.0	10/4	-
20/10	Pakistan-International Airlines	$ 27.5	7	-
Latin America				
15/5	Venezuela - Super Octanos	$ 70	11/3	5/8
24/9	Jamaica - Air Jamaica	$ 56.5	12	1 1/2
Communist				
29/10	China - Bank of China	DM 47.4	10	1/16
5/11	China - Sinopec	$150	10/2	0.01
12/11	Bulgaria - Foreign Trade Bank	$ 25.0	5/3	1/4
Middle East				
6/5	Iraq	£17.7	5	7/8
	Oman	$100	8/4	-2/5
South Europe				
30/6	Greece - Public Power Corporation	$150	8/5	-
30/9	Greece - Bank of Greece	DM 306.8	6/5	1/2-5/8
Pacific				
13/8	Papua New Guinea - Electricity Commission	$17	7/3	3/4

Date Announced	Borrower	Amount (mn)	Maturity/ Grace (years)	Spread or Fixed rate (%)
BONDS				
Asia				
9/7	India - ICICI	SFR 80	7	5 1/4
20/8	India - Industrial Development Bank of India	DM 250	7	5 5/8
23/7	Taiwan - Bank of Communications	$100	5	9 3/8
9/7	Thailand	DM 200	5	5 3/4
5/10	Indonesia	DM 300	5	6 3/8
Communist				
2/9	National Bank of Hungary	DM 200	6.5	6 1/4
24/9	National Bank of Hungary	Yen 30 bn	10	5 9/10
5/11	National Bank of Hungary	SwFc 75	6	5 1/2
22/10	Bank of China	DM 200	5	1/16
South America				
20/8	Venezuela	$100	5	1 7/8
29/10	Venezuela	DM 100	5	8 1/4
South Europe				
27/8	Greece - Bank of Greece	Yen 20 bn	10	5 9/10
Africa				
9/9	Banque Exterieure d'Algerie	DM 150	7	
30/9	Tunisia	$171.2	6	9 8/10
30/9	Tunisia	$25	16	9 1/8
8/10	Banque Exterieure d'Algerie	Yen 10 bn	7	6 6/10
	Banque de l'Agriculture & du Developpement Rural	Yen 8.7 bn	7	n/a

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21.11.88

OVERDUE OBLIGATIONS TO THE FUND(1) (SDR mn)

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding (SDR mn)	Forthcoming Obligations (to 1999)
KAMPUCHEA	13 March 1975	32.2	13.7
GUYANA	31 May 1983	84.6	23.5*
VIET NAM	6 February 1984	94.7	36.7*
SUDAN	12 July 1984	669.8	193.4*
LIBERIA	14 March 1985	234.9	71.4*
PERU	9 December 1985	483.3	289.7**
ZAMBIA	6 June 1986	544.2	334.4**
SIERRA LEONE	13 February 1987	48.6	42.7**
SOMALIA	2 July 1987	46.3	98.9=
PANAMA	28 December 1987	67.3	39.1=
ZAIRE	29 June 1988	81.1	580.0**
		2,387.0	1,771.2

(1) Includes both overdue repurchases and charges of members with at least one obligation overdue for more than one month.

NB The above figures are from Fund papers issued with respect to individual country complaints. There will have been further obligations falling due subsequently, so the figures are not entirely up-to-date.

* Guyana, Liberia, Sudan and Vietnam only to 1992.
** Peru, Sierra Leone, Zaire and Zambia only to 1993.
# Panama and Somalia only to 1994.

NB Haiti settled on 24 October 1988 (see EBS/88/173. Supp 3.); Honduras settled on 9 November.

.EBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1987	End-June 1988	End-March 1987 [2]	End-March 1987 [3]
Latin America				
Argentina	57	3.4(0.1)	0.2	0.2
Brazil	121	6.2(0.7)	1.0	1.9
Chile	20	1.0(0.0)	-	0.1
Colombia	17	0.5(0.1)	0.1	0.1
Ecuador	10	0.6(0.0)	0.1	0.1
Jamaica	4	0.2(0.0)	-	-
Mexico	104	6.0(0.1)	0.7	1.3
Peru	18	0.3(0.0)	0.1	0.2
Uruguay	5	0.3(0.0)	-	-
Venezuela	35	2.1(0.1)	-	-
Far East and Australasia				
Indonesia	46	0.6(0.3)	0.9	1.8
Philippines	29	1.3(0.0)	0.1	0.2
Eastern Europe (convertible currency)				
Bulgaria	6	0.2(0.1)	-	0.1
Hungary	18	0.3(0.0)	-	0.1
Poland	39	0.7(0.0)	1.3	1.4
Romania	6	0.1(0.0)	0.3	0.4
Yugoslavia	20	0.8(0.1)	0.7	0.9

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[1] Defined as consolidated external claims including portfolio investments with a contractual repayment date, adjusted for certain inward and outward risk transfers in respect of guaranteed loans, plus any net claims on local residents in local currency. Amounts in brackets represent total unused commitments adjusted for certain inward and outward risk transfers in respect of guaranteed loans. Other portfolio investments in these countries amounted to $56 mn at end-June 1988.

[2] Defined as ECGD-guaranteed loans disbursed, plus political claims paid and claims under examination.

[3] Defined as ECGD-guaranteed loans (disbursed and undisbursed) and contractual interest, plus political claims paid and claims under examination.

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EBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1987	End-June 1988	End-March 1987 [2]	End-March 1987 [3]
Europe				
Greece	21	1.3(0.4)	0.1	0.3
Turkey	38	0.4(0.1)	0.2	0.6
Sub-Saharan Africa				
Cote d'Ivoire	12	0.3(0.0)	0.1	0.1
Nigeria	26	1.3(0.1)	2.5	3.5
South Africa	23	3.7(0.6)	0.9	2.5
Sudan	12	0.0(0.0)	0.2	0.2
Middle East and North Africa				
Algeria	24	0.4(0.1)	0.2	0.4
Egypt	50	0.2(0.1)	0.3	1.3
Iraq	65[4]	0.1(0.1)	0.6	1.6
Jordan	5[5]	0.2(0.0)	0.1	0.7
Morocco	20	0.2(0.0)	0.2	0.3
Oman	3	0.1(0.1)	0.7	1.9
Saudi Arabia	18[6]	0.7(0.2)	0.2	0.3

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[4] Includes $30 bn from Arab countries.

[5] End-December 1986 estimate which excludes sizeable military debt. More recent estimates put the figure at $6.5 bn (again probably excluding military debt).

[6] External bank and guaranteed trade debt at end-December 1987.

Mr S Pond IDD
Mr J Youd IDD

cc Chief Executive
Mr M Hawtin - Director RMG
Mr M Pentecost - IDD
Mr E Walsby - PD8
Mr P Roderick - IDD
Mr J Tyler - TMD
Mr C Miles - BoE
Mr C Garrett - ERD/FCO
Miss A Higgins - HMT

ECGD BILATERAL NEGOTIATIONS / AGREEMENTS - POSITION AS AT 1 DECEMBER 1988

1 The enclosed printout shows the latest position of progress in respect of negotiation and signature of our bilateral debt agreements as at the above date. Also attached is a tentative programme for future Paris Club restructuring exercises.

2 If you need any further information on this return please do not hesitate either to contact me on the number below or Mr N Williams on Ext. 7165 (for non-African countries)/ Mr N Thompson on Ext 7007 (for African countries).

R P OGLEBY
International Debt Division
Ext. 7356
8 December 1988

BILATERAL NEGOTIATIONS / AGREEMENTS - CURRENT POSITION AS AT 1 DECEMBER 1988

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
ANGOLA I	-	-	17.11.87	04.12.87 (London)	04.12.87		Final version of the Portuguese translation of the text was returned to FCO for comment by Angolans on 29/11.
ARGENTINA I	16.01.85	30.06.85	23.04.85	15.05.85 + 29-31.01.86+ 25.10.88 (Paris)	28.08.87		English and Spanish texts agreed. Meeting held in Paris 25/10 to discuss outstanding issues.FCO arranging Exchange of Notes through "Protecting Powers"-Switzerland and Brazil.Bilaterals signed 15 out of 16.
ARGENTINA II	20.05.87	31.12.87	19.10.88	25.10.88 (Paris)			Following recent negotiations a revised text has been prepared and passed to FCO for clearance 6/12. Bilaterals signed 10 out of 14
BOLIVIA II	14.11.88	30.04.89		To be arranged			Draft text has been prepared.
BRAZIL III	29.07.88	31.03.89	27.10.88	To be arranged			Draft text sent to Brasilia 27/10 (Portuguese version sent 24/11). Negotiations postponed for time being as the result of new constitution.
JAMAICA IV	24.10.88	30.04.89		To be arranged			Draft text passed to FCO for clearance 22/11.
MADAGASCAR VI	28.10.88	31.08.89		To be arranged			Draft text has been prepared.
MALAWI III	22.04.88	31.12.88	11.07.88	To be arranged			Text passed to MoF 18/7 by Post. We have suggested conclusion by correspondence. Post chased 4/10.MoF unhappy with proposed interest rate of LIBOR+0.5% but we explained that "Toronto terms" will not be applicable 25/10. Asked Post enquire on progress 2/12.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
MALI I	27.10.88	31.07.89		To be arranged			Draft text has been prepared.
MAURITANIA II	16.05.86	31.12.86	14.07.86	28.11.86 (London)	28.11.86		Documents passed to British Embassy in Paris 14/1. Cabled Post 18/11 asking to explain that telex recently received from Mauritanians does not constitute signature.
MAURITANIA III	15.06.87	29.02.88	08.01.88	By correspondence	03.03.88		FCO despatched Exchange of Notes 4/5. Cable to Dakar 18/11 also asks to chase progress of this Agreement - letter of acceptance 3/3 insufficient.
MOROCCO III	06.03.87	30.09.87	29.07.87	19/20.10.87 (London)	20.10.87		Agreement now signed.
MOROCCO IV	26.10.88	31.08.89		To be arranged			Draft text has been prepared.
MOZAMBIQUE II	16.06.87	30.09.88	31.12.87	11.01.88 + 19.04.88 (London)			Preliminary discussions held with MoF have so far proved inconclusive - Mozambicans continue to insist on extremely concessionary rate of interest. Post cabled 23/11. Bilaterals initialled 3 out of 14.
PERU III	05.06.84	31.01.85					Bilaterals were not negotiated following suspension from IMF facilities after signature of the Agreed Minute.This will now lapse.
POLAND IV	16.12.87	31.05.88	04.02.88	9/10.03.88 (Warsaw)			Offer put to Poles in negotiations rejected on 30/3. We have reaffirmed our position but left way clear for another meeting, the date of which has still to be arranged. Bilaterals initialled 2 out of 17
SIERRA LEONE IV	19.11.86	30.04.87	23.03.87	26.03.87 (London)	26.03.87		Despite numerous "chasers" the High Commission feels there is little prospect of making any progress. FCO last chased Post 14/10.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
SOMALIA II	22.07.87	31.12.87	27.11.87	8\9.12.87 (London)	09.12.87		Documents sent to Mogadishu 7/1. FCO chased formally 17/3.The Head of Chancery was informed of our concern about delay in signature during an informal meeting in London -1/8.FCO chased again-27/10.
SUDAN IV	03.05.84	28.02.85	24.07.85	08.08.85 (London)	08.08.85		Formal signature still outstanding. No action taken to pursue due to increasing arrears under previous agreements and Sudan's position in relation to IMF.
TOGO VI	22.03.88	31.10.88	08.07.88	9/10.08.88 +18/10/88 (London)	18.10.88		Exchange of Notes forwarded to Post 14/11.
YUGOSLAVIA IV	13.07.88	31.12.88	15.08.88	01.11.88 -03.11.88 (London)	03.11.88		Interest rate of LIBOR + 0.5% agreed. Documents (including amendment to No 3) sent to Belgrade 17/11.
ZAIRE VII	15.05.86	31.12.86	16.06.86	07.07.86 (London)	07.07.86		Delays on part of Zaire to arrange conclusion of agreement. See below.
ZAIRE VIII	18.05.87	31.12.87	30.09.87	06.10.87 (London)	07.10.87		Documents sent to Kinshasa on 26/1.Embassy has requested details for a formal signing ceremony for both VII and VIII.Cable from Post 28/7 indicated that Zairoise were awaiting conclusion of IPPA loan negotiations beforehand - FCO have since explained that these have no connection with signature of bilateral - we were given an apology for delay 19/8.FCO chased again 25/10.

BILATPS.RET

PARIS CLUB FORWARD PROGRAMME

Coun[illegible]	Extant bilateral agreements (rescheduling/ refinancing)	Possible timing of next Paris Club restructuring	Non-consolidated arrears at 30 June 1988	Non-consolidated forward exposure 1 July 1988 - 31 December 1989	Expiry of last consolidation period
[illegible].A.R	1 (1/0)	Dec 1988	GBP 0.00m	GBP 0.00m	31.12.81
Congo	1 (1/0)	1989	GBP 3.30m	GBP 18.63m	31.03.88
Costa Rica	2 (2/0)	1989	GBP 2.25m	GBP 0.56m	31.03.86
Cuba	4 (4/0)	Feb 1989	GBP 4.87m	GBP 2.69m	31.12.86
Equatorial Guinea	0 (0/0)	Jan 1989	GBP 0.00m	GBP 0.00m	30.06.86
Guatemala	0 (0/0)	Feb 1989	TBA	TBA	N/A
Guyana	0 (0/0)	1989	GBP 53.36m	GBP 3.96m	N/A
Mauritania	3 (3/0)	1989	GBP 0.00m	GBP 1.13m	31.05.88
Niger	5 (5/0)	Dec 1988	GBP 0.00m	GBP 0.00m	31.12.88
Nigeria	1 (1/0)	Jan 1989	GBP 272.46m	GBP 782.96m	31.12.87
Philippines	2 (1/1)	1989	GBP 0.00m	GBP 6.32m	31.08.88
Senegal	5 (5/0)	Dec 1988	GBP 0.18m	GBP 0.22m	31.10.88
Tanzania	1 (1/0)	Dec 1988	GBP 1.40m	GBP 3.74m	30.09.87
Trinidad and Tobago	0 (0/0)	Jan 1989	GBP 0.01m	GBP 11.73m	N/A
Uganda	3 (3/0)	Jan 1989	GBP 0.00m	GBP 0.00m	30.06.88
Zaire	8 (8/0)	Feb 1989	GBP 0.00m	GBP 0.00m	14.05.88

All figures based on latest P.C declaration forms

RPO
03/12
PCFP.RET

aef.tp/mountfield/min/260

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Ch/
Content?

FROM: A R BOTTRILL
DATE: 20 DECEMBER 1988

JT
21/12

1. MR LANKESTER R 21/12
2. MR J M G TAYLOR

Copies for:
Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr N Wicks
Mr J Anson

cc: Mr Scholar
Mr H P Evans
Mr Mountfield
Mr H Walsh
Mr S Matthews
Mr P Davis
Mrs Thomson
Mr Cassell
(UKDEL/IMF)

INTERNATIONAL FINANCIAL SCENE

I attach a draft letter to No.10 covering international debt.

T. Potter
p.p. A R BOTTRILL

X is inadequate (re the Nigerian loan package). Need to mention that [illegible] Lawson talked the [illegible] $100m [illegible] considered [illegible] the [illegible] would at least a [illegible] stand-by [illegible] further $150m, which [illegible] Lawson proposed [illegible] voluntarily to do.

BOTTRILL TO JMGT 20 DEC

dec.m.19

please type for signature

DRAFT LETTER TO CHARLES POWELL AT NO 10

INTERNATIONAL FINANCIAL SCENE

I attach a report on developments in the international debt scene.

2. Developments in the world economy have been rather more favourable than expected this year with real output in major industrial countries likely to have risen by over 4 per cent and the volume of world trade by a rapid 8½-9 per cent. Commodity prices are currently some 20 per cent higher in SDR terms than at this time last year, although oil prices have fallen. In spite of this generally very helpful background, however, debtor countries have made less progress than might have been hoped.

3. Most major debtors' exports have grown and this has helped to ease the burden of debt interest payments - except in the case of oil producers. Domestic policies, however, have remained inadequate in a number of countries which have had difficulty agreeing IMF programmes and obtaining external finance. Lax budgetary policies have been accompanied by chronic inflationary problems and disappointing growth.

4. The prospect next year is for continued, substantial increases in world output and trade, though at a somewhat slower pace, together with probably higher average interest rates and some flattening of commodity prices. This will provide a more difficult background for debtors. Political considerations in

advance of or in the wake of elections could also strain the debt strategy in the major Latin American countries.

5. The trend for official creditors to bear an increasing share of the burden of financing major debtors has continued. Banks have remained reluctant to provide new money packages commensurate with their share of exposure, although they have continued to show interest in debt reduction options. Finance Ministers at the IMF/IBRD annual meetings in Berlin in late-September agreed that the menu approach to financing packages should be broadened to increase financial flows and reduce debt through voluntary market-based schemes without transferring risk from private to official creditors. The Bank of England is preparing a paper on the various methods of debt reduction.

6. Official creditors have had continued difficulty in securing adequate conditionality from debtors. The IBRD's approval of major policy loans for Argentina, on the basis of macro-economic targets which fell short of those sought by the IMF, threatened to undermine the Fund's role. The UK, however, has supported firmly the IMF's primacy. G10 Finance Ministers are to discuss a report on the roles of the IMF and IBRD at their April meetings in Washington.

7. In the Paris Club, the first concessional reschedulings for the poorest sub-Saharan African countries have been agreed on the lines of the proposals endorsed by Summit leaders at Toronto. Tanzania was the first Commonwealth country to benefit in early December. Others have been Mali, Madagascar, the Central African

Republic and Niger. Creditors failed to agree on Senegal which some (though not the UK) felt was too rich to benefit. The majority of creditors, in common with the UK, has chosen to reduce interest rates.

8. The attitude of major debtors has shown some signs of hardening. In late-October the presidents of the G8 Latin American countries issued a 'Declaration of Uruguay' calling among other things for urgent talks on debt with the new US Administration. Their finance ministers meeting in Rio de Janeiro in early December reaffirmed their interest in reducing their debts. The new Mexican president has said that growth must not be sacrificed to debt service and has spoken of re-opening negotiations with creditors. Venezuela's new leader is also advocating a tougher stance. Argentina and Brazil both face elections in 1989. These may not only paralyse economic policy-making for an important period but will also provide an opportunity for critical debate on debt issues.

9. The attitude of the new US Administration to the debt strategy is not yet clear. President-elect Bush has announced a major review. The move of Mr James Baker from the US Treasury to the State Department, however, suggests that hemispheric political considerations will continue to play an important role in US thinking. The continued fragility of parts of the US financial system will also be a factor, although American banks have generally strengthened their position.

10. <u>Argentina</u> is the country where lack of agreement with the IMF and mounting interest arrears to commercial banks threaten to

cause strains in the coming weeks. The government's Primavera Plan has had some success in reducing inflation but its reliance on administrative controls without the necessary underpinning of firm fiscal and monetary policies means that it is likely to be short-lived. The IBRD's disbursement of further tranches of the policy loans agreed in October depends at least partly on satisfactory macro-economic policies; but Argentina's 1989 budget seems likely to exceed even the IBRD's targets let alone the IMF's more stringent demands. Lack of an IMF agreement is likely to hamper Argentina's negotiations with commercial banks which have already rejected a $3½ billion new money request. It is difficult to envisage how President Alfonsin can take the necessary measures before May's elections, particularly in view of the recent army mutiny.

11. Mexico's external payments situation has worsened sharply as lower oil exports and the liberalisation of imports have led to an unexpectedly large current deficit. Expectations of a peso devaluation immediately before or after the presidential election were accompanied by substantial capital flight and a sharp drain on reserves. In these circumstances, the US has offered a $3.5 billion bridge loan. Last week's announcement of a new wage and price pact, together with a one peso per day devaluation from 1 January, seem unlikely to reverse the trend. The external financing gap for 1989, therefore, looks particularly large and is likely to lead to calls on all creditors. The new Salinas Administration, however, will not find it easy to agree a policy package with the IMF. The World Bank is actively considering possible loans for Mexico, but it will be important that the IBRD

does not again go ahead of the Fund - even if the US lobbies for exceptionally favourable treatment.

12. Brazil's strong trade performance has been overshadowed by continued domestic budgetary problems which have brought the country to the brink of hyperinflation as monthly price increases have approached 2,000 per cent a year. Further measures seem likely to be required if the Standby Arrangement with the IMF is to be kept on track. The Finance Minister Mailson da Nobrega has suggested a tax package to reduce the budget deficit with President Sarney's hesitant support - but opposition from other Ministers is strong.

13. The Prime Minister is familiar with the efforts made in recent weeks to secure an agreement between Nigeria and the IMF backed by adequate financial support from creditors. The Nigerian government has agreed at the second attempt a package of measures to reverse this year's soaring budget deficit and unify the naira exchange market. A programme is expected to be brought to the IMF Executive Board in January. The IBRD is prepared to offer new policy loans and a generous Paris Club rescheduling will be needed. Commercial banks have settled the outline of an agreement without any new money. ~~Donors are being asked to fill the remaining financing gap.~~ Nigeria's ~~reluctance~~ unwillingness to draw Fund money ~~, however,~~ is one factor weakening other creditors' support and also makes the programme more vulnerable to a fall in oil prices.

have proved reluctant to do.

14. Among other debtors, Poland has now signalled its intention to seek a formal IMF programme in the New Year, although it is not

The UK has taken the lead in trying to put together a donor package to fill the remaining financing gap, offering $100 million conditional on others providing at least $150 million, which so far they clear whether its proposed reforms will satisfy the Fund, or what attitude the new US Administration will take. Yugoslavia's current IMF programme will be reviewed in early-1989 against a background of satisfactory external performance but soaring domestic inflation. In the Middle East, Iraq has now approached the UK to discuss bilateral rescheduling of its debts. Jordan's external position has continued to deteriorate and some policy-makers, including the Crown Prince, see no alternative to an approach to the IMF. We would welcome such IMF involvement. Egypt has still failed to take adequate policy measures, and the IMF sees no prospect of an agreement within six months. The government in Algeria has introduced reforms following October's riots but payments delays are worsening.

15. I am copying this letter and enclosures to ~~Robert Culshaw~~ Bob Pierce (FCO), Jeremy Godfrey (DTI) and John Footman (Bank of England).

chex.md/aa/120 **CONFIDENTIAL**

Pwp

cc CST
EST
~~Sir P. Middleton~~
~~Sir G. Littler~~
~~Mr N. Wicks~~
Mr J. Anson
Mr Scholar
Mr Lankester
Mr H.P. Evans
Mr Mountfield
Mr Walsh
Mr Matthews
Mr P. Davis
Mrs Thomson
Mr Cassell

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

22 December 1988

Charles Powell Esq
PS/Prime Minister
No.10 Downing Street
London SW1

Dear Charles,

INTERNATIONAL FINANCIAL SCENE

... I attach a report on developments in the international debt scene.

Developments in the world economy have been rather more favourable than expected this year with real output in major industrial countries likely to have risen by over 4 per cent and the volume of world trade by a rapid 8½-9 per cent. Commodity prices are currently some 20 per cent higher in SDR terms than at this time last year, although oil prices have fallen. In spite of this generally very helpful background, however, debtor countries have made less progress than might have been hoped.

Most major debtors' exports have grown and this has helped to ease the burden of debt interest payments - except in the case of oil producers. Domestic policies, however, have remained inadequate in a number of countries which have had difficulty agreeing IMF programmes and obtaining external finance. Lax budgetary policies have been accompanied by chronic inflationary problems and disappointing growth.

The prospect next year is for continued substantial increases in world output and trade, though at a somewhat slower pace, together with probably higher average interest rates and some flattening of commodity prices. This will provide a more difficult background for debtors. Political considerations in advance of or in the wake of elections could also strain the debt strategy in the major Latin American countries.

The trend for official creditors to bear an increasing share of the burden of financing major debtors has continued. Banks have remained reluctant to provide new money packages commensurate with their share of exposure, although they have continued to show interest in debt reduction options. Finance Ministers at the IMF/ IBRD annual meetings in Berlin in late-September agreed that the menu approach to financing packages should be broadened to

WALLACE TO POWELL 22 DEC

$150 million, which so far they have proved reluctant to do. Nigeria's unwillingness to draw Fund money is one factor weakening other creditors' support and also makes the programme more vulnerable to a fall in oil prices.

Among other debtors, Poland has now signalled its intention to seek a formal IMF programme in the New Year, although it is not clear whether its proposed reforms will satisfy the Fund, or what attitude the new US Administration will take. Yugoslavia's current IMF programme will be reviewed in early-1989 against a background of satisfactory external performance but soaring domestic inflation. In the Middle East, Iraq has now approached the UK to discuss bilateral rescheduling of its debts. Jordan's external position has continued to deteriorate and some policy-makers, including the Crown Prince, see no alternative to an approach to the IMF. We would welcome such IMF involvement. Egypt has still failed to take adequate policy measures, and the IMF sees no prospect of an agreement within six months. The government in Algeria has introduced reforms following October's riots but payments delays are worsening.

I am copying this letter and enclosures to Bob Pierce (FCO), Jeremy Godfrey (DTI) and John Footman (Bank of England).

Yours,

Moira Wallace

MOIRA WALLACE
Private Secretary

increase financial flows and reduce debt through voluntary market-based schemes without transferring risk from private to official creditors. The Bank of England is preparing a paper on the various methods of debt reduction.

Official creditors have had continued difficulty in securing adequate conditionality from debtors. The IBRD's approval of major policy loans for Argentina, on the basis of macro-economic targets which fell short of those sought by the IMF, threatened to undermine the Fund's role. The UK, however, has supported firmly the IMF's primacy. G10 Finance Ministers are to discuss a report on the roles of the IMF and IBRD at their April meetings in Washington.

In the Paris Club, the first concessional reschedulings for the poorest sub-Saharan African countries have been agreed on the lines of the proposals endorsed by Summit leaders at Toronto. Tanzania was the first Commonwealth country to benefit in early December. Others have been Mali, Madagascar, the Central African Republic and Niger. Creditors failed to agree on Senegal which some (though not the UK) felt was too rich to benefit. The majority of creditors, in common with the UK, has chosen to reduce interest rates.

The attitude of major debtors has shown some signs of hardening. In late-October the presidents of the G8 Latin American countries issued a 'Declaration of Uruguay' calling among other things for urgent talks on debt with the new US Administration. Their finance ministers meeting in Rio de Janeiro in early December reaffirmed their interest in reducing their debts. The new Mexican president has said that growth must not be sacrificed to debt service and has spoken of re-opening negotiations with creditors. Venezuela's new leader is also advocating a tougher stance. Argentina and Brazil both face elections in 1989. These may not only paralyse economic policy-making for an important period but will also provide an opportunity for critical debate on debt issues.

The attitude of the new US Administration to the debt strategy is not yet clear. President-elect Bush has announced a major review. The move of Mr James Baker from the US Treasury to the State Department, however, suggests that hemispheric political considerations will continue to play an important role in US thinking. The continued fragility of parts of the US financial system will also be a factor, although American banks have generally strengthened their position.

<u>Argentina</u> is the country where lack of agreement with the IMF and mounting interest arrears to commercial banks threaten to cause strains in the coming weeks. The government's Primavera Plan has had some success in reducing inflation but its reliance on administrative controls without the necessary underpinning of firm

fiscal and monetary policies means that it is likely to be short-lived. The IBRD's disbursement of further tranches of the policy loans agreed in October depends at least partly on satisfactory macro-economic policies; but Argentina's 1989 budget seems likely to exceed even the IBRD's targets let alone the IMF's more stringent demands. Lack of an IMF agreement is likely to hamper Argentina's negotiations with commercial banks which have already rejected a $3½ billion new money request. It is difficult to envisage how President Alfonsin can take the necessary measures before May's elections, particularly in view of the recent army mutiny.

Mexico's external payments situation has worsened sharply as lower oil exports and the liberalisation of imports have led to an unexpectedly large current deficit. Expectations of a peso devaluation immediately before or after the presidential election were accompanied by substantial capital flight and a sharp drain on reserves. In these circumstances, the US has offered a $3.5 billion bridge loan. Last week's announcement of a new wage and price pact, together with a one peso per day devaluation from 1 January, seem unlikely to reverse the trend. The external financing gap for 1989, therefore, looks particularly large and is likely to lead to calls on all creditors. The new Salinas Administration, however, will not find it easy to agree a policy package with the IMF. The World Bank is actively considering possible loans for Mexico, but it will be important that the IBRD does not again go ahead of the Fund - even if the US lobbies for exceptionally favourable treatment.

Brazil's strong trade performance has been overshadowed by continued domestic budgetary problems which have brought the country to the brink of hyperinflation as monthly price increases have approached 2,000 per cent a year. Further measures seem likely to be required if the Standby Arrangement with the IMF is to be kept on track. The Finance Minister Mailson da Nobrega has suggested a tax package to reduce the budget deficit with President Sarney's hesitant support - but opposition from other Ministers is strong.

The Prime Minister is familiar with the efforts made in recent weeks to secure an agreement between Nigeria and the IMF backed by adequate financial support from creditors. The Nigerian government has agreed at the second attempt a package of measures to reverse this year's soaring budget deficit and unify the naira exchange market. A programme is expected to be brought to the IMF Executive Board in January. The IBRD is prepared to offer new policy loans and a generous Paris Club rescheduling will be needed. Commercial banks have settled the outline of an agreement without any new money. The UK has taken the lead in trying to put together a donor package to fill the remaining financing gap, offering $100 million conditional on others providing at least

INTERNATIONAL ISSUES: PROBLEM COUNTRIES

aef.tp/mountfield/min/291

FROM: P MOUNTFIELD
DATE: 21 JANUARY 1989

CHANCELLOR OF THE EXCHEQUER

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Byatt
Mr Lankester
Mr H P Evans
Mr R I G Allen
Mr Bottrill
Mr Cassell
Mrs Thomson
Mr Savage
Mr Gieve
Mr Tyrie
Ms Wallace

INTERNATIONAL ISSUES: PROBLEM COUNTRIES

This is on the agenda for your meeting on Monday. There is not too much to add to the last report from the Lankester Group (~~Mr~~ ~~Allen~~'s letter of ~~21~~ December). The main changes are:
actually Miss Wallace's letter of 22 December

Brazil

2. Sarney has introduced his "summer plan". Details are thin. Our preliminary impression is that the plan is not likely to be strong enough to bring inflation (currently 1000 per cent) under control. US Treasury shares some of our doubts: what happens at the end of wage freeze; is the fiscal deficit really under control? But until the IMF Mission goes there in February, we cannot be sure. The plan is already under attack in the Brazilian

MOUNTFIELD TO CX 21 JAN

congress. Meanwhile negotiations with the banks continue. Earlier this week it was reported that Brazil was threatening to withhold $500 million in payments due to banks - apparently in an attempt to blackmail US into offering a Mexico-style bridging loan. The US stood firm, Brazil withdrew, and the late payment is now being blamed on a 'computer error'.

Mexico

3. We had the Mexican Embassy in earlier this week. It is clear that fresh proposals, probably covering official as well as bank creditors, are being drawn up for 1989 and beyond. Salinas, in his inaugural speech on 2 December, spoke of a ceiling on debt service. Even without such an artificial limit, Mexico's financing gap next year is of the order of $5 billion, and the banks are increasingly reluctant to fill it. Salinas' proposals are expected in the next few weeks.

Venezuela

4. The new President (Androes Perez) takes over on 2 February. Press reports indicate that he, too, is going to seek new debt repayment terms, including a ceiling on payments.

Argentina

5. The banks are unlikely to agree a new package before May.

Nigeria

6. Mr Lankester has reported the results of the Consultative Group two weeks ago. The next step is the Paris Club. This is planned for the end of February. We shall be having preliminary discussions among creditors in Paris on Tuesday.

Toronto terms

7. We also hope to reschedule Senegal and Uganda on Toronto terms next week. (We are also rescheduling Trinidad, which does

not qualify and has not asked.) It is not yet clear whether diplomatic efforts have persuaded Spain to withdraw its veto (in return for the Paris Club's refusal to extend Toronto terms to Bolivia). As for Uganda, this turns on settlement of a bilateral dispute with Israel; we have worked hard behind the scenes to sort that one out, but I still do not know the outcome. In Parliament, there has been criticism (from Sir John Stanley) of the apparently-low costs of your initiative. ODA will try to put the record straight at the time of publication of the PEWP.

Poland

8. The Poles are going round all capitals, seeking support for a long-term settlement with a degree of concessionality. They have had a cold reception. It is not yet clear whether the new US administration will allow an IMF programme for Poland; if it does, handling the debt problem should become a little easier, on fairly conventional lines.

Egypt

9. A Fund team leave on technical mission this week, but there is still no sign of agreement. Mubarak may be planning a tour of capitals in March. Egypt needs to clear up its debt arrears (to the US, at least) by July if it is not to forfeit its access to further US aid, under the Brooke Amendment.

PM

P MOUNTFIELD

26th January 1989

Deputies' Report

The Deputies have conducted an assessment of economic developments in light of the short-term performance indicators and medium-term objectives and projections. Our principle conclusions are as follows:

Performance Indicators

Growth and Inflation

During 1988 demand and output growth have continued to exceed earlier expectations. Output in the G-7 economies expanded by more than 4 percent thereby exceeding last March projections by more than one percentage point. The strength of demand during the year reflects a remarkable rapid growth of business investment.

Inflation has remained fairly moderate given the strength of economic activity. For the G-7 economies as a group consumer price inflation rose from 2.8 percent in 1987 to 3.1 percent in 1988. Factors that have contributed to restrain the inflationary pressures include strong productivity growth, weakness of oil prices (until late in 1988) and steps to tighten monetary conditions. In spite of these factors, in some of the G-7 economies inflation remains a problem. If the momentum of aggregate demand remains strong then renewed inflationary pressures could not be ruled out. This risk is most pronounced in Canada, the United Kingdom and the United States where the degree of slack has diminished substantially and capacity constraints have appeared in certain sectors. Against this background, the reduction in growth to 3.3 percent that is projected for 1989 in the G-7 economies is viewed as a positive development.

External Balance

During 1988 the current account deficit of the United States is estimated to have declined by about $ 30 billion from its level in 1987. The current account surplus of Japan is estimated to have declined by about $ 8 billion while the surplus of Germany is estimated to have risen somewhat in dollar terms. The external balance of the United Kingdom continued to deteriorate during 1988. During most of the year the pattern of demand and output growth in the countries with the largest imbalances was consistent with balance of payments adjustment. In the United States the growth of output exceeded the growth of demand by about one percentage point while in Japan demand growth exceeded output growth by almost 2 percentage points. In Germany the difference between demand and output growth was about 0,3 of one percent. Developments during the latter part of the year suggest that the pace of adjustment has slowed down considerably. Indeed, the projections for 1989 indicate that the discrepancies between output and demand growth in the United States Japan and Germany that are necessary for external adjustment are likely to narrow down significantly, thereby reducing the pace of adjustment. The imbalance is projected in 1989 to exceed 2 percent of GNP in the United States and Japan and to reach almost 4 percent in Germany (most of which is with respect to other European economies).

Key Issues

1. Do Ministers and Governors believe that the projected evolutionof output and demand growth indicates a danger of a significant slowdown in the pace of external adjustment?

2. If a perception of such a slowdown prevails are there risks of a negative reaction in financial and currency markets as well as increased sentiments for protectionism?

3. Do Ministers and Governors consider inflation or inflationary expectations a serious risk?

4. Do they consider the recent interest rate increase appropriate and adequate. Are they concerned with the implications of such interest rate rise on investment, growth and on the debt-servicing difficulties of developing countries?

5. What are the policy measures that Ministers and Governors consider to be appropriate in order to deal satisfactorily with <u>both</u> the external adjustment and the inflation problems?

   Cut budget deficit

   a) What should the United States do to reduce its current account deficit?

   Stimulate

   b) What should Germany and Japan do in order to reduce their current account surpluses and sustain growth?

   higher pvt savings

   c) What should deficit countries do in order to strengthen their domestic saving?

6. A credible process of international cooperation implies a degree of international "burden sharing". What would Ministers and Governors consider to be the appropriate and credible mix of specific fiscal, monetary and structural policies that the various deficit and surplus countries must undertake in order to contribute to the simultaneous attainment of external adjustment, growth and price stability?

7. In view of the projected continuation of significant current account imbalances do Ministers and Governors believe that the pattern of exchange rates is still broadly satisfactory? Are they concerned with the recent strengthening of the US dollar? What could be the appropriate role of official intervention and what are the implications of interest rate developments for exchange market stability?

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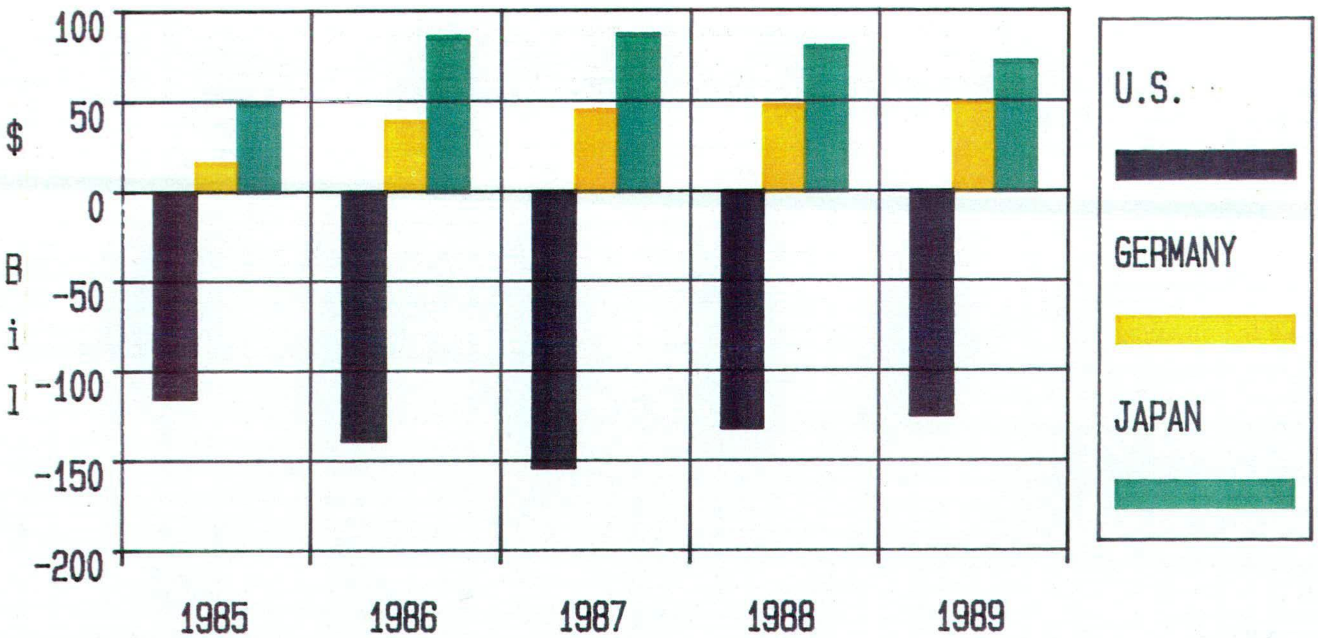
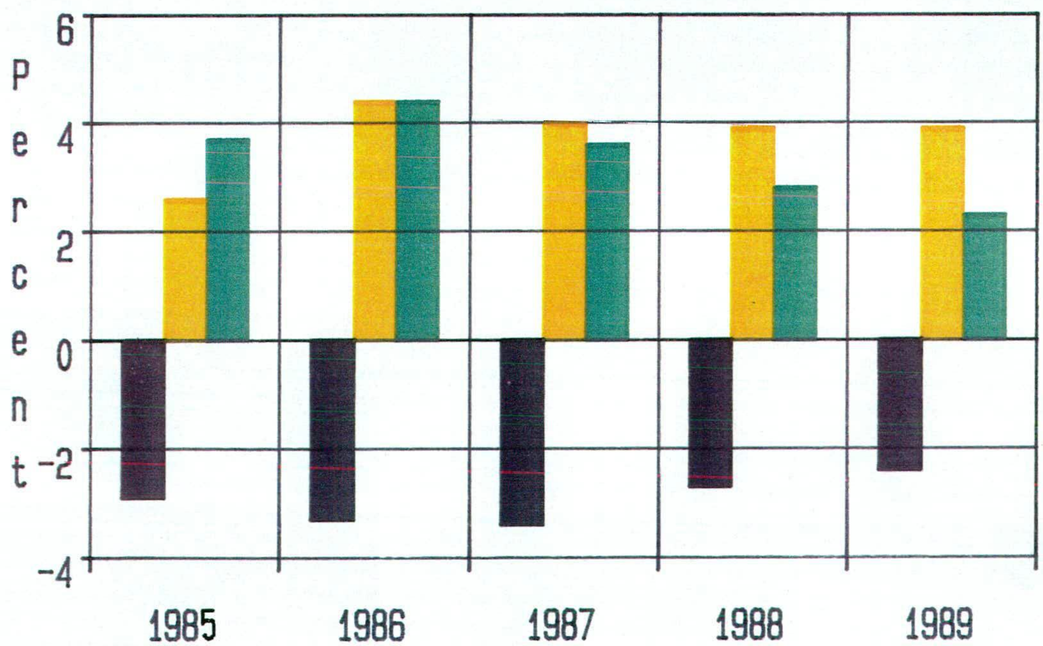
MULFORD'S CHARTS

CHART 1

Current Account Balances
($ Billions)



Current Account Balances
(As Percent of GNP/GDP)



OASIA/IMI 1/17/89

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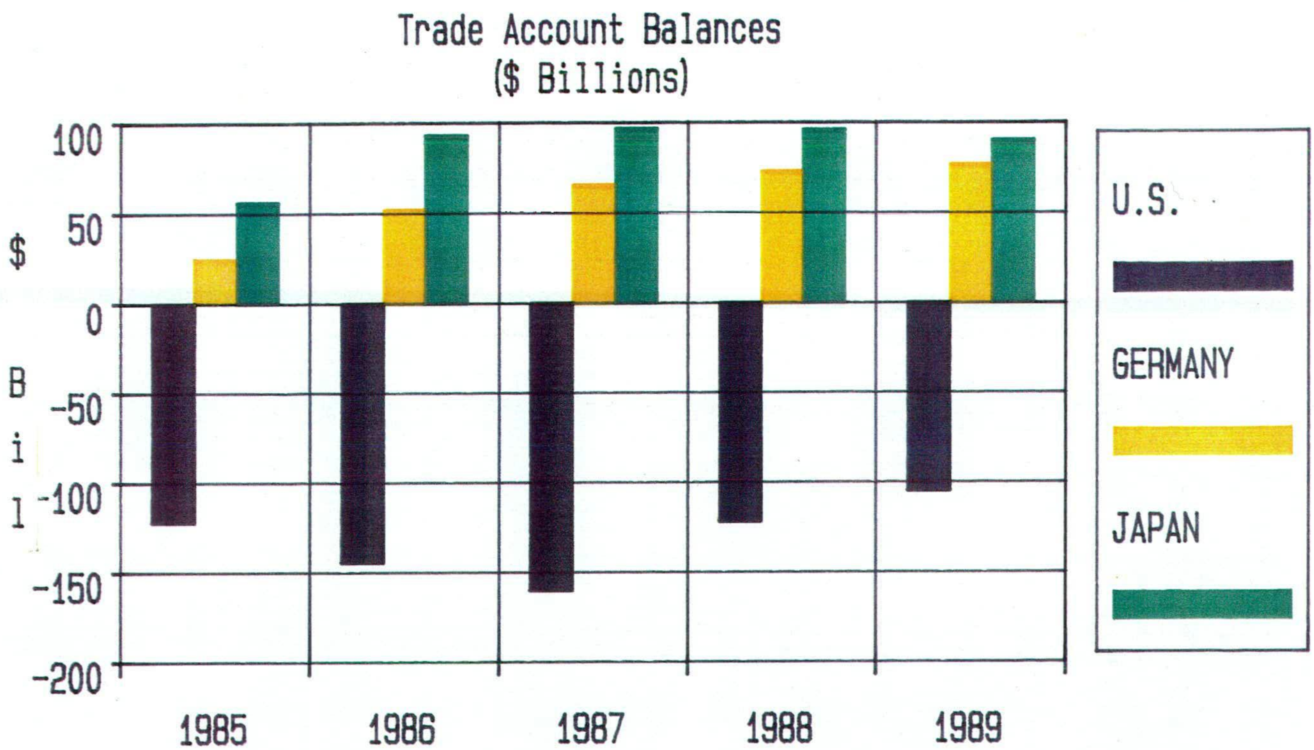
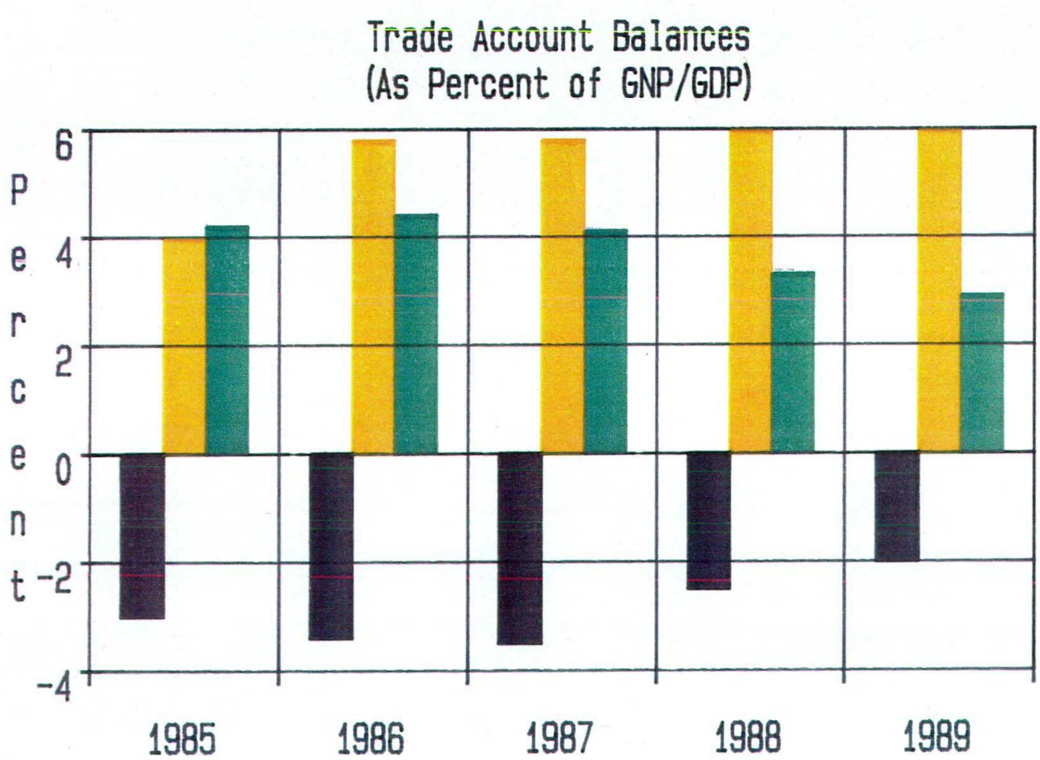
CHART 2





OASIA/IMI 1/17/89

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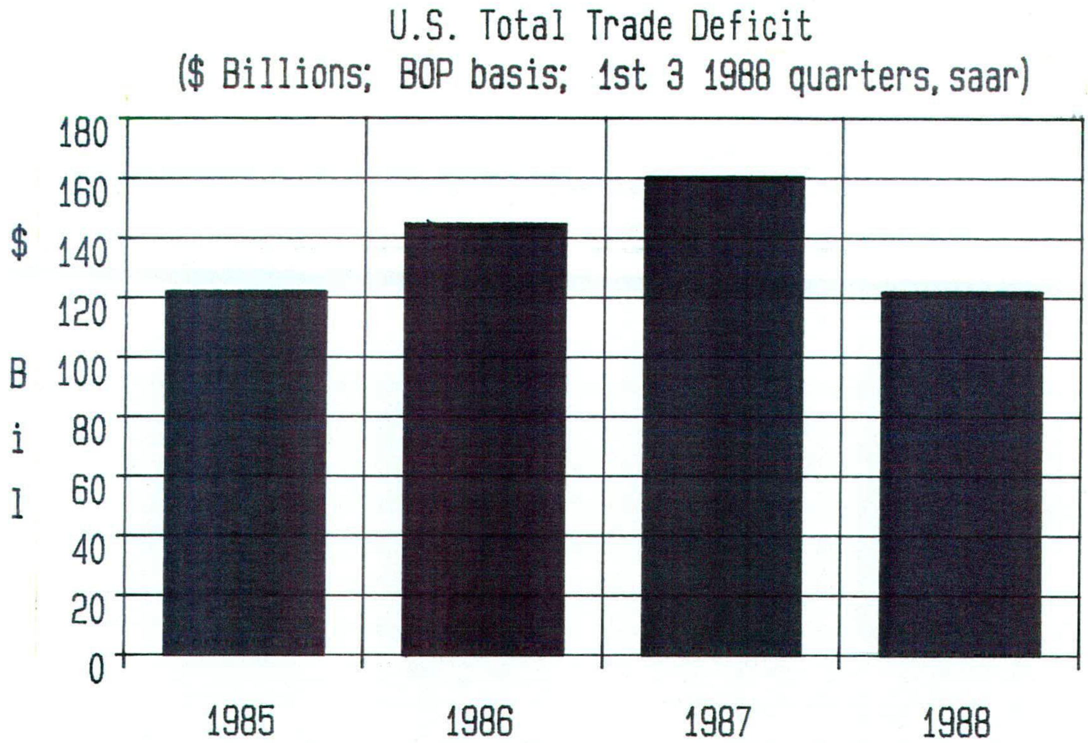
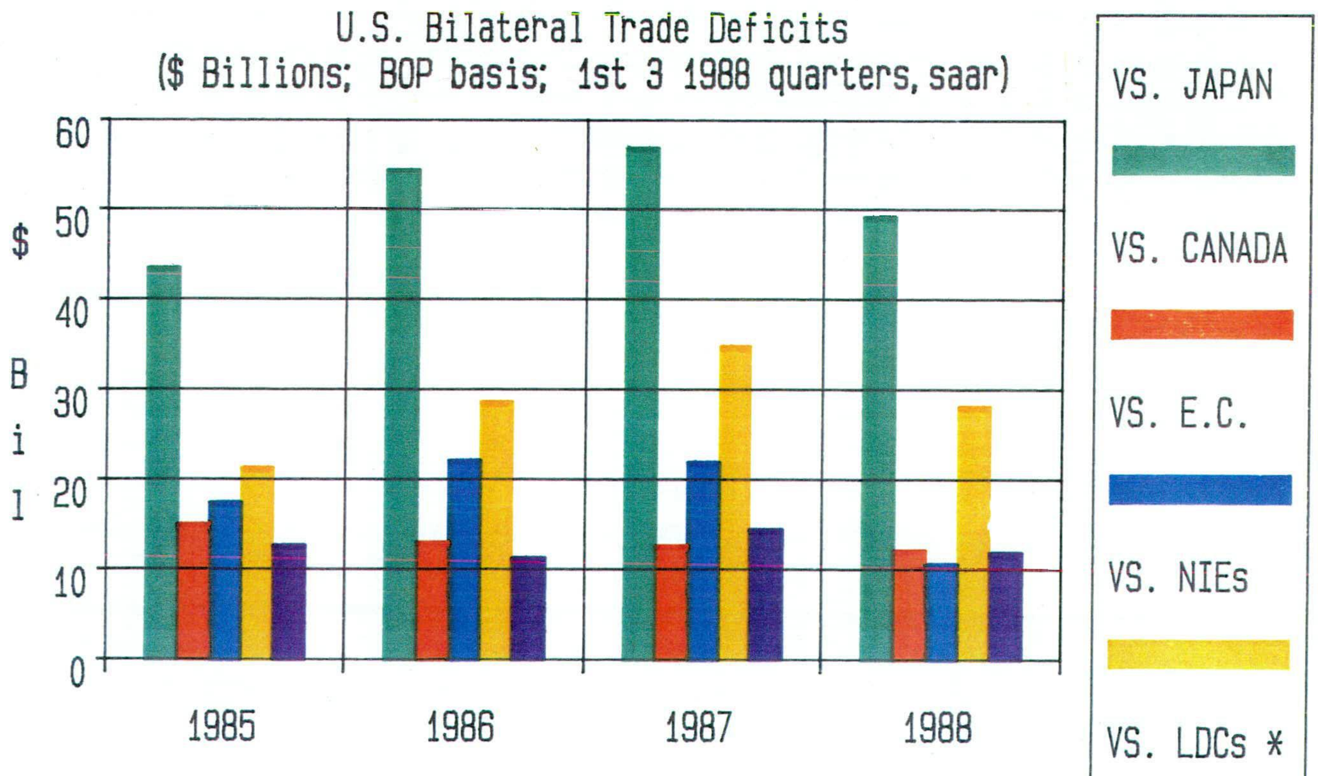
CHART 3





* Excluding OPEC and NIEs

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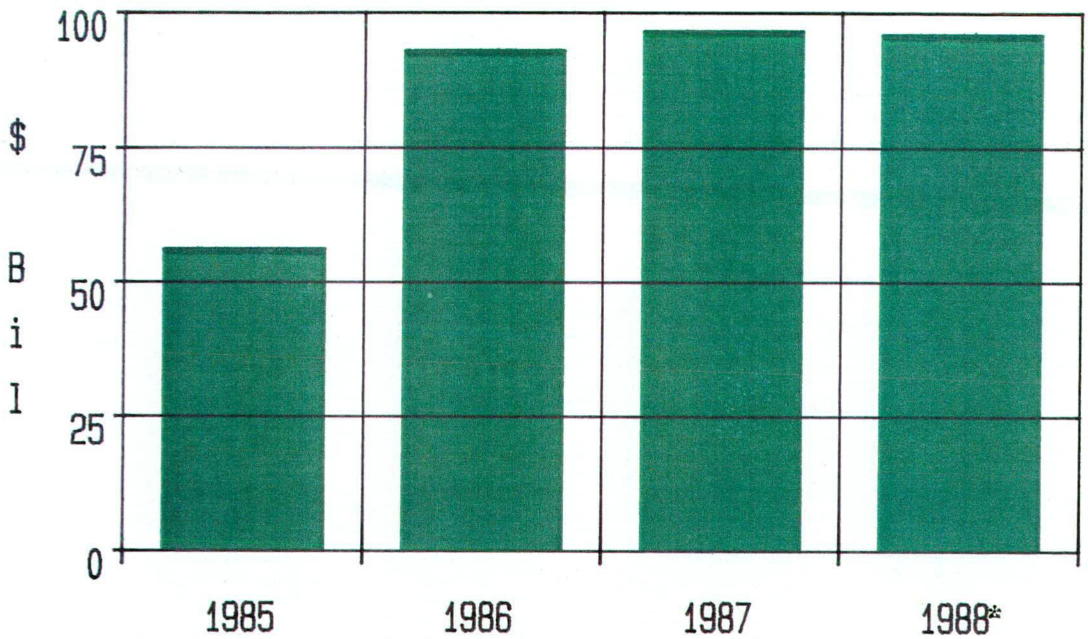
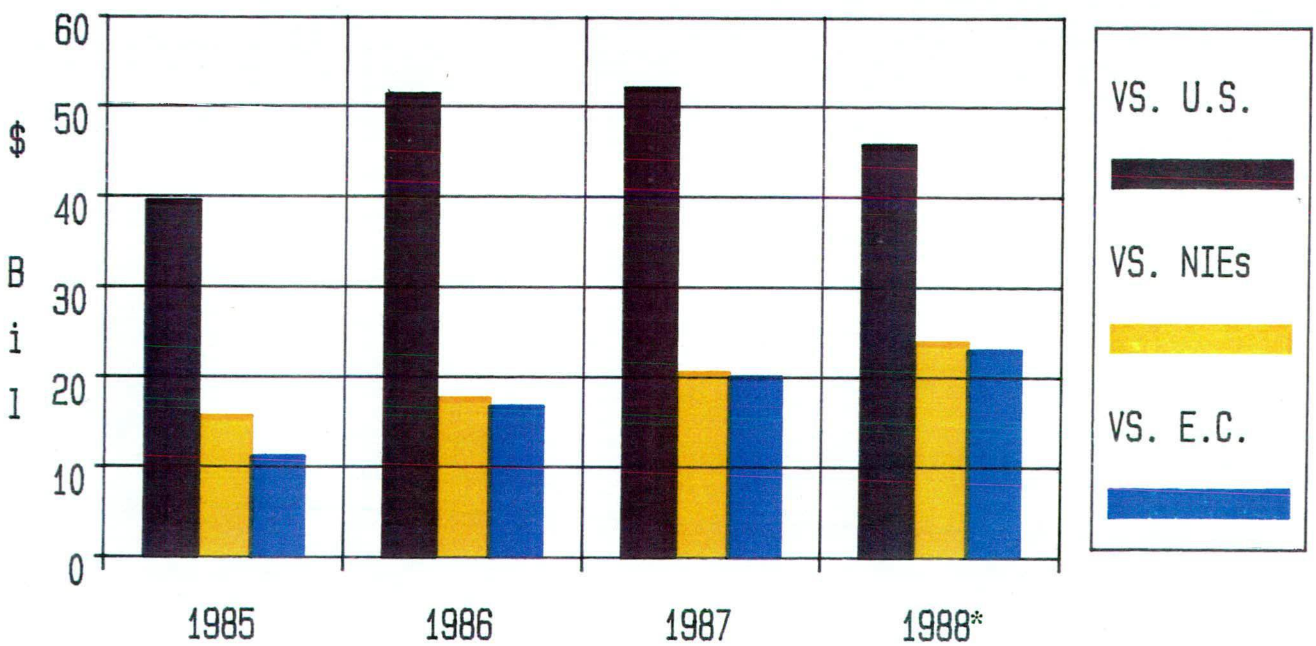
CHART 4

Japanese Total Trade Surplus
($ Billions; BOP basis)



* ($ Billions; 1st 10 1988 months, saar)

Japanese Bilateral Trade Surpluses**
($ Billions)



** Customs (fob/cif) basis

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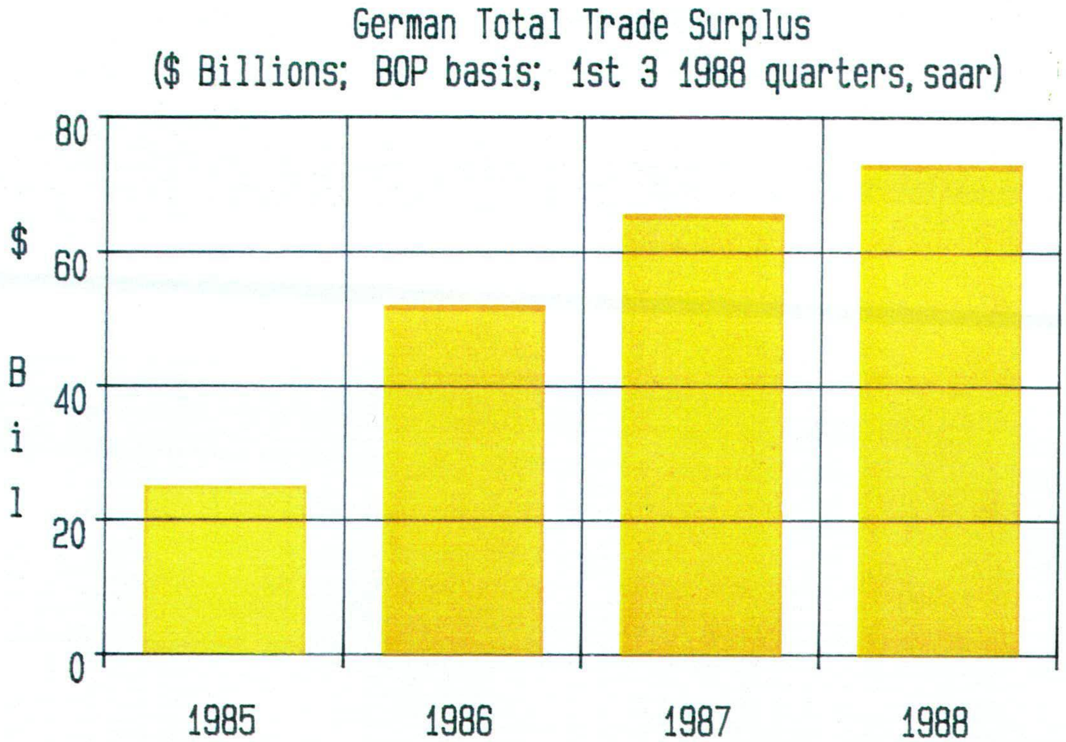
CHART 5



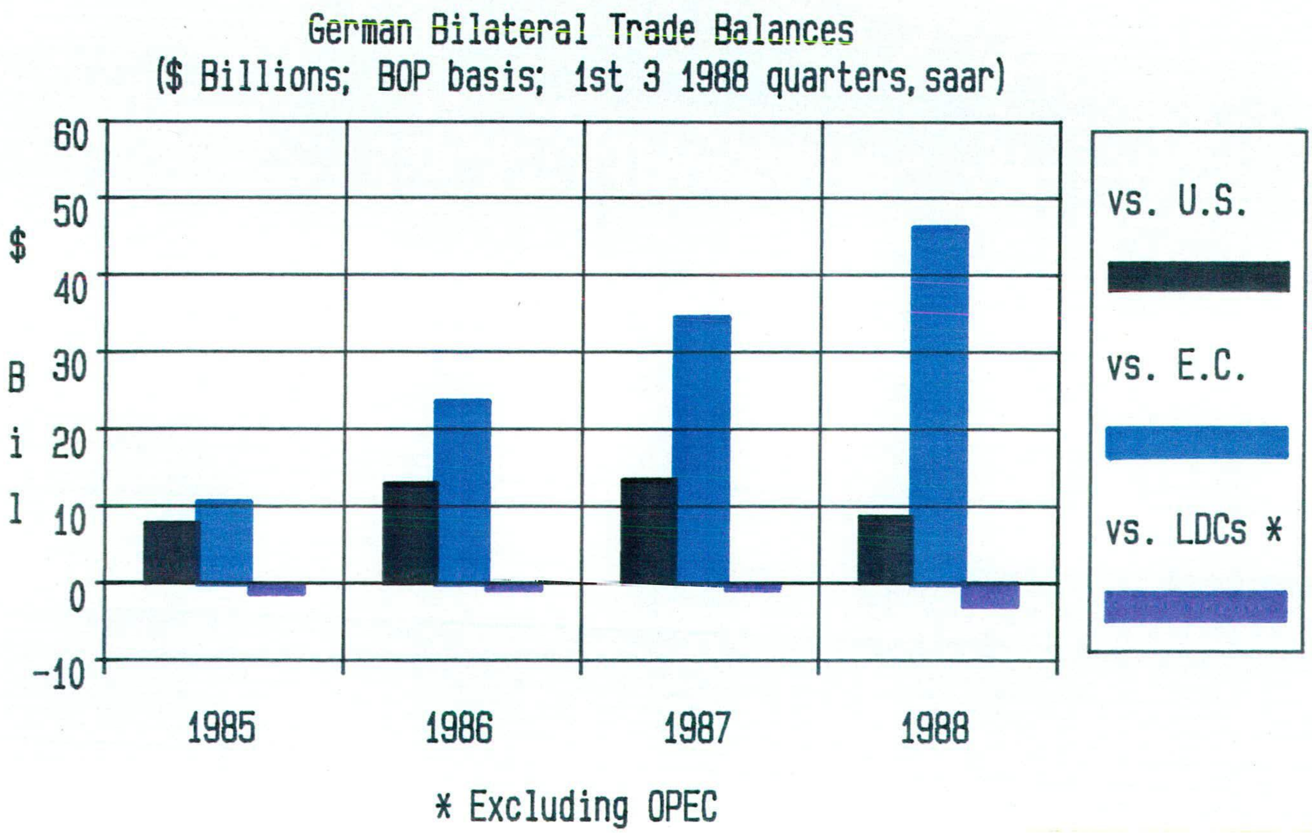


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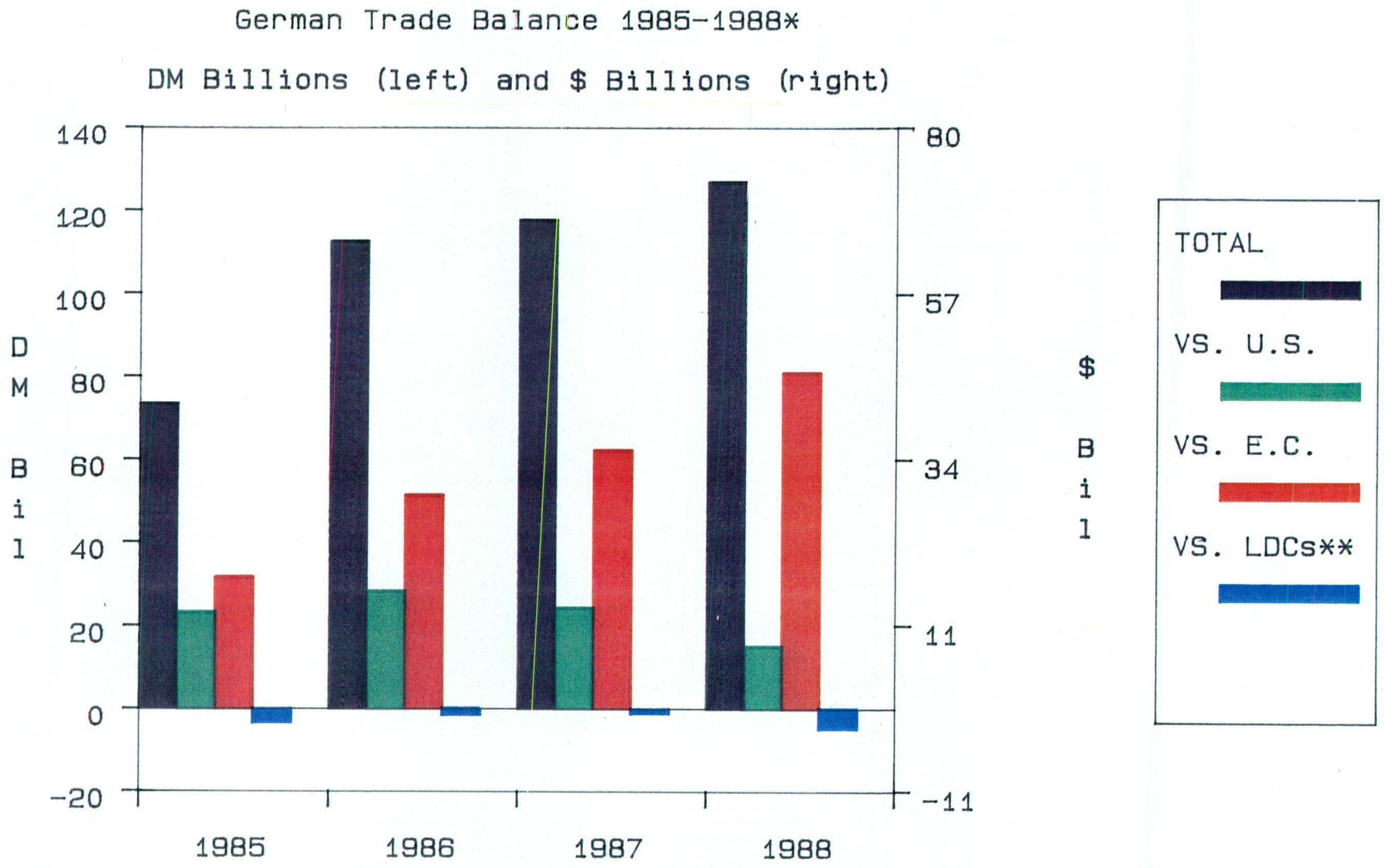
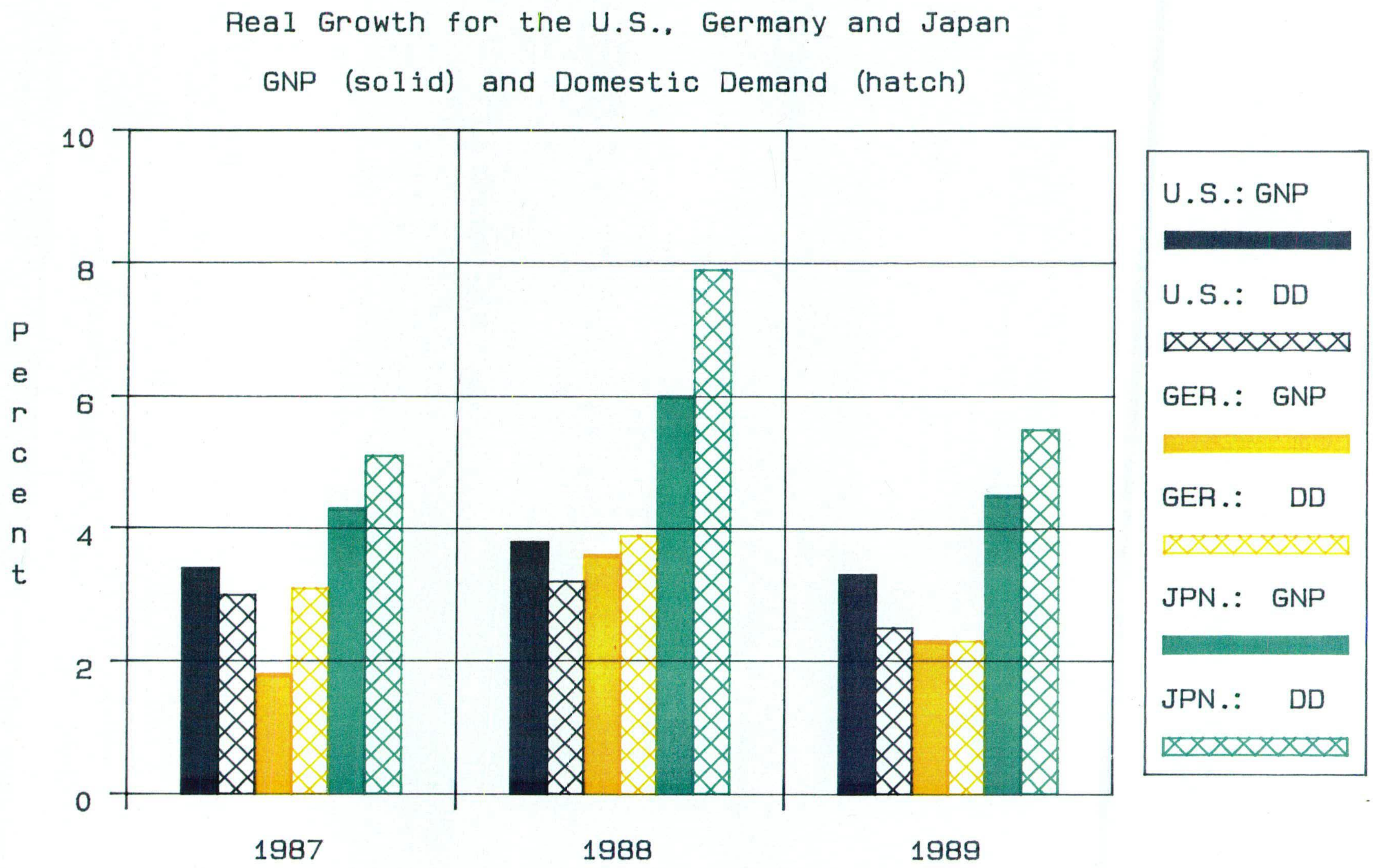
CHART 6



*1988: First three quarters at saar. **: minus OPEC

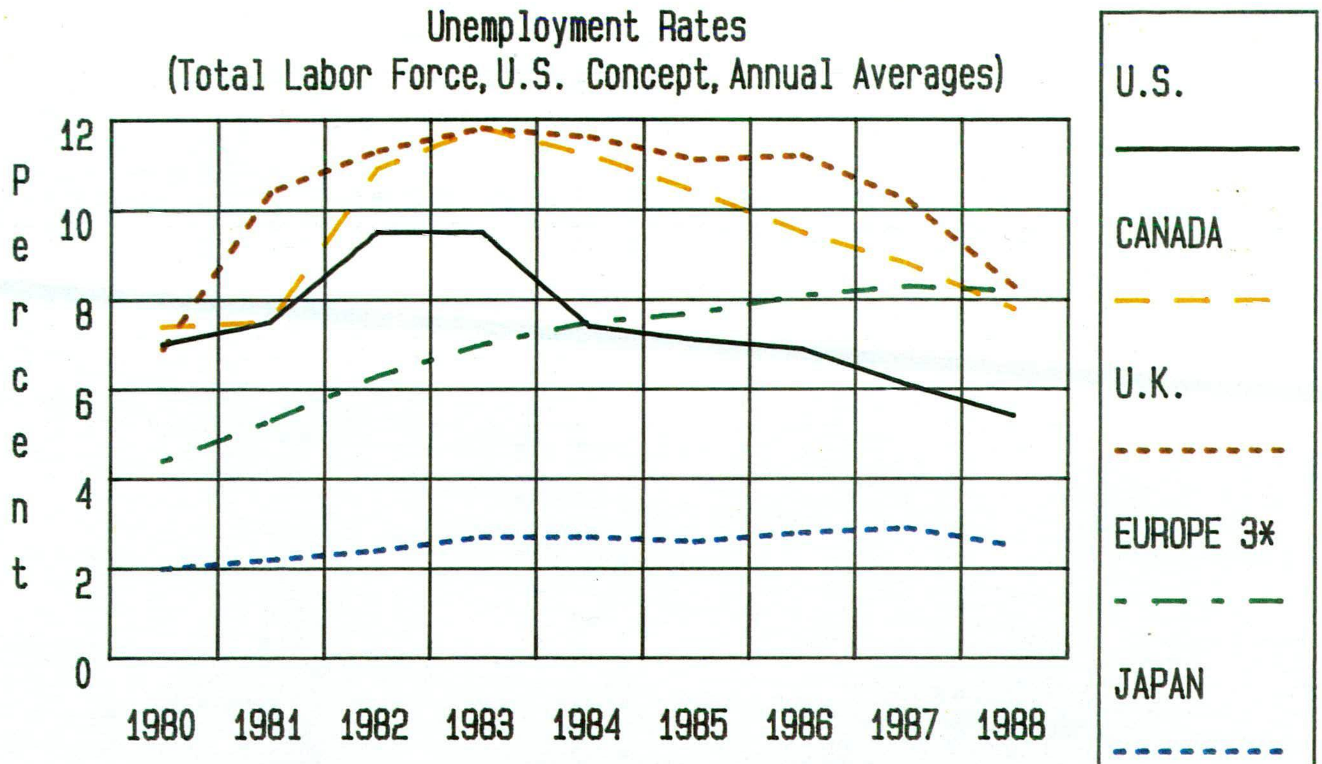
OASIA/IMI 1/13/89

CHART 7

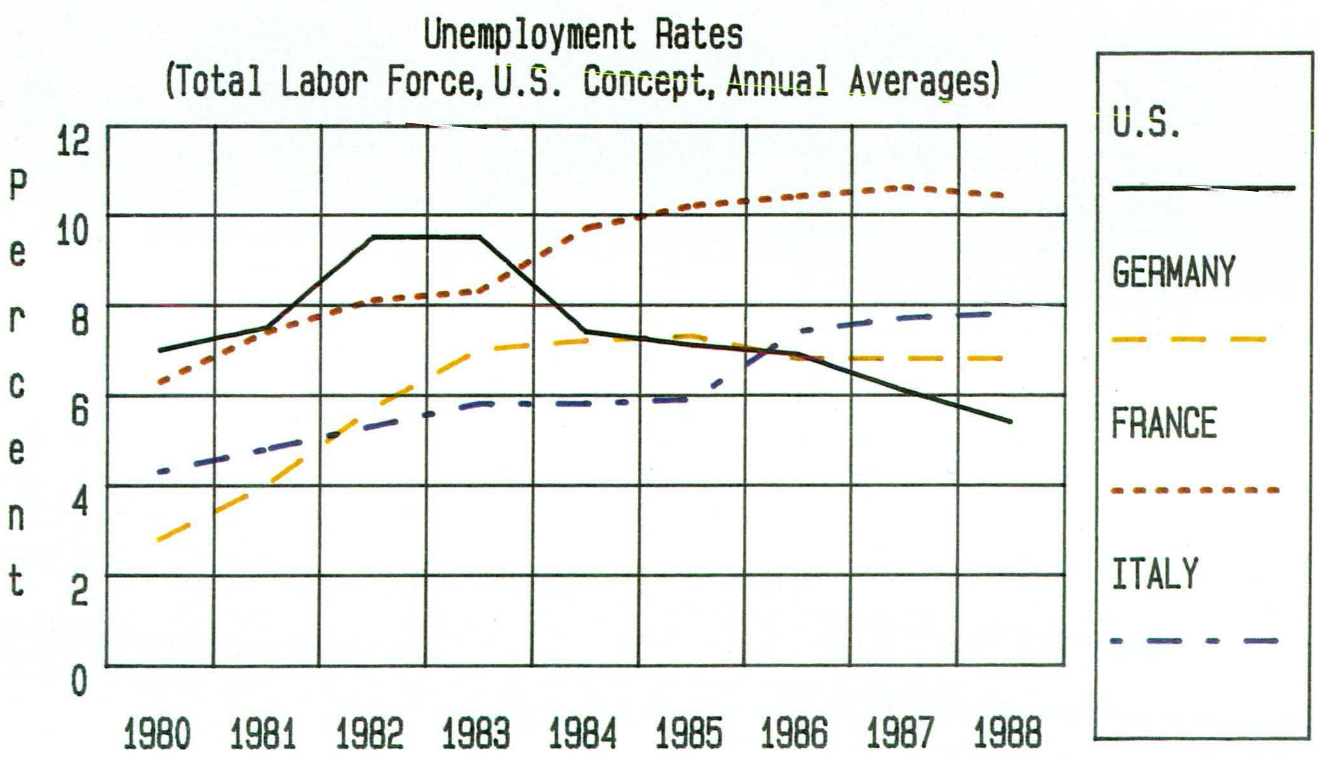


OASIA/IMI 1/17/89

CHART 8



*Europe 3 is Germany, France & Italy



OASIA/IMI 1/19/89

QUESTIONS SUGGESTED BY MULFORD

1. Do Ministers agree with the IMF view that the reduction of imbalances has stalled? If modest further gains envision by countries are realized will these prospects for improvements be sufficient for exchange and financial market stability?

2. What are the policy priorities for surplus countries? Is it preferable to fight potential inflation at the risk of no external adjustment or does the risk of exchange and financial market turbulence warrant that greater priority be given to adjustment?

3. Will US budget deficit reduction alone satisfy external adjustment needs? Are Ministers willing to accept the implications of slower US growth on LDC debt problems and the global economy? If US action is not offset by strong foreign growth is there a risk of recession?

4. Will structural measures by surplus countries, if unaccompanied by new macro measures, represent a credible contribution to correcting imbalances? Will exchange markets see them as sufficient evidence of international cooperation?

5. Are Ministers prepared to accept new exchange rate understandings to facilitate adjustment if other measures are ruled out an insufficient adjustment becomes evident?

CONFIDENTIAL

FROM: N L WICKS
DATE: 27 JANUARY 1989

CHANCELLOR OF THE EXCHEQUER

cc EST
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Lankester
Mr Scholar
Mr H P Evans
Mr Mountfield (B,C,D)
Mr R I G Allen (D)
Mr Melliss (A)
Mr Walsh (B,C)
Mr Ilett (D)
Mr Gieve
Mr Tyrie

Mr Loehnis - B/E

Germany/Japan: ?? looser fiscal, tighter monetary. [US opposite]. Effect on UK?? more relaxed

CW vice versa!

G7 MEETING

I attach, as background for next week's G7 meeting, an account of the discussion at the G7 Deputies' meeting of:

- multilateral surveillance and policy co-ordination - Annex A;
- IMF quota increase - Annex B;
- problem countries - Annex C;
- miscellaneous issues - Annex D.

now in relevant places in folder.

N.L.W.

N L WICKS

WICKS TO CX 27JAN

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ANNEX A

MULTILATERAL SURVEILLANCE AND POLICY CO-ORDINATION

The following points emerged from the G7 Deputies' review of the international and economic situation at their meeting in Zurich on 25-26 January 1989. Trichet (France), detained in Paris by the insider trading issue, was absent from the first part of the discussion on the Thursday evening.

2. Frankel (IMF) described in orthodox terms the economic history of 1988 emphasising:

- the rapid and unexpected increase in activity throughout G7; a 1¼ per cent increase in output appeared within 9 months from March 1988;

- this increase represented "good" activity, business investment, especially in Europe;

- a remarkable inflation performance in view of the rapid output rise (because of productivity growth, helpful oil prices and tightening monetary policy). The inflation rate was in fact better than the published figures suggested because of their upward bias due to factors like the UK's mortgage interest;;

- the substantial improvement in the G7 budgetary position, largely due to revenue from higher activity;

- only one really worrying feature in 1988 which was the slowing down, perhaps even the stopping, in H2 1988 of the adjustment of current account imbalances;

- the unique situation in the UK was acknowledged.

3. Regarding 1989, the Fund had fears of potential inflation, especially since most economies were producing at over-capacity. But he would not exaggerate the risks here. The trend of commodity prices, which were still only at 1980 levels, were not suggesting an inflationary outlook. (This was the only mention of the commodity indicators during the meeting.) Much more worrying in his view were the risks from the slowing down or even stopping

of the adjustment of current account imbalances. The IMF's analysis suggested that the imbalances were here to stay. They could not, in the Fund's view, be reduced by reflation in the surplus countries since they were already operating at near full capacity. The surplus countries needed to find a way of reducing their outflow of savings while the deficit countries needed to increase theirs. This led him to put considerable weight on structural policies which could, in certain circumstances, produce a much quicker response than might be expected. Finally, he warned against placing too much burden on monetary policies at the expense of fiscal action.

4. Mulford (USA) said that this was the worst paper he had ever seen from the IMF. It placed higher priority on avoiding inflation in the surplus countries than on stimulating adjustment to deal with the current account imbalances. The inflationary risk in Japan and Germany were negligible. The paper had nothing new to say about structural adjustment, an issue which G7 Ministers had traditionally found difficult to deal with. The Fund were living in a dreamland and the markets would make a judgement when they saw that G7 Ministers were side-stepping the real issues. He criticised the recent increase in German interest rates. He called on Germany to take the sort of stimulative action the Japanese took in 1987 which had brought beneficial results to the world economy, notably through some reduction in the Japanese current account imbalance, without generating inflation. Gyohten (Japan) replied that these benefits had come, to a large extent, from improved structural policies in Japan, rather than from fiscal stimulus. (Mulford circulated the charts, attached, which he said would be used in briefing the President.)

5. Gyohten accepted the Fund's broad analysis, but was not so pessimistic about the pace of reduction in the imbalances. Particular factors had benefited Japan's current account in 1988: the worldwide investment boom from which their (and German) industries were particularly well placed to benefit; the lower oil price, which they expected to recover in 1989, and the effect on their import bill of their growing import elasticity.

6. Sarcinelli (Italy) saw in the Fund's analysis an implication that the burden of adjustment was being placed unfairly on the

deficit countries, a point which Frankel later strongly contested. Certainly, there needed to be greater emphasis on the continuation of the international adjustment process. He suggested that growth in the surplus countries could be greater without risk of inflation. After all, 1988's higher investment should permit higher growth. He also drew comfort from the shape of the yield curve.

7. Dobson (Canada) agreed that Mulford had correctly prescribed the problem - the need to push forward the adjustment of current accounts - but disagreed with his criticism. Sharing of the adjustment burden was in the centre of the frame. The G7's credibility was at risk. If it emerged that there was disagreement in G7, the markets would take fright.

8. I made the following points.

(i) We believed that the response of the UK economy to the tighter monetary policy was faster than the Fund figures showed; and I passed Frankel a note of the latest evidence.

(ii) On the economic prospect, though there could be arguments about precise figures, we shared the Fund's judgement that the adjustment of the current account imbalances had virtually ceased. Obviously this adjustment process needed to be restarted, but we should not want to rush to the conclusion that 1989 would be a difficult year on account of the reasons described by Mulford. More emphasis should be placed on protectionism as a reason for dealing with the imbalances. As was well known, we did not regard fiscal policy as an instrument for fine tuning demand. For that reason I found it difficult to follow arguments for pressing Germany and Japan to take significant fiscal action. Regarding the US budgetary situation, the debt trap was ineluctably drawing closer and was reason in itself for urgent action on the budget deficit. There was a need in every country, particularly in the surplus countries, for further structural reform which could, depending on the nature of the reform, bring benefits to the international current account adjustment process.

9. Tietmeyer (Germany) said that inflationary risks were defined differently in different countries. Some countries saw dangers if

inflation rose above 5 per cent. Germany had a much lower threshold. There were some inflationary risks in the outlook, especially if the UK, Canada and perhaps the USA did not maintain responsible monetary policies. He did not blame the Bundersbank for the recent interest rate rise (which he hinted could have gone to 1 per cent); after all inflation in Germany had been controlled by appropriate monetary measures. The crucial issue was the external imbalances and that their adjustment had undoubtedly slowed down. But the Deputies' discussion had overlooked the change in the structure of those surpluses. So far as Germany was concerned, it had reduced its trade surplus with the USA and increased it with Europe, especially the UK, Italy and the Netherlands, largely as a result of the booming activity in those countries. There had been a greater degree of adjustment of current account imbalances between the major three countries when they were calculated on a bilateral basis. What looked to be ceasing was the adjustment of the three countries' imbalances with the world as a whole. (Though Tietmeyer made the arithmetic of his point clear, he did not elucidate its consequences for policy.) He would not wish to try to persuade the French to devalue, because of the effect on their own price stabilisation programme. As regards the future, the surplus countries should maintain a higher level of internal demand than GDP growth and should make further progress in the structural reform. He recognised the risk that the US current account deficit might not be financeable, but thought that if the G7 countries were careful, that could be managed. He agreed that there were serious risks from protectionism.

10. In a final intervention, <u>Mulford</u> returned to his theme that the surplus countries were placing greater priority on reducing inflation than in reducing the international current account imbalances. But if those imbalances were not reduced, protectionism would grow, the US would be forced to dump international co-ordination, there would be no further co-operation in the exchange markets and their would be an international recession. (The tenor of Mulford's intervention, can be gauged from the attached questions which he suggested unsuccessfully should be put before G7 Ministers.)

most unattractive

11. Trichet (France), who joined the discussion the following morning, said that Japanese and Germany monetary and fiscal policy was not consistent with the objective of reducing overall world imbalances. There would be problems on foreign exchange markets and on the Stock Exchange if the world financial community perceived that. German economic policy was contrary to what was required. Last week's increases in interest rates were in exactly the wrong direction. He was particularly concerned about the direction of the UK economy, and feared that France might go the same way.

12. The Deputies agreed to summarise their discussion by way of a paper for Ministers which posed the main policy questions. A copy of the paper is attached.

13. It should be suggested to Ministers that they should have a multilateral surveillance discussion at both their February and April meetings.

[Action: **Mr Evans** to prepare a brief focusing on the questions in the Deputies' note.]

M34

FROM: C MELLISS

DATE: 30 January 1989

1. MR WICKS N.L.W. 30.1

2. CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Lankester
Mr R I G Allen
Mr H Evans
Mrs M Brown

Thanks. [illegible] There are clear reasons why structural reforms [illegible] higher personal [illegible] domestic demand [illegible] imports. But I suspect [illegible] [illegible] good for the current a/c.

GERMANY, STRUCTURAL REFORMS AND THE CURRENT ACCOUNT

1. At your meeting on overseas issues last Monday we briefly discussed the reaction of the German current account surplus to a successful programme of structural reform. You wondered whether greater efficiency would lead to a rise in the German current account surplus.

2. The basic principle here is that an economy which increases its efficiency through structural reform may see either an increase or decrease in its current account. The net effect is likely to depend on the responses of national saving and the exchange rate. Thus, if a general programme of structural reform were to raise the rate of return on capital employed, one might expect to see higher investment, higher capital inflows and a smaller current account surplus. However if the effects on aggregate demand are weak, for example because policy does not fully accommodate the increase in supply, then it is quite possible that an increase in aggregate supply might increase the current account surplus and raise the level of national savings, as you suggested.

They didn't greatly help ours in the 1960s & 1970s.

The German Case

3. Data on current account surpluses and rates of growth of output and productivity do not lend much support to a positive relationship between the size of current account surpluses and rates of growth, either across countries or for the same country through time. However it is interesting to note that Germany,

which has seen a slowing in its rate of growth relative to the OECD average from the 1950s through to the 1980's, has run surpluses more persistently than any other G7 country, including Japan. Moreover the surplus as a proportion of GNP has been significantly higher in the 1980s than in previous decades, as Germany's relative growth fell significantly below the OECD average for the first time in the post war period.

4. If the general economic arguments and aggregate data lead to a neutral conclusion, I think one can be more specific about how the German current account surplus might react to a programme of structural reform of the type that we and some German commentators advocate.

5. It is clear that the bulk of German manufacturing industry is unprotected, unregulated and highly competitive on world markets. In 1986 the trade surplus in manufactures was $76 billion, compared with a current account surplus of $40 billion. Manufacturing is also comparatively large, accounting for 33 per cent of GDP, compared with about 20 per cent in the US and UK. Not all manufacturing industries are unprotected, and there are relative high subsidies for steel, shipbuilding and aerospace.

6. The main areas of regulation and protection lie outside manufacturing. Examples are telecommunications (preferential purchasing), insurance and other financial services (non-tariff barriers), agriculture (subsidies in addition to those provided for under the CAP), and retail and road transport (both heavily regulated). In nearly all these cases it is likely that overseas producers have a comparative advantage. The rigidities therefore tend to raise the prices in these sectors and shift demand away from them. Some evidence for this effect is provided by the higher proportion of manufacturing in GDP in Germany than in other G7 countries and the lower proportion of services. Where the structural rigidity takes the form of a non-tariff barrier the overseas producer's share of an already restricted market is further reduced.

7. In addition to these sectoral considerations I think there is some evidence that a general lack of flexibility inhibits macroeconomic adjustment in Germany, in particular by reducing the sensitivity of the current account to exchange rate changes. This may help explain why the German current account surplus, having risen so strongly in 1986 following the fall in oil prices - to $39 billion from $16 billion in 1985 - has since persisted at high levels. (Imports of fuel fell by about $9 bn between 1985 and 1986.) The terms of trade gain represented by the fall in oil prices appears to have been transmitted into an acceleration in the growth of import volumes only to a very limited extent. To put it another way, the rise in the Deutschemark in real terms of about 15 per cent between the beginning of 1986 and the end of 1987 had only a weak impact on trade volumes.

8. How does this lack of responsiveness come about? Partly it is a matter of the non-tariff barriers already alluded to. Partly it is a question of the particular form of protection. For example agricultural subsidies vary with the gap between world and domestic prices, so shielding German producers from Deutschemark appreciation. But there are further factors, not so far mentioned, such as taxes and the labour market. Germany has high marginal rates of tax on both persons and companies and a high average rate of tax on corporations. These factors will tend to reduce the positive employment and supply side consequences that one would expect from a favourable supply side shock such as the fall in oil prices. Although less obviously related to the current account I would expect lower marginal taxes and greater labour market flexibility to increase the responsiveness of the economy to changes in the exchange rate, so easing the problem of correcting the current account imbalance.

<u>Conclusions</u>

9. It is in our interests to encourage structural reforms which give priority to removing barriers to trade and regulations in the services sectors, especially financial services, and to removing subsidies in such as industries as agriculture, coal, and shipbuilding. In none of these industries does Germany have an

obvious comparative advantage, and so these reforms should tend to increase the share of imports in German markets, as well as raising growth potential. These reforms would also benefit manufacturing industry, both by providing access to more efficient services and by allowing resources to switch from services to manufacturing. Nevertheless the net effect of a more open economy in which the comparative advantage of overseas producers is no longer masked by structural rigidities would probably be to reduce the current account surplus.

10. There are also reasons for thinking that certain structural features such as high marginal tax rates and labour market rigidities reduce the responsiveness of the German economy to market signals. Reform in these areas could therefore contribute to faster and more complete adjustment of the balance of payments. Of course none of this is to deny that suitable macroeconomic policies are the main instrument for achieving current account adjustment. X

11. Finally I would note that some, although not all, the same arguments apply in the Japanese case.

ChM

C MELLISS

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

MANAGING DIRECTOR

CABLE AD
INTERF

TO: Mr. Cassell
Mr. Dallara
Mr. Filosa
Mr. Grosche
Mr. Massé
Mrs. Ploix
Mr. Yamazaki

DATE: January 30, 1989

FROM: The Managing Director

SUBJECT: Meeting of Ministers and Governors of Major Industrial Countries

The attached note and tables have been prepared as background for the forthcoming meeting of Ministers and Governors of the major industrial countries. I should be grateful if you would arrange to transmit this material to your authorities.

Attachment

CH/EXCHEQUER
REC. 31 JAN 1989
ACTION Mr HP Evans
COPIES TO Sir P Middleton
Sir T Burns, Mr Wicks,
Mr Lankester, Mr Mellis
Mr Tyrie

31/1

(copy sent to Bank separately).

IMF PAPER

World Economic Situation and Policy Issues

Note by Michel Camdessus

Managing Director, International Monetary Fund

The accompanying material shows the latest estimates for key economic indicators by national authorities and Fund staff. This note briefly reviews the economic outlook and raises some policy considerations.

Recent developments and short-term prospects

The strength of activity in industrial countries has continued to exceed expectations (Table I). Real GNP in the seven major countries rose by 4.2 percent in 1988 and is projected to increase by 3.3 percent in 1989, which would still be slightly above the estimated growth of potential output for these countries. The recent performance extends an unusually long period of economic expansion and has featured a strong rise in business investment. Moreover, the rapid growth of output and demand in 1988 took place in an environment of moderate inflation, partly because rapid increases in non-oil commodity prices were offset by weak oil prices during much of the year (Charts 1 and 2). On average, the rate of increase in consumer prices in the seven countries rose from 2.8 percent in 1987 to 3.1 percent in 1988. As a ratio to GNP, the current account imbalances of Japan and the United States narrowed significantly in 1988 but the pace of adjustment slowed markedly toward the end of the year. Germany's surplus remained unchanged in relation to GNP while the external position deteriorated sharply in the United Kingdom.

Except in Japan, monetary conditions have tightened significantly during the past year, with short-term interest rates rising by 1 1/2 to 2 1/4 percentage points in the United States, Germany, and Canada, and by 4 1/4 percentage points in the United Kingdom. The policy of monetary restraint has reflected concern about the outlook for inflation, particularly in the United States, Canada, and the United Kingdom, where capacity utilization is high by historical standards; efforts to resist downward pressure on exchange rates were also a factor in continental Europe. The relative stability of long-term interest rates suggests that, by allowing short-term rates to increase, the monetary authorities have been successful in preventing a rise in expectations about inflation.

In the area of fiscal policies, notwithstanding the expansionary measures announced in May 1987, Japan's budgetary position strengthened somewhat in 1988 because of significant increases in tax revenue. The federal deficit in the United States widened slightly in nominal terms but it declined somewhat in relation to GNP. In both countries, currently enacted policies suggest that the budgetary situation will change little in 1989. In Germany, the budget deficit widened last year, reflecting a cut in direct taxes early in 1988, but it is expected to decline in 1989 owing partly to an increase in indirect taxes. Fiscal imbalances narrowed in 1988 in Canada and France; the Italian budget deficit remained unchanged at 11 1/2 percent of GNP; and the fiscal position of the United Kingdom shifted into surplus.

Despite significant increases in non-oil commodity prices and strong growth of world trade (estimated at 9 percent in real terms in 1988), the recent performance of the developing countries has been mixed. Many exporters of manufactures, particularly the newly industrialized economies (NIEs) of Asia, have benefited strongly from the favorable international environment; growth has also been strong in China and India. Some of the NIEs have allowed their currencies to appreciate and have begun to liberalize imports in order to reduce their external surpluses. Taiwan's current account surplus narrowed from $18 billion in 1987 to an estimated $8-10 billion in 1988. Despite strong expansion of domestic demand, the surplus of Korea widened from $10 billion in 1987 to some $14 billion in 1988; in 1989, the Fund staff expects Korea's surplus to narrow to $12 billion.

The export earnings of the heavily indebted countries also increased significantly in 1988, but this did not translate into stronger output growth. In the 15 countries targeted in the Baker initiative the rate of increase in real GDP fell from 2.2 percent in 1987 to 1.4 percent in 1988; in sub-Saharan Africa, growth slowed from 1.8 percent in 1987 to 1.5 percent in 1988. While debt-to-export ratios generally declined in 1988, other aspects of the indebted countries' situation remain of concern including a sharp increase in inflation in some major countries, inadequate growth of investment, and a failure of creditworthiness to improve as suggested by a further widening of secondary market discounts on their debt. The rise in interest rates during the past year together with continuing difficulties in domestic policy implementation suggest that growth in the heavily indebted countries will improve only slightly, if at all, in 1989.

Policy considerations

Inflation. The tightening of monetary conditions during 1988 has reduced the danger of an increase in inflation during the period ahead. The rise in interest rates during 1988 was needed to keep inflation under control--particularly in the United Kingdom, Italy, Canada and the United States, where inflationary pressures have been relatively strong--and hence to avoid the risk of a steeper rise in the future. However, the upward pressure on interest rates, which has spilled over to other countries, could have adverse effects on the interest-sensitive components of demand, notably investment. It is likely also to complicate the management of the debt situation and hinder growth in developing countries. To avoid these consequences, and to prevent the crowding out of business investment, it is particularly important to ease the burden on monetary policy by reducing the public sector's absorption of private savings in countries where budget consolidation efforts must be reinforced.

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alr. [illegible]

External imbalances. Although significant progress has been made in reducing external imbalances, signs emerged in the second half of 1988 that the pace of adjustment was slowing. On the basis of current policies and the present pattern of exchange rates it is likely that the imbalances would remain large over the medium term. Thus, a further strengthening of adjustment policies is desirable, which will require contributions from both deficit and surplus countries. In view of the high rate of capacity utilization in the United States, additional action to reduce the federal deficit is essential to limit the expansion of domestic demand in relation to the trend growth of output, and make room for an increase in net exports and sustain the growth of investment. An early announcement of deficit reduction measures would have a most favorable influence on expectations. In surplus countries, policies should seek to sustain adequate growth of domestic demand. While medium-term fiscal objectives and the current buoyancy of demand suggest that the case for stimulating demand in these countries through fiscal action may not be compelling at present, they should be prepared to take timely steps should the need arise. Moreover, decisive action in the area of structural policies will be required.

A strengthening of policy coordination along these lines would reduce the risk of future exchange rate instability and ensure that external adjustment does not come at the expense of capital formation, growth, and price performance. The major industrial countries could also contribute to a substantial improvement in the global outlook by reaffirming their strong commitment to a solution of the debt problem, with emphasis on growth-oriented adjustment programs and all appropriate means of reducing the debt burden.

Structural reform. Much remains to be done to remove structural rigidities and to improve the functioning of markets. While structural reforms cannot substitute for appropriate fiscal and monetary policies, they can play an important role in sustaining growth and alleviating pressures on prices. Structural policies can also facilitate external adjustment by enhancing the flexibility of markets in reacting to changes in policies and relative prices. Measures that would be helpful in this area include reduction of distortions in the tax system that affect household saving in the United States; land reform and enhanced flexibility of the distribution system in Japan; and improvements in labor market policies in Europe, particularly where unemployment remains high. In Germany, there is also scope for reducing industrial subsidies which constitute a heavy burden on fiscal policy and an impediment to external adjustment. In the area of trade policy, there is a continued need for countering protectionism and for opening markets. It is important that countries' commitment to free trade be reinforced through a successful conclusion of the current Uruguay Round of multilateral trade negotiations, including steps to resolve issues related to agricultural subsidies and protection.

~~Ger~~ France services / Ireland also agric (prices, green currencies)

5

DATE : JANUARY 30

TABLE I. PERFORMANCE INDICATORS FOR 1988 AND 1989 AND OUTCOME FOR FIRST THREE QUARTERS OF 1988 1/
(CHANGES IN PERCENT, EXCEPT IF OTHERWISE NOTED)

PRELIMINARY OUTTURN FOR 1988 AS A WHOLE IS INDICATED AS **; * INDICATES THAT OUTTURN DATA APPLY ONLY TO THE FIRST HALF OF

	REAL GNP/GDP GROWTH		REAL TOTAL DOMESTIC DEMAND GROWTH		CONSUMER PRICE INFLATION		CURRENT ACCOUNT BALANCE ($ BILL.)		TRADE BALA ($ BILL.)	
	1988	1989	1988	1989	1988	1989	1988	1989	1988	1
CANADA										
JANUARY 1989 PROJECTIONS	4.2	2.3	5.1	2.7	4.0	3.8	-7.8	-10.6	8.5	8
IMF STAFF, SEPTEMBER 1988	4.2	3.2	5.3	4.0	3.9	3.5	-8.6	-12.0	8.0	[illegible]
IMF STAFF, JANUARY 1989	4.2	2.9	5.1	3.5	4.1	3.9	-7.3	-11.3	8.8	9
FIRST 3 QUARTERS, 1988	4.6		5.7		4.0		-6.3		7.8	
UNITED STATES										
JANUARY 1989 PROJECTIONS	3.8	3.3	2.9	2.8	3.9	3.9	-135.0	-115.0	-123.0	-10
IMF STAFF, SEPTEMBER 1988	4.0	2.8	3.0	2.7	4.1	4.5	-128.9	-129.0	-125.3	-12
IMF STAFF, JANUARY 1989	3.9	3.0	2.9	2.5	4.1	4.7	-123.4	-124.9	-120.9	-11
FIRST 3 QUARTERS, 1988	3.9**		3.0**		4.1**		-135.4		-125.1	
JAPAN										
JANUARY 1989 PROJECTIONS 3/	4.9	4.0	6.7	4.7	0.7	2.0	78.0	71.0	93.0	8
IMF STAFF, SEPTEMBER 1988	5.8	4.2	7.4	4.9	1.1	1.6	78.1	81.3	88.4	8
IMF STAFF, JANUARY 1989	5.8	4.8	7.8	5.3	0.7	1.4	79.4	86.4	94.4	10
FIRST 3 QUARTERS, 1988	6.1		8.4		0.7**		78.2		94.3**	
GERMANY, FED. REP. OF										
JANUARY 1989 PROJECTIONS	3.4	2.5	3.7	2.5	1.2	2.3	48.0	48.0	76.8	7
IMF STAFF, SEPTEMBER 1988	2.9	1.9	3.2	2.0	1.2	2.4	45.0	41.5	73.4	72
IMF STAFF, JANUARY 1989	3.5	2.4	3.7	2.2	1.2	2.4	49.1	52.4	79.4	87
FIRST 3 QUARTERS, 1988	3.4**		3.8**		1.2**		47.1		73.2**	
FRANCE										
JANUARY 1989 PROJECTIONS	3.4	2.8	3.8	2.7	2.7	2.5	-4.0	-4.5	-6.0	-
IMF STAFF, SEPTEMBER 1988	2.9	2.4	3.0	2.4	2.5	2.5	-3.1	-2.9	-4.6	-
IMF STAFF, JANUARY 1989	3.4	2.9	3.5	2.8	2.8	3.0	-3.7	-2.7	-5.5	-
FIRST 3 QUARTERS, 1988	3.4		3.3		2.7**		-2.4		-6.8**	
ITALY										
JANUARY 1989 PROJECTIONS	3.6	3.0	4.2	3.5	4.8	4.0	-3.7	-5.2	-2.6	-
IMF STAFF, SEPTEMBER 1988	3.0	2.4	3.8	2.9	4.9	5.0	-2.8	-4.2	-0.5	-1
IMF STAFF, JANUARY 1989	3.8	3.1	4.2	3.4	5.0	5.3	-2.8	-3.0	-1.0	-1
FIRST 3 QUARTERS, 1988	3.6		3.4		5.0**		-3.8 *		-11.3	
UNITED KINGDOM										
JANUARY 1989 PROJECTIONS 4/	4.5	3.0	6.0	3.0	6.3	5.0	-23.0	-20.0	-33.0	-30
IMF STAFF, SEPTEMBER 1988	4.0	2.5	6.1	2.8	4.9	4.6	-18.5	-19.2	-31.6	-35
IMF STAFF, JANUARY 1989	4.4	3.5	6.2	4.5	4.9	7.3	-25.3	-31.4	-37.6	-43
FIRST 3 QUARTERS, 1988	4.2		6.0 *		4.9**		-25.4**		-36.3**	
MAJOR INDUSTRIAL COUNTRIES										
JANUARY 1989 PROJECTIONS	4.0	3.3	4.2	3.2	3.1	3.3	-47.5	-36.3	13.7	33
IMF STAFF, SEPTEMBER 1988	4.1	3.0	4.2	3.2	3.2	3.5	-38.8	-44.6	7.8	1
IMF STAFF, JANUARY 1989	4.2	3.3	4.4	3.3	3.1	3.8	-34.2	-34.6	17.5	35
FIRST 3 QUARTERS, 1988 5/	4.3		4.5		3.1		-48.0		-3.3	

1/ THE AUTHORITIES' LATEST ESTIMATES ARE INDICATED AS "JANUARY 1989 PROJECTIONS". ACTUAL DATA FOR FIRST THREE QUARTERS (HALF) OF 1988 ARE INDICATED AS PERCENT CHANGES FROM A YEAR EARLIER; CURRENT ACCOUNT AND TRADE BALANCE DATA SHOW THE CUMULATIVE OUTCOME FOR THE FOUR QUARTERS TO Q3 (Q2) 1988 SEASONALLY ADJUSTED; FOR CANADA AND ITALY, TRADE BALANCE DATA SHOW THE CUMULATIVE OUTCOME FOR THE TWELVE MONTHS TO NOVEMBER 1988.

2/ JANUARY 1989 PROJECTIONS PROVIDED BY NATIONAL AUTHORITIES IN NATIONAL CURRENCY OR IN PERCENT OF GNP/GDP HAVE BEEN CONVERTED INTO U.S. DOLLAR USING NATIONALLY PROVIDED EXCHANGE RATES. FOR GERMANY, FED. REP. OF, FRANCE AND ITALY, DATA FOR FIRST THREE QUARTERS (FIRST HALF) ARE ON A TRADE RETURN BASIS.

3/ DATA PERTAIN TO FISCAL YEARS ENDING MARCH 31 OF THE FOLLOWING YEAR.

4/ CONSUMER PRICE FIGURES REFER TO THE RETAIL PRICE INDEX AND ARE ON A FOURTH-QUARTER TO FOURTH-QUARTER BASIS.

5/ WEIGHTED AVERAGE OR SUM OF INDIVIDUAL COUNTRIES' DATA FOR FIRST THREE QUARTERS OR FIRST HALF.

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DATE : JANUARY 30, 1989

TABLE II. COMPOSITE INDICATORS FOR MAJOR SEVEN COUNTRIES — LATEST INDICATORS
(PERCENT CHANGES AT ANNUAL RATES, EXCEPT IF OTHERWISE NOTED)

	1987			1988							
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	SEPT	OCT	NOV	DEC
REAL GNP/GDP	3.8	5.8	5.1	5.5	1.0	4.9	...	...	...	...	...
INDUSTRIAL PRODUCTION	5.0	7.8	8.1	5.9	2.5	7.8	...	1.8	-2.9	...	...
CONSUMER PRICES	3.6	2.9	2.7	2.1	3.4	4.0	...	3.7	4.8	3.1	...
COMMODITY PRICES											
BROAD INDEX, 1980=100	69.7	74.3	76.1	72.4	75.5	76.8	74.8	75.5	74.4	73.3	76.7
PERCENT CHANGE	11.7	29.4	9.9	-18.0	18.2	6.7	-9.9	-24.0	-17.1	-15.8	73.1
NARROW INDEX, 1980=100	79.9	86.0	91.9	89.7	94.0	97.5	96.9	97.1	97.3	95.8	97.7
PERCENT CHANGE	15.4	33.8	30.8	-9.2	20.7	15.8	-2.5	-3.9	2.0	-16.7	26.4
MONETARY GROWTH											
M1	10.3	5.1	5.4	6.6	8.9	6.1	...	-0.2	...	...	...
M2	7.4	6.7	7.3	7.5	8.9	8.5	...	6.0	8.6	6.7	...
SHORT-TERM INTEREST RATES											
NOMINAL	6.0	6.3	6.3	6.0	6.2	7.0	7.6	7.2	7.3	7.5	7.9
REAL 1/	3.4	3.4	3.1	3.2	3.4	3.9	...	4.1	3.9	4.2	...
LONG-TERM INTEREST RATES											
NOMINAL	7.3	8.2	8.2	7.6	7.8	8.1	7.9	8.1	7.9	7.8	7.9
REAL 1/	4.7	5.3	5.0	4.7	5.0	5.0	...	4.9	4.5	4.5	...
EMPLOYMENT	0.9	2.3	1.1	2.1	...	...	...	...	...	...	...
UNEMPLOYMENT RATES	6.8	6.7	6.5	6.3	6.2	6.2	...	6.1	6.0	...	...

1/ NOMINAL INTEREST RATE LESS INCREASE IN CONSUMER PRICE INDEX FROM TWELVE MONTHS EARLIER.

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DATE : JANUARY 30, 1989

TABLE III. SPOT EXCHANGE RATES, AND NOMINAL AND REAL EFFECTIVE EXCHANGE RATES
(PERIOD AVERAGES)

	1980	1987	1988	1985 Q1	1988 JAN.	1988 SEP.	1988 OCT.	1988 NOV.	1988 DEC.	1989 JAN. 27
SPOT EXCHANGE RATES (CURRENCY UNITS PER U.S. DOLLAR EXCEPT AS NOTED)										
CANADA	1.17	1.33	1.23	1.35	1.29	1.23	1.21	1.22	1.20	1.19
JAPAN	227	145	128	258	128	134	129	123	124	129
GERMANY, FED. REP. OF	1.82	1.80	1.76	3.26	1.65	1.87	1.82	1.75	1.76	1.85
FRANCE	4.23	6.01	5.96	9.96	5.58	6.35	6.22	5.97	6.00	6.30
ITALY	856	1296	1302	2021	1214	1393	1357	1299	1295	1355
UNITED KINGDOM (US$/POUND)	2.33	1.64	1.78	1.12	1.80	1.68	1.74	1.81	1.83	1.77
EFFECTIVE EXCHANGE RATES (INDICES, 1974-86=100)										
IN REAL TERMS 1/										
CANADA	91.5	92.5	100.0	98.4	94.7	101.9	102.9	100.7	102.5	104.7
UNITED STATES	85.8	87.4	82.3	142.1	80.4	86.2	83.8	81.1	80.9	83.6
JAPAN	93.2	115.3	122.1	95.0	121.4	119.7	123.0	125.6	124.6	122.2
GERMANY, FED. REP. OF	105.0	108.6	107.7	95.8	109.0	107.0	107.1	107.8	107.7	105.6
FRANCE	105.1	97.5	94.0	87.6	97.0	92.5	92.1	92.4	91.8	90.4
ITALY	95.9	105.1	104.3	98.0	106.2	103.0	103.5	104.4	104.9	103.9
UNITED KINGDOM	114.8	106.9	119.3	112.4	113.6	119.7	121.3	122.5	124.1	124.2
IN NOMINAL TERMS 2/										
CANADA	92.5	85.3	90.3	98.5	85.5	92.2	92.9	90.6	92.2	94.2
UNITED STATES	85.0	91.7	86.4	135.9	85.0	90.2	87.8	85.0	84.8	87.6
JAPAN	92.9	161.9	179.4	113.5	176.5	175.6	180.9	185.9	185.1	181.5
GERMANY, FED. REP. OF	108.1	123.8	122.9	100.1	126.1	121.0	121.4	122.4	122.0	119.7
FRANCE	112.3	85.9	84.0	75.7	86.8	82.3	82.3	83.1	82.7	81.5
ITALY	100.2	70.9	68.4	68.4	70.7	66.8	67.2	68.0	68.2	67.6
UNITED KINGDOM	109.7	82.9	87.4	82.3	85.7	86.2	87.1	88.0	89.1	89.1

1/ BASED ON THE FUND'S CALCULATIONS OF RELATIVE NORMALIZED UNIT LABOR COSTS IN MANUFACTURING IN A COMMON CURRENCY.
2/ BASED ON THE FUND'S MERM CALCULATIONS.

DATE : JANUARY 30,

TABLE IV. NOMINAL AND REAL SHORT-TERM INTEREST RATES 1/
(IN PERCENT, PERIOD AVERAGES)

				1988							19
	1986	1987	1988	JAN.	JULY	AUG.	SEP.	OCT.	NOV.	DEC.	JAN.
NOMINAL RATES											
CANADA	9.0	8.2	9.4	8.4	9.3	9.5	10.2	10.3	10.6	10.9	11
UNITED STATES	6.2	6.0	6.9	6.0	6.9	7.3	7.5	7.6	8.0	8.3	8
JAPAN	5.1	3.9	4.1	3.8	4.0	4.1	4.3	4.3	4.5	4.6	4
GERMANY, FED. REP. OF	4.6	4.0	4.3	3.4	4.9	5.3	4.9	5.0	4.9	5.3	5
FRANCE	7.7	8.1	7.8	8.2	7.3	7.6	7.9	7.9	8.0	8.4	8
ITALY	12.6	11.1	11.0	10.5	11.0	11.0	11.3	11.3	11.5	12.0	12
UNITED KINGDOM	10.9	9.6	10.3	8.8	10.4	11.3	12.1	11.9	12.2	13.0	13
REAL RATES 2/											
CANADA	4.8	3.8	5.4	4.3	5.4	5.5	6.1	6.1	6.5	7.1	7
UNITED STATES	4.3	2.3	2.8	2.0	2.8	3.2	3.3	3.3	3.8	4.3	4
JAPAN	4.5	3.8	3.4	2.9	3.5	3.4	3.7	3.1	3.4	3.6	3
GERMANY, FED. REP. OF	4.8	3.7	3.1	2.7	3.9	4.1	3.5	3.7	3.3	3.7	3
FRANCE	5.2	4.8	5.1	5.8	4.6	4.8	4.9	4.9	5.0	5.2	5
ITALY	6.6	6.6	6.0	5.5	6.1	6.0	6.4	6.6	6.1	6.4	7
UNITED KINGDOM	7.5	5.5	5.3	5.6	5.6	5.6	6.2	5.5	5.8	6.2	6

1/ INTEREST RATES ON THE FOLLOWING INSTRUMENTS: CANADA AND THE UNITED STATES, THREE-MONTH TREASURY BILLS; JAPAN, DISCOUNT RATE ON TWO-MONTH PRIVATE BILLS; FRANCE, THE FEDERAL REPUBLIC OF GERMANY, ITALY, AND THE UNITED KINGDOM, THREE-MONTH INTERBANK LOAN RATES.

2/ NOMINAL RATES LESS INCREASE IN CONSUMER PRICE INDEX FROM TWELVE MONTHS EARLIER; FOR THE MOST RECENT PERIOD, STAFF PROJECTIONS OF THE DEFLATOR ARE USED.

DATE : JANUARY 31, :

A. OUTPUT AND DEMAND
(CHANGES, IN PERCENT, EXCEPT IF OTHERWISE NOTED)

	NATIONAL AUTHORITIES ESTIMATES (IMF STAFF ESTIMATES)									
	1988		1989		1990		1991		1992	
REAL GNP/GDP										
CANADA	4.2	(4.2)	2.3	(2.9)	2.1	(2.5)	3.0	(3.0)	3.5	(3.0)
UNITED STATES	3.8	(3.9)	3.3	(3.0)	3.2	(2.9)	3.3	(2.8)	3.2	(2.8)
JAPAN	4.9	(5.8)	4.0	(4.8)	3.7	(4.3)	3.7	(4.2)	3.7	(4.2)
GERMANY, FED. REP. OF	3.4	(3.5)	2.5	(2.4)	...	(2.8)	...	(2.5)	...	(2.4)
FRANCE	3.4	(3.4)	2.8	(2.9)	2.9	(2.8)	2.9	(2.9)	3.0	(3.0)
ITALY	3.6	(3.8)	3.0	(3.1)	3.1	(3.0)	3.2	(3.0)	3.3	(2.9)
UNITED KINGDOM 1/	4.5	(4.4)	3.0	(3.5)	...	(2.0)	...	(2.8)	...	(2.7)
MAJOR INDUSTRIAL COUNTRIES	4.0	(4.2)	3.3	(3.3)	...	(3.1)	...	(3.1)	...	(3.1)
OTHER INDUSTRIAL COUNTRIES		(3.1)		(2.6)		(2.5)		(2.6)		(2.6)
DEVELOPING COUNTRIES		(4.4)		(3.4)		(4.3)		(4.8)		(4.9)
REAL TOTAL DOMESTIC DEMAND										
CANADA	5.1	(5.1)	2.7	(3.5)	1.2	(2.7)	2.2	(3.3)	3.6	(3.3)
UNITED STATES	2.9	(2.9)	2.8	(2.5)	2.6	(2.7)	2.9	(2.7)	2.9	(2.7)
JAPAN	6.7	(7.8)	4.7	(6.3)	4.2	(4.8)	4.2	(4.0)	4.2	(4.3)
GERMANY, FED. REP. OF	3.7	(3.7)	2.5	(2.2)	...	(3.2)	...	(2.7)	...	(2.4)
FRANCE	3.8	(3.5)	2.7	(2.8)	2.8	(2.8)	2.8	(2.8)	2.9	(3.0)
ITALY	4.2	(4.2)	3.5	(3.4)	3.4	(3.4)	3.4	(3.5)	3.4	(3.4)
ED KINGDOM	6.0	(6.2)	3.0	(4.5)	...	(1.2)	...	(2.5)	...	(2.4)
MAJOR INDUSTRIAL COUNTRIES	4.2	(4.4)	3.2	(3.3)	...	(3.2)	...	(3.2)	...	(3.2)
OTHER INDUSTRIAL COUNTRIES		(3.7)		(2.8)		(2.7)		(2.6)		(2.6)
CHANGES IN REAL FOREIGN BALANCE (IN PERCENT OF GNP/GDP)										
CANADA	-0.9	(-0.9)	-0.3	(-0.5)	0.8	(-0.1)	0.9	(-0.3)	-0.1	(-0.3)
UNITED STATES	1.0	(0.9)	0.5	(0.4)	0.5	(0)	0.5	(0)	0.3	(0.1)
JAPAN	-1.6	(-2.0)	-0.7	(-0.5)	-0.5	(-0.5)	-0.5	(-0.4)	-0.5	(-0.1)
GERMANY, FED. REP. OF	-0.3	(-0.2)	-0.1	(0.2)	...	(-0.4)	...	(-0.2)	...	(0)
FRANCE	-0.4	(-0.1)	0.1	(0.1)	0.1	(0)	0.1	(0.1)	0.1	(0)
ITALY	-0.6	(-0.5)	-0.5	(-0.3)	-0.3	(-0.5)	-0.2	(-0.5)	-0.1	(-0.5)
UNITED KINGDOM	-3.5	(-3.3)	0.3	(-1.5)	...	(0.7)	...	(0.3)	...	(0.3)
MAJOR INDUSTRIAL COUNTRIES	-0.2	(-0.2)	0	(0)	...	(-0.1)	...	(-0.1)	...	(0)
OTHER INDUSTRIAL COUNTRIES		(-0.6)		(-0.2)		(-0.1)		(0)		(0)

1/ AVERAGE MEASURE OF GDP.

GENERAL NOTE: THE ESTIMATES SHOWN REFLECT DIFFERING NATIONAL PRACTICES. FOR CHARACTERIZATIONS OF NATIONAL ESTIMATES, SEE THE ATTACHED GENERAL AND TABLE-SPECIFIC NOTES. THE SAME DEGREE OF PRECISION IS APPLIED FOR ALL COUNTRIES SOLELY AS A MATTER OF CONVENIENCE. IT IS NOT INTENDED TO CONVEY ANY CONNOTATION REGARDING THE DEGREE OF ACCURACY ATTACHING TO THESE ESTIMATES AND PROJECTIONS. THE PROJECTIONS BY NATIONAL AUTHORITIES WERE SUBMITTED IN JANUARY 1989. THE IMF STAFF PROJECTIONS IN THIS AND THE FOLLOWING TABLES WERE FINALIZED ON JANUARY 18, 1989 AND REFLECT THE FOLLOWING WORKING ASSUMPTIONS: OIL PRICES ARE ASSUMED TO AVERAGE $13.20 PER BARREL IN 1989, $14.30 PER BARREL IN 1990 AND TO REMAIN CONSTANT IN REAL TERMS THEREAFTER; EXCHANGE RATES ARE ASSUMED TO REMAIN UNCHANGED IN REAL TERM FROM THE AVERAGE LEVEL PREVAILING IN DECEMBER, 1988; "PRESENT" ECONOMIC POLICIES OF THE NATIONAL AUTHORITIES ARE ASSUMED TO BE MAINTAINED. UNLESS OTHERWISE NOTED, IMF STAFF PROJECTIONS REFER TO CALENDAR YEARS.

DATE : JANUARY 30,

B. INFLATION
(CHANGES, IN PERCENT)

	NATIONAL AUTHORITIES ESTIMATES (IMF STAFF ESTIMATES)				
	1988	1989	1990	1991	1992
GNP/GDP DEFLATOR					
CANADA	4.1 (4.1)	3.3 (3.9)	3.1 (3.5)	2.8 (3.4)	3.0 (3.3)
UNITED STATES	3.3 (3.4)	4.0 (4.6)	3.6 (4.5)	3.2 (4.3)	2.7 (4.1)
JAPAN	0.5 (0.5)	1.2 (1.3)	1.0 (1.2)	1.0 (1.1)	1.0 (1.0)
GERMANY, FED. REP. OF	1.9 (1.8)	2.0 (2.2)	... (2.4)	... (2.3)	... (2.2)
FRANCE	2.7 (2.9)	2.5 (2.9)	2.3 (2.4)	2.1 (2.5)	2.0 (2.5)
ITALY	5.0 (5.6)	4.3 (5.5)	3.6 (4.7)	3.6 (4.4)	3.6 (4.0)
UNITED KINGDOM	6.3 (6.0)	5.0 (6.6)	3.5 (5.8)	3.0 (4.5)	... (4.0)
MAJOR INDUSTRIAL COUNTRIES	2.9 (3.0)	3.1 (3.7)	... (3.4)	... (3.2)	... (3.0)
CONSUMER PRICES					
CANADA	4.0 (4.1)	3.8 (3.9)	3.5 (3.4)	3.2 (3.4)	3.2 (3.3)
UNITED STATES	3.9 (4.1)	3.9 (4.7)	3.7 (4.5)	3.2 (4.3)	2.7 (4.1)
JAPAN	0.7 (0.7)	2.0 (1.4)	1.5 (1.0)	1.5 (1.0)	1.5 (1.0)
GERMANY, FED. REP. OF	1.2 (1.2)	2.3 (2.4)	... (2.4)	... (2.3)	... (2.2)
FRANCE	2.7 (2.8)	2.5 (3.0)	2.3 (2.5)	2.1 (2.5)	2.0 (2.5)
ITALY	4.8 (5.0)	4.0 (5.3)	3.3 (4.6)	3.3 (4.4)	3.3 (4.0)
UNITED KINGDOM	6.3 (4.9)	5.0 (7.3)	... (5.8)	... (4.5)	... (4.0)
MAJOR INDUSTRIAL COUNTRIES	3.1 (3.1)	3.3 (3.8)	... (3.4)	... (3.1)	... (3.0)

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DATE : JANUARY 30

C. CURRENT ACCOUNT AND TRADE BALANCES

NATIONAL AUTHORITIES ESTIMATES (IMF STAFF ESTIMATES)

	1988		1989		1990		1991		1992	
CURRENT ACCOUNT (IN BILLIONS OF U.S. DOLLARS)										
CANADA	-8	(-7)	-11	(-11)	-9	(-13)	-4	(-15)	-4	(-18)
UNITED STATES	-135	(-123)	-115	(-125)	-110	(-137)	-95	(-150)	-85	(-162)
JAPAN 1/	78	(79)	71	(86)	66	(93)	62	(98)	60	(104)
GERMANY, FED. REP. OF	48	(49)	48	(52)	...	(53)	...	(54)	...	(57)
FRANCE	-4	(-4)	-5	(-3)	-3	(-3)	-2	(-2)	0	(-2)
ITALY	-4	(-3)	-5	(-3)	-5	(-5)	-4	(-8)	-3	(-10)
UNITED KINGDOM	-23	(-25)	-20	(-31)	...	(-30)	...	(-29)	...	(-29)
MAJOR INDUSTRIAL COUNTRIES	-47	(-34)	-36	(-35)	...	(-43)	...	(-54)	...	(-61)
OTHER INDUSTRIAL COUNTRIES		(-8)		(-10)		(-12)		(-12)		(-12)
DEVELOPING COUNTRIES		(-19)		(-28)		(-33)		(-27)		(-27)
CURRENT ACCOUNT (IN PERCENT OF GNP/GDP)										
CANADA	-1.6	(-1.5)	-2.0	(-2.1)	-1.6	(-2.3)	-0.8	(-2.6)	-0.7	(-2.8)
UNITED STATES	-2.8	(-2.5)	-2.2	(-2.4)	-1.9	(-2.4)	-1.6	(-2.5)	-1.3	(-2.5)
JAPAN 1/	2.7	(2.8)	2.2	(2.7)	2.0	(2.6)	1.8	(2.5)	1.7	(2.5)
GERMANY, FED. REP. OF	4.0	(4.0)	3.9	(4.0)	...	(3.8)	...	(3.6)	...	(3.6)
FRANCE	-0.4	(-0.4)	-0.4	(-0.3)	-0.3	(-0.3)	-0.2	(-0.2)	0	(-0.2)
ITALY	-0.4	(-0.3)	-0.6	(-0.3)	-0.5	(-0.5)	-0.4	(-0.7)	-0.3	(-0.9)
UNITED KINGDOM	-2.8	(-3.1)	-2.3	(-3.4)	...	(-3.0)	...	(-2.7)	...	(-2.6)
MAJOR INDUSTRIAL COUNTRIES	-0.4	(-0.3)	-0.3	(-0.3)	...	(-0.3)	...	(-0.4)	...	(-0.4)
OTHER INDUSTRIAL COUNTRIES		(-0.5)		(-0.5)		(-0.6)		(-0.5)		(-0.5)
DEVELOPING COUNTRIES		(-0.5)		(-0.8)		(-0.8)		(-0.6)		(-0.5)
TRADE BALANCE (IN PERCENT OF GNP/GDP)										
CANADA	1.8	(1.8)	1.6	(1.7)	2.2	(1.5)	2.9	(1.4)	2.6	(1.3)
UNITED STATES	-2.5	(-2.5)	-1.9	(-2.2)	-1.5	(-2.2)	-1.2	(-2.1)	-0.9	(-2.0)
JAPAN	3.2	(3.3)	2.8	(3.2)	2.5	(3.1)	2.4	(3.0)	2.2	(2.9)
GERMANY, FED. REP. OF	6.4	(6.5)	6.4	(6.7)	...	(6.4)	...	(6.3)	...	(6.2)
FRANCE	-0.6	(-0.6)	-0.6	(-0.5)	-0.4	(-0.5)	-0.3	(-0.5)	-0.1	(-0.6)
ITALY	-0.3	(-0.1)	-0.5	(-0.1)	-0.5	(-0.3)	-0.5	(-0.6)	-0.4	(-0.7)
UNITED KINGDOM	-4.0	(-4.6)	-3.5	(-4.7)	...	(-4.3)	...	(-3.9)	...	(-3.7)
MAJOR INDUSTRIAL COUNTRIES	0.1	(0.1)	0.3	(0.3)	...	(0.2)	...	(0.2)	...	(0.2)
OTHER INDUSTRIAL COUNTRIES		(-0.5)		(-0.5)		(-0.6)		(-0.5)		(-0.5)
DEVELOPING COUNTRIES		(0.8)		(0.5)		(0.4)		(0.3)		(0.3)

1/ NATIONAL AUTHORITIES' ESTIMATES ARE ON A FISCAL YEAR BASIS.

DATE : JANUARY 30,

D. FISCAL BALANCES

NATIONAL AUTHORITIES ESTIMATES (IMF STAFF ESTIMATES)

	1988		1989		1990		1991		1992	
BUDGET BALANCE — NATIONAL CONVENTIONS (IN PERCENT OF GNP/GDP) 1/										
CANADA	-3.5	(-3.5)	-4.7	(-4.2)	-4.0	(-3.7)	-3.3	(-3.6)	-2.7	(-3.3)
UNITED STATES	-3.2	(-3.2)	-3.2	(-3.3)	-1.7	(-2.6)	-1.1	(-2.3)	-0.5	(-1.9)
JAPAN	-2.4	(-2.4)	-1.8	(-1.8)	...	(...)	...	(...)	...	(...)
GERMANY, FED. REP. OF	-2.6	(-2.6)	-2.1	(-2.0)	...	(-2.2)	...	(-2.1)	...	(-1.9)
FRANCE	-2.0	(-1.8)	-1.7	(-1.6)	-1.4	(-1.5)	-1.1	(-1.3)	-0.8	(-1.1)
ITALY	-11.0	(-11.5)	-10.1	(-11.7)	-8.7	(-11.4)	-7.3	(-10.9)	-6.1	(-10.4)
UNITED KINGDOM	2.0	(2.4)	2.0	(2.7)	...	(2.5)	...	(2.0)	...	(1.0)
GENERAL GOVERNMENT BALANCE (IN PERCENT OF GNP/GDP) 2/										
CANADA	-3.1	(-3.3)	-4.0	(-4.4)	-3.9	(-3.8)	-3.2	(-3.6)	-2.4	(-3.1)
UNITED STATES	-2.1	(-2.1)	-2.0	(-2.2)	-0.5	(-1.6)	0	(-1.3)	-0.7	(-0.9)
JAPAN 3/ 4/	...	(...)	...	(...)	...	(...)	...	(...)	...	(...)
GERMANY, FED. REP. OF 3/	...	(-2.0)	...	(-0.8)	...	(-1.4)	...	(-1.2)	...	(-1.1)
FRANCE	-1.6	(-1.9)	-1.6	(-1.8)	-1.3	(-1.7)	-1.0	(-1.4)	-0.7	(-1.3)
ITALY	-9.9	(-10.4)	-9.5	(-10.4)	-8.2	(-10.0)	-7.0	(-9.6)	-5.8	(-9.2)
UNITED KINGDOM	0.8	(0.5)	...	(1.7)	...	(1.9)	...	(1.0)	...	(0)
MAJOR INDUSTRIAL COUNTRIES	...	(-1.9)	...	(-1.6)	...	(-1.3)	...	(-1.1)	...	(-1.0)

1/ CANADA; CENTRAL GOVERNMENT (FISCAL YEAR BASIS); UNITED STATES: FEDERAL GOVERNMENT (FISCAL YEAR BASIS); JAPAN: CENTRAL GOVERNMENT GENERAL ACCOUNT (FISCAL YEAR BASIS) — REFLECTS BOND FINANCING OF GENERAL ACCOUNT; GERMANY: TERRITORIAL AUTHORITIE FRANCE: CENTRAL GOVERNMENT; ITALY: CENTRAL GOVERNMENT; UNITED KINGDOM: PUBLIC SECTOR BORROWING REQUIREMENT (FINANCIAL YEAR BASIS).

2/ NATIONAL INCOME ACCOUNTS BASIS.

3/ THE JAPANESE AND GERMAN AUTHORITIES DO NOT FIND THIS CONCEPT MEANINGFUL.

4/ IMF STAFF ESTIMATES OF THE GENERAL GOVERNMENT BALANCE FOR JAPAN ARE 1.1 PERCENT OF GNP IN 1988, 1.3 PERCENT OF GNP IN 1989, AND 1.5 PERCENT OF GNP IN 1990, 1991 AND 1992.

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DATE : JANUARY 30,

E. MONETARY CONDITIONS

	NATIONAL AUTHORITIES ESTIMATES (IMF STAFF ESTIMATES)				
	1988	1989	1990	1991	1992
MONETARY GROWTH RATES: TARGET OR FORECASTED AGGREGATE (IN PERCENT) 1/					
CANADA (M1)	4.4 (3.4)	2.9 (7.4)	6.7 (6.8)	8.9 (6.5)	7.5 (6.3)
UNITED STATES (M2)	5.4 (5.4)	3 – 7 (3 – 7)	2.5–6.5 (3 – 7)	2 – 6 (2.5–6.5)	1.5–5.5 (2 – 6)
(M3)	6.3	3.5–7.5	3 – 7	2.5–6.5	2 – 6
JAPAN (M2+CD)	10.7 (10.5)	9 (10.0)	8 (10.0)	8 (9)	8 (8)
GERMANY, FED. REP. OF (M3)	... (6.7)	... (5.0)	... (4.9)	... (4.5)	... (4.5)
FRANCE (M2)	4 (5)	4 – 6 (4)	5 (4)	5 (4)	5 (4)
ITALY (M2)	6 – 9 (9.0)	... (7.5)	... (7.5)	... (5.5–8.5)	... (5 – 8)
UNITED KINGDOM (M0)	1 – 5 (8)	1 – 5 (6.0)	0 – 4 (4.5)	0 – 4 (4.5)	... (4.0)
SHORT-TERM INTEREST RATES — NOMINAL					
CANADA	9.7	11.1	9.6	8.0	7.7
UNITED STATES	6.6	6.3	5.5	4.5	4.0
JAPAN	4.1	...	...	...	...
GERMANY, FED. REP. OF	...	...	...	...	...
FRANCE	7.9	8.0	7.0	6.3	5.5
ITALY	11.2	...	...	...	...
UNITED KINGDOM	...	...	...	...	...
LONG-TERM INTEREST RATES — NOMINAL					
CANADA	11.3	11.6	10.9	9.9	9.4
UNITED STATES	8.9	8.3	7.2	6.0	5.0
JAPAN	5.1	...	...	...	...
GERMANY, FED. REP. OF	...	...	...	...	...
FRANCE	9.0	9.0	8.5	8.0	7.5
ITALY	12.1	...	...	...	...
UNITED KINGDOM	...	...	...	...	...

1/ NATIONAL AUTHORITIES DATA FOR THE UNITED STATES AND THE FEDERAL REPUBLIC OF GERMANY AND IMF STAFF ESTIMATES FOR ALL COUNTRIES REFER TO THE RATE OF CHANGE DURING YEAR.

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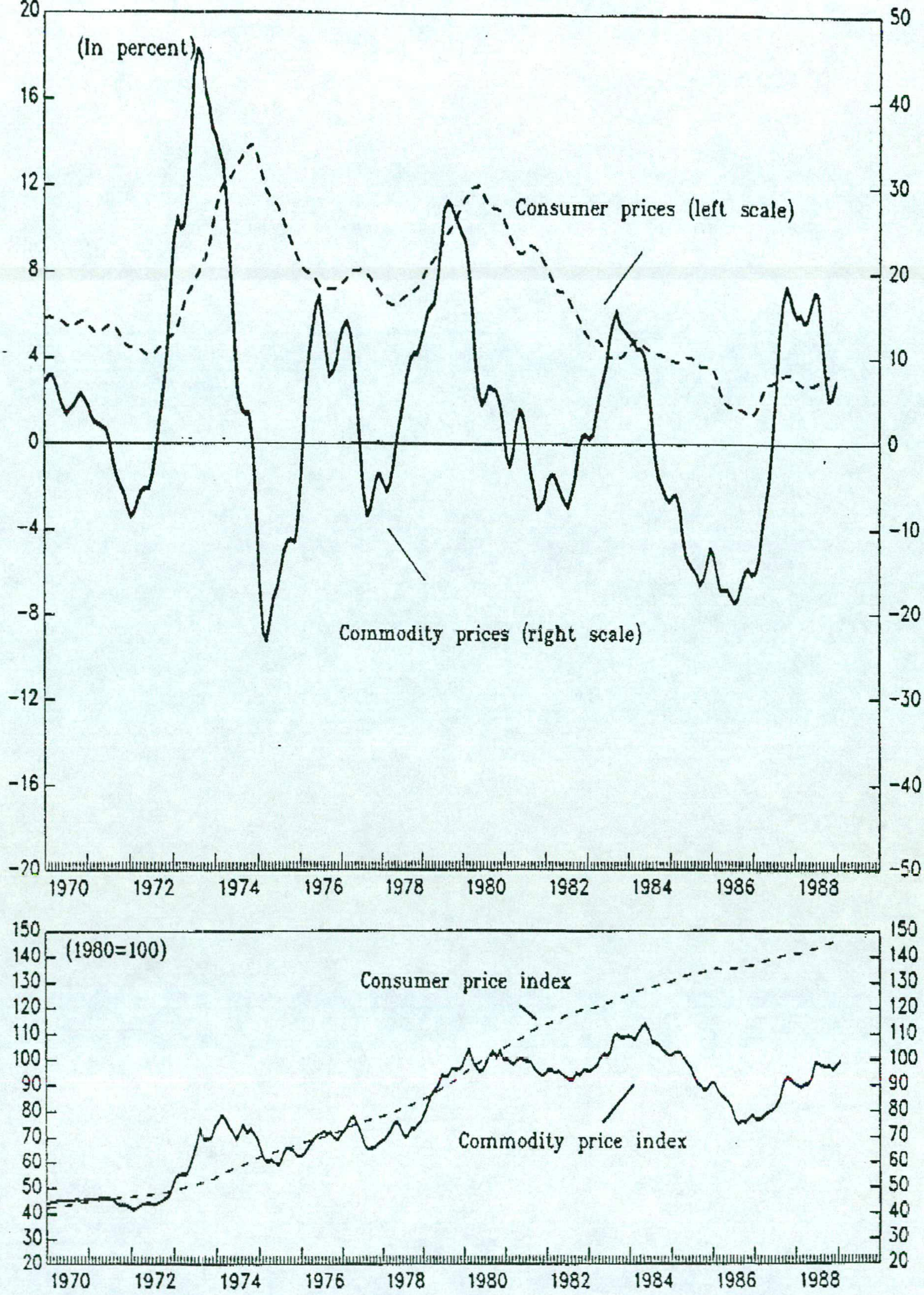
Chart 1. Inflation Rates for Non-oil Commodity Prices and G-7 Consumer Prices 1/



1/ Commodity prices are denominated in SDRs; consumer prices are measured in local currencies and are averaged using GNP weights. The top panel shows 3-month centered moving averages of 12-month inflation rates. Consumer prices are shown through November 1988. Commodity prices for January 1989 are estimates based on actual data for January 1-20.

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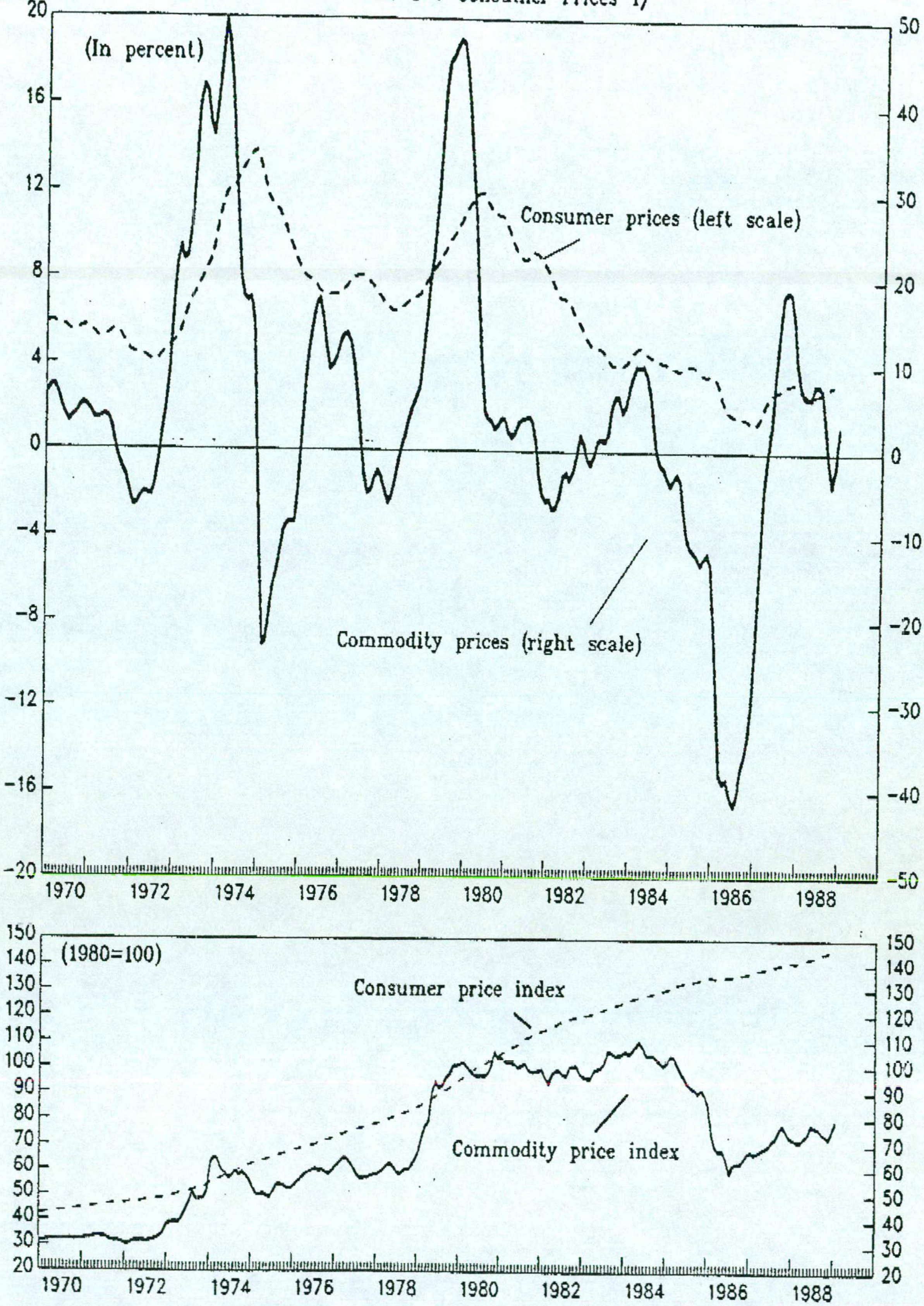
Chart 2. Inflation Rates for Commodity Prices Including Oil and G-7 Consumer Prices 1/



1/ Commodity prices are denominated in SDRs; consumer prices are measured in local currencies and are averaged using GNP weights. The top panel shows 3-month centered moving averages of 12-month inflation rates. Consumer prices are shown through November 1988. Commodity prices for January 1989 are estimates based on actual data for January 1-20.

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January 30, 1989

Notes to Economic Indicator Tables

The national authorities' estimates shown in Tables A-E were submitted early in January 1989 and reflect a variety of national conventions, forecasting procedures, and working assumptions. The following notes clarify the main differences in the various estimates, first by providing a general characterization for each country, and second by listing some table-specific comments.

1. General characteristics

Canada

The estimates are on a calendar year basis. They were prepared in December 1988 and reflect the third quarter 1988 Income and Expenditure Accounts. The policy assumptions reflect status quo fiscal policies at both the federal and provincial level and do not make provision for Stage II of the Tax Reform, the timing and exact form of which remain uncertain. The estimated impact of the Canada/U.S. Free Trade Agreement is reflected in the estimates. The exchange rate is assumed to average C$1.22 per U.S. dollar over the forecast period.

United States

The economic forecast was prepared in mid-November 1988 and is on a calendar year basis. The Budget estimates were prepared in December 1988 and pertain to fiscal years ending September 30 of the year indicated. For 1991-92, the economic indicators are objectives, not forecasts or projections.

Japan

The estimates pertain to fiscal years ending March 31 of the following year. The exchange rate assumption is ¥123 per dollar, the average rate prevailing from end-November to end-December 1988. With the exception of monetary conditions, data for FY 1988-89 are based on the FY 1988 and FY 1989 budgets, and the Economic Outlook for FY 1989.

Monetary growth for FY 1988-92, real total domestic demand, the change in the real foreign balance, the current account, and the trade balance for FY 1990-92 were prepared by the Fund staff on the basis of bilateral discussions with the Japanese authorities. These data are preliminary technical figures and not objectives or projections for each fiscal year. (See table-specific notes.)

Federal Republic of Germany

The estimates are on a calendar year basis. For 1988 they reflect the publication of the Federal Statistical Office of January 1989. For

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1989 the estimates are based on the Federal Government's 1989 forecast. The medium-term estimates will be revised not earlier than May 1989, when the budgetary projections for 1989-93 will be developed. The exchange rate is assumed to average DM 1.75 per dollar in 1989.

France

The estimates were prepared in early January 1989. They are based on the assumption of a constant exchange rate of FF 6 per dollar (the average exchange rate of July 1988). Oil prices are assumed to average $14 per barrel in 1988 and $15 per barrel in 1989.

Italy

The estimates are on a calendar year basis and were prepared on the basis of "Relazione Previsionale e Programmatica" published at the end of September 1988. The conversion factor is Lit 1300 per U.S. dollar throughout the projection period.

United Kingdom

The estimates pertain to calendar years except for the GDP deflator, monetary growth and the budget indicators, which refer to financial years ending March 31 of the following year. They are based on the Autumn Statement forecast published in November 1988 and assume that the exchange rate will remain at the outturn for 1988, $1.79.

Other industrial countries and developing countries

Estimates are based on Fund staff projections under preparation for the February 1989 World Economic Outlook.

2. Table-specific notes

Table A--Output and Demand

Real GNP/GDP. Estimates pertain to GNP for the United States, Japan, and the Federal Republic of Germany, and to GDP for other countries. For Japan, data for FY 1990-92 are based on a mechanical interpolation of average annual figures for the period covered by the Five-Year Economic Management Plan (May 1988) and should not be interpreted as objectives or projections for each fiscal year. For the United Kingdom the average measure of GDP is used throughout the table.

Real total domestic demand. For Japan, data for FY 1990-92 are based on the average annual figures for GNP growth and the growth contribution of real total domestic demand assumed in the Five-Year Economic Management Plan.

Change in real foreign balance. For the United States, data are calculated as the change in the share of the real net export balance in real GNP. For other countries, data are calculated as the difference between the growth rates of real GNP/GDP and real total domestic demand.

Table B--Inflation

GNP/GDP deflator. Estimates pertain to GNP for the United States, Japan, and the Federal Republic of Germany, and to GDP for other countries. For Japan, data for 1990-92 are based on a mechanical interpolation of the average annual figures for the period covered by the Five-Year Economic Management Plan and should not be interpreted as objectives or projections for each fiscal year. For the United Kingdom, the deflator is for GDP at market prices and changes in it were published for financial years in the Autumn Statement as in the FSBR; projections up to 1991-92 were contained in a footnote to Table 1.10 in the Autumn Statement.

Consumer prices. For Japan, data for 1990-92 are based on a mechanical interpolation of the average annual figures for the period covered by the Five-Year Economic Management Plan and should not be interpreted as objectives or projections for each fiscal year. For the United Kingdom, figures refer to the retail price index and are on a fourth-quarter-to-fourth-quarter basis.

Table C--Current account and trade balance

For the United States, estimates of current account and trade balances from 1989 to 1992 are indicated as mid-points of the ranges projected by the authorities. For the current account these ranges are (in U.S.$ billion): 1989: -105 to -125; 1990: -100 to -120; 1991: -85 to -105; 1992: -75 to -95; for the trade balance the ranges are: 1989: -90 to -110; 1990: -75 to -95; 1991: -60 to -80; 1992: -50 to -70. For Japan, data for FY 1990-92 are illustrative Fund staff estimates consistent with the growth rates for real GNP and real total domestic demand as explained above. The exchange rate assumption is ¥123 per dollar.

Table D--Fiscal balances and monetary conditions

Budget balance--national conventions. The data for the United States, Japan, and the United Kingdom pertain to the fiscal or financial years of each country. For the United States, Japan, Canada, France, and Italy, the data refer to federal or central government. For the United States, figures are on a unified budget basis. For the Federal Republic of Germany, the data refer to the Territorial Authorities. For Japan, the budget balance refers to the general account of the central government. Data for FY 1988-89 are based on the Budget for FY 1988 and FY 1989. The medium-term fiscal objective is summarized in the Five-Year Economic Management Plan as follows:

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"The Government will try to eliminate the dependence on deficit financing bonds by FY 1990 and to reduce the ratio of government bond issues to total expenditures during the time covered by the Plan."

For Italy, taking into account the most recent estimate of the State Sector deficit and the fact that the rate of growth should be higher than expected, the authorities estimate a State Sector deficit of around 11.5 percent of GDP in 1988. For the United Kingdom, the data refer to the Public Sector Borrowing Requirement; the Autumn Statement gave a forecast for 1988/89 only, and assumed a similar PSBR in 1989/90 as in 1988/89.

General government balance. Except as noted, estimates are on a national accounts basis. For the United States, Federal budget figures are on a unified basis while figures for state and local governments are on a national accounts basis. For the United Kingdom, the estimate for 1988/89 is based on the published figures for general government expenditure and receipts, adjusted for privatization proceeds.

Monetary growth. For Canada, the data are projections rather than targets. For the United States, the data are on a fourth-quarter-to-fourth-quarter basis. The growth rates of M2 and M3 in 1988 compare with target growth ranges of 4-8 percent for both aggregates. The target ranges for 1989 are tentative and those beyond have not been considered officially by the Federal Reserve. The figures shown are indicative of a trend toward lower ranges over time, consistent with the objective of promoting non-inflationary economic growth. For Japan, the data are based mainly on an extrapolation of the relationship between monetary growth and the change in nominal GNP observed between 1984 and 1987. For the United Kingdom, no revised financial year monetary targets for M0 were published in the Autumn Statement; the table reiterates the targets as set out in the FSBR.

Interest rates. Short-term interest rates on the following instruments: Canada, 90-day commercial paper; United States, 91-day T-bills; Japan, the average of the discount rate on two-month private bills from April to December 1988; the Federal Republic of Germany, Frankfurt interbank offer rate for three-month funds; France, money market rate; Italy, gross rates on three-month Treasury Bills. Long-term interest rates on the following instruments: Canada, McLeod Young Weir bonds; United States, 10-year Treasury bonds; Japan, average of 10-year government bonds with longest remaining period to maturity, from April to December 1988; the Federal Republic of Germany, Federal bonds with 7 to 10 years to maturity; France, first-class bonds; Italy, gross average rate on bonds of industrial credit institutions.

Deputies' Report

The Deputies have conducted an assessment of economic developments in light of the short-term performance indicators and medium-term objectives and projections. Our principle conclusions are as follows:

Performance Indicators

Growth and Inflation

During 1988 demand and output growth have continued to exceed earlier expectations. Output in the G-7 economies expanded by more than 4 percent thereby exceeding last March projections by more than one percentage point. The strength of demand during the year reflects a remarkable rapid growth of business investment.

Inflation has remained fairly moderate given the strength of economic activity. For the G-7 economies as a group consumer price inflation rose from 2.8 percent in 1987 to 3.1 percent in 1988. Factors that have contributed to restrain the inflationary pressures include strong productivity growth, weakness of oil prices (until late in 1988) and steps to tighten monetary conditions. In spite of these factors, in some of the G-7 economies inflation remains a problem. If the momentum of aggregate demand remains strong then renewed inflationary pressures could not be ruled out. This risk is most pronounced in Canada, the United Kingdom and the United States where the degree of slack has diminished substantially and capacity constraints have appeared in certain sectors. Against this background, the reduction in growth to 3.3 percent that is projected for 1989 in the G-7 economies is viewed as a positive development.

DEPUTIES REPORT

External Balance

During 1988 the current account deficit of the United States is estimated to have declined by about $ 30 billion from its level in 1987. The current account surplus of Japan is estimated to have declined by about $ 8 billion while the surplus of Germany is estimated to have risen somewhat in dollar terms. The external balance of the United Kingdom continued to deteriorate during 1988. During most of the year the pattern of demand and output growth in the countries with the largest imbalances was consistent with balance of payments adjustment. In the United States the growth of output exceeded the growth of demand by about one percentage point while in Japan demand growth exceeded output growth by almost 2 percentage points. In Germany the difference between demand and output growth was about 0,3 of one percent. Developments during the latter part of the year suggest that the pace of adjustment has slowed down considerably. Indeed, the projections for 1989 indicate that the discrepancies between output and demand growth in the United States Japan and Germany that are necessary for external adjustment are likely to narrow down significantly, thereby reducing the pace of adjustment. The imbalance is projected in 1989 to exceed 2 percent of GNP in the United States and Japan and to reach almost 4 percent in Germany (most of which is with respect to other European economies).

Key Issues

1. Do Ministers and Governors believe that the projected evolutionof output and demand growth indicates a danger of a significant slowdown in the pace of external adjustment?

2. If a perception of such a slowdown prevails are there risks of a negative reaction in financial and currency markets as well as increased sentiments for protectionism?

3. Do Ministers and Governors consider inflation or inflationary expectations a serious risk?

4. Do they consider the recent interest rate increase appropriate and adequate. Are they concerned with the implications of such interest rate rise on investment, growth and on the debt-servicing difficulties of developing countries?

5. What are the policy measures that Ministers and Governors consider to be appropriate in order to deal satisfactorily with <u>both</u> the external adjustment and the inflation problems?

   a) What should the United States do to reduce its current account deficit?

   b) What should Germany and Japan do in order to reduce their current account surpluses and sustain growth?

   c) What should deficit countries do in order to strengthen their domestic saving?

6. A credible process of international cooperation implies a degree of international "burden sharing". What would Ministers and Governors consider to be the appropriate and credible mix of specific fiscal, monetary and structural policies that the various deficit and surplus countries must undertake in order to contribute to the simultaneous attainment of external adjustment, growth and price stability?

7. In view of the projected continuation of significant current account imbalances do Ministers and Governors believe that the pattern of exchange rates is still broadly satisfactory? Are they concerned with the recent strengthening of the US dollar? What could be the appropriate role of official intervention and what are the implications of interest rate developments for exchange market stability?

G

Key issues in paper by Deputies

Question 1: Do Ministers and Governors believe that the projected evolution of output and demand growth indicates a danger of a significant slowdown in the pace of external adjustment?

The pace of external adjustment did slow down in 1988. Projections suggest only modest further adjustment. But projections very uncertain, especially beyond short term; depend heavily on estimates of time lags between exchange rate changes and trade responses. In fact, indices of competitiveness show US now to be extremely competitive.
Main danger to external adjustment in United States is excessive level and growth of domestic demand, and high capacity utilisation.

Question 2: If a perception of such a slowdown prevails are there risks of a negative reaction in financial and currency markets as well as increased sentiments for protectionism?

'KEY ISSUES QUESTIONS'

Markets already well aware of slowdown in 1988 in current account adjustments. Main danger: public row in G7.
Protectionism always a concern. In fact, it arises from loss of output and jobs, as in the US in 1985-6 when the dollar was high, exports suffered and so manufacturing base eroded. Now, by contrast, US economy working at near full capacity and unemployment low. So threat of protectionism, now very much less, must not be used by the US as a lever to secure unwelcome changes elsewhere.

Question 3: Do Ministers and Governors consider inflation or inflationary expectations a serious risk?

The experience of the 1970s reinforced the belief, as the Toronto Summit Communique put it that "the eradication of inflation and of inflationary expectations is fundamental to sustained growth and job creation....We need to maintain vigilance against any resurgence of inflation." Substantial output growth, high capacity utilisation in many countries and rising commodity prices all point to the need for monetary policy to continue to bear down on inflationary pressures.

Question 4: Do they consider the recent interest rate increase appropriate and adequate? Are they concerned with the implication of such interest rate rises on investment, growth and on the debt-servicing difficulties of developing countries?

This question is clearly inspired by the Fund concern that, in its desire to reduce the interest burdens on debtors, too much weight is being placed on monetary policy. The recent increases were clearly needed (and we must accept the implications). Indeed, with the benefit of hindsight, the increases in interest rates could have come earlier. Must be prepared for further increases in 1989 if required. The table below shows current and past levels of interest rates. Main message: current rates, real or nominal, only a little above average.

Three month interest rates

	G7		United States		UK	
	nominal	real*	nominal	real*	nominal	real*
average 1984-88	7.9	4.5	7.9	4.3	10.6	5.6
1988	7.3	4.1	7.8	3.5	10.3	5.2
1 February 1989	8.6	4.8	9.2	4.6	13.0	5.8

*calculated using the consumer price index

Question 5: What are the policy measures that Ministers and Governors consider to be appropriate in order to deal satisfactorily with both the external adjustment and the inflation problems?

(a) What should the United States do to reduce its current account deficit?

(a) The United States, largely because of its low savings rate and the build up in its public debt, needs a credible programme for a sustained reduction in its fiscal deficit. This has been agreed by the Administration, and is expected by the markets. Failure to deliver would be damaging, not least to the prospects for the current account and to the financing of the external and internal deficits. At the Louvre, the US committed itself to a deficit of 2.3 per cent of GDP in ffiscal 1987, equivalent to $108 billion. The outcome was $150 billion for that year; and a similar figure for 1988. Fiscal 1989 we expect to be some $160 billion.

(b) What should Germany and Japan do in order to reduce their currency account surpluses and sustain growth?

(b) (i) both Japan and especially Germany should undertake more structural reforms, especially through measures which reduce protection on goods and services. Some measures, particularly if they affect the services sector most, may, over time, help to reduce current account surpluses - but any such effects are uncertain (even in direction), perhaps long delayed, and cannot be the driving force.

(ii) Germany and especially Japan have seen substantial growth in domestic demand. That needs to be sustained over a period of years, but there is <u>no case</u> in present circumstances for easing fiscal or monetary policy in these countries.

(c) What should deficit countries do in order to strengthen domestic saving?

(c) For those countries with a fiscal deficit, then a necessary step was to reduce - and eventually eliminate - it. Otherwise, raising interest rates was the appropriate action.

Question 6: What is the appropriate and credible mix of specific fiscal, monetary and structural policies that the various countries must undertake?

This can be answered in the time-honoured way by each country submitting its plans and the others commenting on them. In particular, a restated commitment by the United States on its budget deficit would be needed.

Question 7: Is the pattern of exchange rates still broadly satisfactory? Are Ministers and Governors concerned with the recent strengthening of the US dollar?

Present pattern of exchange rates broadly satisfactory, though some concern about current strength of dollar. United States must be prepared to raise its interest rates further, if necessary; and dollar stability is in the US interest. Hence US must not try to trade dollar stability for macro policy measures in other countries. Highly dangerous for US to talk about its willingness to see dollar fall. Line to take at meeting: may need a new understanding on exchange rates later but for now no alternative to sticking to existing arrangements and monitoring closely.

FROM: P MOUNTFIELD
DATE: 31 JANUARY 1989

1. MR WICKS
2. CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Mr Lankester
Mr Evans
Mr Walsh
Mr Bottrill
Mrs Thomson
Mr Batt
Mr Cassell, UKDEL

The key issue is to extract some cash for ECAs from the Poles and not let the banks hog the lot. But an IMF programme, which would unlock a rescheduling, could well be good money after bad - see the cautionary words at X and Y.

N.L.-W.
31.1

MOUNTFIELD TO CX 31 JAN

G7: POLAND: IMF AND PARIS CLUB

Mr Wicks has been warned that Beregovoy may mention this at G7 next weekend. The issue is whether Poland should have an IMF programme this year; and if not, on what basis to reschedule debt falling due to Paris Club creditors in 1989, as well as arrears built up in 1988.

LINE TO TAKE

2. UK recognises need to reschedule Polish debt to official creditors in 1989. Ideally, this should be based on a full SBA. Recognise Poland may not be ready for that: depends on pace of economic and political reform, and ability of Rakowski government to pursue adjustment policies. Second-best would be some form of shadow programme, so that IMF and creditors could at least monitor developments and enforce some conditionality. Third-best would be Paris Club deal with no IMF involvement: unsatisfactory because past experience shows Paris Club cannot enforce conditionality on its own. But must avoid continued de-facto moratorium: banks are

taking money out of Poland and government creditors are getting nothing. (Add reference to general debate about burden-sharing, if it has already taken place.)

BACKGROUND

A. Poland first rescheduled official debt in 1981. Not then an IMF member, so Paris Club appointed a 'task force' to investigate economic situation, agree and subsequently monitor conditionality. A failure (I know: I was there!)

B. After Russian intervention in 1982, negotiations broken off. But banks continued talking, and their rescheduling agreements ensured a continued stream of repayments throughout the 80s. ('We made a big mistake', says Trichet.) In 1981 bank exposure was 60 per cent of total; now it is 40 per cent.

C. Paris Club began talking again in 1983, and eventually signed agreements covering 1982-84; 1985; 1986 and 1987-88. Arrears are building up under last agreement because Poland refuses to sign the implementing 'bilaterals' - alleging that the interest rates demanded by creditors are too high. 'Appropriate market rate' is specified in the Agreed Minute. ECGD and most others want LIBOR plus 0.5 per cent. The Poles want a concessional rate eg 4 per cent.

D. Most creditors, led by FRG, have argued that (in line with normal Paris Club practice) the next agreement must be based on an IMF SBA - for which Poland formally applied last year.

E. US position has remained ambivalent: partly because of genuine worries about Poland's ability to carry through a Fund programme; partly because of need not to alienate Polish-American lobby, and to secure Congressional support for IBRD GCI, &c. Baker has personally taken a strong anti-Polish line. We do not know Brady's attitude yet. State and Treasury both say Adminstration has not yet formed a view.

X

F. <u>IMF staff</u> have begun the dialogue, but have doubts about their ability to design a meaningful programme. They have mentoined to us the possibility of a four-month 'trial period' in 1989 H1 before embarking on a full programme. If this went well it would permit a Paris Club rescheduling later in 1989 based on a full SBA.

G. <u>French motive</u> in raising this now is unclear. They probably want to force US to make their minds up, so that planning for rescheduling can begin. They share UK desire to catch up with banks. But there could be a 'geopolitical' motive - see below.

H. Poland has been on a <u>fishing expedition</u>, visiting all G5 capitals. Mr Cassell's telegram 26, attached, reports a Polish attempt to clarify our position. I am quoted as being 'flexible': in fact I said we wanted a 1989 rescheduling, to regularise position; poured cold water on Polish proposals for a multi-year package on concessional terms; but said that, like other creditors, we could not finally settle the IMF issue until we knew the position of the incoming US administration. I know from Paris Club contacts that France and FRG took much the same line.

I. <u>UK is third-biggest official creditor</u>. ECGD exposure at end 1988 = £1.16 billion (UK bank claims on Poland = £0.75 billion at end June 1988).

J. <u>Polish external position</u> is improving. The IIF forecasts hard-currency trade surplus in 1988 at $1.1 billion. Debt service was $4.1 billion of which banks took about $3.3 billion interest. (USSR, other bloc, LDCs and oil producers make up the balance: Paris Club creditors should have received about $600 million moratorium interest under the 1987 agreement but have actually received no interest.) Exports should rise further in 1989. Imports depend on future domestic politics.

K. <u>Domestic economic position</u> remains a muddle: high inflation, overhang of large dollar deposits, low or negative interest rates, much central direction and a price system which sends the wrong

from what?

signals to producers and consumers. Some aspects are improving: eg. removal of many subsidies, incentives to saving, development of an inter-company market in 'free' foreign exchange, &c. This is still an economy in transition, conditioned to central planning but struggling to adopt to a market system. A conventional IMF programme (though one has been drafted) may not work, at least to start with.

Y

L. Domestic politics are in total confusion as the Tenth Plenum draws to an end. The recognition of Solidarity may make it easier to secure support for economic reform; or it may just set off another round of wage increases and price freezes. However, it should relieve some of the US political constraints.

M. Geopolitics: in 1981, when Solidarity was at its peak, US, France and FRG saw some case for an economic rescue operation to wean Poland away from USSR. In the present atmosphere of detente, there seems no case for any renewal of this. But FRG has just agreed a generous settlement of an old (1975 pre-Paris Club) government-to-government loan, for basically political reasons. And no-one really knows what Mitterand is up to. There could just be some surprises at G7. FCO agree that if the French unexpectedly raise this idea again, you should question the need and argue for reference back to foreign ministers.

3. I suggest that Mr Cassell defers replying to the latest Polish request for a UK view, until we can take stock following the G7 meeting.

PM

P MOUNTFIELD

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TELNO 26
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AND TO ROUTINE WARSAW

IMF: POLAND AND PARIS CLUB RESCHEDULING

1. KROWACKI (POLISH REPRESENTATIVE AT THE IMF) CAME TO SEE US ON 25 JANUARY. HE WAS SEEKING CLARIFICATION OF THE UK'S POSITION ON THE CONDITIONS UNDER WHICH PARIS CLUB RESCHEDULING COULD GO AHEAD.

US AND GERMAN VIEWS

2. KROWACKI SAID THAT THE POLES HAD PICKED UP CONFUSING SIGNALS FROM THEIR DISCUSSIONS WITH BOTH THE GERMANS AND THE AMERICANS. AS FAR AS THE GERMANS WERE CONCERNED, SAWICKI HAD ORIGINALLY BEEN TOLD IN MID-DECEMBER THAT ''SINCE POLAND WOULD NOT BE ABLE TO AGREE A FUND PROGRAM'', THE GERMANS COULD GO ALONG WITH A PARIS CLUB RESCHEDULING WITHOUT A FUND PROGRAM. HOWEVER, KROWACKI SAID THAT GROSCHE (GERMAN DIRECTOR AT THE FUND) HAD SUBSEQUENTLY REPORTED - SPEAKING FOR THE MINISTER OF FINANCE - THAT GERMANY COULD AGREE TO A RESCHEDULING OF POLAND'S 1989 MATURITIES ONLY IF A FUND PROGRAM WAS ''IN VIEW'' AND THE 1987 BILATERALS HAD BEEN SIGNED. FINALLY, WHEN PRIME MINISTER RAKOWSKI HAD MET CHANCELLOR KOHL RECENTLY, KOHL HAD SAID THAT HE WOULD BE PREPARED TO OFFER NEW MONEY FOR JOINT VENTURES IN POLAND, BUT COULD NOT OFFER NEW CREDITS UNLESS THE PARIS CLUB HAD RESCHEDULED POLAND'S 1989 MATURITIES AND POLAND HAD AGREED AN IMF PROGRAM.

3. KROWACKI SAID THAT THE POSITION OF THE US WAS NO CLEARER. BOGOSIAN HAD ORIGINALLY TOLD SAWICKI THAT AN IMF PROGRAM WOULD HAVE TO BE IN PLACE BEFORE PARIS CLUB RESCHEDULING COULD BE CONTEMPLATED. HOWEVER, MILAM HAD SUBSEQUENTLY TOLD SAWICKI THAT THE US DID NOT BELIEVE THAT A FULL PROGRAM COULD BE AGREED WITH THE FUND IN THE SHORT-TERM. NEVERTHELESS, MILAM HAD SAID THAT IF THE POLES WOULD AGREE TO A FUND-DESIGNED SHADOW PROGRAM, THE US WOULD SUPPORT RESCHEDULING OF 100 PER CENT OF 1989 MATURITIES AND INTEREST.

UK VIEWS

4. KROWACKI REPORTED THAT SAWICKI HAD FOUND MOUNTFIELD TO BE ''FLEXIBLE''. KROWACKI WAS KEEN TO KNOW THE UK'S DEFINITIVE POSITION ON THE PRE-CONDITIONS NECESSARY FOR PARIS

TELE
NO
26

CLUB RESCHEDULING. HE WAS ALSO MOST ANXIOUS TO ESTABLISH WHAT HAD OCCURRED AT THE PARIS CLUB TOUR D'HORIZON ON 23 JANUARY.

COMMENT

5. WE WOULD BE GRATEFUL FOR YOUR ADVICE ON HOW WE SHOULD RESPOND TO KROWACKI'S QUESTIONS. THE POLES ARE VERY RELUCTANT TO GET INVOLVED IN LONG NEGOTIATIONS WITH PARIS CLUB CREDITORS IF THERE IS ULTIMATELY NO CHANCE OF A NEW RESCHEDULING AGREEMENT IN THE ABSENCE OF A FUND PROGRAM (AND PRESUMABLY VICE VERSA - IF A FUND PROGRAM IS NOT SEEN AS A NECESSARY CONDITION FOR RESCHEDULING, THE PRESSURE TO REACH AGREEMENT WITH THE FUND WOULD BE SOMEWHAT REDUCED). AT PRESENT, THEY ARE CLEARLY PUZZLED BY CREDITORS' VIEWS.

6. FCO PLEASE PASS TO BOTTRILL AND BATT (HMT), WARE (BOE), RICHARDSON (ERD), BREACH (EGGD) AND SHORT (CABINET OFFICE).

CASSELL

YYYY

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WARE,BANK OF ENGLAND
BREACH,ECGD
SHORT,CABINET OFFICE

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ANNEX C

ProbPoland

CONFIDENTIAL

ANNEX C

PROBLEM COUNTRIES: POLAND AND GUYANA

POLAND

Trichet described the "absurd" situation where the Poles were paying interest and some capital to the banks but were paying nothing to the export credit agencies. Before the Paris Club could settle its tactics with Poland, it was necessary to decide whether Poland would have an IMF programme - rescheduling was normally only permitted to countries with such programmes.

2. Tietmeyer commented that without the conditionality of an IMF programme, there was no chance that Poland would take the necessary measures of reform. He was not suggesting a large standby and he would be opposed to a weak programme. Mulford commented that the new Administration had not reached a view on a Polish programme, but he thought that they may not want one for the immediate future. Poland's economic situation seemed, in his view (and I must say in mine too), to make that country an early candidate for the Fund's Arrears Club. Trichet, while being mildly sympathetic to the case for a Polish programme for Paris Club reasons, thought the country to be in an awful economic mess; any IMF standby would need to be rolled over for the foreseeable future if one was granted.

3. It was left that the issue might be raised at the G7 meeting.

GUYANA

4. Dobson reported that the Guyana Support Group seemed likely to recommend that clearance of that country's arrears required a bridge of some $50 million for a year. She asked G7 member countries to consider whether they could make a contribution. Mulford noted that the US were unable, except in the most special circumstances, to bridge for more than 6 months.

[Action: **Mr Mountfield** to prepare briefing on the Polish and Guyanan cases.]

aef.tp/mountfield/min/321

FROM: P MOUNTFIELD
DATE: 31 JANUARY 1989

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Mr Wicks
Mr Lankester
Mr Evans
Mr Walsh
Mr Bottrill
Mr Gieve
Mr Batt
Mr Tarkowski
Mrs Thomson
Mr Miles, B/E

[Mr Mountfield telephoned to say that the US now say the FT report is inaccurate.] Tim also telephoned to say he believes US denials.

G7: PROBLEM COUNTRIES: MEXICO

The FT reports (31 January) details of a leaked US Treasury plan for restructuring Mexican debt. This subject is bound to come up.

Line to take

2. Very interested to read reports of US plans for Mexico. Pity we were not consulted earlier. Recognise still at an early stage. US clearly has major stake in Mexico. But line proposed here has implications for debt strategy generally. In particular, two of the options seem to run contrary to the Interim Committee decision last October, because they involve a further transfer of risk from the private to the public sector. Do not want to discuss in detail now: no firm proposals before us, and no opportunity to analyse. Hope there can be further discussion, eg. in G7 deputies, before final decisions are taken.

MOUNTFIELD TO CX 31 JAN

Background

3. The last attempt at a debt relief programme for Mexico was a purely voluntary mechanism. In March 1987, Mexico offered, on a voluntary basis, a "auction" of conversion bonds. The principle was collatoralised by a special ZCB issued by US Treasury, paid for out of Mexican reserves, but the interest was a Mexican sovereign risk. Not surprisingly, the take-up was low.

Options

4. The three options now under discussion (see FT cutting below) combine elements of that experiment, with some of the ideas which emanate from the World Bank (Ernie Stern) and some new gimmicks. They do not appear to constitute a menu; the US would choose one of these three, and try to impose its will on other creditors.

A

5. The first option is very close to the 1988 conversion bond, except that it appears to be compulsory, rather than voluntary and seems to apply to the ECAs as well as the banks; involves a fixed discount (somewhat below the present market rate); and involves a rolling three-year World Bank guarantee of Mexican interest payments. The first element is likely to be unacceptable to the banks, without considerable arm twisting; the third offends against the Interim Committee decision on risk transfer.

B

6. This option involves a temporary cut in bank interest rates (and presumably, interest rates charged by ECAs as well). It appears to involve a degree of compulsion. This interest would be foregone, not capitalised. There is no mention of the fiscal and regulatory measures which would be needed to facilitate such a deal.

C

7. The Press report is not very clear. But this appears to involve offering the banks a menu of three different options.

(i) This is almost the same as the first variant (case A above) except that the bonds would be 30 year.

(ii) Oil bonds introduce an element of "equity incentive" into the conversion operation.

(iii) This appears to involve the substitution of a Mexican sovereign risk for a World Bank guarantee on the bonds at C(iii), the holders being compensated by a higher face value and a higher coupon.

8. It is impossible to assess these three schemes adequately on this very flimsy report. But they carry clear implications for ECAs, as well as for the World Bank (and for the debt strategy in other countries where western government creditors are more deeply involved). The Americans went ahead with the 1988 operation without consultation, on the grounds that it was a purely voluntary operation, with no direct government involvement and no pressure on the banks. The proposals in this paper appear to be very different, and require some form of multilateral discussion. We think you should therefore press for this, preferably in G7 deputies, or in any other forum which ministers think is appropriate. You could add, sotto voce, that the Financial Times seems to find it easier to get hold of US Treasury documents than does the British Treasury. Mr Wicks confirms that Mulford gave no hint of this proposal at the last G7 deputies.

T. Pott

p.p **P MOUNTFIELD**

US draws up plan for Mexican debt relief

By Richard Johns in Mexico City

THE US Treasury has drawn up a plan for the restructuring and relief of Mexico's debt in consultation with leading American creditors.

The working paper sees Mexico as "the test case for a new less-developed countries' strategy" which the US is developing in its revision of the 1985 Baker Plan. The working paper, a copy of which has been obtained by the FT, outlines three specific approaches to Mexican debt and economic policy.

A The first option envisages new bank lending of $9bn (£5.1bn) over a three-year period. It is based on the "Brazilian menu" of new money, debt-for-equity swaps and exit bonds.

The US Treasury says that of Mexico's $74.4bn bank debt $48.2bn is owed to institutions which are unlikely to sell their loans at a discount. Those banks would provide the new loans.

The package would reduce the net transfer of resources from Mexico to banks over the three-year period from $20.8bn to $10.3bn and all creditors from $23.3bn to $12.8bn. Among the basic assumptions underlying all three scenarios considered are $2bn in loans from the World Bank, other multilateral agencies and official lenders, a $15 per barrel oil price and a Libor rate of 8.5 per cent.

It also envisages bonds being issued in exchange for old loans at a fixed tender with a 40 per cent discount. They would be collateralised by 20-year zero-coupon US Treasury bonds purchased by Mexico with interest guaranteed by the World Bank for a rolling three-year period.

Mexico has been looking for such guarantees since the disappointing results of its innovative zero-coupon bond scheme reduced its overall debt by only $1.1bn a year ago.

Acceptance of the concept of interest securitisation would be a major breakthrough for Mexico and other Latin American debtors.

B The second option examined concentrates on interest rate reduction, together with debt for bond swaps. It suggests that interest rates on Mexico's commercial term loans be temporarily cut to bring down the country's interest to export ratio from the 1988 level of 26.8 per cent to 20 per cent in 1991.

The scheme would bring about the biggest reduction in interest payments of the three presented but over the three-year period would only lower net transfers to banks to $13.9bn and all lenders to $16.4bn.

C Under the third and most radical option the bank debt in its totality would be exchanged for three new securities issued by Mexico:

- Mexican 30-year bonds collateralised by US Treasury zero-coupon bonds purchased by Mexico and with World Bank rolling guarantees on interest.
- Mexican perpetual oil bonds tied to oil prices.
- Mexican 30-year bond warrants, providing holders with the choice of exchanging $2 of previously issueed 30-year bonds for $2.5 of new bonds with yields equal to Libor plus two percentage points.

Net transfer of resources to banks would be lowered to $14.3bn over the three-year period and to all creditors to $16.8bn.

Initial losses to banks would be larger than under the other two options. The third also faces the problem of imposing the same solution on all banks.

35/1 aef2/th.4.30.1

FROM: MRS S THOMSON

DATE: 31 JANUARY 1989

1. MR MOUNTFIELD approved in draft
2. CHANCELLOR

cc Sir P Middleton
Mr Wicks
Mr Lankester
Mr Evans
Mr Davis
Mr Bottrill

JANUARY PARIS CLUB: SENEGAL, TRINIDAD AND ~~TORONTO~~ TOBAGO (!); UGANDA

There were three reschedulings at the January Paris Club, two on concessional terms.

SENEGAL

2. Following the UK joint demarche with France and Canada, Spain, Belgium and Netherlands agreed on 25 January that Senegal, whose rescheduling had been held over from December because of their opposition, could receive Toronto terms. Arguments over the proportion of previously rescheduled debt to be included occupied an entire day, largely because of Netherlands's intransigence and in total Senegal's rescheduling took two and half days.

THOMSON TO CX 31 JAN

UGANDA

3. Uganda also received Toronto terms, the second commonwealth country and the seventh country in all to do so. [We estimate that the total debt now rescheduled on concessional terms is around $1 billion, UK share about 9 per cent] We had been worried that Israel would block the rescheduling because of unresolved claims and counter claims left over from 1987. However, although the Ugandan delegation, led by Kiyonga, objected to Israel's creditor status, eventually a compromise was reached which enabled them and the Israelis to sign an Agreed Minute which referred to 'participating countries' rather than 'participating creditor countries".

4. Creditors stood firm in resisting Ugandan demands to move the cut-off date but agreed to reschedule previously rescheduled debt and arrears. Israel choose option C - lower interest rates.

TRINIDAD AND TOBAGO

5. This was the first time Trinidad and Tobago has rescheduled. The reason seems to be a short-term liquidity problem caused by the drop in oil revenues rather than structural problems in the economy. The Trinidadians negotiated in a reasonable manner and settled for a 100 per cent of principal rescheduled over ten years, of which five years' grace, and 100 per cent of arrears of principal to be rescheduled over nine years, of which four grace. The terms are slightly better than those given by the banks, and creditors resisted rescheduling interest.

S J Thomson

MRS S THOMSON

3/1

FROM: P MOUNTFIELD
DATE: 31 JANUARY 1989

CHANCELLOR

cc: Chief Secretary
Economic Secretary
Sir P Middleton
Mr Wicks
Mr Lankester
Mr Evans
Mr Walsh
Mr Bottrill
Mr Gieve
Mrs Thomson
Mr Batt
Mr Miles, B/E

Ch/
Content that Mr Cassell should take line proposed (+ with other recommendations in para 10)?
31/1

MOUNTFIELD TO CX 31 JAN

G7: NIGERIA: IMF AND PARIS CLUB

This note seeks your agreement to the line we should brief Mr Cassell to take at the Fund Board on Friday. It also suggests a line for you to take in the G7 and subsequently.

Problem

2. The IMF programme for Nigeria is constructed on two assumptions: an aid package of approximately the size promised at the Consultative Group meeting in January; and a generous Paris Club rescheduling. The first assumption is now reasonably secure; the second shows signs of coming unstitched.

3. Nigeria has paid very little to Paris Club creditors during 1988, either in respect of new maturities of debt, or of previously-rescheduled debt (PRD). It needs a Paris Club agreement, to regularise the position of these arrears, and to

deal with maturities during 1989. There will be a Paris Club meeting at the end of February.

4. The arrears which built up last year are very unevenly spread. Some countries have been paid in full (for example, Japan, in order to unlock the very large aid package); some countries have abandoned some of their claims (eg FRG); some, like the UK, have been paid about one-third; some, like Belgium, Netherlands, Denmark and Spain have been paid almost nothing. There is a lot of ill-will towards Nigeria among the creditors (entirely understandable). Last week's negotiations on Senegal demonstrated the ability of small creditors to hold up, and even to block, a deal in the Paris Club, which has to proceed by consensus (because it has no formal constitution).

See Mrs Thompson's note, behind

5. The staff paper assumes that the rescheduling begins from 1 January 1988 - although, as noted above, some creditors have received certain payments since then. Quite large sums are due to some of the small creditors on 30 June 1988. They are therefore thinking in terms of starting the rescheduling from 1 July 1988. That would open up a quite big financing gap. It is impossible to estimate this precisely on the present data, but we and the IMF think it would be between \$300 and \$350 million.

6. The staff say this would not necessarily put the programme at risk. The oil price is currently over \$2 a barrel higher than the programme assumes (\$14.50); the Donor Group was a bit more generous than expected (and more is in the pipeline from Japan, though this cannot be publicly stated); other creditors, including Saudi Arabia, may come up with some more help; there is scope for a little bit more import compression or reduced Reserve Bill by Nigeria; in the last resort, Nigeria could be pressurised to take a Fund drawing.

W.N. Important

7. For these reasons, the staff are recommending that the programme go to the Board as planned on Friday (we asked them to consider whether it would be wise to postpone it). Camdessus has not yet decided whether to go for full or conditional approval.

8. The issue for us is whether to press for conditional approval. The object would be to put pressure on the smaller creditors to be as generous as possible. If Camdessus wants to go for unconditional approval we could achieve the same result if the Managing Director made a statement, in his summing up, urging creditors to be understanding and as generous as possible. For this reason, we do not intend to lobby Camdessus beforehand. If he opts for conditional approval, UK could support him. If he opts for full approval, UK would ask him before the meeting to include an appropriate exhortation in his summing-up. You could then follow this up, if you agreed, with a series of lobbying letters next week, on the lines of those you sent at the time when we were constructing the aid package. The targets would probably be the dissident countries listed above.

9. You will note that this could mean asking the Board to approve a programme which is not yet quite fully-funded. This could be seen as contrary to our previous policy (though in line with some of the suggestions we discussed with you on Monday). As you know, we have discussed with the banks, very informally, the possibility of an improvement in the banking package for 1989. As Mr Lankester reported at the time, the response was entirely negative. We would not rule out the chance of some improvement next year, when the climate will be rather different. But if the Fund Board approve the programme unconditionally on Friday, it will not be in order to put any further pressure on the banks (in the way we discussed on Monday) - rather the reverse, to bring the smaller government creditors into line with what we have already decided ourselves is inevitable.

Recommendation

10. Having discussed with Mr Wicks and with the FCO, I recommend that:

(a) you authorise Mr Cassell to vote for full approval or conditional approval of the programme on Friday, (whichever Camdessus proposes);

(b) if Camdessus goes for full approval, we should ask for a supporting statement;

(c) that you speak on the lines of the following note at the G7;

(d) that subsequently, you write to the finance ministers of the smaller creditor countries urging them to cooperate (drafts to be provided next week, in the light of discussion at the Board and at G7).

Line to take

11. If you agree, the line you might take at G7 would be as follows:

also unavoidable? (& very unattractive)

"IMF Board will be discussing Nigeria on Friday. At last, adjustment programme looks reasonably strong. Still a long way to go, but Nigeria has begun process of diversifying away from oil. Very grateful for all the help the UK had in trying to put together IBRD aid package in January. Very successful operation - largely closed financing gap. Instrumental in persuading Nigeria to adopt new policies. Will need to go on monitoring progress very carefully. Remaining gap can be closed by generous Paris Club rescheduling. A Fund staff paper assumed that we would have to reschedule 100 per cent of everything falling due in 1988-89, including previously-rescheduled debt. Means including the arrears which have already built up. Most/all G7 countries recognise the need. But some of the smaller creditors still unhappy. Nigeria has been very silly, in allowing disparities to build up between different groups. Nigeria may now need to make minor concessions to keep smaller creditors sweet. Hope G7 countries can stand firmly together, under French Chairmanship, to secure successful outcome. Very important not to give Nigerians any reason to doubt willingness of West to help them. That would undo all the good work of the last six months. Hope you will all instruct your representatives at Paris Club, end February, to take constructive line so that package can go ahead as envisaged by IMF. I shall be writing separately to finance ministers of some of smaller creditors."

PM

P MOUNTFIELD

cc PC

AUSTRALIAN HIGH COMMISSION

THE HIGH COMMISSIONER

AUSTRALIA HOUSE
STRAND
LONDON WC2B 4LA
01-438 8220

31 January 1989

The Rt. Hon. Margaret Thatcher MP
Prime Minister of the United Kingdom
No. 10 Downing Street
London SW1A 2AA

My dear Prime Minister.

The Prime Minister of Australia, Bob Hawke, has asked me to pass to you the attached text of his letter, the original of which will follow shortly, urging your continued support in bringing flexibility to the European Commission's position on agriculture in the post-Montreal period.

Warmest personal regards.
Yours sincerely.
Doug McClelland

(DOUGLAS McCLELLAND)
HIGH COMMISSIONER

The Rt Hon. Margaret Thatcher
Prime Minister of the United Kingdom

Dear Margaret,

I am writing at this time to register with you my concern over developments at Montreal in the Multilateral Trade Negotiations. In particular I urge the European Community and the United States to seek a negotiated compromise on agriculture which will assist in our common endeavour to improve the multilateral trading framework and ensure the future health of the world economy.

The Montreal meeting was not the success that we had been looking for at the mid point of the Uruguay Round and now failure to negotiate an agreed text on agriculture in the coming months will threaten the success of the entire Round. The action by a number of countries to hold up further negotiations across the range of issues covered by the Round because of the Montreal failure to agree a text on agriculture clearly identifies agriculture as the most critical issue.

At Montreal it was clearly recognised that it is now up to the main protagonists in the agriculture debate, the United States and the European Community, to break the impasse which has paralysed negotiations. We had hoped that some movement would have been evident at Montreal, and Australia and the Cairns Group, which we chair, had put forward proposals which we felt provided a basis for bridging the wide gap between the EC and US positions. Without this movement being achieved in the period to April 1989 we are pessimistic about the prospects for agricultural liberalisation and the overall success of the current multilateral trade negotiations.

Time is therefore short and I am concerned that unless both the major players can start to reconsider their approaches at the earliest opportunity, the possibility of agreement in April will slip away.

We are in no doubt that the Community needs to seriously rethink its own position on agriculture. To date the Community has provided no indication that it is willing to commit itself to substantial reform of the support mechanisms which form the Common Agricultural Policy. It will be important for member states to provide the Commission with a mandate to show greater flexibility and precision in addressing the long-term objective. Such a signal will, in our view, be necessary to encourage the US to move from its current position.

At the same time, we believe the United States also needs to re-examine its insistence that a zero trade distorting agricultural support objective be a pre-condition to negotiations across all issues which will need to be covered in the agricultural area.

I have written in similar terms to President Bush, Commission President Delors, and the Heads of Government of France, the Federal Republic of Germany, The Netherlands, and Spain, expressing my concern at the prospect of a continued impasse in the agriculture negotiations and urging them to take a more flexible approach than has been evidenced to date.

We in Australia stand ready to assist the negotiations on agriculture in whatever way we can. The Australian Minister for Trade Negotiations, Michael Duffy, who is Chairman of the Cairns Group, will be making early contact with his counterparts in the US and EC administrations to discuss how we might assist in securing a positive outcome on agriculture.

Your personal efforts and those of your Government to bring more sanity to agricultural trade regimes both globally and within the Community are well appreciated in Australia. I am therefore sure you agree on the vital need to adequately address the agriculture issues, enabling the Uruguay Round to progress and deliver its promise of a better trading system for us all.

Yours sincerely,

(Bob Hawke)

ANNEX D

M

CONFIDENTIAL

ANNEX D

MISCELLANEOUS ISSUES

(i) Dobson (Canada) said that Mr Wilson would urge Finance Ministers to become more involved in their capitals in settling a negotiating line in the MTNs for trade and agriculture. I said that the Chancellor was already well involved. Some Deputies said that institutional and political factors in their capitals made it harder for their Ministers to play a role.

[Action: **Mr Allen** to produce a short briefing note on the next steps in the MTN negotiations.]

(ii) Mulford (US) expressed concern about the handling of financial services in the MTN negotiations. The treatment of financial services should be different from that of products and should be handled by Finance Ministry, not Trade Ministry, experts. Mr Brady might raise this issue in Washington.

[Action: **Mr Allen** to produce a briefing note.]

(iii) Mulford registered concern about the Commission's proposals for reciprocity in banking services. If the EC adopted reciprocity procedures, there would be a "swift and very severe" reaction by the US. Tietmeyer explained the current state of play in the EC and pointed out that both Germany and the UK opposed the Commission's approach.

[Action: **Mr Ilett** to produce a short briefing note for the G7 discussion.]

CH/EXCHEQUER
REC. 01 FEB 1989
Mr MOLAN
CST, FST, PMG, EST,
Sir T. BURNS,
Mr HICKS, Mr LANKESTER,
Mr MONCK, Mr EVANS
Mr MOUNTFIELD, Mr R.I.G. ALLEN,
Mr BONNEY, Mr MELLISS,
Mrs BROWN,
Mr HOOD, Mr GIBBS
Mr TYRIE.

1/2

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

31 January 1989

AGRICULTURE AND THE GATT

I enclose a copy of a message to the Prime Minister from Mr. Hawke, urging greater flexibility in the European Community's negotiating position on agriculture in renewed GATT negotiations. I should be grateful for a draft reply.

I am copying this letter and enclosure to Shirley Stagg (Ministry of Agriculture, Fisheries and Food), Alex Allan (H.M. Treasury), Stephen Wall (Foreign and Commonwealth Office) and Roger Lavelle (Cabinet Office).

(CHARLES POWELL)

Neil Thornton, Esq.,
Department of Trade and Industry.

108g.mg.ld/Polin/(1)1.2.min

COVERING SECRET

FROM: I POLIN

DATE: 31 January 1989

1. MISS O'MARA mom 1/2
2. CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Sir T Burns
Mr Wicks
Mr Scholar
Mr Peretz
Ms Ryding
Mr N P Williams

G7: EXCHANGE RATES, INTEREST RATES AND INTERVENTION

As background for this week's meetings, I attach;

i. graphs of movements in the £ERI, $/£, DM/£, Yen/$ and DM/$ from the Louvre Accord to date. The last two graphs show the (secret) agreed G7 ranges;

ii. a table of movements in exchange rates from key dates;

iii. a table of long-term and short-term nominal and real interest rates in G7 countries;

iv. the yield curve at Budget time and currently;

v. a table of recent UK base rate movements and the configuration of exchange rates at the time;

vi. a table of recent mortgage rate movements;

vii. recent monetary statistics;

viii. fact sheets on the UK's official reserves and foreign currency debt;

ix. UK monthly official reserve changes (underlying and total) since the beginning of 1986;

x. tables on the composition of the reserves on the basis of latest published and unpublished data;

xi. tables using unpublished material showing the UK's net currency reserve assets at the end of 1986, 1987 and the end of December 1988;

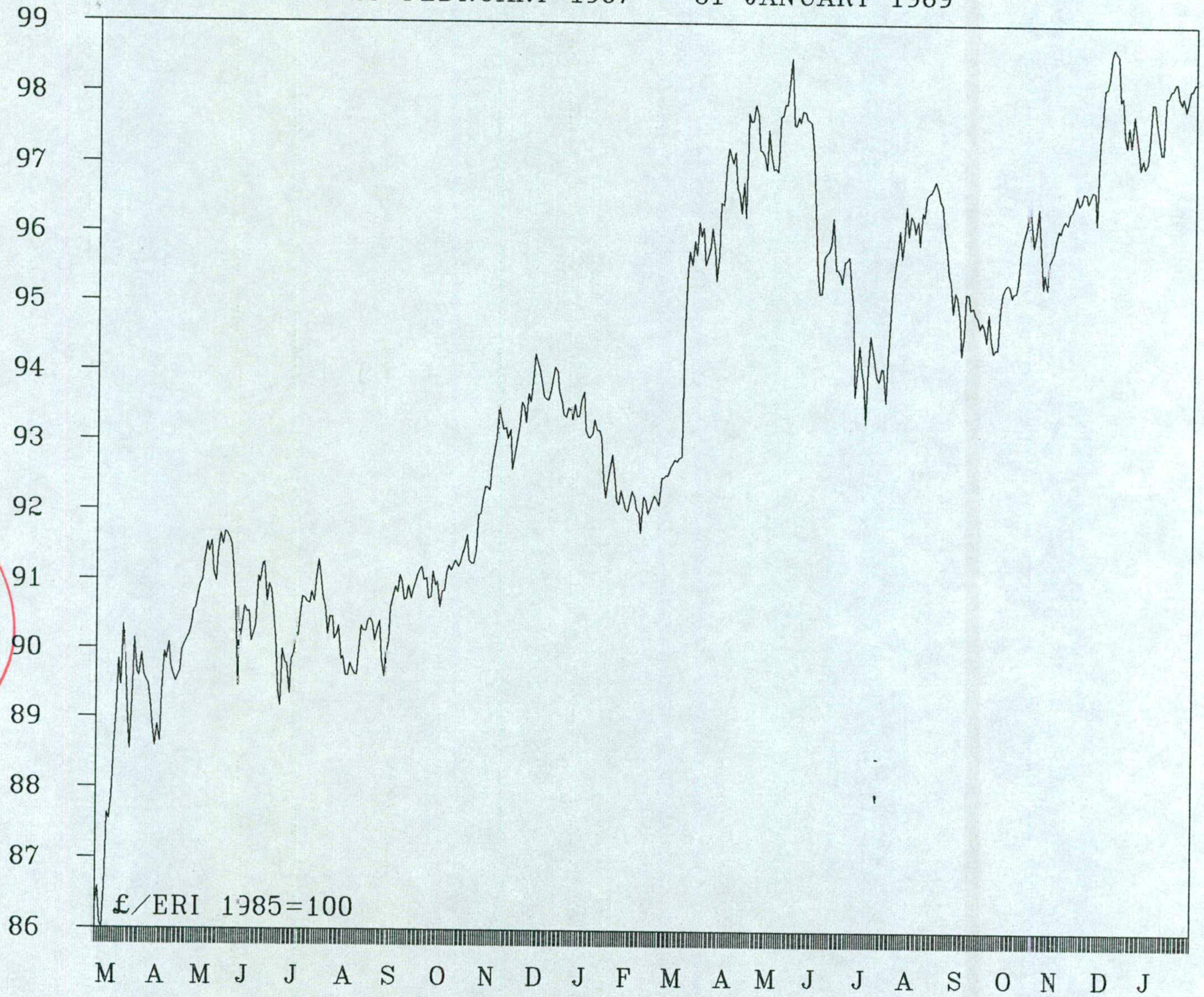
xii. three summary tables showing unpublished G7 reported market intervention for 1987, 1988 and 1989 so far, together with monthly breakdowns.

Ian Polin

I POLIN

STERLING EFFECTIVE RATE INDEX

23 FEBRUARY 1987 – 31 JANUARY 1989



(DAILY DATA)

XR GRAPHS

DOLLAR STERLING

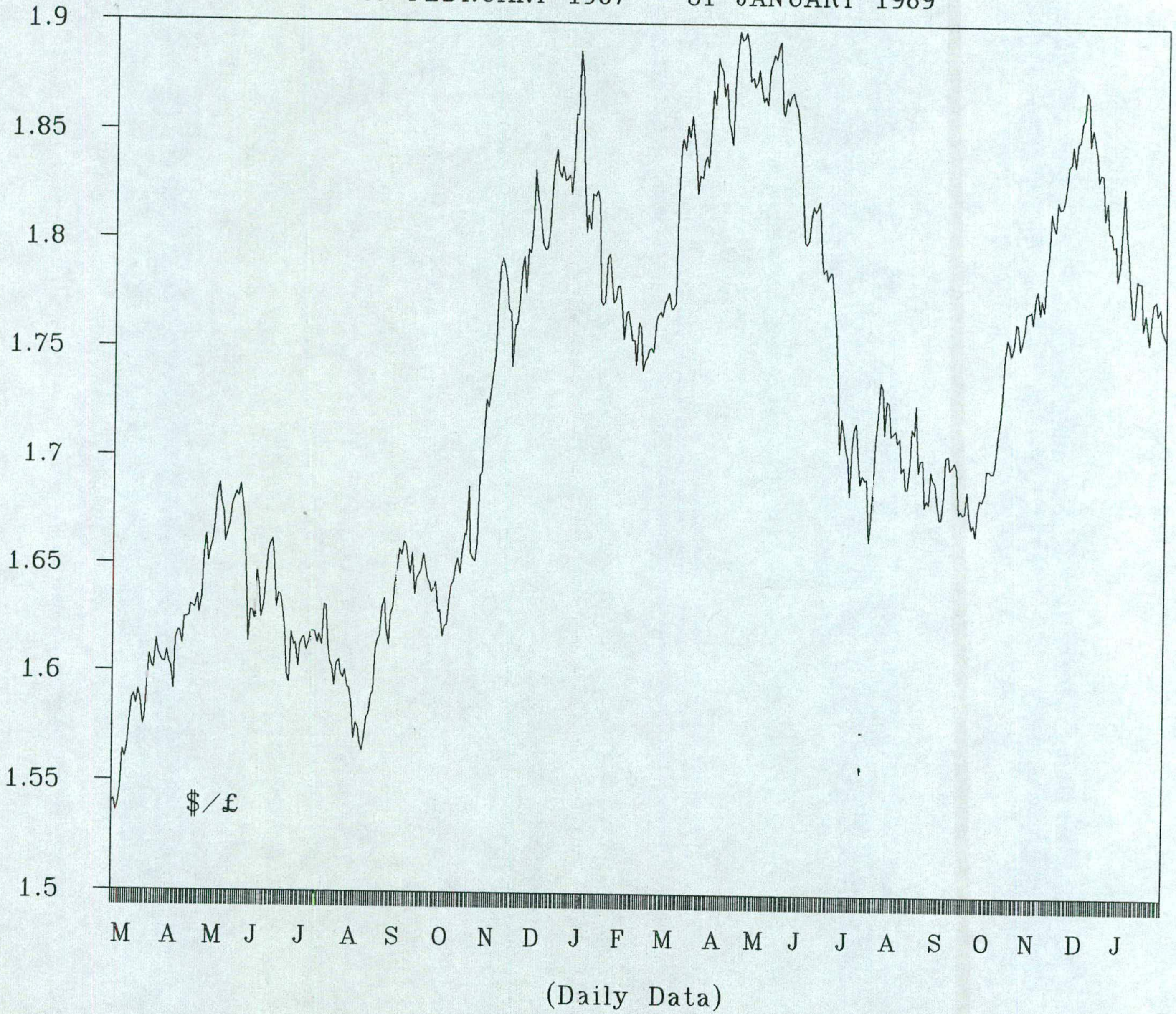
23 FEBRUARY 1987 - 31 JANUARY 1989

22

1·76

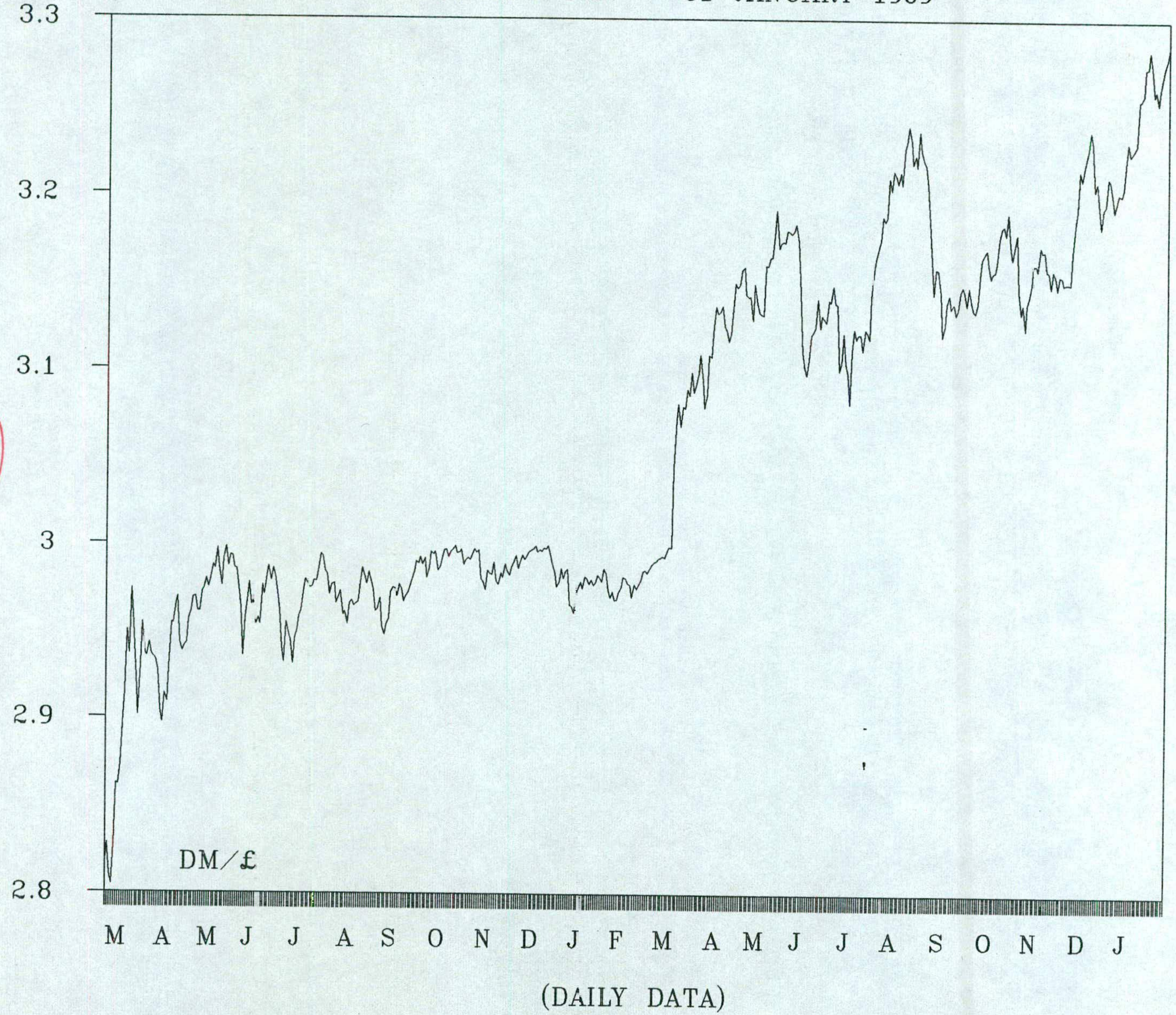
154

+14¢ in 2m



DEUTSCHEMARK STERLING

23 FEBRUARY 1987 - 31 JANUARY 1989



285

325

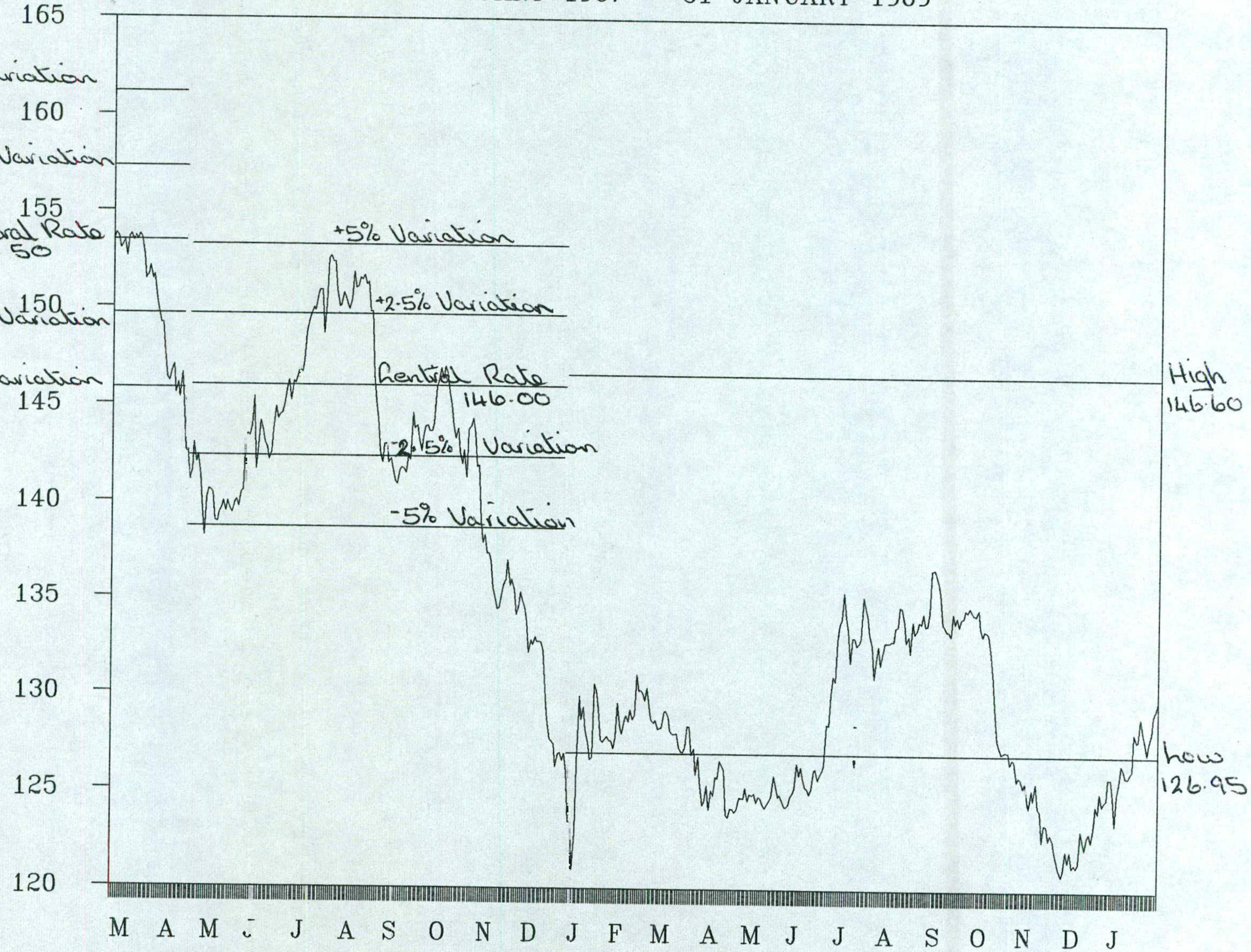
60

+14% ~ 2m

SECRET

YEN DOLLAR

23 FEBRUARY 1987 - 31 JANUARY 1989

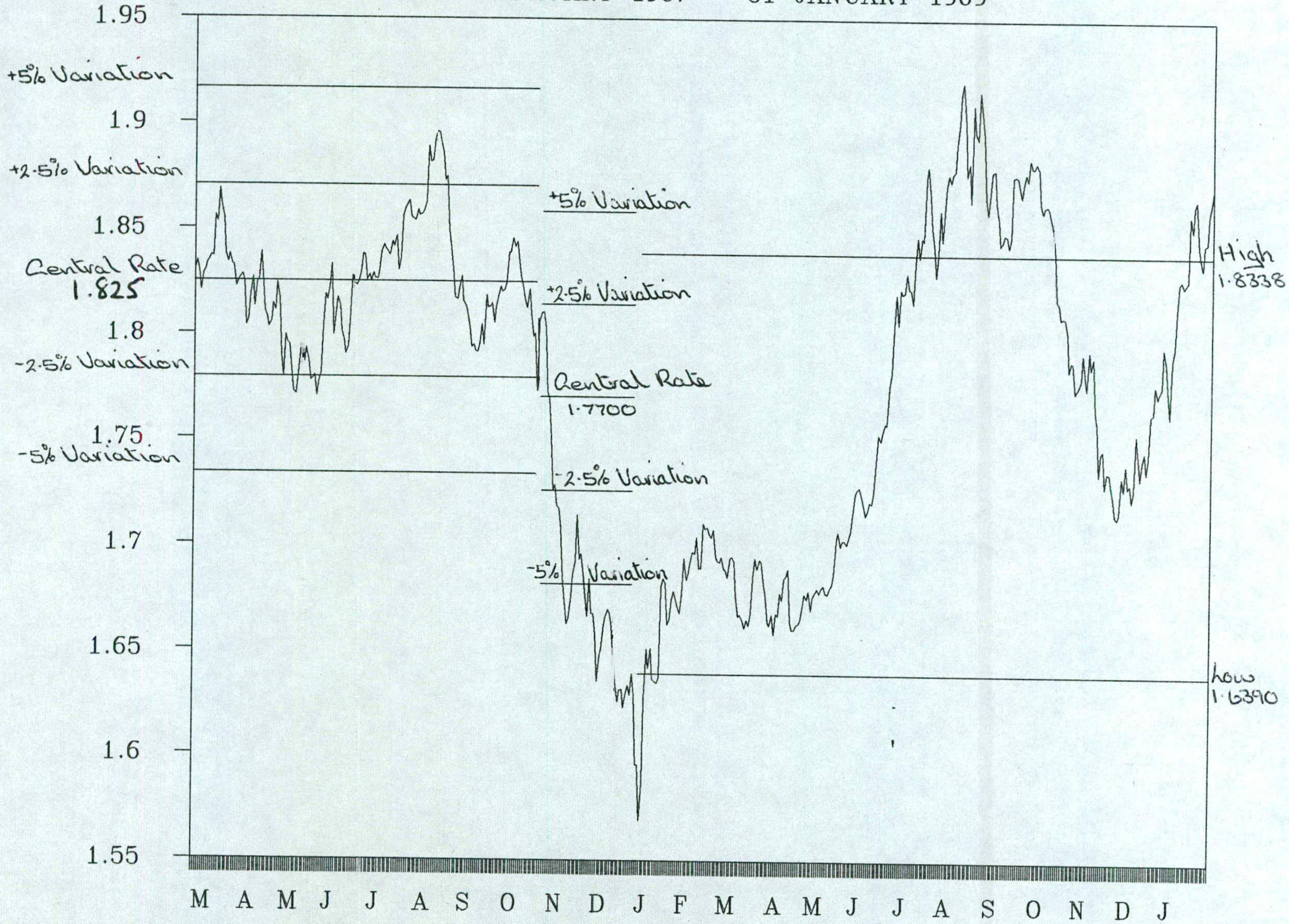


(Daily Data)

SECRET

DEUTSCHEMARK DOLLAR

23 FEBRUARY 1987 - 31 JANUARY 1989



(Daily Data)

(i) MOVEMENTS IN STERLING AND THE DOLLAR AGAINST OTHER MAJOR CURRENCIES

% change to Closing 31 January 1989 since

	Opening Level 31.01.89	General Election 3.5.1979	All time £ low point against $ 26.02.85	Paris Accord 20.02.87	Black Friday 16.10.87	G7 Statement 23.12.87	Budget 1988 15.03.88	US Election 08.11.88
STERLING								
£/ERI	98.2	-8.2 107.0 *	8.0 90.9 *	14.7 85.6 *	7.3 91.5 *	5.3 93.3 *	2.1 96.2	2.1 96.2
$/£	1.7560	-15.4 2.0759 *	69.5 1.0357 *	14.9 1.5283 *	4.1 1.6865 *	-3.6 1.821 *	-5.5 1.858	-1.3 1.7797
DM/£	3.2855	-16.7 3.9450 *	-9.0 3.6121 *	17.7 2.7914 *	10.0 2.9881 *	10.1 2.9846 *	6.4 3.0889	3.7 3.1686
Yen/£	228.00	-51.1 466.5	-16.2 272.1	-2.8 234.7	-4.3 238.3	-1.4 231.2	-3.4 236.06	2.0 223.48
DOLLAR								
$ Effective	67.6	-3.2 69.8 *	-40.2 113.1 *	-6.8 72.6 *	-2.9 69.6 *	5.0 64.4 *	5.1 64.3	2.0 66.3
DM/$	1.8710	1.6 1.9004 *	85.3 3.4665 *	-2.4 1.8265 *	-5.3 1.7718 *	-12.4 1.6390 *	-11.1 1.6625	4.5 1.7905
Yen/$	129.85	73.0 224.70 *	101.1 261.15 *	18.3 153.55 *	8.8 141.30 *	-2.2 126.95 *	-2.2 127.05	3.4 125.57

(ii) Sterling all-time lows: ERI 83.7 (8 October 1986), $1.036 (26 February 1985), DM 2.7349 (28 January 1987)

(iii) Recent £ Highs

ERI	98.5	(16 May 1988)
$	1.9065	(18 April 1988)
DM	3.2915	(31 January 1989)

(iv) Dollar all-time lows

ERI	63.3	(30 October 1978)
DM	1.5620	(4 January 1988)
YEN	120.25	(4 January 1988)

I don't recall the
precise lengths; but
if we're 15% down against
the $ since the 1979 GE,
17% down against the DM &
51% down against the yen, how
come we're only 8% down
against the basket?

INTEREST RATES + MONEY SUPPLY

3 Month Nominal and Real Interest Rates in G7

1 February 1989-opening

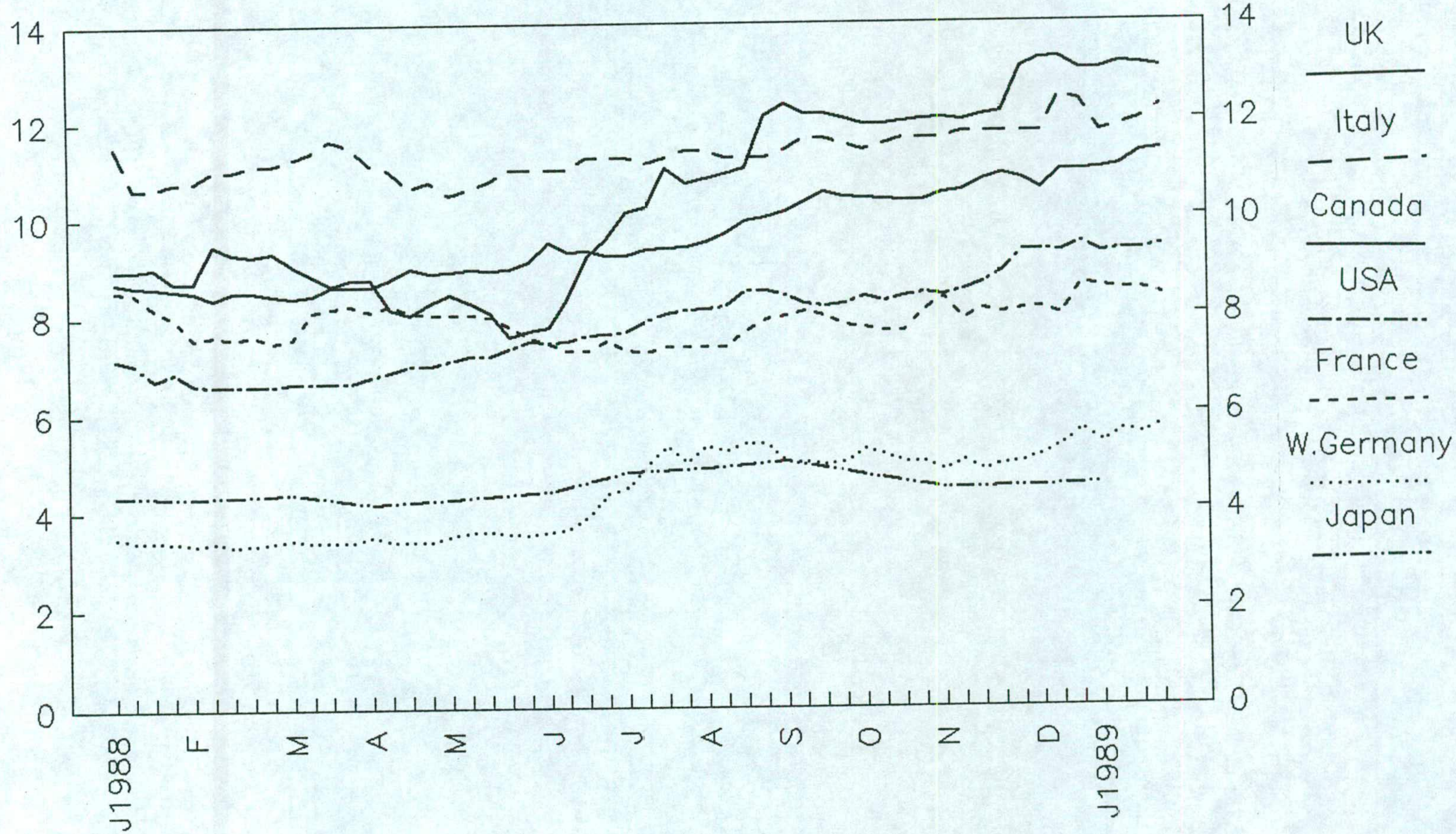
	Nominal	Real (1)	Inflation
UK	13.0	5.8	6.8
USA	9.2	4.6	4.4
Japan	4.6	3.6	1.0
Germany	6.0	4.3	1.6
France	8.9	5.7	3.0
Italy	12.4	6.5	5.5
Canada	11.4	7.1	4.0
AVERAGE	8.6	4.8	3.8

10 Year Bond Yields (30 January 1989)

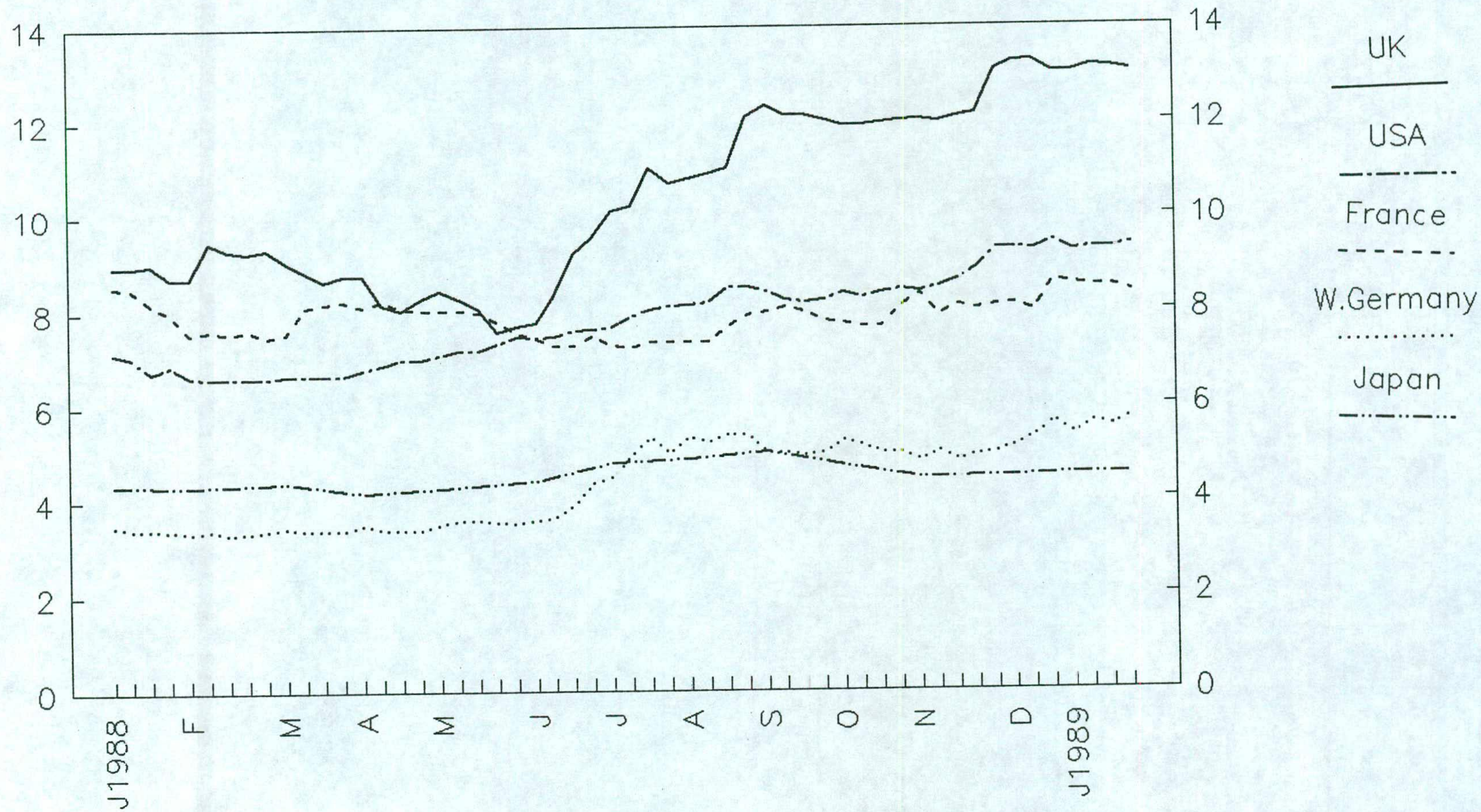
	Nominal	Relative to inflation (2)	Inflation
UK	9.7	2.7	6.8
USA	9.2	4.6	4.4
Japan	4.9	3.9	1.0
Germany	6.7	5.0	1.6
France	8.7	5.5	3.0
Italy	10.6	4.9	5.5
Canada	10.3	6.0	4.0
AVERAGE	8.2	4.5	3.8

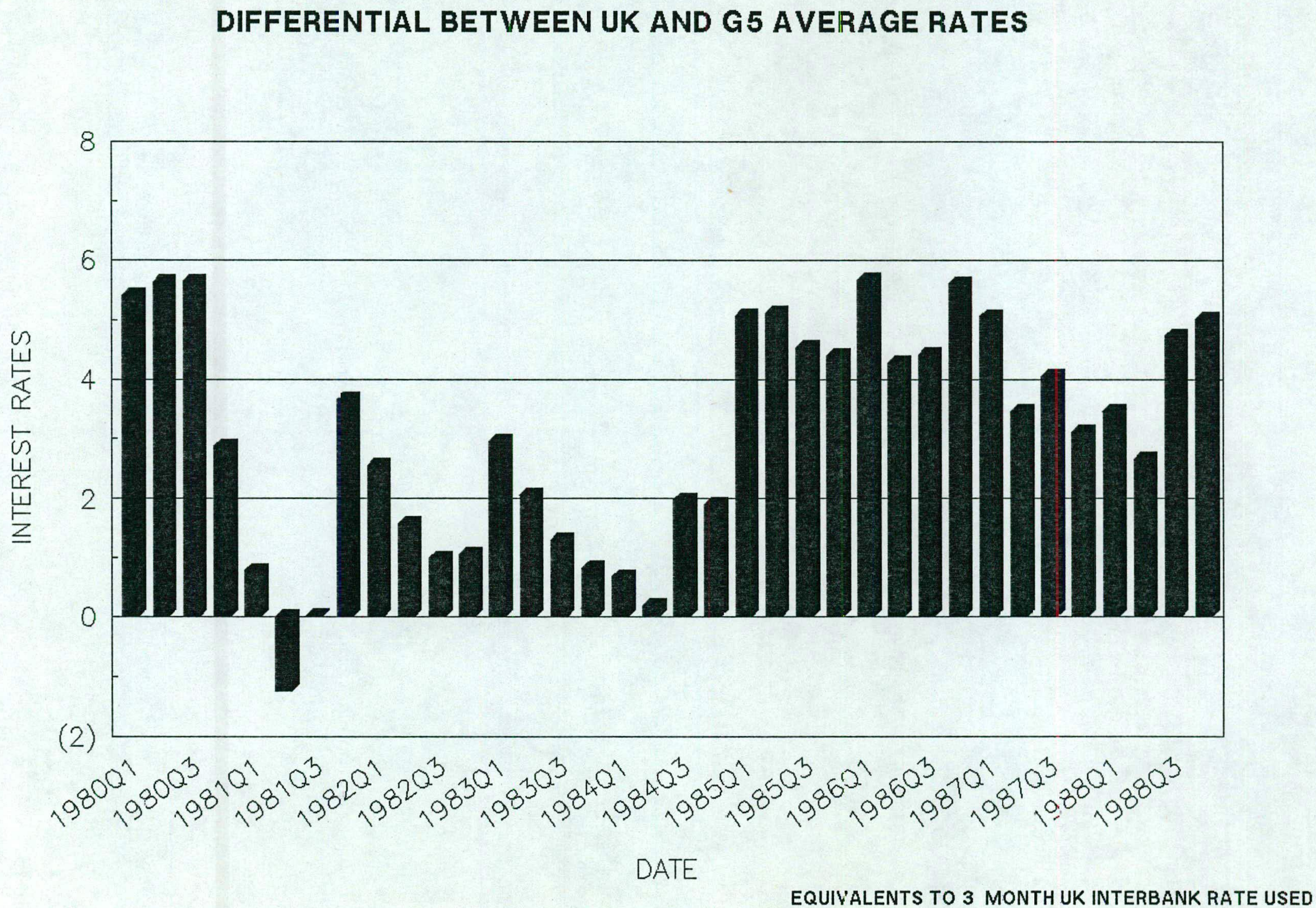
(1) Deflated by latest Consumer Price Index
(2) No generally accepted defintion of real long term rates:these rates deflated by latest CPI

G7 3mth interest rates



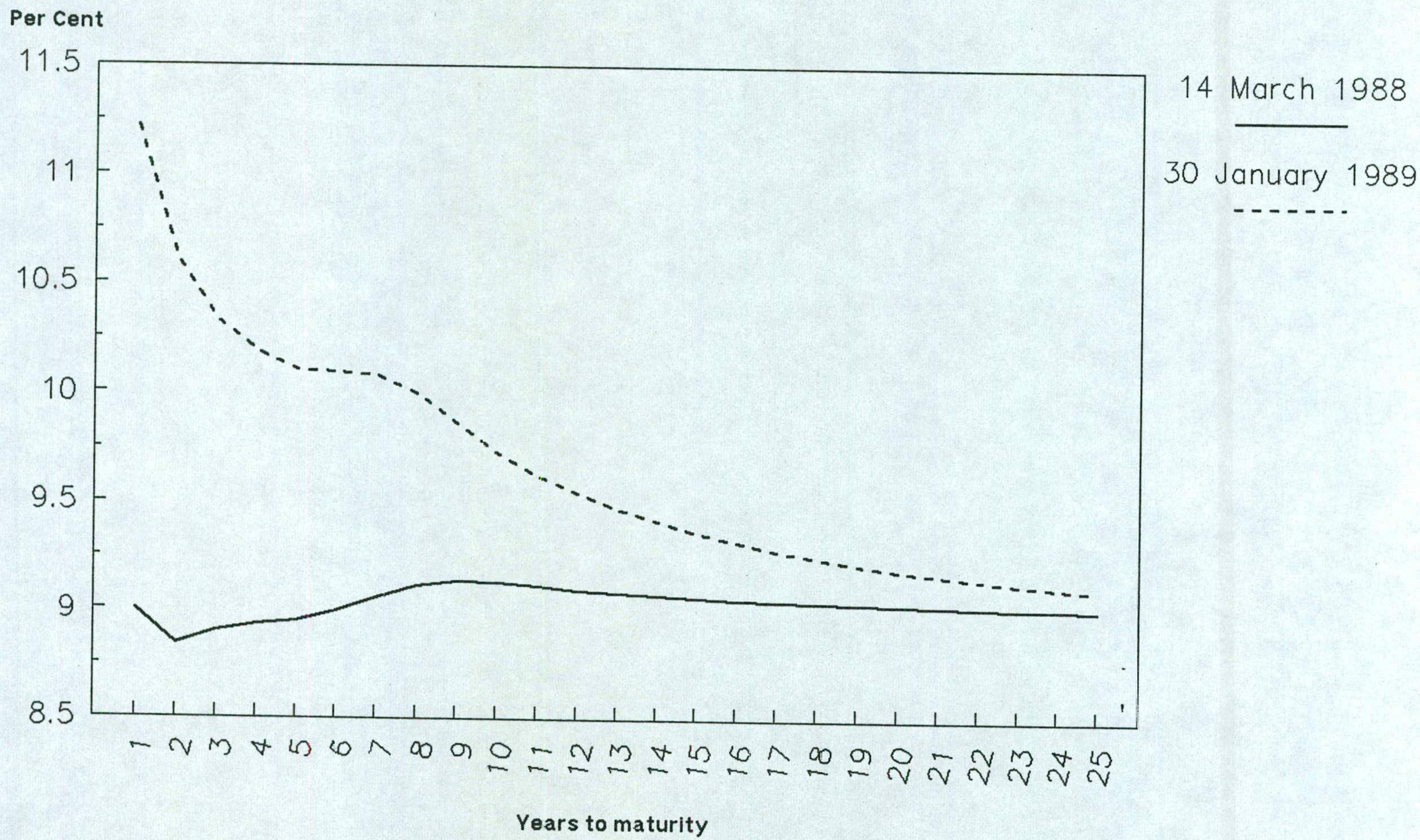
G5 3mth interest rates





DIFFERENTIAL BETWEEN UK AND G5 AVERAGE RATES
8
6
4
2
0
(2)
INTEREST RATES
1980Q1
1980Q3
1981Q1
1981Q3
1982Q1
1982Q3
1983Q1
1983Q3
1984Q1
1984Q3
1985Q1
1985Q3
1986Q1
1986Q3
1987Q1
1987Q3
1988Q1
1988Q3
DATE
EQUIVALENTS TO 3 MONTH UK INTERBANK RATE USED

PAR GROSS REDEMPTION YIELDS



RECENT BASE RATE MOVEMENTS (1)

	Base Rates (1)	20 year gilt yields	DM	$	ERI
1987					
6 August	10	9.8	2.96	1.58	89.7
23 October	9 1/2	9.6	2.99	1.66	91.4
4 November	9	9.1	2.98	1.75	92.8
3 December	8 1/2	9.3	3.00	1.80	93.8
1988					
1 February	9	9.4	2.97	1.76	92.0
17 March	8 1/2	9.1	3.10	1.84	96.1
8 April	8	9.1	3.14	1.87	97.2
17 May	7 1/2	9.3	3.17	1.86	97.6
2 June	8	9.3	3.11	1.80	95.4
6 June	8 1/2	9.2	3.10	1.80	95.1
22 June	9	9.3	3.15	1.77	95.7
28 June	9 1/2	9.5	3.10	1.72	94.0
4 July	10	9.6	3.08	1.68	93.3
18 July	10 1/2	9.6	3.14	1.67	94.2
8 August	11	9.4	3.23	1.70	96.3
25 August	12	9.6	3.16	1.70	95.3
25 November	13	9.4	3.17	1.85	96.2
1989					
1 February-opening	13	9.2*	3.28	1.75	98.2

(1) Date when Bank announced change in dealing rates.Base rates moved on next working day.

* Close 30 January

RECENT MORTGAGE RATE MOVEMENTS

	Mortgage Rate
1987 August	11.25
Dec 1987/Jan 1988	10.0-10.30
1988 May	9.75
August	11.50
October	12.75
1989 January/February	13.50

note! fall only 1/4 – 1/2 2

BANK AND BUILDING SOCIETY LENDING

	BANK & BUILDING SOCIETY LENDING £bn Increase on previous month	% Annual Increase	BANK LENDING £bn Increase on previous month	% Annual Increase
July	+9.0	+23.5	+6.2	+27.8
August	+4.5	+24.1	+1.6	+27.9
September	+8.9	+24.2	+7.1	+27.9
October	+6.4	+24.7	+4.2	+28.1
November	+4.8	+24.4	+2.6	+27.3
December	+7.5	+24.3	+6.5	+27.1

CHANGES IN MAIN MONETARY AGGREGATES DECEMBER

All figures percentages

	MO	M4
12 Month Growth Rate	+8.5 (+7.7)	+17.4 (+17.3)
Annualised Six Month Growth	(+9.4)	(+19.0)
Annualised Three Month Growth	(+4.6)*	(+13.6)
One Month Change	+7.5 (+0.9)	+1.5 (+1.9)

* distorted by postal strike

(Figures in brackets seasonally adjusted)

Previous reserve levels and changes

(i) Reserves levels at key dates:

End-period	Level of reserves
	$ million
Labour	
End-December 1976 (Low)	4,129
End-March 1979 (High)	21,947
Conservative	
End-March 1985 (Low)	13,528
End-December 1988 (High)	51,685
Recent levels	
End-December 1986	21,923
End-December 1987	44,326
End-December 1988	51,685

RESERVES

(ii) Recent reserve changes:

$ million

		Underlying change	Total change	Level of reserves at end period
1988	January	+ 38	- 1,233	43,093
	February	- 25	- 166	42,927
	March	+ 2,225	+ 1,713	47,519**
	April	+ 514	+ 338	47,857
	May	+ 814	+ 676	48,533
	June	+ 84	- 14	48,519
	July	+ 910	+ 1,307	49,826
	August	+ 827	+ 813	50,639
	September	- 143	- 157	50,482
	October	+ 1,124	- 434	50,048
	November	+ 428	+ 992	51,040
	December	+ 461	+ 645	51,685
		-------	-------	
Totals since January 1988		+ 7,257	+ 4,480	

(iii) Underlying rise in reserves in 1988 totalled $7,257 million as compared with $20,475 million in 1987.

(iv) October 1987 underlying change of $6,699 million was largest ever.

(v) Reserves in December 1988 of $51,685 million are highest ever.

Level of official debt

Level at end-period	$ billion
May 1979	22.0
September 1988	16.6*

* latest published figure from Financial Statistics, December 1988, Table 10.6. But among other items, subsequently repaid $2.5 billion floating rate notes and borrowed around $2 billion in Ecus.

*at end September market rates.

**after revaluation of + $2,879 million.

PUBLISHED CHANGES IN UK OFFICIAL RESERVES 1986 - TO DECEMBER 1988

$ million

	Underlying Change	Total Change	Level of Spot Reserves at end Period
1986			
January	+ 132	+ 17	15,560
February	+ 112	+ 250	15,810
March	+ 278	+ 435	18,750*
April	+ 264	+ 237	18,987
May	+ 138	+ 179	19,166
June	+ 291	+ 22	19,188
July	- 4	- 105	19,083
August	- 141	- 159	18,924
September	- 372	+3502	22,426
October	- 668	- 434	21,992
November	+ 35	+ 14	22,006
December	+ 96	- 83	21,923
1986 Sub-Total	+ 161	+3875	
1987			
January	+ 72	+ 29	21,952
February	+ 287	+ 305	22,257
March	+1785	+1892	27,039*
April	+2912	+2768	29,807
May	+4760	+4872	34,679
June	- 230	- 315	34,364
July	+ 499	+ 551	34,915
August	- 457	- 550	34,365
September	+ 380	+ 443	34,808
October	+6699	+6591	41,399
November	+ 31	- 118	41,281
December	+3737	+3045	44,326
1987 Sub-Total	+20475	+19513	
1988			
January	+ 38	-1233	43,093
February	- 25	- 166	42,927
March	+2225	+1713	47,519*
April	+ 514	+ 338	47,857
May	+ 814	+ 676	48,533
June	+ 84	- 14	48,519
July	+ 910	+1307	49,826
August	+ 827	+ 813	50,639
September	- 143	-157	50,482
October	+1124	-434	50,048
November	+ 428	+ 992	51,040
December	+ 461	+ 645	51,685
1988 Sub-Total	+7257	+4480	
TOTALS	+27893	+27868	

* After revaluation change

NOTE
All totals do not include effect of annual revaluation changes.

TABLE- LATEST PUBLISHED COMPOSITION OF RESERVES 1979-1988

	End Period	Total	Gold	Special Drawing Rights(SDR's)	Reserve position in the IMF	Convertible Currencies
1979		22,538	3,259	1,245	-	18,034
1988	January	43,093	5,792	1,128	1,584	34,589
	February	42,927	5,793	1,113	1,588	34,433
	March(pre-revaluation)	44,640	5,793	1,209	1,604	36,034
	March(post-revaluation)	47,519	6,469	1,311	1,741	37,998
	April	47,857	6,468	1,389	1,752	38,248
	May	48,533	6,468	1,396	1,765	38,904
	June	48,519	6,468	1,525	1,763	38,763
	July	49,826	6,468	1,375	1,768	40,215
	August	50,639				
	September	50,482				
	October	50,048				

NB: These are latest figures published in the Bank of England Quarterly Bulletin,November 1988, (Table 17.1).Next Bank of England Quarterly Bulletin will be published on 9 February 1989.

NOTES

1. Figure for Gold does not include amount of Gold held by the European Monetary Cooperation Fund (EMCF) under quarterly swap arrangements ;in July was $1,617m equivalent.

2. Figure for Convertible Currencies includes the gold held by the EMCF,referred to in Note 1 above plus the valuation difference in the EMCF swap in force in July (+$921m).

S E C R E T
(NOT FOR PUBLIC USE)

TABLE- UNPUBLISHED COMPOSITION OF TOTAL RESERVES 1979-1988

End Period	Foreign Exchange								
	$	Others	Total	Gold	SDR's	EMCF Valuation	TOTAL SPOT RESERVES (PUBLISHED)	FORWARD BOOK (UNPUBLISHED)	TOTAL RESERVES
December 1979	12,091	4,752	16,843	4,075	1,245	375	22,358	937	23,475
March 1988 (pre-revaluation)	21,661	12,914	34,575	7,240	2,813	11	44,640	5,974	50,614
March 1988 (post-revaluation)	21,661	14,296	35,957	8,086	3,052	425	47,519	6,001	53,520
August 1988	23,631	14,797	38,428	8,085	3,205	921	50,639	5,038	55,677
October 1988	22,075	15,722	37,797	8,085	3,143	1,023	50,048	3,764	53,812
November 1988	22,637	16,388	39,025	8,084	2,908	1,023	51,040	3,767	54,807
Dec[illegible]r 1988	22,846	16,697	39,543	8,083	3,036	1,023	51,685	3,713	55,398

NOTE: THESE FIGURES ARE NOT PUBLISHED.

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TABLE : NET CURRENCY RESERVES ASSETS: END DECEMBER 1988

$ million

	Assets*	Liabilities	Net assets
US$	18024	9999 +	8025
DM	13288	2711	10577
DFLS	464	299	165
Yen	5565	266	5299
Sw fr	26	121	-95
Canadian $	713	390 ++	323
ECU	3988	2186	1802
Others	2211 **	10	2201
	44279	15982	28297

Note: Liabilities valued on reserves valuation basis.

* both spot and forward, and includes dollars pledged to EMCF.

\+ of which $1,806 million long-term North American loans.

++ Long-term North American loans.

** includes +2067 Ffr,+134 Bfr ($ million equivalent).

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TABLE : NET CURRENCY RESERVES ASSETS: END DECEMBER 1987

$ million

	Assets*	Liabilities	Net assets
US$	26461	14747 +	11714
DM	9246	2447	6799
DFLS	496	315	181
Yen	1909	255	1654
Sw fr	102	142	-40
Canadian $	667	391 ++	276
Others**	1060	29	1031
	39941	18326	21615

Note: Liabilities valued on reserves valuation basis.

* both spot and forward, and includes dollars pledged to EMCF.

\+ of which $1,912 million long-term North American loans.

++ Long-term North American loans.

** includes +280 ECU,+715 Ffr,+25 BFr,+34 Lira ($ million equivalent).

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TABLE : NET CURRENCY RESERVES ASSETS: END DECEMBER 1986

$ million

	Assets*	Liabilities	Net assets
US$	8950	16260 +	-7310
DM	2516	1391	1125
DFLS	116	289	-173
Yen	958	232	726
Sw fr	104	116	-12
Canadian $	278	393 ++	-115
Others	3	15	-12
	12925	18696	-5771

Note: Liabilities valued on reserves valuation basis.

* both spot and forward, and includes dollars pledged to EMCF.

\+ of which $2,020 million long-term North American loans.

++ Long-term North American loans.

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TABLE: 1989 (JANUARY 2nd to 31st) SUMMARY OF TOTAL G7 REPORTED MARKET INTERVENTION+

$ million equivalent

	$	DM	Yen	FFr	ECU	Other Currencies	Total
US	-1,880 (agst DM)	-	-	-	-	-	-1,880
Germany	-1,356	-	-	-	-	-	-1,356
Japan	-	-	-	-	-	-	-
France	- 190 (agst DM)	+ 88	-	-	-	-	- 102
Italy	- 25 - 133 (agst DM)	+ 1752	-	+ 21	-13	-	+1,602
Canada	- 33 - 185 (agst DM)	+ 529	-	-	-	-	+ 311
UK	- 205 (agst DM)	+ 125	-	-	-	-	- 80
	-4,007	+2,494	-	+ 21	-13	-	
						Grand Total	-1,505

+ on a done date basis

INTERVENTION

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TABLE: 1988 (JANUARY TO DECEMBER) SUMMARY OF TOTAL G7 REPORTED MARKET INTERVENTION+

$ million equivalent

	$	DM	Yen	FFr	ECU	Other Currencies	Total
US	+2755 (agst Yen) -3,716 (agst DM)	-	-	-	-	-	- 961
Germany	-7,125 +175 (agst Yen)	-	-	-	-	-	-6,950
Japan	+5,311 -150 (agst DM)	-	-	-	-	-	+5,161
France	-3,005 -45 (agst DM) +20 (agst Yen)	+2,218	-	-	-	-	-812
Italy	-1,137 -254 (agst DM)	-525	-	+570	+99	-	-1,247
Canada	+8,299 +82 (agst Yen) -204 (agst DM)	+52	-79	-	-	-	+8,150
UK	+1,579 -230 (agst DM) +35 (agst Lira)	+1,620	-	+1,202	+1,356	+98 BFr	+5,660
	+2,390	+3,365	-79	+1,772	+1,455	+98	
						Grand Total	+9,001

+ on a done date basis

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TABLE: G7 REPORTED MARKET INTERVENTION± 1988

$ million equivalent

January 1988 to December 1988	US	Germany	Japan	France	Italy	Canada	UK
1988							
January	+235$ agst Yen +480$ agst DM	+415$ +50$ agst Yen	+1060$	+610$, +3513DM +30$ agst DM	+366$,+795DM, +85ECU, +30$ agst DM	+1217$,+32Y,+91DM, +18$ agst Yen +37$ agst DM	+25$ agst DM
February	-	-	-	+356DM	-93$,-61DM -23Ffr	+840$, +116Y,+72DM	+35$ agst Lira
March	+318$ agst Yen		+379$	-90DM,+190$	-1236DM,-697$ -13Ffr	+1839$,-25$ agst Yen	+242$,+1004ECU +731DM,+951Ffr
April	+260$ agst Yen +240$ agst DM	+150$ +125$ agst Yen	+813$	+65$ +50$ agst DM +20$ agst Yen	-1650DM,-12Ffr -14ECU, -27$ +20$ agst DM	+809$ +48$ agst Yen +25$ agst DM -12 Yen	+540$
May	-	-7$	-	+98 DM	-372$ -294 DM +20 FFr	-372$	+670$ +100 FFr +100 ECU
June	-520$ agst DM	-1466$	-	-26$,-20$ agst DM	-91$,-20$ agst DM +678 DM, +68ECU	+2865$, -23$ agst DM	+125$,-50$ agst DM, +179 DM
July	-2410$ agst DM	-4169$	-150$ agst DM	-180$,-30$ agst DM	-312$,-187$ agst DM	-167$,-126$ agst DM	-150$ agst DM +575DM,+252ECU +98Bfr,+151FFr
August	-1806$ agst DM	-1976$	-	-731$,-175$ agst DM, +26DM	-366$,-91$ agst DM, +1139 DM -68FFr	-1448$ -140$ agst DM	-225$,-130$ agst DM, +66DM
September	-330$ agst DM -28$ agst Yen	-235$	-	-1364$, -146DM	-1350$, -6$ agst DM -220 DM -40 ECU +30FFr	+964$ -25$ agst DM	-363$,+80DM
October	+200$ agst Yen	-21$	+356$	-1006$,-1204DM	+1081$,+17DM +356 FFr	+1105$,-57DM -14 Yen	+200$,-112DM
November	+1570$ agst Yen + 530$ agst DM	+358$	+2653$	+100$ agst DM, - 83DM	+250DM,+724$,+236FFr	+809$,-54DM + 16$ agst Yen + 23$ agst DM -201 Yen	+315$,+75$ agst DM
December	+ 200$ agst Yen + 100$ agst DM	-174$	+ 50$	- 563$,-252DM	+ 57DM + 44ffr	-162$ + 25$ agst Yen	+ 75$,+101DM

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TABLE: 1987 SUMMARY OF TOTAL G7 REPORTED MARKET INTERVENTION+

$ million equivalent

	$	DM	Yen	FFr	ECU	Other Currencies	Total
US	+ 6,020 (agst Yen) + 2,378 (agst DM)	-	-	-	-	-	+ 8,398
Germany	+ 4,106 + 755 (agst Yen)	-	-	+ 3,308	-	+ 92 DKr + 2 I£	+ 8,263
Japan	+ 34,798 + 85 (agst DM)	-	-	-	-	-	+ 34,883
France	+ 6,597 + 710 (agst Yen) + 47 (agst DM)	- 10,041	-	-	-	-	- 2,687
It[illegible]	+ 1,632 + 71 (agst Yen) + 106 (agst DM) + 34 (agst ECU)	- 1,211	-	-	+ 75	-	+ 707
Canada	+ 4,972 + 72 (agst DM) + 123 (agst Yen)	- 1,781	-	-	-	-	+ 3,386
UK	+ 26,999 + 200 (agst Yen) - 40 (agst DM)	+ 3,551	-	+ 658	+ 133	+ 38 Lira + 28 BFr	+ 31,567
	+ 89,665	- 9,482	-	+ 3,966	+ 208	+ 160	
						Grand Total	+ 84,517

+ on a done date basis

TABLE: G7 REPORTED MARKET INTERVENTION± 1987

$ million equivalent

January 1987 to December 1987	US	Germany	Japan	France	Italy	Canada	UK
1987							
January	+50$ agst Yen	+566$, +2I£ +3308ffr,+92DKr	+8649$	+189$,-4217DM	+394$,-628DM,-12ECU	+1445$	+181$
February	-	-	-	+661$,+2111DM	+493$,+1978DM	+291$	+174$,+30DM
March	+2395$ agst Yen -30$ agst DM	+200$ agst Yen	+8533$	+883$,+4084DM +250$ agst Yen	+37$,+612DM +27ECU	+1578$	+3630$ +100$ agst Yen +225DM
April	+1530$ agst Yen +99$ agst DM	+555$ agst Yen, +327$	+7398$ +50$ agst DM	+4525$,-970DM +460$ agst Yen	+1067$,+26ECU -1290DM, +71$ agst Yen	-1781DM	+5525$,+100$agst Yen +156DM
May	+20$ agst Yen +273$ agst DM	+269$	+35$ agst DM	-918DM	+169$,-1572DM	-553$	+6715$
June	+103$ agst Yen +415$ agst DM	+150$	+80$	+70$ agst DM -480DM	-47$,-855DM +25$ agst DM	+579$	-85$
July	-	-	-	+81DM	-953$,-455DM	+77$	+487$,+517DM
August	-681$ agst DM +105$ agst Yen	-133$	+959$	-714$,-40DM -267$ agst DM	-2102$,-870DM	+712$,-50$ agst DM	-526$,-150$agstDM
September	+235$ agst Yen	+216$	+670$	+20$ agst DM, -1138DM	+233$,+1844DM	+353$ +20$ agst Yen	+1603$,+35$ agst DM +664DM
October	+65$ agst Yen +395$ agst DM	+760$	+2012$	+338$,-6284DM, +60$ agst DM	+890$,+724DM, +10$ agst DM +34ECU	+138$ +38$ agst DM	+5818$,+50$ agst DM +1128DM
November	+428$ agst Yen +788$ agst DM	+812$	+3074$	-2270DM	+992$,-374DM	-21$,+17$ agst DM	-
December	+1089$ agst Yen +1119$ agst DM	+1139$	+3423$	+715$ +164$ agst DM	+459$,-325DM +71$ agst DM	+373$,+67$agst DM, +103$ agst Yen +34$ agst ECU	+3477$,+25$ agst DM +831DM, +658Ffr, +133ECU, +38Lira +28Bfr

ANNEX B

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ANNEX B

IMF QUOTA INCREASE

There was a brief tour de table of positions on the quota increase.

Mulford - no decision likely at the April meeting. Brady had yet to make up his mind. Jim Baker had been totally opposed to any increase - too many troubles already on the Hill. Personally, he saw it inconceivable to envisage the substantial increase in Fund lending contemplated in the Managing Director's proposal.

Gyohten - wanted April decision, but obviously would respect US wishes. Urged special quota increase for Japan. If no decision in April, needed to set an unbreakable deadline. Would argue for "substantial" quote increase and was ready to discuss with others what that meant.

Wicks - our views for a "moderate" increase well known and set out in G10 Deputies' paper. Obviously a decision not possible in April - needed to see how the situation developed.

Trichet - the time may come when a big country may need to go to the Fund. France could go up to a 100 per cent increase.

Sarcinelli - wanted a "large and sizeable increase".

Dobson - a lot of sympathy with the Managing Director's arguments. Favoured a substantial increase in quota "above 50 per cent". Saw a substantial increase in the use of Fund credit in the developing countries. A decision in April was not essential, but would like to settle an unbreakable deadline.

Tietmeyer - needed a substantial increase, not a doubling but say between 50 per cent and two-thirds because, Fund should not continue to rely on loans and should be equipped to deal with the problems of industrial countries. If a decision could not be taken in April, it should be taken as early as possible.

[Action: **Mr Evans** to produce a short brief for the Washington meeting.]

Financing Burden-Sharing
IMF vs. Banks
(Billions of SDRs)

		1983-89	1990-94 Scenario A	1990-94 Scenario B
1.	Flows (Annual Averages)			
	Financing Gap 1/	6.4	13.2	13.2
	Financing Source			
	IMF Net	1.2	4.1	7.9
	(Share)	(19%)	(31%)	(59%)
	Banks 2/	5.2	9.2	5.4
	(Share)	(81%)	(69%)	(41%)
2.	Credit Outstanding			
	IMF	25	50 3/	65
	Banks	255 4/	301	282
3.	IMF Quota	90	155-170	288-310

1/ All capital importing developing countries except Korea, Taiwan, South Africa, Malaysia, Hong Kong, and Singapore.

2/ "Other financing" -- mainly commercial banks, but is residual in WEO calculations.

3/ Includes SDR 4 billion financing for special facilities (not included in "IMF Net" above).

4/ $344 billion end-1989 estimate for all capital importing developing countries in latest WEO (excluding six countries in note 1 above; public and publicly-guaranteed debt only), converted at 1 SDR = $1.35.

Source: EB/CQuota/88/11 of 12/16/88, Table 1.
WEO October 1988, Table A-48, page 125.

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IMF: QUOTAS

1. CAMDESSUS (FUND MD) INVITED ENOCH AND ME ALONG YESTERDAY EVENING TO DISCUSS THE UK'S POSITION ON THE SIZE OF THE QUOTA INCREASE. CAMDESSUS WAS ACCOMPANIED BY ERB (DEPUTY MD) AND WILLAMS (DEPUTY TREASURER). THE MEETING HAD BEEN ARRANGED ORIGINALLY AS A PRELUDE TO CAMDESSUS' CALL ON THE CHANCELLOR IN LONDON, BUT HE WENT AHEAD WITH IT EVEN THOUGH THE VISIT TO LONDON WAS NO LONGER ON.

2. WE REPEATED THE ARGUMENTS ON THE SIZE OF THE FUND MADE IN YOUR TELNO 4 AND WHICH WE HAD ALREADY PRESENTED IN THE FUND BOARD ON JANUARY 9. CAMDESSUS RESPONDED ON A NUMBER OF THESE POINTS. HE ARGUED:

(A) GIVEN THE UNCERTAINTIES IN THE WORLD ECONOMY AND RECENT DEVELOPMENTS IN A NUMBER OF COUNTRIES, IT WAS POSSIBLE THAT SEVERAL LARGE COUNTRIES, SOME OF WHOM HAD NOT BEEN TO THE FUND BEFORE, MIGHT SEEK TO BORROW SUBSTANTIAL SUMS FROM THE FUND IN THE NEXT FEW YEARS. VENEZUELA, ALGERIA, INDIA, CHINA AND EASTERN EUROPE WERE MENTIONED AS EXAMPLES. IN ADDITION, ONE OR MORE OF THE INDUSTRIALISED COUNTRIES MIGHT ALSO WISH TO DRAW.

(B) PROJECTED FUND FINANCE WOULD HAVE TO COME FROM THE FUND'S GENERAL RESOURCES, ESSENTIALLY WITHOUT BEING SUPPLEMENTED FROM SAF/ESAF AND THE GAB, AS WE HAD ARGUED. APART FROM INDIA AND CHINA, WHO IN ANY CASE HAD DENIED THEMSELVES ACCESS, NONE OF THE PROSPECTIVE MAJOR BORROWERS WAS SAF/ESAF-ELIGIBLE. REGARDING THE GAB, ITS USE WAS HEAVILY CIRCUMSCRIBED, AND IT COULD NOT BE REGARDED AS A FIRST LINE OF DEFENCE.

(C) THE FUND HAD TO BE ABLE TO MAINTAIN NOTIONAL LEVELS OF ACCESS FOR ALL ITS MEMBERS. IN RESPONSE TO OUR OBSERVATION THAT FUND MANAGEMENT HAD IN RECENT YEARS NOT PRESENTED PROGRAMMES WHICH TOOK A BORROWER EVEN CLOSE TO ITS NOTIONAL ACCESS LIMIT, CAMDESSUS RESPONDED THAT (I) THE POTENTIAL FOR SUCH ACCESS HAD TO BE SAFEGUARDED, AND (II) IT WOULD GIVE A VERY NEGATIVE SIGNAL TO THE INTERNATIONAL COMMUNITY IF A

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QUOTA INCREASE WERE AGREED WHICH DID NOT SAFEGUARD EXISTING NOTIONAL ACCESS LEVELS.

(D) A 70 PER CENT LIQUIDITY RATIO WAS AN APPROPRIATE PRUDENTIAL CONSTRAINT FOR THE FUND. IN RESPONSE TO OUR OBSERVATION THAT THIS HAD NOT BEEN OBSERVED FOR MUCH OF THE PAST DECADE, CAMDESSUS RESPONDED THAT (I) AS HEAD OF A MONETARY INSTITUTION, HE COULD NOT ENDORSE A STRATEGY THAT COULD LEAD TO ANY RELAXATION OF THIS PRUDENTIAL CONSTRAINT, (II) THE LIQUIDITY RATIO COULD ANYWAY RAPIDLY COME UNDER PRESSURE IF A NUMBER OF LARGE BORROWERS CAME TO THE FUND AND (III) SECURING A QUOTA INCREASE WHICH WOULD SAFEGUARD THIS LIQUIDITY RATIO WOULD ESSENTIALLY BE COSTLESS (COMMENT: I.E. QUOTA SUBSCRIPTIONS AT THE MARGIN ARE REMUNERATED).

(E) A SUBSTANTIAL QUOTA INCREASE WOULD NOT BE REGARDED AS A SIGN THAT THE FUND WAS PREPARING TO BAIL OUT THE BANKS, RATHER IT WOULD SIGNAL THAT THE FUND WOULD CONTINUE TO PLAY ITS EXISTING CATALYTIC ROLE AND WAS NOT SEEKING TO WITHDRAW. (WE POINTED OUT THAT THE BANKS MIGHT INTERPRET THE SIGNAL IN PRECISELY THE OPPOSITE WAY: AS REDUCING THE NEED FOR THEM TO PUT UP NEW MONEY.)

(F) THE FUND COULD NOT EXPECT OTHER OFFICIAL CREDITORS TO CONTINUE TO PLAY AS LARGE A ROLE AS IN RECENT YEARS IN FINANCING PAYMENTS IMBALANCES. THE WORLD BANK WAS EXPECTING SIGNIFICANT REFLOWS, SO ITS NET LENDING WAS PROJECTED TO BE SMALL. THE PARIS CLUB MIGHT NOT BE INVOLVED IN A NUMBER OF THE LARGE POTENTIAL BORROWERS, SUCH AS CHINA AND INDIA.

(G) IT WOULD BE TOO OPTIMISTIC TO EXPECT MANY EXISTING LARGE BORROWERS TO CEASE TO HAVE NEED OF FUND RESOURCES OVER THE NEXT QUOTA PERIOD. PAST SUCCESS CASES (CAMDESSUS MENTIONED TURKEY AND KOREA) HAD ENJOYED VERY HIGH LEVELS OF ACCESS TO FUND RESOURCES FOR MANY YEARS: INDEED FUND LENDING TO THESE COUNTRIES HAD BEEN CRITICISED AT THE TIME AS BEING IMPRUDENTLY LARGE. CAMDESSUS WAS DISMISSIVE WHEN WE SUGGESTED SOME EXISTING BORROWERS (E.G. CHILE, MOROCCO) MIGHT SOON ALSO NOT NEED FURTHER BORROWING AND COULD THEREFORE PROVIDE SIGNIFICANT REFLOWS TO THE FUND.

3. WE HAD A BRIEF DISCUSSION ON PROSPECTS FOR THE QUOTA REVIEW. I SUGGESTED THAT CAMDESSUS WAS NOT BEING REALISTIC IN HIS EXPECTATIONS, NOT LEAST BECAUSE THE AMERICANS - WHO HAVE A BLOCKING VOTE - WERE HOSTILE TO A SUBSTANTIAL QUOTA INCREASE. ERB RESPONDED TO THIS, SAYING THAT THE PRESENT US POSITION GAVE HIM A STRONG SENSE OF DEJA VU. AS FUND ED DURING THE LAST QUOTA REVIEW, HE HAD MADE SIMILAR STATEMENTS

TO THOSE DALLARA WAS NOW MAKING ON THE ABSENCE OF A REAL NEED FOR A QUOTA INCREASE, THE DIFFICULTY OF PASSING AN INCREASE THROUGH CONGRESS AND SO ON. HOWEVER, HAVING EXAMINED THE ISSUES, THE US HAD THEN QUICKLY AGREED TO A 60 PER CENT QUOTA INCREASE, A TRIPLING IN THE SIZE OF THE GAB, AND SIGNIFICANT NEW BORROWING BY THE FUND (COMMENT: THIS WAS IN 1982, DURING A PERIOD OF PERCEIVED SYSTEMIC CRISIS, RATHER DIFFERENT FROM THE BACKGROUND TO THE PRESENT REVIEW). CAMDESSUS TOOK THIS UP, STRESSING THAT THE US HAD NOT YET STATED A POSITION, BUT THAT HE EXPECTED TO HAVE A US RESPONSE BY THE END OF FEBRUARY.

4. COMMENT: NOTHING REALLY NEW EMERGED AT THIS MEETING, ALTHOUGH FUND MANAGEMENT HAVE CLEARLY BEEN WORKING ON RESPONDING TO SOME OF THE CRITICISMS WE HAVE MADE TO THEIR ARGUMENTS FOR A SUBSTANTIAL QUOTA INCREASE. THE QUESTION OF THE DISTRIBUTION OF ANY QUOTA INCREASE WAS NOT RAISED. THE PURPOSE OF THIS MEETING WOULD SEEM TO BE FOR CAMDESSUS TO ASSESS WHETHER HE CAN ISOLATE THE AMERICANS ON THE SIZE OF THE QUOTA INCREASE. CAMDESSUS CONTINUES TO BE VERY KEEN TO HAVE AN EARLY OPPORTUNITY TO PERSUADE THE CHANCELLOR ON THIS. ON TACTICAL GROUNDS, THERE SEEMS NOTHING WHATEVER TO BE SAID FOR CHANGING OUR POSITION IN ANY WAY UNTIL THE AMERICANS HAVE FINALLY DECIDED ON THEIR OWN POSITION.

5. FCO PLEASE ADVANCE TO PS/CHANCELLOR, WICKS, EVANS AND BATT (HMT), WARE (BANK OF ENGLAND) AND RICHARDSON (ERD).

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GATT Negotiations

Provisional agreement was reached by Ministers in Montreal in eleven out of the fifteen negotiating areas. The four outstanding areas are agriculture, textiles, intellectual property and safeguards. The key issue is agriculture and the failure to obtain agreement over that sector influenced in part the refusal of some countries to agree on the three other outstanding areas. Consultations on the four issues between the key players are now taking place with the GATT Director General, Arthur Dunkel, acting as broker. The aim is to lay the ground for deals to be struck when the Trade Negotiating Committee (TNC) meets at senior official level in Geneva in early April. The TNC will also be asked to formally endorse the agreements settled at Montreal.

2. The current deadlock on agriculture stems from the refusal of the US to drop its insistence that the "elimination" of all trade-distorting subsidies should be the aim of the negotiation. There have been some signs recently that the US may be more flexible on the long term objective and, in the event that they move, the EC will be under considerable pressure to shift its position as the short term reductions in support it may be prepared to offer could prove to be inadequate, and it is unwilling to offer separate concessions on import access or export subsidies. Between now and April the UK will be encouraging the Commission to be flexible on the long term objective and, when tabling proposals for short term reductions, to go beyond the February 1988 CAP reforms.

3. On textiles, the UK will be pressing the Community to redefine its objectives in a manner that will facilitate agreement on the way forward in the negotiations. The EC's current position is that liberalisation must be dependent upon increased access to developing countries' markets and improved GATT disciplines (safeguards in particular). The developing countries are insisting that a timetable for liberalisation be agreed without any conditions. E(CP) decided in January that the UK's objective should be to phase out the Multi-Fibre Arrangement and that trade-offs in negotiation ultimately should not stand in the way of this objective.

<u>Line to take</u>

4. Disappointed that all issues could not be resolved at Montreal, especially agriculture. All countries must address themselves now to finding solutions to outstanding issues.

5. Understand US desire to see agricultural subsidies eliminated. But commitment to total elimination not necessary to make progress towards this objective in the short or long term and is not politically feasible.

6. Recognise that EC too will have to move further and UK will be encouraging it to do so. CAP reforms agreed last February were a step in the right direction but more is needed.

GATT AND FINANCIAL SERVICES

One the objectives of the current negotiations is to reach agreement on a means of subjecting services to GATT disciplines. At Montreal agreement was reached on a comprehensive framework for the remainder of the negotiations and on definitions of the key principles and methods of negotiation. No final decision was taken on the types of services which will be included in the final agreement though it was stated no sector should be excluded a priori. There is a reference however to the possibility of certain sectors being excluded for "overriding considerations". In part this reflects the concern of the US Treasury who would prefer to see financial services detached from the negotiations or negotiated in some other forum. They are reluctant to let negotiations in this sector be handled by the USTR and are concerned that some aspects of prudential control might fall foul of GATT rules. The prudential worry is a serious one but the framework agreement has been drafted in such a way that such a conflict should be avoidable. The implications of the final agreement for specific sectors will have to be considered before the agreement is finalised. In any negotiations on financial services we would expect the Commission to be guided by the officials responsible for this sector in Member States.

2. Following lobbying by US officials last autumn, HMT, the Bank and DTI have been considering in detail the likely implications of subjecting financial services to GATT disciplines. The intention is to go back to the Americans when this work is completed. The UK started with a strong prejudice in favour of putting financial services into GATT, and DTI still regard themselves as committed to this. But the Bank now considers that the UK's comparative advantage in this field ~~was~~ is not as great as it was so it may not serve UK interests to go on arguing within the EC for inclusion. DTI are concerned that, if financial services were withdrawn from the negotiations, other sectors may be pulled out thus undermining the services negotiations as a whole. This wider consideration may override any doubts about the UK maintaining its current stance.

Line to take

3. Pleased that framework agreement reached at Montreal on services. Agreement allows for impact of final agreement on individual sectors to be considered. Would be premature for major player to try and remove any particular sector before end of negotiations. May be useful though if US and UK officials informally consider implications of including financial services in final agreement.

G7: 3 FEBRUARY

Reciprocity in banking directive

Line to take

UK has made clear its opposition to reciprocity provision in present text of Second Banking Directive. Well aware of protectionist threat it poses. Our aim is to see open, liberalised single market in financial services from which all can benefit. All member states agreed in December that the Commission's proposal as originally formulated was unworkable. The Commission has agreed to reconsider. UK participating in negotiations without prejudice to our stated position.

Background note

2. Article 7 of the draft second banking coordination directive provides that the Commission may delay the authorisation of a subsidiary whose parent undertaking is governed by the laws of a third country, or the takeover of an existing Community credit institution by an undertaking governed by the laws of a third country, while it considers whether any member state experiences reciprocity problems with that third country.

3. The report of the interdepartmental reciprocity working group concluded that the Commission was unlikely to abandon entirely a reciprocity provision, and considered whether some form of limited reserve power might be more acceptable to the UK. At ECOFIN on 7 November, all member states, including those who welcome the principle of reciprocity, opposed the Commission's current proposal as unworkable. The Commission is rethinking; it is possible that its new proposals may be less unworkable but no less unacceptable to the UK and that we and our allies will have to push harder. Among EC, G7 countries, the UK and Germany are opposed to a reciprocity provision but France and Italy accept the principle.

4. On 14 September 1988, then acting US Treasury Secretary McPherson wrote to the Chancellor expressing his concern about the reciprocity provisions in the banking directive. The Chancellor replied on 18 October, making clear the UK's opposition to the Commission's current proposals. While the Chancellor can continue to assure the Americans that the UK is opposed to the reciprocity proposals, it would be better not to give an unqualified assurance that the UK will vote against any variant of the reciprocity principle. We may in the end find a weak reserve power under Council control acceptable. But it is probably too early to warn the Americans that we may have to concede something - though we shall have to persuade them not to over-react if that is what eventually happens.