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Chancellor's (Lawson) Papers:
New Initiatives for Relieving International Debt.

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DD's: 25 Years
D Anderson
9/2/96.

FROM: H G WALSH
DATE: 1 MAY 1987

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir G Littler
Mr Lavelle
Mr Evans
Mr Mountfield
Mr Culpin
Miss Noble
Ms Evans
Ms Life
Mr Pitcairn

Mr Drummond, ERD

ALL-PARTY GROUP ON OVERSEAS DEVELOPMENT: REPORT OF DEBT WORKING PARTY

The above report, by an unofficial group of Parliamentarians chaired by Bowen Wells, MP, will be published at 11.30 on Tuesday, 5 May. (The membership of the Debt Working Party of the Committee is on the attached press invitation). We have just obtained a copy of the report and have not had a chance to study it in depth.

2. Our fist reaction to the report is that it is out of date, since it was clearly prepared before your sub-Saharan initiative. The specific proposals in the attached Section 6 (A Framework of Recommendations) are related to the provision of assistance or relief, and there is very little in the entire report about the need for adjustment in LDCs. There is little analysis, but a lot of sympathy for debtors of all types.

3. The solution for Africa is recommended to be a writing down of debt (by which is meant debt forgiveness) and elsewhere in the low income developing world, where debt is owed mainly to banks, the recommendation is a longer-term rescheduling of principal together with interest-rate capping. There is also favourable mention of Mr Moynihan's ideas in linking drugs and debt (debt-development swaps) with which the Economic Secretary is only too familiar after two adjournment debates.

4. For the major debtors, rescheduling, debt-equity swaps, interest-rate relief, more World Bank/RDB funding, and faster restoration of export credits are all supported. A favourable mention is given to an International Debt Facility to buy up debt at secondary market value (perhaps using Japanese recycled money) and reducing the scale of repayments.

5. It is recommended that the UK Government should take the debt issue to the United Nations General Assembly, as the most comprehensive forum.

6. The line we should take on the report would seem to be:-

We are studying the report but our initial reactions are: the report was written before the Chancellor's three-point plan for sub-Saharan Africa launched at the Spring Meetings of the IMF/IBRD on 9 and 10 April, being carried forward in discussions in the Paris Club and elsewhere. We believe that debt issues can best be resolved by this means and through other existing specialised international institutions such as the IMF and World Bank. Finance without adjustment will not bring about a sustainable solution. There is a clear need to ensure that debtors implement adequate growth-oriented adjustment programmes, and that finance is made conditional on this.

7. Mr Patten may be asked to react to the report at a meeting of OXFAM that he is attending on 5 May.

H.W.

H G WALSH

HOUSE OF COMMONS
LONDON SW1A 0AA

ALL PARTY PARLIAMENTARY GROUP ON OVERSEAS DEVELOPMENT

Chairman: Lord Oram   Deputy Chairman: Jim Lester MP   Joint Secretaries: Guy Barnett MP   Bowen Wells MP   Treasurer: Kevin McNamara MP
Honorary Vice-Chairmen: Alan Beith MP   Tom Clarke MP   Reg Prentice MP   Lord Seebohm

You are invited to the Press launch of
the Report of the Second Working Party of the
All Party Parliamentary Group on Overseas Development

on

MANAGING THIRD WORLD DEBT

in Committee Room 13
House of Commons
11.30 am Tuesday 5 May

introduced by Bowen Wells, Chairman of the Working Party

The Third World's debt burden has become a barrier to development, for low-income Africa as for Latin America. Overall, Third World countries are now exporting capital back to us. This report recognises that economic growth must be part of the solution, rather than the pay-off after years of austerity. It finds the banks quite realistic about their prospects of repayment but the creditor governments reluctant to initiate concessions.

The Working Party has drawn up a framework of recommendations after meeting representatives of all points of view - banks, creditor and debtor governments, as well as international financial institutions in Washington and independent experts. The report's recommendations should strengthen the resolve of the Government to secure better arrangements within the Paris Club for Africa's debt and facilitate the adoption of an appropriate menu of facilities to deal with developing countries' bank debt.

Copies of the book will be available at the launch meeting. If you plan to attend, or for further information please contact Inez Woodhouse on 01-935 1644.

MEMBERSHIP OF THE WORKING PARTY

Bowen Wells (Conservative) Chairman

Alan Beith (Liberal)	Tom Clarke (Labour)
Baroness Ewart-Biggs (Labour)	Lord Greenhill (Independent)
Robert Harvey (Conservative)	Jim Lester (Conservative)
Oonagh McDonald (Labour)	Colin Moynihan (Conservative)
Lord Seebohm (Independent)	Tim Yeo (Conservative)

Research Adviser: Adrian Hewitt
Overseas Development Institute, Regent's College.

possible along the path involving multi-year rescheduling and some limited debt write-offs, with conversion of bilateral official loans into grants. Creditors are reluctant to commit themselves to write-offs because of the risk of creating a precedent, but many are prepared to recognise that in particular cases a partial debt write-off is the only sensible course, permitting both economic recovery and a stronger chance of political stability in the debtor country.

6

A Framework of Recommendations

6.1 The Necessity of Political Will

As an all-party group concerned primarily with development issues, we have taken the view that the existing procedures adopted to handle the ldc debt problem have been excessively focused on financial solutions. These have involved the imposition of austerity on nations which are already very poor. Moreover, the financial imperative has inclined policy-makers to the adoption of very short time horizons for adjustment measures, which usually fail and then have to be repeated with consequent loss of efficiency for all concerned.

The time has therefore come for **new political initiatives** and we base our case on three interrelated propositions:

- First, that in 1987, the Third World's debt problem seems no closer to resolution than it did in 1982 (when the crisis broke) or in 1984 (when the major international institutions predicted an upturn). Since 1983, in fact, developing countries' net capital transfers have turned negative. They are, moreover, now paying more interest than principal repayments. Net bank lending to most ldcs has stopped, the expected spontaneous revival of lending has not materialised, and the 'Baker Plan' and the innovations of the late-1986 Mexico deal have not altered that overall pattern. Adjustment and retrenchment have not of themselves brought a return to creditworthiness.
- Second, that so long as the debt burden cripples the performance of so many developing countries, it stifles the growth potential of the world economy — in particular world trade growth, but also the market for credit. Thus, economic and social costs are borne by us all in an apparent endeavour to satisfy some creditors' financial requirements. Senator Bradley told us how US exports to Latin America had fallen by 25% between 1981 and 1985; over the same period, the World Bank calculates Latin American and Caribbean imports from all countries have fallen by 40%. Africa — already

facing economic stagnation in 1981 — saw its import levels further decline by one-fifth to 1985. Those lost imports represent jobs and new investment in improved technology in the North. At the same time, debtor countries are obliged to expand their exports — whether of commodities (effectively depressing world prices) or of manufactures and semi-processed goods (raising further protectionist opposition in the West) — instead of investing in their own economic development.

- And third, that Third World debt is already being discounted. A secondary market for ldc sovereign debt already exists where obligations can be traded for a fraction of their face value — proof, if any is needed, that private financial institutions do not seriously expect to recover all their outstanding loans. Many donor governments have also written off oda debt for the poorer countries by converting outstanding loans into grants. In contrast, however, new multilateral facilities such as the IMF's SAF are conceived largely to enable interest payments to be maintained.

The least we could do in our recommendations, then, would be to develop a framework which takes these realities into account. This leads us to our initial recommendation: **the political will should be generated for a far more innovative approach, and since a certain amount of debt is already being written off informally, a way should be opened for making this official, thus allowing new credits to be established with improved underlying guarantees.**

6.2 Need for Government Action

During our inquiry it was put to us from several official sources that the debt problem, though requiring constant attention, remained manageable. The Baker initiative itself represented a note of confidence in the existing institutions — notably the World Bank and the IMF — and a belief that slight modifications to the traditional adjustment formula would be adequate to restore creditworthiness in due course. Even the IIF believed that adequate finance would emerge voluntarily from the commercial banks if debtor countries which had 'adjusted up' to an unsustainable standard of living in the 1970s were prepared now to retrench. The British Government's view was expressed in similar vein by the Economic Secretary to the Treasury, Mr Ian Stewart, who saw it as natural that any period of 'overborrowing' should be followed by an unravelling, with inevitable social and economic costs for the debtor nations.

Not even the largest debtors have favoured policies threatening or moving towards outright default. Most see their interest in working jointly with creditors to devise more generous schedules of debt service which will avoid damaging the solvency both of the debtors and of the banks, enabling a market for lending to resume. This is in stark contrast to the 1930s, when a number of Latin American countries defaulted first, and then sought solutions to their access to credit later. Today, we recognise that there is a strong desire for jointly workable solutions which, however, do not leave the debtors with the whole burden of adjustment.

Although the bulk of ldc debt (notably excluding that owed by low-income Africa) represents as much a banking as a debt crisis, we recognise that new government initiatives are now required to address the problem. After five years of 'crisis', incapacity to service debt is no longer a temporary problem, but an issue hampering the efficient management of the world economy. The mechanism which keeps ldc debt service just about current — IMF stabilisation programmes, a dose of involuntary lending and a requirement to generate export surpluses — has been shown to be unsustainable. **We believe therefore that once development interests (not just the interests of developing countries) are adequately taken into account, the need for public sector initiatives becomes imperative.**

We justify government action on three counts:

- interest payments are now a major part of the ldcs' debt problem (particularly as a result of the shift to variable interest rate loans): the overall level of interest rates is determined by the policies of governments, notably of the Group of Five;
- it is governments through their central banks which regulate their private banks' lending and rescheduling practices. The same governments are also ultimately responsible for the policies of the IMF and World Bank;
- while a high share of private lending to ldcs was a feature of the decade after 1973, the normal pattern is for official or officially controlled and guaranteed flows to dominate (as in Africa today). Already the relative failure of post-Baker voluntary lending indicates a need for a stronger role for publicly-backed financial flows (and also for alternatives to loans, such as direct investment and equity capital).

6.3 Focus on the Real Economy

The concentration on purely financial solutions to the ldc debt problem has led to a gross imbalance in the system of international financial management. Such an approach has required the IMF to impose conditionality on ldc debtors but not on the United States (the world's major debtor and with an enormous budget deficit), nor on member countries like West Germany and Japan in chronic balance of payments surplus. It has given Western banks the 'breathing space' to strengthen their capital bases but not the developing countries the required breathing space to restructure their economies. It has overlooked the need to sustain the momentum of development in Third World economies. Negotiators and international institutions have too lightly assumed that their task is to protect the international financial system rather than to safeguard the living conditions of people in developing countries, at a time when even the appropriate international supervisory organisation, the Bank for International Settlements, questions this narrow approach. The new emphasis on growth since the Baker initiative may seem to have partially redressed this imbalance, but it is not evident that sacrifices of ldc growth have ceased, or that development based on export expansion and domestic austerity is politically or socially sustainable.

Nor does the financial solution make sense in terms of economics. At prevailing world interest rates it involves a continuing leakage of capital from the Third World to the First. All economic logic would indicate that this is perverse. Over any reasonable time-scale, the marginal efficiency of capital will always be greater in developing countries where it is scarce than in industrial societies.

Our case for a wider focus does not simply rest on this premise, however. By forcing developing countries to carry the whole burden of adjustment, other highly important sectors of our own economy have suffered from the second-round effects of contraction. We have already referred to the loss of exports, and hence of employment, following ldc import cutbacks and declines in GDP. Furthermore, the continuing debt problem has restricted the market for direct foreign investment and this represents another area where our own economic agents are being denied their normal scope for expansion.

We thus conclude that **debt management has in the past been too preoccupied with narrow financial settlements. The interests of world economic growth, and employment in our own countries, require a much broader approach.**

6.4 Equitable Treatment and the 'Risks' of Precedent

The distribution of debt relief between developing countries is a delicate question. The arguments about international fairness in

according more generous debt relief fall into three parts:

- First, that any financial concessions to heavily indebted countries would be unfair to 'prudent' borrowers, like the South Asian countries.
- Second, that the most generous terms offered to the most grievously indebted states would be taken by others as a precedent on which their own case would be negotiated. This is also an issue of equity, between borrowers who can and cannot or who try and do not try to repay.
- Third, that sovereign debt is contracted by governments but is used and consumed by particular interest groups who may not be the most deserving.

Our riposte is, first, that there is a legitimate world interest in restoring sustained growth in major parts of Latin America and Africa; this can only be to the benefit of the world economy as a whole. In any case, those countries which have maintained a prudent record of creditworthiness would not lose it just because other countries' credit ratings are restored, say, through partial write-offs. Donor governments have the capacity to increase public concessional flows to South Asia if they wish — though the IDA cutbacks indicate that their main preoccupations are elsewhere.

Second, the issue of establishing precedents in debt negotiations is not new. Other debtors would like to adopt features of the 1986 Mexico deal — compensatory facilities linked to an export commodity price or to growth rates, extended rescheduling periods, etc — and may in time succeed in establishing these as a precedent. Providing generalised debt relief would still require a procedure whereby debtors' sustained capacity to pay is studied on a case-by-case basis. The issue of precedent arises hardly more than under the existing Paris Club rules, where the conventional wisdom is that debtors (as well as creditors) must be ensured equality of treatment. The ultimate restraint on 'good debtors' demanding the same concessions as 'the profligate' will remain the fear of losing creditworthiness. Sensible management of case-by-case treatment of debtors would remain the safeguard against unwelcome precedents.

Lastly, debt relief is too blunt an instrument with which to address the problem of income inequality within developing countries. Experience has demonstrated that not having a generous debt settlement leads to more domestic inequality than having one. Many studies, notably those sponsored and conducted by UNICEF, have shown that the poor bear an unfair share of the burden of adjustment.

They should accordingly benefit disproportionately from the relief. Safeguards as to the distributional consequences of government policies could be made a condition of debt relief. They have yet to become a feature of IMF adjustment packages; the position of the poor need be no worse therefore, and could be potentially better, than under the present ad hoc debt management procedures where growth of the whole economy is forgone.

We conclude, therefore that **measures to resolve the debt problem which are based more firmly on the expansion of developing countries and on a revival of demand in the world economy would represent an advance on excessively narrow financial measures.**

6.5 Specific Proposals

We start by acknowledging that not all developing countries need special debt relief measures. The poorest countries in Africa are in such a difficult plight that we would work towards a **writing-down of most of their external debt**, which in any case is mainly owed to governments and institutions rather than banks. Elsewhere in the developing world, where the restoration of lending for trade credit and of investment flows is crucial to economic recovery, and where debts are mainly owed to commercial banks, relief measures should involve a package of much **longer-term rescheduling of principal, together with interest-rate capping** to reduce the total service payments to manageable proportions.

> *Box 5: Debt-Development Swaps*
>
> A country whose commercial debt is already heavily discounted can negotiate with a donor agency to swap debt relief for an agreed development programme. An example would be Bolivia, whose outstanding debt of $2.5 bn (of which $800m. is owed to commercial banks) is trading on the London secondary market at about 8% of its nominal value. The banks holding that debt (who have already made provision for substantial losses) could be persuaded to sell the $800m. debt for around $80m. (ie already at a premium to the market rate), if there were a willing government purchaser. A donor government (or several) which already wanted to spend $80m. on an aid programme inside Bolivia could thus purchase the debt at a deep discount, while to implement the domestic aid spending (in this case, a drug eradication programme) the Bolivian Government would simply have to raise $80m. worth of local currency through taxation or other means. The commercial creditors receive hard currency in redemption of the debts they hold, at or above the market rate; the donor governments have to raise no new money to fund the development programme, since this was planned in advance; the debtor government is relieved of its bank debt obligation and so saves foreign exchange on amortisation; its only obligation is to raise real resources locally and adjust according to a programme agreed with creditor governments. In other circumstances, part or all of a country's commercial debt could be bought back in this way. An agreed poverty alleviation programme could be the target of the counterpart spending. Innovations of this sort are necessary to address particular countries' debt problems. *(Further details in Colin Moynihan's adjournment debate, House of Commons Debates, 18 December 1986.)*

Advantage should be taken of the fact that in many cases bank debt is already heavily discounted in these countries and is sometimes traded at rates of a fraction of its face value. Making debt relief (on principal) official would in these circumstances simply amount to regularising the debtor's status. One such solution is outlined in the box **Debt-Development Swaps**, an imaginative variant on the debt-equity swaps suggestion in chapter 5. In Table 6.1 we estimate the approximate 'cost', in terms of nominally forgone creditor revenue, of a **general government-led debt relief initiative**. If ultimately it revives growth in the world economy, it will not have been a real 'cost' at all.

The $29bn shown in the table would represent the maximum amount of debt service payable annually by developing countries, a reduction of about two-thirds from their present burden of $87bn. Not only would this return their net transfer on loan transactions into surplus; the total debt service on long- and medium-term loans would be less than their annual aid receipts ($30 bn from the OECD countries, or a total of $36 bn from all sources). Most developing countries would then be well primed for recovery, with the most disadvantaged having been accorded the highest level of relief.

We justify these debt relief measures as follows. We take first the case of **the poorest countries**, which could be defined as all countries eligible for IDA credits. A bilateral precedent for debt write-offs already exists for this group with the Retrospective Terms Adjustment, a procedure started in 1978, with the UK in the lead, by which oda loans were converted into grants, ie the loan element was 'adjusted', relieved or ultimately written off (see Table 6.2). Only $6bn of debt relief has been accorded in this way, however, and major donors like the United States and Japan have barely begun to convert their official loans to grants. Much more could be encouraged by the force of example. Relief could also be extended on the same principle to official loans other than aid; the World Bank already recognises that

Table 6.1 Debt relief measures: illustrative costing ($ bn))

Present ldc debt repayments	Principal	43
	Interest	44
	Total	87
Stage I.	Relief of poorest African countries interest ($1bn) and principal ($1bn)	2
Stage II.	Roll over remainder of principal outstanding —reschedule over 20 years +	42
Stage III.	Reduce $43 bn interest payments by one-third	14
Remains for debt service: interest of		29

(Figures based on 1985 flows in World Bank, *World Debt Tables 1986/87*)

at least a dozen of the poorest countries will never be able to service their debts.

Whether the international financial institutions should concede their status as preferred creditors by also converting their loans (even IDA soft credits) into grants is a contentious problem. We recognise this could undermine their capacity to raise future capital for market-rate lending, but it need not affect the facilities which are totally funded by governments. Where World Bank/IMF/regional development bank loans are a substantial part of a country's debt problem, it makes little sense to exclude them from debt relief measures, unless new credits from those same institutions were to be sufficiently increased effectively to refinance the debt. Much larger flows will be required to fund this; the projected DAC increase of 2% per annum to 1990 would be quite inadequate.

Given that new lending to problem debtors currently tends to be policy- rather than project-based, we would favour an audit of the stock of individual project loans in the case of the World Bank/IDA. Where poor funding and implementation decisions are identified under the audit procedure, then the IFI in question should offer debt relief. Where the loan generates an adequate return, no relief may be necessary.

Table 6.2 Nominal value of RTA measures taken with respect to oda debt ($m)

		Nature of measures taken			
DAC members	*Total*	*Debt cancellation*	*Waiving of interest payments*	*Refinancing/ rescheduling*	*Conversion to local cost aid or local currency payments*
Australia	0.2	0.2	—	—	—
Austria	5.7	4.4	1.3	—	—
Belgium	15.1	—	2.2	12.9	—
Canada	220.5	188.1	30.0	2.4	—
Denmark	94.5	94.5	—	—	—
Finland	70.3	70.3	—	—	—
France	125.1	100.2	—	—	
Germany, Fed. Republic of	2,072.6	1,772.6	300.0	—	—
Italy	71.4	71.4a	—	—	—
Japan	147.3	56.3a	91.0	—	—
Netherlands	349.3	159.0	190.3	—	—
New Zealand	3.5	3.5	—	—	—
Sweden	285.4	247.3	38.1	—	—
Switzerland	69.2	69.2	—	—	—
UK	1,941.5	692.2	52.2	—	1,196.8
USA	691.0	—	—	—	691.0
Total DAC	6,162.6	3,529.2	730.3	15.3	1,887.8

Note: (a) including interest payments

Source: Unctad TD/B (XXX) CRP.3, 25 March 1985.

Inevitably, governments and IFIs which offer debt relief on their public loans will expect to exercise more leverage over the policies adopted and applied in the debtor country. It is a fact of life that debtor countries wishing to start afresh with greater dependence on concessional finance during the recovery stage will have to accept more external guidance and supervision over their financial and economic decisions. Donor governments which engage in debt-development swaps will also find themselves in a position where their advice on domestic policies will be more closely heeded.

For the **major ldc debtors**, a three-pronged solution seems necessary. Principal repayments, largely owed to commercial banks, have to be reduced substantially through **rescheduling**, **debt-equity swaps** or other means. Interest payments should be maintained but not in excess of the rates which the lenders themselves expected: so **interest-rate relief** makes economic as well as political sense. And thirdly, the catalytic power of IFI lending has to be enhanced through **greater World Bank/RDB funding and a more rapid restoration of government-guaranteed export credits.**

Twenty-year rescheduling on a sinking fund basis, as outlined in chapter 5, could also apply to the major debtors; negotiations on bank debt have already moved towards multi-year rescheduling programmes with built-in policy adjustment measures in the medium term. An alternative discount procedure would be the debt-development swaps outlined above. Of course, the rates of discount vary greatly — at end 1986 Bolivian debt could be bought for 8% of face value, but Philippine debt stood at 75% — and might be very different for large purchases rather than the present marginal trading. The scope for this proposal is limited by other factors, notably the volume of current demand for investment in some debtors: it is not suggested that Brazil could find foreign government purchasers for all its stock of debt ($105bn) discounted at 75% to $80bn. Such sums are much too large, but a limited amount of debt-development swaps, together with the more conventional debt-equity swaps which could be attractive to new private investors, foreign or domestic, should help to reduce the principal outstanding. Even a measure involving no formal writing-down of principal, such as the introduction of a five-year grace period on repayments of existing loans, followed by an assessment of the debtor's position, would give a much needed breathing space.

As for interest payments, various ways of 'capping' the interest rate have been suggested. Instead of unilateral disruptive action on the part of the debtors, we see the attraction of a co-ordinated international

policy of reducing interest through a **centralised interest equalisation fund**. Such a scheme has been attributed to the German banker, Alfred Herrenhausen. A central fund, possibly to be administered by the IMF on similar terms to the Compensatory Financing Facility for merchandise trade, would be established with government, IFI, and private bank contributions, to compensate lenders for interest rate payments in excess of an agreed norm of, say, 6% on dollar loans. Developing countries would be spared the obligation of paying interest at beyond its long-term market cost, but would be obliged to repay the fund when interest rates fall again. Exception could be made for the poorest countries. Commercial banks would need such international supervision and guarantees if they were to be re-allocating funds set aside as provision against non-payment into a compensation scheme.

The third leg of an enduring solution to the ldc debt problem would use the available surplus of a major creditor nation to establish a new **international debt facility** which could buy up sovereign debt at its secondary-market value and assist in new development financing. The obvious source of such a surplus is Japan, whose currency has become so strong on account of its trade position, similar to that of the United States after World War II: an economy in search of new markets and benefitting from world economic growth with stability. As with the US, a Marshall Plan-type response, initially involving public generosity, could be used to redound to the benefit of the world economy, by creating new non-inflationary demand. Japan has shown with its voluntary additional contribution to the IDA-8 replenishment that it might be willing to fund a major debt relief effort, possibly with the involvement of the World Bank. One variant on this would be to establish an international 'Solidarity Bank' to lend on softer terms as well as retiring old debt.

6.6 Conclusions

All our proposals demand a generous response on the part of the creditors. All demand the involvement of governments, sometimes with some direct commitment to additional funding and guarantees but mainly as intermediaries. What is required is a politically-initiated formal debt relief arrangement among debtors, creditors and governments which grants the debtors a major breathing space and brings an end to the uncertainty which inhibits new investment. To achieve this requires burden-sharing among the three parties. Obviously, a counterpart to any such arrangement would be increased external influence over ldc economic policies in future. Even under a growth programme, however, it is important that the interests of the poorest sections of the population are protected as general policy conditions are applied, with funding drawn from the local currency counterpart to the debts written-off.

Inevitably there is a connection between rolling over or writing down the stock of debt arising from past decisions and securing larger and more stable flows of finance in future. Certain creditors — notably the IFIs — stress this. But the alternative of allowing the debt problem to drag on is in no one's interest. Not only do our own economies lose output and employment, but also the ever-present threat of a major default threatens the security of the financial system in which our country has a major stake. With leadership from government, we believe that the banks, which frankly admit to the existence of a secondary market for ldc debt already, would be willing to offer realistic and lasting solutions. This would improve stability in the world market for credit and allow those developing countries which can attract direct and portfolio investment to benefit from a recovery of confidence, which in turn would stimulate local finance and savings.

The Third World debt problem is complex and far from homogeneous; the problems of Sudan are very different from those of Brazil, and so the solutions to be applied must also differ. We have outlined a framework of multiple solutions, applicable still to a case-by-case treatment of individual debtors. Its common features are:

a) a greater involvement of creditor governments in initiating debt relief and adjusting their regulations to enable banks to respond;
b) recognition that readiness to write off at least a portion of the principal outstanding would not only give debtor nations a breathing space to restore their domestic savings and investment but would also reflect the view of the markets, which have already discounted many Third World debts; and
c) co-ordinated action by the creditor nations, possibly using surplus funds, to reduce the burden of current debt service by returning interest rates to the sort of real levels originally expected by the lenders.

What has been our UK response? Apart from according generous aid-debt relief to the poorest countries, the Government have not launched any innovations. Treasury caution has determined the agenda at the expense of our interests in developing countries. The Government have preferred a reactive response, closely attuned to the US position. We note, however, that the US itself is now showing a

greater sense of urgency. Our banks show realism about the problem, but are awaiting a signal from government. The UK places great trust in the IMF and the World Bank. These are excellent and valuable institutions. But their close involvement in lending and policy prescriptions in ldcs over the past five years means they are also part of the problem. They must be part of the solution, but the political will to innovate must start elsewhere.

The issue must be treated at the level of governments. All interested parties, debtors as well as creditors, developed and developing countries, must be heard. All the issues, economic and social as well as financial, must be covered. That is why we believe the United Nations to be the most appropriate forum. **We propose therefore that the UK Government now take the debt issue to the United Nations General Assembly**. We believe that support should be urgently sought for the spirit of our recommendations from the Commonwealth, our European partners, the United States and Japan. Governments could then take a stronger consensus view to the annual meeting of the World Bank/IMF in September.

ANNOTATED AGENDA

LITTLER TO CH/GL 7/5

CONFIDENTIAL

From: Sir G.Littler
Date: 7 May 1987

CHANCELLOR

c.c. Economic Secretary
Sir P.Middleton
Sir T.Burns
Mr Lavelle
Mr Huw Evans
Mr Mountfield
Mrs Case
Mr Walsh
Mr Ross Goobey

INTERNATIONAL DEBT
STEERING BRIEF FOR 8 MAY MEETING

I suggest we might break the subject into four parts:

- Sub-Saharan Africa: how to retain the initiative (and the credit) and develop it? (Mr Mountfield's 27 and 28 April minutes and the material below);
- Forthcoming major meetings: OECD, Summit (Notes below);
- The UK domestic interest: our commercial banks (note from Mrs Lomax to Sir P.Middleton of 6 May)* and ECGD?
- Particular countries: Egypt and Zaire (Separate notes are coming to you (below)), and perhaps Brazil, are the only cases of special interest in the near future.

(Mr Evans' minute of today (below) is also relevant background).

<u>Sub-Saharan Africa</u>

2. Your initiative had a good launch and has made progress since: a few declared supporters among other creditors: the rest with few exceptions discussing it positively. Compared with other ideas (especially the French) it has the great merit of directness in dealing with the problem - although the direct cost is the main obstacle for some Treasuries.

3. To carry the process through, we need:

- to exert bilateral pressure on creditor countries which see difficulties: this means United States (worried as always about Congress, and I suspect overdoing it: you need to get at Baker personally); Japan and Germany (both resistant but showing some willingness to be brought round - I can do something with Gyohten, possibly Tietmeyer; you should tackle Stoltenberg);
- to foster multilateral discussion: Peter Mountfield has made a good beginning in the Paris Club (incidentally an appropriate and necessary forum, and not one in which we cede the initiative to the French, although the name does enable them to claim some credit). We are pressing for further discussion in a World Bank sponsored group of creditors: this should be helpful in two ways - their active participation is going to be necessary for policy monitoring in beneficiary countries, and they sympathise with our approach;
- to deal with rivals, on which I have two comments: first, a weakness in the French approach is that it is partly based on their perennial desire to manage and support commodity prices; they do not enjoy strong support among creditors and are vulnerable to the argument that weak commodity prices are affecting a quite different, even if overlapping, range of countries; secondly, an element present in some French thinking, but which has come out much more clearly in a very recent Canadian paper, is that the UK type of approach on debt to Governments

should be matched by a scheme to secure concessional terms in substitution for the more or less commercial IMF and IBRD lending that makes up quite a large share of the obligations of the poorest countries; I believe there is something in this, and propose that we might try to work out a scheme with the Canadians (the Commonwealth link could be helpful).

4. To retain the credit, we need:

- internationally, to take all opportunities to restate our proposal and get communiques to reflect it: OECD and the Summit are the next occasions;
- domestically, to take opportunities of reminders when we brief and debrief for international meetings; to include our proposal in occasional speeches; and to follow up the recent suggestion of an EPR article.

OECD and Summit

5. For the OECD, I suggest you want simply to include a brief restatement of the Sub-Saharan Africa proposal and not try to say anything significant about wider debt problems. There could also be the chance of speaking to Baker bilaterally on that occasion (I have warned Mulford that you might wish to do so).

6. The Summit presents rather more difficulty. As far as the wider debt problem is concerned, I would recommend that the UK stick to your line in the Interim Committee discussion. I can see no prospect of agreement on any new line at present, however itchy some participants may be.

7. My guess is that the French will make a strong plea at the Summit for their scheme - or for some statement on commodities which might help them promote their scheme later. I am sure that commodity price support arrangements would be a mistake; almost equally bad would be special terms linked to commodity earnings. We should therefore be ready to resist a French move of this kind, and I believe we can hope for support from the US, Japan, and Germany, and probably Canada. We should clearly campaign for our own scheme and a communique which either supports it explicitly or encourages it implicitly. Detailed briefing nearer the time will take account of any intervening developments.

U.K. Domestic Interests

8. Three points worth touching on:

- provisions by commercial banks: ? pursue separately based on Mrs Lomax' minute of 6 May to Sir P.Middleton;
- commercial bank negotiations: some recent ideas need very careful handling: could we perhaps confirm:
    - we still want to leave our banks essentially to their own responsibility;
    - we could in a general way (as the US would like) encourage them to find ways of facilitating the negotiations - new instruments, etc - but with responsibility clearly staying with them;
    - we must resist French ideas of responsibility being taken by 'financial centres' - much better to leave as now to national groups.
- ECGD: provisions; and dangers of excessive new exposures.

CONFIDENTIAL

Particular Countries

9. You saw the most recent review by Roger Lavelle's group. Among cases imminently needing some action or expression of view we have Egypt and Zaire in IMF Board discussion (see separate submissions). The only other individual country point perhaps worth a mention just now is Brazil: if, as we fear, the US are going to press for agreements even on a weak programme, should we be prepared to fight for more appropriate conditionality.

GL

(Geoffrey Littler)

psl/4A

UNCLASSIFIED

PW

Guardian OK, FT rather less so; but verbatim for Reuters! What's their excuse?

FROM: A C S ALLAN
DATE: 1 June 1988

MR BUSH

cc PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr Lankester
Mr H P Evans
Mr Mountfield
Mr Gieve (o/r)

US

CHANCELLOR'S DEBT INITIATIVE

This is to record that, following Baker's comments reported on Reuters this evening, the Chancellor issued the following statement, which you gave to Reuters, PA and AP/Dow Jones:

> "I welcome the announcement by Secretary Baker that the United States is prepared to move towards acceptance of the initiative I launched last year to help ease the debt burden on the very poorest countries. I very much hope that we can now reach agreement on this initiative at this month's Economic Summit in Toronto".

ACSA

A C S ALLAN

NEW US DEBT INITIATIVE FOR POOREST OF POOR - BAKER NRFO

ABIDJAN, JUNE 1, REUTER - U.S. TREASURY SECRETARY JAMES BAKER ON WEDNESDAY ANNOUNCED A NEW UNITED STATES DEBT INITIATIVE TO HELP THE WORLD'S POOREST NATIONS.

SPEAKING AT THE ANNUAL MEETING OF THE AFRICAN DEVELOPMENT BANK, BAKER SAID WASHINGTON WAS PREPARED TO SUPPORT CONCESSIONAL INTEREST RATE RESCHEDULINGS WITHIN THE PARIS CLUB OF OFFICIAL CREDITOR NATIONS TO HELP THE "POOREST OF THE POOR."

01-JUN-1704. MON661 MOND

CONTINUED ON - NRFP

P

REUTER MONITOR 1949

NEW US DEBT =2 ABIDJAN NRFP

"I AM PLEASED TO ANNOUNCE TODAY THE WILLINGNESS OF THE UNITED STATES TO EXPAND THE RANGE OF OPTIONS WITHIN THE PARIS CLUB," HE SAID.

BAKER, THE FIRST U.S. TREASURY SECRETARY TO ADDRESS AN AFRICAN DEVELOPMENT BANK ANNUAL MEETING, ADDED THAT THE MOVE WOULD MEAN THAT CREDITOR GOVERNMENTS, IN A POSITION TO DO SO, COULD PROVIDE CONCESSIONAL INTEREST RATE RESCHEDULINGS FOR THE POOREST COUNTRIES.

ELIGIBILITY WOULD BE EXAMINED ON A CASE-BY-CASE BASIS, HE ADDED.

01-JUN-1708. MON667 MOND

CONTINUED FROM - NRFO CONTINUED ON - NRFQ

P

REUTER MONITOR 1949

NEW US DEBT =3 ABIDJAN NRFQ

BAKER SAID OTHER COUNTRIES MIGHT MAKE A CONTRIBUTION TOWARDS DEBT RELIEF BY CONSIDERING A BROADER RANGE OF MATURITIES FOR RESCHEDULED DEBT THAN IS CURRENTLY THE CASE.

BAKER EMPHASISED THAT PERMITTING SUCH DIFFERENTIATION REPRESENTED "A SIGNIFICANT ADDITION TO THE OPTIONS AVAILABLE TO THE PARIS CLUB TO ADDRESS DIRE DEBT SITUATIONS".

HE SAID THE MOVE WAS CONSISTENT WITH WASHINGTON'S FAVOURED CASE-BY-CASE APPROACH TO ADDRESSING DEBT PROBLEMS IN DEVELOPING COUNTRIES AND DID NOT CONSTITUTE A GENERALISED APPROACH.

"IT IS A SPECIAL TECHNIQUE AVAILABLE TO ASSIST ONLY THE POOREST OF THE POOR," HE SAID.

01-JUN-1719. MON691 MOND

CONTINUED FROM - NRFP CONTINUED ON - NRFR

P

REUTER MONITOR 1949

NEW US DEBT =4 ABIDJAN NRFR

BAKER SAID WASHINGTON'S APPROACH TO TACKLING THE THIRD WORLD DEBT CRISIS WAS CONSTRAINED BY U.S. LAWS, POLICIES AND BUDGET REALITIES.

BAKER SAID THE UNITED STATES AND OTHER OFFICIAL CREDITORS WERE PROVIDING SIGNIFICANT DEBT RELIEF THROUGH PARIS CLUB RESCHEDULINGS IN SUPPORT OF APPROPRIATE ECONOMIC PROGRAMS.

"THE PARIS CLUB HAS ALSO BEGUN TO EXTEND GRACE AND REPAYMENT TERMS FOR LOW-INCOME HEAVILY-INDEBTED COUNTRIES IN A FURTHER EFFORT TO BE RESPONSIVE TO AFRICA'S ECONOMIC PROBLEMS," HE SAID.

01-JUN-1738. MON711 MOND
CONTINUED FROM - NRFQ CONTINUED ON - NRFS
P
REUTER MONITOR 1949

NEW US DEBT =5 ABIDJAN NRFS

"IN THIS CONTEXT, WHILE WE RECOGNISE THAT RESCHEDULING OF INTEREST PAYMENTS PROVIDES TEMPORARY LIQUIDITY RELIEF, THE BUILD-UP OF RESCHEDULED DEBT OFTEN PRESENTS A DIFFICULT PROBLEM FOR THE POOREST COUNTRIES," HE ADDED.

HE SAID INTERNATIONAL LENDING AGENCIES SUCH AS THE AFRICAN DEVELOPMENT BANK, THE WORLD BANK AND THE INTERNATIONAL MONETARY FUND WERE RESPONDING TO THE CRISIS BY INCREASING THE RESOURCES AVAILABLE FOR LOANS.

01-JUN-1739. MON712 MOND
CONTINUED FROM - NRFR ENDS
P
REUTER MONITOR 1949

FT 2/6/88

Baker unveils debt plan to aid poorest countries

BY LIONEL BARBER IN WASHINGTON AND NICHOLAS WOODSWORTH IN ABIDJAN

THE US Treasury Secretary, Mr James Baker, yesterday unveiled a new debt initiative to help the world's poorest countries, many of them in sub-Saharan Africa.

Mr Baker said the US was prepared to support concessional interest rate reschedulings and to stretch out debt repayment within the Paris Club, the informal group of Western creditor nations.

The proposed expanded range of debt relief options would provide "substantial new relief" to the poorest countries, Mr Baker said to loud applause during an address to the annual meeting of the African Development Bank (ADB) in Abidjan, Ivory Coast.

Mr Baker's speech signalled a new flexibility on the part of the US toward the poorest countries, whose chronic balance-of-payments problems, due to drought, famine and slumping exports, make them a special case among debtor countries.

The US has previously maintained that a uniform policy approach to debt rescheduling must be acknowledged by all members of the Paris Club.

The Treasury Secretary said the US now conceded the appropriateness of letting individual creditors decide their own terms of debt relief, either in the provision of concessional interest rate reschedulings or in a broader range of maturities for rescheduled debt than now exists.

Mr Baker, the first US Treasury Secretary to address the ADB, made clear that the new initiative did not amount to a generalised approach which could be applied to the middle-income debtors of Latin America. "It is a special technique available to assist only the poorest of the poor in a further effort to support their return to stability and growth."

Africa's foreign debt is estimated at around \$218bn (£120bn) out of a total world debt of about \$1.2 trillion (million billion).

Mr Baker's plan follows an initiative by the British Chancellor of the Exchequer, Mr Nigel Lawson, whose own proposals met some criticism among industrialised countries because they contained an element of debt forgiveness.

The Baker initiative also complements efforts by the International Monetary Fund to help sub-Saharan debtors by means of an \$8.4bn new fund providing an easy pool of credit to the poorest country debtors.

This year, the Reagan administration appeared unenthusiastic about contributing large sums to the fund, called the Enhanced Structural Adjustment Facility.

Mr Baker acknowledged in his speech that the build-up of rescheduled debt "often presents a difficult problem for the poorest countries." But he added that the Paris Club had begun to extend grace and repayment terms for low-income, heavily indebted countries.

Guardian 2/6/88

Better baked

A WARM welcome, finally, to a change of heart from the Americans on debt relief for the poorest countries in Africa. This scheme, promoted by our Chancellor, is intended to allow rescheduling of debt on very favourable terms. But it was blocked by the US.

Until yesterday, that was. Mr James Baker, the US Treasury secretary, said in Washington that the US will now support this initiative on a case-by-case basis. Given the very small cost of such a venture, it would have been more helpful to have had agreement last October at the annual Fund/Bank meeting. But better one sinner that repenteth . . .

072704
MDHIAN 1630

UNCLASSIFIED
FM ABIDJAN
TO DESKBY 021000Z FCO
TELNO 171
OF 020820Z JUNE 88

FROM BUIST AT AFRICAN DEVELOPMENT BANK

YOUR TELEGRAM 171 : DEBT INITIATIVE

1. SEVRETARY BAKER INCLUDED FOLLOWING PASSAGE IN HIS SPEECH TODAY
BEGINS
THE PARIS CLUB HAS ALSO BEGUN TO EXTEND GRACE AND REPAYMENT TERMS FOR LOW-INCOME, HEAVILY-INDEBTED COUNTRIES IN A FURTHER EFFORT TO BE RESPONSIVE TO AFRICA'S ECONOMIC PROBLEMS.
IN THIS CONTEXT, WHILE WE RECOGNISE THAT THE RESCHEDULING OF INTEREST PAYMENTS PROVIDES TEMPORARY LIQUIDITY RELIEF THE BUILD -UP OF RESCHEDULED DEBT OFTEN PRESENTS A DIFFICULT PROBLEM FOR THE POOREST COUNTRIES. THIS IS ONE OF THE MOST DIFFICULT ISSUES WHICH THE PARIS CLUB HAS WRESTLED WITH, GIVEN THE DIFFERENT FINANCIAL AND LEGAL REQUIREMENTS WITHIN WHICH EACH OF THE CREDITOR GOVERNMENTS MUST OPERATE. IN OUR CASE, FOR EXAMPLE, UNITED STATES LAWS, POLICY, AND BUDGETARY REALITIES CONSTRAIN US.
HOWEVER, TO HELP ADDRESS THIS PROBLEM, I WOULD LIKE TO ANNOUNCE TODAY THE WILLINGNESS OF THE UNITED STATES TO EXPAND THE RANGE OF OPTIONS WITHIN THE PARIS CLUB SO THAT CREDITOR GOVERNMENTS WHICH ARE IN A POSITION TO DO SO CAN ON A CASE-BY-CASE BASIS - PROVIDE CONCESSIMNAL INTEREST RATE RESCHEDULINGS FOR THE POOREST COUNTRIES. OTHER COUNTRIES MIGHT MAKE A CONTRIBUTION TOWARD RELIEF BY CONSIDERING A BROADER RANGE OF MATURITIES FOR RESCHEDULED DEBT THAN IS CURRENTLY THE CASE. TOGETHER, WE BELIEVE THESE CHANGES CAN PRODUCE SUBSTANTIAL NEWSRELIEF FOR THE POOREST COUNTRIES.
ENDS

2. SEE MIFT.

SUTHERLAND

YYYY

072704
MDHIAN 1630

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MAIN 177

.MONETARY
ERD

MR FAIRWEATHER
OADS

ADDITIONAL 1

MR WICKS NO 10 DOWNING ST

NNNN

PWP

072720
MDHIAN 1633

We shall need to consider our tactics v. carefully.

CONFIDENTIAL
FM ABIDJAN
TO DESKBY 021000Z FCO
TELNO 172
OF 020845Z JUNE 88

FROM BUIST AT AFRICAN DEVELOPMENT BANK

MIPT : ECONOMIC SUMMIT : DEBT INITIATIVE

1. BAKER'S SPEECH HAS EFFECTIVELY SCOOPED UP CANADIAN INITIATIVE. BUT IT REMAINS UNCERTAIN HOW FAR THE US WILL ITSELF BE ABLE TO GO. MALPASS (US TREASURY) SAID THEY WOULD CERTAINLY NOT PROVIDE INTEREST SUBSIDIES, BUL LONGER MATURITIES (HE COULD NOT SAY HOW LONG) WOULD BE ''CONSIDERED'' : THEY WERE STILL DIFFICULT, BUT NOT SO DIFFICULT AS A SUBSIDY. HE INDICATED THAT THE US WANTED TO REACH A FINAL CONCLUSION OVER OUR INITIATIVE AND REALISED SOMETHING MUST BE DONE TO LAY IT TO REST.

2. IN AFDB OPEN DEBATE US MOVE WAS WIDELY WELCOMED,BUT SOME (EG CANADA, DUTCH) ARE PRIVATELY SCEPTICAL THAT THE US MEAN ONLY TO LET OTHERS EXERCISE THE OPTIONS WITHOUT DOING SO THEMSELVES. IN MY SPEECH I CLAIMED BAKER'S DECLARATION AS EVIDENCE THAT OPINION WAS NOW MOVING TOWARDS CHANCELLOR'S INITIATIVE. SAMUEL-LAJEUNESSE WELCOMED IT IN THE CONTEXT OF PARIS CLUB'S ''CONTINUING EFFORTS TO EVOLVE A CONSENSUS '' ON A BROADER RANGE OF POSSIBLE ACTIONS. REST OF G7 HAVE NOT YET MADE STATEMENTS.

3. SAMUEL-LAJEUNESSE COULD ADD VERY LITTLE TO INFORMATION IN PARIS TELEGRAM 534. BUT HE INDICATED THAT ACTION CONTEMPLATED WOULD IN PART BE UNILATERAL FOR FRANCE. POLICY WOULD BE BASED ON MITTERRAND'S ELECTION MANIFESTO AND LATTER WOULD PROBABLY WRITE TO OTHER G7 HEADS OF GOVERNMENT SETTING OUT HIS IDEAS. TRICHET MIGHT ALSO EXPLAIN THESE AT NEXT WEDNESDAY'S PARIS CLUB TOUR D'HORIZON. HE NOTED THAT ON AID LOANS ALONE FRANCE HAD APPLIED RTA TO THE LEAST DEVELOPED, BUT CONTINUED TO LEND FOR AID PURPOSES. HOWEVER ACTION CONTEMPLATED WOULD GO BEYOND AID LOANS, AND COULD INCLUDE SOME NEW PARIS CLUB VARIANTS. HE COULD NOT BE MORE SPECIFIC UNTIL FINAL DECISIONS HAD BEEN TAKEN IN THE ELYSEE.

SUTHERLAND

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MR FAIRWEATHER
OADS

ADDITIONAL 1

MR WICKS NO 10 DOWNING ST

NNNN

Minister of Finance — CANADA — Ministre des Finances

CH/EXCHEQUER
REC. 17 JUN 1988
ACTION Mr Lankester
COPIES TO PS/EST, Sir P. Middleton, Sir G Littler, Mr Anson, Mr Turnbull, Mr Mountfield, Mr H.P. Evans, Mr Bottrill, Mr P. Davies, Mrs Thomson

17/6

JUN JUIN 8 1988

Mr. Nigel Lawson
Chancellor of the Exchequer
H.M. Treasury
Parliament Street
London, SW1P 3AG
UNITED KINGDOM

My dear ~~Colleague~~ Nigel:

Over the last eighteen months, all our governments have been searching for ways of alleviating the debt problem confronting the poorest and most debt-distressed countries, primarily in sub-Saharan Africa. During this time we have taken some steps to respond to the desperate economic situation which prevails in many of these countries. The Paris Club has provided extended grace and repayment periods, the Enhanced Structural Adjustment Facility of the IMF is now operational, and donors have pledged increased support for World Bank adjustment programs in low-income debt-distressed countries.

Nevertheless, there remains a real question of whether these measures, even if accompanied by improved economic policies in sub-Saharan Africa, will be sufficient to put a halt to the precipitous decline in per capita incomes and the sharp increases in debt service burdens most of these countries have experienced during the first half of this decade.

In the middle-income countries, where commercial banks hold the largest share of the debt, the menu of options has been broadened to include voluntary and market based schemes which allow for a reduction in the net present value of debt outstanding. At present, no such option exists for the poorest countries whose debt

.../2

is held almost in its entirety by official creditors. These countries must continue to reschedule debt on commercial terms which, in many cases, simply creates a situation in which the debt stock grows at a rate that exceeds foreign exchange receipts, thus continually increasing the debt service burden.

It is for this reason that I welcomed and endorsed the important initiative you launched last year to reschedule the official commercial credits of these countries on concessional terms. However, I recognize the difficulties this proposal presents to a number of governments. Consequently, I would ask that your government give serious consideration to the proposal put forward by Canada at the April meeting of the Paris Club.

In essence, we are proposing that, when rescheduling the debt of the poorest and most debt-distressed countries, the Paris Club give official creditors the option of rescheduling on commercial terms over the standard 20 year grace and repayment period or on concessional terms over a shorter time frame. Thus, official creditors could voluntarily choose between a reduction in the net present value of their outstanding claims and the higher risk associated with longer grace and repayment periods. The adoption of this proposal could potentially provide these countries with a significant measure of debt relief while respecting the institutional and legal constraints that prohibit some countries from participating in concessional reschedulings.

Mr. Frederick W. Gorbet, my Deputy Minister, has written other G-7 Deputies to present a more detailed explanation of our proposal. It is my hope that, at the Summit in June, we will be able to agree on this compromise regarding concessional debt rescheduling for the poorest countries. I look forward to seeing you in Toronto.

Yours sincerely,

Mike

Michael H. Wilson

Minister of Finance   Ministre des Finances

CANADA

The IBRD lady (cf the Bank 2x in 20 yrs Brazil??

JUN JUIN 8 1988

CH/EXCHEQUER
REC. 09 JUN1988
ACTION Mr BOTTRILL
COPIES TO EST. Sir P MIDDLETON, Sir G. LITTLER, Sir T. BURNS, Mr LANKESTER, Mr MOUNTFIELD, Mr H.P. EVANS.

CANADA

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Chancellor of the Exchequer
H.M. Treasury
Parliament Street
London, SW1P 3AG
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Yours sincerely,

Mike

Michael H. Wilson

CH/EXCHEQUER
REC. 08 JUN1988
ACTION MR BOTTRILL
COPIES TO PS/EST
SIR P Middleton
SIR G Littler
Sir T Burns
MR Lankester
MR Mountfield
MR H.P. Evans

Foreign and Commonwealth Office

London SW1A 2AH

8 June 1988

Dear Charles,

French Initiative on Debt

Thank you for your letter of 8 June enclosing a copy of one to the Prime Minister from President Mitterrand. As requested, I enclose a translation.

There is one point to which I should draw your attention. Our translators have opted to translate the French word "consolidation" as "rescheduling", on the grounds that the literal translation (consolidation) does not appear to make much sense in the context, and because the World Bank glossary gives "rescheduling" as an acceptable translation. The traditional term for rescheduling is however "rééchelonnement". I am making further enquiries, and hope to be able to confirm early tomorrow morning whether "rescheduling" is an accurate translation, or whether there is a degree of ambiguity in the French.

I am sending copies of this letter to Jonathan Taylor (HMT) and Miles Wickstead (ODA).

Yours ever,

Lyn Parker

(L Parker)
Private Secretary

C D Powell Esq
PS/No 10 Downing Street

MESSAGE FROM MONSIEUR FRANCOIS MITTERAND
PRESIDENT OF THE REPUBLIC

TO

THE RT. HON. MARGARET THATCHER, M.P.
PRIME MINISTER

Paris, 7 June 1988

Dear Prime Minister,

It has never been so urgent and necessary to act to assist third world countries, as the gap between rich and poor countries continues to widen.

While their resources are diminishing, particularly as a result of the fall in prices of raw materials, while they have to cope with famines, epidemics and natural calamities and while extreme poverty is on the increase in Africa, Latin America and many parts of Asia, the poorest developing countries are not, and will not be, in a position to repay their debt to the developed countries in full on the conditions at present imposed on them.

We can no longer accept a situation where financial transfers from South to North exceed transfers in the opposite direction by almost 30 thousand million dollars and the burden of repayment outweighs new credits.

At the Venice Summit, we recognised the need for a special programme for the poorest countries which have made efforts to "adjust". We decided to seek agreement on extending repayment periods and that was done. On the other hand, we have made no progress in applying lower interest rates when rescheduling debts.

To escape from the present stalemate, I propose therefore that the repayment conditions for the poorest countries, defined according to criteria we drew up at the Venice Summit, be relaxed, leaving it open to creditor countries to propose one of the following three options :

- one third of the debt to be written off immediately within the framework of agreements for rescheduling over a period of the order of 10 years ;

- the debt to be rescheduled at market rates but with a maximum duration of 25 years (instead of the present maximum of 20 years);

- the debt to be rescheduled at a preferential rate, reduced by at least half over a repayment period of the order of 15 years.

I hope that this proposal may meet with your approval and that of all the other Heads of State and Government participating in the forthcoming Toronto Summit.

I can tell you now that France, for its part, intends in any case to offer to write off one third of the debt of all debtor countries who so wish; that option, which has the advantage of entailing an immediate reduction in the outstanding debt, seems to me the one best adapted to the situation of the poorest countries.

Of course, increasing action for the benefit of the most destitute countries does not however mean that we should relax our efforts for the so-called "medium-income" countries which are often heavily in debt.

We must show imagination and realism, for example by widening the scope for rescheduling official debts, extending it if necessary to include due dates for payment of interest. Mobilisation of new resources and recourse to new financial instruments based on market techniques must be encouraged in the case of bank debts. Finally, it is essential that recent multilateral decisions on official development assistance be implemented more quickly, I am thinking for example of the increase in World Bank capital.

I look forward, Prime Minister, to discussing all these questions with you in Toronto.

[complimentary close]

[signed] François Mitterand

BONN FORGIVES INITIAL 86 MLN MARKS OF DEBT NRFB

BONN, JUNE 8, REUTER - THE WEST GERMAN GOVERNMENT HAS WRITTEN OFF 86 MLN MARKS OF DEBT OWED BY FIVE AFRICAN COUNTRIES AND IS DISCUSSING FORGIVING A FURTHER 2.2 BILLION MARKS, A SPOKESMAN FOR THE DEVELOPMENT MINISTRY SAID.

GOVERNMENT SPOKESMAN FRIEDHELM OST ANNOUNCED EARLIER THAT 86 MLN MARKS OF DEBT FOR THE CENTRAL AFRICAN REPUBLIC, GUINEA, SIERRA LEONE, SUDAN AND TOGO HAD BEEN WRITTEN OFF.

THE MINISTRY SPOKESMAN SAID FINANCE MINISTER GERHARD STOLTENBERG AND DEVELOPMENT MINISTER HANS KLEIN WOULD NOW DISCUSS WRITING OFF ANOTHER 2.2 BILLION MARKS TO BRING THE TOTAL TO AROUND 2.3 BILLION. A DECISION WAS EXPECTED NEXT WEEK.

08-JUN-1701. MON044 MONE

CONTINUED ON - NRFC

P

REUTER MONITOR 1855

GERMANY

BONN FORGIVES =2 BONN NRFC

OST SAID THE FIVE NATIONS INVOLVED WERE AMONG THE 24 LEAST DEVELOPED COUNTRIES IN THE WORLD. HE ADDED THAT THE DEBT CRISIS WOULD BE AN ISSUE AT THE FORTHCOMING TORONTO SUMMIT.

GOVERNMENT SOURCES SAID WEST GERMAN CHANCELLOR HELMUT KOHL WOULD MAKE SUGGESTIONS TO AMELIORATE THE DEBT SITUATION FOR THE WORLD'S POOREST COUNTRIES IN TORONTO.

WEST GERMANY ITSELF WAS AIMING FOR FULL RELIEF FOR DEBTS INCURRED THROUGH OFFICIAL DEVELOPMENT AID OF SOME COUNTRIES.

EXACTLY WHICH COUNTRIES WOULD BENEFIT WAS STILL BEING DEBATED. BUT COUNTRIES STILL HAD TO AGREE TO CONDITIONS SET BY THE INTERNATIONAL MONETARY FUND (IMF).

08-JUN-1702. MON045 MONE

CONTINUED FROM - NRFB CONTINUED ON - NRFD

P

REUTER MONITOR 1855

BONN FORGIVES =3 BONN NRFD

THE SOURCES SAID THAT WHILE WEST GERMANY WAS NOT OPPOSED TO CONCESSIONARY INTEREST RATES ON RESCHEDULING AGREEMENTS ON OVERSEAS DEVELOPMENT AID, IT WAS STILL OPPOSED TO CHEAPER INTEREST RATES ON GOVERNMENT-BACKED EXPORT CREDITS.

U.K. CHANCELLOR OF THE EXCHEQUER NIGEL LAWSON HAS PROPOSED CUTTING INTEREST RATES ON EXPORT CREDITS TO ALLEVIATE THE DEBT BURDEN OF THE MOST IMPOVERISHED COUNTRIES.

WEST GERMAN GOVERNMENT SOURCES SAID LOWERING INTEREST RATES ON OUTSTANDING EXPORT CREDITS UNDERMINED THE PROCESS OF FINANCING EXPORTS GENERALLY.

08-JUN-1703. MON047 MONE

CONTINUED FROM - NRFC CONTINUED ON - NRFE

P

REUTER MONITOR 1855

BONN FORGIVES =4 BONN NRFE

THEY NOTED ONE SUGGESTION FROM CANADA, WHICH HAS BEEN BACKED BY U.S. TREASURY SECRETARY JAMES BAKER, IS THAT SOME CREDITOR COUNTRIES MAY GIVE CONCESSIONARY INTEREST RATES WHILE OTHERS COULD LENGHTEN REPAYMENT PERIODS.

08-JUN-1703. MON048 MONE

OTHER COUNTRIES

CH/EXCHEQUER

REC. 10 JUN 1988

ACTION Mr BOTTRILL

COPIES TO PS/EST, Sir P. MIDDLETON, Sir G. LITTLER, Sir T. BURNS, Mr LANKESTER, Mr MOUNTFIELD, Mr H.P. EVANS.

√ 10/6

Foreign and Commonwealth Office

London SW1A 2AH

9 June 1988

1. ~~Alex~~

2. Andrew

Dear Charles,

French Initiative on Debt

Further to my letter of last night, this is just to confirm what you and Jonathan Taylor have already heard on the telephone this morning - that the considered view of our people in Paris, who have discussed with Treasury experts, is that the French word "consolidation" should be translated as "consolidation" in English. Mitterrand's proposals are not very specific. The word can apparently encompass both rescheduling and refinancing.

I am sending copies of this letter to Jonathan Taylor (HMT) and Miles Wickstead (ODA).

Yours ever,

Lyn Parker

(L Parker)
Private Secretary

C D Powell Esq
10 Downing Street

131603
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TO IMMEDIATE TOKYO
TELNO 487
OF 131800Z JUNE 88

TORONTO SUMMIT: JAPANESE IDEAS ON DEBT

1. CHANCELLOR HAS ASKED WHETHER REUTERS REPORT DATED 8 JUNE OF JAPANESE INTENT TO UNVEIL PLANS TO HELP DEBTORS AT THE SUMMIT ARE ACCURATE AND FOR A BRIEF BY CLOSE ON 14 JUNE.
2. REUTERS REPORT THAT JAPANESE PLAN IS AIMED TO REDUCE DEBT OF MIDDLE INCOME COUNTRIES. THE IMF WOULD SET UP A SPECIAL TRUSTEE FUND WITH MONEY FROM JAPAN AND DEBTOR COUNTRIES. THIS WOULD BE USED AS COLLATERAL TO BACK BONDS ISSUED BY DEBTORS AND SWAPPED FOR DEBT OWED TO COMMERCIAL BANKS AT A DISCOUNT. THIS IS SIMILAR TO THE MEXICO DEBT CONVERSION SCHEME ANNOUNCED IN DECEMBER 1987.
3. PLEASE ADVISE BY RETURN WHETHER REPORT IS ACCURATE, AND PROVIDE ANY FURTHER DETAILS AND COMMENTS.

HOWE

YYYY

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JAPAN

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pup

FROM: G R WESTHEAD
DATE: 17 June 1988

PS/CHANCELLOR

cc Sir G Littler
Mr Lankester
Mr H P Evans
Mr Mountfield
Mr Bottrill
Mr P G F Davies
Mrs Thompson

NOTED

ECONOMIC SECRETARY'S MEETING WITH BARONESS HART : INTERNATIONAL DEBT

The Economic Secretary met former Minister for Overseas Development Baroness Judith Hart for a meeting on Wednesday to discuss international debt measures in advance of the Toronto Economic Summit. Baroness Hart is now Chairman of the Economic and Social Affairs Committee of the United Nations Association. She was accompanied by development economist on the Committee - Mrs Graham.

2. Baroness Hart said that in its two last Councils the Economic and Social Affairs Committee had issued strong statements on new measures on aid, trade and debt for developing countries. But this year as last, they had congratulated the Chancellor on his Sub-Saharan African initiative. She said she had been personally very dissapointed to see the French wresting the initiative from the Chancellor by President Mitterand's announcement. She hoped the UK would wrest the initiative back at the Toronto Summit.

3. The Economic Secretary said he too had been surprised about press reaction to the French "initiative", which implied that the French were offering something radically new. What really mattered now was that G7 should reach overall agreement as quickly as possible on a workable package of measures to alleviate the burden of debt for the poorest countries.

4 Baroness Hart said that she was rather concerned to see the

decline in the UK's proportion of GDP devoted to the aid programme. The Economic Secretary said that in 1987 the aid: GDP figure had been depressed because the timing of various aid payments at the end of the financial year. It had also been a victim of the very success of the UK economy. The Economic Secretary added that although the aid programme had grown in real terms in recent years, the Government tended to put even greater emphasis on free trade, capital liberalisation and debt.

5. Mrs Graham said that there was a continuing problem with the commerial debt owed by middle-income countries and new bank lending was lower than envisaged under the Baker Plan. The World Bank had suggested a whole range of measures to alleviate the problem (including debt-equity swaps), but very little appeared to be happening. Many people thought the problem would get worse unless there was some action on the part of governments. Baroness Hart said that she did not think that the Government should wash its hands of the problem by saying that the commercial debt of middle-income countries was a commercial matter for the banks alone. The countries concerned had suffered a disastrous decline in export prices for the commodities they produced.

6. During the Economic Secretary's absence to vote in the House of Commons, Mr Walsh explained to Baroness Hart that it was not the Government's policy to bail out banks for their past mistakes. Although the Government did not intend to make actual financial contributions to banks, if and when they recorded losses on their past loans, the Government allowed provisions and tax relief on these in the usual way. New lending was a separate issue. In exceptional cases, such as Mexico, Governments had agreed to partial World Bank guarantees on new commercial bank lending. Better compensation for commodity price fluctuations would be available under the IMF's Compensatory and contingency financing facility (CCFF).

7. Baroness Hart hoped the problem of middle-income debtors would be discussed at Toronto although there were no firm proposals on the table. The Economic Secretary said this was possible, but for the time being G7 was concentrating all its efforts on helping the

poorest countries.

8. Baroness Hart raised conditionality and structural adjustment programmes. She observed that tough conditions built into IMF programmes - eg lowering of exchange rates, phasing out of subsidies and increasing prices, reduction in wage bills etc - made the poor in developing countries poorer. She thought that ultimately the rigorous measures in these adjustment programmes were a dangerous threat to democracies and said they would lead to takeovers by military juntas where the people rioted at the measures.

We cannot be drawn by this

cf Nigeria!

9. The Economic Secretary said that the Government thought conditionality very necessary and beneficial to the countries involved. It forced developing countries Governments to take the necessary measures to restructure and rebuild their economies. It was not finance from the IFIs, but reform, on which their future prosperity depended. It was inevitable that some of these measures would be painful but he did not agree that they represented a threat to democracies. Moreover, some measures, such as increased prices for agricultural products, actually benefitted poor farmers who did not form a vocal pressure group unlike the urban masses in LDCs.

10. Baroness Hart concluded by saying that she hoped that at the Toronto Economic Summit there would be some thought given to the problem of middle-income debtors as well as the poorest countries.

11. The Economic Secretary said that although he did not agree with Baroness Hart on everything she had said, nevertheless they had a lot of common ground about the debt problem. He thanked her for a useful discussion.

PB

pp GUY WESTHEAD
Assistant Private Secretary

3872/45

CONFIDENTIAL

CHANCELLOR

From : R G LAVELLE

17 June 1987

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr H P Evans
Mrs Lomax
Mr Mountfield o/r
Mr Peretz
Mrs Case
Mr Pitcairn
Mr Lankester

INTERNATIONAL FINANCIAL SCENE

After consultation with MG, I attach an updated and revised paragraph 4 for the letter to No 10, to reflect the Natwest move announced yesterday.

R G LAVELLE

Ok

17/6

Revised paragraph 4

4. On the general scene, there has been little change in the economic outlook, whether for debtors or for creditors, although the rise in dollar interest rates is clearly increasing debtor anxiety. The most important new development is the move by Citicorp followed by a number of other US banks to increase its loan loss reserves by $3 billion, equivalent to providing against 25 per cent of its sovereign debt exposure. The scale of increased provisions by US banks has swiftly been overtaken by the decision announced earlier this week by Natwest to increase its provisions from 13 per cent to close on 30 per cent. These are long looked for moves in the direction of greater realism by the commercial banks, away from the orchestrated world of crisis management, and should be a healthy development for the longer term. The expectation of such decisions has been a central element in the debt strategy of buying time: the banks' moves have been welcomed in the market and reflected in strengthened share prices. It is possible that in the shorter term, say the next twelve to eighteen months, debt negotiations could be more difficult in some cases. Commercial banks may negotiate more toughly, be less prepared to make concessions or to provide new credit, and more prepared to risk defaults. Debtors could react by agreeing to quicker settlements, seeing little gain from holding out and risking breakdown: alternatively, some at least may see the balance tipped towards default. An increased risk of non-payment would also affect government creditors and export credit agencies.

CONFIDENTIAL

FROM: MRS A F CASE
DATE: 17 June 1987

1. MR LAVELLE

2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Evans
Mr Mountfield o/r
Mr Peretz
Mr Pitcairn
Mr Lankester

INTERNATIONAL FINANCIAL SCENE

I attach the report from the Lavelle Group to No 10. This covers the state of play on debt issues, especially Sub-Saharan Africa, after the Summit as well as individual countries. Of these, the most difficult remains Brazil where decisions seem likely to be needed within the next few weeks.

AFC

MRS A F CASE

2/141

CONFIDENTIAL

33

~~DRAFT~~ LETTER TO CHARLES POWELL, NO 10

cc Tony Galsworthy - FCO
Tim Walker - DTI
John Footman - BOE

INTERNATIONAL FINANCIAL SCENE

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

2. Since the last such report, after the Washington Interim and Development Committee meetings, the Venice Summit has taken stock of the debt situation and generally endorsed the present strategy for handling it. The Summit communiqué recognised the particular problems of the poorest, most heavily indebted countries in Sub-Saharan Africa to which the Chancellor's initiative at the Washington meetings was directed. Although the communiqué fell short of endorsing our proposals on concessional interest rates, it is being interpreted as a clear signal to press on with the necessary work to provide the countries concerned with debt relief. The next step will be an informal meeting, jointly organised by the Bank and Fund in early July for G10 members, to discuss the various initiatives in this area, including the treatment of debt owed to the international financial institutions and M. Camdessus' proposal for a significant increase in the resources

of the Structural Adjustment Facility. It will be followed by a further Paris Club meeting in late July. Although the communique only talks of a conclusion within the year, we shall be pressing for decisions by the time of the Autumn Bank/Fund meeting.

3. In the meantime, the discussions in Venice should be helpful in dealing with the debt issue at UNCTAD. They will also provide a basis on which we and others can reply to the now traditional pre-Summit letter from the Cartagena Group of countries.

Replace by Roger Lavelle re-draft

~~4. On the general scene, there has been little change in the economic outlook, whether for debtors or for creditors, although the rise in dollar interest rates is clearly increasing debtor anxiety. The most important new development is the move by Citicorp followed by a number of other US banks to increase its loan loss reserves by $3 billion, equivalent to providing against 25% of its sovereign debt exposure. This is long looked for move in the direction of greater realism by the commercial banks, away from the orchestrated world of crisis management, and should be a healthy development for the longer term. The Bank of England will be looking for parallel moves by UK banks. However, in the shorter term, say the next 12 to 18 months, it will make debt negotiations more difficult. Commercial banks may~~

~~negotiate more toughly, be less prepared to make concessions or to provide new credit, and more prepared to risk defaults. Debtors could react by agreeing to quicker settlements, seeing little gain from holding out and risking breakdown: alternatively, some at least may see the balance tipped towards default. This increased risk of non-payment will also affect government creditors and export credit agencies.~~

5. Turning to individual countries, of the three major Latin American debtors, only Mexico is making satisfactory progress. Brazil remains the major problem; with political uncertainties compounding a poor economic outlook - very rapid inflation, lax fiscal policy and a trade balance only benefiting from recession. The new economic team have introduced an interim package of anti-inflation measures, including a further devaluation, a short-term wage and price freeze and cuts in public spending. A comprehensive macro-economic plan is still said to be in preparation. In the meantime, Brazil has asked the Paris Club for postponement of deadlines in the January rescheduling agreement. There will be difficult decisions about how far to go along with Brazilian requests for more time without a clearer idea of Brazilian intentions.

6. The situation in Argentina also gives cause for concern. Economic performance is moving away

from the IMF programme on a number of fronts and the programme could be off track by the time the critical mass of commercial bank financing is secured.

7. Elsewhere further action is still needed in Nigeria before the first review of its IMF programme can be completed~~, although the latest IMF mission was encouraged by the authorities' apparent commitment to reform~~. In Zambia, President Kaunda has broken with the IMF and abandoned ~~its~~ the IMF adjustment programme. Among Francophone countries, the Cote d'Ivoire, an earlier successful rescheduler has suspended debt servicing. On the other side of the coin following approval of Zaire's SBA, SAF and CFF despite reservations, the Paris Club agreed a rescheduling over 15 years - a partial implementation of one of the elements in our Sub-Saharan African initiative. Similar treatment may be offered to other African countries whose rescheduling requests come before the Paris Club this week.

(Latta's info casts doubt on this)

8. Finally, problems over implementing the second stage of the Yugoslav MYRA seem to have been resolved. Doubts about whether the Yugoslavs are taking sufficient action remain but creditors, on the basis of a cautious assessment from the Fund Managing Director, seem likely to let Stage 2 go ahead and to focus on tightening conditionality for Stage 3.

9. I am copying this letter to Tony Galsworthy, Tim Walker and John Footman.

SUB-SAHARAN AFRICA - UK INITIATIVE

CONFIDENTIAL

FROM: P MOUNTFIELD
DATE: 19 June 1987

CHANCELLOR OF THE EXCHEQUER

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

MOUNTFIELD → CH/EX 19/6

PARIS CLUB: JUNE MEETING

In this week's meeting, the debts of Mauritania, Mozambique and Uganda have been rescheduled: 15 years for Mauritania (where the UK has virtually no exposure) and 20 years for Mozambique and (I think) Uganda - the talks were still going on when I left. So your initiative is bearing fruit. But more important than the formal negotiations were the subjects discussed in the margins and in side-meetings.

BRAZIL. The chairman received a letter from the new Brazilian Finance Minister, seeking:

a. An extension of time for the rescheduling agreement covering the first half of 1987. We agreed that this will now come into effect on 15 September (rather than 15 July) provided Brazil has by then settled with the banks and received a favourable Article IV report from the Fund. I am sure this was a sensible move, giving the new Brazilian team a bit of time to get its act together.

b. Rescheduling of maturities in the second half of 1987. To this, we agreed that the chairman would reply, reminding Brazil of its pledge to return to current debt service from 1 July. Orally (but not in a document which will circulate widely in Brasilia, lest it be seen as an ultimatum) the chairman will tell Bresser Pereira that our terms for any further rescheduling will be a standby agreement (though he may hint gently at the possibility of something more like the Nigerian solution as an acceptable alternative). There is little real sign that Brazil intends to go back to the Fund for an SBA, despite some rather misleading press reports earlier in the week. So the medium-term future still looks very uncertain.

Meanwhile, there are two immediate problems for the UK. Most countries, except France, remain off cover, and there is a clear split in the French ranks. However there is circumstantial evidence that France is offering generous credit terms for military sales to Brazil, and the UK is coming under great pressure to match these to promote a sale of Westland helicopters. There will shortly be a Ministerial letter, probably from Lord Young about this case. Our advice remains that we should not offer any cover to Brazil until the debt situation is sorted out. Even then, cover for military sales seems quite inappropriate.

Second, we shall have to take an early decision on whether to refinance or reschedule the maturities of the first half of 1987, given the present impasse with the IMF, and with other creditors, it is hard to see Brazil as a safe enough bet to justify refinancing. A separate submission will be coming forward shortly on this issue.

POLAND. Your instructions were to seek any solution which provided for an early resumption of payments, the bigger the better. We had a very gloomy 'working dinner' with the Polish negotiator. As a result, we have made him an offer: to reschedule all money falling due in 1986, 1987 and the first quarter (possibly the first half, if the US agree) of 1988, including payments under the hitherto-sacred 1981 pre-sanctions agreement, provided Poland makes a substantial payment of its arrears: we started by asking for about $500m on account (which is just within their abilities, though it will mean a cessation of payments to the banks after September). It is not clear whether Poland is serious about negotiating on such terms: we shall see. Meanwhile, the main block to further progress remains the effective but hidden US veto on an IMF programme. Most other creditors are now fed up with the US position, and there will be attempts to organise concerted pressure both by EC Finance Ministers and EC Foreign Ministers. We shall be briefing you separately on this next time there is an opportunity to discuss the issue among Finance Ministers.

YUGOSLAVIA. Our line here has been to press for an improved adjustment programme to improve our chances of eventual recovery. Despite a fairly lukewarm report from Camdessus, on the latest Yugoslav economic measures, we abandoned any attempt to strengthen them in the short-term, and put into effect the second stage of the rescheduling agreement (covering maturities from May 1987 to March 1988). Instead we concentrated on stage three. We stated our terms for any further rescheduling after March 1988, and I managed to toughen up considerably the draft of the chairman's reply to the Yugoslav Finance Minister so as to specify the areas in which we were looking for improvement.

SUB-SAHARAN AFRICA. It was confirmed that the next stage will be a meeting chaired by the IMF and the IBRD (and probably by Camdessus himself) at the end of the WP3 meeting in Paris on 10 July, which Sir G Littler will be attending. This meeting will also discuss the Camdessus proposals on the SAF.* It will be followed by a further technical meeting in the Paris Club in the week of 20 July. So, despite the more relaxed timetable of the Venice Communique ('Within this year') the pressure is being kept on for rapid progress. There will be a chance to discuss tactics for these meetings at the talk on Debt Strategy which you have called on 29 June.

PM

P MOUNTFIELD

ANNOTATED AGENDA

CONFIDENTIAL

FROM: **HUW EVANS**
DATE: **25 June 1987**

CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lavelle
Mrs Lomax
Mr Mountfield
Mr Culpin
Mrs Case
Mr Walsh
Ms Life

INTERNATIONAL DEBT

This is an annotated agenda for your meeting on debt on 29 June.

2. Discussion might focus on:

- Sub-Saharan Africa: (i) The UK initiative (Mr Mountfield's minutes 27 April and 19 June). (attached)

  (ii) Responding to the Camdessus proposal for enlarging the SAF.

- Developments in provisioning by Citicorp, Natwest, ECGD and others

- Conditionality: for Brazil, Argentina, Sub-Saharan African countries (including Zaire)

- Looking ahead to the Annual Meetings

- Publicity

EVANS TO CH/EX 25/6

Sub-Saharan Africa: UK Initiative

3. The proposals for extending the length of rescheduling and grace periods on Paris Club debt received support in Venice, and have now been implemented in several cases. (Zaire, Mauritania,

Mozambique and Uganda). We propose to take credit for this both in speeches and in the EPR article. Work at a technical level in IBRD and elsewhere continues: the Bank of England has prepared a paper on the consequences for debt repayment profiles of SSA countries of various assumptions about interest rates, debt servicing capacity etc, based on a model developed by the Bank. In addition there are some technical expenditure issues on which Mr Mountfield minuted the Chief Secretary on 24 June. ([illegible] to CST [illegible])

4. But reductions in interest rates have not been agreed:

(i) The Americans in particular will probably not agree until the end of the year (the same timetable as Camdessus has in mind for enlarging the SAF) if they agree at all.

(ii) The French proposals for an enhanced CFF and a new 'window' at the IBRD have still not been ruled out.

(iii) The Camdessus proposal for an enlarged SAF has stolen the stage from the French and Canadian proposals for refinancing facilities but these proposals are still on the table.

5. We need to focus on getting the interest rate subsidy agreed during the forthcoming meetings (see below). **Should an approach to other G5 (especially the US) be made? If so, at what level?**

SAF Enlargement

6. The IMF's Structural Adjustment Facility is a highly concessional ten year loan facility available to very poor countries (much like IDA, on a smaller scale and with shorter maturity). On enlargement of the SAF, the Camdessus proposal takes the form of a 6 bn SDR addition to the existing 2.7 bn SDR. Before making any commitment we should try to ensure that:

(i) the maximum contribution to enlargement is made by the Japanese, and

(ii) the option for finance by gold sales from the $40 bn stock held by the IMF is fully explored (we will be sending you a paper on this shortly).

7. Our discussion with IMF Staff on 30 June (see Mr Walsh's minute of 24 June) will be exploratory only. Were we to respond in full to the Camdessus request and make a loan or grant to the IMF this might mean extra public expenditure of as much as £100m a year over the next three years, though it could be less. We are however exploring other options and their public expenditure implications and will report following the IMF visit. We shall be putting papers to you next month with definite proposals. Meanwhile the likelihood of an additional bid is being fed into the current PES; we have asked ODA if they would take responsibility for the bid. Because of your SSA initiative on official debt, the UK will be expected to make some contribution. **Is it agreed that in principle we can make at least a small contribution to SAF enlargement from the aid vote as additional public expenditure?**

8. The timetable of meetings on Sub-Saharan Africa is:

30 June	-	Visit by IMF team to Treasury to discuss Camdessus initiative on the SAF.
10 July	-	Meeting in Paris chaired by Camdessus to discuss all aspects of Sub-Saharan Africa.
Mid July	-	Settle public expenditure treatment
Late July (could carry over to September)	-	Paris Club meeting to discuss interest rate concessions.

September	-	IMF and World Bank Boards discuss contribution of IFIs to concessional finance.
30 September-2 October	-	Annual meetings to ratify overall action on SSA.

This is the most optimistic timetable and could easily slip: the Summit communique urged a conclusion "within this year" i.e by end December 1987.

Provisioning: the Banks and ECGD (see Vol. K covering note)(papers in separate 4th folder)

9. Natwest's extra provisioning, at a level of 30 per cent, (Citicorp was 25 per cent) will soon be followed by other UK banks. The Bank has decided to ask UK banks to provision various percentages for various countries on the basis of a new matrix approach, with an average level of provision of 25 per cent. This will cost them perhaps very broadly £2 bn and will not count towards their capital. The Inland Revenue are considering the appropriate tax treatment within existing tax law of LDC debt that is regarded as non-collectable under the new matrix approach.

10. You have welcomed the steps the banks have taken as a blow for realism and as strengthening their capital base. We also welcome the "menu" approach, by which banks adopt new instruments for financing LDCs. However, there is likely to be increasing difficulty in arranging new money packages. We are moving into a world in which banks will negotiate directly with debtors, with less need for concerted management by the IMF, World Bank and the Fed.

11. The same pressures are affecting ECGD: Mrs Case is reporting separately.

Major Debtors

12. The most important is **Brazil,** who are currently holding discussions with the IMF. The measures announced so far are certainly in the right direction. Recent indications are that the Brazilians are some way yet from agreeing to an SBA, though increasingly anxious to get some form of IMF approval. We await the announcement of further measures. The Brazilian economy is now moving rapidly into recession, triggered by rising inflation and interest rates, as a reaction to the unsustainable boom of the last 18 months. In consequence, the level of imports is falling and the trade balance recovering. But sustainable policies must be based on export-led growth.

13. The Paris Club deadline for finalising the rescheduling of the first half of 1987 conditional on an accommodation with the IMF has now been extended to 15 September. Brazil has also asked for maturities in 1987 H2 to be rescheduled. The Paris Club has, so far, refused this request and is holding out for an SBA first but may be prepared to compromise on something like the Nigerian solution.Decisions may be needed on ECGD cover for Brazil, though the immediate urgency (a Westland military helicopter order) seems to have evaporated. Most other countries including US are still off cover, and UK should, we think, stick to this common line so as to put further pressure on Brazil to regularise its position and seek some form of IMF endorsement.

14. On **Argentina,** the SBA is in considerable danger of not being made effective because some IMF performance targets have not been met. Mr Pitcairn's minute of 19 June (attached) refers. There are signs that the IMF staff is weakening in its previous insistence on conditionality. Meanwhile the critical mass of bank finance has almost been obtained. IMF board discussion will take place before 15 July. **Nigeria:** the Fund staff have yet to agree the second review (see AEF minute of 25 June). (below)

Sub-Saharan Africa

15. There is a separate problem with the many weak programmes mainly in SSA now coming up in the IMF and World Bank Boards. Our main test is whether we believe - as distinct from what the IMF tell us - that they will make significant progress towards balance of payments viability taking normal capital inflows (including aid) and rescheduling into account. This broad test has already led us to abstain in the IMF (and in the World Bank) on **Zaire.** It is a test that we shall continue to apply. We shall continue not to go out of our way to help non-co-operative countries such as **Zambia.**

Conditionality

16. We need to improve our concertation on conditionality for both SSA and middle income debtors. This points to your speaking to some of your G5 colleagues on the next suitable occasion, and we need to bring the FCO in as well, in order to persuade their appropriate numbers. There is also a need to agree with FCO/ODA on how we impose stricter conditionality at the World Bank.

Looking Ahead to the Annual Meetings in September

17. Our main aim in the SSA context must be to get as far as possible towards agreement on lower interest rates in the Paris Club and on extra funds from the IFIs.

18. On the general issues of international debt, a line for September could include the following elements:

(i) speech in April set out what needed to be done: now wide recognition that special treatment necessary for SSA by both Paris Club and IFIs.

(ii) For middle income debtors, now wide recognition that insufficient progress was being made towards long term aim of restoring creditworthiness. Moves by commercial banks a natural consequence of the realistic appraisal urged in April speech.

(iii) Moves by banks open up likelihood of more market-orientated approach.

(iv) Restate needs for policy reforms in debtor countries.

(v) Baker approach (case-by-case, new lending where justified by policy reforms aimed at medium term grants and external viability etc) continues. (Specific numbers in Baker plan never signed up to).

19. Perhaps the most difficult element will be the absence of convincing evidence - on G7 growth, trade, agriculture, interest rates - of any improvement in the external environment. The strengthening of commodity prices so far this year offers a little comfort for debtors.

Publicity

20. We will be circulating tomorrow a draft EPR article scheduled for publication on 15 July. **Are there additional points for inclusion?**

21. The EPR article contains a little of the analysis from the big IF paper on debt circulated in March. I see some advantage to be gained from putting out a fuller analysis, particularly now that the banks have shifted their ground. A Treasury Working Paper is the obvious way to do this: **do you agree that we should prepare a draft?** It could be published in late July, August, or early September.

22. Speech material on debt will be circulated tomorrow.

HPE

H P EVANS

CONFIDENTIAL : MARKET SENSITIVE

BOARD TO CH/EX 26/6

FROM: D R H BOARD
DATE: 26 June 1987

There is inevitably some tension between the Bank's approach to provisioning and the Revenue's. So there should be! But both sides are fully aware of the nature of the problem.
JC 26/6

1. MR CASSELL
2. CHANCELLOR

c c Economic Secretary
Sir P Middleton
Sir G Littler
Mrs Lomax
Miss Noble

INTERNATIONAL DEBT : PROVISIONING

NLW @

This side note is not copied to the Bank or to the Revenue.

2. The main Treasury and Revenue submissions which will reach you today on banks' provisioning present the main facts below. But the Bank and the Revenue are still being coy on some details.

3. Both the Bank and the Revenue are extremely reluctant to divulge much detail about individual banks. Of course the Banking Act does not extend to disclosure to the Revenue: the Revenue and the Bank have been operating on consent from the banks themselves to exchange figures, but only broad ones. So the exercise has been dogged with some imprecision despite best endeavours on both sides; more information is being worked on all the time.

4. There are two particular aspects of this to draw privately to your attention. The first is the size of the potential gap between the percentage provisioning levels which the Revenue will be prepared to concede and the Bank's matrix levels. We will never pin this down completely because that would mean the Revenue throwing all their negotiating cards away. But one thing would help. On a rule of thumb basis, the Revenue's £750m tax cost implies £2.1bn additional provisions allowed for relief. The Bank are talking of £3.5-4bn additional provisions on a group wide basis, ie going outside the UK tax net. An estimate of how much of the difference is accounted

split
88-89 400 m
89-90 300
90-91 50
750
see Painter's note.

for by provisions outside the UK tax net would be a helpful figure.

5. The second is the position of the major UK banks individually, and of second-tier or consortium banks which may be particularly at risk. It is important that the Bank talk to us on Banking Act terms, which means excluding the Revenue. It would also be helpful to have your authority to seek fuller information from the Bank. In the meantime the following table is a start and illustrates in particular the need for Midland and Standard Chartered to consider raising additional capital.

X

(£M)

	Exposure to problem countries	25% provision	1986 Pre-tax profit	1986 shareholders' funds
Nat West	2,800*	840*	1,010	4,620
Barclays	2,900	725	895	3,700
Lloyds	3,700	925	700	2,750
Midland	4,100	1,025	430	2,020
Standard Chartered	2,800	700	250	1,300

[*Published figures on a group-wide basis, with 30 per cent (rather than 25 per cent) provision.

The other exposure figures have been reported by the banks themselves on their own definitions of problem countries, for the Bank to pass to the Revenue. Although the banks already have some provisions in place (which would reduce the impact on their profit), on the other hand the table does not include exposures outside the UK tax net (which would add to the impact on profit). These figures should only be taken as preliminary indications.]

Douglas Board

D R H BOARD

* Pse let me have a quick note on the relationship betw the market and the % value of each ~~[illegible]~~ country's sovereign debt in the secondary market (two pages).

2. Re X, you have my authority.

C10/23

BF6/7
for Tony

AA
Wt spoke:

FROM: A W KUCZYS
DATE: 26 JUNE 1987

CHANCELLOR

cc Mr Allan
Mr Hudson

INTERNATIONAL DEBT

You may remember you originally asked for a meeting on debt issues at the beginning of May. This then had to be postponed, but you said you would still like a discussion when normal service resumed.

2. Huw Evans has produced an annotated agenda for the meeting, but I think this may be a little over-ambitious in two places. First, we do not have the right people (Chief Secretary, Robin Butler) for a full discussion of the public expenditure implications of the debt initiative. That merits a meeting in its own right - for the Chief Secretary, rather than for you. And similarly, although Rachel Lomax will be present, we do not want to get bogged down on either prudential or tax aspects of provisioning.

3. So the subjects to concentrate on are, therefore:

- Your debt initiative;
- the Camdessus proposal for enlarging the SAF;
- conditionality;
- looking ahead to the annual meetings;
- publicity.

AWK

A W KUCZYS

SPEECH MATERIAL

FROM: HUW EVANS
DATE: 26 June 1987

MR HUDSON

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lavelle
Mrs Lomax
Mr Mountfield
Mr Culpin
Mr Walsh
Ms Life

POSSIBLE SPEECH ON THE WORLD ECONOMY AND DEBT

Your minute of 24 June to Mr Walsh asked for speaking notes on international debt, partly to pre-empt the Paris meeting on 10 July.

2. The attached speaking notes develop the themes of the Interim Committee speech, together with more recent developments. The headlines would be something like:

(a) Provisioning moves by Citicorp, NatWest, etc are logical and welcome steps. Mark transition away from involuntary lending by banks to voluntary lending.

(b) Progress on Sub-Saharan Africa: Paris Club already beginning to implement parts of Chancellor's proposal; progress being made on persuading others to agree to lower interest rates. IMF have launched a complementary initiative.

EVANS TO HUDSON 26/6

3. The notes do not at this stage include anything on the world economy and will need to be looked at again in the light of the Chancellor's meeting on Monday.

H P E

H P EVANS

INTERNATIONAL DEBT

In April, in speech to Interim Committee in Washington, I reviewed debt strategy and put forward UK Government proposals for relieving the poorest countries in Sub-Saharan Africa of part of their debt burden. Today I want to report progress.

2. Since the 1982 crisis, we have successfully bought time for:

(i) implementation of stronger reform policies and for these to take effect ;

(ii) reducing the systemic risks to the world financial system by strengthening the position of banks.

3. Long term aim has always been to encourage the debtor countries to get back to full creditworthiness so that they can once again make use of international capital markets. Tragic that just as the scale and sophistication of these markets has multiplied in recent years, so many developing countries have been unable to make use of them.

4. Wrong to think that all developing countries have been affected. Pay tribute to many countries, especially in Asia, such as India, who have made sensible use of external borrowings on a prudent scale. In consequence they have obtained access to capital markets and done conspicuously better in recent years in terms of economic growth. The population of developing countries is some 3,500 million. Of this total little more than 1,000 million live in countries which have been forced to rescheduling debts.

5. The debt strategy since 1982 can score a number of successes:

(i) the world banking system is in better shape;

(ii) many debtor countries put in place reform policies. Many have come to see the benefits of freeing up markets and reducing their budget deficits;

(iii) the international institutions, both the IMF and the World Bank have become more closely involved;

(iv) the world economy is in a stronger position than in 1982; growth has been over 3 per cent a year, and inflation and interest rates have come down sharply.

6. Yet major problems remain, above all in the economies of many of the debtors. There is still a great deal to be done in order to lay the foundations for sustainable growth of output and of exports. Important to continue to support the present case by case strategy, as it continues to evolve.

7. The extra provisioning led by Citicorp must be seen against this background. It is being followed by all major US and UK banks. Welcome this strengthening of banks' financial position as a recognition of reality. It marks another stage in necessary transition from involuntary lending to voluntary lending by banks. It is an essential part of a more market orientated approach.

8. Being realistic about debt has another dimension. Sub-Saharan Africa has some of the poorest and most indebted countries in the world, facing a range of massive problems. Income per head is very low, typically less than $350. Debt is very high. Much of it is owed to governments. Real danger of debt snowballing, as interest is piled on interest.

9. I therefore proposed in my Washington speech a three point plan, for those countries in SSA pursuing satisfactory reform policies:

(i) convert aid loans in to outright grants - UK almost completed doing this;

(ii) allow longer repayments of up to 20 years when rescheduling official loans to these countries;

(iii) reduce interest rate on the debt to a few points below market levels. This will give relief that is desperately needed in reducing the overall burden of debt.

10. Progress so far is encouraging:

(i) widespread recognition that analysis is correct, and the proposal had been welcomed at the Venice Summit;

(ii) in the Paris Club, rescheduling on more generous terms has already been agreed for some debtors [Mauritania, Mozambique, Uganda and Zaire]. Some creditor countries, while sympathetic to the need to reduce, rather than add to, the debt burden, have yet to agree to lower interest rates;

(iii) IMF and World Bank have recognised the need to tackle the debt problems of Sub-Saharan Africa. The Managing Director of the Fund has proposed a tripling of IMF's concessional funds. We of course welcome this recognition that the international financial institutions need to play a role in Sub-Saharan Africa parallel with that proposed for the Paris Club. The Camdessus initiative was also welcomed by the Summit. How precisely we achieve the agreed objective is not yet clear. Further consultation needed. A large increase in the SAF is one of a number of possible approaches.

11. We now see a clear way forward for the poorest countries of Sub-Saharan Africa. We will press hard for an early and successful conclusion to these discussions.

RE12.2 UNCLASSIFIED

FROM: A P HUDSON
DATE: 24 June 1987

MR WALSH

cc PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Mountfield
Mr H P Evans
Mr Turnbull
Mrs Lomax
Mrs Case
Mr Culpin
Mr S Matthews
Mr Pickford
Ms Life
Miss C Evans
Mr Cropper
Mr Tyrie

POSSIBLE SPEECH ON THE WORLD ECONOMY AND DEBT

We had a word yesterday about the Chancellor's intention to make a speech about international debt, to pre-empt the Paris meeting on 10 July (Mr Kuczys's 23 June minute). I mentioned that the Chancellor was also interested in addressing the theme "whither the world economy", either at the same time or separately.

2. I think the best way forward would be if you could let him have a fairly full outline of speeches on these subjects, assuming for the moment that they will be dealt with separately. Note form is fine, but it would be helpful to have the material by mid-afternoon on Friday (26 June).

3. I put in to the Chancellor Mr Evans's 19 June minute (not copied to all), suggesting how the Chancellor might cover the world economy in his speech in the Debate on the Address. I shall let you know if I have any reactions from him.

APH

A P HUDSON

HUDSON TO WALSH 24/6

4/7

CONFIDENTIAL

FROM: A BOTTRILL

DATE: 27 JUNE 1988

Ch.
Content? (NB Mr Lankester's ms. note below).
29/6

1. MR LANKESTER
2. MR J M G TAYLOR

OK

cc: Mr Scholar
Mr H P Evans
Mrs Lomax
Mr Mountfield
Mr H G Walsh
Mr Kilpatrick
Mrs Thomson
Miss Higgins

Copies attached for: Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler

WHITEHALL DEBT GROUP - JUNE REPORT

I attach a draft Private Secretary letter to No 10.

A Bottrill

A BOTTRILL

I have slightly revised the draft letter. The bank mentioned in para 6 as considering debt forgiveness in Africa is Barclays. They are consulting us about country eligibility etc. I have told them that, while of course this is their decision, we welcome any move they may feel able to make on this front. TL 28/6

CONFIDENTIAL

Pre 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. The world economic outlook as it affects debtor countries in the current year has improved recently in some respects. Output in major industrial economies seems likely to grow by 4 per cent, world trade is increasing by 8-9 per cent and commodity prices in SDR terms are more than 30 per cent higher than the depressed levels of a year ago. These factors should boost many non-oil developing countries' export earnings and help to offset the adverse impact on their current balance of payments of the upward trend in world interest rates. Oil prices, however, remain well below last year's average and continue to limit oil producers' earnings. Over the slightly longer time horizon, the prospects for debtor countries depend at least partly on the ability of the US and other major economies to sustain growth without a renewed surge in inflation which might trigger a tightening of policies.

3. Summit leaders discussed debt prospects in Toronto last week. They agreed that official creditors should ease the debt burden of the poorest countries through concessional interest rates, longer repayment periods, partial write-offs, or a combination of these options. Details are to be worked out in the Paris Club. We expect negotiations to be tough and we shall try to combine with the French to persuade the US to ensure comparable burdens between creditors.

4. The Summit reaffirmed the case by case approach to middle income debtors and noted commercial banks' increasing use of innovative, market-orientated financing techniques. A Japanese proposal aimed at improving the prospects for the refinancing of bank loans - under IMF management but without IMF money - was not discussed. Summit leaders, however, did reiterate the role of the IMF and World Bank in the debt strategy, and this is to be the subject of a G10 study commissioned by Finance Ministers at their April meetings in Washington.

5. Neither debtors' or creditors' attitudes have changed significantly in recent months. The major Latin American debtors seem likely to become increasingly keen to capture some of the secondary market discount on their loans. We should expect further initiatives from the Mexicans after July's elections. President Alfonsin is also seeking interest rate concessions for Argentina. Latin American leaders, however, decided not to approach Summit leaders for global relief. An important issue will be the need to ring-fence the proposals for relief to the poorest countries. Nigeria, Yugoslavia and Poland have already asked tentatively for similar consideration.

6. Among creditors, the attitude of commercial banks to middle income debtors has toughened as their capital base and provisioning has strengthened. One UK bank, however, is considering debt forgiveness for the poorer African countries in the wake of the Summit agreement. Official creditors are continuing their case by case approach to middle income debtors and little change is in prospect ahead of the US elections. If Dukakis were elected, however, the US approach might change.

7. Nigeria causes increasing concern. The IMF programme agreed in 1986 went badly off tack, and the balance of payments position is now critical. The prospects of a satisfactory new programme are poor. An IMF mission returned to Washington from Lagos recently reporting a lack of appreciation at the political level as to the seriousness of the situation and no coherent strategy for budgetary, credit or exchange rate policies. Nevertheless, the Fund's Managing Director has agreed to send the IMF team back after a plea from the Nigerians. We have told the Fund that we want to see a firm adjustment programme. It would have been wiser for the Managing Director to have waited for some action from the Nigerians before agreeing to send a mission back. The Nigerians are seeking 'Toronto' concessions on their debt, but we do not believe that these should be even considered unless and until the Nigerians are at least close to agreeing an IMF programme. The absence of progress with the Fund means that the Nigerians will need a further roll-over of principal payments to banks beyond 30 June.

8. Brazil has agreed a multi-year rescheduling with the steering committee of commercial banks bringing to an end the moratorium declared last year. The agreement provides for some $5.2 billion of new money and increased short-term credits. It will go alongside a new 18-month IMF Standby Arrangement which is expected to be put to the Fund's Executive Board in late-July. Brazil's external trade surplus has risen in the wake of domestic recession but budgetary problems remain and excessive credit expansion is leading to 600 per cent inflation. The Fund programme, therefore, will need to ensure that the authorities regain control of public finances, particularly ahead of the 1989 election.

9. Argentina is likely to face a hostile attitude from commercial banks now that the banks' agreement with Brazil has freed them to concentrate on the Argentine problem. The IMF programme is off track with disbursements suspended. Budgetary policy is proving less restrictive than targetted. The Argentines have also failed to fill the 1988 external financing gap with at least some banks unwilling to provide new money. Negotiations with the Fund and with other creditors are likely to prove very difficult. Alfonsin has already called for a cut in interest rates to 4 per cent. Arrears to banks are mounting and some US banks may classify Argentina loans as non-performing.

10. Egypt's inadequate IMF programme has broken down - as feared - and there is no early prospect of bridging the gap between the authorities and the Fund. The budget deficit has risen to about 17 per cent of GDP, real interest rates remain negative and the official exchange rate remains over-valued. Egypt may well seek 'Toronto' concessions but is not on the World Bank's list for Special Assistance and, in any case, the absence of an IMF programme will jeopardise any future Paris Club rescheduling.

11. Yugoslavia has finally concluded a new round of agreements with the IMF, the Paris Club and the commercial banks - supported additionally by a bridging facility organised by the BIS. The IMF programme contains an ambitious set of desirable structural liberalisation measures which may nevertheless be difficult to reconcile with the macro-economic need to curb inflation, restrain domestic demand and secure an adequate external payments performance. Arguments continue within Yugoslavia on the direction of economic policy. Repayment fo the BIS facility will be from the proceeds of IMF disbursements later this year so that implementation of the programme is important to achieve this.

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

JMGT
P-S

3774/042 NH

CONFIDENTIAL

FROM: D R H BOARD

DATE: 1 July 1987

BOARD TO CH/EX 1/7

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Lavelle
Mr H Evans
Mrs Lomax
Mr Mountfield
Mr Scholar
Miss Noble
Mr Cropper

Mr McGivern - IR

Mr Barnes - B of E

Thanks. Re X, I do find it surprising that the matrix takes such (limited) account of discounts. Nor [illegible] market-orientated approach [illegible] looks [illegible] practice of provisioning [illegible] from 2/3 of the [illegible] discount.

INTERNATIONAL DEBT: PROVISIONING

You asked for a quick note on the relationship between the Bank's matrix and the percentage value of each country's sovereign debt in the secondary market.

2. An illustrative table is below. But it might be helpful to say something first about general principles, and about the mechanics of how the secondary market value enters into the matrix.

3. The purpose of the matrix is a dual one, namely to provide a reasonably objective tool for prudential discussions between the Bank and banks and provide something which it is hoped will be helpful for the Revenue's purposes too. As para 13 of Mr Painter's submission made clear, to the extent that the matrix includes factors which do not bear directly on an assessment of what percentage of a debt will never be repaid, the Revenue will need to discount the results. (The Bank are continuing to discuss the matrix with the Revenue who have made a number of comments.)

4. From the tax perspective, secondary market values are only directly relevant if debt is actually sold in the secondary market (in that case tax relief would be based on the market price received and hence the actual loss incurred). Where value-impaired debt remains on the books, the secondary market discount will normally be greater than the allowable tax provision (which would be based on the extent to which the debt will never be repaid). The market price will take into account the present value of the expected cash flow from the asset, including potential interest service problems (delay or default) as well as applying a time discount to the eventual capital repayment. The market price may also recognise a margin of profit for the buyer for taking on the risks of uncertain repayment.

5. Both specific provisions and tax look at ultimate repayment in nominal terms. Loans will be written into the bank's books at cost. Specific provisions only need to be made against the loan eventually being repaid at less than book value. Rescheduling the repayment date does not require a provision, provided that long rescheduling and the debtor's creditworthiness do not raise questions about ultimate full repayment.

X 6. Against this background it is not surprising that the matrix takes only limited account of secondary market discounts. The current version of the matrix allows a maximum points score for any country of 76, contributed almost equally by three groups of factors:

A - presence of rescheduling of obligations, moratoria or unilateral limits;

B - presence of arrears on current obligations;

C - general economic and more judgemental factors.

Within group C, there is a score of 2 if debt is trading in the secondary market at less than 80% of book value. This is a very low weighting, since C scores only count if there is a score of at least 10 from the "harder" information in groups A and B. Thus if the matrix results (when converted from scores into provision percentages) and secondary market prices are comparable, that is because they are both reacting to factors such as A and B, not because there is an arithmetical link.

7. A sample of comparisons follows. They suggest an encouraging correspondence in country relativities between provisions and market discounts.

Country	Matrix points score	(%) Matrix provisioning band	(%) Possible matrix provisioning level*		(%) Secondary market discount**
Chile	25	16 - 25	20	20	30
Mexico	30	16 - 25	25	19	43
Argentina	40	26 - 40	33	33	49
Poland	53	41 - 60	44	47	55
Peru	66	61 - 100	61	76	84

* The matrix relates bands of possible scores to bands of provisioning levels. This column shows the pro rata provisioning level within the band - for example, if the score is half way between the ends of a score band, it takes the provisioning level half way between the ends of the corresponding provisioning band.

** Source: Salomon Bros, June 1987.

8. It should be emphasised that the Bank's work on the matrix is not finished; but if more background is of interest, you might like to see their note of 18 June (attached to top copy).

Douglas Board

D R H BOARD

RT4.75 CONFIDENTIAL

PPS

FROM: A W KUCZYS

DATE: 3 July 1987

MR BOARD

I trust the IR are taking full note of secondary market discount.

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Lavelle
Mr H Evans
Mrs Lomax
Mr Mountfield
Mr Scholar
Miss Noble
Mr Cropper
Mr McGivern - IR
Mr Barnes - B of E

INTERNATIONAL DEBT: PROVISIONING

The Chancellor was grateful for your further note of 1 July.

2. In your paragraph 6, you said it is not surprising that the matrix takes only limited account of secondary market discounts. The Chancellor <u>does</u>, however, find it surprising. This is not a very market-oriented approach. But in practice it looks as if the provisioning level permitted will not vary very much from $^{2}/_{3}$ of the secondary market discount.

c. Mr Board.

AWK

A W KUCZYS

PS/Chancellor.

On X - it isn't. The Bank have had but one eye on IR, in devising this matrix. But this cannot be admitted.

RL
6/7.

156/11

1. Jonathan ✓
2 pup

Ch

PEM v exercised about this stuff floating round Whitehall & banks. But Bank have agreed (see x) to remove most sensitive bit: index of political stability.

AA

Right. The answers to (a) & (b) are unpublishable, & respectively, Similarly IR unpublishable; to (c) is no. And so is change [illegible] response to [illegible] this [illegible] max. secrecy.

CONFIDENTIAL

Thanks. Para 3 is key. I note it:-

FROM: MRS R LOMAX
DATE: 14 JULY 1987

PS/CHANCELLOR

cc Mr Cassell
Mr Scholar
Mr Board

INTERNATIONAL DEBT: PROVISIONING

You recorded the Chancellor's hope that the Inland Revenue take full note of relative secondary market discounts.

2. The Revenue's position is that secondary market discounts are different in kind from the appropriate level of provisions for bad and doubtful debts: there is no necessary reason why they should mirror each other closely, even in relative terms, though it may turn out that way in practice. Under present tax legislation, debts are doubtful for tax purposes to the extent that they are estimated to be bad: and a bad debt is one that will <u>never</u> be repaid. Secondary market prices are more akin to present values: that is, they reflect the probability of debt rescheduling of one kind or another as well as ultimate default. Moreover, market values include an element of inducement for purchasers to assume the risk of loss, as well as the market's best central estimate of the loss itself. There is also the point that the markets for sovereign debt are very thin, and to that extent market values are not necessarily a good guide to the prices at which arms length transactions could take place.

3. All that said, the bank that disposes of its sovereign debt in the open market can set its actual loss against tax, based on secondary market prices. This is what the American banks are planning to do: and it is what some Japanese banks have been doing, using a company set up for the purpose in the Cayman Islands. If the Inland Revenue's guidelines are too far adrift of the secondary market, they may find that they have created an incentive for our banks to behave in the same way.

4. Meanwhile, the Bank and Inland Revenue are still negotiating about the fine print of the Bank's matrix. The hope is that sufficient agreement will be reached shortly to allow the Bank to circulate guidance to UK institutions before the end of this month. We will report back before that happens.

X

RL.

RACHEL LOMAX

FROM: M G REDLEY
DATE: 28 July 1987

1. MR MOUNTFIELD
2. CHANCELLOR

cc PS/ Chief Secretary
PS/Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Lavelle
Mrs Lomax
Mr Turnbull
Mrs Case
Mr Davis
Mr Bonney
Mr Walsh
Mr S Matthews
Ms Life
Ms Symes
Mr Pitcairn
Mr Batt

Ch/ Some useful points in the annex. Do you want this to be picked up in IMF/IBRD briefing, as suggested in para 4?
30/7

Yes.

INTERNATIONAL DEBT

~~At~~ After your meeting on debt on 3 July, you asked for instances of protectionist measures adopted by the main waiverers on your debt strategy which damage developing countries. The aim is to strengthen the arguments in its favour. Clearly we must choose cases where the UK (for above the board trade measures, this of course in practice means the EC) has a clean record itself. They are not easy to find. But the objective can also be secured using cases where the EC grants better access to its markets than the main waiverers - the US and Japan in particular - do to theirs. Points to make with a short note on half a dozen examples are attached.

2. The danger is obviously that others may respond by pointing to areas where the EC record is genuinely worse. The main case here is obviously agriculture. The OECD's recent work on Producer Subsidy Equivalents - which we have pressed them to publish - has established that the EC is second only to Japan in the scale of its subsidy regimes. There has been much publicity - which is being used by G77 countries at UNCTAD VII in Geneva this week - about the damage inflicted on developing countries by the CAP. Your repost would be to assert that all are sinners and to stress the UK's positive role within EC in working for the reform of the CAP.

but these are not the poorest countries

3. But specific instances could still be damaging. EC markets for Latin American beef have for example virtually disappeared in the last few years. The enlargement of the Community to include Spain and Portugal is progressively reducing the access of non-Community citrus and vegetable exporters to EC markets. The effects on the trade of Mediterranean developing countries will be substantial.

4. You would clearly want to avoid a useless row about who does least in concrete terms for developing countries. The ground could be prepared to some extent by briefing on the major areas of current difficulty with trading partners. Progress with the protectionist US Trade Bill and any current disputes with the EC would clearly be relevant. We could do this for any meeting with the Americans before the Autumn IMF and World Bank gatherings, as well as for the annual meetings themselves.

M G REDLEY

POINTS ON TRADE FOR CHANCELLOR'S DEBT DISCUSSIONS

Point to make

EC grants duty-free access to a far wider range of developing countries than US or Japan.

Background

Under the Lome Convention, all industrial products originating in 66 African, Caribbean and Pacific (APC) states (including most of Sub-Saharan African debtors) benefit from duty-free access to EC markets. The same is true of much agricultural produce, although special arrangements apply to sugar, beef, bananas and rum. The total value of trade under the Lome Convention is around $30 bn per annum. The US grants such generous terms to developing countries only in connection with its free trade treaties with some Caribbean basin countries. Japan has no comparable scheme at all.

Point to make

The EC grants far better terms of access generally to all developing countries than the US or Japan.

Background

Apart from Lome, the Community gives preferential access for industrial products - often duty-free - to a further 80 developing countries under its Generalised System of Preferences (GSP). Duty-free access is granted to sensitive products subject to a tariff quota which provides for automatic reversion to MFN rates for imports in excess of the quota. The US and Japan both have schemes operating in a similar way. But product coverage and the circle of eligible countries is far wider under the EC GSP. The US scheme totally excludes a wide range of products declared to be "import sensitive". In 1980, the latest date for which information is available on a comparable basis, 92% of the imports of all developing countries benefit from preferential (largely duty-free) treatment. Comparable figures for the US and Japan are roughly 40 per cent and 30 per cent.

Point to make

(To the US).

The EC grants far more generous access for textiles to European markets than you do to yours.

Background

The Multi-Fibre Arrangement (MFA) negotiated last year provides the general framework for world textile trade. Details are settled in bilateral deals with suppliers. EC terms give far greater access to developing country textile than the US has conceded, particularly to the least developed suppliers. For example, the EC has recently removed quotas entirely for Bangladesh, Mexico and Colombia, while the US retains them for all three. The US has also extended the MFA coverage to new textiles such as ramie. So far the EC has not.

Point to make

(To Japan)

Your restrictions on imports of leather and leather goods are damaging to developing country (as well as developed country) exporters.

Background

Japan has a notorious high protection regime for leather and a wide range of finished leather goods. It operates a global quota within which there is a duty of 20%, compared with a duty of 60% outside the quota. The present EC ratc for all levels of imports is 7%. A joint EC/US complaint in GATT in 1984 secured a ruling against Japan. But subsequent changes to the regime have made little practical difference to access. The developed countries would mainly benefit together with some newly industrialising countries from a change in the regime for leather goods. But some developing countries would also be well placed to take of better access to Japan's market.

FROM: HUW EVANS
DATE: 3 SEPTEMBER 1987

SIR TERENCE BURNS

cc ~~PPS~~
Sir G Littler
Mr Mountfield
Mr Walsh
Ms Life
Mr Carpinter

[illegible] for we know debtors [illegible] [illegible] made by the banks in this direction. N.

attached

NATWEST PAPER ON THE DEBT SITUATION

A number of copies have been received of the Lomax paper. It has also been widely distributed in the Bank of England and elsewhere.

2. Lomax makes two proposals:

(i) for debtors to use their foreign exchange resources to buy back their debt in the marketplace. This is a natural part of the more market orientated strategy to which the Chancellor has referred in recent speeches on debt. Voluntary arrangements of this kind directly between banks and debtors can be welcomed, and we propose that the Chancellor should say so in Washington.

(ii) OECD governments and international organisations should provide debt relief by lending countries the necessary funds to buy back their own debt. In effect, the governments would take over (at a suggested discount of only 25 per cent!) the assets of the banks and shoulder all further risk themselves. This is clearly unacceptable.

3. I have asked IF1 Division to provide a draft reply (which might come from Mr Mountfield) to David Lomax, making these two points and maybe some others.

4. Mr Mountfield has reminded me that there could well be a read across to ECGD debt: while there is no market in this, it is quite possible that offers might be made, at sizeable discounts, to ECGD. ECGD has already provisioned substantially against this kind of outcome and we would certainly not want to rule out such buy backs if the price was judged appropriate. We are not ready to say so in public, but it is an implication that some people may draw and we should be prepared for it.

H P EVANS

CONFIDENTIAL

Ch/ Content with conclusions + line to take? 25 11/9

FROM: P CARPINTER

DATE: 10 SEPTEMBER 1987

1. ~~MR EVANS~~

2. CHANCELLOR

The pressures we identified earlier this year and which triggered off the extra bank provisioning are now leading to increased discussion of various forms of debt relief for middle income debtors. While we should recognize this privately, our public emphasis should continue to be on the need for IMF conditionality for new money. We would not want to discourage alternative, market-related, approaches such as debt buybacks not involving government or IFI money.

HPE 10/9

OK. See n 14(6) but rather concentrate on debt buy-backs (or other private concessions @ this stage) so as to maintain distinction btw this & SSA initiative. N.

cc
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Lavelle
Mrs Lomax
Mr Mountfield
Mr Walsh
Ms Life
Mr Batt
Mr Stern

MIDDLE INCOME DEBTORS; RECENT PROGRESS AND PROSPECTS

INTRODUCTION

1. In his speeches on debt in April and July, the Chancellor called for a market-oriented approach to the resolution of the problems of the middle income debtors, with a continuation of the basic strategy that provision of extra creditor support would be predicated on the implementation of appropriate adjustment programmes. This minute assesses the changes in the position of the main middle income debtors and their creditors over the last six months, leading to suggestions for a line to take at the Annual meetings.

DEBTORS

2. The main middle income debtors can usefully be seen as two main groups; four countries (Brazil, Argentina, Mexico and Venezuela) which have a large (systemic) exposure to the commercial banks, and about a dozen smaller countries. A summary of the recent progress of the most important debtors is attached as Annex 1. More detail will be found in the next report of the

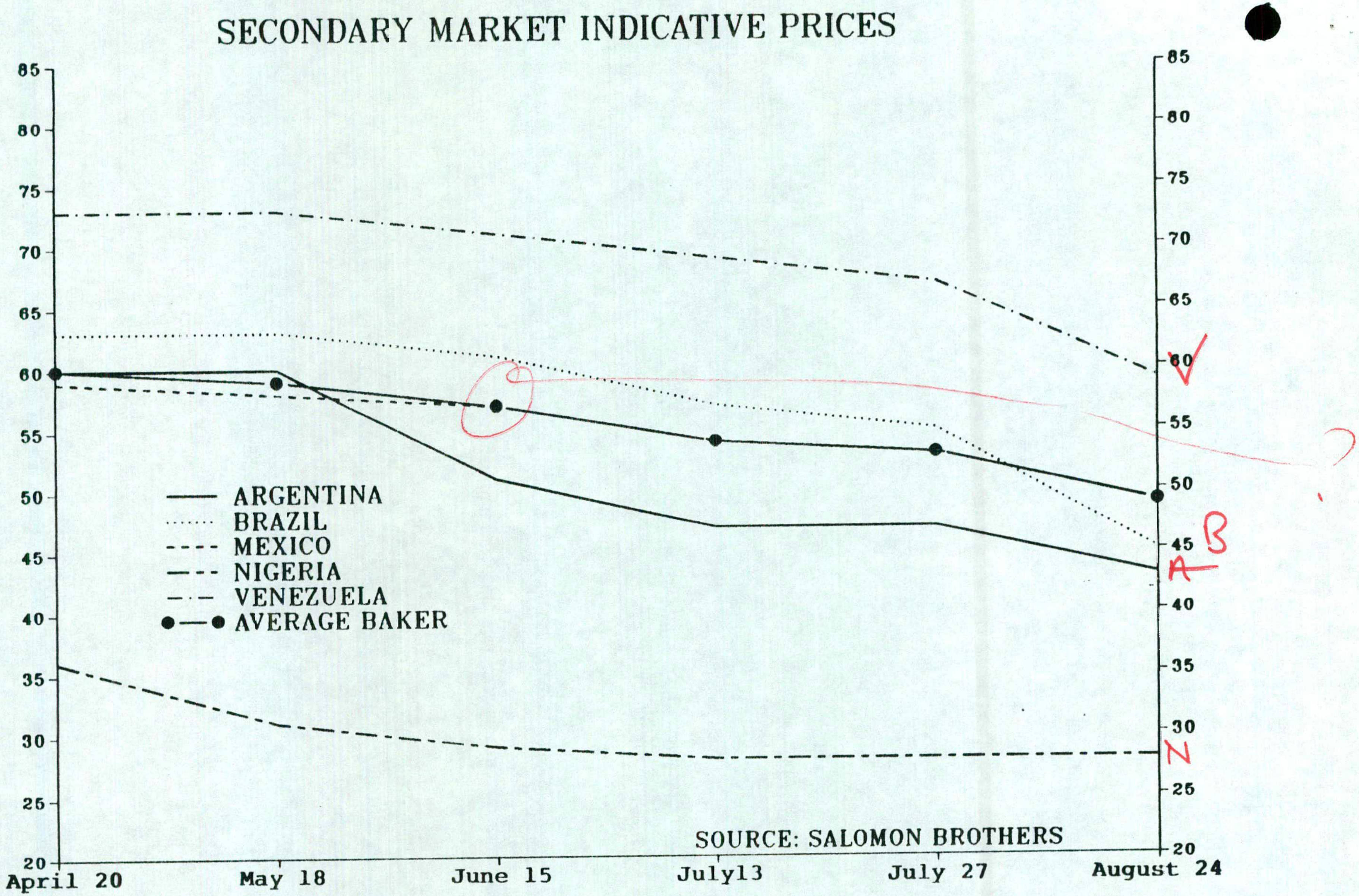
Lavelle Group, which is due to be circulated before the Annual meetings.

3. In brief, middle income debtors have made very mixed progress since earlier in the year. Only Mexico can be said to have done reasonably well, with substantial export growth but with continuing rapid inflation. Both Argentina and Brazil are in much worse shape than seemed likely a year ago, although Brazil's trade performance has recently improved. Brazil and Argentina have recently given indications of wishing to form a debtors' cartel, which Mexico has refused to join.

4. The debt strategy has been based on the assumption that the medium term prospects for the main middle income debtors are such that, given implementation of sensible policies, almost all middle income debtors could over time service their debts if they so wished. This was very much the conclusion reached in previous IMF forecasts prepared since the onset of the debt crisis. But in fact there has been little progress towards creditworthiness. Although the external environment has not been quite as supportive as assumed in earlier years, with commodity prices much lower than forecast, the main reason for the lack of progress towards creditworthiness has been the lack of consistent and appropriate policy implementation. Recent developments in Argentina and Brazil indicate a renewed reluctance of some middle income debtors to co-operate in implementing the debt strategy, because of the perceived short term costs and political difficulties.

CREDITORS

5. The changes in valuations in the secondary market for bank debt over the last six months suggest that financial markets are taking an increasingly pessimistic view of progress. Salomons suggest that the average ~~discount on~~ [illegible] bank debt for the 15 main debtors fell from 60% to 49% between April and August. The attached chart shows the movements in valuations for some of the main debtors. The market is still comparatively thin, with total trading this year likely to be about $10b, compared with bank lending of about $300b.


SECONDARY MARKET INDICATIVE PRICES
85
80
75
70
65
60
55
50
45
40
35
30
25
20
ARGENTINA
BRAZIL
MEXICO
NIGERIA
VENEZUELA
AVERAGE BAKER
SOURCE: SALOMON BROTHERS
April 20
May 18
June 15
July13
July 27
August 24
V
B
A
N

Banks

6. There has been little or no spontaneous bank lending to any country that has rescheduled since the start of the debt crisis. Net flows of principal and interest to the banks are continuing.

Bank Capital Flows ($b)

	March quarter 1987	**Year ending March 1987**
15 Middle Income Debtors	-1.2	0.1
All Non-Opec Developing Countries	4.6	0.9

Source: International Banking Developments, BIS 1987

7. The lack of confidence inherent in the lending figures has been manifested in other actions by the banks. The most obvious has been the spread in higher provisioning levels from the continental banks to those in the US, UK and Canada, triggered by Citicorp's move in May. Other large US banks rapidly followed Citicorp, which suggested that many had already decided on similar moves. Most American, Canadian and UK banks are now rebuilding their balance sheets to reflect the view that the underlying value of their claims is considerably lower than their face value. This process will be painful for a number of the financially weaker banks, some of which are comparatively large. Citicorp's latest move, the raising of a rights issue, is also likely to increase competitive pressure on other banks to follow suit where they can. Those which cannot, such as the Bank of America, may have to borrow on onerous terms to rebuild their capital. The markets have reacted favourably to provisioning.

8. It is difficult to assess all the implications of the banks' moves. Although Citicorp in particular has stressed that it will continue to lend to the main debtors, as well as becoming more active in shifting existing debt of its balance sheet, and banks will want to protect the 70% of unprovisioned debt, the moves are

a clear signal to the debtors that banks no longer expect all existing debt to be serviced in full. The main debtors have made it clear that they expect to benefit from the discounts at which their debt now trades. Though it is unlikely that there will be many more conventional concerted bank lending packages, there is increasing evidence of innovative thinking in the form of debt buy-back or refinancing schemes;

1) The banks involved have tentatively agreed to sell debt back to Bolivia at the market discount under certain conditions, the most important of which is that finance is provided by other parties;

2) The Chief Economist of Natwest has suggested that Mexico might use some of its high level of reserves to buy back some of its own debt at close to the market value. (Mexican Ministers have shown some interest in the idea).

3) There are various proposals to transform existing bank exposure into longer term bonds with concessions either in their face value or in their interest rates.

9. Many of these thoughts have been reflected in the IMF's recent work, which has (for the first time) openly canvassed some of the options for debt relief for middle income debtors, after noting that some of the existing arrangements - debt-equity schemes and exit bonds - are unlikely in themselves to make much difference to scheduled debt servicing.

IFIs

10. The IMF's exposure to the middle income debtors has fallen over the last year, and that trend seems likely to continue over the next year. The Fund has had fewer programmes for middle income debtors this year, reflecting a lack of demand from debtors and the increasing difficulties involved in arranging the necessary bank finance associated with these programmes. Most of the programmes for middle income debtors it has agreed this year have been widely perceived as being very weak. The World Bank is continuing to increase its lending to problem debtors implementing adjustment policies.

11. The changes in the banks' position this year are likely to put increasing pressure on both the Bank and the Fund, for two reasons;

(i) The growing acceptance that banks' exposure is worth less than its face value could raise questions about the value of the IFIs' exposure.

(ii) There will be increasing pressure on the IFIs to increase their lending to cover the reductions in bank funding.

ECAs

Export credit agencies

12. There is likely to be a sharp fall in traditional ECA project-related business and hence in exposure to middle income debtors in the next few years, reflecting past downturns in project approvals. This fall is likely even if trade cover is resumed and maintained for countries implementing appropriate policies and if new projects emerge from increased World Bank collaboration. This is not necessarily a bad thing, given the type of projects that ECAs have frequently supported in the past, but the reduction in expected net flows is likely to lead to difficulties for ECAs as debtors face reduced incentives to service their debt. The banks' moves also cast increasing doubt on the value of existing ECA exposure in many countries. The recent proposals to securitise and reduce the value of bank exposure could well lead to suggestions from some middle income debtors for similar changes to ECA credit.

CONCLUSIONS

13. The experience of the last six months suggests that the message and analysis in recent speeches were broadly correct. Many of the main debtors are not implementing the type of economic policies necessary to retain creditor support or to restore credibility and some have adopted a more aggressive stance; the banks have reacted by starting the process of acknowledging the underlying value of debt, perhaps more rapidly than earlier anticipated. That process is likely to continue, with debtors looking for, and probably getting, some form of concession on

interest flows, though we will almost certainly go through a period of difficult negotiation. The immediate conclusions seem to be;

(i) As regards the provision of finance by banks:-

Now that the US and UK banks have increased their provisioning, the next major event will be negotiations about the debts owed to banks by Brazil and the provision of new finance. This may lead to a major confrontation (eg at the next meeting of the Interim Committee) but in any case it is not likely that these negotiations will reach an early conclusion. They will take place strictly between the banks and Brazil. We should do nothing in the Fund or elsewhere to relax conditionality in an attempt to further their progress, acting where possible in concert with other G5 countries.

(ii) As regards innovations:-

The other major developments likely to affect the middle income debtors is the extension beyond Bolivia of proposals for formal debt buy-back schemes for commercial debt or the negotiation of other refinancing schemes involving concessions on interest rates. There is no reason why we should object to either of these developments, providing there is no question of any government contribution towards debt buy-back or public subsidy towards interest concessions by banks to middle income debtors. In neither case would IFI conditionality necessarily be involved. But reform programmes would have to be put in place before private debtors would resume capital flows to these traditional importers of capital, so that conditionality would be imposed by the market.

14. The proposed line to take on middle income debtors is therefore as follows;

1. Vital to distinguish sharply between problems of heavily indebted but potentially strong and creditworthy economies, and the poorest debtors, above all in Africa.

2. Basis of strategy remains the provision of finance by creditors to middle income debtors following appropriate adjustment policies; Government creditors ready to play their part, but no question of support outside that framework.

3. Clear responsibility on banks and debtors to manage the debt owed to the commercial banks.

4. Against all schemes in which taxpayers bail out banks: misuse of public money, and bad banking practice.

5. Welcome provisioning, paving way for more market oriented approach. (Points 3, 4 and 5 are as in July speech).

6. Debt buy-backs/reductions in interest flows can play a role when agreed between banks and debtors. Not for Governments or IFIs to provide money or guarantees.

Are you content with the conclusions in paragraph 13 and the proposed line to take in paragraph 14?

P. Carpinter

P Carpinter IF1

Annex 1

Mexico has allowed its real exchange rate to depreciate substantially and has followed a tight monetary policy; it has enjoyed rapid non-oil export growth and some return of flight capital. Oil prices have also recovered somewhat. Reserves are now at comparatively high levels. But inflation is still very high and increasing, and Presidential elections are looming.

4. Argentina had a very weak IMF programme agreed in February, and arranged bank financing with the help of an innovative package, but then missed almost all the performance targets in the first programme review. A new, even weaker programme is now in operation, but there are grave doubts about whether Argentina will be able to meet its targets. There are also increasing signs that the balance of payments out-turn this year will be well below the level assumed for the Fund programme and the bank financing package. The Government has faced a serious setback in the most recent elections.

5. Brazil is now running substantial trade surpluses again, but there is no coherent economic policy; the latest economic plan (which covered most of the right policy areas) seems to be falling apart over the issue of spending cuts. Inflation is still very high. Negotiations with the banks and the IMF have not yet formally begun, six months after the declaration of the interest moratorium.

6. Other middle income debtors are also having serious difficulties. Nigeria is likely to require a new Fund programme because of missed targets in the present arrangement. Egypt is also having problems meeting its obligations, even under its exceptionally weak programme.

7. On the other hand, Chile and Uruguay seem to be making reasonable progress, and Colombia is negotiating a new package of lending from the banks.

Restricted

FROM: P CARPINTER

DATE: 18 SEPTEMBER 1987

1. MR H WALSH

2. PS/CHANCELLOR

cc Sir T Burns
Sir G Littler
Mr H Evans
Mr Mountfield
Ms Life

NATWEST PAPER ON THE DEBT SITUATION

The Chancellor asked whether, as suggested in the recent Natwest paper, any debtors were using their foreign exchange reserves to buy back their debt in the market place, and whether any effort is being made by the banks in this direction.

2. The short answer is that we do not know the answers to the Chancellor's questions.

3. There are some existing schemes which are similar to Natwest's proposal. The Bolivian debt buy-back scheme explicitly involves one of the poorest debtors offering to buy its own bank debt back at a deep discount, with the major requirement that it should be funded by donor Governments rather than out of Bolivia's own reserves. Debt-equity schemes also involve debtor Governments trading their own debt, although the resources used by the debtor Government are usually internal rather than external.

4. Whether debtor Governments are actually purchasing their own debt is very difficult to establish. Debtors are meant to treat all their creditor banks equally, and purchasing debt of one bank without offering the same terms to others would be in breach of most loan agreements. That may not stop individual banks and Governments cooperating if they felt it was in their own best interests - as Peru and Midland are recently reported to have in a debt for exports deal - but it inhibits reporting of such

activities. There are however some indications that trading is not large. The secondary market for bank debt is still thin, especially for countries that do not have active debt-equity schemes, and the low levels of turnover suggest that there may be little demand from debtors for their own debt, either inside or outside the reported market.

5. Perhaps only Mexico of the major debtors has sufficient reserves to contemplate large scale purchases of its own debt (it has about $15b, together with an undrawn $2.5b from last year's bank loan). There has been some public discussion in Mexico about the possibility of using some of their existing reserves in this way, but there has been opposition expressed to the idea of using hard-won reserves to buy out the banks. Mexico could draw down the remaining $2.5b to purchase some debt, but the banks would probably prefer that Mexico did not draw down the funds for this purpose. And Mexico may not wish to draw down the remainder of the loan because of the potential expansionary effects on domestic liquidity and hence on its IMF programme.

6. So the signs are that there has not been much activity so far. But previous debt crises in Latin America often led to the main debtors repurchasing outstanding bonds, normally at substantial discounts. It could happen again with bank debt.

P. Carpinter

P Carpinter IF1

FROM: HUW EVANS
DATE: 7 OCTOBER 1987

Ch/ Content? JT 7/10 — NO!

CHANCELLOR

cc Sir G Littler
Mr Mountfield
Mr Culpin
Mr Walsh

Appalling

INTERNATIONAL DEBT: MINUTE TO THE PM BEFORE CHOGM

I attach a draft minute for you to send in the next day or so to the Prime Minister, covering your position on the SSA initiative, the enlargement of the SAF, middle-income debtors and the Seaga plan.

HPE

H P EVANS

Ch
Pretty wooden. I have suggested some amendments to the Seaga bit where I do not think the line is quite right
AA

DRAFT MINUTE FROM CHANCELLOR TO PRIME MINISTER

Present (a) conditionality (b) provision of (c) confirmation to -NOTE points.

INTERNATIONAL DEBT

One of the main concerns at CHOGM next week will be the problems of international debt. Following the Commonwealth Finance Ministers' and Washington meetings, I thought you might like a report on where we stand on the main issues and initiatives.

There is now widespread agreement that the problems of the poorest countries, especially in Sub-Saharan Africa, are in the words of the Venice Summit "uniquely difficult and need special treatment". These extremely poor countries have no hope of becoming creditworthy by their own unaided efforts. They also owe their debts mainly to governments and international financial institutions rather than to banks.

My

~~The UK~~ initiative, launched in April, called for governments to

to help these countries

~~play their part~~ by converting aid loans into grants, ~~by~~ extending maturities and grace periods on bilateral official debt, ~~and~~ by introducing concessional interest rates on this debt, We are making good progress in the Paris Club on the first two. (Canada,

Australia also

~~has recently~~ decided to follow our example in writing off old aid loans and we should welcome that, while privately expressing our reservations about the lack of conditionality). But concessional interest rates ~~are proving difficult for many countries to accept~~,

provided the ~~the~~ countries are pursuing sensible economic policies.

Many countries ~~are~~ refusing to go along with the idea of

For a number of ostensible reasons ranging from the

~~partly out of~~ ostensibly fear of setting a contagious precedent~~, but mainly because of~~ to budgetary pressures and institutional obstacles. (A) The formal position is that the proposals remain on the table having been endorsed by the Commonwealth Finance Ministers. I hope that they will be re-endorsed at CHOGM. We have gained considerable political credit from our approach.

The IMF's ~~parallel~~ subsequent proposal for more concessional loans for very poor countries that are implementing adjustment policies - the enlargement of the Structural Adjustment Facility - was extensively discussed in Washington. I emphasised the need to ensure that within this enlargement resources were concentrated on ~~very poor and~~ the heavily indebted countries of the type that would qualify for our own initiative. I said that "the UK stands ready to make a contribution on the basis that all other major countries do so as well".

It has secured a considerable degree of support, but there remain some significant refusals to participate — notably from the US.

The discussion on the UK and IMF initiatives took place against the target set by the Venice Summit for a conclusion on these discussions by the end of this year. As of now, I ~~shall continue~~ believe we should to press for ~~early decisions~~ agreement on interest rate concessions by the creditors in the Paris Club acting together, ~~but it would not be right for us to do this unilaterally.~~ Even though, realistically, ~~Realistically,~~ we are unlikely to be much further forward ~~on this issue~~ by the end of ~~this~~ the year. (Some countries have, however, indicated that, while unable to support the proposal for concessional interest rates, they would be able to make broadly equivalent contributions in other ways.)

Whether or not the proposal to enlarge the SAF will meet the end-year target will depend in large part on whether the United States can be persuaded to make ~~at least some~~ an adequate? commitment, which should also bring the Japanese ~~and Germans~~ on board. If this can be achieved, and if we can secure favourable access to extra SAF funds for the very poorest and most indebted, then the UK ~~will~~ should be able to make its contribution. At some stage, though not now, we may need to consider whether we are satisfied that our objectives are met by a combination of the first two elements of the package.

I originally launched a call for interest rates for the poorest having the debts continuing with an enlarged SAF.

~~Many of the middle income debtors face difficult problems. In the case of most Latin American countries this is largely of their own making and we must continue to make clear our policy that the debts owed to the commercial banks are a matter for them, not for governments.~~ Even so, it ~~is worth~~ may be worth noting how the debt strategy has evolved over the past year, with the strengthening of the banks' balance sheets and the willingness to offer debtors a far greater range of financing options.

Check.

There are only a few large middle income debtors in the Commonwealth, though quite a number of small ones, particularly in the Caribbean. Jamaica is pressing its CARICOM initiative hard. I discussed this with Prime Minister Seaga at the Commonwealth Finance Ministers meeting in Barbados. He will be presenting the case for targeting debt service ratios again at Vancouver. His problem, and a very real one, is that his debts are owed mainly to the IMF and World Bank who never ~~- for very good reasons -~~ reschedule. Jamaica is not of course poor enough to qualify for ~~special~~ assistance from my initiative or from the SAF. The answer One precondition for any help for Jamaica is that it must to remain eligible for credit at the Fund and Bank, by pursuing the necessary reform programmes and meeting its repayments when these fall due.

There are good reasons for that approach, but I told Seaga - and repeated ~~in my~~ ~~speeches~~ in Washington, we do need to consider in the Fund & the Bank whether there are things which could be done to help with these specific problems.

As we acknowledged in the Venice Summit communiqué,

~~It~~ is important to keep the problems of the poorest countries separate from those of the middle income debtors. ~~We can rely on the African countries, which stand to benefit from the UK and IMF initiatives, to take the lead in emphasising that priority for the poorest, most indebted countries would be set back by any endorsement of Seaga type plans.~~

in Latin America and elsewhere. Most of these countries' debts are owed to the commercial banks, and we should continue to reiterate our ~~[illegible]~~ understood position that this is a problem that can best be resolved between the debtor ~~[illegible]~~ countries, the banks, and not by the govts (ie the taxpayer) of the creditor countries.

(A) But there is no doubt that the emergence of the IMF plan referred to in the next paragraph has caused concern that we would have to persuade the UK to accept interest rate proposals and ~~[illegible]~~ to opt for the IMF own system.

15 (previous page)

Final Para over

4

There are, however, a number of middle income debtors whose debts are owed not to the commercial banks, which have readily agreed to substantial rescheduling, but to the IMF and World Bank, which are not prepared to reschedule. There are a number of such countries in the Commonwealth, including Jamaica. Hence Seaga's CARICOM initiative, which he will present again at Vancouver. I discussed this with him in Barbados, and explained that while I could not accept his proposal, which involved ~~[illegible]~~ special financial assistance for these countries, I would raise with the Fund in Washington the particular rescheduling problem he faces, and ask them to look at what might be done. This I duly did.

At Vancouver, we ought to be able to bring the African countries to recognise that any proposal for concessional interest rates for the poorest countries, whether via the UK proposal — or via the IMF's, could be taken further by Seaga's plan, to extend similar help to middle-income debtors.

22/10/87.

FCS/87/213

CHANCELLOR OF THE EXCHEQUER

I will write to Mr W after BP & due course
(the Plan Care) & whether there ...

International Debt

1. You sent me a copy of your minute to the Prime Minister of 9 October. We made progress at CHOGM in obtaining an unqualified endorsement of your debt initiative, and in achieving language that stressed the importance of reaching early agreement to reduce interest rates on the rescheduled debts of the poorest and most indebted countries. The Canadians announced their full support early in the proceedings, and you might want to take a suitable opportunity to express our appreciation to Mr Wilson. The Australians said that they were in agreement with "95% of our proposals", and that they would not stand out against their endorsement. We (and Canada) were also singled out in the Communique for our willingness to contribute to the enlargement of the Structural Adjustment Facility. This is politically very helpful.

2. I agree with your analysis, and I believe that we should continue to press for agreement in the Paris Club on interest rate concessions. Like you, I doubt whether we shall make much progress before the end of the year. But it is important that when the OAU's debt conference takes place in December the more sensible African countries should be able to point to the initiatives under discussion - yours, Camdessus' and perhaps Mr Baker's proposal for an External Contingency Facility - as evidence that creditors and debtors can cooperate

/in

in efforts to reduce the burden of indebtedness and underpin adjustment policies. Otherwise the extremists may have it all their own way. So we should actively promote your initiative, while privately considering what other package might meet your essential objectives.

4. Your minute also mentioned Seaga's CARICOM initiative. The language of the relevant paragraph in the CHOGM Communique corresponds closely to the text agreed at Barbados. We told the Jamaicans that you had raised their problems with M. Camdessus, and they were duly grateful. Caribbean delegations gave your initiative useful support, although they knew that they would not benefit from it. Their own problem lies with what the communique describes as their "uncomfortably bunched" debts to the IMF and World Bank. Perhaps we can find ways of helping them without going so far as to urge the Fund - still less the Bank - to reschedule their debts.

5. I am copying this minute to the Prime Minister.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
22 October 1987

CONFIDENTIAL

FROM: MRS A F CASE
DATE: 6 November 1987

CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Evans
Mrs Lomax
Mr Mountfield
Mr Allen
Mr Walsh
Mr Halligan
Mr Lancaster - UKDEL

Ch, / Content for me to write to No 10 as suggested? (one or two small amendments).
6/11

D8985

INTERNATIONAL FINANCIAL SCENE

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

2. The covering letter brings the text up to date with the latest state of play in the negotiations between the commercial banks and Brazil. The agreement was reached last night, as reported in my minute earlier today, and a message to that effect has been sent by the Advisory Committee to the banks involved. The expectation is that this will be sufficient to prevent the down-grading of Brazilian loans by ICERC, though this had not yet been confirmed. Discussion continues on a term sheet which is now promised for the middle of next week, after-which the Adivsory Committee and the Brazilians will have a difficult marketing exercise to conclude.

I have changed the heading, for Brazilian reasons, & also the assessment of the consequences of the stock market slide, with much of which I disagree. Otherwise OK.

AFC

MRS A F CASE

10/152

A type for my sig

CONFIDENTIAL

C Powell, Esq

DRAFT LETTER TO NO 10

(from 2HMT)

cc FCO, DTI, BOE

INTERNATIONAL ~~FINANCIAL~~ DEBT SCENE

I attach the regular report on developments in the international debt scene. The main developments since the Bank and Fund meetings in Washington in September are summarised on the first page of the report.

2. The major new development discussed by the Interdepartmental Debt Group was the impact of the collapse in world stock markets on the outlook for debtor countries. It is too early to reach any firm conclusions on this. The eventual outcome will depend on what happens in the markets, on the policy response in the major industrialised countries, and on the effects on confidence. But, ~~on balance, the impact~~ it is clear that the ~~is likely to be harmful. The recent falls in interest rates, though helpful to debtor countries, only reverse earlier increases; while~~ debtor countries' export prospects will be damaged by ~~the~~ any slowdown in growth, particularly in the US, and by ~~the likelihood~~ the likelihood of lower commodity prices. ~~If dollar weakness were to lead to higher US interest rates, this would worsen the position further.~~ The JIC plans to make a fuller assessment in December, if the situation has got any clearer

by then.

3. The earlier Bank and Fund meetings themselves made a constructive contribution towards the overall debt strategy with progress being made on a GCI for the World Bank, enhancement of the IMF's SAF and acknowledgement of the need for special treatment for the poorest most heavily indebted countries (to whom the Chancellor's initiative is directed). Some interesting ideas emerged from Secretary Baker and Managing Director Camdessus on how to keep adjustment programmes on track by allowing some flexibility, particularly in the short term for events outside the debtors' control. Baker proposed that the Compensatory Finance Facility be developed into a conditional External Contingency Facility (covering a wider range of contingencies including interest rates) and Camdessus proposed greater use of the Extended Fund Facility. Fund Staff are now working on these ideas.

4. On individual countries, <u>Brazil</u> and the commercial banks Advisory committee have reached an understanding under which $4.5 billion would be made available - $3.0 billion from banks and $1.5 billion from Brazil - as an interim package to enable Brazil to pay interest arrears. The agreement includes a commitment by Brazil to seek an IMF programme as part of a further medium-term package, which is to be in place by mid-

1988. These are welcome developments but the Advisory Committee may still have problems "selling" the agreement to other banks.

5. Elsewhere, the report notes the inadequacy of the recent measures in Argentina and the need to send a suitable response in the Fund Board, and a further deterioration in the outlook for Yugoslavia. On the positive side, Mexico continues to perform well and the Poles have reached a new agreement with the Paris Club covering the period to the end of 1988. Although the Fund programme has broken down, there are some indications that the Nigerians will take the steps necessary to put their adjustment programme back on course.

6. I am copying this letter to Tony Galsworthy (FCO), Tim Walker (DTI) and John Footman (BOE).

0071u

CONFIDENTIAL

INTER-DEPARTMENTAL DEBT GROUP REPORT: NOVEMBER 1987

1 Main points

- The collapse in world stock markets, while accompanied by a partial reversal of recent increases in interest rates, is likely to have an adverse impact on the export prospects for ldcs and, overall, to aggravate their external financing difficulties.

- The IMF/IBRD meetings produced a number of initiatives. Momentum on the SAF expansion and the World Bank GCI has built up.

- Brazil's negotiations with the banks remain delicately poised. However, an interim financing package, which would commit the Brazilians to seek an IMF programme as part of a longer term arrangement, is nearing agreement. It should prevent US loans to Brazil from being declared "value impaired" by ICERC*

- Argentina has introduced an economic package and will have been encouraged by the readiness of the US to assist with bridging finance. The government's policies, while probably insufficiently tough to satisfy creditors, have provoked a Peronist-led general strike.

- Only two-thirds of a $1.06 bn "voluntary" loan to Colombia has been taken up.

- Poland and Uruguay have reached rescheduling agreements with the Paris Club and the banks respectively.

- Nigeria has made progress in meeting IMF conditions for an SBA, raising hopes of a signing of a modified agreement with the banks and a resumption of IBRD lending. The Nigerians have made proposals to reschedule promissory notes to unguaranteed commercial creditors on terms far inferior to those negotiated by the Paris Club.

- The credibility of IMF adjustment programmes will be tested by forthcoming consideration of programmes/waivers for Argentina, Ivory Coast and Egypt.

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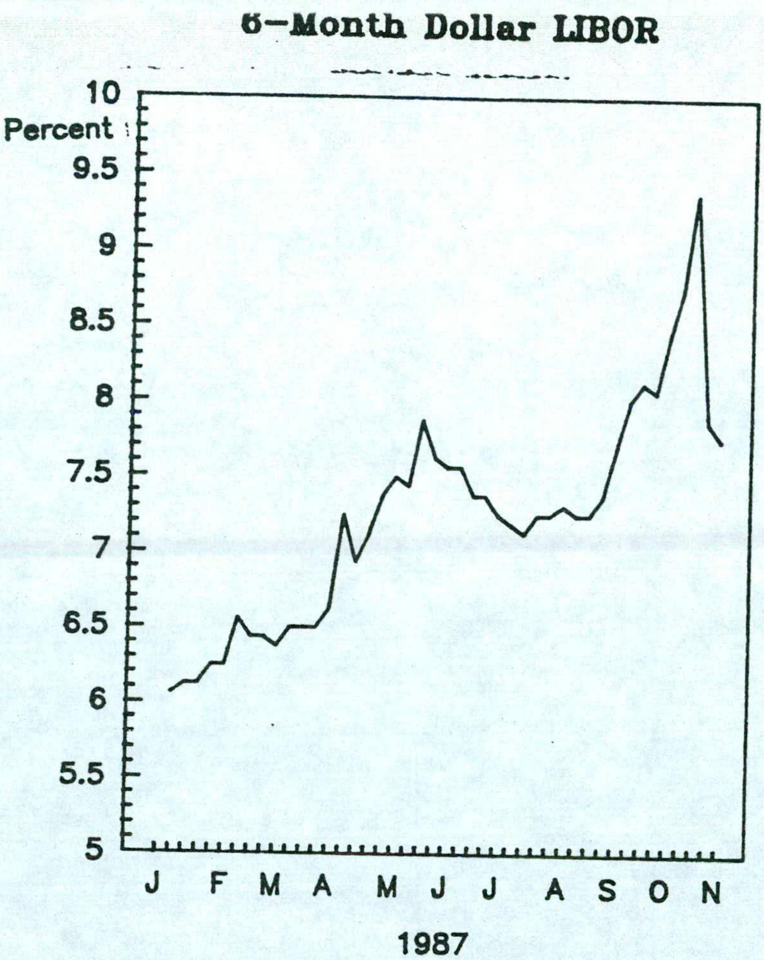
* The US Inter-Agency Country Exposure Review Committee

CHART 1



VULNERABILITY OF DEBTOR COUNTRIES TO A 1% RISE IN LIBOR

TABLE 1

Country	(1) total debt at end 1986 $Bns	(2) foreign currency reserves at end 1986 $Bns	(3) % of debt floating	(4) cost of 1% rise in LIBOR gross $Bns	(5) cost of 1% rise in LIBOR net* $Bns	(6) Exports of goods & services (XGS) in 1986 $Bns	(7) 1% rise in LIBOR as % of XGS gross	(8) 1% rise in LIBOR as % of XGS net*
Mexico	98.1	5.7	80.1	0.8	0.7	22.0	3.6	3.3
Argentina	51.7	2.3	60.2	0.3	0.3	8.7	3.6	3.3
Brazil	110.3	5.8	71.5	0.8	0.7	24.3	3.2	3.0
Venezuela	36.0	6.4	93.4	0.3	0.3	9.4	3.6	2.9
Chile	19.3	2.4	81.5	0.2	0.1	5.0	3.1	2.7
Poland	33.5	0.7	50.0	0.2	0.2	7.1	2.4	2.3
Morocco	17.8	0.2	36.3	0.1	0.1	3.0	2.2	2.1
Ecuador	8.4	0.6	71.7	0.1	0.1	2.6	2.3	2.1
Peru	15.0	1.4	40.3	0.1	0.0	3.3	1.8	1.4
Uruguay	3.9	0.5	64.3	0.0	0.0	1.5	1.7	1.4
Cote d'Ivoire	9.3	0.0	47.6	0.0	0.0	3.9	1.1	1.1
Egypt	44.6	0.8	12.8	0.1	0.0	4.5	1.3	1.1
Philippines	29.3	1.7	35.2	0.1	0.1	8.3	1.2	1.0
Nigeria	20.3	1.1	41.7	0.1	0.1	7.6	1.1	1.0
Bolivia	3.7	0.2	26.4	0.0	0.0	0.8	1.2	1.0
Yugoslavia	19.4	1.5	61.0	0.1	0.1	12.8	0.9	0.8
Colombia	15.0	2.7	40.7	0.1	0.0	6.5	0.9	0.5
Jamaica	3.9	0.1	18.8	0.0	0.0	1.4	0.5	0.5
TOTAL SAMPLE	539.5	34.1		3.2	2.9	132.8	2.4	2.2

* interest on debt less foreign currency reserves

International Financial Scene

2 Prior to the collapse in world stock markets, interest rates had continued to rise, driven by inflationary fears and concerns regarding continuing fiscal and external imbalances within the G3. On 19 October 6-month eurodollar rates had risen to 9.44%, more than 3 percentage points higher than their level at the end of 1986. Had the increase been sustained, it would have raised net annual payments by the Baker 15 middle income debtors by about $6 bn, or around 4% of exports of goods and services. (The vulnerability of individual debtors to changes in interest rates is shown in Table 1.)

3 Interest rates have subsequently fallen back sharply (Chart 1) as a global shift in portfolios out of equities found its counterpart in heavier investor demand for government securities and for liquid assets. While the reversal of recent interest rate trends will benefit indebted ldcs, the effect may well be outweighed by the adverse implications of the stock markets' collapse on growth in the industrial countries. Although the consequences of the impact on agents' wealth and investors' confidence is hard to quantify, and in any case will be conditioned by any changes in fiscal and financial policies within the G3, it seems likely that previous expectations regarding short term prospects for nominal income growth in industrial countries will not be realised. The WEP forecast completed before the collapse suggested domestic demand growth in major industrial countries (ex UK) over the next 2 years of around 2 3/4% pa, with import growth a fairly healthy 4-4 1/2%. With these growth rates now being marked down, ldc export markets and commodity prices will be less buoyant. More subdued real activity and fading inflationary fears should help to depress world interest rates. This prospect could, however, be upset by a sharp adjustment of the dollar with the attendant risk of higher US rates. Moreover, from the perspective of the debtors, real interest rates on borrowing will depend not only on the general trend in nominal rates but on their export prices (which could weaken) and on the risk premium demanded by lenders (which may well rise if their financing difficulties are perceived to have worsened). A widening in the spread between bank deposit rates and TB rates in the US (this had jumped sharply at the time of Citibank's provisioning but had subsequently fallen back) may partly reflect a deterioration in debtors' prospects. A recession could also strengthen protectionist sentiment, particularly in the US Congress. Overall, the external economic environment facing undebted ldcs has probably worsened.

4 Non-oil commodity prices have been volatile in recent weeks. (Chart 2.) Prior to the collapse in equity prices, which has had a knock-on effect in the commodity markets, metal prices had more than reversed earlier falls, with large gains in

CHART 2

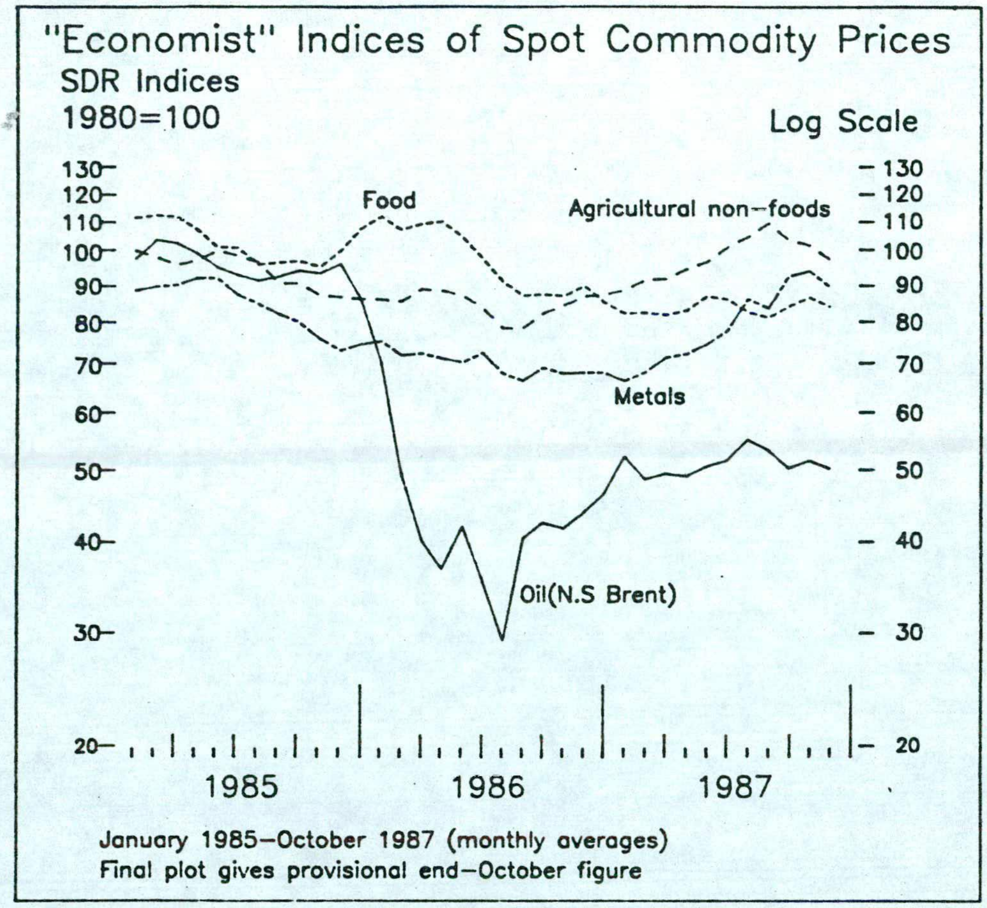


TABLE 2

Estimated Changes in Terms of Trade (%)
1986 Q4 to 1987 Q3(1)

Venezuela	24
Egypt	15
Mexico	12
Chile	9
Philippines	-2
Yugoslavia	-2
Zimbabwe	-3
Kenya	-5
Argentina	-6
Brazil	-7
Ivory Coast	-9

(1) Rough estimates based on movements in spot commodity prices and export prices of manufactures by industrial countries.

aluminium and copper. Prices fell more than 8% as equity prices dived. Prices of agricultural raw materials have weakened 10 1/2% since early September and food prices have reversed earlier gains over the past two months. The recent general weakness, conceals, however, a diverse pattern of commodity price movements in the year to the third quarter which is likely to have been reflected in the main debtors' terms of trade. Table 2 shows rough estimates of changes in the terms of trade of a number of debtors since 1986 Q4 based on spot commodity price movements. The recovery of oil prices has clearly been a major factor benefitting the terms of trade of net oil exporters, but countries dependent on agricultural exports have probably seen a further deterioration. Beneficiaries of the rise in metal prices include Chile and Peru.

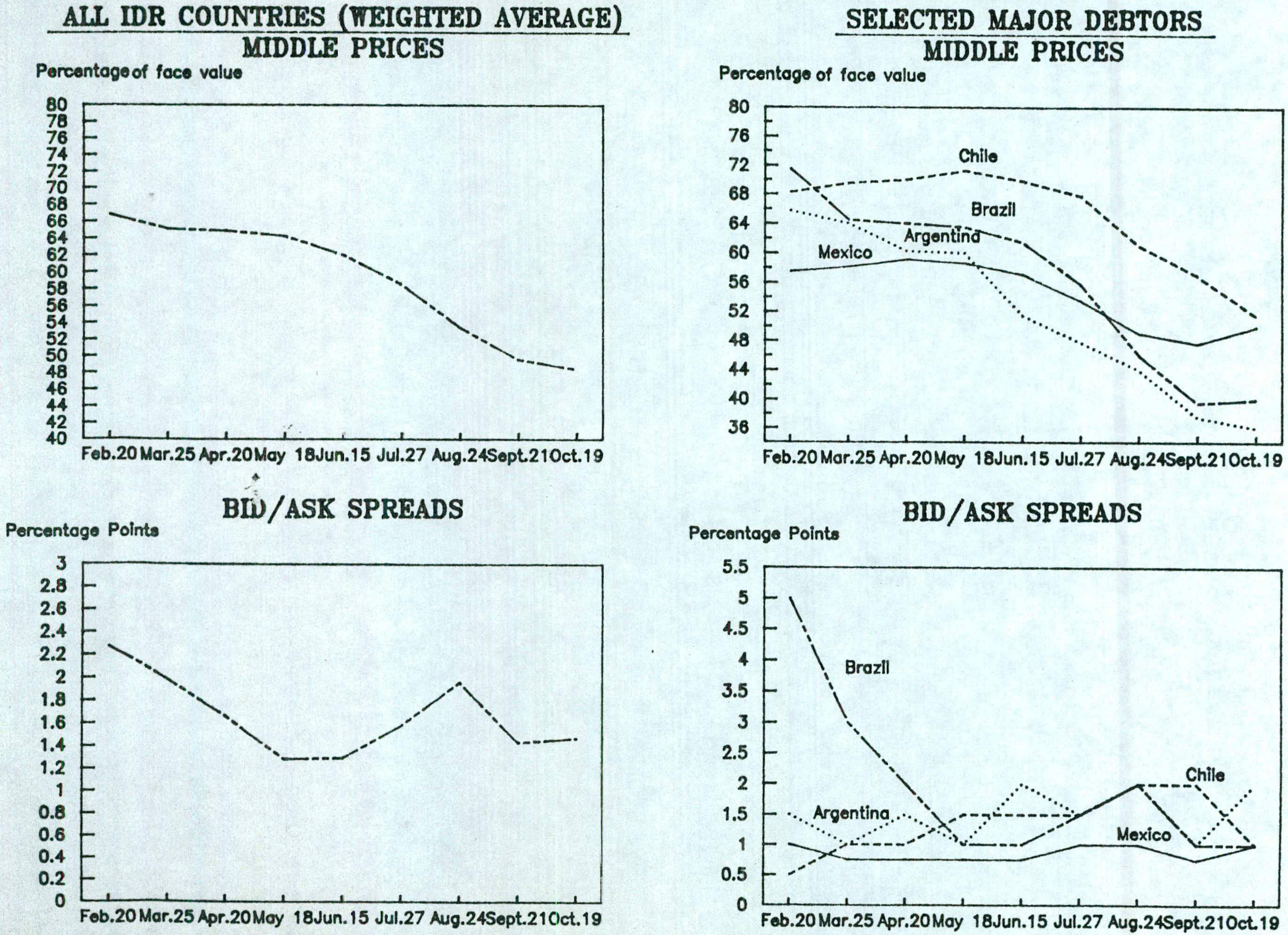
5 Recent market borrowing by ldcs has included a 5-year, $200 mn bond at 1/16% over LIBOR by the Bank of China (the first Chinese eurobond issue in London since the settlement of the dispute over pre-revolution bonds) and a 9 1/2 year credit (3/8-5/8 over LIBOR) for the Chinese agency Liangmake Towers Co Ltd. A 5 year $100 mn syndicated loan was also arranged for Pakistan. Of greater significance to the debt strategy is a $50 mn 1 year bankers' acceptance for National Bank of Commerce of Tanzania (at a spread of 1 3/8% over eligible bill rate) providing pre-export finance for next year's coffee crop. This represents the first bank financing for a poor debt-distressed country subsequent to a rescheduling under an IMF programme. Cameroon has also been granted a FF184 mn ($30 mn) bank facility effectively subsidised by Brazil's ECA to finance imports of agricultural machinery.

6 Overall, secondary market prices for ldc debt have fallen in recent weeks, but at a declining rate. (Chart 3 - but data are only available for the period prior to the stock market crash.) Bid/offer spreads, which had risen sharply in the late summer, have fallen back. The uncertain outcome of Brazil's negotiations with the banks and Argentina's growing economic difficulties had led to sharp decline in the market value of their debt. More recently, the price of Brazil's debt has stabilised. Mexico's relatively strong performance has both limited the fall in the price of its debt at a time of a general decline in values and has subsequently led to some recovery.

7 Bankers Trust has complied with a recent High Court judgment, after obtaining special licences from the US Treasury, and paid the Libyan Arab Foreign Bank the $292 mn (plus interest) frozen in London and New York, following the US blocking of Libyan assets in January 1986. Similar court cases are a possibility if Libyan entities now seek repayment of further dollar balances frozen in London.

CHART 3

SALOMONS SECONDARY MARKET PRICES



8 Although well-established positions were re-stated, speeches at the IMF/IBRD Annual Meetings were, nevertheless, generally conciliatory in tone and progress in key areas such as the proposed expansion of the SAF and GCI was apparent. Debtors predictably emphasised the burden of high interest rates and again aired the notion of a "sharing" of secondary market discounts with creditors. Senhor Bresser, speaking on behalf of Latin America and the Philippines, nevertheless rejected confrontation, and stressed the need for internal adjustment and the danger of pursuing "populist" policies.

9 Creditors, while remaining insistent on sound and sustained adjustment policies, and rejecting relief for middle income debtors, gave greater emphasis to the need for growth and stressed the importance of adequate financing from all sources over adjustment periods that now seem likely to be prolonged. Several creditors (including the UK) stressed the importance of expanding the "menu" of commercial bank lending. M Camdessus suggested that countries should make more use of the Extended Fund Facility and proposed measures to make Fund conditionality more flexible and administratively less burdensome while maintaining its effectiveness. Mr Baker proposed further development of the Compensatory Finance Facility into a conditional "External Contingency Facility" as a way of ensuring that growth-oriented programmes were not blown off course by events beyond a debtor's control. Such events would include, inter alia, a "sustained" rise in international interest rates. An expansion of the Fund's resources for the Facility was, however, explicitly ruled out.

10 At the meeting the US pledged support for a World Bank GCI and for the expansion of the SAF - providing the latter was financed by surplus countries. IMF staff are currently sounding out potential creditors regarding the capitalisation and interest subsidy elements of the expanded Facility. The UK has suggested a skewing of access limits in favour of the poorest debt distressed countries. As expected, however, most creditors remain resistant to UK and World Bank proposals to reduce interest rates on rescheduled official credits to the poorest countries, although other elements of proposed relief packages have received qualified support. Discussion of the SAF expansion and sub-Saharan African initiatives is likely to take place in a number of fora over the next few months. The IBRD have planned a special multidonor meeting in Paris on 3-4 December to review progress and, more specifically, to seek commitments on amounts to be made available by governments for cofinancing. This will follow a high level DAC meeting on 1-2 December. From the UK and other creditors' standpoint, damage limitation will be the main objective at a forthcoming UNIDO debt colloquium in Bangkok, the OAU debt summit, and the UN General Assembly's Second Committee.

11 Japan's foreign ministry has stated that Latin America will receive $4 bn of the $20 bn additional finance for indebted developing countries announced last May. Most of this will, however, be on non-concessional terms. Disbursements will be over the next three years, to countries following IMF-agreed adjustment programmes. Untied credits from Japan's EX-IM Bank will form 15% of the funds; 40% will go as capital replenishments for the IADB and the World Bank or private subscriptions to their bond issues; and 45% will be mixed credits from EX-IM Bank, the Overseas Economic Co-operation Fund and Japanese banks. As part of a wide-ranging package of measures for the Middle East, Japan also announced it will give aid to both Oman and Jordan (up to $200 mn and $300 mn respectively) and is also reported to be ready to provide assistance to Iran and Iraq for post-war reconstruction. (Such aid will be particularly welcome in Jordan where recent evidence suggests further deterioration in the government's finances and in the external position.)

12 Commonwealth Heads of Government endorsed the Chancellor's proposals for debt relief to Sub-Saharan Africa. At the CFM Mr Seaga's debt proposal (targeted at middle income debtors with a large share of debt to IFIs which cannot be rescheduled) was effectively sidelined.

13 Argentina, Brazil and Mexico have established a Latin American Group of 3 to strengthen consultations. Several basic points on debt were agreed: adjustment by debtors was only part of the solution; capital flight must be controlled; mechanisms should be found to create more automaticity in the provision of agreed disbursements and the financing of interest; better terms should be provided related to the real repayment capacity; individual IFIs should continue to be net lenders. Nevertheless, trenchant criticism of IMF policies made around the time of Argentina's election has not been repeated. The Argentine authorities will have been encouraged by positive US reactions to a new economic package and the haste at which a bridging loan has been proposed. The Americans' early support may have effectively finessed any move by other creditors to toughen conditions for further Argentine drawings under the SBA.

Details on individual countries are given below.

LATIN AMERICA AND CARIBBEAN

Brazil

14 Despite an easing of domestic price controls from end-August, monthly inflation in September fell slightly to 5.9% (6.4% in August); year-on-year, prices have risen 274%. A tightening of monetary policy since early 1987 is now having a dampening

impact on domestic demand. Cost-push factors, however, have continued to fuel inflationary expectations and, with the CPI expected to rise by about 9% in October, short-term interest rates, having dropped in September, rose back to 13% a month by mid-October. The downturn in domestic demand is underlined by the continuing strength of the trade balance, which registered a surplus of $1.5 bn in September, bringing this year's total to $7.8 bn (cf $8.7 bn January-September 1986). However, there continues to be strong pressure on both President Sarney and Finance Minister Bresser to resist deflationary measures and to take a hard line against an agreement with the IMF (but see para 16 below). Sarney's position looks particularly weak with Congressional calls for early Presidential elections.

15 Under the agreement reached in January, the Paris Club required a positive summing-up from the IMF MD on the basis of an Article IV report as a condition of implementing the rescheduling. At its September meeting, the Club did not consider the summing-up to be sufficiently positive and notified the Brazilian authorities that compliance with a full IMF programme would be a precondition of any rescheduling of 1987 maturities. The Brazilians have responded with a request for further discussions.

16 Negotiations with Brazil's commercial bank creditors resumed on 25 September when the authorities made a formal presentation to the Advisory Committee of their macroeconomic plan and 1987-89 financing requirement. The latter is broadly as reported previously, the major change being that the authorities have raised their financing requirement (either in fresh loans or in capitalisation of interest) by $3.1 bn, to $10.4 bn, spanning 1989 as well as 1987-88. The banks remained unwilling to consider financing of the magnitude requested and over such a time-scale unless the Brazilians also sought a fully-funded IMF programme. At a meeting on 2 October the Brazilians indicated a desire to have contingency facilities to cover changes in international interest rates and in terms of trade.

17 The pace of negotiations increased in late October with both the Brazilians and US banks anxious to head off an ICERC decision to classify loans to Brazil as "value-impaired". To avoid this step, which could threaten the provision of future new medium-term credits and short term lines, the US authorities themselves prepared an interim financing proposal which would require Brazil's agreement to seek an IMF programme. Under direct pressure from Baker, Bresser has apparently conceded this crucial point. The Advisory Committee are preparing a preliminary terms sheet but

the deal may still be hard to sell. The arrangements involve two stages and the establishment of an escrow account at the BIS. In stage one, which covers only interest payments due in Q4, Brazil will place $1/2 bn in escrow and the banks will make a binding commitment to lend $1 bn. Payment of the interest will be in two tranches: $1 bn on 30 November and $1/2 bn on 31 December. In stage two, which will cover interest arrears from 20 February to 30 September this year, the Brazilians will place $1 bn in escrow and the banks will commit $2 bn. The funds will be drawn on 16 June next and provide a 2 week bridge to be repaid on 30 June when, it is assumed, a drawing of new money will be available under a longer-term agreement to be negotiated.

Mexico

18 Mexico's trade surplus of $6.3 bn in the first nine months of the year (cf $2.4 bn in the same period of 1986) reflects both the recovery in oil prices and a rise of more than 25% in non-oil exports. Imports, moreover, have fallen 10%. The current account was in surplus of $3.1 bn in H1 (cf a deficit of $1.1 bn in 1986 H1). Gross reserves have risen strongly ($14.6 bn at end-August as against $7.0 bn at end-December). A 25% minimum wage rise from 1 October implies a continuing fall in real wages, contrary to the Government's public pronouncements. Monthly inflation slowed a little between August (8.2%) and September (6.6%), but September's 12 month change rose to 135%. The authorities hope that real exchange rate appreciation, tariff cuts and import liberalisation will help reduce inflation. Higher oil revenues resulted in a significantly lower PSBR in the first half of 1987 than had been targetted by the IMF.

19 Mexico's ruling party, the PRI, announced that the Budget and Planning Minister Carlos Salinas de Gortari would be their candidate in next July's Presidential elections, which the PRI is certain to win. The selection was greeted enthusiastically by the Mexican stock market and by foreign bankers, but not by the unions. His appointment tends to signal continuation of current policy.

20 Mexico will draw the second and third tranches ($0.9 bn) of its commercial bank loan on 4 November, after the rescheduling agreement became effective on 22 October. (A drawing in August foundered because one US bank, in the throes of a takeover, delayed its signing of the rescheduling agreement. These tranches, unlike the first, depend on the agreement being in effect.) Total borrowing under the banks' financial package will rise to $4.4 bn on receipt of the money, leaving $1 bn to be drawn from the $6 bn new money component; under the terms of the agreement, the size of the package has been reduced by $569 mn because of $250 mn saving on interest and $319 mn

"excess" external receipts in H1. The $500 mn growth contingency facility remains available as does (at least notionally) $172 mn of the oil-price linked investment support facility. Mexico's debt:equity programme is to be reviewed with the aim of minimising its expansionary monetary impact.

Argentina

21 Against a background of rapid inflation, a deteriorating trade surplus, and critically low foreign exchange reserves, the authorities have announced a package of measures including an indefinite wage-price freeze (after initial selective increases), a significant real devaluation of the exchange rate, tax increases, and structural reforms. The government's policies, while insufficiently tough to please creditors, have nevertheless provoked an opposition-led general strike and the threat of further disruption.

22 The wage-price freeze, following in the wake of a 12 month inflation rate of 136% in September, was, however, preceded by real increases in the minimum wage level and family benefits; prices of certain items will be excluded from the freeze so as to minimise shortages. (Prices are reported to have risen 18-20% in October.) In the foreign exchange market the commercial rate, normally subject to regular minidevaluations broadly in line with relative inflation rates, was devalued by a further 10.8% following an 11.5% devaluation earlier in the month, while the newly-created "financial" rate (used for virtually all dollar transactions carried out by Argentine residents) is to be left to float freely, which it has done initially at a discount of almost 20% to the commercial rate. (A third-tier black market still operates.) The improvement in competitiveness should eventually help to offset part of the effect of weak agricultural prices which have been an important factor depressing the trade balance. Before the measures, the 1987 trade surplus was expected to be between $1 bn and $1.5 bn compared with $1.9 bn forecast earlier by the IMF. Argentina's trade surplus for the first 8 months of 1987 was $650 mn (cf $1930 mn in the same period in 1986). Exports were 19% lower and imports 12% higher. Fiscal measures include an increase in income and property taxes and a rise in the rate of import duties from 10% to 15%. Structural measures include a freeing of domestic money market interest rates, a forced-savings scheme, the elimination of a 45% discount on world oil prices on purchases of crude from local producers by the state oil company, and a lifting of quotas on a number of imported industrial inputs. Further privatisations will also be undertaken.

X 23 The package, whose main weakness is the absence of ~~lacking~~ measures to curb government spending, does contain a number of welcome elements. Moreover, following elections which saw significant Peronist gains, President Alfonsin retained his

Economy and Finance Ministers and still appears to retain sufficient political support to pursue modest counter-inflationary reforms including a reduction of the fiscal deficit (now reported to be as high as 10% of GDP), financial reforms and privatisation. Nevertheless, the overall effectiveness of the measures must be in doubt. The package is presumably intended to anticipate potentially tricky negotiations with the IMF on the next stage of the revised SBA which was activated by the signing of the banks' new $1.95 bn new money loan in August. (The loan was oversubscribed and the first tranche of $750 mn was disbursed on 6 October.) Having failed to meet end-August targets under the SBA, it is unclear whether the authorities will obtain a waiver to enable the second drawing under the existing SBA (SDR 165.5 mn) to be made, or whether a new programme will have to be agreed. In considering a request, the UK will have to decide whether to press for agreement being made conditional upon Argentina abandoning its discrimination against UK commercial interests. The drawing, which is unlikely to take place this month as scheduled, is required to trigger disbursement of the second ($300 mn) tranche of bank money. The Federal Reserve is in the process of putting together a further bridging loan for Argentina; the loan, for $475 mn, would be repaid from the second tranche of the SBA ($210 mn), and IBRD trade policy and project loans ($265 mn). As with previous bridging facilities, the loan will be arranged under the auspices of the BIS. The UK was not asked to contribute. The "drop-dead" date for the bridge is 10 November after which time the offer will no longer stand. (The authorities have recently been backing off from criticism of the IMF and its policies.)

Venezuela

24 In September, the authorities declared an indefinite extension of the price freeze on "essential goods". Prices rose by 0.8% in August, bringing the year-on-year rate to 32.6%. While the recovery in oil prices has strengthened the trade balance, non-oil export performance continues to suffer from an over-valued exchange rate, with the bolivar at a discount of 55% on the official rate at end-September. At 16 September, gross international reserves of the Central Bank were reportedly $9.7 bn, following the transfer of $485 mn from the Venezuelan Investment Fund (reserves were $9.9 bn at the end of 1986). Despite criticism from internal and external observers, including the IMF, the government seems committed to its expansionary policies. The 1988 draft budget reportedly includes a 5% real increase in expenditure over the revised 1987 budget.

25 The Venezuelan government and some of the banks have signed the MYRA covering $21.2 bn of public sector debt but completion of the signing which began on 21 September has been delayed over administrative problems; although some banks

originally said they would not sign the MYRA until difficulties relating to the rescheduling of private sector liabilities had been solved, banks are now anxious to complete signature of the deal. It is hoped that the MYRA will be signed by 16 November, the deadline for ensuring that Venezuela will benefit retroactively from the reduced spreads. Banks have refused to discuss the possibility of new money until the MYRA is signed.

26 Press reports suggesting that Venezuela was on the verge of issuing a series of floating rate bonds appear to be unfounded, although Venezuela has obtained a number of project financings. Japanese banks and Japan's Ex-Im Bank have agreed to provide $324 mn in yen-denominated loans for a hydro-electric project (the loans are maximum maturity of 8 1/2 years, at an interest rate of 5.7%; it is not known whether they are tied). The Japanese are also discussing a separate credit of $100 mn for a bauxite mine. The Spanish state agency Focoex has agreed to lend $20 mn to Alcasa, the state aluminium company (15 years, with 7 grace). In September, the Andean Reserve Fund approved a $271 mn balance of payments loan (4 years, 1 grace, Libor +0.5%). The authorities have also claimed that Venezuelan private banks have been receiving significantly more in trade credits (up $800 mn in the period January-August, to nearly $3 bn).

Chile

27 After real growth of 6 1/2% between 1986 H1 and 1987 H1, the IMF expects GDP to rise 5% in 1987. Buoyant domestic demand has, however, led to a rise in inflation to 21% over the twelve months to September and the authorities have said that their inflation target of 15% for the calendar year is likely to be missed. The strength of domestic demand has also brought about some deterioration in the trade balance despite a recovery of copper prices and higher exports of manufactured goods. In January-August the trade surplus was $679 mn (cf $870 mn in the same period last year) while the overall balance of payments deficit widened to $538 mn in H1 (cf $272 mn in 1986 H1). Normal ECGD cover has been restored.

28 On the political front, the National Workers' Command staged the first strike in over a year to press for a 22% pay rise and a 64% increase in the minimum wage. However the strike was not well supported.

29 The World Bank will shortly discuss Chile's request for a third SAL (possibly for $250 mn). The SAL is to consolidate advances made in the export orientation of the economy, raise public sector savings and reduce the social costs of structural adjustment. The Chilean authorities expect the US to abstain from voting on the loan

on human rights grounds (as they did for the second SAL); nevertheless, the Chileans believe that the loan will be approved. Ministers will need to decide how the UK should vote in this event; last year the UK voted in favour of the second SAL but made a demarche on human rights in Santiago and encouraged a PQ on the reasons for our vote.

30 Recent changes in legislation have opened the way for foreign-owned investment funds to invest the proceeds from debt-equity swaps on the stock market thus providing further scope for the reduction of debt. Midland Bank and the IFC are each investing $7.5 mn in the first of such funds which will be for a total of $75 mn.

Ecuador

31 Real GDP is now expected to contract by only 1.5% in 1987 - previous estimates had suggested that the decline would be much greater (4-8% GDP) - and the Finance Minister has forecast real growth of 6-8% in 1988. The public sector deficit is, moreover, expected to be contained to roughly 3% of GDP compared with earlier IMF projections of 8.6%. Inflation is still rising (32% in the 12 months to July), but may slow over the remainder of the year. External performance has, however, been worse than that projected in the Fund's post-earthquake forecasts, with a trade deficit of $71 mn over January-August 1987 (cf a surplus of $469 mn in January-August 1986). Net reserves were $58 mn at end-September (cf $147 mn at end-September last year).

32 Both the banks and the authorities are keen to agree a financing package before the first round of the Presidential elections in January. The banks' preliminary offer is a rescheduling of old debt (previously rescheduled in 1983 and 1985) over 19 years including 7 years' grace and a margin of 15/16% over LIBOR; old new money from 1983 and 1985 ($631 mn) would also be rescheduled over 10 years/3 grace at LIBOR +1%, thus giving Ecuador slightly inferior terms to those for Mexico, Argentina and Venezuela. Ecuador has requested new money of $350 mn, equal to interest arrears. $100 mn may take the form of a four-year deposit relending scheme, and a further $100 mn as low interest bonds with a maturity of 7 years including 2 years' grace. The remaining $150 mn may involve World Bank cofinancing, although the IBRD is not keen to take part on the grounds that its support may be interpreted as bailing out the banks. The US authorities are also known to be unhappy with the idea of World Bank involvement. Japanese and Canadian banks are, nevertheless, adamant that the Bank should participate. A condition of the loan would be that Ecuador should start paying current interest, possibly from 15 November. A further consideration is that the first drawdown from the banks should be conditional on the first drawing being made under an IMF programme. The Ecuadorean authorities have now officially accepted

the banks' proposals. Preliminary discussions with the Paris Club have taken place for the rescheduling of 100% of principal repayments due in 1987-88. Negotiations will begin once a bank rescheduling is in place.

Peru

33 The government's main economic objectives for 1987-90 have been outlined. The plan adds little to the policies of the past 2 years, but, optimistically, envisages average annual GDP growth of 5%, firm control of inflation, increased efficiency in the public sector (including improved tax systems), higher taxation and a public sector deficit of below 4% of GDP, the maintenance of foreign exchange reserves equal to at least 3 months' imports, an import programme that directs foreign exchange towards productive and export activities, and a more competitive exchange rate for exports. GDP growth in the first 6 months of 1987 was reported to be 8.6% at an annual rate. In August consumer prices rose by 7.4% (annual inflation is now 88.2%). Recent data indicate that government revenues fell by 15.3% in real terms between H1 1986 and H1 1987, while spending rose by 7.8%. Over the same period imports rose by 51.4%. Between end-1986 and mid September, reserves fell by $401 mn to $557 mn, suggesting that the government is not being successful in maintaining its reserve target of three months' import cover. $208 mn of this decline occurred following President Garcia's announcement of bank nationalisation of end July.

34 The Senate passed the bank nationalisation bill on 28 September, but added an amendment to exclude foreign banks already established in Peru: these can continue to accept current account deposits, but must retain their compulsory credit lines to the Government. However, foreign banks will not be allowed to open new offices. Implementation of the nationalisation continues to be problematic because of constitutional obstacles and has been accompanied by some violence on the part of the authorities. Uncertainty surrounding the bill may explain falls of 2.9% in real credit and 1.1% in the real money supply during August.

35 A Fund team visited Lima in the second half of September to complete the Article IV consultations and the Board is to consider the report no later than 25 November. An IBRD mission has visited Peru and a further visit may be made in November to discuss a normalisation of relations with the government in October: arrears to the Bank in early October were $128 mn. The Paris Club has indicated its willingness to meet the authorities but has made its usual condition that an SBA would be needed for a rescheduling. The Peruvians have also contacted Citibank, with a proposal to re-open discussions with a view to an agreement by the second half of January. Their terms, however, include a limitation on debt service and no IMF programme.

36 Two debt-for-goods deals have been signed. Midland Bank will sell the equivalent of $145.7 mn in non-traditional exports on behalf of Peru. From the proceeds the Peruvian Government will receive $87.4 mn in cash, and $58.3 mn in short-term working capital debt will be retired. An initial $23 mn "pilot" scheme, which cancels $8.8 mn of debt must first be completed by the end of 1987. The details of another scheme, also involving only short-term debt, appear to be in dispute. The Peruvians claim that First Interstate Bank will retain only $14mn of the $42 mn proceeds of sales of goods, but the bank says it will retain more than that. Such deals seem to threaten creditor solidarity.

Colombia

37 Banks had to commit by 16 October to take advantage of the full facility fee for the proposed $1,060 mn "voluntary" loan, but commitments so far total only 66% (including all the major British banks, although one has done so for less than its pro-rata share). The lead banks met on 22 October to discuss what, if any, further action they could take. The Colombian government has been under pressure from opposition parties to convert the loan into a formal rescheduling, on grounds of cost (the spread, 15/16%, is high compared with most other recent Latin American reschedulings).

Bolivia

38 Real growth is likely to be over 2% this year following six years of economic decline; inflation too continues to be relatively low - 10.9% in the year to August. There has been little further progress on the debt buy-back scheme, the basis of which is that Bolivia should secure aid funds from donors to buy back uninsured debt from the banks at a discount. So far, only the Dutch and the Spanish are believed to have given a specific commitment of funds, although some other governments are thought to be sympathetic. Ministers will need to decide whether to agree to the Bolivian request to divert an existing aid commitment for this purpose (the Bolivians accept that no new money will be provided). This raises the issue of whether governments should finance such schemes or leave the debtor and the banks to find their own market solution. On 21 October, the Fund Board authorised the Fund's role as trustee of a "voluntary contribution account" set up for the scheme.

39 Fund Board discussion of three-year EFF had been held up by the failure of Argentina and Bolivia to settle their dispute over the price of Bolivia's gas exports. Agreement was finally reached this month on a new (lower) price for the gas

and on the settlement of outstanding debts, and the Board is likely to discuss the EFF in November. Separately, Bolivia has been offered a concessional loan of $220 mn from the USSR, (20 years, 8 years' grace, interest at 2.5%).

Uruguay

40 GDP in H1 was 6% higher than a year earlier and the central bank has released a forecast showing 5% growth for 1987 as a whole, significantly higher than earlier government projections. Inflation was 60% over the twelve months to September 1987, but was down from 71% at the end of 1986, and is likely to fall close to the government's estimate of about 55% by the end of the year. The strong growth in activity has led to a deterioration in the trade surplus: $38 mn in the period January to August (cf $154 mn during the same period in 1986). Increased sales to the EC and Argentina compensated partly for the reduction in exports to Brazil. Imports, however, were a third up on the same period in 1986, mainly reflecting higher oil prices and imports of raw materials and capital goods.

41 Uruguay and the banks reached agreement on a $1.8 bn rescheduling package. This will replace last year's rescheduling of $1.7 bn of loans originally falling due between 1985 and 1989, and also includes $100 mn of debt due to be repaid in 1990-91. Loans will be rescheduled over 17 years with 3 years' grace at a spread of 7/8 over LIBOR.

Costa Rica

42 Emergency measures were introduced on 4 September because a long-awaited tax package, approval of which is an important part of the programme proposed to the Fund, is still being blocked by the opposition in the legislature. The package includes greater control of public expenditure as well as expenditure cuts and measures to improve tax collection. The Fund Board has now approved an SBA, and an SAL is in the pipeline. A late October meeting with the banks made no further progress but discussions will resume in December. The Paris Club is likely to consider a rescheduling later this month. Disbursement of economic support from US AID for 1986 ($40 mn), and that tentatively budgeted for 1987 ($85 mn), is reportedly still under discussion; a failure to liberalise the domestic banking system is the major issue to be resolved.

Jamaica

43 The economy grew rapidly in H1 with industrial production up 12.2%. Strong import growth led to a deficit on current account of $10 mn (cf a surplus of $45 mn in

1986 H1). The pace of activity has since slackened and consumer prices rose 2.1% in H1 1987, against 5.3% in H1 1986, and the annual rate remains on target at 7%. The end-September performance criteria were comfortably met and the Fund Board will discuss the second review of the SBA later this month.

Cuba

44 The Paris Club has indicated to Cuba its willingness to discuss the conclusions of the Club's "Task Force" report and possible developments in Cuba's financial relations with creditor governments. The banks' Steering Group is scheduled to meet by mid-November to discuss refinancing possibilities; a meeting with the Cubans may follow soon afterwards.

IADB

45 The IADB Committee of Governors met in Guatemala City on 6-7 October to try to resolve the deadlock regarding the 7th Replenishment (for 1987-90). However, negotiations stalled over the issue of voting mechanisms in the Executive Board, and no further meetings are in prospect. In the absence of agreement on a new Replenishment, loan approvals will continue to be made from the carry-over of funds available under the 6th Replenishment and repayments; the rate of commitment remains to be decided. The IADB's lending plans, however, may well have to be curtailed which will place more of the region's financing burden at the door of the World Bank, emphasising the need for an early GCI.

SOUTH AND EAST ASIA

Philippines

46 In its second review of the Philippines SBA, the IMF has highlighted the success of the Aquino administration in implementing structural reforms and supportive financial policies despite the volatility of the political situation. The Fund, nevertheless, has revised downwards its forecasts for growth in 1987 from 6.5% to 5.6% and the new target still appears ambitious. In a major speech to business groups that was well-received, the President hit back at her critics and promised a newly-decisive administration.

47 Following the August coup attempt, the peso has come under speculative pressure and has fallen by 10% in the black market. This has increased inflationary pressures and an annual inflation rate of 8% by Q1 1988 is a distinct possibility. Slower than

expected disbursements of aid and official transfers have been largely responsible for a deterioration in the current account and a run-off of reserves. H1 1987 figures show a current account deficit of $0.1 bn as against a corresponding projected surplus, and reserves stood at only 2.7 months of imports of goods and services, considerably lower than the Fund target of 3.8 months. About thirty of the creditor banks have still to sign the latest debt restructuring agreement as they seek to obtain a satisfactory resolution to the question of non-performing loans extended to Planters Products Inc, whose debts the previous administration had agreed to honour. However, there are some signs that a compromise may be reached before the deadline for signatures of 15 November. The Senate has passed a resolution allowing the Government to conclude the rescheduling agreement on condition that new negotiations are opened in the near future. The resolution replaces three bills designed to limit debt-service payments.

Malaysia

48 In its annual pre-budget report, the Ministry of Finance has forecast that real GDP growth will increase from 2% in 1987 to 4% in 1988. The forecast is based on continued increases in the prices of and demand for Malaysia's oil and traditional commodities (such as rubber and palm oil) as well as for manufactures (especially electronics, textiles and agri-based goods). The report projects current account surpluses of $0.8 bn this year and next - rather better than most earlier forecasts. It has been announced that Malaysia will prepay $2 bn of external debt later this year drawing from reserves (currently at $7 bn). This will help to smooth a bunching of repayments due in future years.

Indonesia

49 GDP growth in FY 1986/87 was 3.2% (against 1.9% a year earlier) reflecting a strong performance of the non-oil sector. A partial recovery of oil and gas prices has improved prospects for this year although the effects of a prolonged drought could depress real incomes and push up inflation. A recent bout of speculation against the rupiah appears to have been halted by higher domestic interest rates, and foreign direct investment inflows are set to rise considerably, with commitments in the first half of 1987 registering a four-fold increase on a year earlier.

Thailand

50 The economy continues to strengthen with the growth rate for 1987 now predicted to be at least 5.4% (cf 3.8% in 1986), assisted by a firming of international prices of major crops and almost full capacity operation of export-oriented industries. Whilst

exports have risen by around 10% in the eight months to August, imports have risen by some 32%, leading to a sharp rise in the trade deficit. However, invisible earnings, particularly from tourism, are said to be running at an all-time high. Thailand's current account has switched to a deficit of $150 mn in the first eight months of 1987 from a surplus of $282 mn in the same period of 1986.

EASTERN AND SOUTHERN EUROPE

Poland

51 On October 31, a Paris Club agreement was initialled which reschedules over 10 years (5 grace) $8.5 bn of arrears, and interest and principal due in 1988. Under the agreement, Poland will pay a total of $1010 mn between end-November 1987 and end-March 1988, including 50% of the arrears outstanding under the 1987 agreement. (The terms are less favourable than those obtained by the commercial banks in their recent rescheduling.) The discussions were characterised by a seriousness of intent on the part of the Polish authorities which contrasted with some earlier meetings. The US representative at the meeting made no explicit reference to an IMF SBA, progress towards which is also a condition for the release of significant IBRD resources. The payments now due to creditors over the next fifteen months should, on present policies and in the absence of unanticipated shocks, leave some modest margin for slippage within Poland's likely payments capacity. Foreign exchange receipts have strengthened in dollar terms in the first 9 months of 1987, reflecting an increased trade surplus and higher inflows of private transfers. The speed of implementation of different elements of the government's proposals to reform the domestic economy, in particular the price structure and subsidies, will largely depend upon the outcome of a nationwide referendum to be held on 29 November. By the end of 1987, real output should be less than 5% below the pre-crisis level attained in 1978, while real per capita consumption should regain its 1980 peak. However, inflationary pressures have increased and prices are rising at an annual rate of around 23%.

Yugoslavia

52 The Paris Club has advised the Yugoslav authorities that a rescheduling would have to be tied to an SBA (or EFF) and not to enhanced surveillance. Although some official creditors report arrears, the brunt of Yugoslavia's current financing gap is being met by delays in payments to banks. The banks rejected on 29 October an initial Yugoslav request which asked for (inter alia) $1 bn of new money and a 9 year MYRA repayable over 20 years at a margin of 1/2% and made no mention of a Fund programme. Full details of the authorities' long awaited economic package have yet to emerge.

Hungary

53 It is hoped to open negotiations on a SBA in November with a view to an Executive Board discussion in January. IMF staff envisage a three year adjustment package (either in the form of a succession of SBAs or an EFF depending upon the programme agreed with the Hungarians) of around $1 bn gross (some $300-400 mn net). The aim will be to limit the current account deficit to around $400 mn in 1988 and achieve balance by 1990. The Hungarians are likely to approach the IBRD for an Industrial Restructuring Loan. Commercial banks are becoming increasingly uneasy: short term lines are being maintained but there is little interest in medium term loans and response to the DM 1 bn loan has been mixed.

Greece

54 There has been some improvement on the external side recently: two monthly current account surpluses totalling $753 mn in July and August have brought the cumulative deficit for the first eight months of the year down to $712 mn (compared to a target of $1.25 bn for the year). On the domestic front, inflation fell by 2.2 percentage points between July and August to 16.3% (year-on-year), but little progress has been made in reducing the PSBR, largely because of expenditure overruns by the social insurance funds. The government has announced an end to the wage freeze, which was imposed in October 1985 (real wages have been cut by almost 13% in the past two years), and has pledged tax reductions for 1988.

SUB-SAHARAN AFRICA

Nigeria

55 The Nigerians have reportedly made significant progress in meeting Fund conditions for a fresh SBA: the necessary measures, including elimination of the petroleum subsidy, have been approved for inclusion in the forthcoming budget. It is hoped that a Letter of Intent will be signed in early January, leading to Executive Board approval of a new SBA in February. A Fund mission is leaving for Lagos on 7-8 November. A World Bank mission is currently there, and the Nigerians hope that the budget measures will allow a resumption of Bank lending. In the light of the Fund timetable above, the commercial banks have modified their, as yet unsigned, 1986/7 rescheduling and new money agreements. The modifications will be recommended to participating banks by the Steering Committee this week for approval by end-November. The agreement, originally contingent on the previous SBA being in place, is now tied to approval and implementation of a new Fund programme. Half of

the $320 mn new money element would be disbursed upon Executive Board approval of the programme, and half on compliance with the first quarter IMF performance criteria. The banks are not insisting on the existence of a Fund programme as a pre-condition for the rescheduling part of the agreement, but if no new IMF programme is agreed, this would constitute a default, and short-term credit lines would lapse. The delay in the disbursal of new money pending a new IMF programme will increase Nigeria's cash flow problem. To ease this, the banks have delayed and rephased payments of principal and interest due under earlier versions of the agreement. Before news of progress with the Fund and the banks broke, the Paris Club ~~had sent~~ was intending to send a strongly worded message to Lagos urging compliance with the Fund, more rapid progress with other creditors, and adequate payments to ECAs under negotiated agreements, which we have now asked should be delayed. The deadline for completion of bilaterals and the reconciliation of debt lists was extended to end-February.

56 Following negotiations with the Law Debenture Trust Corporation (LDTC), the authorities have announced rescheduling proposals for the $3.2 bn of promissory notes already issued. The terms (repayment over 22 years starting 1988, with a yield equivalent to an interest rate of around 5% per annum) are far inferior to those achieved by the Paris Club for comparable debt. The proposals also include a termination of the process of reconciling claims (implying, in effect, the rejection of some $2.6 bn of debt), though there is a provision for the issue of further notes in respect of claims that have already been matched and which are under review by the Central Bank of Nigeria (CBN). The proposals, described by LDTC as the "best attainable", have been greeted by noteholders with a mixture of resignation, disappointment and infuriation. A meeting of noteholders will be convened by the CBN (probably in January) to vote on whether to accept the proposals.

Angola

57 After failing to gain support from creditors for its debt securitisation proposals, Angola has now applied for membership of the IMF with a view to negotiating a conventional Paris Club rescheduling. The US has still not revealed whether or not it will support the application.

Cote d'Ivoire

58 The moratorium in Cote d'Ivoire continues, although a second Letter of Intent has been agreed. The terms are even softer than those envisaged in its now defunct predecessor although not as weak as the Ivorians wanted. The World Bank has yet to agree to the programme outline and shows no signs of ending its insistence that any

new programme must be 'growth oriented'. An added problem is that the Ivorians want the Fund to agree to softening of terms on exchange restrictions. Even if these difficulties between the Bank and the Fund are resolved, a weak programme may well encounter strong resistance in the Fund's Executive Board.

Zambia

59 Zambia has been lobbying IFIs and donors for support for its New Economic Recovery Programme (NERP). The response seems to have been to welcome Zambia's intention to adjust its economy, but to register concerns over the viability of the plan.

Zimbabwe

60 The Zimbabwe authorities have held discussions with the IBRD. Relations between Zimbabwe and the IBRD appear to have improved over the last year and there is now agreement over the diagnosis of Zimbabwe's difficulties. Differences remain, however, in particular over the speed of trade liberalisation and the nature of reform of foreign exchange allocation. The Zimbabwe government has shelved the Export Promotion Programme.

South Africa

61 It has been revealed that nearly \$0.5 bn of debt caught in the moratorium has been converted into the 10-year loan option available under the second interim arrangement.

Sudan

62 On 3 October the Finance Minister announced - incorrectly and for reasons which remain obscure - that an "agreement" had been signed with the IMF which would open the way to IFI and donor assistance of some \$5 bn. The reality is, however, very different. The Sudanese have introduced a package of measures agreed with the IMF in August. These include a 44% devaluation, commodity price increases, a reduction of import duties and closer control of the money supply. The Sudanese have also been promised immediate supplies of oil and sugar from Saudi Arabia and the EC respectively, although not as much as they wanted. The IMF has not, however, offered any money and donors remain hesitant given continuing doubts about the programme's adequacy and implementation, particularly in the light of the uncertain position of the coalition government and the costly civil war. A Fund team is now

in Khartoum to agree, inter alia, quarterly benchmarks for performance criteria and will report back to the Executive Board on 6 November. A consultative group meeting is to be held in December under Fund/Bank auspices to consider the provision of $150 mn to cover Sudan's immediate foreign exchange requirements in FY 1987/88. (This would exclude clearance of IMF arrears and normalisation of debt service obligations.) Ministers will be asked to decide whether the UK should contribute.

MIDDLE EAST & NORTH AFRICA

Egypt

63 In Egypt, where President Mubarak was re-elected unopposed for a second 6-year term on 5 October, all of the IMF's end-June performance criteria, under the SBA agreed in May, may, unexpectedly, have been met (although the position is unclear). The foreign exchange position has been significantly strenthened by the recovery in oil prices in 1987 and by a recovery in tourism. The next round of discussions with the IMF, which will focus on (privately promised) measures to strengthen the acknowledged weaknesses in the programme, is due to take place in Cairo later this month. The discussions will be difficult, not least over the promised increases in domestic interest rates. The Fund staff are, moreover, concerned about both the size of the public sector deficit, which at 17% of GDP for FY 1986/87 has overshot the indicative target by 2 percentage points, and its financing - much apparently from undisclosed external sources. The Staff also have doubts about the operation of the new foreign exchange system which has, so far, failed to attract the hoped-for flows of remittances back into official channels. The position of foreign bank branches remains very difficult. The authorities have, however, indicated a willingness to accelerate the process of exchange rate unification; and there have been confused reports that banks may soon be permitted to use 20% of the new foreign exchange pool to cover private sector debts (estimated at some $3 bn).

64 Although the deadline for signing bilaterals under the May Paris Club has been missed, progress has been made. Negotiations with the UK cannot begin until January although the eligible debt has been reconciled and a draft text of the bilateral has been sent to Cairo; an agreement has now been signed with France (with no major concession on interest rates); Germany is reportedly close to signing. Egypt is also seeking to reduce agreed payments into its special account at the Bank of France (as provided for under its Paris Club rescheduling) by the value of the repayments it needs to make the US, pursuant to the Brooke Amendment, to avoid it being declared ineligible for further US aid. The US-Egypt bilateral has yet to be signed.

Morocco

65 Morocco finally signed its rescheduling agreement with commercial banks on 23/24 September. Allowing for the consolidation process, the deal should become effective on 4 December. The agreement should bring Morocco fully into line with the performance criteria under its IMF programme (which has required waivers on the external arrears criterion in the past).

Algeria

66 Banks are becoming increasingly cautious: a 7-year syndicated loan for state-owned bank, Credit Populaire d'Algerie, (admittedly, at the fine rate of LIBOR +5/8%) raised only $35 mn of the $50 mn sought, with only 4 banks participating; and the market has still to be approached for a $200-250 mn loan, co-financed by the World Bank, originally expected to be syndicated in the summer. The delay may well be related to the emergence of arrears to the World Bank (now over 90 days). These difficulties in maintaining substantial capital inflows, combined with Algeria's need to finance a current account deficit of around $1 bn this year and meet heavy amortisation payments, has renewed press speculation about a possible rescheduling. Such speculation has been given more plausibility by the Algerians recently floating a number of unacceptable proposals to HM Ambassador in Algiers (eg untying ECGD cover, and extended terms even for "cash" goods). This provides an inauspicious background to the first meeting of a Joint Commission intended to foster commercial links between Algeria and the UK.

Iraq

67 ECGD has agreed to provide Iraq with new lines of credit worth £175 mn, which, in maintaining the UK's favoured creditor status, should lead to a reduction in the level of exposure. Most other creditors however continue to face payments delays and demands for rescheduling principal repayments as they fall due. In September, a $1.5 bn contract for a new pipeline through Saudi Arabia (IPSA II) was finally awarded after several months of delay. Payment is to be mainly in oil. On completion (due in mid-1989) the pipeline will add 1 mbd to Iraq's export capacity (currently around 2.2 mbd).

OVERDUE FINANCIAL OBLIGATIONS TO THE FUND✓

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding as at 9.10.87 (SDR mn)	Forthcoming obligations (to 1993 except* 1992)
Kampuchea	13 March 1975	30.3	48.6
Guyana	31 May 1983	59.9	42.6*
Viet Nam	6 February 1984	73.7	54.5
Sudan	12 July 1984	481.1	353.5
Liberia	25 January 1985	156.7	426.5*
Peru	9 September 1985	305.8	442.9
Zambia	30 April 1986	262.1	486.9
Sierra Leone	16 January 1987	12.3	72.7
Somalia	2 July 1987	7.4	132.8
Uganda	17 August 1987	8.7	215.1
		1398.0	2276.1

NB The above figures are derived from Fund papers issued with respect to individual country complaints. there will have been further overdue obligations falling due subsequently, so the figures are not completely up-to-date. A Fund source indicates that total arrears were SDR 1,480 mn as at 28.9.87 but this figure is not divided country by country.

✓ For members with at least on obligation with respect to repurchases or charges overdue for more than one month.

Guyana, Viet Nam, Sudan, Peru, Liberia and Zambia are ineligible. Kampuchea is out of contact with the Fund.

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INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1986*	End-June 1987	End-March 1987 [2]	End-March 1987 [3]
Latin America				
Argentina	52	3.1(0.2)	0.2	0.2
Brazil	110	6.6(1.6)	1.0	1.9
Chile	19	1.2(0.1)	-	0.1
Colombia	15	0.5(0.1)	0.1	0.1
Ecuador	8	0.5(0.1)	0.1	0.1
Jamaica	4	- (-)	-	-
Mexico	98	6.3(0.6)	0.7	1.3
Peru	15	0.3(-)	0.1	0.2
Uruguay	4	0.3(-)	-	-
Venezuela	36	2.1(0.2)	-	-
Far East				
Indonesia	42	0.8(0.3)	0.9	1.8
Malaysia	21	1.1(0.3)	0.1	0.1
Philippines	29	1.4(0.1)	0.1	0.2
Eastern Europe (convertible currency)				
Bulgaria	5	0.3(0.1)	-	0.1
Hungary	15	0.3(-)	-	0.1
Poland	34	0.6(-)	1.3	1.4
Romania	6	0.2(-)	0.3	0.4
Yugoslavia	19	0.7(0.1)	0.7	0.9
Southern Europe				
Greece	20	1.3(0.2)	0.1	0.3
Turkey	31	0.5(0.2)	0.2	0.6

[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 36 countries amounted to $8.9 million at end-December 1986.

[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.

* Current estimate.

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INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1986*	End-June 1987	End-March 1987 [2]	End-March 1987 [3]
Sub-Saharan Africa				
Cote d'Ivoire	9	0.3(-)	0.1	0.1
Nigeria	20	1.3(0.1)	2.5	3.5
South Africa	22	3.7(0.5)	0.9	2.5
Sudan	11	- (-)	0.2	0.2
Middle East and North Africa				
Algeria	27	0.4(0.1)	0.2	0.4
Egypt	45	0.3(0.2)	0.3	1.3
Iraq	55[4]	0.1(-)	0.6	1.6
Israel	32	0.4(0.1)	0.1	0.2
Morocco	18	0.2(-)	0.2	0.3
Oman	3	0.1(0.1)	0.7	1.9
Saudi Arabia	14[5]	0.5(0.3)	0.2	0.3

[4] Includes $30 bn from Arab countries.
[5] Excludes unguaranteed non-bank claims.

BILATERAL AGREEMENTS - CURRENT POSITION AT 1 OCTOBER 1987

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
ARGENTINA I	16.01.85	30.06.85	23.04.85	15.05.85 + 29-31.01.86 (Paris)	28.08.87		English and Spanish texts agreed. FCO arranging Exchange of Notes through "Protecting Powers".
ARGENTINA II	20.05.87	31.12.87		To be arranged			Draft text prepared;awaiting signature of Agreement No 1 before sending to Argentinians.
BOLIVIA I	18.07.86	31.03.87	14.11.86	02.03.87 (London)	02.03.87	08.06.87	Exchange of Notes concluded.
BRAZIL II	21.01.87	31.07.87	16.04.87	27-30.07.87 (Brasilia)	29.07.87		Documents for Exchange of Notes on agreed rescheduling basis sent to Brasilia 28/9. Signature to be effected shortly.
CHILE IV	01.04.87	31.10.87	04.06.87	02.07.87 (London)	02.07.87		FCO chased 23/9;Ambassador sent Note to MFA,who advised Central Bank should reply.Necessary authority to be obtained for this.
CONGO I	18.07.86	28.02.87	13.11.86	24.11.86 (London)	24.11.86	22.01.87	Correct Congolese Reply Note and Annex now received. Date of signature remains as stated in original Reply Note.
COTE D'IVOIRE IV	27.06.86	31.01.87	08.10.86	24.10.86 (Paris)	24.10.86		Comments sent to FCO on 16/9 on Ivoreans' proposed amendments to text.Translation Branch to give their agreement prior to FCO responding to Abidjan.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
CUBA IV	16.07.86	28.02.87	04.11.86	10-12.03.87 (Madrid)	11.03.87		Final text sent to Havana. FCO chasing position on 29/7; hoped to finalise arrangements for signature in W/C 17/8. FCO chasing position again in W/C 7/9.
EGYPT I	22.05.87	31.10.87	07.08.87	October/November (London)			Bilateral text sent to Cairo on 7/8. Provisional debt list dispatched 26/8. Debt reconciliation visit to Cairo concluded 17/9;comments on bilateral text received via Post.For assessment/response prior to arranging negotiations.
GABON I	21.01.87	31.07.87	19.05.87	11-12.06.87	12.06.87		Copies of initialled text sent to FCO on 17/6. FCO spoke to Post early August; most officials on holiday to month-end.FCO chased 22/9;signing of agreement anticipated by mid-October.
GAMBIA I	19.09.86	30.04.87	07.01.87	17-20.03.87 (Banjul)	18.03.87		Copies of agreed bilateral text sent to FCO on 31/3. Error spotted in text, fresh documents sent to FCO on 14/5. chased FCO on 10/8; no news.Further papers requested from Banjul 1/9;FCO chased again 22/9.
GUINEA REP I	18.04.86	31.12.86	16.09.86	29.10.86 (London)	29.10.86		Guinean Finance Minister expresses wish to conclude Exchange in Conakry. FCO approval given but officials on holiday until early September.FCO chased 22/9.
JAMAICA III	05.03.87	30.09.87	20.05.87	09.06.87 (London)	09.06.87		Documents sent to Kingston,to effect Exchange of Notes 29/7. Enquired whether Exchange of Notes completed in our letter sent to Kingston 26/8. FCO chased 24/9. 1st Sec (Commercial) to chase o/r 5/10.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
LIBERIA IV	17.12.84	30.06.85	14.06.85	18.06.85	18.06.85		Documents have been prepared for formal signing ceremony; meanwhile Liberians await Full Powers. Signing in London arranged for 15/10.
MADAGASCAR V	23.10.86	30.04.87	19.01.87	13.03.87 (Paris)	13.03.87	03.06.87	Exchange of Notes concluded in Antananarivo.
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 for onward transmission to Novakchott. No response yet; FCO taking further follow-up action 7/5. FCO chased again 10/8.
MAURITANIA III	15.06.87	29.02.88		To be arranged			Draft bilateral text under preparation.
MOROCCO III	06.03.87	30.09.87	29.07.87	W/C 19 October (London)			Draft documentation despatched to Rabat. Moroccans proposed negotiations in London mid-October; awaiting reaction to proposal for talks W/C 19/10.
MOZAMBIQUE II	16.06.87	29.02.88		To be arranged			Draft bilateral text under preparation.
NIGER IV	20.11.86	31.07.87	20.01.87	29.01.87 (Paris)	29.01.87		Documents passed to British Embassy in Paris 12/2 for onward transmission to Niger Ambassador in Paris. No response yet. FCO chasing for reaction. FCO chased 1/5 and 10/8.
PHILIPPINES II	22.01.87	30.09.87	13.07.87	Early November (Manila)			Embassy in Manila advise negotiations now proposed for early November. Response to be sent indicating suitable dates for visit to Manila.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
SIERRA LEONE IV	19.11.86	30.04.87	23.03.87	26.03.87 (London)	26.03.87		Ambassador in Freetown sent note to MoF 22/5. No response despite chaser sent on 13/7. FCO advised Ambassador 30/7 to press for reply.
SOMALIA II	22.07.87	31.12.87		To be arranged			Draft bilateral text under preparation,sent for clearance to FCO 17/9.
SUDAN IV	03.05.84	28.02.85	24.07.85	08.08.85	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.
TANZANIA I	18.09.86	30.04.87	20.02.87	05-08.05.87 (Dar-es-Salaam)	07.05.87	08.08.87	Exchange of Notes concluded in Dar-es-Salaam.
UGANDA III	18.06.87	29.02.88		Early November (London)			Draft bilateral text under preparation,sent for clearance to FCO 7/7;reply sent 17/9 - yet to be evaluated. Post advise Ugandans avaiable to visit London early November; reply to be sent outlining available dates.
YUGOSLAVIA III	13.05.86	28.02.87	25.11.86	10-12.12.86 (London) + 23-24.02.87 (Belgrade)	24.02.87	29.07.87	Agreement concluded in Belgrade.
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. FCO chased June and are doing so again now. UK position of willingness to sign has been frequently stated. Zaireans apparently have habit of losing papers. Hope to arrange conclusion when Zaire delegation in London to negotiate Agreement No 8.

COUNTRY	DATE OF PARIS CLUB AGREEMENT	DEADLINE FOR BI-LATERALS	DATE DRAFTS SENT OUT	DATE OF NEGOTIATIONS	DATE AGREEMENT INITIALLED	DATE AGREEMENT SIGNED	COMMENTS
ZAIRE VIII	18.05.87	31.12.87	30.09.87	06.10.87 (London)			Draft documentation sent to Zaire Embassy in London 30/9;negotiations proposed for 6/10.
ZAMBIA III	04.03.86	31.10.86	09.05.86	In correspondence	20.08.86		Zambian Reply Note received but did not quote Annex. Revised Note submitted to Zambians who have yet to respond. FCO have no news of progress.

BRID2049.M87

4/150/LJB/79/1

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FROM: A F CASE

DATE: 23 DECEMBER 1987

CHANCELLOR 12/2.

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Evans
Mrs Lomax
Mr Mountfield
Mr Allen IDT
Mr Davis
Mr Halligan
Mr Lankester

OK -

INTERNATIONAL DEBT SCENE: DEBT GROUP REPORT

I attach the usual report on the international financial scene. This should go to Number 10 before Christmas in order to provide background - on Nigeria in particular - for the Prime Minister's forthcoming visit.

A F CASE

030/150/LJB/79/1

DRAFT LETTER TO NO. 10

cc PS/FCO
PS/DTI
PS/Governer

INTERNATIONAL FINANCIAL SCENE

I attach the regular report on developments in the international debt scene. The Prime Minister may find this useful background for her forthcoming visits, in particular her visit to Nigeria.

The last report, prepared immediately after the fall on world stockmarkets, noted that it was then too early to reach conclusions about the longer term impact on the debt scene. Developments since then - the substantial cut, world-wide, in interest rates, the stronger than expected growth of activity in the autumn, and the strength of forward-looking indicators - suggest that the outlook for the world economy will be less recessionary than had been feared. The main impact on debtors will be through the US dollar and dollar interest rates. US interest rates are well below their mid-October level and upward pressures on US interest rates in recent weeks have so far been largely resisted, but the ~~downside~~ risk for the debtors is a serious one. Uncertainties on this score, together with some of the other developments noted below, make the overall debt situation harder ~~less easy~~ to manage than appeared in the early autumn.

There has, however, been positive progress on the IMF's extended structural adjustment facility to which the UK has offered a significant contribution, rising to some £40 million a year, and on additional co-financing disbursements for aid loans to debt distressed countries (UK contribution £120 million) following a ~~IBRD~~ World Bank sponsored meeting in December. For the moment, no further progress has been made on the interest rate component of the Chancellor's initiative, though a lengthened re-scheduling period is now the norm for debt distressed countries in Africa attending the Paris Club. Since the last report, 2 major international meetings have focussed on debt: the Acapulco meeting of Latin American Heads of State and the OAU Debt Summit. Little new emerged. Their main importance appears to have been political rather than financial.

On a less favourable tack, there has been a worrying weakening in Fund conditionality, most recently on Argentina (on which the UK abstained) and Cote d'Ivoire (which the UK reluctantly approved but asked for a strengthening of the programme at the first review).

Among individual countries, the outlook for Nigeria's adjustment programme continues to cause concern. Although considerable progress has been made, the recent Fund Article IV Mission Report (due to be discussed in the Board on 6 January) showed a major and alarming slippage in fiscal policy during 1987, with no sign of improvement in 1988. UKDEL will be briefed to use discussion in the Fund Board to reinforce the message in the brief for the Prime Minister's visit that much more must be done, above all, on reducing the fiscal deficit, and stiffen the Nigerian Government's resolve to adhere to an economic adjustment programme endorsed by the IMF.

Despite agreement on an interim banking package, Brazil remains a major problem. There is already considerable uncertainty about the next stage of the banking package, on which negotiations should already be starting. With the resignation of Bresser Pereira, the Finance Minister, the chances of an early IMF programme - already limited- seem likely to have receded. Whatever approach the Brazilians choose to adopt over the next few months may set a precedent elsewhere in Latin America.

Finally, the Egyptian programne is off-track. Despite their undertaking when the Fund Board approved the original very weak programme that this would be strengthened at the time of the first review, the authorities are unwilling to take corrective measures. Surprisingly, in the light of their attitude towards the original Fund programme, the US are at last taking a tougher line and have lobbied in this sense in Cairo. They would like other G5 countries to follow suit and also to try to stiffen the Managing Director's resolve. We shall want to reinforce the US message both in Washington and Cairo. A further opportunity to do so will be during President Mubarak's visit to London in January.

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CONFIDENTIAL

INTER-DEPARTMENTAL DEBT GROUP REPORT: DECEMBER 1987

Main points

- the dollar's decline has led to interest rate cuts by strong currency countries while upward pressure on US rates has so far been largely resisted. There are as yet few signs of a weakening of OECD economic activity following the stock market collapse and non-oil commodity prices have continued to strengthen. The decline in oil prices accelerated after the December OPEC meeting.

- major commercial banks have agreed to subscribe to Brazil's interim financing package. British banks have done so, however, only on the basis that any commitment to the proposed medium term facility will be contingent on Brazil keeping current on interest payments from the beginning of next year and seeking a fully-funded IMF programme. Doubts on the ability of the Brazilians to deliver realistic adjustment measures have been reinforced by Senhor Bresser's resignation.

- while Nigeria has implemented some notable policy reforms, acute problems on the fiscal front (likely to be aggravated by the fall in oil prices) remain. These could be a stumbling block in securing a new IMF programme which is needed to trigger disbursements of new money from the banks. The terms of Nigerian proposals to reschedule amounts due to uninsured creditors are harsh and unsatisfactory.

- Yugoslavia's external position has deteriorated and its recent economic package is unlikely to satisfy creditors. The authorities have agreed to seek an IMF programme but may well lack the political strength to implement tough adjustment policies.

- arrangements for establishing the IMF's Extended Structural Adjustment Facility (ESAF) have progressed, with the UK offering a substantial sum to finance the interest subsidy. The IBRD has secured an estimated $3 bn in additional commitments for aid to the poorest debt-distressed countries.

Chart 1

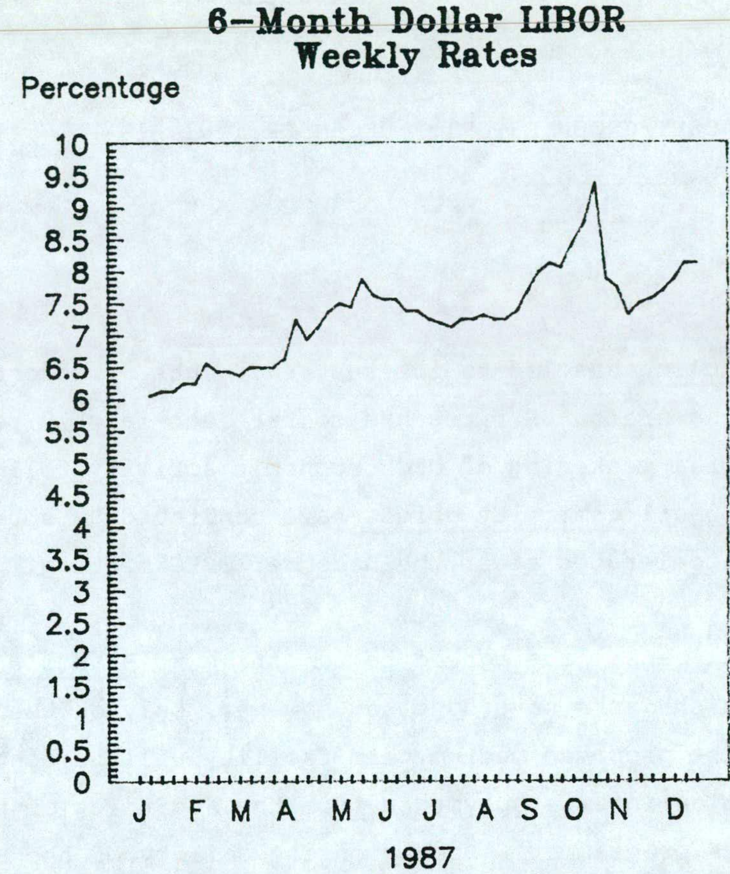
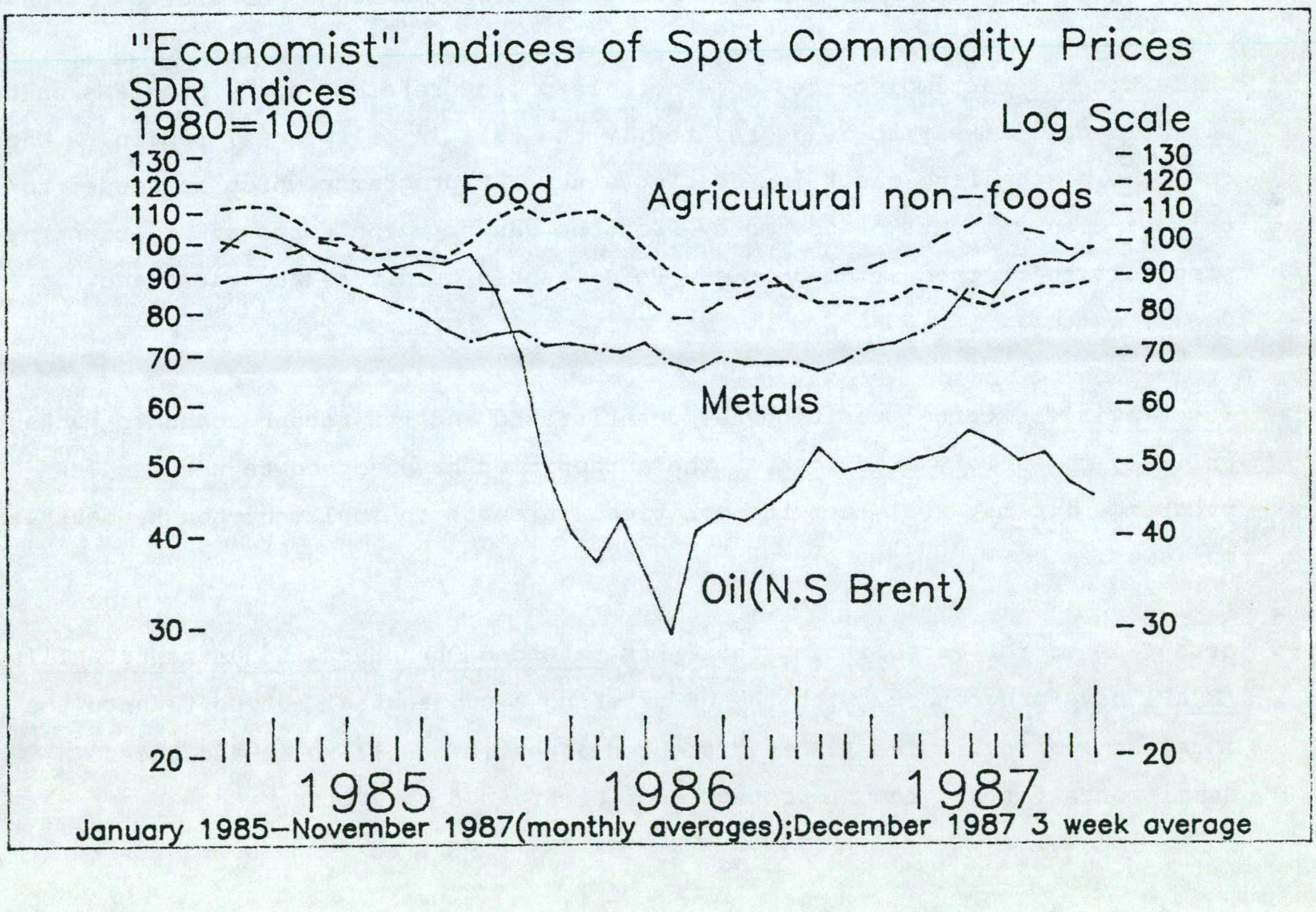


Chart 2



under pressure from the US authorities who feared that Argentina was close to declaring a moratorium, the IMF Board (with the UK abstaining) has agreed to an extraordinarily soft amendment of its already weak Stand-by Agreement (SBA). A weakening of IMF conditionality is also evident in an SBA recently agreed for Cote d'Ivoire.

- some regional US banks have increased the level of their provisioning against ldc debt significantly beyond that established by Citibank and others earlier this year. While the move may not be followed (or could not be afforded) by major US banks, it may signal a less unified approach by creditors and could reinforce debtors' demands for relief.

- signature of the "Acapulco Commitment" by Heads of State of 8 Latin American countries, and the threat of 10 year suspension of debt service at the OAU debt summit reflect debtors' growing impatience with the current strategy. However, such moves fall far short of effective concerted action by debtor countries.

INTERNATIONAL FINANCIAL SCENE

World Economic Developments

1 There is, as yet, little sign of a weakening of OECD economic activity attributable to the collapse of world stock markets. Third quarter data indicate that prior to the crash growth was unexpectedly strong, and the latest indicators for the US provide little evidence of a slackening of output and investment, although consumer demand is flat. With post-crash fears of recession receding a little, and given the fall in the dollar that has occurred (over 5% in effective terms since end-October) coupled with a round of interest rate cuts in Europe, the Fed may be less resistant in future to upward pressure on US interest rates. These have firmed somewhat in recent weeks from lows recorded after the crash (Chart 1). While domestic concerns will remain paramount, the US authorities are no doubt also mindful of the dangers higher rates pose for the debt strategy (Table 1).

2 Since early November, non-oil commodity prices have also strengthened (Chart 2), although apparently more in reaction to short run supply side factors than more bullish expectations of demand. Metal prices have recovered particularly sharply, although prices of agricultural raw materials have remained flat. A rise in food prices largely reflects lower grain harvests and anticipation of higher Russian demand for soya meal and sugar.

TABLE 1

VULNERABILITY OF DEBTOR COUNTRIES TO A 1% RISE IN LIBOR

Country	(1) total debt at end 1986 $Bns	(2) foreign currency reserves at end 1986 $Bns	(3) % of debt floating	(4) cost of 1% rise in LIBOR gross $Bns	(5) net* $Bns	(6) Exports of goods & services(XGS) in 1986 $Bns	(7) 1% rise in LIBOR as % of XGS gross	(8) net*
Mexico	98.1	5.7	80.1	0.8	0.7	22.0	3.6	3.3
Argentina	51.7	2.3	60.2	0.3	0.3	8.7	3.6	3.3
Brazil	110.3	5.8	71.5	0.8	0.7	24.3	3.2	3.0
Venezuela	36.0	6.4	93.4	0.3	0.3	9.4	3.6	2.9
Chile	19.3	2.4	81.5	0.2	0.1	5.0	3.1	2.7
Poland	33.5	0.7	50.0	0.2	0.2	7.1	2.4	2.3
Morocco	17.8	0.2	36.3	0.1	0.1	3.0	2.2	2.1
Ecuador	8.4	0.6	71.7	0.1	0.1	2.6	2.3	2.1
Peru	15.0	1.4	40.3	0.1	0.0	3.3	1.8	1.4
Uruguay	3.9	0.5	64.3	0.0	0.0	1.5	1.7	1.4
Cote d'Ivoire	9.3	0.0	47.6	0.0	0.0	3.9	1.1	1.1
Egypt	44.6	0.8	12.8	0.1	0.0	4.5	1.3	1.1
Philippines	29.3	1.7	35.2	0.1	0.1	8.3	1.2	1.0
Nigeria	20.3	1.1	41.7	0.1	0.1	7.6	1.1	1.0
Bolivia	3.7	0.2	26.4	0.0	0.0	0.8	1.2	1.0
Yugoslavia	19.4	1.5	61.0	0.1	0.1	12.8	0.9	0.8
Colombia	15.0	2.7	40.7	0.1	0.0	6.5	0.9	0.5
Jamaica	3.9	0.1	18.8	0.0	0.0	1.4	0.5	0.5
Total sample	539.5	34.1		3.2	2.9	132.8	2.4	2.2

* interest on debt less foreign currency reserves

3 Oil prices have declined more than 15% since July against a background of surplus stocks and overproduction, particularly by Iran, Iraq, Kuwait and the UAE. Differences within OPEC over future pricing and production policy were not resolved at the Ministerial meeting (which merely reaffirmed existing quotas and the $18 benchmark) and prices subsequently fell sharply. If sustained, weaker oil prices will compound the problems of debtors who are major oil exporters, while bringing only limited benefit to others whose net oil imports have declined sharply since the price shocks of the 70s (Table 2).

4 Significant sovereign or sovereign guaranteed market borrowing by debtors since end-October include syndicated credits to Indonesia ($300 mn) and Greece's telecommunications utility OTE ($175 mn). International bond issuers include China's International Trust and Investment Corporation ($362 mn), the Industrial Development Bank of India ($120 mn) the Bank of Greece ($180 mn) and Trinidad and Tobago ($56 mn)[1].

Debtor Creditor relations

5 Signature of the $3 bn interim financing package for Brazil began as scheduled on 15 December. For purposes of selling the deal domestically it was important for Brazil to claim that the banks had been persuaded to put up new money (in respect of 1987 Q4 interest) without a formal IMF programme being in place. On the other hand the banks will be receiving more in interest than they are lending. British banks have made it clear that their participation in any medium term facility (which will trigger the second tranche of the interim facility - this amounts to a bridging loan covering 1987 interest arrears) will be contingent on Brazil seeking a fully funded IMF programme and being current on interest from the beginning of 1988. (However, discussions on a Fund programme have not yet commenced). Peer pressure had to be applied to some UK banks (those standing to receive less in net terms relative to their exposure) before they agreed to participate. The banks will be relying on an unwavering stand by the Paris Club which is now insisting on an SBA in return for agreeing to reschedule 1987 principal. The resignation of the Finance Minister, Senhor Bresser, in protest over the slow progress on the fiscal front casts a shadow over the prospects of securing medium term financings associated with adequate adjustment measures.

6 Past attempts by debtors to present a united front (eg the Cartagena Declaration of June 1984) have met with little success, largely owing to a lack of political commitment and a diversity of interests. The "Acapulco Commitment [to Peace, Development and

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(1) Amounts shown are US dollar equivalents. Annex Table H lists bank borrowing and international bond issues over the past three months.

TABLE 2

VULNERABILITY OF BAKER 15 TO A $1 PER BARREL FALL IN THE OIL PRICE

Country	Change in value of net oil exports (1) (million dollars)	Exports of goods & services (XGS) in 1986 (billion dollars)	$1 FALL in oil price as % of XGS
Argentina	-43.4	8.7	-0.5
Bolivia	NA	0.8	NA
Brazil	185.1	24.3	0.8
Chile	19.1	5.0	0.4
Colombia	-39.6	6.5	-0.6
Cote d'Ivoire	6.9	3.9	0.2
Ecuador	-74.5	2.6	-2.8
Mexico	-484.9	22.0	-2.2
Morocco	36.0	3.0	1.2
Nigeria	-452.6	7.6	-5.9
Peru	-20.4	3.3	-0.6
Philippines	51.0	8.3	0.6
Uruguay	9.8	1.5	0.7
Venezuela	-560.0	9.4	-6.0
Yugoslavia	73.7	12.8	0.6
Egypt	-91.3	4.5	-2.0
Total Baker 15 (Omitting Bolivia but including Egypt)	-1385.1	123.5	-1.1
Memoranda			
Major net exporters (Ecuador,Mexico,Nigeria Venezuela and Egypt)	-1663.3	46.1	-3.6
Remaining countries	278.2	77.4	0.4

(1) Calculated from 1986 net export volumes (Egypt figure based on 1985 and Cote d'Ivoire figure a 1985 projection), assuming no supply / demand adjustment as a consequence of the price fall.

Democracy]" recently signed by eight[1] Latin American Heads of State is more a reflection of debtor frustration with the current strategy than a signal of the beginning of a concerted approach to future debt negotiations. None of the objectives set out in the Commitment is new and emphasis is given to supporting fellow signatories in their individual negotiations with creditors. While the document falls short of calling for unilateral limitations on debt service, it does suggest that such a step may become necessary if negotiations fail. Its expression of solidarity with those countries who have already opted for a partial moratorium may persuade others to follow suit.

7 Contemporaneous with the stance taken at Acapulco, the special OAU Debt Summit concluded with a call for a conference with creditors to agree a concessional rescheduling of Africa's debt over 50 years and an increase in aid flows. In the event of a failure to reach agreement, a 10-year suspension of debt service from next year was threatened. The Summit was, however, poorly attended and it is unlikely that the more moderate leaders would join a moratorium.

IFI Conditionality

8 With agreement on an effective IMF programme for Brazil a distant prospect at best, the credibility of the IMF's conditionality has, at least in UK eyes, been undermined by the Executive Board's approval of soft amendments of Argentina's already weak SBA. The UK abstained and would have voted against had it not been for the risk that such a step would have been regarded as politically motivated. Under pressure from the US authorities and M Camdessus, who had become convinced that Argentina would have declared a moratorium, the Board was effectively presented with a fait accompli. Other countries, which unlike the UK had participated in the bridging loan, had little choice but to support if they were to get their money back (Board approval was required for the disbursement of IMF and IBRD funds). The move is, however, likely to be interpreted by debtors, and particularly the Brazilians, as a weakening of creditors' resolve when under pressure. The IMF also loses credibility with the banks, whose reluctance to participate in future credit packages will only have been reinforced. Recent Board approval in principle of a weak programme for Cote d'Ivoire is also unhelpful, although the UK received some support in calling for the programme to be strengthened at its first review. The US does, however, appear to have hardened its previously soft attitude to Egypt's weak SBA. Political

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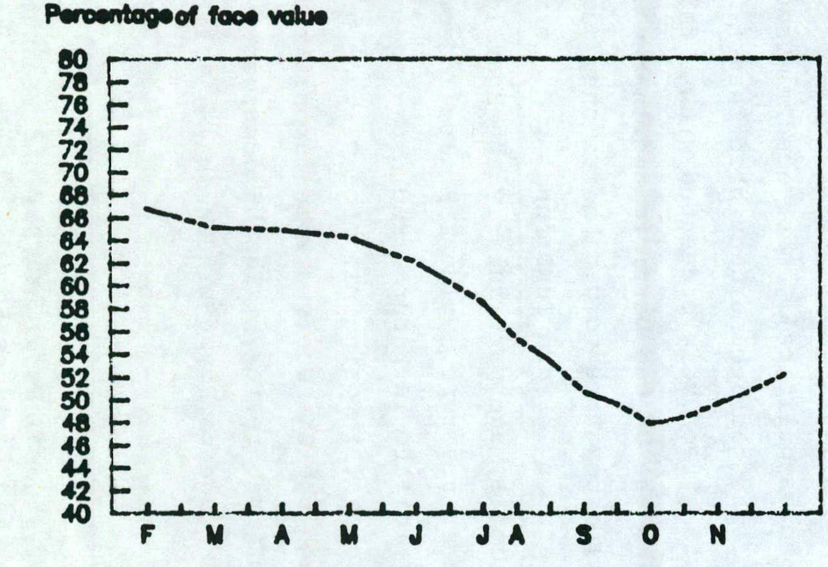
(1) Argentina, Brazil, Colombia, Mexico, Panama, Peru, Uruguay and Venezuela. The Cartagena group excludes Panama but also includes Bolivia, Chile, Ecuador and the Dominican Republic.

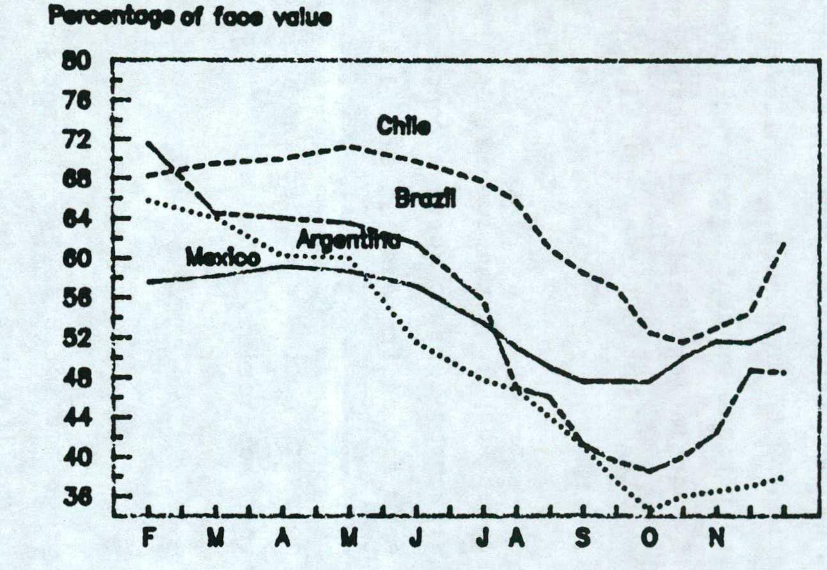
CHART 3

SALOMONS SECONDARY MARKET PRICES

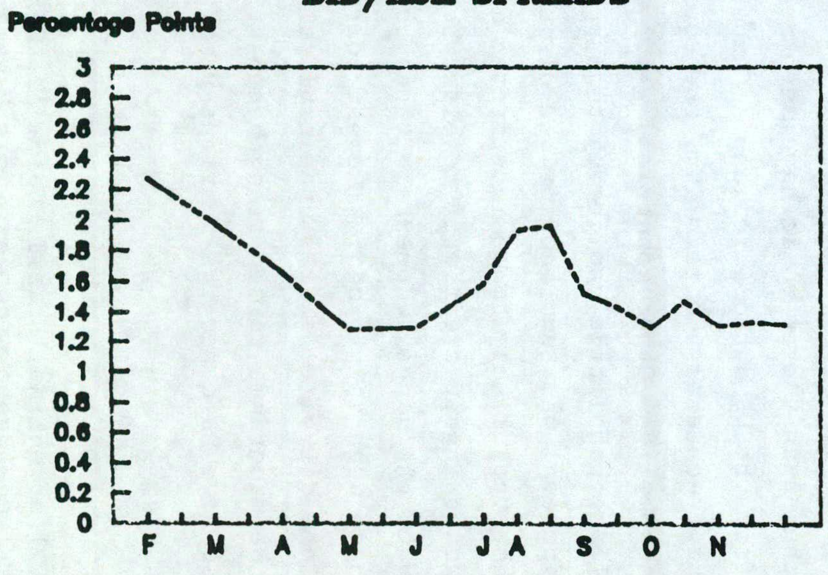
ALL IDR COUNTRIES (WEIGHTED AVERAGE)
MIDDLE PRICES



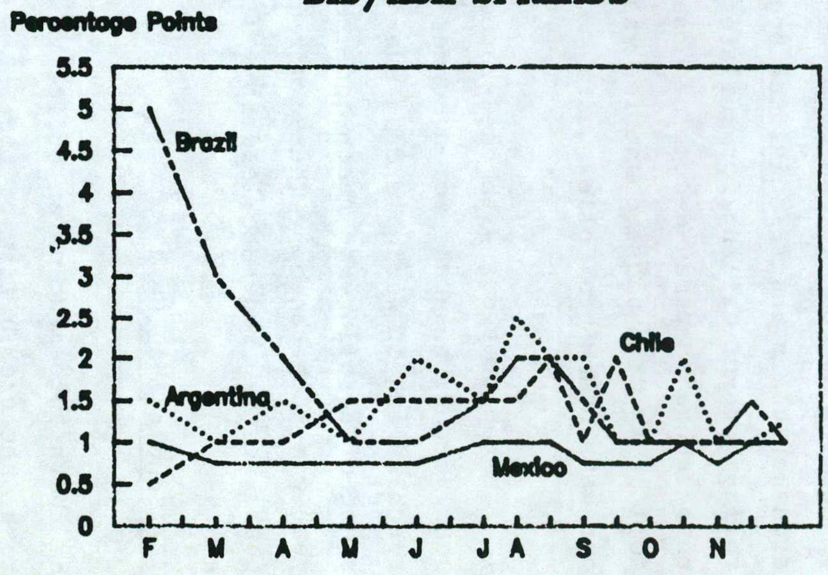
SELECTED MAJOR DEBTORS
MIDDLE PRICES



BID/ASK SPREADS



BID/ASK SPREADS



Opposition to a third Structural Adjustment Loan for Chile was led by the US in the World Bank, although the loan was approved. The UK, supported by Germany and Japan, took the line that there were no economic grounds for refusing the loan and to do so for political reasons would threaten the integrity of the Bank and would lay open creditors to the charge of inconsistency. While supporting the loan, the UK has used the opportunity (as on a similar occasion last year) to underline our concerns on human rights through a direct approach to the authorities in Santiago.

Secondary market

9 Debtors have increasingly pointed to the large discounts on their debt in the secondary market (Chart 3 - but prices are available only to late November) as a basis for debt relief (capturing a share of the discount was stated to be one of the primary objectives of the Acapulco Commitment). Apart from a basic resistance in principle to calls for relief to middle income debtors, creditors have stressed that turnover in the market represents a tiny proportion of the debt outstanding and is often motivated by special tax and regulatory factors; prices struck in the market may therefore be unrepresentative of expectations regarding future debt service. A serious objection to basing debt relief on secondary market discounts (assuming that relief had indeed been conceded) is that of moral hazard: a good part of the discount can be attributed to the unsound policies of the debtors themselves and their perceived unwillingness to service their debts in full.

10 Given these arguments, it is unfortunate that the Bank of Boston (one of the largest regional banks in the US), in announcing an increase in provisions against non trade-related ldc loans to levels well above those established following Citibank's move last May, should cite deep secondary market discounts as a factor. The bank has also written down the value of its loans and placed them on a non-accrual basis; in future it will effectively treat interest receipts as repayments of principal. Other middle-ranking US banks have also raised their provisions. Such moves are unlikely to be followed (or can be afforded at present) by the main money centre banks (which have a heavier ldc exposure), but may well encourage debtors in their demands for relief. (Prepayments of private sector debt at large discounts to face value also appear to have been prominent in the capital outflows which accompanied the collapse of Mexico's stock market. With the rescheduling terms on this debt recently extended to 20 years, some banks were prepared to bear the cost in return for immediate repayment.) Secondary market sales do not formally absolve the banks from contributing to new money packages but such divestments are likely to mean an increasing reluctance to participate.

Support for the Poorest Countries

11 The IMF's SDR 8.2 bn Extended Structural Adjustment Facility (ESAF) (SDR 6 bn plus what remains of the original SAF) continues to take shape. The UK has offered to contribute sufficient funds to finance an interest subsidy on about SDR 1 bn (about one sixth) of the low interest loans to be made available. A UK proposal that access limits to the new facility be formally skewed in favour of the most debt-distressed is unlikely to be adopted, although in practice such countries are likely to enjoy a larger than average quota share of the resources available. At a donor's meeting held under IBRD auspices, $6.3 bn of assistance over 1988-90 (about half representing additional sums) was pledged. The UK announced that it expected to provide £250 mn of programme aid grants, of which £120 mn would be in the form of co-financing with World Bank policy based loans. At the Paris Club an IBRD presentation, using rescheduling options for Zambia as a model, usefully reinforced the UK case for cuts in moratorium interest rates for the poorest countries making genuine adjustment efforts. The UK also proposed that the Club examine revised AfDB proposals (formulated by Warburgs) for the concessional securitisation of African debt, recognising that these continue to present problems in terms of effective conditionality, sovereignty and equality of treatment between creditors. Securitisation was also raised at the Franco-African summit. The UK, along with other donors, has also increased its contribution to the Fifth Replenishment of the African Development Fund to compensate for a shortfall in the US contribution.

Further details on individual countries are given below.

LATIN AMERICA AND CARIBBEAN

Brazil

12 The domestic recession, which has been an important contributory factor to a strong improvement in the trade balance, continues: industrial output fell over 5% in the year to September (against a rise of 7.6% in the year to July) and unemployment has returned to the levels of H1 1986. In spite of the temporary price freeze (lifted at the end of August), inflation remains high and has increased to 338% in the 12 months to November. The trade surplus for January-November was $10.1 bn.

13 The authorities are considering further action to control the inflationary impact of the fiscal deficit by creating a capital gains tax and eliminating a range of tax incentives for certain imports and investment funds. They have, however, withdrawn proposals for a 1/2% personal wealth tax. The short-term impact of these measures,

if implemented, will probably damage the prospects for industrial growth. The 1987 operational deficit is now projected by the authorities to be nearly 5% of GDP rather than the original 3.5%, and 1988's operational deficit is forecast to be 4%. Finance Minister Bresser's frustration with the slow progress on the fiscal front led to his resignation.

14 More generally, political uncertainty has increased: the Constituent Assembly's "systematisation" committee has voted for a parliamentary form of government and to restrict President Sarney's term of office to four years; Congress is likely to endorse this decision which would require a presidential election in late 1988.

15 The timetable for progress towards a medium-term financing is as follows: terms sheet to be agreed by 15 January, critical mass (undefined) of commitments by 15 March, effectiveness by 16 June. If effectiveness is not achieved as scheduled no disbursements will be made under stage two of the interim deal.

Mexico

16 Trade figures which will reflect the recent weakening of oil prices are not yet available. In the first 8 months of the year non-oil trade was in approximate balance with exports up 27% and imports down 3% on a year earlier. There are signs, however, of import growth picking up sharply. Oil exports in the year to August were 46% higher than in the same period of 1986. Tourist receipts in the first 7 months were 35% up on a year earlier.

17 Prices on the domestic stock market, which had risen spectacularly earlier in the year, suffered a dramatic reversal in recent weeks: by 19 November prices had fallen 75% from their peak before recovering subsequently. As investors switched into dollars, interest rates were raised to record levels. When Central Bank support for the free market peso was withdrawn on 18 November, the rate fell 35-40% in 2 days before partly recovering. Despite recent losses the reserves remain high, at over $14 bn.

18 With inflationary expectations boosted by the sharp depreciation, and the unions threatening a general strike, the Government has secured a new "Economic Solidarity Pact" (PSE). Elements of the package include a 17 1/2% devaluation of the controlled peso, a wage-price package involving immediate once-off increases in wages and public sector prices to be followed by a 2 month freeze and subsequent de facto wage indexation, cuts in government spending, and a reduction in import tariffs. The aim is to increase the primary fiscal surplus from 5.4% to 8.3% of GDP and to reduce the

overall deficit (which includes the inflation indexed element of interest paid on domestic debt) from 22% to 20.5% of GDP. By the end of 1988 the authorities aim (optimistically) to have reduced monthly increases in consumer prices to 2%.

19 Disbursements from the banks' financing package reached $4.37 bn in November following the drawing of the second tranche of new money ($872 mn) after the effectiveness of the package was attained on 22 October. The IBRD approved a second Trade Policy Loan for $500 mn on 12 November, rewarding measures taken in 1987. The debt-equity scheme was suspended for two weeks in November while the authorities reviewed its potential inflationary impact. Since the scheme's inception in April 1986 applications have totalled $2.5 bn, approvals have been $1.7 bn, and up to H1 1987 $815 mn had been put into effect.

Argentina

20 Industrial activity declined by 0.5% in Q3. The IMF's forecast for real GDP growth this year has been revised down by half to 2% (against actual growth of 5 1/4% in 1986). Following the introduction of the wage-price freeze in October the authorities expect inflationary pressures to ease, but prices still rose by 10% in November, the 12 month change increasing to nearly 180%. Argentina's external position continues to deteriorate although any benefits from October's 10.8% depreciation have, of course, yet to work through. The current account deficit for Q1-Q3 was $2.2 bn against $2.9 bn in the whole of 1986.

21 The IMF Board approved an amended SBA on 2 December, the UK, Australian and Dutch directors abstaining. Performance under the existing programme had been extremely poor: five of eight performance criteria were missed at end-August. Only three, much weaker, end-year performance criteria have been specified under the new programme and end-year targets for macro-economic indicators have been substantially relaxed. The PSBR is forecast to be 5.6% of GDP, against 3.9% projected in August. Inflation is forecast to be 150% by December, against 82% in 1986. The overall balance of payments deficit is forecast to rise to $4 bn and will be met by a postponement to 1988 of the proposed decrease in arrears and drawings from international reserves. There are no targets or projections for 1988 but a significant financing gap exists. Approval of the SBA amendments permits disbursement of the second tranche of the programme (SDR 165.5 mn) and of the second tranche of the World Bank Trade Policy loan which together provide the take-out for the official bridging loans of $475 mn, disbursed on 11 November and due to be repaid by 31 December. (Repayment may be delayed as payment of the IBRD money may not be made until January.) Disbursement of the second tranche ($500 mn) of the commercial bank new money package is also

conditional upon the resumption of Fund drawings. The amended programme's success depends upon proper implementation of measures contained in October's economic package. However, Congressional approval of the measures is proving difficult and there have been strikes and other public opposition. There has been a surprising measure of agreement between the Radicals and Peronists in Congress on a range of issues including tax reform. But this is likely to result in dilution of tax measures and further slippages against already weak IMF targets. Despite the obvious weaknesses of the programme, the UK has little choice but to participate in a new Paris Club rescheduling (assuming bilateral agreements for the 1985 and 1987 reschedulings are signed).

Venezuela

22 Real GDP growth is expected to slow from 5.2% in 1986 to 2.8%. The PSBR for 1987 is officially forecast to be 6.2% of GDP, virtually the same as last year, but, somewhat optimistically, is expected to decline to 4% in 1988 even though expansionary policies are set to continue. Despite the price freezes since May, inflation continues to be a problem as the effects of last December's devaluations and the mid-year compensatory wage bonus continue to be felt: prices rose by 2.4% in October to give an annual rate of 34.9%, against 13.4% at October 1986. The high rate of inflation has pushed the fixed official exchange rate to an even more over-valued position.

23 All commercial banks signed the amended public sector MYRA on 13 November, ahead of the 16 November deadline: Venezuela may now benefit retroactively from the reduced interest rate spread which will be applied from 1 April 1987. Some progress has been made on the private sector debt rescheduling but several issues remain outstanding. Hector Hurtado, who has replaced Azpura as Finance Minister, has stated that Venezuela is seeking $8 bn of additional external borrowing before 1991 to finance large-scale industrial and infrastructure projects. He is also seeking to increase short-term credits to the private sector from $2.5 bn to around $4 bn. No formal request for new money from the banks has, however, been made.

24 Following a mission earlier in the year, the IBRD has declared Venezuela re-eligible for loans (having graduated from IBRD lending in 1975): trade reforms are being discussed and may form the basis of a trade policy loan. The Fund Board is due to discuss Venezuela's Article IV report on 18 December: Fund staff were still critical of the government's expansionary policies and recommended a reduction of fiscal spending plans and a more effective exchange rate policy.

Chile

25 GDP grew by 6 1/2% in H1 compared with H1 1986, and 5% growth is expected for 1987 as a whole. Domestic demand remained buoyant in Q3. The inflation rate continues to rise (22.3% in the 12 months to October). While exports have been boosted by the rise in copper prices, imports are up strongly - consumer goods imports were 26% higher than during the same period last year, and may partly reflect greater black-market trade with Bolivia, goods being subsequently smuggled from Chile to Bolivia. In the first 9 months of the year there was a trade surplus of $742 mn, against $905 mn for January-September 1986. The IBRD Board has approved a third SAL (see para 8 above).

26 Debt-equity swaps rose from an average of $50 mn a month to $100 mn in October, partly in response to the change in legislation which now allows foreign-owned investment funds to invest debt-equity swap proceeds in the stock market.

Ecuador

27 The January-September trade deficit was $5 mn (cf a surplus of $541 mn during the same period in 1986). Oil exports have, however, resumed since August. The exchange rate continues to be under pressure: the free market rate depreciated by 50% in the period January-November while the official rate fell 31% over the same period, despite various measures including higher reserve requirements and import deposits. Inflation has begun to slow, however, falling to 27.3% in the 12 months to October as against 32% in July.

28 Ecuador and the banks reached a preliminary agreement at end-October: old debt of $4.3 bn will be rescheduled over 19 years/7 grace at LIBOR +15/16%, old "new" money ($631 mn) will be rescheduled over 10 years/3 grace at LIBOR +1%. $350 mn in new money from the banks has also been requested and will be provided without IBRD co-financing but with a parallel loan. A condition of the loan, that interest payments be current from 15 November, has broadly been met. A Paris Club rescheduling has been set for January.

Peru

29 The economy goes from bad to worse with the authorities doing little but to respond to the pressure of events. During January-July there was a trade deficit of $109 mn, against a surplus of $347 mn during the same period last year: exports were little changed while imports were 46% higher and were boosted by rising consumption

and a huge (57%) appreciation of the real effective exchange rate in the first nine months of 1987. There was, however, a nominal devaluation of 20% in October followed by a 39% devaluation in December. Interest rates may also be sharply raised to stem capital flight. In H1 the current account deficit was $792 mn. The IMF foresees a current account deficit of $1.6 bn for the year. Inflation continues to rise: the CPI rose 104.8% in the twelve months to November, against 62.9% at end-1986. Real GDP growth of 6% is forecast for 1987. The PSBR (including arrears) is expected to reach 9.1% of GDP in 1987, up from 7.4% in 1986: net losses of parastatals are of particular concern and are likely to reach 5.3% of GDP against a 2.6% surplus in 1985. Arrears are expected to rise by $2.6 bn (10.6% of GDP) in 1987 to total $7.6 bn (31% of GDP). (Arrears to the IMF and the IBRD have risen to SDR 350 mn and $157 mn respectively.) Central bank net reserves were only $240 mn at end-November, against $958 mn at end-1986.

30 Public sector debt servicing during January-July was 14.8% of goods exports, against a 19.5% outturn for 1986. The government has recently contacted the Paris Club and other creditor groups but has not offered anything really new. A resumption of IBRD lending has been requested, including a possible $1 bn in programme lending. No Fund programme is being contemplated. The banks have been asked for de jure recognition of the 10% debt servicing limit and the build-up of principal arrears: a meeting between the banks and Peru may occur in the second half of January. Reference has also been made to further "unorthodox" deals with creditors following the three debt-for-goods deals that have already been signed. At the political level President Garcia's popularity continues to decline but neither right nor left is able to present a credible alternative.

Colombia

31 With coffee prices falling sharply, there was a trade surplus of $221 mn on a cash basis in the first 7 months of the year as against $642 mn in the same period in 1986. Non-coffee exports, however, were up 27%, being boosted by higher oil exports. Total reserves (excluding gold) have remained constant this year, and were $2.7 bn at end-September; however, during the same period gold holdings have declined by half, suggesting that some liquidation has been occurring to compensate for lower export receipts. On the domestic side, the monthly rate of inflation has slowed slightly, although the October's 12 month figure was 24.8%, against 15.6% in October 1986.

32 The authorities' implementation of the tax reform introduced in December 1986 appears to have had some success: the PSBR forecast has been revised to 2.6% of GDP for 1987 against an earlier projection of 3.3%. The Fund's recent Article IV report

was broadly favourable in its appraisal of the direction and implementation of Colombian economic policy. However, attention was drawn to the need to maintain a cautious fiscal policy to dampen inflationary pressures. The IBRD Board is expected to approve a $300 mn power sector loan on 8 December, as part of a $1.3 bn financing package for the power sector which also involves the IDB, foreign governments and commercial banks.

33 The banks' "voluntary" loan closed at $1 bn on 11 December. Earlier, the Colombian authorities, frustrated with the slow pace of progress, had threatened to suspend principal payments if the original 90% critical mass was not reached. All the major British banks have committed to the loan, though one has done so for less than its pro-rata share because of commitments to other new business with the Colombian government. All the loan will be disbursed in 1988.

Bolivia

34 The debt buy-back scheme took legal effect in November, following the Cabinet's approval of the scheme on 13 November. Bolivia now has a four-month period in which to make a repurchase offer to the banks. The Bolivians have said that any debt still outstanding after the repurchase period elapses will need to be recheduled on concessional terms. There have been no further specific offers of funds from donor governments since the last Report. ODA has not yet come to any decision on the possible redirection of its aid contributions to the buy-back scheme. A delay in approval of the new Fund programme has resulted in the Paris Club discussion of a further rescheduling being deferred from December to February or March 1988.

Other countries

35 Uruguay has enjoyed stronger than expected growth and made progress in reducing inflation. Its trade balance has, however, deteriorated. The IMF have, exceptionally, approved an SBA for Costa Rica even though the authorities and the banks have not yet reached an understanding on a new financial package and interest is only being partly paid. Jamaica has benefited from a boom in tourism and is meeting targets under its SBA. No further commercial bank rescheduling is expected but a further approach to official creditors is likely. Political unrest in Panama led to a suspension of US aid and a delay in negotiations with the Fund on an SBA. Although a short term rescheduling package was agreed with the banks at the end of August, in the absence of an IMF programme no progress has been made in rescheduling Paris Club Debt. In late November ECGD guaranteed a soft loan of £14.2 mn for Panama for a power station project. The loan blends an export credit with a grant from ODA's ATP soft loan scheme and is the first such loan to finance UK exports to Latin America.

SOUTH AND EAST ASIA

Philippines

36 Real GNP was 6.8% higher in Q3 than a year earlier. However, the current account recorded a $219 mn deficit in the first three quarters of 1987 (cf a surplus of $809 mn in the same period of 1986), markedly worse than official forecasts. The authorities have pinpointed higher than expected purchases of capital goods as the main culprit but argue that this underlines the strength of the economic recovery. On the political front President Aquino's position has strengthened, promising greater stability than of late.

37 A compromise has finally laid the issue of Planters Products Inc. (PPI) to rest. Barclays and fellow creditors have agreed to a discount of 15% on PPI debt, as opposed to 12 1/2% originally proposed. The somewhat complex mechanics of the compromise deal result in the banks exchanging PPI debt for Central Bank debt. On the strength of the compromise, Barclays signed the rescheduling agreement on 13 November and it is almost certain that the remaining loose ends will be tied up before the new deadline of 22 December.

Malaysia

38 In Malaysia the FY1988 Budget was presented on 23 October. Total Federal Government expenditure is earmarked to rise by 4% (around 3% in real terms) in 1988, whilst the Government expects higher domestic demand and more buoyant tax receipts to push revenue up by 20% (the projected consolidated public sector deficit is nevertheless equivalent to 15% of GDP). The government's recent move to ban three newspapers and imprison over 100 prominent activists (44 have subsequently been released) is unlikely to improve the climate for foreign investment.

Indonesia

39 In Indonesia the recent crash in global equity markets is seen, at least in the short term, as helpful by the authorities, as nervous investors are said to have switched their money out of foreign equities and back into deposits with the banks in Indonesia. As a result, the level of readily usable reserves, which had been depleted after a major capital flight panic in the summer, is probably higher than the latest estimate of $4.5 bn (4.8 months' of imports of goods and services). The authorities are also expected to announce a cut in interest rates in the near future - from 17% to around 15.5% on 30 day deposits. Nevertheless, with inflation currently

running at around 7% p/a (down from a peak of 11% in August) real interest rates remain high. Although the fall in US interest rates following the stock market crash will have a beneficial impact on Indonesia's dollar debt servicing, this will be countered by dearer payments on the country's yen borrowings. Yen denominated debt makes up a third of total external debt at present.

EASTERN AND SOUTHERN EUROPE

Poland

40 At end-November Poland made the first payment ($73 mn) to official creditors under the rescheduling agreement reached at the October Paris Club and signed on 17 December. The banks continue to make progress in the documentation of their two-stage MYRA and it is hoped to sign in March. At this stage it is unclear to what extent the recent referendum result will have the effect of decelerating the pace of the planned reforms, but the Poles have probably lost the opportunity of using the result to counter US opposition to an IMF programme this side of the Presidential election. Recent changes in the Party politburo and Central Committee have, however, favoured the reformers. IBRD loans in support of exports and agriculture are apparently under discussion.

Yugoslavia

41 The commercial banks at their meeting with Yugoslavia in New York at end-October rejected a request for a 9-year MYRA to be repaid over 20 years with 7 years' grace and $0.9 bn new money. Negotiations are due to resume in mid-January and the banks will be looking for greater realism from the Yugoslavs. The Paris Club has made it clear that no negotiations can take place before an agreement is reached on a Fund programme. The package of economic measures announced in October was clearly an inadequate response, and the prices and wages freeze announced in November has already begun to fall apart. With cash flow problems becoming critical, the Yugoslavs have now requested an SBA but it remains to be seen whether the government's political position is sufficiently strong to enable it to implement the required adjustment measures.

Hungary

42 Preliminary negotiations between Hungary and the IMF over an SDR 700 mn programme, either in the form of an EFF or a succession of SBAs, ran into difficulty over the pace of adjustment. The Fund are pressing to reduce the convertible currency current account deficit to $400 mn in 1988 while the Hungarians envisage $500 mn. A

compromise is likely and it remains feasible that an agreement can be reached in the early new year. Tax measures announced in September and due to be introduced in the new year will dampen import demand. A recent government reshuffle also provides encouraging signs of commitment to reform.

Romania

43 Some discontent with current austerity measures has been reported. Imports have been severely constrained and reserves are very low as a result of the rapid debt repayment policy. The Romanians are seeking a CFF from the Fund in order to help finance the pre-payment of more expensive IBRD debt, although it is uncertain that they will qualify. Ceausescu has recently reaffirmed Romania's commitment to service its hard currency debt following earlier reports that Romania would not service IBRD loans until more favourable terms had been negotiated.

Greece

44 Although the current account position has improved this year, the end-1987 target for inflation look likely to be missed. The fiscal position has deteriorated sharply. Despite this there are indications that policy will be further loosened next year in advance of a general election. However, judged by the terms of recent borrowing, market confidence appears to remain unaffected.

Turkey

45 Prime Minister Ozal won 292 of the 450 seats in Turkey's general election on 29 November. The timing of the election has led to a four month postponement of the budget, in which austerity measures to curb the deficit are expected to be announced; long-delayed public sector price increases have, however, been implemented. Ozal has denied any intention to reschedule Turkey's debt ($33.1 bn at end-June) and indicated that the policy of gradual depreciation of the lira will continue rather than a step devaluation.

SUB-SAHARAN AFRICA

Nigeria

46 In late November, the Nigerians and the Steering Committee of commercial banks finally signed the 1986/7 rescheduling and $320 mn new money agreement. The main focus of attention is currently on the negotiations for a new Fund programme, agreement on which will trigger the first tranche of the banks' new money.

Although the Nigerians have made impressive progress in several areas such as exchange rate reform, the authorities will be urged to do more. The previous SBA broke down in the face of considerable slippages in fiscal policy and greater than programmed foreign exchange expenditure. While the government are prepared to take some action on the petroleum subsidy and have announced a number of price rises, the Fund is concerned that the 1988 budget will nevertheless be more expansionary than this year's, and that the Nigerians apparently intend to limit their debt service ratio in 1988 to 30%. According to the Fund, this will be inadequate to service Nigeria's likely external commitments even after rescheduling. As regards filling the 1988 financing gap, the Fund and World Bank are hoping for generous rescheduling of principal and interest from the Paris Club together with $500 mn of new money from ECAs, and that the commercial banks will maintain their exposure through 1988. These assumptions appear optimistic given, among other things, Nigeria's poor record in 1987. Banks will probably want to reduce their exposure and the Paris Club will be unwilling to reschedule interest if the banks are, in effect, taking it out. Uninsured creditors have been offered harsh terms for the rescheduling of promissory notes. A meeting of noteholders will be held in London on 14 January.

Cote d'Ivoire

47 The weakness of coffee and cocoa prices continues to dictate Cote D'Ivoire's economic fortunes. It is estimated that the loss of export earnings in 1987 from these two commodities ammounted to one half of the total debt service due. After declaring a moratorium in May, the Ivorians had protracted negotiations with the IMF and World Bank over a new adjustment programme. The new SBA is, however, weak, providing for inadequate fiscal adjustment and offering no prospect of balance of payments viability. Substantial financing gaps are in prospect into the early 1990s. Nevertheless, following approval of the SBA, the Paris Club agreed a rescheduling with a consolidation period matching that of the SBA. (100% of principal and 95% of interest were rescheduled over 10 years with 6 years' grace.)

Kenya

48 Also a victim of sharp falls in the price of tropical beverages and of the recovery in the oil price, Kenya has seen its balance of payments position deteriorate sharply this year and the financing gap is likely to be filled by IMF borrowing. Kenya's vulnerability to swings in commodity prices has meant that it has been a frequent user of IMF resources. It has, nevertheless, an excellent record in adopting Fund policy prescriptions and meeting programme targets. Kenya has so

far avoided a rescheduling of its debt. Its relatively weak bargaining position means, however, that it has to pay a higher spread on its borrowing than, for example, the problem debtors of Latin America.

Malawi

49 The authorities have accepted the need for a Fund programme together with a Paris and London Club rescheduling. An SBA could come to the Board early in 1988 with a SAF and a fourth SAL late in the year.

Zambia

50 President Kaunda has now accepted that certain aspects of the Interim National Development Plan (INDP) are 'negotiable'. This, coupled with the appointment of a new Bank of Zambia Governor, may possibly indicate an interest in moving towards a rapprochement with the international financial community.

Sudan

51 Despite the new found willingness of the authorities to implement adjustment policies, the immediate economic prospects for Sudan remain grim. Export earnings (which do not appear to reflect higher cotton prices), workers' remittances and aid flows (from the Gulf States and EC) have all been lower than expected. As a result, the narrowly defined financing gap for the balance of payments - which allows only for the most essential debt servicing and excludes clearance of arrears, eg, to the IMF and Paris Club - has been increased to $207 mn from $150 mn for the financial year ending June 1988.

52 On the domestic front, the situation is much the same. Lack of foreign exchange has caused severe shortages of essential imported inputs and limited budgetary resources have resulted in cutbacks in public investment.

53 The IMF is due to return to Khartoum in January for the Article IV consultations when it is hoped to discuss policies for 1988 in the context of a draft 4-year economic plan which the Sudanese authorities hope will be available by then. Arrears to the Fund now total SDR 520 mn and it is by no means clear that the international donor community will provide funds on the scale necessary to enable this position to be regularised. If an arrangement can be agreed to finance the arrears, Sudan may be a candidate for ESAF funds.

54 In the meantime, a fairly successful mini consultative group meeting took place on 2 December. Firm offers of aid were received totalling $140 mn including the UK (£10 mn), USA ($65 mn) and Netherlands ($30 mn), and the financing gap is expected to be closed by further contributions from Germany, Japan and Saudi Arabia. UK support was particularly well received by the Sudanese delegation. The meeting was followed by inconclusive discussions with the London Club.

MIDDLE EAST & NORTH AFRICA

Egypt

55 An IMF review mission to Cairo in early November found the adjustment programme off track and the Egyptian authorities unwilling to specify corrective measures. Without further measures, the budget deficit for FY 87/88 is likely to be 16-17% of GDP, compared with a targeted 13%. The government is concerned that rapid adjustment will arouse political opposition and further depress the economy. But unless there is significant movement - on the budget and interest rates in particular - by the authorities, the Fund Staff will find it difficult to complete the first review when they return to Cairo in January. Previously soft US attitudes to the weak SBA have recently hardened and the UK will be keen to support any initiative to strengthen the programme.

56 The authorities are moving faster than expected in the crucial area of foreign exchange reform. However, even though the new 'free rate' has attracted $1.3 bn of foreign exchange in the first five months since May, there are signs that it is being held artificially high and a parallel market has re-emerged. And the problems imposed for foreign banks, including Lloyds, remain unresolved: many of those affected are reconsidering their continued presence in this market.

Morocco

57 Despite H1 1987 improvements on the external account - exports rose 6.3% while import growth was restricted to 2.6% - the effects of a poor harvest and lower levels of remittances are likely to lead to a deterioration in the second half of the year. At the same time, domestic inefficiencies and fiscal austerity have depressed growth expectations; real GDP is now projected to grow by only 1% this year, down from 3% originally projected. As a result, it now seems certain that Morocco will be unable to meet all of its end-1987 performance criteria under the IMF programme; and there are signs that the authorities intend next year to give higher priority to protecting

the lower paid, with adverse implications for the fiscal position. The rescheduling agreement with the commercial banks has reached critical mass and the deal will become effective on 4 January.

Algeria

58 Estimates of Algerian indebtedness have recently been revised sharply downwards although the true position remains uncertain. Nevertheless, the economy remains depressed as the authorities continue to restrain imports and government expenditure. The IBRD recently reported that GDP fell in 1986 and forecast only 2% growth until 1990, less than expected population growth of 3.2% pa. Externally, it appears that Algeria has met its financing requirements this year (estimated at around $5 bn). Debt service is officially projected to increase in 1988 to $5.5 bn, giving a financing requirement of some $4 bn; with banks still very cautious about Algerian risk, further generous credit terms will be required if increased payments delays or rescheduling are to be avoided. Algeria's Finance Minister recently floated a number of proposals (eg seeking untied credit, and extended terms even for "cash" goods) particularly to those countries (including the UK) with which the Algerians think they have a bilateral trade deficit. Some (including the US) have agreed to provide food aid on generous terms or, like West Germany, to increase purchases of gas. HMG have resisted the Algerians' demands and pointed out that if the Algerians deliberately exclude UK goods which are better or cheaper than those produced by competitors, then they will suffer more than the UK. HMG remains keen to promote UK/Algerian trading links - and there will be a first meeting of an Anglo/Algerian Joint Commission early next year.

OVERDUE FINANCIAL OBLIGATIONS TO THE FUND(1)

Country	Due Date of Earliest Arrears Outstanding	Total Outstanding as at 10.12.87 SDR (mn)	Forthcoming Obligations (to 1999)
Kampuchea	13 March 1975	30.8	14.1
Guyana	31 May 1983	67.3	43.0
Viet Nam	6 February 1984	82.3	46.8*
Sudan	12 July 1984	517.3	322.3*
Liberia	25 January 1985	171.0	133.5
Peru	9 September 1985	338.4	414.0*
Zambia	30 April 1986	291.5	585.2
Siera Leone	16 January 1987	21.5	68.3*
Somalia	2 July 1987	8.5	144.6
Uganda	17 August 1987	9.6	214.5*
		1,538.2	1,986.3

(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. A Fund source indicates that total arrears were SDR1,542 mn as at 12.11.87 but this figure is not broken down by country.

Guyana, Viet Nam, Sudan, Peru, Liberia and Zambia are ineligible. Kampuchea is out of contact with the Fund.

* To 1993 only.

0072u

CONFIDENTIAL

INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1987*	End-June 1987	End-March 1987 [2]	End-March 1987 [3]
Latin America				
Argentina	54	3.1(0.2)	0.2	0.2
Brazil	113	6.6(1.6)	1.0	1.9
Chile	19	1.2(0.1)	-	0.1
Colombia	15	0.5(0.1)	0.1	0.1
Costa Rica	4	0.1(-)	-	-
Ecuador	9	0.5(0.1)	0.1	0.1
Jamaica	3	- (-)	-	-
Mexico	104	6.3(0.6)	0.7	1.3
Peru	16	0.3(-)	0.1	0.2
Uruguay	4	0.3(-)	-	-
Venezuela	36	2.1(0.2)	-	-
Far East				
Indonesia	44	0.8(0.3)	0.9	1.8
Malaysia	20	1.1(0.3)	0.1	0.1
Philippines	29	1.4(0.1)	0.1	0.2
Eastern Europe (convertible currency)				
Bulgaria	5	0.3(-)	-	0.1
Hungary	18	0.3(-)	-	0.1
Poland	37	0.6(-)	1.3	1.4
Romania	5	0.2(-)	0.3	0.4
Yugoslavia	19	0.7(0.1)	0.7	0.9
Southern Europe				
Greece	20	1.3(0.2)	0.1	0.3
Turkey	33	0.5(0.2)	0.2	0.6

[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 33 countries amounted to $18 million at end-June 1987.

[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.

* Current estimate.

0072u

CONFIDENTIAL

INDEBTEDNESS AND BRITISH EXPOSURE $ billion

	Total external debt $bn	British-owned banks' exposure[1]	ECGD amounts at risk	
	End-Dec 1987*	End-June 1987	End-March 1987 [2]	End-March 1987 [3]
Sub-Saharan Africa				
Cote d'Ivoire	10	0.3(-)	0.1	0.1
Kenya	4	- (-)	0.2	0.5
Nigeria	26	1.3(0.1)	2.5	3.5
South Africa	21	3.7(0.5)	0.9	2.5
Sudan	11[6]	- (-)	0.2	0.2
Middle East and North Africa				
Algeria	27	0.4(0.1)	0.2	0.4
Egypt	47	0.3(0.2)	0.3	1.3
Iraq	55[4][6]	0.1(-)	0.6	1.6
Israel	31	0.4(0.1)	0.1	0.2
Morocco	20	0.2(-)	0.2	0.3
Oman	3[6]	0.1(0.1)	0.7	1.9
Saudi Arabia	14[5][7]	0.5(0.3)	0.2	0.3

[4] Includes $30 bn from Arab countries.
[5] Excludes unguaranteed non-bank claims.
[6] Total external debt at end-December 1986.
* Current estimate.
[7] Gross external debt to banks at end-December 1985.

CH/EXCHEQUER J30/12
REC. 30 DEC 1987
ACTION Mrs Case
COPIES TO CST, EST, Sir P Middleton, Sir G Littler, Mr Cassell, Mr Evans, Mrs Lomax, Mr Mountfield, Mr Allen, Mr Davis, Mr Halligan, Mr Lankester

BF 5/1

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

29 December 1987

Dear Alex,

INTERNATIONAL FINANCIAL SCENE

The Prime Minister has read the summary of developments in the international debt scene conveyed in Jonathan Taylor's letter of 24 December. She has commented that the IMF is being too weak, with the result that some debtor countries seem to have stopped trying. It follows that she agrees very much with the Chancellor on the costs where he proposes that we should take a firm line, for instance over Argentina and Egypt.

?

I am copying this letter to Robert Culshaw (Foreign and Commonwealth Office), Alison Brimelow (Department of Trade and Industry) and John Footman (Bank of England).

Yours sincerely,

Charles Powell

(C. D. POWELL)

Alex Allan, Esq.,
HM Treasury.

94/2/sm/3103/36

FROM: G SEGAL

DATE: 13 JANUARY 1988

I see no particular objection to this, but the time constraint is ridiculously tight.

RA. 13/1

1. MR ALLEN

2. CHANCELLOR

Ch/ Content for us to arrange draft answers?

OK

JF 13/1

cc
PS/Economic Secretary
PS/Sir P Middleton
Sir G Littler
Mr H P Evans
Mr Mountfield
Mrs Case
Mr Halligan
Mr Carpinter
Ms A Higgins
Mr Bush

O GLOBO: INTERNATIONAL DEBT

Mr Milton da Graca, London correspondent for the Brazilian daily, O Globo has submitted a list of questions to you (attached) on the subject of international debt. He wants to write up the answers as an interview in the newspaper.

2. O Globo is part of the Globo media conglomerate which is not only the largest in Brazil but also in South America. The newspaper has an average daily circulation of 280,000 and 550,000 for its Sunday edition. It is for the latter that Mr da Graca intends his article.

3. Although we have only just received these questions, Mr da Graca is hoping to publish his "interview" this Sunday. Assuming we comply with his request I imagine the earliest we could provide him with any answers would be next week.

G Segal

G SEGAL

260/1

THE UNITED STATES OF AMERICA HAVE JUST ENDORSED A NEW PLAN TO CHANGE MEXICAN DEBT FOR NEW US 10 BILLION LONG TERM BONDS, GUARANTEED BY US TREASURY. WOULD BRITAIN ALSO BE CONTEMPLATING A CHANGE OF POLICY, WHICH COULD INCLUDE OFFICIAL PARTICIPATION AND FINANCIAL INVOLVEMENT IN THE NEGOTIATIONS BETWEEN DEBTOR GOVERNMENTS AND PRIVATE CREDITOR BANKS?
DOES BRITAIN CONSIDER THE AMERICAN INITIATIVE AS A POSITIVE STEP TOWARDS A GLOBAL SOLUTION FOR THE THIRD WORLD DEBT PROBLEM?

BRITISH REVENUE AUTHORITIES HAVE AGREED TO GIVE TAX RELIEF TO ~~IN~~SPECIFIC PROVISIONS ESTABLISHED BY PRIVATE BANKS FOR DOUBTFUL LOANS TO THIRD WORLD COUNTRIES. THIS HELPS THE BANKS BUT DOES NOT IMPROVE THE AVAILABILITY OF RESOURCES FOR DEBTOR COUNTRIES. WITHOUT ACCESS TO THE PRIVATE INTERNATIONAL CREDIT MARKET, WHAT, IN YOUR VIEW, SHOULD BE DONE BY THIRD WORLD COUNTRIES TO OPEN NEW CHANNELS OF FINANCING FOR DEVELOPMENT PROJECTS?

PRIVATE BANKS SEE THE CHANGE OF DEBT FOR EQUITY AS A VERY SMALL HELP NOT A SOLUTION, ESPECIALLY FOR THE BIG DEBTORS - BRAZIL, MEXICO AND ARGENTINA. DO YOU AGREE WITH THAT POINT OF VIEW?

THERE ARE MANY FORECASTS THAT THE ECONOMIC GROWTH WILL SLOW DOWN IN ALMOST ALL 24 OECD COUNTRIES. IF THEY ARE CONFIRMED BY REALITY, WHAT DO YOU THINK SHOULD BE DONE TO AVOID A FALL IN DEBTOR COUNTRIES' EXPORTS AND A 'PAYMENT CRISIS'?

MILTON C. DA GRACA
O GLOBO
31 FOLEY STREET - 4TH FLOOR
PHONE: 580-7456
TELEX: 27193

9
End of message

FROM: VIVIEN LIFE
DATE: 20 JANUARY 1988

CHANCELLOR

cc: PS/EST
Sir P Middleton
Sir G Littler
Mr Evans
Mr Mountfield
Mrs Lomax
Mr R I G Allen
Mrs Case
Mr Matthews
Mr Walsh
Mr Halligan
Mr Dolphin
Mr Stern
Miss Higgins
Mr Bush
Mr Segal

Answers 1, 3 & 4 OK [illegible]

Content with draft replies?
29/1

O GLOBO: INTERNATIONAL DEBT

1. You agreed to answer in writing a number of questions submitted by the Brazilian daily, "O Globo", to be published as an interview, and asked for draft answers to be prepared.

2. I attach the list of questions, together with suggested draft replies. These have been cleared with the Foreign Office, who see no problem with the "interview " going ahead. I understand from Mr Segal that the article will cover only your answers, and will not involve other industrialised country finance ministers.

3. If you were able to clear the answers during the course of tomorrow, Thursday, then it will be possible for the article to appear in this coming Sunday's edition of "O Globo". Otherwise, it could wait another week, but the correspondent is concerned that it may be a little out of date by then.

Vivien Life

VIVIEN LIFE

1 THE UNITED STATES OF AMERICA HAVE JUST ENDORSED A NEW PLAN TO CHANGE MEXICAN DEBT FOR NEW US 10 BILLION LONG TERM BONDS, GUARANTEED BY US TREASURY. WOULD BRITAIN ALSO BE CONTEMPLATING A CHANGE OF POLICY, WHICH COULD INCLUDE OFFICIAL PARTICIPATION AND FINANCIAL INVOLVEMENT IN THE NEGOTIATIONS BETWEEN DEBTOR GOVERNMENTS AND PRIVATE CREDITOR BANKS?
DOES BRITAIN CONSIDER THE AMERICAN INITIATIVE AS A POSITIVE STEP TOWARDS A GLOBAL SOLUTION FOR THE THIRD WORLD DEBT PROBLEM?

2 BRITISH REVENUE AUTHORITIES HAVE AGREED TO GIVE TAX RELIEF TO ~~IN~~ SPECIFIC PROVISIONS ESTABLISHED BY PRIVATE BANKS FOR DOUBTFUL LOANS TO THIRD WORLD COUNTRIES. THIS HELPS THE BANKS BUT DOES NOT IMPROVE THE AVAILABILITY OF RESOURCES FOR DEBTOR COUNTRIES. WITHOUT ACCESS TO THE PRIVATE INTERNATIONAL CREDIT MARKET, WHAT, IN YOUR VIEW, SHOULD BE DONE BY THIRD WORLD COUNTRIES TO OPEN NEW CHANNELS OF FINANCING FOR DEVELOPMENT PROJECTS?

3 PRIVATE BANKS SEE THE CHANGE OF DEBT FOR EQUITY AS A VERY SMALL HELP NOT A SOLUTION, ESPECIALLY FOR THE BIG DEBTORS - BRAZIL, MEXICO AND ARGENTINA. DO YOU AGREE WITH THAT POINT OF VIEW?

4 THERE ARE MANY FORECASTS THAT THE ECONOMIC GROWTH WILL SLOW DOWN IN ALMOST ALL 24 OECD COUNTRIES. IF THEY ARE CONFIRMED BY REALITY, WHAT DO YOU THINK SHOULD BE DONE TO AVOID A FALL IN DEBTOR COUNTRIES' EXPORTS AND A 'PAYMENT CRISIS'?

MILTON C. DA GRACA
O GLOBO
31 FOLEY STREET - 4TH FLOOR
PHONE: 580-7456
TELEX: 27193

9
End of message

O GLOBO: DRAFT ANSWERS TO QUESTIONS

1. Mexico

I? ~~We~~ regard the proposal put forward by Mexico to the commercial banks to exchange their debt for bonds at a discount as an imaginative extension of the market-based menu approach to commercial bank debt. But whether the banks wish to participate in such a scheme is a matter for their commercial judgement.

stet

The scheme is possible in the particular case of Mexico not only because ~~their~~ its reserves are high but also because ~~they have~~ it has a good record on economic ~~reform~~ reform. This has clearly increased the willingness of the US administration and the World Bank to facilitate the scheme.

Whether or not the scheme provides a model for more general application for other debtor countries remains to be seen. This will be again a matter for these countries and the commercial banks to decide. ~~in the first instance. Should they agree that a scheme along the Mexican lines would be appropriate then the UK would not stand in the way, but nor would we try to influence the banks to agree.~~

What a signal!!

2. Tax relief for provisioning / Private investment

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The UK tax law in respect of bad debts is the same for banks as for other companies; relief is available only on losses or provisions against losses which our tax rules deem irrecoverable. No changes in UK tax laws have been made in recent years on account of loans to third world countries.

In no sense 'help to the banks'

Last year I welcomed the increase in provisioning by the commercial banks. Not only is this a proper commercial recognition of reality, but it is consistent with a more market oriented approach to managing their holdings of the debt of middle income countries, and facilitates arrangements which may be agreed between the banks and the debtors, such as the Mexico debt bond swap.

There is in my view great potential for larger private investment flows from the industrialised countries to the developing world. The lessons of the 1970s should be clear: direct and portfolio investment should play a bigger role and floating rate bank finance a smaller role in private investment.

The economic potential of many countries in Latin America is enormous; the returns to new investment can be very large; and the foreign investor with his technical and financial assets can make a major contribution to economic development.

International financial institutions have a role to play here; the innovative approaches of the IFC and the Multilateral Investment Guarantee Agency (which I hope to see up and running soon) will help to encourage new investors into developing countries.

The UK's private direct investment in developing countries is second only to the United States. But investors - either foreign or domestic - will only flourish if the developing countries put in place appropriate policies: opening up their economies to more inward investment and pursuing sound fiscal and monetary policies that will encourage investors. This often means taking on and sticking to strong programmes for structural adjustment. Mexico is one illustration of a country which by adopting such an approach has succeeded in stemming and then reversing capital flight.

As well as private sources, developing countries can look to increased lending from the World Bank to finance development. The UK supports an early and substantial General Capital Increase for the IBRD which will enable it to expand its lending, in particular in support of structural adjustment. The UK has always given strong support to the Inter American Development Bank and we are willing to play our part in a 7th replenishment as soon as current difficulties can be resolved.

3. Debt/ Equity Swaps

I welcome

Debt equity swaps which have a useful role to play in reducing the overall burden of debt and replacing it with investment where the risks are shared between the investor and the debtor country.

~~There are however a number of constraints. There is a limit on the rate at which equity investment opportunities in debtor countries can be developed. The debtor country has to find the local currency for redemption of the debt and this is limited because of inflationary risks.~~

I would therefore like to see

~~There is scope to increase the scale of debt equity swap transactions:~~ debtor countries ~~could lift~~ lifting some of the restrictions they are placing on the type of investment allowed and on the repatriation of dividends. This would in turn increase the number of investors. The commercial banks ~~may~~ would also then be likely be more willing to sell their debt on the secondary market.

There is no single panacea for debt problems, only a variety of solutions and each country must select those that fit its own circumstances. On their own, debt equity swaps will not transform the debt problems of any country, but in conjunction with other developments can play a useful role as several countries have already found.

4. Growth

All the signs are that economic activity in The OECD countries grew strongly in the second half of 1987 and I expect this strength to be maintained into 1988. Developing countries will be benefiting from this ~~surge in activity~~ both through increased export volumes and because stronger activity has been associated with increases in commodity prices. (The Economist index, measured in SDRs, is 23 per cent up over the last year).

Governments in The OECD countries are committed to policies aimed at sustained non-inflationary growth, reducing ~~existing~~ major current account imbalances and maintaining open markets. As a result of these policies the OECD economy as a whole is beginning its sixth year of growth. Developing countries, including the debtors, have benefited, and will continue to benefit, from this growth. There has also been a rapid growth in imports to OECD countries, averaging over 7% per year since 1983~~, and 6½% growth in imports into the UK economy~~.

But to improve their performance over the next few years developing countries must continue to adopt sound fiscal, monetary and structural policies aimed at improving the efficiency of their economies. This will enable them to make best use of their human and natural resources so as to increase both exports and the living standards of their ~~populations~~ people while servicing their debts.

INTERNATIONAL DEBT: MIDDLE INCOME DEBTORS

CON

hpe22/14.3

FROM: HUW EVANS
DATE: 23 MARCH 1988

CHANCELLOR

cc Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Littler
Mr Lankester
Mr Mountfield
Mr R Allen
Mr Walsh
Mr Matthews
Mr Hudson
Mr Allan
Ms Life
Mr Stern
Mr Cropper
Mr Tyrie

INTERNATIONAL DEBT: MIDDLE INCOME DEBTORS

We have reviewed the debt strategy in the light of recent developments. This minute and the attached paper, which reflect discussions with Mr Lankester and others, present the results which we would like to discuss at your meeting on 25 March. (We will prepare the usual letter to No 10, covering the Bank of England paper on debt, after your meeting.)

Policy

2. A year ago, in your speech to the Interim Committee, you set out the following line:

(i) the 1982 strategy achieved its immediate objectives, but debt problems of many countries had nonetheless worsened;

(ii) for middle-income debtors, the IMF and World Bank should continue to provide loans where appropriate, but with stronger conditionality; in the debtors' relations with private creditors, more use should be made of market mechanisms, and of direct investment;

(iii) for the poorest, most debt-distressed, countries in Africa, debt relief by creditor governments was needed, in the form of below market interest rates on official debt.

3. This approach was developed further in the July APGOOD speech, with its clear rejection of any bail-out of the banks, and welcome for the higher provisions by banks.

Recent developments

4. Over the last year, there have been important developments, including a lot of progress (via the ESAF) for the poorest countries. The perception that most debtors had moved further away from creditworthiness became widespread, among creditors and debtors and was reflected in the banks' unwillingness to lend and in their provisioning, as well as in the falls in prices on the secondary markets.

5. We have seen an increasing use of market mechanisms in the relationships between banks and debtors: greater use of secondary markets, the Bolivian buy-back and the Mexican exchange schemes, and an expansion of items on the menu.

6. 1987 was a year in which the banks recognised the riskiness of their loans by strengthening their financial position. The debtors showed mixed progress: Brazil imposing and then abandoning its moratorium; some notably weak IMF programmes (cf Egypt); and some recovery in commodity prices (including oil) and continued growth in the world economy enabling many countries to reduce a little the burden of debt.

7. The attached paper reviews in some detail recent developments among both creditors and debtors, setting the indicators for 1987 in a longer term context. Two points in particular are worth noting:

(i) the increasing share of exposure to middle income debtors being borne by governments and the World Bank.

(ii) The continuing concern of the United States (much more than of other creditors) over the major debtors in Latin America: political and trade ties are much closer, while the decline in the dollar has further reduced most other creditors' risks, leaving many big US banks more vulnerable than their competitors.

Prospects

8. Compared with recent years, the prospects facing debtors are less favourable. But with continued growth in the world economy, and some recovery last year in commodity prices, the problem debtors should be capable of muddling through and sustaining a slow rise in living standards, while continuing to service - albeit probably erratically - a good part of their debts.

9. Debts are not likely to be serviced in full. But overall, and taking into account the stronger position of the banks, there will probably be enough debt serviced to avoid a major threat to the banking system. The Brazil moratorium and the renewed attempt to reestablish relations with the creditors - even though an IMF programme is still to be agreed - suggest that negotiated solutions are still the most likely. My own view is that sooner or later negotiated agreements between banks and debtors will incorporate explicit elements of debt relief (also known these days as compression, reduction, or defeasance!). But the banks are in no hurry to go down this route - they have little to gain because this move will not by itself improve the quality of their remaining assets or new lending, and something to lose because they are giving up a legal claim. Whether or not the menu approach gives a major role to debt relief, it is not for governments or the IFIs to put pressure on the banks to grant either debt forgiveness or new money. You will want to look at the proposed line (agreed with the Bank of England) on commercial banks: paragraphs (42-48) of the summary and conclusions. We make a recommendation at paragraph 46 that could make a modest contribution to improving the quality of their new lending.

Line for the Spring Meetings

10. The basic message is that we got it right a year ago: the situation in Sub-Saharan Africa is different in kind from that of the middle income debtors. Developments since then have confirmed those judgments. We should now press on with the Paris Club initiative for Sub-Saharan Africa. Elsewhere we should support

market mechanisms to allow the banks to manage this debt and provide the right economic environment: reduction of tensions in the world economy; and sustainable, low inflation growth; freer trade, especially in agriculture, via GATT; and support for development and adjustment through bilateral aid and the IMF and the World Bank. This does not amount to a hands-off approach: we are making a large contribution through the IMF, World Bank and the Paris Club. We should press for better co-ordination between the IMF and World Bank (paragraph 41).

11. The United States, more concerned about the middle income debtors because of the heavy involvement of US banks, is more ready to use extra Fund resources for these countries. Camdessus, who is concerned (as the amount of Fund credit outstanding falls) that the Fund should play an active role in resolving debt problems, is inclined to do likewise. Unless the Fund can achieve better programmes, both should be resisted. So too should suggestions that we or the IMF lean on the banks to grant debt relief, or that we join in one of the still proliferating proposals for global debt facilities.

HPE

H P EVANS

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INTERNATIONAL DEBT: MIDDLE INCOME COUNTRIES

SUMMARY AND CONCLUSIONS

PRESENT POSITION AND RECENT DEVELOPMENTS

1. The world economic background, since the onset of the debt crisis in 1982, has been characterised by a strong growth in output (3½ per cent a year for the main industrial countries) and a halving in nominal interest rates. The main factors unfavourable to debtors have been falling commodity prices and the continuation of strongly positive real interest rates. A rapid growth (7 per cent a year) in imports into the main industrial countries has occurred despite a continued slow growth in protectionism. Whether this has benefited an individual debtor has depended crucially on the composition of its exports. Raw material exporters have fared worst.

2. Major debtors tend to fall into four major political categories. The first includes Mexico, Chile, Venezuela, Uruguay and Colombia, which have relatively stable governments and are characterised by relatively good recent economic management. The second category includes countries which are politically volatile, which tend to externalise the blame for their debt problems, and which apply reform programmes only intermittently - with erratic implications for debt service. These countries include Brazil, Argentina, Ecuador, Nigeria, Bolivia, Morocco and the Philippines. A third category have stable governments but do not have a good record of adjustment, including (most notably) Egypt, Poland and Yugoslavia. In a fourth category of its own is Peru, which is already in default and likely to stay there. Of all the countries, Nigeria is the one in which UK political and economic influence is strongest. Consequently we have a special responsibility for the application of conditionality there.

3. Against this background, the tests of the debt strategy are whether, and if so how far, (i) debtors have moved closer to creditworthiness and (ii) creditors have strengthened their position and reduced systemic risk.

Debtors

4. Since 1982, most of the Baker 15 debtors have:

(i) put in place reform programmes;

(ii) reduced domestic spending (consumption and especially investment);

(iii) increased (non-oil) exports; and so

(iv) reduced trade deficits, frequently converted trade deficits into trade surpluses, as the external inflow of capital dried up. Between 1979 and 1987 the improvement in the trade balance at constant prices has been 8 per cent of GDP.

(v) reduced capital flight.

5. These varied efforts and achievements provide evidence of the progress that has been made: by comparison with the unsustainable pre-1982 trends much has been achieved. But by comparison with the adjustment effort needed, not enough has been done: debt burdens in relation to ability to repay, for almost all debtors, are much greater than in 1982. For example the ratio of external debt to exports for Baker 15 countries has increased from 268 per cent to 329 per cent.

6. So since 1982 most debtors have moved further away from regaining creditworthiness. This is reflected in the unwillingness of banks to put up new money, in their recognition through higher provisioning of the scale of risks, and in the halving - to an average level of some 45 per cent - in prices in secondary markets. It would be wrong to dismiss altogether the significance of discounts in secondary markets. Investors or debtor governments who believe that the prospects for debtor economies and for debt servicing are substantially better than

indicated in the secondary markets are able to buy debt in those markets. But with very few exceptions, there is little demand.

7. The deterioration is also widely recognised by the debtors, often said to be suffering from "adjustment fatigue" - for example the weak IMF programmes agreed for Argentina and Ivory Coast, and the increasing difficulties in constructing adjustment programmes with full debt servicing (e.g Nigeria and Egypt).

8. Although the deterioration in the position of most problem debtors since 1982 is clear, the change over the last year is not clear cut: there are signs of modest improvements in some areas.

9. Two middle income debtors - Peru and Brazil - imposed unilateral moratoria. There are growing, but still fairly modest, arrears to the IMF and World Bank. **But the majority of debtors have continued to pay interest in full to IFIs and commercial banks.** ECAs, less able to refinance old loans, have often had to reschedule interest as well as capital.

?

10. Overall, the middle income debtors are a small and shrinking part of the world economy, taking about 4 per cent of OECD exports (3 per cent for the UK, 13 per cent for the United States), the fall reflecting mainly import compression. Of course their potential as markets is greater than this, but higher exports to the debtors are only beneficial to the UK if exports are paid for.

Creditors

11. Developments affecting the **creditors** can be summed up as follows:

(i) The big decline in the dollar since 1985 has meant that, for the major countries outside the United States, there has been a big shrinkage in the real size of the debt problem - a very different perception from that of United States creditors.

(ii) Total creditor exposure to problem debtors has been rising much more slowly in recent years.

(iii) Within total exposure to the Baker 15, that of commercial banks has declined from 72 per cent to 60 per cent between 1982 and 1987; that of official creditors and IFIs has risen from 22 per cent to 29 per cent. Net lending from commercial banks is now negative not including the build-up of interest arrears.

(iv) Commercial banks have strengthened their capital bases, provisioned, cut back sharply on lending to LDCs, and expanded their business elsewhere to a point where systemic risks have been much reduced, especially for banks outside the United States. Nevertheless, default by the three largest debtors (Brazil, Mexico and Argentina) would cause significant problems for the international financial system and the US banks in particular.

(ECGD v. weak)

(v) Export credit agencies - supported by their taxpayers - have in general provisioned hardly at all, despite their rise in exposure and their falling chances of being fully repaid.

(vi) The IMF does not need to provision because of its enormous gold holdings. The World Bank has a very large capital base and provides against its long term arrears which are very small.

(vii) Private direct investment, which fell sharply after 1982, is now showing limited signs of recovery.

12. Thus the private banks have so far achieved their aim of strengthening their financial position. Public sector creditors are backed heavily by solvent OECD countries. The debtors, on the other hand, despite substantial and sometimes painful policy measures and in most cases full payment of interest, are very little if at all closer to creditworthiness than a year ago and further away than in 1982.

Prospects

13. Middle income debtors are looking for substantially increased capital inflows in order to increase the growth of imports, investment and consumption (and hence to finance interest payments more easily). The World Bank has suggested net financing of $16 billion a year over the next five years, 50 per cent more than over the past three years.

14. Inflows on this scale are very unlikely, with no early revival in prospect of private sector - banking or other - credit flows. Some extra lending is however likely from the World Bank and export credit agencies.

15. In the absence of any substantial revival of private flows, the middle-income debtors may continue, much as in the last year or two, to muddle along, maintaining something like the present degree of adjustment, enough to service most but not all their debt. Oil producers will have particular problems. The gap may be filled by ad hoc arrears build-ups, or possibly for some countries by negotiated agreements with banks that result in lower servicing.

16. On this basis, and with the world economy growing a little more slowly than in recent years, standards of living in debtor countries should be capable of rising slowly over the next few years, after the fall since 1982. This conclusion stems mainly from the assumption that little more adjustment is likely and that commodity prices are broadly maintained in real terms.

17. The IMF staff have recently examined the possible consequences of higher private financing. Their analysis is based on the unrealistic assumption that all of the extra funds would be used to raise profitable investment. While this would raise output in the debtor economies as the investment came to fruition, it would not raise consumption levels for some years and there would be an initial increase in debt and debt service. If on the other hand the extra financing were used for extra

consumption, then the result would be to worsen the debt problem, and the longer term prospects for growth. So, except possibly in the short run, extra finance is not a soft option - even politically.

18. Another possibility is that the political process in the debtors, disappointed at the lack of their progress towards creditworthiness despite sizeable adjustment efforts, will lead to a reduced effort to service debt in the belief that this will lead to less austerity. The consequences could include capital flight, even less new money, and loss of (and higher interest rates on) trade cover from banks and ECAs. The example of Brazil in 1987 points to the advantages to debtors of reaching agreement with banks.

19. A concerted, worldwide, refusal by debtors to pay any interest on debt continues to look unlikely. A partial, temporary, inability or unwillingness to pay, which does seem likely to continue, would probably not have major effects on the world economy or even on the world banking system:

(i) Middle-income debtors are dwindling in importance as world export markets, only taking about 4 per cent of all OECD exports.

(ii) Commercial banks, even in the USA, are now much stronger.

(iii) The direct trade implications are small. But debt problems could sour relations between LDCs and developed countries and this could have implications for the Uruguay round.

CONCLUSIONS ON STRATEGY

20. Developments over the past year confirm that the UK was correct (i) to distinguish in its policies between poor debt-distressed SSA countries and middle income debtors and (ii) to

call for greater use of market mechanisms in resolving debt problems of middle income debtors.

21. The Chancellor's initiative, the ESAF and the World Bank's Special Programme of concessional assistance represent recognition that SSA's urgent needs are beyond the scope of self-help. Differential treatment in favour of SSA should therefore continue, including pressing our initiative on interest rates in the Paris Club.

22. Net lending to problem debtors has almost dried up and incentives to adjust as perceived by debtors have been much reduced. But steps to increase the flow of such lending would not by themselves ensure progress by the debtors. A large extension of IMF credit could only be justified if there were a prospect of achieving stronger conditionality and more effective reform programmes.

23. There is scope for an increase in private direct investment: this would require much more encouragement from debtors, and could be helped by the efforts of the IFIs.

24. Perhaps the key question is whether we can see scope for implementing strong conditionality in return for extra inducements. If we reject, as we should, any bail out of the banks, then governments' support rests with the provision of finance by the IFIs - and there is a substantial element of risk in that support, given the lack of creditworthiness of the debtors. We should continue to welcome moves by the banks to provision appropriately, write down LDC debts on their books to more realistic levels, and come to voluntary agreements with debtors including debt relief.

25. The World Bank is already taking too high a proportion of total lending to the middle income debtors into its portfolio. It is tending to depend on its almost unique role as a provider of net new money more than on its policy success in order to impose

repayment discipline. The Bank should continue to use policy loans to encourage structural adjustment and to liberalise restrictive rules on inward direct investment.

26. Because both medium term macroeconomic and structural adjustment are required for debtors, the IMF and World Bank must adapt their procedures so as to co-operate much more closely. The Bank is increasing and the Fund reducing its exposure to the debtor countries. The role of each institution is intended to be complementary to the other.

27. The commercial banks have increased their provisioning and will probably continue to do so. They are unlikely to wish to do more new voluntary lending for some time. There is no case for asking them to lend more against their commercial judgement. There are still legitimate worries about the health of the US banking system in particular, and the acquisition of more dubious LDC assets by commercial banks would not be desirable. But there may be scope for achieving more senior status for new bank lending over old debt.

28. Provisioning is the first stage of a process that could lead to a partial write off (debt forgiveness) of debtors' liabilities. Voluntary agreements which involve elements of debt relief may be negotiated between banks and debtor. The effect on the creditworthiness will depend on the policies pursued by their country: it can be positive if old debt is cleared out of the way and new serviced fully. Widespread debt forgiveness by banks to give the debtor the full benefit of secondary market discount is unlikely, since from the point of the individual bank there is in general no advantage in giving up a legal claim on a debtor. But both the US and we have already supported the Mexico exchange deal, which is leading to a moderate amount of debt compression.

29. Now that provisions have been made by banks, granting debt forgiveness is a strategy that may prove attractive to them in the context of packages based on IMF programmes as an alternative to providing new money. It is less risky because it results in less,

rather than more, exposure to problem debtors and no new provisioning is required as it is with new lending. Debt compression could be credited to the banks as their voluntary contribution to these packages. In any case there will be a tendency for the lead banks to put pressure on smaller banks either to provide new money or to exit with a degree of writedown. In the latter case this will lead to some debt compression.

30. There are a few countries outside Africa - eg Bolivia - where debt is impossibly high in relation to capacity to repay but where the banks' exposure is still very small in their total exposure to LDCs. In such cases, even where we cannot contribute ourselves we should not oppose "consensual" solutions under which, for instance, bilateral donors provide funds to enable the Bolivians to buy back their debt from the banks.

31. Debt/equity swaps would remain as a non-concerted and highly desirable form of fixed debt compression.

32. This is very far from being a "hands-off" attitude by the industrial countries to the middle-income debtors. On the contrary there are very positive elements: support for the IFIs, support for freer trade via GATT, and the continued efforts via G7 co-operation and surveillance to strengthen the world economy and sustain faster growth.

CONCLUSION ON UK POLICIES

IMF

33. At the IMF, the UK should continue to judge each case on its merits, on the basis that strong reforms merit strong financial support. We should continue to look for ways of achieving more conditionality in return for more finance. But the UK should encourage increased use of the EFF - or other facilities - only in support of sound programmes. A massive injection of funds without adjustment would be in the longer-term interests neither of the debtors nor of the Fund.

34. We should support contingencies mechanisms to help prevent programmes from going off track for reasons beyond the control of the country concerned.

35. We should continue with the higher profile adopted on conditionality in 1987 and concert our position with other G10/EC, against bad programmes that do not lead to fiscal or balance of payments viability. From a debt strategy standpoint, favouritism to "client" countries such as Nigeria would be in the interests neither of these countries nor of our own credibility and should be rejected.

36. We should pursue proposals to align export credit cover policy within OECD more closely with IMF conditionality.

37. We should oppose in the IMF Board moves to use Article VIII, which can prevent the legal enforcement of loan service, to put pressure on banks to contribute to new money packages.

World Bank and MDBs

38. At the World Bank, we should contribute to the GCI as soon as possible to relieve lending headroom problems and argue against proposals likely to endanger the Bank's AAA status in world capital markets. But we should be willing to consider an increase in the World Bank's co-financing with the private banks, and the extension of its ban on lending to countries in arrears to arrears on commercial banks' co-financing loans.

39. We should encourage the further development of structural conditionality at the World Bank, and continue to associate our programme aid with this.

40. We should continue to encourage a resolution of the problems at the IADB to provide - through the replenishment now under discussion - some greater scope for lending within its area and to take some of the burden off the World Bank.

41. We should encourage a clearer demarcation of roles between the IMF and the World Bank. Both are seeking to expand their roles in the debt strategy. Current mechanisms for co-ordination between the two do not seem to be adequate since there have been

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cases of conflicting advice being given to individual countries. To increase co-operation between the IMF and World Bank, we should propose more staff exchanges, joint missions and ask the Fund and Bank to consider how the PFP process, now used for SAF-eligible countries only, could be extended to the middle income debtors. We should also seek to avoid any attempt at delinkage of World Bank structural/sectoral programmes from IMF ones.

42. We should take a close interest in the World Bank Review of Private Sector Development so as to encourage the Bank group to give effective support to the private sector, and in particular, private direct investment. We should also continue to give full support to IFC and MIGA.

Commercial Banks

43. We should continue to take the line that management of commercial bank debt is a matter for voluntary negotiation between the banks and the debtors, while continuing to encourage the menu approach. We may have to take a view at some stage on the degree to which concerted finance should be allowed to be detached from IMF conditionality.

44. We can recognise - and might wish to say - that debt compression is a likely outcome to negotiated agreement between banks and debtors. We should welcome voluntary agreements between banks and debtors, including any which provide debt relief, after they have been agreed. But creditor governments and the IFIs will not want to give comfort to the debtors by taking a high profile in encouraging write-offs by banks: not only is the extent and timing of such write-offs very uncertain, but it would be inconsistent with our hands-off approach to commercial banks.

45. As well as continuing to support debt-equity swaps, we should more positively support other forms of debt compression (eg buy-backs) in suitable cases, and agree to credit such compression to the banks as a contribution to IMF packages.

46. We should propose that the World Bank management should study the possibility of associating more commercial bank co-financing with its programmes in order to improve the quality of such new lending, and ask for the IMF to investigate other ways of achieving senior status for new bank lending.

47. We should encourage in general terms further strengthening of the banks' finances. Provisioning should continue to be encouraged especially where there is a need shown by the Bank of England matrix, and it should continue to be offsettable against tax according to the existing rules. The matrix should be kept under review to ensure that it takes adequate account of the changing value of loan assets.

48. The UK tax treatment of banks is about right. It would be a major departure from basic tax principles to attempt to withhold eligibility for tax relief in order to put pressure on banks, eg to grant debt forgiveness.

cst.rj/docs/2.11.3

RESTRICTED

FROM: A G TYRIE

DATE: 2 November 1988

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Turnbull
Mr Odling-Smee
Mr Peretz
Mr Gieve
Mr Hudson
Mrs Chaplin
Mr Call

CHANCELLOR

Cathy: worth saying something like this in debate on the address. N

SELLING THE VIRTUES OF DEBT REPAYMENT

One point made quite forcibly by the troops at the Backbench Finance Committee meeting was the need to sell the benefits of debt repayment in a way that a wider public can understand.

2. Some possible points we could make are:

- The saving in interest payments of £2¼ billion resulting from debt repayment over the Survey period is equivalent to x hospitals, y roads etc.

- One pound paid now is a pound our children won't have to find.

- We are paying off the debts of past Labour governments. Under Conservative governments the burden of debt servicing (interest payments/GDP ratio) goes down. Under Labour governments, who borrow as if there were no tomorrow, it goes up. [True?]

- We are the only major country whose finances are strong enough to be able to repay debt. [True?]

3. A good slot for this stuff might be the Debate on the Address. We would need to follow it up with press briefing,

particularly for the tabloids, and also, possibly a couple of paragraphs in a Members' Brief.

4. Do copy recipients have any further suggestions on points to make?

pp RJ.
A G TYRIE

est.ld/westhead/062

RESTRICTED

ECONOMIC SECRETARY TO THE TREASURY

FROM: G R WESTHEAD
DATE: 7 November 1988

PS/CHANCELLOR

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Mr Turnbull
Mr Odling-Smee
Mr Peretz
Mr Gieve
Mr Hudson
Mrs Chaplin
Mr Call
Mr Tyrie

Andrew
Lay on talks for
rather long – not worth
publicity in now?

SELLING THE VIRTUES OF DEBT REPAYMENT

The Economic Secretary has seen Mr Tyrie's minute of 2 November to the Chancellor on the above.

2. He thinks that one additional point to make is that our total debt interest bill every year (£17 billion plus) is of the same order of magnitude as a huge department like Education, and not far short of the NHS.

C.

A more positive way of putting this is that this is the first year since [whenever) that we've been able to spend more on education than we've needed to spend on debt interest, and that until [2] years ago ~~we~~ more went on debt interest than the NHS, etc. I'll get GEP to check these rankings.

AH

9.11

Guy Westhead.

GUY WESTHEAD
ASSISTANT PRIVATE SECRETARY