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Econ PM 2
Prime Minister
Mr Coles - to see
Nov 29/11
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24/11

Treasury Chambers, Parliament Street, SW1P 3AG
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Michael Scholar Esq
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26 November 1982

New Michael,

INTERNATIONAL FINANCIAL SCENE

The Bank of England recently prepared the attached further stock-taking note on developments in international banking and debt problems.

2. Events move fast in this field, and I have been asked to add the following supplementary points:-

- i. relating primarily to Mexico, but with obvious wider implications, the IMF Managing Director recently had a meeting with representative commercial banks, at which he was able to explain the IMF attitude and intentions towards Mexico, emphasising the strength of the proposed adjustment programme, but emphasising also the need for commercial banks to play their part in maintaining some flow of credit;
- ii. Brazil is now in very urgent short-term difficulty, and the authorities are engaged on a major operation to mount a short-term flow of credit to meet debts immediately due. There is a prospect of some early help from the IMF under the Compensatory Financing Facility, but the bulk of the money will have to come from those banks already heavily engaged in Brazil;
- iii. at US Government initiative, there is to be a meeting of Government Representatives of the US, UK, France and Germany in Paris on 2 December to consider what line should best be taken in response to the deep-rooted Yugoslav problem.

3. I am copying this letter and enclosure to Brian Fall (FCO) and to Tim Allen at the Bank of England.

Yours ever,
J O Kerr
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THE INTERNATIONAL FINANCIAL SCENE

Conditions in the international money markets have eased somewhat since September. Falling interest rates and official action in managing the crisis have encouraged most banks to be patient and responsible in their market behaviour. Recent announcements that the IMF management has reached agreement in principle with Mexico and Argentina on stabilisation programmes have been helpful to sentiment. But banks remain anxious about their exposure to problem countries, and many small ones are looking for opportunities to reduce it, so that the situation in the banking markets has not yet stabilised fully.

Mexico remains the chief worry for the markets. The immediate liquidity position of the Mexican banks in London and New York has improved. The activities of the Advisory Group (of thirteen major banks co-ordinating the approach of the very many banks with claims on Mexico), the Bank of England and the Federal Reserve Bank, together with the funds provided by the joint BIS/US facility, have played a crucial part in bringing this about. Nevertheless the Mexican banks' overseas offices continue to lose liquidity from withdrawals of some interbank deposits, the attitude of small and regional US banks being of particular concern in this respect. At the same time, although the Mexicans are keeping interest payments on their public sector debt current (having proposed with the support of the Advisory Group a four months' extension from 23 November of the moratorium on repayments of the principal), there is a continued build-up of interest arrears (now amounting to some \$750 mn) on private sector debt which is creating difficulties for the banks. Beyond this the banks have become more acutely aware of the amounts of new lending being sought from them next year even on favourable assumptions about the rescheduling or roll-over of existing debt. Thus there are still serious problems for them in consolidating the improvement recorded in recent weeks. However, the agreement in principle between the IMF and Mexico is a positive development which - as well as triggering the release of the remainder of the BIS/US joint facility - should offer encouragement to the banks to continue to play their part in dealing with Mexican liquidity needs.

There are a number of other, potential problems facing the market at the moment of which Brazil is the biggest. A payments interruption by Brazil, whose financial situation is precariously balanced, would deal a very severe blow to confidence at a time when the market had not fully recovered from the previous shock. Brazilian banks in London have already experienced some funding problems in the last three months, although these have receded somewhat in recent weeks. The position of Brazil, like that of Mexico, depends critically on the provision of new money by the commercial banks. The government has already achieved some success in arranging further short-term finance from US banks and is seeking similar assistance from British and other European banks. It is commonly expected that the Brazilian authorities will approach the IMF for a loan following the recent election and this will help confidence. Even so the large financing requirement in 1983 is a source of concern to banks facing other demands domestically as well as internationally next year.

Among other debtor countries adding to the strain on market confidence is Argentina. Its immediate problems have been eased by an agreement with major UK banks on the treatment of outstanding arrears and by the apparently satisfactory outcome of negotiations on an IMF programme, but some rescheduling of existing debts seems unavoidable. Further debt difficulties are in prospect in Eastern Europe and much depends on their being handled in an orderly manner. Yugoslavia is a clear case for rescheduling, although its leaders seem for the moment to have set their face against it, and East Germany could follow. Meanwhile IMF assistance should gradually take over from the BIS in shoring up confidence in Hungary.

The fall in interest rates has brought an easing of conditions in the international money markets but some larger banks still have to pay a (now marginally) higher-than-normal price for their funds. The markets remain cautious about certain major banks from the industrialised countries whose names have been associated with well publicised difficulties of various kinds. Some banks, including the UK clearing banks, have taken advantage of their relatively good standing to strengthen their balance sheets by raising new capital. Equity and bond markets, though disturbed

latterly by the possibility that the fall in interest rates may have stalled, seem to have been relatively untouched by international debt problems. The shares of US banks, however, remain generally depressed in the United States and the share prices of the UK clearing banks have dipped in November first on fears of a prospective rise in provisions against bad debts and later on the announcement of a substantial increase by LBI.

In their immediate response to present difficulties the authorities and the banks have demonstrated that they can act rapidly to sustain confidence in the international financial system. Conditional lending by the IMF, as well as the continuing commitment of the banks, will be an important element in carrying matters forward and recent indications that a quicker and substantial increase in Fund resources may be possible have also helped to improve sentiment. Meanwhile the banks are proposing to establish an international institute to facilitate communication with borrowing countries and enhance the capacity of its members to make their own more informed judgments about lending decisions with a view in the medium term to the avoidance of crises rather than the management of them.

Bank of England

November 1982

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