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PREM 19/697

Indebtedness of various countries and its effect on the Western Banking System.

PART 1

ECONOMIC POLICY

AUGUST 1982.

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~25.8.82~~		~~18.11.82~~					
~~27.8.82~~		~~19.11.82~~					
~~1.9.82~~		~~22.11.82.~~					
~~6.9.82~~		~~26.11.82~~					
10~~.9.82~~		~~29.11.82~~					
~~1.10.82.~~		~~3.12.82~~					
~~12.10.82~~		30.11.82					
15.10.82.		— pt ends —					
~~18.10.82~~							
~~25.10.82~~							
~~29.10.82~~							
~~4.11.82~~							
~~12.11.82~~							
~~16.11.82~~							

PREM 19/697

Dd 533270 5M 2/78 8362633 JET

PART 1 ends:-

HMT to MCS 30.11.82

PART 2 begins:-

PM to PM of New Zealand, T229A/82 1.12.82

G10

(1)

Prime Minister

Agree that BNA be exempted?

MCS 1/12

ECONOMIC SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Why does the Ec. Sec think that Argentina would be in a position to honour the guarantee?

M C Scholar Esq
10 Downing Street
LONDON
SW1

30 November 1982

Dear Michael,

BANKING ACT 1979: EXEMPTION FROM DEPOSIT PROTECTION FUND: APPLICATION FROM THE BANCO DE LA NACION ARGENTINA

You will recall that the Deposit Protection Fund was set up earlier this year under the provisions of the Banking Act 1979 in order to afford some protection to depositors. All non-exempt banks are required to contribute to the Fund. In most cases the contribution, which is based on sterling deposits, is pretty small.

The Banco de la Nacion Argentina, which is a state-owned bank, is one of 30 or so foreign banks in London whose applications for exemption from the obligation to contribute to the Fund have been recommended to the Treasury by the Deposit Protection Board. The Banking Act makes it clear that it is the Treasury's duty to decide which applications should be accepted. The exemptions are then put into effect by a statutory instrument subject to the negative resolution procedure. It is hoped that the first such Order will be made shortly.

Sterling deposits with the BNA in the UK are guaranteed by the Argentine Government. Such a guarantee is normally sufficient to secure exemption from the obligation to contribute. The problem with the BNA, however, is whether the Argentine Government's guarantee is acceptable. Following consultations at official level with the FCO and the Bank of England, the Economic Secretary has concluded that, now that financial relations with Argentina are in the process of normalisation, there are no grounds on which he could reasonably refuse to accept the Argentine guarantee. He has therefore decided to include the BNA in the list of foreign banks to be exempted.

It is likely that this decision will receive some publicity, at least in the financial press, and it is possible ~~that~~ there may be some criticism in the press and Parliament generally. Treasury Ministers would respond to any criticism by pointing out that there are no grounds for refusing the BNA's application under the Banking Act 1979 in the present state of financial relations with Argentina. The effect of exemption is only to save the BNA from paying a token (probably £2,000) initial contribution to the Fund, and future small payments if the Fund requires further support.

I should be most grateful if you could let me know by the end of this week if you see any objection to the Economic Secretary's proposals.

I am sending copies of this letter to Brian Fall in the FCO, and Tim Allen in the Governor's Office at the Bank of England.

Yours sincerely,

Chris Harrison

C D HARRISON

c.c. JV.

Econ Pol

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

29 November 1982

A.J. Coles, Esq.,
No.10 Downing Street

Type letter pl.

A.J.C. 29/11.

Dear John,

INTERNATIONAL FINANCIAL SITUATION

In your letter of 18 November you asked me to provide the draft of a substantive letter in which the Prime Minister, following up her letter of 18 November, might comment on Mr. Muldoon's address to the Commonwealth Regional Heads of Government Meeting and on his article in the Royal Commonwealth Society journal, which were enclosed with his letter of 28 October.

.... The attached draft comments as sympathetically as possible on Mr. Muldoon's approach. We hope that it will demonstrate that the Prime Minister has studied the two statements carefully.

As the draft says, there are many points in Mr. Muldoon's analysis with which we can agree, but the Muldoon version of a "new Bretton Woods" looks on the face of it more like a new order for LDCs on protection, aid and IMF lending and conditionality.

This no doubt is why Mr. Muldoon was hailed as an instant hero by most of those present at the Lancaster House meeting of Commonwealth Finance Ministers at the end of August. He made the same case at the IMF meeting at Toronto. One result is the study, now being conducted by the Commonwealth Secretariat, of the international trade and payments system. Agricultural protection has, of course, been a major bone of contention in the GATT Ministerial meeting.

We cannot subscribe to what Mr. Muldoon says about the need for more relaxed conditionality on the part of the IMF, though we do agree about the need for more resources for the Fund.

/As to aid,

RESTRICTED

As to aid, it would be unwise to follow his proposal, which apparently envisages an annual and very large SDR issue to the LDCs as a form of redistribution from the wealthier countries - possibly in substitution for part or all of their multilateral aid. It sounds rather like taxation by inflation.

Yours ever,

J.O. Kerr

J.O. KERR

DRAFT LETTER FROM THE CHANCELLOR

TO: THE RT. HON. R.D. MULDOON, C.H.
Prime Minister and Minister of Finance
New Zealand

I have now had a chance to read carefully the copy of your speech at Suva, which you sent to me on 18 November; and to look also at your article for the journal of the Royal Commonwealth Society. ~~I found~~ Both the analysis and theproposals you made were interesting and thought-provoking.

I found myself in agreement with nearly all your analysis. I agree with you that it was a sad day when the exchange rate part of the Bretton Woods system finally collapsed under the strains of American inflation, and when the oil price increase destroyed all hope of an early return to stable exchange rates. I am sure you are right to say that growing protectionism and the international debt situation should be looked at together as threats to the international trade and payments system of the free world; and that protectionism has taken many new forms not originally recognised in the GATT. I see the force of your argument about agricultural protectionism, and the damage it inflicts on third countries. You know we have done our best for New Zealand in that area.

I agree that there has been over-lending to some of the newly industrialising countries in the 1970s - and to Eastern Europe - and that time will be needed to put the situation right. And of course you are right to say that cutting back subsidies and budget deficits in these countries can be particularly painful, though we have to remember that bank lending helped some of the newly industrialising countries to maintain or achieve very high growth rates in the 1970s in spite of the enormous oil price increases.

You say in your article that you have no simple solution for the problems which beset us but you do have a number

/of lines of

of lines of attack. In the complex world in which we now live - vastly more complex in its power balance and in its financial and economic structure than the world of 1946 - that must be the right approach, always provided that one does not lose sight of certain basic lessons on which I am sure we would both agree: that the free market economic system has performed infinitely better than the bureaucratic Marxist command economy; that the free system has successfully accommodated great changes in economic strength among nations; and that inflation and monopoly have been the main forces damaging its performance and its ability to provide sustained growth and jobs.

On lines of advance, I agree that we must provide substantial new resources for the IMF. Indeed I hope we can find ways of accelerating the process of doing so and demonstrating that the international community can reach speedy and constructive agreements. There is certainly something to be said for trying to encourage countries in trouble to turn sooner rather than later to the Fund. But I think we should do them (and ourselves) a disservice if we went too far to suggest that due conditionality could be avoided.

I agree too that we must by a whole series of steps reduce the risk of banking failures and rebuild confidence. I like your point about "symmetrical surveillance" of surplus as well as deficit countries, though I am not sure how you would apply it to OPEC surplus countries. But I would myself want to be careful about really long-term lending by the IMF, with conditionality extending over equally long periods and tending in practice to become nominal. The IMF may have to do more, but I don't think it can or should take over a large part of what has been done by the international banks and by private investment.

I was interested in what you said about a new Bretton Woods conference. Geoffrey Howe told me how you developed the argument at Lancaster House and in Toronto. I look forward to seeing the results of the review of the international financial system that is now being undertaken by the Commonwealth Secretariat.

/Of course you

Of course you are right about the need for political will and about the irrelevance of some existing machinery like the "global negotiations". But would your conference go beyond the questions of protectionism and alleviations for LDCs described in your proposals? To many people, including myself, "Bretton Woods" means the post-war currency system which ended in 1973. Currency fluctuations can cause acute trade problems and greatly affect LDCs. I would much like to see a way out of currency instability, but I don't see that happening without a durably lower level of inflation and interest rates in major countries and the avoidance of shocks like the oil price increases.

I have replied at length: forgive me. As you can see, I found your speech and article of great interest.

29 NOV 1982

Econ Pol

Prime Minister

Mr Coles - to see

MES 29/11

WR 26/11

SECRET

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

Michael Scholar Esq
10 Downing Street
LONDON
SW1

26 November 1982

Dear 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,

John Kerr.

J O KERR

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 managementhas reachedagreement 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

CONFIDENTIAL

ECON POL. PM

FILE

SUBJECT

a Master Set

10 DOWNING STREET

From the Private Secretary

22 November 1982

Dear John,

Call by Mr de Larosiere

Mr. de Larosiere, the Managing Director of the IMF, called upon the Prime Minister this afternoon. The Chancellor of the Exchequer and Mr. Alan Walters were also present.

The Prime Minister said that she had asked Mr. de Larosiere to come in because she was concerned about the international financial scene. As she saw it, we had a difficult year ahead. Was the Fund programme for Mexico sufficiently rigorous? She had, further, noticed that the amount of Fund money which would be paid to Mexico was small in relation to the due debt, and she wondered whether the commercial banks would follow the Fund and make the sizable large financial commitments which were necessary. She was concerned, too, about the prospects for Argentina, and for Eastern Europe. The situation was full of dangers: there would be secondary effects as countries ran into difficulty, whose impact on the international financial system had not yet been fully appreciated.

Mr. de Larosiere said that time was running out. The immediate task was to sort out Mexico. He agreed that the secondary effects of default and of delayed payments were worrying. The Fund programme for Mexico could certainly not be described as mild. It provided for a reduction in the public sector deficit of 8 percentage points of GDP in one year. He believed that there had been no Fund programme for any country as tough as that before. This objective would be buttressed by a series of tough, specific, policy changes. He was not at liberty to disclose what these were, but the Mexicans had drawn up three scenarios with policy changes which, if implemented, should lead to the required reduction in the public sector deficit. It had been made clear to the Mexicans that if these decisions were not taken there would be no IMF programme. Mr. de Larosiere said that in his view the programme was very harsh indeed, and probably too demanding. For 1983 $7 billion would, apart from the IMF loans, be needed by Mexico. Of this, some $2 billion would come from public sources, for example from EXIM; the rest would have to

/come

CM

from commercial banks, who would thus increase their exposure by some 8 percent. Some 1600 banks were involved. He had had discussions with the banks, and made it clear to them that, if they were to recuperate the interest of some $12 billion which was due to them in 1983, they would have to make available this further $5 billion. He would not put this whole package forward to the Fund Board until all these elements were in place.

The Chancellor commented that we were taking action on these international financial problems on a number of fronts: we were keeping up the pressure on the Administration to take corrective fiscal action; we were aiming to tighten up international banking supervision; and we were doing all we could to increase the Fund's resources and bring forward the operative date for the quota increase. The Prime Minister enquired about the Fund borrowing in its own name from the markets. Would this not take up funds which would otherwise be deposited with the banking system? Mr de Larosiere agreed, and said that the Fund were going slow on this at the moment; they were not themselves in the recycling business.

Argentina, Mr de Larosiere said, was a less formidable problem, if only because the sums involved were smaller: only $3 billion was required, of which some $2 billion would come back to the banks immediately in payment arrears. Brazil's problems seemed likely to come to the fore next.

There followed some discussion of the US scene. The Prime Minister said that she now had the firm impression that Mr Volker had relaxed monetary policy, mainly because of his worries about US banks. But US fiscal policy was in disarray. Mr de Larosiere said that the Administration would have to make up their minds: the deficit currently projected would not be absorbable without either a fresh bout of inflation, or very high interest rates. The likely 1983 deficit was around $180 billion. This would absorb nearly 80 per cent of US savings. As he saw it, this made urgent the need for the Chancellor of the Exchequer to secure the chairmanship of the Interim Committee, because the UK was the only country which could have the desired influence on the Administration. He hoped that the Prime Minister would feel able to put these points herself to President Reagan.

The Prime Minister said that the Administration were running, in effect, a Keynesian policy, under the description of "supply-side economics". She had been sympathetic before the Versailles Summit to the case which had been put to her, through Mr Shultz, that expenditure cuts and not tax increases were what was required. But the situation had worsened since then, and she now believed that both were urgently needed. Mr de Larosiere referred to the scope that existed for increasing indirect taxes in the US. Their impact was at present not heavy, and the Administration could do much to alleviate the problems of the international financial system, if it were prepared to increase these taxes.

He reiterated his hope that the Prime Minister would herself put these concerns directly to the President.

/I am

I am copying this letter to Brian Fall (Foreign and Commonwealth Office) and Richard Hatfield (Cabinet Office).

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
HM Treasury

CONFIDENTIAL Econ. Pol

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

19 November 1982

Prime Minister (2)

MCS 22/11

M C Scholar Esq
10 Downing Street
London
SW1

Dear Michael,

ARGENTINIAN ARREARS TO BRITISH BANKS

I thought you might like to be brought up to date on how matters have developed on this subject.

As you may have seen in the press, the four London Clearers signed an agreement with the Argentinian Central Bank in New York on 5 November about the manner in which arrears arising from the freezing of assets are to be settled. The basic principles are that they are to receive payment of outstanding interest on all their loans, plus the principal amounts due on all syndicated loans in which they participated, on medium and long-term bilateral loans to the public sector and on officially insured export credits; but they will roll-over for six months from the original maturity date all short-term debt. Given Argentina's present financial state, they may well have to consider continuing to roll-over such debt for some time to come.

As a gesture of good faith, the Argentinians had placed deposits in the name of the Central Bank with each of the Clearers in approximately the amounts payable under the agreement some weeks prior to its signature. Part of these deposits has now been released and paid over to the Clearers in settlement of their claims, and further payments are expected in the near future.

The Bank is in touch with other British banks with similar claims and helping so far as it can, by acting as a central communications point, to expedite settlement of such claims on the same lines as the Clearers' agreement. The sums involved are very much smaller in these cases.

All of this is reasonably satisfactory, even if the time it has taken to achieve it is not. The banks consider that they have now been put substantially where they would have been vis-a-vis Argentinian debt had the conflict never taken place, and that they are now in no worse case than other foreign banks involved with Argentina.

The next step in Argentina's financial rehabilitation is their application to the IMF and the related bridging loan for $1.1 bn from commercial banks. The management group with which the Argentinians have been discussing this loan for some time consists of eleven of the main international banks represented in Buenos Aires, including Lloyds Bank International. We understand that, given the good progress made with Argentina's application to the Fund, the negotiations on the loan are also nearing a conclusion, although the terms still have to be approved by the Argentinian Government.. After that the managers will attempt to sell the loan down to a further 50 banks or so, which will include a number of British banks. They will of course make their own commercial judgments about whether to participate, but I imagine that in view of the normalisation of their banking relationships with Argentina, a number of them will decide to do so.

I am sending a copy of this letter to John Kerr at the Treasury.

Yours ever
Anthony.

A D Loehnis

Econ. Pol

GRS 390

UNCLASSIFIED
FM MEXICO CITY 182300Z NOV 82
TO PRIORITY FCO
TELEGRAM NUMBER 977 OF 18 NOVEMBER
AND TO PRIORITY TREASURY, DOT, ECGD, BANK OF ENGLAND, UKDEL IMF/
IBRD WASHINGTON.

MY TELNO 956: MEXICAN ECONOMIC CRISIS/IMF

1. ON 17 NOVEMBER THE FINANCE MINISTER APPEARED BEFORE THE FINANCE COMMISSION OF THE CHAMBER OF DEPUTIES TO ANSWER QUESTIONS ABOUT THE MEXICAN LETTER OF INTENT TO THE IMF. SILVA HERZOG TOOK THE OPPORTUNITY TO SPEAK ABOUT THE ECONOMIC SITUATION IN GENERAL AS WELL. THE FOLLOWING WERE THE MAIN POINTS:

(I) THE ECONOMIC ADJUSTMENT PROGRAMME WHICH MEXICO FACED WOULD REQUIRE A PERIOD OF STRICT AUSTERITY WHICH WOULD AFFECT ALL SOCIAL SECTORS. THE ADJUSTMENT PROGRAMME DID NOT DERIVE FROM THE LETTER OF INTENT: RATHER THE LETTER FORMED PART OF THE ADJUSTMENT PROGRAMME WHICH MEXICO WOULD HAVE HAD TO UNDERTAKE WITH OR WITHOUT THE IMF. THE COUNTRY STILL FACED A SERIOUS FOREIGN EXCHANGE SHORTAGE. THE ADJUSTMENT PROGRAMME WOULD HAVE TO BE CARRIED OUT AS FAIRLY AS POSSIBLE BEARING IN MIND THAT IN MEXICO WEALTH WAS POORLY DISTRIBUTED.
(II) THE MEXICAN GOVERNMENT HAD REQUESTED A FURTHER EXTENSION OF 120 DAYS FOR THE REPAYMENT OF PRINCIPAL ON ITS FOREIGN DEBT. SILVA HERZOG WAS SURE THAT THE REQUEST WOULD BE GRANTED.
(III) MEXICO WOULD NOT JOIN WITH OTHER LATIN AMERICAN COUNTRIES IN DECLARING A SUSPENSION OF DEBT PAYMENTS. THE CONSEQUENCES WOULD BE DISASTROUS.
(IV) ECONOMIC GROWTH IN 1983 WOULD BE BETWEEN ZERO AND ONE PER CENT.
(V) THERE WAS NO OTHER ICOUNTRY IN THE WORLD WHICH HAD EXCHANGE CONTROLS AND A 2,000 MILE BORDER WITH THE MOST POWERFUL COUNTRY IN THE WORLD. IN HIS VIEW, THE EXCHANGE CONTROL MECHANISMS WOULD THEREFORE HAVE TO CONTINUE TO BE ADAPTED TO AVOID FURTHER MASSIVE CAPITAL FLIGHT.
(VI) THE REDUCTION OF THE PUBLIC SECTOR DEFICIT FROM 16% TO 8.5% OF GDP WOULD BE VERY DIFFICULT. SUCH A REDUCTION HAD PRACTICALLY NEVER BEEN ACHIEVED ANYWHERE. BUT THERE WERE NO RESOURCES TO FINANCE A GREATER DEFICIT. THE ONLY ALTERNATIVE WOULD BE TO PRINT MORE MONEY, BUT THAT WOULD INCREASE INFLATION YET FURTHER.

/2. SEVERAL

2. SEVERAL OPPOSITION DEPUTIES EXPRESSED THEIR DISSATISFACTION WITH SILVA HERZOG'S PRESENTATION. ROLANDO CORDERO (LEADER IN THE CHAMBER OF THE COMMUNIST-DOMINATED UNITED SOCIALIST PARTY OF MEXICO AND A CLOSE FRIEND AND COLLABORATOR OF THE GOVERNOR OF THE BANK OF MEXICO) CLAIMED THAT THE GOVERNMENT HAD FAILED TO ADOPT A CLEARLY-DEFINED ECONOMIC POLICY, WHILE THE RIGHT-WING NATIONAL ACTION PARTY CRITICISED THE GOVERNMENT FOR NOT HAVING TAKEN STRICTER MEASURES EARLIER AND FOR NOT CONSULTING CONGRESS BEFORE SIGNING THE LETTER OF INTENT.

TICKELL

THIS TELEGRAM
WAS NOT
ADVANCED

FINANCIAL
ERD
MCAD
NAD

COPIES TO:

MR BALFOUR)
MR JAGGERS) BANK OF ENGLAND

MR ATKINSON)
MR BATTRELL) TREASURY
MR PERETZ)

Prime Minister

We have arranged for Mr de Larosiere to come in, with the Chancellor, privately at 1445 on Monday.

MCS 19/11

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

PRIME MINISTER

IMF QUOTA INCREASE AND THE INTERNATIONAL DEBT AND BANKING SCENE

As you know, I have thought for some time that an early resolution of present international discussions on replenishing IMF resources could contribute to greater confidence in the international debt and banking field. I think too that the United Kingdom may be able to play a useful part in achieving such a resolution. The objective would be similar to the one you had in mind when you were considering whether and how to advance the timing of the 1983 Seven Power Economic Summit partly in order to tackle these debt and banking problems.

2. We have now reached a point where 13 of the 22 constituencies which make up the IMF Interim Committee have said they would support me for the Chairmanship of the Committee. In addition to all the larger and medium sized developed countries and Canada, Australia and New Zealand, I have the support of India, Brazil, Mexico, Sri Lanka, the Philippines and Zaire. The US, Japan, France and Germany have all been active on my behalf. It would still be a mistake to take the outcome for granted - the present Belgian Finance Minister - who has had the job once before - might like to be a candidate in the event of an upset - but it seems likely that Larosiere (who wishes me to accept) will shortly be able to initiate the formal procedure which should settle the matter.

3. I intend to play an active role in advancing the next meeting of the Interim Committee from the date now planned at the end of April to late January or early February, and seeking to ensure that agreement on new resources for the Fund is reached

at that meeting. It would indeed be unwise to advance the meeting unless there were good prospects of agreement. A deal fortifying the monetary system would help confidence; failure to agree would be correspondingly damaging.

4. At the Toronto meeting of the IMF in September it looked as if opinion was moving towards an Eighth Quota Increase which would raise the Fund by between 50 and 65% from the present level of 62 billion SDRs to 90 to 100 billion SDRs. This quota increase would have become effective after ratification from 1 January 1986. However the United States then argued for a much smaller (but unspecified) quota increase, plus an Emergency Fund fed by borrowing. The details and character of the Emergency Fund were not well defined.

5. In October and November there have been two rounds of discussion in Washington between the Finance Ministries of the Five on a possible replenishment "package" intended to command the widest possible agreement. Three main elements of this package would be:-

i. a quota increase to at least 85 billion SDRs, but more probably to between 90 and 100 billion. The Americans have moved a long way on this;

ii. a determined effort to make this operative from 1 July 1984 instead of 1 January 1986, including legislation in the US Congress in 1983. The effect of acceleration would of course be that the enhanced resources would be available sooner and that present IMF resources would have to last only 18 months instead of 3 years. This would be very relevant to the increased demands on the IMF from Latin America, Eastern Europe and elsewhere;

iii. a pre-arranged lending facility for the IMF based on the present General Arrangements to Borrow of the Group of Ten industrial countries, but intended to have the support of Saudi Arabia also. The present GAB enable the Ten (plus Switzerland) to lend to the IMF so that the Fund can lend in turn to one of the Ten; it is a mutual help agreement, with a ceiling of 6.2 billion SDR's which has been unchanged since 1962. This might be replaced by a new limit of 15 to 20 billion SDR's, which would cover both traditional lending to the Fund for GAB members and an emergency facility for lending to the Fund for non-members. To activate this reserve facility there would have to be a situation imposing an exceptional strain on the international monetary system; and the Fund would have to show that it was running out of resources to meet valid applications. This version of an emergency borrowing facility seems to have been accepted by the Americans as a satisfactory variant of their own Toronto proposal. It is in fact simpler and more attainable because it builds on existing institutions, and on the recent precedent under which Saudi Arabia and the main developed countries made parallel loans totalling over 5 billion SDR's to the Fund. It requires a decision only of the Ten developed countries, not the whole IMF membership; and the Ten retain control of its activation.

6. A package with these main components has a number of attractions. Advancing the operative date and including the pre-arranged borrowing facility would be a response to the widely felt need for special, urgent action by the international community. The package could have more appeal for the US Congress than a straight quota increase on traditional lines, partly because the innovations follow US proposals and partly because

the lending facility could be used to help Latin America but would remain largely under US control, given their weight in the G10. From our own standpoint I believe this package would strike the right balance between the inflationary ambitions of some LDC's about the scale and terms of future borrowing from the IMF and the type of quota review first envisaged by the Americans which would probably be non-negotiable and would do nothing for confidence in the system.

7. During the past week we have been able to discuss the package with both Larosiere and with other Community Finance Ministers. Larosiere is well content and sees here a basis for agreement at an advanced Interim Committee meeting. There is general support within the Community, which suggests that the G10 also are likely to be supportive. There are plans for G5 and G10 meetings in the coming weeks to carry matters forward. But special efforts will be needed to ensure the agreement of the Saudis and of some of the major LDCs. Larosiere will certainly play a part in that. There are also some contentious questions on the permissible scale of access to the Fund by borrowers after the Eighth Quota Increase; and on the distribution of quota increases in the light of changes in relative economic strength among members. We shall have to decide by mid-December whether there is enough agreement to justify bringing forward the Interim Committee meeting.

8. I hope that in parallel with these efforts on IMF resources it will be possible to see progress on specifically banking issues where there could be benefits for confidence. I am in touch with the Governor about this. However this is likely to be a more gradual and piecemeal business than the more structured initiative on IMF resources. The international banking scene is of course a little less worrying than in the early autumn, given the IMF agreement with Mexico and Argentina - and the

Argentine agreement with the British banks. But the gradual deterioration in the financial situation of Yugoslavia causes increasing concern.

9. I am copying this minute to the Foreign and Commonwealth Secretary, to Gordon Richardson, and to Sir Robert Armstrong.

G.H.

18 November 1982

File BRE
Eco Pol

18 November 1982

INTERNATIONAL FIHANCIAL SITUATION

I enclose copies of an exchange of correspondence between the Prime Minister of New Zealand and the Prime Minister, together with copies of the two documents to which Mr. Muldoon refers.

The Prime Minister would like to send a further comment to Mr. Muldoon on these documents. I should be grateful if you could let me have a draft.

A. J. COLES

John Kerr, Esq.,
HM Treasury

JC

SUBJECT cc Master + Ord

Econ Pol cc Fco

BM

10 DOWNING STREET

THE PRIME MINISTER

18 November 1982

PRIME MINISTER'S
PERSONAL MESSAGE
SERIAL No. T222/82

Dear Rob,

Thank you so much for your letter of 28 October enclosing a copy of your address to CHOGRM and your article for the Commonwealth magazine on the present conditions of the international monetary system. We shall study these and let you have our thoughts.

Meanwhile, you may like to have the enclosed copy of a speech I gave in London on 15 November, a large part of which dealt with the world financial situation.

Yours sincerely

Margaret

The Right Honourable Robert Muldoon, CH, MP pc MASTER

File Econ Pol

da

SUBJECT

cc AW.

10 DOWNING STREET

From the Private Secretary

16 November 1982

Call by Dr. Alan Greenspan

Dr. Alan Greenspan called upon the Prime Minister this morning. Dr. Greenspan said that the Western economies were moving into a difficult time. Re-adjustment to a world with much lower inflationary expectations was not a painless process. There would continue to be problems with individual countries: in the case of Mexico, for example, although conclusion of the agreement with the IMF was a major step, it remained to be seen whether the Mexicans would live up to the programme to which they had put their names. We were now seeing a reduction in the size of the Eurocurrency market, and borrowers would face a difficult time as the expansion of credit came to a halt. Banks had now recognised that some of their lendings would never be recovered - for example the Polish loans. There would also be troublesome secondary effects: a country like Bolivia, for example, might experience difficulties as payments to it from, for example, Argentina, were delayed. We had seen little of such effects so far. His conclusion was that the next six months would be critical.

The Prime Minister enquired about the prospects for the US economy. Dr. Greenspan said that he did not expect a turn before February or March. There had been good progress on the budgetary and inflation front, and in his view it would be only when the long-term budget prospects were clearly under control that long-term interest rates would come down from their present excessively high levels. The Prime Minister commented that the Administration had two clear years before the Presidential Election; it needed to take action now. Dr. Greenspan referred to the Congressional problems which the Administration faced, and said that the position had not been made easier by promises which were made during the recent Election campaign. The next six months on this front, too, would be decisive. He had been engaged, as Chairman of a Bi-Partisan Commission on Social Security, in working for an agreement on these issues which would be acceptable to the Administration and to Congress.

/If the long-term

CONFIDENTIAL

If the long-term budget deficit could be brought down from $200 billion to, say, $125 billion, that would be a great achievement. The Prime Minister said that she doubted whether the Administration would be able to cut expenditure quickly enough to produce a sufficiently quick effect on the budget deficit. As she saw it, something would have to be done about the revenue side. This, after all, had been the inevitable conclusion to which her own administration had been obliged to come. Dr. Greenspan agreed, and spoke of the benefits, in terms of increased investment, which would arise as inflation fell.

The Prime Minister referred to the flatness of the UK economy this year. Dr. Greenspan said that he had never subscribed to the locomotive theory, but he did not believe that there could be a buoyant world economy when the US economy was in deep recession. It was the shrinking of the world economy at the end of 1981 and earlier this year which, in his view, had stifled the beginnings of recovery in the UK. But he believed that there had been a very great improvement in the underlying economic situation in the UK, and that when there was an improvement in world trading conditions the UK would move ahead faster than many other countries.

The Prime Minister enquired about Dr. Greenspan's view of recent monetary events in the United States. Dr. Greenspan said that he believed that the Fed had relaxed their monetary stance somewhat, partly because of their worries about international financial fragility. As he read it, Mr. Volker believed that the recent easing in inflationary pressures left him room for some relaxation of policy; and that if he tried to push down the money supply bulge short-term interest rates would rise sharply, with unfortunate consequences. This modification of policy was merely a tactical move, and the monetary strategy remained intact.

I am sending a copy of this letter to Brian Fall (Foreign and Commonwealth Office).

M. C. SCHOLAR

John Kerr, Esq.,
HM Treasury.

Prime Minister

MES 15/11

15 November 1982

ALAN WALTERS

PRIME MINISTER

VISIT OF DR. ALAN GREENSPAN

Dr. Greenspan was Chief Economic Adviser to President Ford. He was the Chairman of the Committee of Economic Advisers. It was a very distinguished Committee, including people such as William Fellner. Most people whose judgement I respect, regard Greenspan as the best Chairman of the Council. I understand that after Murray Wiedenbaum departed, Greenspan was again the first choice as Chairman of the CEA. But he preferred his present activities, split jointly between private consulting and public service.

I suggest you discuss with him the following topics.

(a) American Monetary Policy

The main issue is whether there has been a substantial change of policy at the Fed. There are mixed signals from the media. (For example, Bill Ford, President of the Atlanta Fed, clearly indicated last week that monetary policy was going to be much more expansionist. This was in the context of a panel discussion, and it is not clear whether Ford made the point that the media attribute to him.)

As you know, I believe that there has been no substantial change in monetary policy. The Americans are running into the same sort of problems we encountered in 1981 with some indicators being temporarily upset or misleading.

(b) The American Budgetary Deficit

Forecasts of the budget deficit for next year tend to be near $200 billion. Greenspan may well have a good appreciation of what measures are likely to be taken in order to reduce the deficit.

(c) Social Security

Greenspan is Chairman of a bi-partisan commission charged with the job of producing a consensus on how to handle the enormous social security deficits that

/are looming

are looming in the years ahead. Although the short answer is to increase social security payments and/or reduce the benefits, the politically acceptable answer is much more complicated. He has had some considerable experience in negotiating feasible and acceptable solutions. You might wish to ask him whether he could make any recommendations about our pension problem.*

15 November 1982

ALAN WALTERS

*See Wall Street Journal, 12 November (attached).

WSJ 11/12

Greenspan, Playing Mediator, Tries to Prod Diverse Social Security Panel to Agreement

By Robert W. Merry
Staff Reporter of The Wall Street Journal

ALEXANDRIA, Va. – Alan Greenspan, the New York economist, isn't a stranger to controversy. A few years ago, when he was President Ford's top economic adviser and economic stagflation was battering the country, he remarked publicly that stock brokers were among those hardest hit by hard times.

The comment produced an enormous controversy. A relative newcomer to Washington at the time, the brainy, low-keyed conservative learned quickly how sensitive some issues can be.

Now Mr. Greenspan finds himself in a political situation as delicate as Washington has seen in years. He is chairman of a high-level, bipartisan commission charged with producing by year-end a consensus on how to handle Social Security's financial ills. Some people on Capitol Hill call the issue "the middle rail of American politics–touch it and you're dead."

Yet something has to be done to save Social Security. Its trust funds may be unable to cover promised benefit payments within a year or so. And the major proposals for solving the problem–cutting scheduled growth in benefit payments or raising taxes–strike most members of Congress as much too painful.

"If Alan Greenspan can succeed," says Rep. Willis Gradison, an Ohio Republican, "he should get the Nobel Peace Prize."

Mr. Greenspan doesn't seem to have any illusions about the difficulties of the job. "We've now clearly become aware of the extent to which the general weakness of the economy has real negative impact on the Social Security trust funds," he said yesterday as the commission began three days of public discussions here.

He steered the commission to agreement that the trust funds will need between $150 billion and $200 billion in tax increases or benefit-growth cuts through the rest of the decade.

"If Alan Greenspan can succeed," an Ohio Republican says, "he should get the Nobel Peace Prize."

Mr. Greenspan has cultivated the image of an impassive mediator dedicated to drawing together diverse viewpoints. "It's clear to most people that Greenspan is putting aside any personal opinions," says Laurie Fiori of the American Association of Retired Persons.

But some are beginning to wonder if Mr. Greenspan's approach is forceful enough to produce an actual consensus. Commission member Robert Dole, chairman of the Senate Finance Committee, says the 15-member panel will probably produce 15 answers. "Don't look for miracles," the Kansas Republican says.

The panel is composed of 10 members appointed by President Reagan and Senate Republican leader Howard Baker, and five appointed by the Democratic House Speaker, Thomas P. O'Neill. As a result, the commission is a repository for all the views and political forces that have contributed to political stalemate on the issue over the past two years.

Speaker O'Neill's five appointees are the most willing to accept large payroll-tax increases. For some of them, the idea of benefit-growth reductions–considered necessary by many Republicans and some Democrats–represents an assault on the legacy of the Democratic Party.

The group includes Robert Ball, a former Social Security commissioner and a bureaucratic infighter. He favors speeding up to next year the non-Medicare payroll tax increases scheduled for 1985 and 1990, which would raise the maximum Social Security tax nearly $300 next year and ensure further increases later. Other O'Neill appointees are Florida's octogenarian Rep. Claude Pepper, who has recently focused most of his energy on opposing Republican efforts to check Social Security benefit growth, and New

Please Turn to Page 14, Column 4

Greenspan, Playing the Mediator, Tries to Prod Social Security Panel

Continued From Page 9

York's Democratic Sen. Daniel P. Moynihan, who argued until recently that there was no need for any Social Security overhaul at all.

Some Republican members are getting jittery that Chairman Greenspan may become too cozy with these Democrats. "My concern," says a staff aide to an influential commission member, "is that catering to Bob Ball could pull the commission to the left of Congress." It could also lead to the loss of conservative backing.

But Mr. Greenspan's mandate is to produce a consensus report that can be the basis for congressional action. And many consider support from some of these Democrats crucial. Without Mr. Ball, for example, the reasoning goes, you don't get Speaker O'Neill; without Speaker O'Neill, you don't have any real bipartisan cooperation.

The commission's conservative members fall into two categories–the hardliners and the more flexible. Leading the hardliners is Sen. William Armstrong, a Colorado Republican and the chairman of the Senate Social Security subcommittee. Along with many in Congress, Sen. Armstrong is afraid that major payroll-tax increases could retard any economic recovery. He also vows to lead a filibuster against any such tax-increase measure.

Other conservative commission members are less adamant. Finance Committee Chairman Dole and New York's Rep. Barber Conable, senior Republican on the House Ways and Means Committee, have suggested they might accept some payroll-tax increases if they're accompanied by some important benefit-growth reductions.

Chairman Greenspan has another delicate task as well: getting agreement on the nature of Social Security's long-term problem. He and most other commissioners are afraid disaster will strike the system when the large "baby boom" generation reaches retirement age and finds there aren't sufficient Americans in the work place to finance their pensions. Mr. Ball and other Democrats doubt that this problem is as dire as some pessimists fear. They oppose the kinds of phased-in benefit reductions often proposed to address it.

Mr. Ball says many short-term solutions will reduce the long-term problem, and he supports payroll-tax increases to solve the rest. This approach is anathema to many conservatives, which leads may to wonder what Mr. Greenspan will have to give up to reach commission consensus on long-term solvency measures. Will he have to give up more than the conservatives will accept?

All of this leads some to suggest that the commission won't produce a comprehensive package at all, but will merely settle as many questions as possible and leave the rest to Congress. "They may end up going for a higher percentage of consensus on a lower percentage of completed work," says a congressional staff assistant.

But there's even disagreement on whether this makes sense. Some say it does because Congress has ultimate responsibility anyway. Others don't agree. "We've got to take the heat," says Rep. Conable. "If we don't, how can we expect Congress to?"

WALL ST. JOURNAL
12 NOVEMBER 1982

Econ Pol

GR 160
UNCLASSIFIED
FM BUDAPEST 121145Z NOV 82
TO ROUTINE FCO
TELEGRAM NUMBER 313 OF 12 NOVEMBER 1982
INFO ROUTINE UKDEL IMF/IBRD WASHINGTON

MR

HUNGARY/IMF

1. THE OFFICIAL HUNGARIAN NEWS AGENCY CARRIED THE FOLLOWING REPORT IN ENGLISH ON 11 NOVEMBER:

''UPI HAS ISSUED A BRIEF REPORT ABOUT THE LOAN NEGOTIATIONS BETWEEN THE IMF AND HUNGARY. WE THEREFORE CONSIDER IT NECESSARY TO REPORT THE FOLLOWING, WHICH IS BASED ON INFORMATION FROM OFFICIAL HUNGARIAN SOURCES. -
ON THE BASIS OF RECENT NEGOTIATIONS BETWEEN STAFF MEMBERS OF THE IMF AND REPRESENTATIVES AND EXPERTS OF THE HUNGARIAN GOVERNMENT, A PRELIMINARY AGREEMENT HAS BEEN CONCLUDED ON THE GRANTING OF A 475 MILLION SDR STAND-BY ARRANGEMENT, AND BEYOND THIS ON THE PARTIAL FINANCING OF LOSSES DUE TO PRICE DECREASES OF HUNGARIAN EXPORTS DURING THE SECOND HALF OF 1981 AND THE FIRST HALF OF 1982. THE STAND-BY ARRANGEMENT WILL SUPPORT THE ECONOMIC DEVELOPMENT PROGRAMME WHICH WAS INITIATED BY THE HUNGARIAN GOVERNMENT FOR THE FURTHER STRONG IMPROVEMENT OF EXTERNAL EQUILIBRIUM IN 1983. IT IS EXPECTED THAT THESE CREDIT ARRANGEMENTS WILL BE DISCUSSED AND APPROVED BY THE BOARD OF EXECUTIVE DIRECTORS OF THE FUND IN THE FIRST HALF OF DECEMBER''.

2. THE HUNGARIAN DOMESTIC PRESS SO FAR CONTAINS NO MENTION OF THE ABOVE.

CARTLEDGE

MONETARY
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GR 320

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DESKBY 150900Z
FM UKDEL IMF/IBRD WASHINGTON 122317Z NOV 82
TO IMMEDIATE FCO
TELEGRAM NUMBER 255 OF 12 NOVEMBER
INFO NAIROBI

KENYA: DONORS' MEETING

1. FOLLOWING TELECON OF 11 NOVEMBER BETWEEN AITKEN (ODA) AND DINHAM, WE ASKED THE FUND STAFF (JIMENEZ) TO BRING US UP TO DATE REGARDING THE FUND'S NEGOTIATIONS WITH KENYA. HE SAID THAT AFTER THREE DAYS OF MEETINGS WITH OFFICIALS IN WASHINGTON, SUBSTANTIAL PROGRESS HAD BEEN MADE AND AGREEMENT HAD BEEN REACHED ON THE MAIN OBJECTIVES UNDER A NEW PROGRAMME. THERE REMAINED SEVERAL DIFFICULTIES ABOUT THE NUMBERS BUT THESE COULD PROBABLY BE IRONED OUT. A FUND TEAM WOULD PROBABLY VISIT NAIROBI IN DECEMBER AND IT WAS HOPED THAT AGREEMENT COULD BE CONFIRMED AT THAT STAGE.

2. THE STAFF HAD BEEN WORKING TOWARDS A NEW STANDBY ARRANGEMENT TO REPLACE THE EXISTING ONE. THE NEW ARRANGEMENT WOULD RUN FOR 18 MONTHS. IT HAD NOT SEEMED WORTH TRYING TO REVIVE THE EXISTING ARRANGEMENT. (OUR TELNOS 222 OF 20 OCTOBER AND 206 OF 5 OCTOBER GAVE BACKGROUND.)

3. THE EXISTING ARRANGEMENT HAD BEEN SUSPENDED ON ACCOUNT OF A BREACH OF THE CEILING ON BANK CREDIT TO THE GOVERNMENT. ALTHOUGH THE BREACH HAD BEEN FAIRLY SMALL IN RELATION TO TOTAL DOMESTIC CREDIT CREATION, IT HAD BEEN QUITE LARGE IN RELATION TO CREDIT TO GOVERNMENT. THE BREACH HAD BEEN CAUSED BY SHORTFALLS IN THE AVAILABILITY OF FINANCE FROM OUTSIDE THE BANKING SYSTEM, INCLUDING EXTERNAL FINANCE. IN OTHER RESPECTS, THE FISCAL STANCE HAD WORKED OUT PRETTY WELL. BOTH PUBLIC EXPENDITURE AND THE GOVERNMENT'S DEFICIT HAD BEEN VERY MUCH IN LINE WITH THE PROGRAMME'S FISCAL OBJECTIVES. HAD THE KENYANS ACTED EARLIER (JIMENEZ SAID), THEY MIGHT WELL HAVE ESCAPED WITH A WAIVER TO THE PERFORMANCE CRITERION.

4. THE NEGOTIATIONS REGARDING THE EXCHANGE RATE WERE AT AN EXTREMELY DELICATE STAGE AND JIMENEZ WOULD NOT BE DRAWN AS TO DETAIL, BEYOND SAYING THAT THE SIZE AND NATURE OF THE ADJUSTMENT BEING ASKED FOR DEPENDED IN PART ON OTHER MEASURES THAT MIGHT BE TAKEN.

5. FCO PLEASE ADVANCE TO PS/MR ONSLOW, APPLEYARD (ERD), AITKEN (EWAD, ODA), BEASTALL (HMT) AND HUMPHRYES (BANK OF ENGLAND).

(ADVANCED AS REQUESTED)

ANSON

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GRS360

UNCLASSIFIED [CULL]
DESKBY 110900Z NOV
FROM MEXICO CITY 110100Z NOV 82
TO IMMEDIATE FCO
TELEGRAM NUMBER 949 OF 11 NOV
AND TO IMMEDIATE DOT, ECGD, TREASURY, BANK OF ENGLAND, UKDEL IMF/IBRD WASHINGTON

MY TELNO 936: MEXICAN ECONOMIC CRISIS

1. THE MEXICAN MINISTER OF FINANCE CALLED A PRESS CONFERENCE THIS AFTERNOON AT WHICH HE APPARENTLY ANNOUNCED THAT MEXICO HAD SIGNED A LETTER OF INTENT TO THE IMF REQUESTING AN EXTENDED FINANCIAL FACILITY OF US DOLLARS 3.84 BILLION OVER 3 YEARS, WITH THE POSSIBILITY OF COMPENSATORY FINANCIAL FACILITY LEFT OPEN.

2. THE LETTER OF INTENT, WHICH SILVA HERZOG READ OUT, SAID THAT MEXICO'S PUBLIC SECTOR DEFICIT, ESTIMATED AT 16.5% OF GDP IN 1982, WOULD BE REDUCED TO 8.5% IN 1983, 5.5% IN 1984 AND 3.5% IN 1985. THE NET INCREASE IN THE PUBLIC SECTOR FOREIGN DEBT WOULD NOT EXCEED US DOLLARS 5 BILLION IN 1983. THE PRESENT EXCHANGE SYSTEM WOULD BE MAINTAINED TEMPORARILY, BUT THE GOVERNMENT WOULD MOVE TOWARDS A SYSTEM WHICH ENSURED THAT THE PESO DID NOT AGAIN BECOME OVER-VALUED. INTEREST RATES, WHICH HAD DECLINED AND WERE NEGATIVE IN REAL TERMS, WOULD BE MADE ATTRACTIVE TO SAVERS. SUBSIDITS WOULD BE REDUCED. THERE WOULD BE RATIONALISATION OF THE ARRANGEMENTS FOR PROTECTING MEXICAN INDUSTRY.

3. SILVA HERZOG SAID THAT HE HOPED A FORMAL AGREEMENT WOULD BE IN PLACE BY MID-DECEMBER. SIGNATURE OF THE LETTER OF INTENT WOULD UNBLOCK THE SECOND AND THIRD TRANCHES OF THE BIS LOAN AND OPEN THE POSSIBILITY OF NEW MONEY BECOMING AVAILABLE FROM THE COMMERCIAL BANKS.

AGREEMENT WITH THE IMF WOULD ENABLE MEXICO TO MEET ITS OBLIGATIONS AND AVOID A DEFAULT. THIS WOULD HAVE HAD GRAVE REPERCUSSIONS BOTH FOR MEXICO AND FOR THE INTERNATIONAL FINANCIAL SYSTEM.

4. AT THE END OF SILVA HERZOG'S STATEMENT THE GOVERNOR OF THE BANK OF MEXICO APPARENTLY SAID HE WISHED TO CLARIFY A FEW POINTS. THE DUAL PARITY FIXED EXCHANGE RATE SYSTEM WOULD BE MAINTAINED. THERE WOULD BE NO FLOATING DOWN OF THE PESO. THE EXISTING SYSTEM OF IMPORT CONTROLS WOULD CONTINUE. EXCHANGE CONTROLS WOULD ALSO BE MAINTAINED.

/ 5. TELLO'S

5. TELLO'S INTERVENTION CAUSED SOME PUZZLEMENT TO THE PRESS AS HIS COMMENTS SEEMED TO CONTRADICT WHAT WAS IMPLIED, IF NOT DIRECTLY STATED , IN THE LETTER OF INTENT READ OUT BY SILVA HERZOG. HE EVIDENTLY WISHED TO MAKE IT CLEAR THAT THE MEASURES WITH WHICH HE IS PARTICULARLY ASSOCIATED - EXCHANGE AND IMPORT CONTROLS AND THE FIXED PARITIES OF THE PESO - WOULD NOT BE REVERSED AT LEAST IMMEDIATELY AS A CONSEQUENCE OF THE IMF AGREEMENT.

TICKELL

FINANCIAL
ERD
MCAD
NAD

COPIES TO:

MR BALFOUR
MR JAGGERS } BANK OF ENGLAND

MR ATKINSON
MR BATTRELL } HM TREASURY
MR PERETZ

DOT

ECGD

GRS 320 CONFIDENTIAL

CONFIDENTIAL

DESKBY 110900Z

FM UKDEL IMF/IBRD WASHINGTON 102312Z NOV 82

TO IMMEDIATE FCO

TELEGRAM NUMBER 249 OF 10 NOVEMBER

IMF: ARGENTINA

1. THE MANAGING DIRECTOR ANNOUNCED AT THE CLOSE OF THIS MORNING'S BOARD MEETING THAT AGREEMENT HAD BEEN REACHED WITH MEXICO (SEE MIPT) AND WITH ARGENTINA. WHAT HE CALLED QUOTE FINAL AGREEMENT UNQUOTE HAD JUST BEEN REACHED THIS MORNING WITH THE ARGENTINE AUTHORITIES ON A LETTER OF INTENT AND ASSOCIATED DOCUMENTS. THE PROPOSAL WAS FOR A 15 MONTH SBA TO RUN FROM JANUARY 1983 TO MARCH 1984, FOR SDR 1 1/2 BN (187 PERCENT OF QUOTA). THE AUTHORITIES HAD BEEN INFORMED THAT GIVEN NORMAL IMPLEMENTATION OF AGREED MEASURES, THE MANAGING DIRECTOR WOULD RECOMMEND THE PROGRAMME TO THE BOARD.

2. THE STAFF PAPER SHOULD BE ON THE BOARD AGENDA BY THE SECOND HALF OF JANUARY. SOME WORK WAS STILL NEEDED ON TECHNICAL ASPECTS WHEN NOVEMBER FIGURES WERE AVAILABLE AND THIS WOULD REQUIRE A SMALL MISSION IN DECEMBER. THE REPORT OUGHT TO BE READY TOWARDS THE END OF DECEMBER.

3. UNLIKE MEXICO, THE AUTHORITIES PLANNED NOT TO MAKE THE LETTER OF INTENT PUBLIC AND IT WOULD THEREFORE NOT BE CIRCULATED IN ADVANCE OF THE STAFF REPORT. IT WOULD BE UP TO THE AUTHORITIES TO ANNOUNCE AGREEMENT, WHICH THEY WOULD PROBABLY DO AT AN EARLY STAGE.

4. THERE WOULD ALSO BE A CFF REQUEST. THE AMOUNT HAD NOT YET BEEN DECIDED BUT IT COULD BE OF THE ORDER OF SDR500-600 MN.

5. AS WITH MEXICO, THE MANAGING DIRECTOR OBSERVED THAT BEFORE ACTION WAS TAKEN HE WOULD NEED TO BE SATISFIED THAT THE NECESSARY FINANCING ENVIRONMENT EXISTED FOR CARRYING OUT THE PROGRAMME, AND THIS WOULD BE LOOKED INTO.

6. FCO PLEASE ADVANCE TO APPLEYARD (ERD), ATKINSON (HMT) AND GILCHRIST (BANK OF ENGLAND).

ANSON (ADVANCED AS REQUESTED)

COPIES TO:-
MR ATKINSON H.M. TREASURY
MR GILCHRIST - B/ENGLAND

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DESKBY 110900Z
FM UKDEL IMF/IBRD WASHINGTON 102310Z NOV 82
TO IMMEDIATE FCO
TELEGRAM NUMBER 248 OF 10 NOVEMBER
INFO MEXICO CITY

IMF: MEXICO

1. THE MANAGING DIRECTOR ANNOUNCED AT THE END OF THIS MORNING'S SESSION OF THE BOARD THAT THE STAFF HAD REACHED AGREEMENT WITH MEXICO AND ARGENTINA (SEE MIFT, NOT TO MEXICO CITY). ON MEXICO, A LETTER OF INTENT AND ASSOCIATED DOCUMENTS HAD BEEN AGREED SUBJECT TO A FEW DRAFTING MATTERS. THE PROPOSAL WAS FOR A THREE-YEAR EFF FOR 450 PERCENT OF QUOTA (SDR3.6 BN), TO RUN FROM 1 JANUARY 1983. A DRAWING UNDER THE CFF WAS, HOWEVER, NOT CONTEMPLATED. THE MD SAID THAT HE HAD TOLD THE AUTHORITIES THAT HE WAS GOING TO PRESENT THE PROGRAMME TO THE EXECUTIVE BOARD WITH A RECOMMENDATION FOR APPROVAL. THE PROPOSAL WAS LIKELY TO BE ON THE BOARD'S AGENDA FOR THURSDAY, 23 DECEMBER. IT WAS HOPED TO CIRCULATE THE STAFF REPORT BY 8/10 DECEMBER, WHICH WOULD ENTAIL SOME SHORTENING OF THE NORMAL PERIOD OF EXAMINATION OF MAJOR PROGRAMMES.

2. THE AUTHORITIES HAD INDICATED THAT THEY WOULD PUBLISH THE LETTER OF INTENT. THIS COULD THEREFORE BE CIRCULATED RELATIVELY SOON. IT WOULD BE FOR THE MEXICANS TO MAKE A PUBLIC ANNOUNCEMENT OF THE AGREEMENT.

3. THE PRESIDENT-ELECT HAD BEEN FULLY INFORMED OF THE PROGRAMME AND HAD INDICATED TO THE STAFF THAT HE INTENDED TO IMPLEMENT IT FULLY UPON COMING INTO OFFICE.

4. THE MANAGING DIRECTOR COMMENTED THAT BEFORE ACTING ON THESE MATTERS, HE WOULD NEED TO BE SATISFIED THAT THE NECESSARY EXTERNAL FINANCING ENVIRONMENT WOULD BE AVAILABLE TO MAKE THE PROGRAMME FEASIBLE. HE WOULD BE LOOKING INTO THIS. THE FINAL DECISION WOULD, OF COURSE, LIE WITH THE BOARD. (WE KNOW FROM PRIVATE CONVERSATIONS WITH THE STAFF THAT THEY ARE WORRIED ABOUT THE RELATIVE INSIGNIFICANCE OF FUND DRAWINGS UNDER THE PROGRAMME IN RELATION TO MEXICO'S IMMEDIATE FINANCING NEEDS. FOR EXAMPLE, THE AMOUNT AVAILABLE FROM THE FUND IN THE FIRST YEAR MIGHT BE BARELY SUFFICIENT TO PAY OFF EVEN THE BRIDGING LOAN FROM THE BIS, LET ALONE OTHER CREDITORS.).

5. FCO PLEASE ADVANCE TO APPLEYARD (ERD), LOEHNIS, BALFOUR AND JAGGERS (BANK OF ENGLAND) AND LITTLER, CAREY AND PERETZ (HMT).

(ADVANCED AS REQUESTED)

ANSON

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Original on Trade: Non Tariff Barriers Pt 2

CONFIDENTIAL

(1) Prime Minister

To note

MCS 4/11

(2) Mr Coles

PRIME MINISTER

I refer to the Chancellor's minute of 19 October proposing measures to reduce export credit risks and subsidies. I comment also on the question of ECGD exposure worldwide and in Mexico which Cabinet raised last month.

The measures proposed by the Chancellor provide a basis for officials of the Departments concerned to draw up some new operating guidelines. But officials need also be instructed to have regard to broader aspects of the problem because it is essential that we get the right balance between financial prudence and the interests of our exporters at a time of continued recession and difficulty.

First, I would strongly underline what the Chancellor says about export interest rate subsidies and credit risks being different issues. Unless our export interest rates match those of our competitors, we will inevitably lose business in many perfectly creditworthy markets. And a substantial proportion of our exports to riskier markets, being on short-term credit, do not attract interest rate subsidy. As the Chancellor notes, the essential control on interest rate subsidies is the level at which the Consensus rates are set. The last two consensus negotiations, together with favourable movements of commercial rates, have markedly reduced the subsidy burden in respect of all markets. I am reluctant to follow him in seeking to anticipate the next round of negotiations. But I do agree that we should seek to persuade our partners to resist a return to the very high subsidy costs of a year or two ago, especially for exports to the rich countries. The Consensus is of particular importance to the competitive position of United Kingdom project exports and I shall be getting advice from the Overseas Projects Board before the next round of negotiations.

CONFIDENTIAL

Secondly, the controls suggested by the Chancellor could be a useful reinforcement to existing mechanisms governing ECGD exposure provided that:-

(i) they are not operated in an unduly rigid fashion;

(ii) they are relaxed as and when circumstances permit; and

(iii) they have regard to the fact that companies cannot swiftly switch from one export market to another - market positions can take much time and money to establish.

I agree, however, that there is a need for prudence in limiting ECGD's credit exposure on markets facing debt service difficulties; and that the country risk should be given more weight in future. I would like official efforts in this direction to be focussed on ECGD's Section 2 (National Interest) operation. I see no cause for breaking the long tradition of relying upon ECGD's statutory Advisory Council's commercial advice in respect of Section 1 operations. I would also hope that any proposed global limit on ECGD's Section 2 exposure - for which I see no strong case - would not be used to force ECGD into an ultra-cautious policy. This would carry the following dangers:-

(a) it would drastically reduce the export opportunities for British exporters (and markets once lost are difficult to recover);

(b) it might in fact lead to more country defaults if it added to the growing crisis of confidence amongst international commercial lenders; and

(c) it could have a long-term effect on the viability of the ECGD scheme by undermining the insurance concept of spead on which it has been built.

Thirdly, I agree that we should have a procedure whereby more of the major projects,for which a competitive financial package has to involve a large amount of subsidy to the customer, should come to Ministers for collective decision. But we should not try to fix some arbitrary limits of acceptability in advance. The various elements in the judgement are too complex for that. And we owe it to our exporters to ensure that such a procedure is operated with the speed required by an intensively competitive market-place.

As to the present position on ECGD's exposure worldwide and in Mexico, I attach two notes summarising the situation. On Mexico, ECGD has already taken steps to avoid adding to its substantial existing exposure for the time being; but I believe that we should avoid any announcement that it is off cover. The situation there could improve fairly rapidly if the present rescue negotiations are carried through successfully; and there is a real risk that an announcement of the withdrawal of ECGD cover would affect the confidence of other lenders.

ECGD's exposure worldwide now totals some £28,600 million. This is reasonably well spread both by markets and by category of export. A large part of it concerns goods sold on cash or short-term credit; and exports to safe, developed markets. Support for exports to the weaker, developing countries is carefully controlled by the ECGD Advisory Council, and by the official Export Guarantees Committee which considers Section 2 applications. It is not possible for ECGD to reduce its exposure quickly since the bulk of its liabilities represent contracts already obtained and in the course of completion. Nothing leads to more ill will than withdrawal of cover from business already being negotiated. But action has already been taken to withdraw cover for future business with a number of countries already experiencing debt service difficulties. The existing procedures for careful scrutiny of the forward country risk, together with the new controls that the Chancellor has proposed, are adequate to ensure that ECGD exposure on highly vulnerable overseas markets does not reach an unacceptable level.

I am sending copies of this minute to the Chancellor, other members of EX, and to Sir Robert Armstrong.

Arthur Cockfield

Department of Trade
1 Victoria Street
London, SW1H OET

LORD COCKFIELD

4 November 1982

MEXICO - ECGD'S POSITION

Mexico is currently the fourth largest market in ECGD's portfolio. Whilst there is no way that the existing exposure can be quickly reduced (as it relates to cover for contracts already signed) action has already been taken to restrict future cover very closely whilst Mexico's debt service problems persist.

Present arrangements for cover

a Short Term credits (up to 180 days)

Cover remains available without formal restriction but ECGD is operating close control over all new applications at present. The volume of this business is not substantial.

b Medium and Long Term credits (normally up to 10 years maximum)

Reduced market limits have now been applied as follows:

Section 1 (commercial account) - £650m

Section 2 (national interest account) - £600m.

The bulk of these limits has already been utilised (only about £75m being uncommitted). Most of this will be needed to support contracts which have already been signed but where the guarantee has yet to be issued, and potential contracts where the negotiations have reached a very advanced stage. However for the time being ECGD is exercising administrative delay in dealing with all new applications for cover.

c Country grading

Mexico has been downgraded from 'B' to 'C' in view of its deteriorating economic outlook (but ECGD's claims experience so far remains good).

Current exposure

ECGD's maximum exposure now totals £1203 million. This relates to firm business where the contracts have been signed and the guarantees issued and includes provisions for future interest payments. Apart from an estimated amount at risk of £28m for Short Term business, the exposure relates to Medium and Long Term credits with payments maturing over the next 20 years.

Specific Cases

i Sunderland Shipbuilders/Trans. Maritima Mexicano (TMM)

This contract valued at £20.8m was signed on 18 June 1982. No ECGD guarantee has as yet been issued but it would be contrary to established practice to refuse to cover a contract signed in all good faith against the Department's indication that cover would be available.

ii Sunderland Shipbuilders/TMM

No contract (potential value £21.5m) has as yet been signed but the builders have reportedly entered into an "agreement to supply" 2 ships of which item i. is the first and this the second. There is no formal ECGD commitment to provide cover for this additional vessel and ECGD does not propose to offer support under current circumstances. (This decision will probably lead to strong protests from the builders).

iii Sicartsa Steel Mill

This is a firm commitment and accounts for approximately £465m of the total exposure of £1203m on Mexico. Following the signing of a Memorandum of Understanding between the Prime Minister and President Portillo, Davy Loewy entered into contracts in February 1982 valued at £350m with a UK content of £200m. This represented Mexico's largest ever export order and will provide 28,000 man years of work for UK industry. Finance is being provided by an ATP grant of £35m and ECGD supported export credits of £197m and Dm 151m at a fixed rate of 7¾% with repayments over 13 years after a 2 year grace period. Loan agreements and ECGD guarantees were signed on 14 April 1982 and, as the contract will take 5 years to complete, final payment will not be due until 2002.

ECGD is legally committed to cover the Davy Loewy contracts and there are no grounds which would allow the Department to withdraw at this stage. Even were the project to be cancelled by the Mexicans there would be termination costs to be funded by loan drawings. In addition ATP funds of £32m have been advanced.

Repayment of principal of the ECGD guaranteed loans is not due to commence until 1989, hopefully well beyond the current period of financial difficulty.

ECGD'S WORLDWIDE EXPOSURE - SEPTEMBER 1982

(Note by Export Credits Guarantee Department)

Introduction

1 This paper reviews ECGD's exposure at the present time and looks in particular at its exposure on vulnerable overseas markets. Like all its counterparts overseas, ECGD is currently passing through a very difficult period in its operations. Because of the world recession major country defaults in addition to the financial difficulties of individual buyers overseas have reached unprecedented levels. Over the last five financial years ECGD has paid claims totalling over £1000 million, against a premium income of about £750 million. Reserves built up in earlier years have thus been sharply reduced. Approximately 65% of claims paid relate to general country problems (delays in transferring foreign exchange etc). ECGD covers about 30% of total British exports but a very much higher proportion of exports of manufactured goods and capital plant which are traditionally sold on Medium and Long Term credit. The Department's business has been based on the concept of spread of risk and covers a wide range of exports to all viable overseas markets. However, because of difficult world trading conditions many important overseas markets are now vulnerable to debt service problems. ECGD's exposure on these is analysed below but it should be noted that ECGD's commitments on an overseas market cannot be reduced quickly as the current amount at risk relates to guarantees issued over recent years insuring contracts at various stages of completion. However the exposure figures, which reflect the maximum amount that the Department has guaranteed including future interest payments, greatly exceed the probable amount of loss that ECGD would suffer if a country defaulted. Even in the unlikely event of a country reneging on its entire existing debt ECGD's liabilities would be reduced by the savings resulting from the stoppage of shipments and drawings under guaranteed credits and the consequential additional reduction in interest payable under the contracts.

Current worldwide exposure

2 The maximum amount ECGD can guarantee is set by Parliament. At present ECGD is authorised to accept liabilities up to a maximum of £30,000 million in sterling and a further SDR 20,000 million in foreign currencies. The actual total amount at risk worldwide is currently estimated at £28,600 million. The comparable figure 3 years ago was £17,000 million. Of the current amount at risk Short Term business (ie where payment is to be made within 180 days) accounts for £4,200 million (£3,900 million). ECGD credit exposure involving repayment terms of 2 years or more is of the order of £24,400 million, (£13,100 million). Of this about 48% is covered under the Section 1 commercial account and 52% under Section 2 national interest account. In general it is the Department's credit exposure - rather than its revolving Short Term business - which is most vulnerable to a deterioration in overseas market conditions. The table at Appendix A shows the 30 largest markets by exposure at the present time. Fortunately this includes many markets where there is no immediate threat of a financial crisis. However, those which might be vulnerable to balance of payments or political difficulties are analysed in more detail below.

Horizon of Risk

3 In accordance with international practice (governed mainly by the OECD Consensus arrangements) the maximum credit periods normally supported range from 5 years for richer markets to 10 years for developing countries. Exceptionally, longer terms can apply in certain sectors (eg nuclear power stations). Allowing for the period between contract and delivery/commissioning therefore the

Department's horizon of risk for major projects can reach 15-20 years. (In the case of the Castle Peak B project in Hong Kong for example, the forward exposure period runs up to the year 2002). Therefore, once ECGD has committed itself to guarantee a contract it is locked in for a long period ahead.

Methods of country assessment

4 Long term forecasting of the sort required is far from an exact science and account has to be taken of political developments as well as economic trends. Appendix B describes the present system of country risk assessment and controls. In assessing market risks the Department has access to international financial statistics and the advice from our embassies abroad. Economic and political developments in all significant markets are kept under continuing review. Decisions on Section 1 cover are taken after consultation with the Advisory Council of businessmen and on the basis of a prudent, commercial view of the overseas risks. Requests for cover on the largest and more marginal risks are directed towards the Section 2 (national interest) account. Here the Export Guarantees Committee of interested Departments (chaired by the Treasury) attempts to balance the UK national interest benefits involved in terms of employment etc against the risk of non-repayment. In recent years greater emphasis seems to have been given by the EGC (and Ministers when agreement at official level is not reached) to the industrial/employment arguments than to the risks involved. Consequentially ECGD's exposure on a number of vulnerable markets is higher than it would have wished.

Spread of risk

5 ECGD's cover is reasonably well spread at the present time. However because of the greater opportunities for exporters of engineering goods and capital plant in developing countries exposure on these is rising. The table at Appendix C shows the present geographical spread of business. Mexico (4.9%) and Latin American countries (7.1%), together with the CMEA bloc (9.3%) account for about 21% of the total exposure, and many of these countries fall into the vulnerable category. Potentially the most dangerous concentration of risk is on Hong Kong/China which already represents 13.5% of the total portfolio (and if the current negotiations on the nuclear power project succeed this figure could be doubled). The table at Appendix D shows exposure in relation to each grade of market. Markets are classified on a 4 grade system (A-D) in accordance with the assessment of their vulnerability to economic/political problems; this increases the premium for cover in the riskier markets, "A" being the lowest and "D" the highest risk category. At present the balance between the exposure on the better (A and B markets) and the riskier C and D markets is satisfactory.

Exposure on vulnerable markets

6 The growing number of developing countries which have run into serious debt service difficulties has meant that ECGD has had to withdraw or severely curtail its cover for many important overseas markets. Appendix E lists those for which credit cover under both Section 1 and Section 2 has been withdrawn in the last year or so and other markets for which no cover is currently available. The amounts at risk shown in all cases are in respect of business underwritten before cover was withdrawn. It is important to bear in mind that although cover may formally have been withdrawn, it is always open for sponsoring Departments to submit a case for supporting a particular contract under the Section 2 national interest arrangements. A measure of cover has, for example, been made available

exceptionally for Ghana and Zambia despite the general non-availability of cover. Countries who have rescheduled their debts (or are about to do so) are listed in Appendix F. It is normal practice to withdraw cover for further business on such markets and this would only be restored when it can be demonstrated that the rescheduling agreement is being honoured and circumstances have improved sufficiently to justify further lending.

7 Because of the Department's adverse experience, cover is therefore not available for countries such as Iran, Poland, Romania, Yugoslavia and Cuba, all of whose economic difficulties are well-known. Nor is it intended to restore cover for Argentina under present circumstances. Other important markets that might run into difficulties are listed in Appendix G. Cover for future business on all of these is being carefully controlled. With the exception of Hong Kong and China, monetary limits (see Appendix B) have been set on the total liability the Department can accept without further review on each of the markets listed under both Section 1 and Section 2. In the case of Hong Kong and China there are no formal Section 2 limits but all project business is considered on a case by case basis in consultation with Whitehall Departments.

No new cover is in practice being given for Mexico at present. Cover is also tightly restricted on Brazil, Egypt, Kenya, GDR and Hungary which seem to be the most vulnerable of the other markets listed. Over a longer term both India and China may present problems if the extend their reliance on official export credit, rather than aid, to finance their major investments.

Conclusions

1 ECGD's worldwide exposure is reasonably well spread:both geographically and between the developed and developing world.

2 Nevertheless ECGD has a high exposure on many major markets that might be vulnerable to a debt crisis over the next few years.

3 No action can be taken to reduce the level of ECGD's existing commitments on these markets but strict limits are being applied to additions to the current exposure.

ECGD
September 1982

ECGD

MARKETS RANKED BY TOTAL AMOUNTS AT RISK OUTSIDE SHORT TERM

Position as at April 1982 (last year's ranking in brackets)

	COUNTRY		GRADE	TOTAL AMOUNT AT RISK £m
1	Hong Kong	(1)	A	2893
2	South Africa	(2)	A	1643
3	USA	(3)	A	1491
4	Mexico	(14)	B	1056
5	Brazil	(4)	C	914
6	Poland	(5)	D	899
7	Nigeria	(12)	C	834
8	Yugoslavia	(8)	D	737
9	USSR	(6)	B	734
10	Iran	(13)	D	592
11	India	(10)	C	585
12	South Korea	(9)	B	557
13	Indonesia	(25)	C	531
14	Iraq	(-)	C	460
15	Egypt	(28)	D	402
16	Romania	(11)	D	400
17	Canada	(22)	A	356
18	Dubai	(7)	B	338
19	Oman	(15)	C	308
20	Algeria	(16)	C	305
21	Argentina	(20)	C	284
22	Kenya	(18)	C	279
23	Greece	(-)	A	277
24	Jordan	(-)	C	274
25	China	(17)	B	210
26	Philippines	(24)	C	208
27	Irish Republic	(23)	A	185
28	Switzerland	(-)	A	179
29	Norway	(21)	A	175
30	Liberia	(26)	C	172

NOTE ON ECGD'S SYSTEM OF COUNTRY ASSESSMENT AND CONTROLS

System of Assessment

1 ECGD makes assessments of the creditworthiness of overseas markets based on all the available information on economic performance (balance of payments, GDP growth, debt service, reserves, etc) and political developments.* ECGD's past experience and commitments are taken into account. In most problem markets limits are set which determine the maximum amount that can be underwritten for that market without further review. These are set after consultation with the Advisory Council of businessmen for Section 1 (commercial account) operations or the inter-Departmental Export Guarantee Committee for Section 2 (national interest) operations. The limits are fixed after taking into account the usual level of demand for cover on the country concerned and represent the maximum amount of exposure for that market. In practice ECGD would not expect to meet claims amounting to the total amount of its exposure even if a country defaulted on all its debts, because many guaranteed contracts would only have been partially completed at the time the default occurred. The table in the Appendix attached gives details of ECGD's current exposure on some of the more vulnerable developing countries.

2 It is important to note that ECGD is not able to take swift evasive action when a debt crisis has become apparent as its commitments run for a long period ahead (allowing for the negotiating, contract completion and credit periods, the Department may need to look 10-20 years ahead). Once a deteriorating trend has been discerned the Department can act to reduce limits or even stop all future cover, but such action is unlikely to affect significantly the amount falling due over the next year or so that might fall for rescheduling if a developing country gets into debt servicing difficulties.

Existing Control Mechanisms

3 The Department's main methods of control over the growth of its liabilities on vulnerable markets are, therefore:-

i country limits applied to the maximum amount at risk on a market (excluding short term business)

and ii a country grading system, which classifies overseas markets in four grades (A to D) in accordance with the assessment of their vulnerability to economic/political problems. This increases the premium charges for medium and long term cover in the riskier markets.

APPENDIX C

ECGD exposure by geographical regions (£m) - Position as at September 1987

	S1	% of total S1 AAR	S2	% of total S2 AAR	Total	% of total AAR
Developed countries:						
EC	691.3	5.9	12.1	0.1	703.4	2.9
Rest of Europe	988.2	8.5	197.6	1.6	1,185.8	4.9
North America	1,043.7	8.9	922.8	7.3	1,966.5	8.1
Others	514.3	4.4	131.6	1.0	645.9	2.7
Developing countries:						
CMEA	820.5	7.0	1,456.2	11.4	2,276.7	9.3
Latin America (excluding Mexico)	753.2	6.4	986.9	7.8	1,740.1	7.1
China, Hong Kong	741.8	6.4	2,554.4	20.1	3,296.2	13.5
Sub-Sahara Africa (inc. South Africa)	2,042.9	17.5	2,002.2	15.7	4,045.1	16.6
Asia (excluding China, Hong Kong)	1,381.7	11.8	1,331.4	10.5	2,713.1	11.1
Middle East	1,318.1	11.3	1,519.0	11.9	2,837.1	11.6
of which oil exporters	868.0	7.4	1,075.6	10.0	1,943.6	8.0

The above Amounts at Risk do not add up to the global Amount at Risk as certain markets eg Caribbean are not included in this Appendix.

APPENDIX D

ECGD exposure by market grades (£m) - Position as at September 1987

Grade	S1	% of total S1 AAR	S2	% of total S2 AAR	Total	% of total AAR
A	4,738.5	40.5	4,360.6	34.2	9,099.1	37.2
B	1,688.9	14.5	1,564.7	12.3	3,253.6	13.3
C	4,480.1	38.3	4,226.5	33.2	8,706.6	35.7
D	788.7	6.7	2,578.2	20.3	3,366.9	13.8

S1 = Section 1 Commercial Account
S2 = Section 2 National Interest Account
AAR = Amount at Risk

Grade A = lowest risk/lowest premium grade
Grade D = highest risk/highest premium grade.

The current distribution of markets over the 4 grades is: A 18.7%; B 10.1%; C 44.4%; D 26.8% out of a total of 198 markets for which we currently have amounts at risk or are open for cover.

APPENDIX E

[illegible]jor markets for which ECGD cover withdrawn
[illegible]ring past 2 years (and not reinstated) (£m) - Position as at September 1982

	S1 AAR	S2 AAR	Total AAR
Poland	161.1	715.7	876.8
Yugoslavia	136.2	575.1	711.3
Romania	53.5	340.7	394.2
Argentina	115.9	152.0	267.9
Tanzania	34.3	57.9	92.2
Cuba	46.3	29.0	75.3
Bolivia	11.2	21.4	32.6
Senegal	26.4	-	26.4
Malawi	11.6	9.8	21.4
Costa Rica	2.9	-	2.9
Dominican Republic	0.2	-	0.2

Other major markets for which no ECGD cover currently available

	S1 AAR	S2 AAR	Total AAR
Iran	59.3	106.0	165.3
Zambia	14.0	91.2	105.2
Turkey	19.4	85.7	105.1
Ghana	8.1	37.0	45.1
Zaire	-	36.7	36.7
Sudan	21.1	9.8	30.9

S1 = Section 1 Commercial Account

S2 = Section 2 National Interest Account

AAR = Amount at Risk

APPENDIX F

RESCHEDULING AGREEMENTS - Position as at September 1982

1) Agreements signed

	£m
Ghana	24.79
Guinea	6.34
Indonesia	9.64
Madagascar	2.43
Peru	6.32
Poland	54.4
Sierra Leone	0.73
Sudan	49.5
Togo	21.0
Turkey	56.30
Zaire	33.26

2) Signatures pending

	£m
Liberia	1.8
Senegal	0.78
Sudan	10.25
Turkey	63.7

3) Negotiations pending on new or extending rescheduling.

Central African Republic - Costa Rica - Guyana - Liberia - Madagascar - Nicaragua - Poland - Romania - Senegal - Sierra Leone - Sudan - Togo - Uganda - Vietnam - Zaire.

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APPENDIX G

Markets of high exposure/vulnerability for which
ECGD cover currently available (£m) - Position as at September 1982

	Ranking in "top 30" list of markets by exposure	S1	% of total S1 AAR	S2	% of total S2 AAR	Total	% of total AAR
Hong Kong	1	550.2	4.7	2,538.6	20.0	3,088.8	12.7
South Africa	2	841.2	7.2	734.3	5.8	1,575.5	6.5
Mexico	4	693.3	5.9	468.5	3.7	1,161.8	4.8
Brazil	5	283.8	2.4	709.7	5.6	993.5	4.1
Nigeria	7	767.2	6.6	239.8	1.9	1,007.0	4.1
USSR	9	473.3	4.1	337.2	2.7	810.5	3.3
India	11	291.1	2.5	294.3	2.3	585.4	2.4
South Korea	12	184.7	1.6	346.0	2.7	530.7	2.2
Indonesia	13	232.2	2.0	334.0	2.6	566.2	2.3
Iraq	14	438.5	3.8	92.8	0.7	531.3	2.2
Egypt	15	122.2	1.1	274.7	2.2	396.9	1.6
Kenya	22	58.2	0.5	206.1	1.6	264.3	1.1
Jordan	24	253.1	2.2	83.8	0.7	336.9	1.4
China	25	191.6	1.6	15.8	0.1	207.4 *	0.9
GDR	-	38.9	0.3	61.8	0.5	100.7	0.4
Hungary	-	34.9	0.3	0.8	neg	35.7	0.1

S1 = Section 1 Commercial Account

S2 = Section 2 National Interest Account

AAR = Amount at Risk

* NB If UK obtains nuclear plant contract, AAR would increase by £1000-4000m.

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AND TO PRIORITY TREASURY, DOT, ECGD, BANK OF ENGLAND, UKDEL IMF/IBRD
WASHINGTON.

MY TELNO 903: MEXICAN ECONOMIC CRISIS

SUMMARY

1. THE MEXICAN PRESIDENT AND GOVERNMENT STILL SEEM UNABLE TO BRING THEMSELVES TO COPE WITH THE INCREASINGLY SEVERE CRISIS AFFLICTING THE MEXICAN ECONOMY. THERE ARE CONFLICTING REPORTS ABOUT THE CURRENT NEGOTIATIONS WITH THE IMF. HOPES ARE PINNED ON THE PRESIDENT-ELECT, WHO TAKES OFFICE IN 33 DAYS.

ROLE OF THE MEXICAN GOVERNMENT

2. WITH 33 DAYS OF THE LOPEZ PORTILLO ADMINISTRATION TO RUN, THE LACK OF DIRECTION AND COHERENCE IN THE GOVERNMENT'S HANDLING OF THE CRISIS IS BECOMING MORE MARKED. HAVING ESTABLISHED FOR GOOD OR ILL HIS PLACE IN MEXICAN HISTORY BY THE MEASURES OF 1 SEPTEMBER, THE PRESIDENT SEEMS TO HAVE RETIRED TO A POSITION OF OLYMPIAN ALOOFNESS. THE MINISTER OF FINANCE IS TRYING TO IMPOSE A SENSE OF REALISM ON THOSE OF HIS COLLEAGUES WHO ARE STILL UNWILLING TO ACCEPT THAT ENORMOUS MISTAKES HAVE BEEN MADE, AND THAT ECONOMIC RECOVERY CAN ONLY COME THROUGH A LONG PERIOD OF AUSTERITY. OFFICIALS ARE STRUGGLING TO PRODUCE WORKABLE REGULATIONS TO DEAL WITH A SITUATION OF WHICH THEY HAVE NO EXPERIENCE AND WHICH IS CONSTANTLY CHANGING.

/SITUATION

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SITUATION OF MEXICAN INDUSTRY.

3. THE PROBLEMS OF MEXICAN INDUSTRY ARE ACCUMULATING. IMPORT LICENCES FOR ESSENTIAL PARTS OR MATERIALS ARE PROVING LESS DIFFICULT TO OBTAIN THAN THE FOREIGN CURRENCY TO PAY FOR THEM. EXCEPT IN THE CASE OF THE STATE OIL COMPANY, PEMEX, FOREIGN CURRENCY EARNINGS FROM EXPORTS ARE FOR THE MOST PART NOT REACHING THE MEXICAN BANKING SYSTEM, AS MORE AND MORE COMPANIES MAKE COMPENSATING, BARTER OR OTHER ARRANGEMENTS TO FINANCE IMPORTS. FOR EXAMPLE, I UNDERSTAND THAT VOLKSWAGEN ARE ENTERING INTO COMPLEX ARRANGEMENTS TO BRING MEXICAN COFFEE TO GERMANY IN ORDER TO IMPORT CAPITAL GOODS AND SPARE PARTS NECESSARY FOR THEIR OPERATIONS IN MEXICO. NO ONE BELIEVES THAT THE PRESENT DUAL PARITY EXCHANGE SYSTEM CAN SURVIVE MUCH LONGER AND THAT THE PROGRAMME FOR SUCCESSIVE REDUCTION OF INTEREST RATES CAN CONTINUE.

LABOUR SITUATION

4. THE THREAT OF WIDE-SPREAD STRIKES IN NOVEMBER REMAINS. THE CTM (CONFEDERATION OF MEXICAN WORKERS) IS BACK-PEDDLING AFTER ITS ORIGINAL DEMAND OFOR A 50% WAGE INCREASE BACK-DATED TO 1 AUGUST. IT NOW SEEMS TO BE ENCOURAGING SETTLEMENTS AT A FLAT RATE OF 50 PESOS A DAY, REPRESENTING AN INCREASE OF ABOUT 12%. SOME SETTLEMENTS HAVE BEEN REACHED ON THIS BASIS OR AT EVEN LOWER LEVELS. BUT NEGOTIATIONS IN THE CRUCIAL NATIONALISED INDUSTRIES HAVE NOT BEEN CONCLUDED, AND SOME PRIVATE SECTOR COMPANIES ARE TAKING A FIRM STAND AGAINST ANY WAGE INCREASE AT A TIME WHEN THEY ARE HAVING TO LAY OFF LABOUR IN A STRUGGLE FOR SURVIVAL. SOME OF THE AMERICAN OWNED CAR COMPANIES, WHICH GAVE BIG WAGE INCREASES IN FEBRUARY AND AGAIN IN THE SUMMER, MIGHT EVEN WELCOME STRIKES AS THEIR STOCKS ARE UNCOMFORTABLY HIGH AND DEMAND IS STILL DECLINING.

NEGOTIATIONS WITH THE IMF

5. THERE ARE CONTRADICTORY ACCOUNTS FROM MEXICAN OFFICIALS ABOUT PROGRESS IN THE IMF NEGOTIATIONS. THE WORD IN THE MINISTRY OF FINANCE IS THAT THE LETTER OF INTENT COULD WELL BE SIGNED WITHIN A FEW DAYS. THE DIRECTOR OF EXTERNAL FINANCE IN THE MINISTRY TOLD US YESTERDAY THAT EVIDENCE OF PROGRESS WAS THAT MEXICO WAS NOW ABLE TO START DRAWING FROM THE SECOND TRANCHE OF THE BIS BRIDGING LOAN. BUT OTHER ACCOUNTS SUGGEST THAT AGREEMENT IS STILL SOME WAY OFF. CARLOS TELLO (GOVERNOR OF THE BANK OF MEXICO) TELLS JOURNALISTS THAT NEGOTIATIONS ARE ON COURSE, BUT WITH FRIENDS HE SPEAKS BITTERLY ABOUT WHAT HE SEES AS THE INFLEXIBILITY AND INSENSITIVITY OF THE IMF NEGOTIATORS. SOME BELIEVE THAT THE MINISTRY OF FINANCE IS GIVING A MISLEADING ACCOUNT OF DRAWINGS FROM THE BIS LOAN: THEY SAY THAT THE AMERICANS ARE WILLING FOR DRAWINGS TO BE MADE FROM THE SECOND TRANCHE, BUT THAT THE EUROPEAN CENTRAL BANKS HAVE SO FAR RESISTED.

/THE FUTURE

THE FUTURE

6. IN THIS STATE OF GLOOM AND UNCERTAINTY MUCH HOPE - PROBABLY TOO MUCH - IS PINNED ON PRESIDENT-ELECT DE LA MADRID. BY 1 DECEMBER THERE SHOULD BE AN AGREEMENT WITH THE IMF, AND PEOPLE WILL FEEL THAT THEY KNOW THE WORST. SHORTLY AFTERWARDS DE LA MADRID WILL UNVEIL A PROGRAMME OF NATIONAL RECOVERY ON WHICH HE AND HIS STAFF HAVE BEEN WORKING FOR MONTHS, AND CAN BE PRESUMED TO ENTER OFFICE WITH CONSISTENT AND COHERENT IDEAS. HE IS KNOWN AS A CAUTIOUS ECONOMIST WITH SOUND UNDERSTANDING OF INTERNATIONAL FINANCE AND THE REALITIES OF MEXICO'S CURRENT PREDICAMENT. HE IS EVEN SAID TO BE WILLING TO REVIEW THE QUESTION OF MEXICAN MEMBERSHIP OF THE GATT. THE CHANGE OF POWER WILL THEREFORE MARK AN IMPORTANT PSYCHOLOGICAL CHANGE, AND WHATEVER HAPPENS, DE LA MADRID WILL ENJOY A HONEYMOON WHICH SHOULD CARRY HIM WELL INTO THE SPRING. IT IS A NICE QUESTION HOW MUCH HE WILL BE ABLE TO BLAME HIS PREDECESSOR FOR MEXICO'S MISFORTUNES. HE MAY FEEL THAT BY SO DOING HE COULD SHAKE CONFIDENCE IN THE SYSTEM OF WHICH HE HIMSELF IS A PRODUCT. CERTAINLY MEXICO'S PROBLEMS CANNOT ME TRANSFORMED OVER-NIGHT, AND MAY INDEED GET WORSE BEFORE THEY CAN GET BETTER. DE LA MADRID WILL BEGIN OFFICE ACUTELY CONSCIOUS NOT ONLY OF THE DANGERS OF THE CURRENT CRISIS BUT OF AN UNDERLYING THREAT TO THE WHOLE POLITICAL SYSTEM.

TICKELL

[THIS TELEGRAM WAS NOT ADVANCED]

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TO IMMEDIATE FCO
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IMF: ARGENTINA

1. THE MANAGING DIRECTOR HELD AN INFORMAL MEETING FOR G5 DIRECTORS THIS EVENING TO BRING THEM UP TO DATE ON NEGOTIATIONS WITH ARGENTINA. MEXICO WAS ALSO DEALT WITH BRIEFLY (SEE MIFT).

2. ROBICHEK (WESTERN HEMISPHERE DEPARTMENT) SPOKE FOR THE STAFF. THE MISSION HAD RETURNED ON THE PREVIOUS DAY AFTER SIX WEEKS OF TALKS. THE NEGOTIATIONS HAD BEEN DIFFICULT. WHEN HE HAD JOINED THE MISSION HE HAD FOUND THAT MANY PROBLEM AREAS NEEDED TO BE PULLED TOGETHER. HE DESCRIBED THE SIZE OF THE ECONOMIC PROBLEM AS SHOCKING.

3. ROBICHEK HAD BROUGHT BACK WITH HIM A MEMORANDUM FROM THE GOVERNMENT OF ARGENTINA DESCRIBING THE STEPS IT HAD TAKEN AND THE POLICIES IT PROPOSED TO FOLLOW IN THE CONTEXT OF A FUND ARRANGEMENT. THERE WERE MANY GAPS IN IT, BOTH IN RELATION TO BASIC INFORMATION AND PROSPECTIVE MEASURES. THE BROAD OBJECTIVES OF A STAND-BY PROGRAM LASTING 15 MONTHS HAD BEEN AGREED AND PROVISIONAL AGREEMENT HAD ALSO BEEN REACHED ON PERFORMANCE CRITERIA. BUT A NUMBER OF SUPPORTING POLICIES NEEDED TO BE SPECIFIED AND DECISIONS WERE URGENTLY REQUIRED IN CERTAIN AREAS. HE MENTIONED IN PARTICULAR INTEREST RATES WHICH WERE TECHNICALLY WITHIN THE CENTRAL BANK'S PROVINCE OF ACTION: AN IMMEDIATE INCREASE WAS NEEDED BUT THE MATTER WOULD HAVE TO BE PUT TO THE QUOTE SUPREME POLITICAL AUTHORITIES UNQUOTE WHO SO FAR SEEMED NOT TO HAVE BEEN CONSULTED ON THE PROGRAM. THE MANAGING DIRECTOR HAD NOT YET SEEN THE POLICY MEMORANDUM AND ROBICHEK COULD NOT SAY WHAT HIS REACTIONS WOULD BE TO IT. PRESS REPORTS OF AGREEMENT IN PRINCIPLE WITH THE FUND HAD BEEN PREMATURE TO SAY THE LEAST.

4. THE ARGENTINIANS WERE MOST ANXIOUS TO HAVE THE MANAGEMENT'S ENDORSEMENT OF THEIR POLICY MEMORANDUM. THE PRESIDENT OF THE CENTRAL BANK WAS TO VISIT WASHINGTON ON NOVEMBER 2 ON HIS WAY TO MEET COMMERCIAL BANKERS IN NEW YORK AND HOPED TO CARRY WITH HIM LAROSIERE'S AGREEMENT IN PRINCIPLE THAT A BASIS FOR A FUND ARRANGEMENT HAD BEEN REACHED.

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5. THE MD INTERVENED TO SAY THAT HE MUST OBVIOUSLY BE MOST CAREFUL NOT TO GIVE A FALSE SIGNAL TO THE BANKERS. HE DID NOT SEE HOW HE COULD GIVE A POSITIVE INDICATION IF THERE WERE INDEED IMPORTANT GAPS IN THE AUTHORITIES' POLICY INTENTIONS. IT SEEMED TO HIM THAT THE FUND WAS STILL FAR FROM BEING IN ACCORD WITH THE AUTHORITIES. ROBICHEK WAS OBLIGED TO AGREE THAT THE MD COULD PROBABLY NOT GIVE A FIRM ENDORSEMENT. UPON FURTHER QUESTIONING BY DIRECTORS, ROBICHEK REVEALED THAT AMONG THE NEW MEASURES REQUIRED WAS ACTION TO MITIGATE THE EFFECTS OF MECHANICAL ADJUSTMENTS IN THE WAGE FORMULAE, WHICH WOULD NEED TO BE DECIDED BY THE END OF NOVEMBER. LARGE REAL WAGE INCREASES WERE IMPLICIT IN THE FORMULAE BUT THE STAFF HAD SAID THAT REAL WAGES MUST NOT RISE BY MORE THAN 5 PERCENT NEXT YEAR. THE STAFF WERE ALSO PRESSING FOR A 30 PERCENT INCREASE IN GASOLINE PRICES IN REAL TERMS EARLY IN THE PROGRAM, BUT THERE WAS AS YET NO INDICATION FROM THE AUTHORITIES THAT THEY WERE READY TO CONTEMPLATE SUCH A LARGE INCREASE. HOWEVER, DISAGREEMENT CENTRED MORE ON THE PACE OF ADJUSTMENT UNDER THE PROGRAM RATHER THAN ON ITS ULTIMATE OBJECTIVES.

TIMETABLE

6. ROBICHEK SAID THAT ASSUMING THE ENCOUNTER WITH ARGENTINE OFFICIALS NEXT WEEK COULD BE MANAGED WITHOUT MISHAP, HE INTENED TO SEND A SMALL STAFF TEAM BACK TO BUENOS AIRES IN LATE NOVEMBER OR EARLY DECEMBER TO MAKE A SERIOUS EFFORT TO MONITOR RECENT POLICY STEPS AND TO SEEK AGREEMENT ON FURTHER PRIOR ACTIONS, IN PARTICULAR ON INTEREST RATES, WAGE ADJUSTMENTS AND GASOLINE PRICES. IF ALL WENT WELL, IT MIGHT THEN BE POSSIBLE TO CIRCULATE A PAPER TO THE BOARD BEFORE THE END OF THE YEAR, WITH A VIEW TO A BOARD DISCUSSION IN LATE JANUARY. HE WAS UNSURE AT THIS STAGE WHETHER IT WOULD BE POSSIBLE TO COUNT ON A SIGNED LETTER OF INTENT BEFORE CIRCULATION OF THE PAPER, BUT FIRM UNDERTAKINGS WOULD OF COURSE HAVE TO BE OBTAINED BEFORE MANAGEMENT COULD GO TO THE BOARD.

7. IN THE COURSE OF THE DISCUSSION THE MD STRESSED THAT THE SITUATION WAS VERY FLUID. ANY REPORTS THAT DIRECTORS MIGHT GIVE TO THEIR CAPITALS WERE IN DANGER OF BEING OUT OF DATE BECAUSE MATTERS WERE CHANGING FROM HOUR TO HOUR.

8. FCO PLEASE ADVANCE TO ATKINSON (TREASURY), APPLEYARD (ERD) AND GILCHRIST (BANK OF ENGLAND).

ANSON

[REPETITION TO BUENOS AIRES REFERRED FOR DEPARTMENTAL DECISION]

MONETARY
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SUBJECT

PRIME MINISTER'S
PERSONAL MESSAGE
SERIAL No. T200AA/82

cc Paris + O.D.

PERSONAL

Prime Minister
Wellington
New Zealand

28 October 1982

The Right Hon. Margaret Thatcher, M.P.,
Prime Minister,
10 Downing Street,
LONDON

Dear Margaret,

In recent months I have given a considerable number of addresses on the present condition of the international monetary system which I believe is extremely dangerous.

At the Commonwealth Finance Ministers' Meeting in London, certain proposals that I made were endorsed by the overwhelming majority of Ministers, and a similar response was experienced at the IMF/World Bank Meeting in Toronto and at the Commonwealth Regional Heads of Government Meeting last week in Suva. This week the North South Round Table in Tokyo also endorsed these proposals. I discussed them with Pierre Trudeau in Ottawa and he agreed with my analysis - he was prepared to be persuaded on my solution.

I have to say that representatives of the major industrial countries have been lukewarm at best, but the issue is now a current one and I would like you to be aware of my thoughts. I am attaching a copy of the address that I gave to CHOGRM and a more succinct treatment which I have written as an article for the Commonwealth magazine.

I hope that you will have time to read at least the shorter article so that you are personally familiar with the proposal.

With kind regards.

Yours sincerely,

Rob Muldoon

26 OCTOBER 1982

ARTICLE FOR THE JOURNAL OF THE ROYAL COMMONWEALTH SOCIETY

RIGHT HON. R.D. MULDOON

In 1977 in my address to the annual meeting of the Governors of the International Monetary Fund and World Bank I said "Toomuch attention is being paid to the financing of external deficits and adjustments by deficit countries, while far too little attention is being given to the root cause of these deficits and the resultant debt accumulation. Too many of us are saying with apparent resignation that these massive surpluses and deficits will be with us for some years yet. The result is, of course, that the debt service ratios of the deficit countries will continue to rise to an unacceptable level. These massive deficits are not simply annual figures, they create a cumulative rise in debt. To speak euphemistically of an 'adjustment process' which is of course largely one-sided is to obscure the reality that what is being required of deficit countries is in essence a reduction in their standard of living.

There is already less confidence in the international financial system than has been apparent for some time, and for the first time for many years we are hearing and reading instead of the term 'rescheduling' the more ominous word 'default'. We cannot say to a poor country 'We will pay you much less in relative terms for your goods than we used to pay, but you need not worry as we will lend you the balance at market rates of interest providing you take steps to lower the standard of living of your people.'" That was five years ago. This year all of those chickens have come home to roost.

The second oil shock of 1979 produced pressures which saw a further massive increase in surpluses and corresponding deficits, reckless expansion of country exposure by the private sector banks, the rise in American interest rates in October 1979, which spread a new and dangerous element throughout the world economy, and then in more recent times, the consequences of energy conservation which this year has seen the majority by number of the oil producing countries move from surplus to deficit. They in turn have cut back in purchases from the industrial economies and are liquidating investments in order to finance their deficits.

A year or two ago the private sector banking system was boasting of its effectiveness in recycling oil surpluses. The money was lent, however, with very little thought or with excessive optimism as to the capacity of the countries concerned to pay it back, and yet as I have pointed out, the threat was apparent to an interested observer even before the second oil shock.

In 1981 fourteen sovereign countries sought rescheduling of their external debt in spite of the implications for their long-term reputations as borrowers. This year the number is greater. The private banks are, of course, locked in. Lord Keynes dictum has been rediscovered that if you owe your bank manager a thousand pounds, you are at his mercy, if you owe him a million pounds, he is at your mercy.

Formal default is only being avoided at the present time by postponing obligations but this cannot be disguised and the edges of the banking system are crumbling as more and more depositors move to get their funds out while that is still possible. Multinational corporate borrowers are a further cause of difficulty for the banking system as they in turn are hit by stagnation in the world economy.

Producers of capital goods are in the great difficulty as they lose their markets because of the gross over-capacity that now exists in terms of world demand. These enterprises are to a considerable extent concentrated in the major industrial economies which should be the powerhouses of economic recovery. Political pressures in those countries are now concentrated not on inflation, but on unemployment, a subject which has little relevance to the poorer countries where food, hunger and even starvation are words which occupy the forefront of concern.

As World War II drew to an end the nations of the allied cause met at Bretton Woods to try to plan a new world financial order which would ensure that we did not move out of World War II back into the economic conditions of the 1930's. The International Monetary Fund and the International Bank for Reconstruction and Development were the result of that conference.

The IMF was charged with the oversight of a fixed but flexible system of exchange rates and given the ability through its quotas and drawing rights, to assist a country in temporary or cyclical difficulties by means of short-term, low cost loans to smooth out its difficulties while engaging in an adjustment process which in many places included a discrete adjustment to the exchange rate of its currency unit.

The system worked reasonably well until the early seventies when for legitimate domestic reasons the United States Administration ended the convertibility of the US dollar into gold. Externally held US dollars at that time were massive in quantity and dangerous in their effect on the world economy as they moved about in a manner that was very largely outside the control of the central banks. It was at that time that the Bretton Woods system collapsed and we entered the era of floating currencies which has remained with us during the past decade.

In 1972 at its annual meeting, the IMF set up the Committee of Twenty which was charged with bringing together a new system to take the place of the Bretton Woods system which had collapsed. Just a year or two later the first oil shock had produced new and dangerous factors which led to the demise of the Committee of Twenty, and the formation of the Interim Committee, which no longer had the objective of producing a new system of management, but rather the less ambitious purpose of giving policy advice to the Fund on a continuing basis.

It is my firm belief that we have lost ten priceless years in our failure to put some new form of control of the world financial system in place of the defunct Bretton Woods rules, and that we have now in fact run out of time. What we are faced with today is a series of ad hoc rescue operations - band aid operations if you like - which will be implemented in a frantic attempt to avoid a crash which a sober analysis of the present situation seesas almost inevitable.

An adjustment process country by country in terms of the harsh application of IMF conditionality is no longer capable of succeeding. For the poorer countries a further reduction of living standards in order to balance the external accounts is not only inhumane, it will inevitably lead to political instability at the very least, and frequently much worse than that.

Even for the middle-income countries, and that includes some of the oil producers, there is no possibility of the kind of short-term turnaround that is still envisaged in IMF lending patterns. The IMF is still the obvious international agency to underpin the world's financial system, but what is needed is to bring the IMF into the decade of the eighties. The rules of the forties are no longer adequate.

I have proposed another Bretton Woods-type conference which will sit not for a day or two, or even a week, but until such time as it has hammered out a solution to our problems. I am well aware that what in 1944 were colonies of the major European powers are now independent nations, and that the wealthy major industrial states fear the combined vote of the third world as threatening both their economic supremacy and indeed their wealth itself. The fact is, of course, that that wealth is gravely threatened by the present situation in any case, and some writers are now speaking of the whole world economy as a house of cards that is likely to collapse at any time.

I have no simple solution for these problems, but I have a number of lines of attack. Firstly, the Fund's quotas must be substantially increased so that it has the ability to finance drawings on a much larger scale than ever before. Then drawings must be for a much longer term than has been the case in the past. For most of the countries which are in difficulty a solution is not a matter of a year or two, or even up to five years, but a decade at least. Regardless of whether its recent actions have been responsible or not, the private banking system must be protected in the interests of the total world economy, and there is a role for the Fund, I believe, in acting as a backlog to private sector loans to deficit countries. We must use, in short, the credit of the world community to prevent default in respect of these advances.

The Fund's conditionality must be eased so as to allow adjustment over a longer period and in a manner that is acceptable in terms of the democratic process country by country. Protectionism must be eased so that the poorer countries can find markets for the things that they are able to produce. It is economic lunacy that the European Community today is the world's second largest exporter of sugar, a basic crop of so many third world countries, but produced in Europe, of course, with a massive subsidy under the CAP.

A system of symmetrical surveillance which was discussed just a few years ago and discarded, must be introduced. The Fund must have the ability to discuss with the surplus countries the means by which their surpluses can be reduced so that the corresponding deficits are equally reduced.

There may well be a place for an economic security council formed in a manner similar to the Security Council of the United Nations Organisation and with a role to discuss, advise and maybe intervene in the case of immediate crisis.

International aid flows have stabilised at around 25 billion dollars a year and are declining year by year in real terms. A case can be made for taking basic international aid flows out of the realm of country by country political decisions and creaming off the top of the wealth of the international community a basic sum year by year which represents minimum aid flows. This could be done by an issue of special drawing rights in the Fund, what was called the "Link Proposal" a decade ago. Bilateral aid programmes would then be easier to finance and easier to justify politically country by country.

At the Commonwealth Finance Ministers' meeting in London in September, my proposals in outline were overwhelmingly supported with reservations being expressed by the three wealthy countries of the old Commonwealth. Nevertheless, a study team is being set up to bring down a report on the matter. It need not rest there.

There was a similar range of support when I put these proposals to the Annual Meeting of the Governors of the Fund and Bank at their annual meeting in Toronto. Again the reservations came from the wealthier countries.

I believe that a move of this kind is essential and that it will come. It remains to be seen how much the world community needs to be frightened before the move is made.

In 1944 the nations of the western alliance feared a return to the depression years of the 1930's. Today that prospect is a very real one. The sooner we realise that fact and move to do something about it, the easier it will be.

ADDRESS BY THE RIGHT HON. R D MULDOON C H

PRIME MINISTER OF NEW ZEALAND

TO

THE COMMONWEALTH HEADS OF GOVERNMENT REGIONAL MEETING

SUVA, FIJI

14 OCTOBER 1982

Mr Chairman, Mr Secretary-General, delegates.

At the recent meeting of Commonwealth Finance Ministers I presented an analysis of the world trade and payments system. I put before that meeting certain proposals as to how we might attempt to come to grips with the deepening crisis now facing us.

My conclusion was that the international community faced a simple choice: we could either begin to search now for comprehensive solutions to the problems caused by the collapse of the Bretton Woods system or wait for the situation to deteriorate further when we would be forced to do so but in much less propitious circumstances.

In the six weeks or so since I advanced these views, the Annual Meetings of the International Monetary Fund and the International Bank for Reconstruction and Development have come and gone. There have been countless further analyses of aspects of the crisis in popular and professional journals. Apparently new, but essentially ad hoc proposals have caused a sudden but passing flurry of interest.

In the meantime, the international financial community has continued its attempts to piece together financial rescue operations for debt-ridden countries that do not have the time to wait for the painful process of international consensus to emerge.

Nothing has occurred in that six week period to lead me to alter my fundamental conclusion that the existing institutions are not coping adequately with the nature and extent of the problems we face.

Nor am I persuaded that any modest recovery in economic activity and world trade that may occur - and that is problematic - will be of sufficient magnitude and duration to sweep these problems away.

It is commonplace to talk of the interdependence of economic and political developments. By belief is that the force of that commonplace observation may be brought home to some countries in new and unpleasant ways. Ultimately, this emerging economic crisis carries with it grave political risks. For this reason alone, Heads of Commonwealth Governments in this region - even those of us from small countries - have a duty to be concerned with such matters. Economics, I have heard, is too serious a business to be left to the care of economists.

Before I take my analysis further I would like to spell out quite clearly what my proposals do not entail. I hope this may assist our subsequent discussions.

First, my proposals are in no way intended to undermine the importance of each country pursuing sound domestic economic policies. I am not calling on developed countries to abandon the fight to contain inflation. I am not suggesting that developing countries can afford to suspend the adjustment process in the hope that improved trade and financing mechanisms will provide an easy answer. However, sound domestic policies cannot function adequately if the international environment within which they operate conspires against their success. Sensible domestic and sensible international economic policies are not mutually exclusive. They are both required. Beating the anti-inflationary drum may address some important issues, but not all.

Second, my proposals are not an attack on the existing international economic institutions. On the contrary, it is central to my proposals that these institutions be strengthened and given the resources to do the job properly.

At the same time I believe changes in their approach are required. The evidence I have seen suggests that these institutions need to embrace reforms at a faster pace than they have been able to achieve in the past decade.

Third, I am not suggesting that these fundamental trade and payments issues be tacked on to the existing agenda for global negotiations. I have reluctantly come to the conclusion that these global negotiations are structured in such a way that the likelihood of their producing sound proposals for reform are slight indeed.

The artificial distinction between those countries that see themselves belonging to Group B and those that identify with the Group of 77 makes little sense for a large number of countries, including New Zealand.

The focus of North-South discussions has tended to be on commodity issues. I would have little confidence that these negotiations, as presently structured, would be the appropriate place to discuss the even more important issue of the future of the international trade and payments system.

I would now like to outline what I believe to be the salient features of the current crisis. For some years now we have faced high and differential rates of inflation, global recession, massive unemployment, unstable exchange rates, excessive interest rates, growing protectionism and financial crises. This has been aggravated by the behaviour of the major exchange rates that cannot be fully explained by differences in relative costs or trading performance.

The balance of payments and debt problems of many developing countries have reached critical levels. For the non-oil developing countries taken as a whole, their cumulative current account deficit was equivalent to over 20 percent of their export earnings. As Mr de Larosiere, the Managing Director of the International Monetary Fund, concluded in a recent survey of this problem: "Deficits on this scale clearly cannot be sustained in terms of potential debt-servicing capacity."

The plight of these developing countries is becoming desperate. It is worth noting that some of the most serious financial difficulties are being faced by certain of the newly industrialising countries.

The international community has a lot riding on these countries. Throughout all the difficulties of the 1970s, they maintained their growth rates, they provided new markets and new opportunities for productive investment. As they moved progressively away from relatively simple, labour intensive industrial processes towards more sophisticated activities, they in turn created economic opportunities for less developed countries to take up and so join their ranks.

In short, their experience confirmed our faith in the development process. The transmission of this growth process depends, however, on some order in the international trade and payments system. Creeping protectionism can choke it off slowly. Financial collapse would kill it stone dead. If we allow these two influences to overwhelm us, I am bound to say that we can put aside all the long-term, optimistic projections.

These two issues - creeping protectionism and the growing possibility of large-scale financial dislocation - are the two central issues on the international economic agenda.

On protectionism, we have the benefit of a comprehensive study produced by the Commonwealth Secretariat. In my view, two salient conclusions emerge from this study.

First, the existing GATT machinery has not managed to deal with the nature of the problem. GATT has largely accomplished its historical function of removing tariffs on industrial imports in developed countries. There are however now over 600 different types of non-tariff barriers ranging from the so-called 'voluntary' restraint agreements through to local content requirements, variable import levies and so forth. The fact is that international trade is becoming less and less governed by the principles and rules formulated by the original negotiators of the GATT. The study contains an estimate that by 1980 almost 50 percent of trade by all market economies was 'managed' trade - that is, trade which is not, for a variety of reasons, governed by the conventional forces of the arms-length free market. There is no evidence that we have the institutions to deal adequately with problems of this magnitude.

Second, the study contains ample documentary evidence of the impact of creeping protectionism on our various economies, developing countries in particular. No country can claim a clear record and there is always a danger of appearing to single out one or two for mention. We in New Zealand, for example, have had to live with the GATT waiver granted to the United States on Agricultural policies for almost three decades.

The Japanese have refined such policies to an art form.

In the case of the European Common Agricultural Policy, there is an estimate in the study that in 1979 the CAP reduced the agricultural exports of the developing countries to the European Community by $2.9 billion, the agricultural exports of the United States by $0.7 billion, the exports of Australia by $1.1 billion and New Zealand exports by $1.8 billion. A figure anywhere approaching that magnitude represents an enormous loss to my country and is only partly compensated by the special arrangements we have been able to negotiate with the community.

The growth of protectionism is closely linked with the growing disorder in international financial markets. Ultimately, loans have to be serviced and the principal paid back by increased export earnings. When protectionism limits the opportunities for investment in competitive export-oriented projects, it begins to feed back into the stability of the financing mechanisms themselves.

The annual GATT Study of International Trade which was published in summary form only last month considers we are now facing the worst economic situation since the 1930s. Its concluding comments are worth quoting in full: "The gradual but continuing accumulation of restrictions on international trade of course poses a threat to the multilateral trading system ..... but the more immediate danger may be that it will trigger a severe disturbance in the already troubled international financial system. This danger was demonstrated in the decade of the great depression."

At an international meeting such as this, protectionism presents a soft target. It is not hard to find appropriate words to include in our communiques about the need to attack protectionism. The innocent observer, who may or may not be found within the ranks of the media, might well be tempted to ask - what then is the problem, if everyone agrees on reducing protectionism?

There are two possible explanations. One is somewhat unflattering to those who attend these meetings. I am not of course referring to our officials who, as always, are quite beyond reproach. The other, and I suggest more astute, explanation is that while we all know what is to be done, we have not found the key to unlock the political difficulties involved in a comprehensive attack on protectionism.

In this present economic climate, it is unrealistic to imagine that any government, whether it be of a democratic nature or not, could sustain a long-term programme of reducing protectionism in all its forms. This can only be done in concert with other countries. It can only be done if new export opportunities are opening up for the products which each of us can produce relatively efficiently. Conventional wisdom has it that bold political initiatives along such lines must wait for better times. It is more correct historically to say that it is only when countries perceive grave risks to international and domestic order that such initiatives enter the realm of possibility.

Before I outline what I believe is required to harness the political will which would enable each of us to tackle protectionism, I would like to turn to the closely related issue of the state of international capital markets.

After the first oil crisis, there was a good deal of justifiable concern about the capacity of the existing financial institutions to recycle funds from surplus to deficit countries. That was almost 10 years ago. In some respects, the recycling process was extremely successful. Certainly it achieved its main objective of avoiding default. Until very recently, few countries have found it difficult to raise from the private capital markets the vast sums required.

In too many cases, however, the very ease of raising funds has masked the adjustment process. The money was lent with very little thought or with excessive optimism as to the capacity of the countries to pay it back. Quantity, not quality, has been the hallmark of those financial operations over the last 8 - 10 years.

The maturity structure of private bank lending has also shortened markedly in recent years. The increasing tendency for loans to mature earlier can only increase the difficulties of refinancing and undermine confidence. It is difficult to avoid the conclusion that the drift to shorter maturities in international lending is due to bankers' concern about debt reschedulings and the now questionable ability of certain overcommitted borrowers to earn enough foreign exchange to maintain the flow of payments on longer-term loans. In 1981, fourteen sovereign countries sought rescheduling of their external debt, in spite of the implications for their long-term reputations as borrowers.

I noticed that a well-known international magazine has recently rediscovered Lord Keynes' dictum that if you owe your bank manager a thousand pounds, you are at his mercy; if you owe him a million pounds, he is at your mercy. All this indicates that a large number of Western banks are now dangerously over-exposed.

The banking system as a whole depends upon maintaining a climate of confidence. Any major collapse would undermine that confidence. We are not at that point yet, but I would much prefer to examine the scope for remedial action whilst we are one or two steps away from the precipice.

This leads directly to my concern about conditionality as applied by the International Monetary Fund. After many years of attending Fund meetings, I have come to the conclusion that there is a profound lack of realism marking the debate over conditionality. Those who have argued for maintaining a tough conditionality have carried the day. The effective result of this has been to discourage member countries from making further approaches to the Fund and to turn towards private sources of lending which, to use shorthand terms, have minimal standards of conditionality in the IMF sense. Countries are now turning to the Fund only when it is almost too late.

I would argue, therefore, that the Fund's approach to conditionality has had the perverse effect of encouraging less adjustment overall than would have occurred had the Fund applied a more flexible and sympathetic approach to conditionality in its own lending and co-financing operations. At the same time we must acknowledge that the Fund requires additional resources to administer a more flexible policy.

We simply have to come to terms with the fact that for many of the poorer countries, balance of payments deficits are not of the transitory or cyclical character originally envisaged by the Fund's rules. The deficits are often semi-permanent, chronic and intractable. The period required for their resolution can be lengthy. Where existing standards of living are already abjectly low, conditionality which is too harsh or oriented excessively to the short-term will simply push these standards down to levels which would be quite unacceptable and ultimately create political instability.

There is also a concern in my mind that a number of private banks, having had their fingers burnt as a result of rushing into lending operations without much thought to the ability of the borrowing country to pay them back, may begin to move sharply in the opposite direction. There is a danger of these banks applying ill-considered, overly tough conditions to their loans to developing countries. Worse still, there is the possibility that some may attempt to opt out of such large scale operations altogether.

The better placed deficit countries with low debt service ratios, such as New Zealand, may well be the beneficiaries of this. Where, however, does that leave the losers? The official agencies do not have the resources to fill any such gap.

The essence of the matter is that the world needs both adjustment and conditionality but it has to be better balanced between deficit and surplus countries, between the rich and the poor, between short and long-terms, and between demand and supply considerations. We need symmetrical surveillance in the broadest sense. We need to encourage countries to turn to the existing institutions which have the professional competence and international standing to undertake this task. This, I believe, will not occur unless the institutions themselves modify their approach in certain critical areas and unless they are given the financial resources commensurate with the task before them.

How can this be achieved? Certainly not within any of the existing forums. The restricted meetings of the major industrial nations have not shown any real capacity to deal adequately with the trade and payments problems I have described.

As for the Fund itself, the second amendment of its

Articles incorporated very little work on monetary reform by the Interim Committee. New facilities were established: the Oil Facility, the Supplementary Financing Facility and, most recently, the larger access policy. However, the total of Fund quotas has failed to keep pace with the expansion of international trade and payments while the role of SDRs has, if anything, declined.

It is equally clear that on the trade side the GATT has failed to keep abreast with the new and virulent forms of non-tariff barriers - such as the so-called voluntary restraints, export credits and export subsidies. Nor has the GATT come close to setting out rules for agricultural trade which might bring agriculture more fully into the mainstream of international trading principles.

In the end, it comes down to a question of political will. There are considerable political risks involved in allowing the current highly compartmentalised international economic debate to drift on. Until sufficient countries are seized of these political risks, I doubt we will see much progress in coming to grips with these key trade and payments issues. This would require a broad-based and comprehensive examination of the underlying issues.

In 1944 at Bretton Woods the international community attempted just that task. By the modest standards of international co-operation the conference was a substantial success. With certain modifications it continued to operate successfully until the 1970s when the fixed exchange rate system collapsed, economic activity slowed and balance of payments deficits and surpluses emerged of a persistent rather than cyclical character.

Bretton Woods succeeded in part because of the individual brilliance of certain key actors. However, I believe it is equally correct to say it succeeded because the world had just emerged from a global depression and global conflict of frightening proportions. Politically, the participants knew what was at stake. They were generally prepared to take the difficult decisions required to bind each of their countries to the rules agreed by the international community at that conference.

We cannot simply decide to recreate the Bretton Woods system as such. We need to take account of the changed political and economic circumstances since then. However, a comprehensive approach along those lines is required again.

On protectionism, I have suggested that our key need is to find some way of unlocking the political difficulties that prevent forward movement. The programme that we might then follow is a problem of lesser dimension.

The Australian Prime Minister's proposal for a stand-still and then wind-back of frontier protection and export subsidies would certainly offer one means of achieving these objectives if the requisite political will exists. Its derivative, the idea of a so-called 'cease-fire', which I understand is currently doing the international rounds, is another, but more modest, approach. Our difficulties on protectionism are primarily political, not analytical.

In calling for a comprehensive examination of the trade and payments system by all the member states of the Fund, I am not suggesting we can afford to ignore current initiatives, such as the forthcoming GATT Ministerial Meeting. There are of course practical steps we can take towards long-term goals. The one practical point about these meetings, however, is that they do not produce significant results.

At the summit meetings of the rich countries there is seldom any difficulty in reaching a common analysis of the problem. It is the next step - searching for a political remedy - that escapes them. Far too often we see the major countries reach an accommodation of their short-term interests. The long-term structural problems get swept away into the too-hard basket.

There is no way we can escape the fact that the political remedies will require each government to make difficult domestic decisions. No government is going to take those decisions unless it can say to its people: This is part of a world programme agreed upon by the world community.

Has this ever happened before? Certainly. It happened in 1944 at Bretton Woods. Then in a short burst of international political activity over the following three years the world community created the IMF, the GATT and the United Nations. That has lasted us for some 30 years. After a decade of stagnation and marking time on the problems, I believe we need to try again as a world community.

I am calling for another conference along the lines of Bretton Woods. People say to me: "Why should we want another conference?" Those of you who know me reasonably well will know that I am far from an enthusiastic conference goer. I am not calling for just another conference. Perhaps once every 20 or 30 years we can realistically propose a fundamental re-examination of the world trade and payments system.

I believe we have just enough commitment left to international co-operation to ensure that no country could afford to sit tight and ignore the opportunities presented by such an occasion. Why do I say opportunities? Because when I go to international meetings and I hear political leaders say - this or that is not negotiable, what I really hear them say is: "This is too hard for me politically." In effect they are saying: "There is nothing likely to come out of this forum which could give me the political justification I need to tackle these problems."

The point about Bretton Woods is that it created opportunities to break the political log-jam on the policies that had caused so much harm to international co-operation. Some four decades later, I believe we are facing another political log-jam on the trade and payments front. As at Bretton Woods, I believe these political problems can be overcome only by making the decisions as a world community.

At Bretton Woods each country had to ask itself: This is what the world community has decided. Now, are we in or are we out? At the end of the day, the vast majority of countries decided there was only one answer to that question. I believe that we will find the political remedies only if we as a world community are prepared to undertake the same process again.

It is not my purpose to spell out the agenda for such a major undertaking. Clearly it would need to deal with the issues I have outlined today. It would need to consider some means of increasing aid flows, which have remained at around $25 billion for several years.

The needs of developing countries today for increased resource flows are such that the present emphasis on dispensing aid through country programmes must be supplemented by improved multilateral mechanisms. If country aid programmes cannot cope with today's development needs - and it is clear they cannot - then we must think again about how we might do this as a world community.

One approach would be for the fund to resolve that, say, thirty billion dollars be allocated to international aid and this sum be taken off the top as it were and dispersed according to need. It may also be necessary to consider setting up some sort of council, based in the Fund, with decision-making powers, as opposed to the Interim Committee which is an advisory body only. Such a council - which on occasions I have referred to as an economic equivalent of the United Nations Security Council - is in fact explicitly provided for in the 1976 second amendment of the Articles of Agreement of the International Monetary Fund. This provision has never been given the serious consideration it merits. These suggestions would need to be discussed at such a conference.

My purpose is primarily to see whether the political will exists to tackle the grave problems facing us. Unless we take the first political steps towards a comprehensive examination of the present world trade and payments system, we shall simply have to accept whatever the existing framework for international economic relations deals out to each of us. In that event, I must be totally pessimistic about the future of international economic co-operation. As Heads of Government, we and others will have to cope with the long-term domestic consequences of that as best we can.

CONFIDENTIAL

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FILE

b/c: Mr WALTERS

10 DOWNING STREET EX: FCO Trade
Ind

From the Private Secretary

25 October, 1982

EXPORT CREDIT SUBSIDIES AND RISKS

The Prime Minister was grateful for the Chancellor's minute of 19 October on export subsidy costs and credit risks.

The Prime Minister agrees that Treasury and ECGD officials, together with other departments concerned, should work up the proposals in paragraphs 6,7 and 8 with a view to turning them into operating guidelines.

I am sending a copy of this letter to the Private Secretaries to the members of EX and Richard Hatfield (Cabinet Office).

M. C. SCHOLAR

J. Kerr, Esq.,
HM Treasury

CONFIDENTIAL

GRS 840
[CULL]

CONFIDENTIAL

Hurfaxed to Chapman Sat 23/10

CONFIDENTIAL
DESKBY 210900Z
FM MEXICO CITY 202015Z OCT 82
TO IMMEDIATE FCO
TELEGRAM NUMBER 897 OF 20 OCTOBER
AND TO IMMEDIATE WASHINGTON, DOT, ECGD, TREASURY, BANK OF ENGLAND.

MY TELNO 879: MEXICAN ECONOMIC CRISIS

1. THERE ARE AT LAST INDICATIONS OF PROGRESS IN MEXICO'S NEGOTIATIONS WITH THE IMF. BUT STRIKE THREATS ARE CAUSING INCREASING ANXIETY THROUGHOUT THE ECONOMY. THE GOVERNMENT IS STILL FAILING TO EXERCISE LEADERSHIP OR EVEN GUIDANCE IN CURRENT TROUBLES.

IMF

2. THE DIRECTOR GENERAL OF EXTERNAL FINANCE IN THE MEXICAN MINISTRY OF FINANCE, WHO IS CLOSELY INVOLVED IN THE IMF NEGOTIATIONS, TOLD US TODAY THAT IN HIS VIEW IT MAY NOT BE NECESSARY FOR THE IMF NEGOTIATING TEAM TO RETURN TO MEXICO TO DISCUSS FURTHER THE TERMS OF THE MEXICAN LETTER OF INTENT. THE GAP WAS NOW SO SMALL THAT IT MIGHT BE POSSIBLE TO BRIDGE IT BY TELEX COMMUNICATIONS OR BY SENDING SOMEONE TO WASHINGTON. HE WAS AWARE THAT THE IMF TEAM'S DEPARTURE FROM MEXICO HAD GIVEN RISE TO RENEWED PESSIMISM ABOUT THE STATE OF NEGOTIATIONS, BUT SAID THAT RELIEF WOULD THUS BE ALL THE GREATER IF IT WERE SOON POSSIBLE TO ANNOUNCE AGREEMENT.

3. THE US EMBASSY HAS TOLD US IN STRICT CONFIDENCE (PLEASE PROTECT) THAT THE MEXICAN MINISTER OF FINANCE PLANS TO FLY TO WASHINGTON DURING THE WEEKEND OF 23/24 OCTOBER. THE EMBASSY EXPECTS HIM TO TRY TO REACH FINAL AGREEMENT ON THE LETTER OF INTENT AND TO PRESS FOR PAYMENT OF THE SECOND TRANCHE OF THE BIS LOAN. THE EMBASSY BELIEVES THAT LIC. SILVA HERZOG IS REASONABLY CONFIDENT OF SUCCESS AND THAT THE LATEST INDICATIONS OF IMF THINKING SUGGEST THAT PROGRESS HAS AT LAST BEEN MADE.

LABOUR PROBLEMS AND THE GOVERNMENT

4. MEANWHILE, DEVELOPMENTS ON THE LABOUR SCENE HAVE AROUSED INCREASING ANXIETY AMONG THOSE WHO WOULD LIKE TO SEE AN EARLY IMF AGREEMENT. THE CTM (CONFEDERATION OF MEXICAN WORKERS) WHICH IS USUALLY SUBJECT TO GOVERNMENT INFLUENCE, AND SOME OTHER UNIONS HAVE CONFIRMED STRIKE NOTICES TO THE PUBLIC AS WELL AS THE PRIVATE SECTOR, INCLUDING THE STATE OIL COMPANY PEMEX, THE CENTRAL ELECTRICITY BOARD AND THE STATE TELEPHONE COMPANY. STRIKES WOULD BEGIN ON 1 NOVEMBER UNLESS AGREEMENT WERE REACHED BEFOREHAND ON UNION DEMANDS WHICH IN MOST CASES ARE FOR A 50% INCREASE BACKDATED TO 1 AUGUST. UNION LEADERS HAVE CLAIMED THAT SOME COMPANIES HAVE ALREADY SETTLED (ON TERMS NOT DISCLOSED) AND THAT THEIR DEMANDS ARE NEGOTIABLE. FIDEL VELAZQUEZ, THE CTM LEADER, HAS SAID THAT HIS OBJECTIVE IS ONLY TO PRESERVE THE WORKERS' PURCHASING POWER. AT LEAST IN

THEIR RHETORIC OTHER TRADE UNIONS HAVE BRUSHED ASIDE THE ARGUMENT THAT BIG WAGE INCREASES WOULD BRING FURTHER BANKRUPTCIES AND LAY-OFFS. THEY CLAIM ON THE CONTRARY THAT EMPLOYMENT WILL SUFFER IF DEMAND CONTINUES TO FALL THROUGH THE LOSS OF PURCHASING POWER OF WAGES.

5. IN THE FACE OF THIS APPARENTLY GRAVE SITUATION THE GOVERNMENT SEEMS INACTIVE AND ALMOST UNCONCERNED. ONE THEORY IS THAT THE CTM HAS BEEN GIVEN THE GREEN LIGHT TO MAKE A PUBLIC DISPLAY OF MILITANCY, IN ORDER TO DEMONSTRATE TO THE IMF THE LIMITS OF AUSTERITY WHICH THE COUNTRY CAN BE EXPECTED TO TOLERATE. ANOTHER MORE PLAUSIBLE POSSIBILITY IS THAT THE GOVERNMENT HAS ALREADY DECIDED TO ACCEPT SUBSTANTIAL WAGE INCREASES IN THE PUBLIC SECTOR BUT DOES NOT WANT TO BE ACCUSED, AS IT WAS IN FEBRUARY, OF AUTHORISING INFLATIONARY WAGE INCREASES BEYOND WHAT THE UNIONS COULD HAVE BEEN INDUCED TO SETTLE FOR.

6. THE POLITICS OF THE LABOUR SCENE ARE UNUSUALLY MURKY. THE CTM IS ONE OF THE PRINCIPAL COMPONENTS OF THE RULING INSTITUTIONAL REVOLUTIONARY PARTY AND FIDEL VELASQUEZ IS A LOYAL AND GENERALLY CONSERVATIVE SUPPORTER OF THE SYSTEM. BUT HE ACCEPTED ONLY WITH RELUCTANCE THE CHOICE OF MIGUEL DE LA MADRID AS SUCCESSOR TO PRESIDENT LOPEZ PORTILLO. HE MAY FEAR THAT DE LA MADRID COULD TRY TO WEAKEN THE CTM BOTH BY TAKING A HARD LINE ON PUBLIC SECTOR WAGES AND BY GIVING TACIT ENCOURAGEMENT TO RIVAL UNION ORGANISATIONS. HE MAY WANT TO STRENGTHEN THE CTM AND HIS OWN LEADERSHIP OF IT BEFORE DE LA MADRID ASSUMES OFFICE. PRESSING FOR AND OBTAINING A BIG WAGE SETTLEMENT MIGHT HELP IN THIS RESPECT.

7. MOST OBSERVERS DOUBT WHETHER VELASQUEZ WILL PRESS UNION CLAIMS TO WHAT WOULD VIRTUALLY BE A GENERAL STRIKE. MANY PRIVATE EMPLOYERS ARE INCAPABLE OF PAYING WAGE INCREASES ON THE SCALE DEMANDED. THEIR MAIN PROBLEM IS SURVIVAL. BIG INCREASES IN THE PUBLIC SECTOR WOULD GRAVELY DAMAGE THE GOVERNMENT'S WHOLE ECONOMIC POLICY, NOT TO MENTION AN AUSTERITY PROGRAMME AGREED WITH THE IMF, AND WEAKEN THE SYSTEM OF WHICH THE CTM IS AN ESSENTIAL PART. ON THE OTHER HAND BIG PRIVATE SECTOR STRIKES WOULD BE EQUALLY DAMAGING, AND ONCE STARTED COULD PROVE DIFFICULT TO STOP WITHOUT EXPENSIVE SETTLEMENTS. A LENGTHY STRIKE IN THE MEXICAN OIL INDUSTRY WOULD BE ESPECIALLY DISASEROUS IN MEXICO'S CURRENT SITUATION.

8. VELASQUEZ WILL BE FULLY CONCIOUS OF THESE CONSIDERATIONS. THERE MAY WELL BE A LOT OF SHADOW-BOXING IN HIS ACTIONS AND THE GOVERMENT'S RESPONSE. HE MAY ALREADY HAVE A GOOD IDEA OF WHAT THE GOVERNMENT WILL SETTLE FOR AND BE PREPARING TO SELL IT AS A VICTORY FOR THE UNION. BUT MEANWHILE THE SITUATION IS CAUSING PERPLEXITY AND APPREHENSION AMONG MEXICANS IN GENERAL AND THE PRIVATE SECTOR BUSINESS COMMUNITY IN PARTICULAR.

9. FCO PLEASE ADVANCE TO APPLEYARD(ERD), BANK OF ENGLAND(LOEHNIS BALFOUR AND JAGGERS) AND TREASURY(LITTLER CAREY AND PERETZ).

TICKELL

FINANCIAL
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COPIES TO
MR BALFOUR. B/ENGLAND
MR ATKINSON
MR BOTTRELL } H.M. TREASURY

CONFIDENTIAL

 Organisation Trade: Non Tariff Barriers Pt 2

Prime Minister

Agree to the work at X in para 4?

MLS 22/10

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

PRIME MINISTER

Yes MT

EXPORT CREDIT SUBSIDIES AND RISKS

At our discussion with the Governor on 1 September about the international financial situation you asked for a note on how to limit the growth of subsidised export credits and the escalation of competitive export subsidies, with a view to tightening up the criteria for lending to countries of doubtful creditworthiness. More recently Cabinet (CC(82)41st Conclusions) has invited the Secretary of State for Trade, in consultation with myself, to review the present level of ECGD exposure worldwide.

2. As you know, I largely share the concerns which underlie both these requests. But there are practical constraints on the measures open to us to limit the costs and risks of ECGD operations. And in considering the options we must obviously pay very careful attention at the present time to both the domestic and the international implications of any moves we decide to make. ?

3. Although I deal in this minute with both subsidy costs and credit risks it is as well to keep in mind that these are two rather different issues. There is no necessary connection between the level of subsidy which has to be offered with a contract and the degree of risk involved, except in the general sense that the OECD Consensus arrangements permit a higher level of interest rate subsidy for exports to the poorer countries.

Subsidy Costs

4. Limiting the growth of subsidised export credit, and the escalation of competitive export subsidies, is the raison d'etre

of the OECD Consensus arrangements. The arrangements are not 100 per cent proof against cheating, but we monitor closely what others - particularly the French and the Japanese - are doing, and it is important that we should continue to do so. Prior to November 1981, the going rate for many officially supported export credit contracts was 7¾ per cent, implying a heavy subsidy cost for most currencies. Increases in Consensus interest rates were agreed in November 1981 and July 1982, and interest rates have recently been falling. The result is that the agreed minimum rates for officially subsidised export credits to rich countries are now at a level (over 12 per cent) which eliminates interest rate subsidy for most currencies.

But not for high inflation countries. France & Italy, with high interest rates, are paying large subsidies.
MCS

5. There is to be another round of negotiations within the Consensus framework next spring. Our general approach to these negotiations, and in particular the view we take on the need for further changes (up or down) in Consensus interest rates will depend, among other things, on the international interest rate climate at the time and our judgement of the impact of such changes on the world trading climate. If interest rates in world markets remain at or below their present level I think one of our priority objectives at the next Consensus round should be to seek agreement on arrangements to prevent the re-emergence of high subsidy costs on future business if interest rates should rise again in future. Indeed, it will be for consideration whether we should not take the opportunity to support the introduction of permanent arrangements to require credits for rich countries to be provided on an unsubsidised basis.

6. There are also some steps we could take on a national basis to improve our control of export credit subsidy costs. The following in particular seem to me worthy of examination:-

(i) Setting a maximum acceptable rate of subsidy in net present value terms for any individual export credit project; and a separate limit on the total subsidy level in ATP cases. The limits could not be mandatory, but would act as a trigger for special consideration (normally by Ministers) of any proposal to exceed the limits.

(ii) The hardening of export credit terms in individual cases or in particular markets or sectors should be considered where this can be achieved without undue loss of desirable business. I understand ECGD are already reviewing the options under this head.

(iii) Close monitoring of the interest rate support scheme in order to trigger a review if the gap between UK market rates and Consensus guidelines begins to widen.

Credit Risks

7. I understand that the Secretary of State for Trade will be circulating a note by ECGD, reviewing their worldwide exposure position and describing their present system of country assessment and controls. As regards the problem of credit risk and country exposure, I recommend:-

(iv) A more rigorous approach to the setting and observance of the "country limits" applicable to Section 1 (Commercial Account) and Section 2 (National Interest) operations of ECGD.

(v) More weight to be attached to considerations of country risk in considering proposals for ECGD Section 2 cover with the aim of directing support towards countries with more favourable repayment prospects.

8. I also think the following measure would be worth examining:-

(vi) Fixing a limit on ECGD's total Section 2 exposure in the riskier markets which would trigger a general review of the Department's exposure under its "national interest" operations.

Conclusions

9. Some of the above proposals need more work before they can be turned into useful operating guidelines, taking account of the work which EX(O) is currently doing on criteria at the request of Ministers. I suggest that Treasury and ECGD officials, together with other departments concerned, should now be asked to undertake that work.

Agreed ms x

10. These changes will not eliminate the need for difficult decisions by Ministers in all cases. Under present arrangements there is an inherent potential conflict between ECGD's responsibilities for trade promotion, and its responsibility to operate commercially and at no net cost to public funds. In the last resort the balance between these objectives is bound to be a matter of judgement, but I think it important that we should all give full weight to prudential considerations in deciding how this balance should be struck.

11. Finally, I would emphasise that I am not seeking to attack officially supported export credit in general; I fully recognise its importance both to domestic industry and to the climate of world trade. Nor am I seeking to pre-empt, for example, Arthur Cockfield's conclusions on the interesting report which I see the CBI have just produced on ECGD. But at a time when over-indebtedness is threatening the stability of the international financial system I believe that more emphasis on the prudential and financial aspects of the export credit business would be to our advantage and in the long run to the advantage of our trading partners as well.

12. I am sending copies of this minute to other members of EX, and to Sir Robert Armstrong.

G.H.
19 October 1982

Covering CONFIDENTIAL

Econ Pol

Mr Coles to see

A.J.C. 20.10

(2)

Prime Minister

MLS 19/10

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

18 October 1982

Michael Scholar, Esq.,
No.10 Downing Street

Dear Michael,

ARGENTINA

The Chancellor has suggested that I should send you the enclosed copy of a Bank of England note on the latest position in Argentina on the removal of financial restrictions. The Bank are continuing to monitor developments.

A copy of this letter goes to Tim Allen in the Governor's office.

Yours ever,

John Kerr.

J.O. KERR

ARGENTINA

Present situation regarding removal of financial restrictions

1 In the report on the International Financial Scene annexed to Miss O'Mara's letter of 20 September to Mr Scholar, for onward transmission to the Prime Minister on her Far Eastern trip, it was reported that first steps were being taken on the implementation by the Argentinians of their side of the reciprocal removal of financial restrictions. This note is a further progress report.

2 The overall picture is one of slow, but significant, progress. There is little doubt that the Argentinian financial authorities are doing their best, but they are limited as to the areas over which they have total discretion, and the dead hand of the military has been apparent in some areas where we had hoped, from the tenor of the negotiations in Toronto, the financial authorities might be more influential. In some cases it is difficult to tell whether the apparent continuation of discrimination against British enterprises is deliberate or merely the result of administrative confusion.

3 On specific points progress is as follows:-

(a) Payment of arrears due to UK banks

The three Clearers with largest arrears frozen in the so-called escrow account (Lloyds, Barclays and NatWest) have all recently been in negotiations with the Central Bank and have either agreed the amounts due or are about to do so. As "evidence of good faith" the Central Bank has agreed to place deposits with these banks in amounts roughly equivalent to what will be agreed to be due. The Clearers seem well satisfied with this progress. The Bank of England is in discussion with the Argentinian Central Bank as to how reconciliation of amounts due to other British banks can be expedited.

(b) Presence of supervisors in British enterprises

The Central Bank has secured the removal of the supervisors from British banks, but has been unable to secure the same for non-banking enterprises. We have been in contact with a cross-secti o f those enterprises, which broadly concur that the activities of the supervisors are not particularly worrying to them, and have certainly diminished in intensity. The presence of the supervisors derives from a Law, which the Argentinian negotiators in Toronto made clear could not be immediately repealed. They undertook, however, to ensure that it was not implemented. They have not so far been fully successful in honouring this undertaking. The Central Bank Governor has informed the Bank of England that he and the Minister of the Economy intend to raise the question of the Law's implementation with President Bignone in the near future.

(c) Payment difficulties

A number of British firms, for whom commercial payments were frozen during the currency of the restrictions have had difficulty in securing the release of such frozen funds. The Argentinian Governor has said that most of Argentina's creditors abroad are in arrears because of shortage of foreign exchange, but has undertaken to make strenuous efforts to ensure that British firms are brought onto equal terms with others as regards the extent of such arrears.

(d) Payments to UK pensioners of Argentine Railways

A firm of Argentine lawyers acting on behalf of some UK pensioners of Argentine Railways claims that the Law referred to in sub-paragraph (b) above prevents them remitting sums due to the UK. Those pensioners who use Lloyds Bank International as agent have no such difficulty. This has been raised with the Central Bank, whose lawyers contest the relevance of the Law. The Central Bank are taking steps to have the impediment removed.

(e) The Central Bank Governor, in response to all enquiries on specific cases brought to his attention by the Bank of England, has responded helpfully and sympathetically. He has invited any British company with payments difficulties or with complaints against the supervisors to make contact with his office, and this information has been passed to the Department of Trade and FCO.

Bank of England
15 October 1982

GRS 305

ECONOMIC POLICY

UNCLASSIFIED [CULL]
DESKBY 150800Z
FM MEXICO CITY 150045Z OCT 82
TO IMMEDIATE FCO
TELEGRAM NUMBER 872 OF 15 OCTOBER
AND TO IMMEDIATE DOT, ECGD, TREASURY, BANK OF ENGLAND
INFO WASHINGTON

N. Sutter to see.

A.J.C. 15/10.

MY TELNO 852: IMF NEGOTIATIONS

1. SEVERAL OF TODAY'S MEXICAN NEWSPAPERS REPORT PROMINENTLY THE DELIVERY YESTERDAY TO THE IMF NEGOTIATIONG TEAM OF A LETTER OF INTENT SIGNED BY THE MEXICAN MINISTER OF FINANCE, WITH AN ANNEX CONTAINING AN ANALYSIS OF THE ECONOMIC SITUATION AND DETAILS OF THE ADJUSTMENT PROGRAMME PROPOSED BY THE MEXICAN AUTHORITIES. THE DOCUMENT IS SAID TO EXPLAIN THAT THE GOVERNMENT'S POLICIES INCLUDE THE INTRODUCTION OF REALISTIC INTEREST AND EXCHANGE RATES, AND A REDUCTION IN THE PUBLIC SECTOR DEFICIT THROUGH TIGHTER CONTROLS ON GOVERNMENT SPENDING, THE INTRODUCTION OF NEW TAXES, INCREASES IN THE RATES OF EXISTING TAXES AND A REDUCTION OF SUBSIDIES. THE DOCUMENT IS SAID TO PROPOSE A TIME-TABLE FOR THE DISMANTLING OF EXCHANGE CONTROLS AND MEASURES TO ECOURAGE MODERATION IN WAGE INCREASES.

2. THE PRESS REPORTS SAY THAT THE PROCEDURES BETWEEN THE DELIVERY OF A LETTER OF INTENT AND FORMAL AGREEMENT BY THE IMF ON STANDBY ARRANGEMENTS USUALLY TAKE FOUR WEEKS, BUT THAT THE IMF HAS GIVEN AN ASSURANCE TO THE MEXICAN GOVERNMENT THAT THE PROCEDURES WILL BE SPEEDED UP AND COMPLETED IN TEN DAYS.

3. THE LEFT WING OPPOSITION PARTIES HAVE PREDICTABLY GIVEN REPORTS OF THE LETTER OF INTENT A HOSTILE RECEPTION. SEVERAL OF THEIR REPRESENTATIVES IN THE CHAMBER OF DEPUTIES HAVE SAID THAT AN IMF AGREEMENT WOULD CONSTITUTE A STRAIGHT-JACKET FOR THE NEXT MEXICAN ADMINISTRATION AND THAT THE CONDITIONS SUPPOSEDLY IMPOSED BY THE IMF, IN PARTICULAR ITS INSISTENCE ON A LIBERAL REGIME FOR FOREIGN TRADE, WOULD NOT BE IN MEXICO'S INTERESTS.

SEE MIFT

FCO PLEASE ADVANCE TO TREASURY (LITTLER, CAREY, PERETZ)
AND BANK OF ENGLAND (LOCHNIS, BALFOUR, JAGGERS)

TICKELL

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COPIES TO:
ADVANCE ADDRESSEES

Mr. Scholar PA 2
Econ Pol

LORD ROTHSCHILD

Telephone: 01-626 4356
Telex: 888031

N.M.Rothschild & Sons Ltd.
New Court
St. Swithin's Lane
London EC4P 4DU

12th October 1982

MS

Dear John,

(1) When the Prime Minister saw me a little while ago, she asked me some questions about the international banking scene and made some comments on it.

(2) I feel sure that the Prime Minister has seen Harold Lever's memorandum on this subject. I showed it to two people here whom I think have top class brains, both in general and at finance in particular. It occurred to me that the Prime Minister might like to see their reactions to Harold Lever's memorandum - neither of them knew he was the author but one correctly guessed he was - and their views are enclosed. You may not think them of sufficient interest for the Prime Minister to see and, if that is your view, just put them in the wastepaper basket.

Yours
Victor

ECONOMIC POLICY : INDEBTEDNESS.

Deficit Finance - Bankers and Governments

In general I agree that the present state of international banks and their exposure to bad risks gives considerable cause for concern and the paper communicates this lucidly.

My reservations centre upon the analysis of the origins of the problem and to a lesser extent on the proposed solution.

The paper attributes the blame mainly to the OPEC surpluses and recycling to poorer countries unable to pay for their oil imports without recourse to the Euromarkets. This does not, however, explain why Mexico & Nigeria are two of the larger and more worrying problem territories whose debts have grown mainly because they are oil exporters whose credit was thought to be good. Nor does the argument that the oil recycling spilled over into lending to larger corporations which are now suspect take us that far.

I would suggest that the problem has some of its origins in the aggressive loan marketing policies of a variety of private sector banks, often led by or influenced by American business policies. These bankers built their operations around highly paid sales teams whose task was to lend more money. In their search for suitable borrowers large corporations, energy projectors and rapidly expanding highly populated oil producing states all seemed reasonable collateral and all needed substantial funds.

The 1981- recession has changed the bankers' perceptions of the security afforded by many of these large companies and energy projects. The weak oil price has made many energy projects approved in the inflationary days of 1980 look unwise. The lower level of world demand has highlighted both the massive structural changes underway in the industrial economy and the competitive inventiveness of the peoples of the Far East basin. This has weakened many large western corporations. Finally it has exposed the dangers of the Nigerian and Mexican dash for growth. All this has coincided with major production difficulties within the Comecon bloc which has borrowed heavily from the west and with the difficulties amongst Ldcs mentioned in the paper.

If you accept this somewhat broader perspective of the crisis the remedies needed are also complex. The problem is in part one of confidence. Most banks are technically bankrupt all the time. This normally does not matter as the bulk of depositors have confidence or new depositors replace those withdrawing funds. We are now approaching a position where banks could experience damaging withdrawals of funds.

To ward this off I agree it may be necessary not only for each Central Bank to act as lender of last resort and to provide the essential short term liquidity, but also for there to be a risk exposure plan for each bank to gradually reduce its involvement with dangerous types of lending. Sovereign risk in many ways seems the easiest to handle. Rescheduling has to take place on terms which entail the IMF dealing with the problem on behalf of the lenders. For those companies badly affected by structural change each central bank will have to conduct its own lifeboat operation making a judicious use of asset sales, capacity reductions and bankruptcies. The U.K. clearers are currently doing this well with our major industrial casualties.

The problem will be exacerbated if the pressures on trading nations leads to a substantial tariff war and a further decline in international trade and activity through protectionism. It will be important to avoid such a trend by renewing efforts in GATT talks.

International agreement would help and I believe work has already been done to achieve it, including plans for dealing with a Euromarket led collapse. Further pressure behind the scenes for such action cannot hurt. Further public discussion could of course adversely affect confidence to the detriment of the system.

Subject .. Deficit Finance - Bankers and Governments

Thank you for the paper on the above. It is particularly clearly (almost glibly) written. It looks like one of Harold Lever's pieces.

You asked if I saw anything wrong in it. There are a number of minor flaws which I won't comment on. However, the two main flaws are, in my view:-

1) The author is essentially suggesting that the major central banks (i.e. governments, the tax payer) lend money to the private sector banks. This is either to replace deposits which they are losing or to replace liquidity (funds) which they have lost because three month loans e.g. to Mexico have (will) become ten year loans.

   Where will the governments get that money from? They will borrow it. The flaw is that the author does not relate the banking crisis, and his solution, to the inflationary impact of his solution on the world.

2) In the past it has rarely been possible to restore lenders' confidence in a bank or in a country once that confidence has gone (e.g. 1974 fringe bank problems in the UK). As the author

/cont'd...

points out, borrowing by countries and companies has reached an insupportable level. It is, therefore, almost impossible for Mexico or International Harvester or British Steel (as examples) to support the debt they have incurred. My point here, and this is the second possible flaw, is that it might in the long run be preferable to encourage defaults now. If countries and companies are allowed to painfully exist, if the debt is insupportable, then they will eventually have to default in any case.

It has taken approximately fifty years for bankers to have forgotten the damage caused by excessive lending in the 1920's and 1930's; a fair dose of pain is probably necessary now to prevent a too premature re-occurrence of the disease.

Econ Pol.

CONFIDENTIAL

10 DOWNING STREET

From the Private Secretary

1 October 1982

The International Bank Scene

Many thanks for your letter of 20 September on the latest developments on the international banking scene. The Prime Minister read this with interest.

The Prime Minister has asked me to thank you for the work that went into it: she found Annex II of particular interest.

M. C. SCHOLAR

Miss Margaret O'Mara
HM Treasury

CONFIDENTIAL

26703 - 1

PP UKDEL WASHINGTON
RR WASHINGTON
PP MEXICO CITY

FERB
Mr. Byatt - to see.

A.J.C. 4/10.

GRS 140
CONFIDENTIAL
CULL
FM FCO OCTOBER 1982
TO PRIORITY MEXICO CITY
TELEGRAM NUMBER 809 OF 1 OCTOBER
AND TO PRIORITY UKDEL IMF/IBRD WASHINGTON
INFO WASHINGTON
MEXICAN DEBT

1. WHITEHALL DEPARTMENTS CONTINUE TO BE VERY INTERESTED IN YOUR REPORTING ON MEXICO'S NEGOTIATIONS WITH THE IMF AND ON THE DOMESTIC SITUATION. DEPARTMENTS WOULD WELCOME YOUR ASSESSMENT OF THE PRESENT STATE OF NEGOTIATIONS BETWEEN THE IMF AND MEXICO AND THE PROSPECTS FOR AN EARLY AGREEMENT. UKDEL IMF/IBRD MAY ALSO WISH TO COMMENT.

2. THE BANK OF ENGLAND FIND BACKGROUND INFORMATION, SUCH AS MORRIS LETTER TO WHITE OF 17 SEPTEMBER, PARTICULARLY USEFUL AT THE PRESENT TIME. GRATEFUL IF FOR THE TIME BEING SUCH REPORTS COULD BE SENT BY TELEGRAM OR TELELETTER.

3. PLEASE MARK TELEGRAMS TO BE ADVANCED TO BANK OF ENGLAND (LOEHNIS, BALFOUR, JAGGERS) AND TREASURY (LITTLER, CAREY, PERETZ).

PYM

NNNN

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COPIES TO
MR LOEHNIS, BANK OF ENGLAND
MR PERETZ, HM TSY

PA mo 4/10

From: P E MIDDLETON
30 September 1982

Chancellor of the Exchequer

cc Sir Douglas Wass
Sir Kenneth Couzens
Mr Lavelle
Mr Monck

THE INTERNATIONAL BANKING SCENE

I have been rather slow in coming back to you on one point which arose at the Prime Minister's discussion about the international banking scene on 1 September. According to the minutes, the Governor referred to discussions which the Bank were having with the Inland Revenue about the tax position of the banks in relation to their provisions against bad debts. I enquired of both the Bank and the Revenue about the position at one of my meetings on bank taxation. In fact no discussions are taking place and the slight implication in the minutes that the Revenue might be about to hold something up is therefore not correct. The Bank are however collecting information and doing some thinking of their own about provisions; if they come to the conclusion that action on the tax side might be desirable they will of course talk to the Revenue at that point.

PEM

P E MIDDLETON

Eco Pol, Aug '82
western Banking System

10 DOWNING STREET

Prime Minister

I'm not sure if you saw this?

MLS 30/9

Yes. Answer it –

[illegible]

[illegible].

CAW

SECRET

Prime Minister ② 6

I asked for this report. Annex II is worth reading.

MCS 21/9

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

20 September, 1982

M. Scholar, Esq.,
10, Downing Street,
LONDON, SW1.

Dear Michael,

THE INTERNATIONAL BANKING SCENE

In your letter of 1 September to John Kerr you recorded the Prime Minister's Seminar that day on the international banking scene. You may like to have some further notes and comment on recent developments.

2. Worries about international banking and the debt positions of some countries and their possible implications were a dominant feature of the Toronto meetings. You have seen the telegram in which the Chancellor reported generally to the Prime Minister, as well as a copy of his plenary speech. In the substantial passage of the speech on the international banking system, the Chancellor took the opportunity of developing ideas which he (and some others) had been pressing and will continue to press in discussions in the IMF and other Committees and Groups, notably:

- the need for economic adjustment in many countries. We must continue to support the IMF in its central role in helping to restore the creditworthiness of its members; creditworthiness maintains the flow of finance for borrowers, and interest and capital repayments to lenders;

- the need to continue to rely on private markets to provide the bulk of finance needed by sovereign borrowers. Although the IMF should be supplied with adequate resources (and some progress was made in Toronto towards settling a future increase in quotas), the international financial institutions are likely to continue to account for no more than a modest proportion of the total;

- the need for further improvement in cooperation between central banks and national banking supervisory bodies covering risk assessment, prudential standards, monitoring and control. Much has already been done, but further progress is needed: in particular in determining a water-tight allocation of supervisory responsibilities and, by individual national authorities, in taking any necessary legal and administrative steps to support it;

- the need to continue to tackle each problem case on its merits, whether it is a corporation, a country or a bank

/that

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that is in trouble; and to resist calls for general or automatic assistance that would relieve banks of the costs of imprudent lending and debtors of the need to adjust;

- the help that the world's major countries can give through lower interest rates if they manage their economies sensibly.

This approach and the emphasis on particular lines of action was both well received at the meeting and well reported in the press.

3. Two particular aspects of the subject which were touched on in Toronto and in subsequent press comment were: whether there should be an international emergency fund for rescue operations in cases like that of Mexico; and how far a reduction of lending to countries which are in difficulty over debt obligations is likely to lead to deflation in the world economy.

4. I attach a short note on the first of these topics. On the second, it certainly seems wrong to assume that such a possible reduction of lending could be a major factor determining world growth: the dominant influence on world activity is much more likely to be the development of the economies of the US and other major industrial countries. Moreover, if banks are more cautious in lending to some Latin American countries and to Eastern Europe this may in part lead to some diversion of credit elsewhere, rather than an overall contraction. It is said that the US and UK Governments are already benefiting from what has been called a "flight to quality" in the markets, meeting their financing needs at lower interest rates than would otherwise have been available. The whole subject will, however, be considered further at a meeting of Permanent Secretaries which Sir Robert Armstrong is arranging for October.

5 There was of course also in the margins of the Toronto meetings much discussion of individual cases, particularly Mexico and Argentina. In both these cases events have moved on. The final enclosure to this note is a commentary, largely by the Bank of England, on recent developments and market reactions to them, and a series of notes on the present position of a number of countries in difficulties.

6. On other points which came up at the Seminar:

- the Bank of England have now provided the schedules of exposure and indebtedness for Mexico;

- the Treasury is working up, in consultation with the ECGD, concrete proposals for tightening criteria for official credit and guarantees.

7. I am copying this letter and the enclosures to Brian Fall (FCO), John Rhodes (Department of Trade) and Tim Allen (Bank of England).

Yours,

Margaret

(MARGARET O'MARA)

SECRET

ANNEX I

AN INTERNATIONAL EMERGENCY FUND

1. In recent discussion of the international banking scene, one thread of argument has been that it was not enough to tackle each succeeding case of problems with a country's debt as it arose. There ought to be some more automatic system or fund for dealing with these problems which would give greater reassurance to the banks and ultimately to world trade and growth.

2. One has to distinguish between rescue arrangements for countries and for banks. Central banks, operating through an agency like the Bank for International Settlements, may play a part in the short-term in rescue operations for countries but beyond the short-term such rescues must be for the IMF or some other form of inter-governmental action (eg the European Community Medium-Term Credit). Rescuing banks is however essentially a central bank matter, often linked to their supervisory responsibilities. The Chancellor's IMF speech included proposals for improving both the supervisory and "last resort" functions of central banks on international banking.

3. On rescuing countries, the G77 have proposed automatic debt rescheduling for LDCs. Nobody has taken that up seriously. It is an assertion of the priority of LDC development over banking obligations. It would lead either to a complete drying up of bank credit for LDCs or to some kind of international public sector fund which would look after the banks and relieve the LDCs of their debts in defined circumstances.

4. That brings us back to the idea of an emergency fund. But the trouble with an international back-up fund is much the same as the trouble with a domestic fund for bailing out companies in trouble, with the added complication that the international version requires the negotiation of a very difficult international agreement. It takes risk out of lending for the banks and reduces the incentive on countries to pursue prudent policies or to undertake adjustment. For similar reasons central banks have not wished to give flat assurances of rescue in need to every bank.

5. The US proposal for an IMF Emergency Fund has not so far been closely defined but may be intended to avoid these pitfalls by a requirement for full IMF conditionality. But then it is not clear

how it differs from ordinary IMF resources. They have suggested that its use be confined to cases like Mexico where the international system was at risk. However that seems a poor basis on which to admit one country to it but not another. The bigger your debts, the better your claim. In the mid 1970's a proposal by Henry Kissinger led to negotiation of a similar scheme (the OECD Support Facility), which however Congress subsequently frustrated by refusing to approve any US contribution. The latest US proposal could be vulnerable to similar Congressional opposition. However it is now to be considered by the IMF Executive Board.

SECRET

ANNEX II

THE INTERNATIONAL FINANCIAL SCENE

1. Conditions in the international money markets have remained uncertain since the IMF meetings in Toronto. Some banks are taking defensive measures to reduce exposure to customers from suspect countries. Recent downward movements in interest rates in the major countries have been helpful, although they appear at present to have reached a floor. Financial markets have so far been relatively calm.

2. Developments in Mexico are at the centre of current concern. Following Silva Herzog's meeting with the President (post-Toronto) there was a welcome announcement from Mexico City that negotiations with the Fund, on the basis of the Fund's memorandum outlining economic objectives and the main thrust of an economic programme, would be resumed. IMF negotiators are due in Mexico City this week. A message on 11 September confirming that the international money market obligations of Mexican banks would be excluded from the 90-day standstill of Mexico's public sector debts was another positive factor. Nevertheless Mexican banks in London and New York are finding it very difficult to renew maturing deposits and, in some cases, are only managing on a day-to-day basis whilst finding it virtually impossible to raise new funds. The Bank of England in London and the Federal Reserve Bank in New York are in close touch with branches of Mexican banks established in these centres, to ensure that accidental defaults by those branches do not occur. The Banco de Mexico has drawn four times on the joint BIS/US facility at the Federal Reserve Bank in order to enable Mexican branches in New York to meet pressing needs for liquidity.

3. An advisory group of 13 major banks, on which LBI (Lloyds Bank International) is the sole British representative, is co-ordinating the approach of the more than 1,000 banks with loans to Mexico in one form or another. This group, which meets in New York, has provided the channel through which, with the encouragement of the main central banks, lending banks have been urged to roll over their deposits with Mexican banks in order to avoid a further erosion of confidence in the banking markets.

SECRET

4. The position of the Mexican banks in the international markets seems very likely to remain precarious until the uncertainties surrounding Mexico's negotiations with the IMF are resolved. There have been unsubstantiated press reports of negotiations for a $12 bn loan to Mexico from Saudi Arabia. Until more is known of such a loan it is difficult to assess how it might affect the international banking markets; as a major injection of liquidity it could help confidence, but it might increase fears that IMF conditionality could be by-passed.

5. Deposits are being moved from the smaller banks, as well as from the banks of LDCs, to the larger banks in the main centres; and the unusually wide spread of interest rates in the banking markets is reflecting this discrimination. There has been a transfer of funds to the British clearing banks, to the principal Japanese banks and to some of the biggest US banks. These banks can raise funds cheaply at present. However, the markets are taking a cautious attitude to certain other major US banks which are being obliged to pay uncharacteristically higher rates. The leading Canadian banks, which recently reported sharply lower profits, are also paying more than usual for funds. The banks from European countries, as a rule are managing reasonably well in the current crisis; but the Banco Ambrosiano affair continues to cast a shadow over Italian banks and the well-publicised difficulties attending the rescue of the AEG-Telefunken group continue to create a certain unease for some W.German banks.

6. Following the removal of restrictions on and by Argentina, reports from UK banks indicate that most of the Argentine deposits in London have still remained here. We also hear from LBI in Buenos Aires that "the working relationship with Argentina appears to be getting back to normal" and that first steps are being taken to facilitate payments due.

7. Further notes on countries in difficulty are attached.

CONFIDENTIAL

NOTES ON PROBLEM COUNTRIES, SEPTEMBER 1982

A - LATIN AMERICA

Argentina - Total indebtedness $37 billion

The rapid deterioration in Argentina's creditworthiness has been exacerbated by the inflationary policies adopted by the Bignone regime since the end of the Falklands crisis and by growing signs of political and social instability. With mounting overdues on repayments of capital and interest, there seems no prospect that Argentina can meet the massive debt service due in the remainder of the year. Principal payments including arrears of some $12 billion fall due for payment by end 1982. The reciprocal removal of UK-Argentine financial sanctions has cleared an obstacle to the major rescheduling which now looks inevitable. The IMF has agreed to send a mission to Buenos Aires for preliminary talks about the financial support programme which would need to accompany a rescheduling operation. Internal political instability is bound to complicate the negotiations. ECGD remain off cover.

Bolivia - Total indebtedness $2.5 billion

Has been in dire financial straits for some time. Negotiations with the IMF have collapsed, causing commercial banks to grant successive waivers to the clause in the debt rescheduling agreement signed in April 1981 which called for an IMF programme. In the meantime the Bolivians have continued to make interest payments, albeit with difficulty. However on 9 September the Central Bank announced that its foreign exchange reserves were exhausted and that a $10 million interest repayment would have to be delayed. But it is doubtful if the banks will actually call a formal default. UK exposure is small; ECGD has been off cover for some time.

Brazil - Total indebtedness expected to reach over $80 billion at end 1982, ie. the same order of magnitude as Mexico

Planning Minister Delfim Neto has pursued generally responsible economic policies and kept debt maturities long. But there are uncertainties about Brazil's short term prospects: policy relaxations before the elections due in November, a deteriorating current account performance and greater caution by the banks following events in Argentina and Mexico may cause Brazil problems in meeting this year's external borrowing programme, which still requires another $4 billion to be raised. Indeed there are already signs that certain Brazilian banks are encountering difficulties in the international money markets. If Delfim Neto - who has consistently opposed domestic pressures for rescheduling - were to go, this could spark a crisis of confidence. But confidence may be helped by a package of austerity measures just announced (involving an increase in the banks' compulsory reserve requirements), which indicates that the authorities are alive to the dangers they face. ECGD remains open for cover, but new commitments are being carefully controlled.

Cuba - Total indebtedness $3 billion

The Cuban authorities formally approached the UK and other Western creditor countries at the end of last month to request a rescheduling of medium and long term debts amounting to over $1 billion. We and other creditors have insisted on multilateral negotiations. Cuba's non-membership of the IMF is a complicating factor. The UK is not a major creditor; ECGD is off cover.

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B - EAST EUROPE

Yugoslavia - Total indebtedness $20 billion

Notwithstanding an IMF upper tranche programme, Yugoslavia has failed to come to grips with increasingly severe payments imbalances resulting from high growth and investment rates in the late 1970s. There are now increasing signs that Yugoslavia will have great difficulty in avoiding a debt rescheduling, but imports are being cut drastically, affecting domestic production and exports, and the Yugoslavs say they will not reschedule. Negotiations have been taking place for some weeks with a group of US, Canadian and Japanese banks for a $200 million loan (with moral support from the State Department) and the BIS is being sounded on the possibility of providing a large stand-by facility. The Governor of the National Bank of Yugoslavia is to visit London later this month to seek further loans from British banks but the latter are unlikely to be enthusiastic. ECGD, which has a substantial exposure (£700 million), is now virtually off cover, except for short term business.

Poland - Total indebtedness $27 billion

Convertible currency obligations falling due in 1982 amount to $10 billion, virtually none of which has been paid. But progress is being made on the rescheduling of unguaranteed banking debt due in 1982, and an agreement may be signed in the Autumn, under which the Poles will receive back about half the interest paid this year in the form of a 3 year credit. Western official creditors agreed after the imposition of martial law not to resume talks on official rescheduling for the time being. Some creditors are now reconsidering, since the effect of this refusal is to allow Poland 100% de facto relief on both principal and interest. But the US (and France) still firmly oppose the resumption of talks. Although to some extent Polish insolvency has been discounted by the banks, many of which (eg. in Germany) have written off a proportion of their loans, total default would still impose a burden.

Hungary - Total indebtedness $9 billion

Faces short term liquidity problems, and a substantial debt burden over the next few years. The immediate position has been eased by a $210 million BIS support package earlier in the year (in which Bank of England participation without official backing is $30 million) and a new commercial bank loan of $260 million. The Hungarians have requested a further $300million BIS facility and this will be considered at Basle on 28 September. Hungary's prospects depend on the outcome of current negotiations with the IMF over a stand-by arrangement which will require tough adjustment measures. Rescheduling remains a possibility. ECGD commitments are modest and under tight control.

Romania - Total indebtedness $11 billion

Agreement with Western Government creditors on the rescheduling of official debts was reached in July. However, an agreement with the banks may not be signed until later this year. An IMF stand-by agreement, withdrawn because of a build up of payments arrears, has been re-activated but seems unlikely to survive for long. There are considerable doubts whether the Romanian authorities are prepared to take the necessary adjustment measures to strengthen the external position, restore banking confidence and avoid the need for further reschedulings. ECGD is off cover.

GDR - Total indebtedness $13 billion

GDR's liquidity position is tightening because of inability to raise substantial new credits from Western banks. It has introduced measures to cut imports from the West and boost exports to convertible currency markets. But a request for debt rescheduling cannot be ruled out in 1982, though is more likely to occur in 1983. ECGD has introduced tighter market limits but is still on cover.

Econ Pol, Aug '84,
Western Banking System

SECRET

Prime Minister (2)

13 September 1982

5

You asked for a

ALAN WALTERS

PRIME MINISTER

Thank you very much

note from Alan on the Bank's Mexico figures

MCS 14/9

BANK CLAIMS ON MEXICO AND OTHER DEVELOPING COUNTRIES

The Bank of England's memorandum (7 September) confirms in figures what we already knew. Broadly speaking, the British Bank's commitment is one-tenth of the total BIS commitments, although this varies somewhat from one country to another. And Mexico's and Venezuela's debt is short compared with that of Brazil.

An additional feature which the Bank memo does not highlight, is the concentration of this lending in the last year. For example, according to my sources in the World Bank, Mexico borrowed about 20 billion dollars in 1981, almost all of it from the world's banks. This was at a time when it was obvious that Portillo had adopted expansionist policies which were clearly worse than those which were pursued during the last two years or so of Echeverria's Presidency. The banks lent on the myth that oil was a substitute for sensible policies, in spite of the experience of countries such as Iran, Nigeria etc.

Mexico and the IMF

There is no doubt that if Mexico showed that she was going to adopt sensible policies (which can come only through an IMF reform package) doubts about solvency and liquidity would rapidly be allayed. The policies pursued by Portillo have been quite dreadful and are unlikely to improve; indeed I think they will get worse. Sr Tello, the Governor of the Central Bank appointed to succeed Sr Mansera, is a product of our own Cambridge school of Marxist economics. It was he who when a Director (and Assistant Director) in the Budget Office, urged that Mexico should repay her debt to the IMF and be free of the need to conform to the IMF's package. He is a strong proponent of a command-siege economy and expanding public spending. On the monetary and budgetary side therefore I suspect things will get considerably worse during the next three months or so.

Meanwhile it is the Mexican season for wage awards. There is an enormously inflated claim by the main trade unions in Mexico. It is designed to more than catch up with inflation. I cannot see how Portillo will deny this claim in his last year of office. This will

/then much

SECRET

then much exacerbate the already serious unemployment problem and stimulate migration into the United States.

Madrid and Prospects of Reform

The hopes of the world financial community are pinned on Sr de la Madrid who will become President in early December. It is anticipated that he will be a much more sensible and prudent President than Portillo. It is worth reflecting, however, that the same thing was said about Portillo six years ago. Portillo had also been a sound Minister of Finance, but changed dramatically when he became President. Sr Madrid has been making all the right noises in his speeches, but it is worthwhile bearing in mind that when he was in the Budget Office he supported expansionist policies. It would be unwise to count too heavily on Sr de la Madrid as the reforming President.

The world's financial community appears to be hoping that the pendulum of Mexican politics will swing again into the hands of the traditional rich ruling class. It is hoped that Sr Madrid will pay attention to the industrialists in the private sector and follow the generally successful lines of policy which they have supported. I believe that the majority of opinion of the World Bank and IMF Latin American specialists is that Madrid will return to those sensible pre-Echeverria policies. But there is a substantial minority of very well informed old Mexican hands who believe that things have gone too far to return to the old nostrums.

In my judgement the evidence so far suggests that Mexico is likely not to repudiate its debts. Although it is unlikely that they will accept fully the IMF reform package, they will go far enough to give sufficient confidence that they mean business on reform. It is likely that they will press some very hard bargains on interim interest rate arrangements, and in that sense they will write off some of their market obligations. In other words, I judge the latent conservative forces to be still powerful enough to assert the need for sensible reform policies.

Repercussion Effects

It is likely, therefore, that Mexico will so frighten its creditors that it will extract from them a reduction in the debt in exchange

/for avoiding

for avoiding all the messy consequences of repudiation. It will be very important for other developing countries, as well as the basket cases in Eastern Europe, to see what Mexico can get away with.

There are various options that are being touted around. Perhaps the most persistent one is that either central banks or the IMF should buy the debt off the banks at a substantial discount, say 70% of its face value. Then this would be treated legally as an indebtedness to the central banks or the IMF. The discount would then compensate for the fact that the debt would be "re-scheduled" and the interest rates would be lower than market rates. Obviously the political and economic implications of these suggested solutions are both complicated and worrying.

The Liquidity Problem

This is all concerned with the solvency problem. On the other hand, the liquidity problem seems to be more or less well covered. The central banks do appear to have the banking system substantially supported to offset any short term run on deposits. I am convinced now that the Ambrosiano Luxembourg phenomenan was a small aberration and not typical of the general operations. More important, I believe that the markets are convinced of this also.

Conclusion

With the liquidity problem at least temporarily out of the way, there is an opportunity for an orderly re-scheduling of Mexico's debt. Mexico will press its advantages here and secure concessions on interest rates etc effectively to reduce its obligations. The Americans must take the lead in all these negotiations, US banks are far more committed than any other country's banking system. It may be that the American Government would want to go rather further than we would to cement its good relationships with the incoming Madrid administration. But I suspect there is little we can do about that. The Americans know that any weakness in dealing with the Mexicans is likely to be taken as a signal by the rest of the developing world to write down their indebtedness. It will be contagious. So there will be a natural check to their propensity to propitiate the new Mexican Government.

/Of the

Of the other candidates for "re-scheduling", I think little has changed since the discussion we had on 31 August. I heard that Peru seems to be in imminent danger of collapse. The indebtedness to the UK is, however, only about ½ billion. I believe that Chile is safely out of the wood, and Venezuela and Brazil not far behind. However, it is most important that Mexico does not profit much from its profligacy "pour encourages les autres".

13 September 1982

ALAN WALTERS

(Dictated but not signed by Alan Walters)

PRIME MINISTER

POSTSCRIPT TO ROBIN BUTLER'S MINUTE OF 10 SEPTEMBER RECORDING THE GOVERNOR'S REPORT ON THE FINANCIAL SCENE

First, the Governor has had a call from Volcker to the effect that Volcker has had a message that the Mexicans propose to proceed to negotiations with the IMF as quickly as possible. This message needs to be validated but suggests that the Mexicans are moving more quickly and seriously to negotiations with the IMF than previously expected.

Second, the Bolivians have said that the delay on the $10 million payment reported earlier is due to technical problems and they expect to complete within 20 days or so.

Third, US money supply is up $1.1 billion this week, again at the top end of the expected range but not outside it.

F.E.R.B.

10 September 1982

SECRET

1. Mr. Scholar - to see
2. File

PRIME MINISTER

INTERNATIONAL FINANCIAL DEVELOPMENTS

The Governor telephoned with a report on developments today.

On the Argentine, we are still on track for the removal of restrictions at the beginning of next week, provided that this is not counter-manded over the weekend. There was a small flurry because de la Rosiere let it be known that the Argentines would be having discussions with the Fund, and there was anxiety that this might upset members of the Junta and provoke them into intervening.

On Mexico, there was no trouble in the short-term money market in New York on Thursday. The last report from Herzog's people before they returned to Mexico suggested that they were hoping not to bring matters to a head. There is a current rumour that the Mexican Finance Ministry are going to make a statement later today, but this may only be a rumour and the statement may not contain anything significant: I have arranged with the Governor to let me know if it does.

A new trouble spot is Bolivia which has informed the banks involved in a $10 million loan that it is seeking a re-scheduling. The amounts here are not large - about $400 million in total, of which the Bank of America is in for about one-third.

In general, the Governor said that the mood in the market both in New York and here was jumpy, although sterling was stable and gold was down to just over $450.

The troubles of Denmark were being much discussed, but they were holding on to the bottom of the EMS range, having let their interest rate on call money go as high as 28 per cent today. As an example of the jumpiness of the market, the Governor said there had been a rumour on Wall Street that a big German Bank was in

/trouble:

SECRET

trouble: This rumour appeared to have arisen because a loss reported by Deutsche BP - a German subsidiary of BP - had been mistakenly interpreted as a write-off by Deutsche Bank.

F.E.R.B.

10 September 1982

Cabinet / Cabinet Committee Document

The following document, which was enclosed on this file, has been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES.

Reference: LCA to CC(82) 48th Conclusions, Minute 1

Date: 9 September 1982

Signed A Wayland Date 14 August 2012

PREM Records Team

DBY 080800Z (Monetary)

IMMEDIATE

ADVANCE COPY

Mr Hannay (in lieu of Mr Evans)
Thomas
Mr Goodison
Mr Hayes
PS
PS/Mr Onslow
PS/Lord Belstead
PS/Mr Marten
PS/PUS
~~Sir J. Bullard~~
RC
Mr Clifford
Mr Ure

Hd ERD
Hd MCAD
Hd ESID
ODA
Hd PUSD (2)
Hd Planning Staff
Hd TRED
Hd News D.
(2) ~~Mr~~ Scholar No 10 D.S.
Mr Littler HM Treasury

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TO IMMEDIATE FCOTZZBEGRAM NUMBER 434 OF 08 SEPTEMBER

INFO TO MEXICO CITY WASHINGTON

FOLLOWING FROM CHANCELLOR TO IMF/IBRD MEETINGS , TORONTO

THE MEXICAN SITUATION

1. THROUGHOUT THE FUND/BANK MEETING ATTENTION HAS BEEN FOCUSSED ON THE MEXICAN SITUATION. IT HAS BECOME CLEAR THAT THE NEGOTIATIONS WITH THE FUND HAVE BEEN GOING VERY SLOWLY, AND THIS HAS BECOME GENERALLY KNOWN. IN PARTICULAR THE ECONOMIC MEASURES OF 4 SEPTEMBER ARE UNLIKELY TO BE COMPATIBLE WITH ANY LIKELY FUND PROGRAMME. SILVA HERZOG AND ALFREDO PHILLIPS (CENTRAL BANK DIRECTOR) HAVE HAD VARIOUS MEETINGS WITH THE GOVERNOR AND BIS PRESIDENT LEUTWILER, AND THEY BOTH CAME TO SEE ME THIS AFTERNOON. THEY ACKNOWLEDGED THAT THE IMF TIMETABLE HAS SLIPPED, AND THAT SEPTEMBER 4 MEASURES, WHICH TOOK PLACE WITHOUT HERZOG'S KNOWLEDGE, MAY HAVE TO BE REVERSED IN DUE COURSE. HERZOG IS RETURNING TO MEXICO WITH A MEMORANDUM PREPARED BY THE FUND SETTING OUT ECONOMIC OBJECTIVES, BUT NOT PARTICULAR DETAILS,

~~SETTING OUT ECONOMIC OBJECTIVES,~~ BUT NOT PARTICULAR DETAILS, OF A FUND PROGRAMME. HE WILL SEEK ''POLITICAL DEFINITIONS'' FROM PRESIDENT LOPEZ PORTILLO. IF THE PRESIDENT BROADLY ACCEPTS THE ECONOMIC OBJECTIVES , WORK ON SPECIFIC PROGRAMME CAN CONTINUE IMMEDIATELY. IF, HOWEVER, HE FINDS POLITICAL DIFICULTIES MORE TIME MAY BE REQUIRED FOR HERZOG TO GAIN THE NECESSARY SUPPORT WITHIN THE FACTIONS SURROUNDING THE PRESIDENT. HERZOG HIMSELF IS FULLY AWARE THAT MEXICO'S CREDIBILITY IS AT STAKE, AND WILL DO HIS UTMOST TO MAKE POSSIBLE THE RESUMPTION OF SERIOUS TALKS ON THE PROGRAMME.

2. MEANWHILE , THESE DIFFICULTIES HAVE CAUSED PROBLEMS FOR THE DRAWING DOWN OF THE BIS AND FED CREDITS, WHICH ARE CONDITIONAL ON SATISFACTORY PROGRESS BEING MADE WITH THE FUND NEGOTIATIONS. THE FIRST TRANCHE TOTALLING DOLLARS 600 MILLION HAS BEEN MADE AVAILABLE TO THE MEXICANS AND WILL BE RELEASED IN ACCORDANCE WITH NEED. THE BIS AND FED WILL DECIDE WHETHER AND WHEN THE SECOND TRANCHE MAY BE DRAWN IN ACCORDANCE WITH THE RESULT OF HERZOG'S TALKS WITHTHE PRESIDENT.

3. NEWS OF THESE DEVELOPMENTS HAVE REACHED THE PRESS, AND THERE MUST BE SOME DANGER THAT IT WILL HELP TO DISLODGE WHAT HAS HITHERTO BEEN GENERALLY POSITIVE RESPONSE BY PRIVATE BANKS TO MEXICO'S APPEAL FOR 90 DAY MORATORIUM. THE LIQUIDITY SITUATION IS BEING REVIEWED BY THE FED AND OTHER CENTRAL BANKING AUTHORITIES ON A DAILY BASIS. THE GOVERNOR IS FULLY INVOLVED.

4. CLEARLY DEVELOPMENTS IN MEXICO OVER THE NEXT WEEKWILL BE CRITICAL.

5. PLEASE ADVANCE TO SCHOLAR (NO10) LITTLE (HMT) EVANS (FCO)

MORAN

NNNN

S E C R E T

(1) 2

PRIME MINISTER

c. 1. Mr. Butler
2. Mr. Coles

MS

Mexico

There have been some developments today. The second tranche of the BIS facility was due to be paid today. The BIS and the Fed have declined to make the payment because of the unsatisfactoryness of Mexico's present policies. In fact, the first tranche, although it has been paid over, has not been used and cannot be used without the agreement of the BIS and the Fed (it has been redeposited with the BIS).

This will produce a useful pressure point on the Mexicans. In order to maintain confidence the BIS banks and the Fed are not making it public that the facility is being withheld, and are saying that the facility is available on the terms agreed. Meanwhile, negotiations continue with the Mexican Central Bank Governor to try to get him in line.

The news of the second development comes from Toronto. The Mexican Finance Minister Hertzog is about to return to Mexico bearing a package of measures which would be acceptable to the international community, and which, I understand is acceptable to himself. He will then have to slug it out with his colleagues in Mexico City.

The Deputy Governor telephoned me about the third development this evening. The managers of local branches of Mexican banks came into the Bank of England this morning, to say that they had received instructions from their head offices not to pay maturing deposits (Euro deposits, sterling deposits, etc.) from today. They had been arguing with their head offices and had secured a day's grace before being obliged to implement these instructions. Mr. McMahon immediately arranged a meeting with Mr. Tello, the Mexican President's emissary, currently in London, who is also the brother of the new Mexican Central Bank Governor, and explained to him the portent of what was being proposed. Mr. Tello immediately telephoned Mexico City. The result was a message a short while later that it had all been a misunderstanding and that no instructions had been sent from Mexico City.

/ Somehow or other

Somehow or other the Guardian got hold of this story this evening. The Bank hope that they have succeeded in persuading them not to print this story. Let us hope that they have succeeded.

MCS

7 September 1982

SECRET

PA IA

MCS 29/7

TELEPHONE
01 - 601 4444

BANK OF ENGLAND
LONDON EC2R 8AH

7 September 1982

Prime Minister (2)

You will probably wish to study these figures over the weekend

MCS 8/9

AW +1

Could I have comment from Alan

M C Scholar Esq
Private Secretary to the
Prime Minister
No 10 Downing Street
London SW1

Dear Michael

At the Seminar on 1 September the Prime Minister asked the Bank to provide a comprehensive schedule of Mexico's due debt repayments and a breakdown of UK exposure to Mexico with a maturity analysis. I enclose a paper prepared here in response to this request. I am sending copies of this letter and its enclosure to Brian Fall (Foreign & Commonwealth Office), John Rhodes (Department of Trade) and John Kerr (HMT).

Yours sincerely
Tim Allen

T E Allen
Private Secretary
to the Governor

BANK CLAIMS ON MEXICO AND OTHER DEVELOPING COUNTRIES

Mexico

Mexico's debts tothe banks of the major industrialised countries with a breakdown by maturity are shown in the attached table. As well as the principal outstanding a rough estimate of interest due is included. Most of the debt is at floating rates so that the interest has to be based on a forecast of international interest rates. The sensitivity of the numbers to a different outturn for interest rates can be judged from the difference which one percentage point either way would make (1% sensitivity).

The totals are for claims of banks located in the BIS reporting area (which embraces the Group of Ten countries, Switzerland, Austria, Denmark, Ireland and branches of US banks in the main offshore centres), and do not therefore include Mexico's other debts of $15 billion at end-1981 to official lenders and to banks elsewhere.

In practice much of the outstanding debt would normally be rolled over or replaced, so reducing the net capital repayments but increasing per contra the cost of interest service. Rescheduling would have a similar effect.

The table also shows the claims of the British banks on a consolidated worldwide basis. The clearing banks account for 4/5 of the total. Some of the total is not owed to the Head Offices in London but to branches or subsidiaries abroad - which would include, for example, Crocker National Bank (owned by Midland) and Union Bank (owned by Standard Chartered) both in California. Loans to Mexico by British banks in pesos are insignificant.

Figures for the British banks are also available for mid-1982, but only from London. It will be several weeks before their lending figures to Mexico are available from other centres (mainly North America). These figures are compared in the table with those for end-1981 on the same, London-only, basis.

These show hardly any change in total. The $1.1 billion in the 0-6 month band at end-1981 will all have run off and just over half has apparently been replaced by new short-term debt in the first half of 1982 (0.2 in the end-1981 6 months-1 year band has fallen into 0-6 months implying new loans of $0.7 billion). The compensating increase was in the 3-5 year band.

Other countries

Similar figures but without estimates for interest are available for other countries. The annex compares British banks' claims on the largest developing country borrowers with the BIS bank claims as a whole. Most noteworthy is the contrast between the maturity profile of Brazil with Mexico, Venezuela, Argentina and Eastern Europe. Venezuela has traditionally kept her debts very short.

Bank of England

7 September 1982

Secret

BANK LOANS TO MEXICO

$ billions

	Total	%	0-6 mths	%	6 mths - 1 yr	%	1-2 yrs	%	2-3 yrs	%	3-5 yrs	%	Over 5 yrs	%	Unallo-cated	%
End-1981																
All BIS banks	56.9	100	← 27.7 →			49	4.8	8	← 22.6 →					40	1.9	3
Interest*	20.4		6.5				3.9		9.8						0.2	
Total estimated debt service	77.3		34.2				8.7		32.4						2.1	
1% sensitivity			0.4				0.3		0.9							
End-1981																
British banks consolidated worldwide	5.7	100	2.3	40	0.4	7	0.5	9	0.4	7	0.8	14	1.3	23	..	
Interest*	2.1		0.4		0.2		0.4		0.3		0.4		0.4			
Total estimated debt service	7.8		2.7		0.6		0.9		0.7		1.2		1.7			
British banks London:																
End-1981	3.7	100	1.1	30	0.2	6	0.4	10	0.2	7	0.7	20	1.0	27	..	
Mid-1982	3.8	100	0.9	25	0.1	4	0.4	11	0.3	9	1.0	26	0.9	25	..	

* Total is the sum of estimated interest due over the whole period of debt outstanding.

TABLE

BIS AND BRITISH BANK CLAIMS ON LARGE BORROWERS (END-1981)

$ billions

(a) = all BIS bank claims
(b) = British banks (consolidated worldwide claims)

		Total	%	Up to 1 yr	%	1-2 yrs	%	Over 2 yrs and unallocated	%
All developing countries	(a)	347.5	(100)	169.1	(50)	25.7	(8)	152.7	(42)
	(b)	37.4	(100)	16.9	(45)	3.3	(9)	17.2	(46)
Argentina	(a)	24.8	(100)	11.6	(47)	3.0	(12)	10.3	(41)
	(b)	2.7		1.2		0.3		1.1	
Brazil	(a)	52.7	(100)	18.3	(35)	4.3	(8)	30.1	(57)
	(b)	4.3		1.2		0.5		2.6	
Chile	(a)	10.5		4.2		0.9		5.4	
	(b)	0.9		0.2		0.1		0.7	
Colombia	(a)	5.4		2.7		0.3		2.5	
	(b)	0.4		0.1		..		0.3	
Mexico	(a)	56.9	(100)	27.7	(49)	4.8	(8)	24.5	(43)
	(b)	5.7		2.7		0.5		2.5	
Peru	(a)	4.4		2.7		0.4		1.4	
	(b)	0.4		0.2		..		0.2	
Venezuela	(a)	26.2	(100)	16.1	(61)	1.7	(6)	8.4	(33)
	(b)	2.5		1.4		0.1		1.0	
Philippines	(a)	10.2		5.8		0.5		4.0	
	(b)	1.5		0.9		0.1		0.5	
South Korea	(a)	19.9		11.5		1.3		7.0	
	(b)	2.4		0.8		0.3		1.3	
Algeria	(a)	8.4		1.5		0.8		6.0	
	(b)	0.6		0.1		0.1		0.4	
Yugoslavia	(a)	10.7		3.0		0.8		6.9	
	(b)	1.3		0.3		0.1		0.9	
Greece	(a)	9.8		3.6		0.7		5.5	
	(b)	1.0		0.4		0.1		0.5	

Secret

BIS AND BRITISH BANK CLAIMS ON LARGE BORROWERS (END-1981) (continued)

$ billions

(a) = all BIS bank claims
(b) = British banks (consolidated worldwide claims)

		Total		Up to 1 yr		1-2 yrs		Over 2 yrs and unallocated	
			%		%		%		%
Eastern Europe	(a)	60.8	(100)	25.6	(42)	6.1	(10)	29.2	(48)
	(b)	6.0		2.3		0.7		3.0	
Bulgaria	(a)	2.4		1.1		0.3		0.9	
	(b)	0.2		0.1		..		0.1	
Czechoslovakia	(a)	3.3		1.2		0.3		1.8	
	(b)	0.3		0.1		..		0.2	
East Germany	(a)	10.7		4.6		1.6		4.5	
	(b)	1.0		0.6		0.2		0.2	
Hungary	(a)	7.7		3.1		0.6		4.1	
	(b)	0.5		0.1		..		0.4	
Poland	(a)	15.3		5.5		1.9		7.9	
	(b)	1.8		0.5		0.2		1.1	
Roumania	(a)	5.1		1.8		0.5		2.8	
	(b)	0.6		0.2		0.1		0.3	
Soviet Union	(a)	16.3		8.2		0.9		7.3	
	(b)	1.6		0.5		0.2		0.9	

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Western Policy
Systems Aug 82 (x5)

ADVANCE COPY
IMMEDIATE

~~Mr~~ Coles, No 10 D.S. (2)
Mr Hannay (in lieu of Mr Evans)
Mr Littler, HM Treasury
Mr Balfour, Bank of England
RC

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OO FCO

GRS 605

Prime Minister

CONFIDENTIAL
FM OTTAWA 061810Z SEP 82
TO IMMEDIATE FCO
TELEGRAM NUMBER 427 OF 06 SEPTEMBER

A.J.C. 7/9

FOLLOWING FOR PRIME MINISTER FROM CHANCELLOR OF EXCHEQUER
AT IMF/IBRD MEETINGS IN TORONTO

1. THESE MEETINGS HAVE SO FAR INCLUDED THE IMF INTERIM AND DEVELOPMENT COMMITTEES, TWO MEETINGS OF THE GROUP OF 5 FINANCE MINISTERS AND ONE EACH OF THE GROUP OF 7, THE GROUP OF 10, WORKING PARTY THREE OF OECD, AND THE GROUP OF SENIOR OFFICIALS OF 6 MAJOR COUNTRIES ON THE IDA PROGRAMME.

2. THERE HAS BEEN SERIOUS CONCERN ABOUT THE STATE OF THE WORLD ECONOMY AND MORE EXPLICIT PRESSURE FROM THE LDCS FOR A CHANGE OF POLICY BY THE INDUSTRIAL COUNTRIES. BUT LAROSIERE HAS RENEWED HIS ADVICE THAT IT WOULD BE A MISTAKE TO CHANGE COURSE AWAY FROM FIGHTING INFLATION AND CONTROLLING BUDGET DEFICITS: AND THERE WAS NO SERIOUS MOVE TO CHALLENGE THIS ADVICE IN THE INTERIM COMMITTEE.

3. US REPRESENTATIVES CONTINUE TO EXPRESS OPTIMISM ABOUT UPTURN IN THE US ECONOMY WITH RESUMED GROWTH IN COMING MONTHS: THEY PREDICT A FOUR AND A HALF PER CENT GROWTH RATE IN 1983. THEY ARE ABLE TO POINT TO SOME MILDLY ENCOURAGING FIGURES FOR RETAIL SALES, HOUSING STARTS AND INDUSTRIAL PRODUCTION FOR JULY TO SUPPORT THE HOPEFUL DEVELOPMENTS ON INTEREST RATES AND IN THE STOCK MARKETS. THERE IS PROBABLY A FAIRLY WIDESPREAD ACCEPTANCE THAT SOME RECOVERY IS IN PROSPECT IN THE US BUT MUCH SCEPTICISM ABOUT THE FOUR AND A HALF PER CENT FORECAST, AND SOME FEAR THAT THE RECOVERY MAY NOT BE SUSTAINED. THIS COMES BACK TO THE QUESTION WHETHER THE US BUDGET DEFICIT WILL BE SET ON A CONVINCING DECLINING PATH AND WHETHER THE FALL IN INTEREST RATES CAN BE CONSOLIDATED AND EXTENDED. THERE IS NO EXPECTATION OF AUTONOMOUS RECOVERY IN EUROPE UNLESS THE STATE OF THE US ECONOMY IS SUCH AS TO SUSTAIN IT.

4. THE WORRIES ABOUT RECOVERY ARE OF COURSE REINFORCED BY CONCERN ABOUT THE BANKING SYSTEM AND IN PARTICULAR ABOUT THE SITUATION IN LATIN AMERICA. IT IS CLEAR THAT THE TRANSITION BETWEEN PRESIDENTS IN MEXICO IS MAKING IT MORE DIFFICULT TO GET NECESSARY MEASURES OF ADJUSTMENT OR TO MAKE PROGRESS IN DISCUSSIONS WITH THE IMF, AND IS ENCOURAGING COUNTER PRODUCTIVE ACTION LIKE THE NATIONALISATION OF THE BANKS. AS WITH POLAND THERE IS NO ESCAPE FROM LABORIOUS STEP BY STEP NEGOTIATION WITH THE MEXICAN GOVERNMENT (WITH A PRESIDENT INCLINED TO OVER-RULE PURELY FINANCIAL ADVICE) ON THE PART OF THE US THE IMF THE BIS AND THE PRIVATE BANKS. I AM DEVOTING A CONSIDERABLE PART OF MY MAIN IMF SPEECH TO A CAREFUL STATEMENT OF THE STEPS WE SHOULD TAKE TO IMPROVE THE PROSPECTS AND STABILITY OF THE INTERNATIONAL BANKING SYSTEM.

5. ON IMF/IBRD BUSINESS THE TWO KEY ISSUES HAVE BEEN THE EIGHTH REVIEW OF QUOTAS AND IDA. ON THE FORMER, ONE CAN DETECT THE MAKINGS OF A CONSENSUS ON ENLARGING THE FUND FROM 61 BILLION SDRS TO 100 BILLION FOR THE PERIOD 1985-1990, BUT THE US IS STANDING OUT ALONE FOR A MUCH LOWER FIGURE. THEIR PROPOSAL FOR A SEPARATE NEW EMERGENCY IMF FACILITY (PERHAPS OF 15-25 BILLION SDRS), (WHICH WOULD BE FINANCED BY BORROWING AND USED APPARENTLY FOR LARGE SPECIAL CASES LIKE MEXICO) HAS NOT BEEN CLEARLY DEFINED, WOULD TAKE AT LEAST A YEAR TO PUT IN PLACE AND IS WIDELY SEEN BY SOME AS A DIVERSIONARY TACTIC. THE IDEA MAY HAVE SOME MERIT BUT IT HAS CERTAINLY NOT BEEN HELPFUL TO INTRODUCE IT WITH LITTLE WARNING AND WITH MARKED LACK OF CLARITY. ON IDA, THERE HAS BEEN CONSIDERABLE PRAISE FOR THE READINESS OF THE UK TO GO BEYOND PROPORTIONALITY WITH REDUCED US CONTRIBUTIONS AND THUS TO MAINTAIN A BETTER FLOW OF FUNDS FOR CONCESSIONAL DEVELOPMENT ASSISTANCE.

6. THE FOLLOW-UP WORK TO THE VERSAILLES SUMMIT UNDERTAKINGS ON MONETARY COOPERATION HAS BEEN FRANKLY DISAPPOINTING. MINISTERIAL DISCUSSION OF THE INTERVENTION STUDY TOOK US NO FURTHER FORWARD: BUT OFFICIALS WILL AIM TO COMPLETE THE STUDY BY THE SPRINGM NOR DID WE MAKE MUCH PROGRESS IN G5 DISCUSSION WITH LAROSIERE ABOUT CONVERGENCE OF POLICY IN SUPPORT OF MORE STABLE EXCHANGE RATES: IN MY PLENARY SPEECH TOMORROW I SHALL TRY TO GINGER THIS UP A BIT.

7. THESEC PARTICULAR ANNUAL MEETINGS WILL PROBABLY NO*TBE SEEN AS ANY SORT OF MILESTONE BUT AT LEAST AT THIS STAGE SEEM UNLIKELY TO PRODUCE ANY DAMAGING RESULTS. THE GENERAL RECOMMITMENT TO A COUNTER INFLATIONARY STRATEGY IS ENCOURAGING: AND THE FLAVOUR OF DISCUSSIONS ON BANKING AND DEBT ISSUES IS MUCH LESS APOCALYPTIC THAN THE PRESS WOULD WISH TO SUGGEST.

8. ON ARGENTINE, SEE MIFT (NOT TO ALL)

9 . PLEASE ADVANCE TO COLES (NO 10) , EVANS (FCO) LITTLER(HMT) AND BALFOUR(BANK).

MORAN

NNNN

CONFIDENTIAL

Econ Pol

JL

10 DOWNING STREET

From the Private Secretary

6 September 1982

Thank you for your letter of 2 September, with its analysis of Lord Lever's views on the international banking situation.

The Prime Minister has read this with interest over the weekend, and looks forward to receiving a further note from the Treasury on these matters following the Bank Fund meetings in Toronto.

I am sending a copy of this letter to Tim Allen (Bank of England) and Alan Walters.

M. C. SCHOLAR

John Kerr, Esq.,
HM Treasury.

3/15

CONFIDENTIAL

(2)

Prime Minister

An effective critique of Lord Lever - but we await the Treasury's further report, on Toronto, for some more positive ideas on how to confront these dangers.

MCS 2/9

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

2 September 1982

Michael Scholar Esq.
10 Downing Street
LONDON
SW1

MT

Dear Michael,

INTERNATIONAL BANKING: LORD LEVER'S MEMORANDUM

I understand that in the course of yesterday seminar on international banking the Prime Minister referred to Lord Lever's views. He recently circulated to the Treasury and others his Memorandum on "Deficit Finance - Bankers and Governments", which has I believe also reached the Prime Minister (copy attached). She may therefore like to see the attached note about it. Lord Lever delivered a lecture at Chatham House on rather similar lines a few week ago.

I am copying the letter and enclosure to Tim Allen at the Bank, and to Alan Walters.

Yours ever,

John Kerr

J O KERR
Principal Private Secretary

LORD LEVER'S MEMORANDUM: DEFICIT FINANCE - BANKERS & GOVERNMENTS

Lord Lever's Memorandum is in two parts: analysis and prescription. The analytical part is a critique of the functioning of the Eurodollar markets in recycling the OPEC surplus to governmental borrowers. The prescriptive part proposes first that central banks should act to prevent banking failures on lines close to those already agreed in Basle; and second that a committee of central banks and governments should determine the total value of liquidity needed and then apportion it between prospective borrowing countries.

2. The thrust of Lord Lever's approach is to substitute centralised decision taking for market operations, and to deplore the operation of the Euromarkets as free markets. But whatever view is taken about how the Euromarkets have operated, it can be said at once that the idea of substituting allocation by committee for allocation by the markets is a complete non-starter. There is no prospect of international agreement on either the total volume of liquidity or its allocation. The nearest approach to a single point of decision on world liquidity is in fact the decisions of the US authorities on the dollar money supply and US monetary policy.

The Euromarkets

3. Lord Lever sees the Eurodollar markets as a dangerous and unsatisfactory channel for the recycling of funds to deficit countries. He complains that lending was left to the "reflexes of the private banking system"; that it was a "soft option" for governments to encourage private bankers to recycle rather than using his committee system; and that it was a "fundamental weakness" of recycling through the Euromarkets that there were no central decisions about total liquidity and its allocation. He concludes that: "We have thus allowed to develop a vast unregulated cash mountain, restlessly moving between currencies to become a major source of parity instability".

4. There has been international debate about the rapid growth of the Euromarkets for a good many years. Chancellor Schmidt has shared some of Lord Lever's views about the character of these markets, and there was a time (1978) when he and US Secretary of the Treasury Miller pressed for a compulsory reserve requirement system in the Euromarkets by international agreement. The UK (Bank and Treasury) had doubts about the practicability and effectiveness of this proposal, and its implications for London as a financial centre. It was not pursued.

5. The Eurodollar markets developed because the compulsory reserve requirements of the Federal Reserve in the US drove a part of the US banking system (and dollar banking generally) offshore. The Eurodeutschemark market based on Luxembourg developed for a similar reason. It was cheaper for both borrower and lender to operate through the Euromarkets. Any system of controls is likely to create a market outside the control and then to complicate or undermine the control system. The UK has tried to avoid policy steps or forms of control which would encourage expansion of the (small) Eurosterling market.

6. The Eurodollar markets are an extension of the domestic US credit markets. It is US monetary policy which determines interest rates in the Eurodollar as in the domestic market. Funds move freely between the domestic and external markets in response to relative demand and to any movement in the (small) difference in interest rates. It is sometimes suggested that the Eurodollar market generates inflation through a multiplier effect in its lending. In fact a bank making an international loan is less able to count on securing deposits as a result of its own lending than a bank making a domestic loan. Like domestic banking markets, the growth of the Euromarkets is determined by the level of interest rates.

7. The Eurodollar markets also made recycling easier politically at a time when countries like Saudi Arabia and Kuwait would have been reluctant to deposit too much of their surpluses directly in

the United States. Their existence has also been of very great importance in the development and health of London as a financial centre.

8. It is not true to suggest that there are no restraints or controls in the Euromarkets. First, the operations of banks in the Euromarkets are subject to their own prudential requirements about capital ratios, which limit the scale of their lending wherever undertaken. Secondly in the US and the UK central bank supervision applies to the consolidated balance sheets of these banks, including overseas subsidiaries. The Bank of England have devoted much effort to extending consolidation (and corresponding central bank responsibility) to other G10 countries eg Germany. All G10 countries have however accepted that parent banks are responsible for their banking subsidiaries as well as branches abroad; and that this must be taken into account in the prudential regulation of parent banks - though this has not stopped the Italians arguing in the Ambrosiano case that the agreement did not apply to subsidiaries which are holding companies rather than registered banks.

DEFICIT FINANCE - BANKERS AND GOVERNMENTS

DIAGNOSIS

This note focuses on the failure of the Western nations to respond adequately to the financial and banking implications of the OPEC cartel.

The artificially high price of oil after 1973 produced enormous current account surpluses for many of the OPEC countries. These surpluses had their mirror image in the deficits of the oil consuming countries, many of the weaker of whom seem likely to remain in chronic or semi-chronic deficit because of their difficulties in raising the relative price or volume of their exports. The governments of the leading countries, motivated by economic, political and moral considerations, recognised that finance would have to be found for these weaker countries for an extended period. But it was not possible, within the existing philosophy and budgetary mechanics, for these governments to provide directly anything like the amount of finance needed. They turned instead to the softer option of encouraging their private bankers to recycle to the weaker countries the vast deposits from the OPEC surplus. The private bankers were not slow to respond.

It would have been virtually impossible for the banks to undertake this novel, enormous and continuing recycling operation within the constraints of the domestic banking regulations of their respective countries. There was, however, an agency ready to hand - the Eurodollar market. This had come into being mainly to escape tax complications and such regulations on bank lending as existed prior to OPEC. Thus, a vast recycling operation proceeded apace after 1974 and in large part through the Eurodollar market. All the great banks of all the great countries were drawn in. Funds flowed plentifully to virtually all the State borrowers in South America, Africa, Asia and even to the Soviet Bloc. Many of the countries who drank from this pool did so not merely to finance their deficits but also to add to their reserves.

A "solution" having been found to the problem of deficit financing, the leaders of the West appeared to feel that they were largely exempt from the need for any further action; they preferred to ignore the fundamental weaknesses of these arrangements. These may be summarised:-

1. The lending effectively under-wrote OPEC's monopoly price and provided the means whereby many of the poorer customers of OPEC could continue to pay whatever price OPEC felt able to exact.

2. There was no decision by governments or central banks on the volume or direction of the recycling, which were left to the reflexes of the private banking system. As a result, no decision was taken as to the total amount of resources that should be channelled through the Western banking system, nor as to how that vast sum should be apportioned between the borrowing countries. Neither was there any real attempt to impose on the lending any conditions which would reflect the legitimate political and economic

interests of the governments of the West. The irony is that as borrowers have successively come under pressure to meet their obligations, the West has falsely been charged with neo-imperialism whereas in fact, a vast, unprotected and largely unconditional transfer of resources has taken place.

3. The economies of many of the borrowing countries were such that only by further borrowing for an indefinite period could they meet their interest and repayment obligations. Neither the leading governments nor the private bankers seriously considered whether the borrowing by these largely impoverished nations could be treated as a purely commercial operation. The inevitable ballooning of the debt, from each year's deficits and accrued interest, was, during the early years, somewhat mitigated by the fact that interest rates were low or even negative in real terms. But the problem has more recently been sharply aggravated by the move into very high real interest rates.

These factors produced a dynamic of increasing incredibility built into the system - a built-in self-destruction of vulnerable arrangements which must ultimately threaten the flow of funds, the demand in world trade which they finance, the political and economic stability of the fragile borrowers and the banking system itself.

There are two further points to note. First, this massive use of the Eurodollar markets by sovereign borrowers developed at a time when corporate borrowers were also very greatly extending their use of them.

Broadly, the multinationals have borrowed on a scale roughly comparable to that of the sovereign borrowers. The over-optimism that infected the market with respect to the latter seems also to have spilled over to the former. The result is that many of the loans to large corporate borrowers are as shaky as those to the sovereign borrowers, and the banks now have two major classes of non-performing assets. Secondly, to make matters worse, the combination of recession, high interest rates and a long period of inflation has driven business and industry within the advanced countries themselves to rely ever more heavily on their domestic banking systems for finance. The banking system as a whole, therefore, is at all points heavily exposed to a unique degree.

We must note, too, that the growth in the Eurodollar market has serious financial implications for the economies of all countries and for their parities. The prudential control and regulation of this enormous market has, by normal banking standards, always been inadequate. The market has been fed by OPEC surpluses but has also attracted surplus cash from the banks in the advanced countries themselves; in addition, the liquidity resources of many multinationals and even of some central banks were added to the total. We have thus allowed to develop a vast and unregulated cash mountain, restlessly moving between currencies to become a major source of parity instability. Moreover, these fund movements jeopardise any attempt within any one country to maintain monetary control.

THE PRESENT FRAGILITY

We have in being a system of deficit financing extremely vulnerable to economic and political spasms and dependent on a high level of technical financial expertise in countries where neither that nor political stability is usual. Criticisms of the fundamental long-term incredibility of this system of lending were, for a number of years, brushed aside by the governments and the bankers themselves. But reality is brutally breaking through. The ballooning debt of countries with only a fragile prospect of ever making repayment has now reached hundreds of billions of dollars. Numerous small defaults have been followed by larger ones, and others, even larger, threaten. Nearly all of the great banks in the Western banking system are heavily over-exposed. The assets against which they have lent their depositors' money are increasingly called into question. Actual default has so far largely been covered over, and formal default avoided, since the latter would have manifestly devalued the bankers' assets in their balance sheets. "Rescheduling" amounts to little more than exchanging a basically incredible promise to pay which has in fact been defaulted for another basically incredible promise to pay at a later date. This process is breaking down. The sheer mechanical problems, complex in the extreme, of hundreds of banks agreeing to roll over past obligations are becoming overwhelming. More important, the larger the scale of these operations the less their effectiveness and credibility. The distinction between actual and formal default is increasingly losing its value in the eyes of auditors and depositors. Moreover, the inducement to the bankrupt borrowers to co-operate is the prospect of new money - this is increasingly difficult to achieve, even under government pressure. The banking system has become hostage to its impoverished debtors.

We now seem to be at the beginning of a period of maximum anxiety for the banks, and individual banks are already experiencing considerable pressure. First, interest payments and repayments of principal have been missed on a substantial scale, leading to a growing cash flow problem for the banks. Secondly, the nervousness of certain depositors is already in evidence. Central banks, who should never have been depositors in the first place, and some multinationals and other investors are withdrawing their deposits on a big scale. Thirdly, the pattern of balance of payments surpluses and deficits is beginning to shift. OPEC surpluses have recently been eroded and some OPEC countries are drawing down deposits to finance their deficits. Unhappily, there is no assurance that the recipients of these funds are depositing them in the same way as these OPEC countries did. Of course, the funds remain somewhere in the banking or central banking system; but a serious problem of mismatch is sure to develop. The banks are thus imminently facing a highly dangerous combination of deposit withdrawals and non-performing assets. The credit markets' reaction is clearly illustrated in the loss by all the major US banks (save Morgan Guaranty) of their triple-A bond rating - a sensational development which has not received the attention it deserves.

AN OUTLINE OF THE REMEDIES

The twin central problems which now face us are

(1) How to cope with the threat that the past lending represents to the financial stability of our banks and of the borrowers?

(2) How to ensure a sustained flow of lending in the future? If this is not achieved, a considerable percentage of the advanced countries' exports would vanish as the finance for them is reduced. This is to say nothing of the damage caused to the politics and economics of the borrowers and ultimately the danger to the banking system itself with multiplier effects throughout the world's economy. The political consequences for the advanced countries need no emphasis.

The governments of the world must now accept some responsibility for past lending and must undertake the necessary supportive action to ensure an adequate future flow. They encouraged the banking system to undertake this lending while guaranteeing only a small proportion of it. Indeed, they often brought pressure on the banks in pursuit of what were basically the political and economic purposes of governments. They must now accept some responsibility in order to protect both these purposes and the banking system.

Ideally, the governments of the leading countries would agree on joint action to protect the world's banking system by setting up an International

Bank both to regulate international finance and to act as lender of last resort. However, we cannot wait for this highly desirable development in order to handle the present dangers. We must at once move to ensure that each central bank acts to support its own private banks by protecting their liquidity situation in the event of defaults or postponements in payment by sovereign borrowers on existing debts. This can be done in a variety of ways. Where such lending has been normal and broadly prudent (so far as that term can be justly used in relation to a wildly imprudent system) each central bank could, for example, offer to discount where necessary the paper of the lending banks and to roll-over interest and repayment to match any defaults or delays by the borrowers. Alternatively, the central bank could buy assets guaranteed by the private banks. The central bank in question would accept delays of interest and repayments subject to a commitment whereby the banks wrote down, as required out of their profits and over a long period, the loans on which there had been default or where payment had been delayed. The banks would be making continuous repayment to the central banks out of their profits as well as out of any funds accruing from their defaulting debtors. Some such arrangement would protect the banking system while exculpating governments from the charge that they were themselves meeting the costs of the banks' misjudgements. It would, in effect, sustain our banks by enabling them to extend the period required to write down their questionable loans without calling their liquidity or solvency into question. The alternative of an enforced abrupt write down would have calamitous consequences. It is in our interests as well as those of the banks to make arrangements which give them time to pay for their own errors and avoid the backlash on us all.

It would be quite inadequate for some arrangement like the above to be carried out by individual central banks acting in isolation from one another. When the difficulties materialise, the central banks must be acting in harmony and be clearly seen to be so acting. There are two reasons for this. First, if the private banks of one or two countries are called into question there are very likely to be massive movements across the foreign exchanges as depositors seek areas of greater safety. This process has already started and parities have already been distorted. Collective arrangements for avoiding further gyrations and distortions in parities must be achieved before the process gets out of hand. This work should be co-ordinated with the Study Groups set up at the last Summit. Secondly, and even more importantly, we must at all costs head off any further widespread withdrawal of funds from the banking system in favour of government obligations, which will certainly take place if bank defaults start and if joint action by governments is not visible. Though individual central banks are to retain responsibility for the banks in their own countries, that responsibility should be in relation to a wider collective plan.

So far as future lending is concerned, governments and central banks must bring into being a systematic and sustainable system. A bare outline of how this might be done is as follows. A committee of central banks, in collaboration with their governments could prepare a periodic outline of the total volume of liquidity recycling or bank lending which is likely to be needed. This overall sum would then have to be apportioned between the prospective borrowing countries. Lending banks would be required to register their proposed loans with the committee, and if there is delay or default by the borrower, the central banks would stand ready to cover the liquidity and solvency problems of the banks broadly on the lines I have outlined in respect of past lending. The lending banks would, as part of their relationship with the central banks committee, be required to submit consolidated balance sheets so as to bring the overall Eurodollar lending under central bank supervision. These arrangements would, of course, have to be operated flexibly. But if international lending is to continue on an appropriate scale, other action will be required by governments. For example, it will be necessary for the IMF and other international institutions to develop a more prominent, coherent and predictable supportive role.

This is a bare outline of my proposals and I will be happy to discuss them more fully if required. In the past, the world's leaders, their finance ministers and the central banks have reacted only to crisis, without even an outline strategy to guide them. To do the same on this occasion would be to make a grievous error. The damage from existing arrangements is already accruing and the costs of delay are rising rapidly. It is imperative that we now organise this outline strategy and find effective agencies for implementing it. In my view the alternative will be a series of crises of the gravest kind.

SUMMARY

The banking system of the western world is now heavily and dangerously overextended. If its lending abruptly contracts there will be an avalanche of large-scale defaults world-wide which will inflict extreme damage on world trade and on the political and economic stability of the borrowing and lending countries. It was broadly right and necessary for the Western countries to mobilise their private banks in support of global political and economic interests. It was in the highest degree dangerous that governments failed collectively to accept the commitments and responsibilities which would have both supported and disciplined the activities of the banks.

The problems I have discussed are an important part of our central problem, namely, that in a world which has become increasingly interdependent we lack agencies capable of thinking about the system as a whole and of organising collective action to defend our global interests.

Harold Lever

3rd August, 1982.

SECRET

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10 DOWNING STREET

From the Private Secretary

1 September, 1982.

Dear John,

Seminar on the International Banking Scene

The Prime Minister had a discussion this morning about the international banking scene. Apart from the Chancellor, the Governor of the Bank of England, Sir Kenneth Couzens, Mr. Loehnis, and Mr. Walters were present. The discussion took place against the background of the three papers attached to your letter to Robin Butler of 27 August.

The Prime Minister said that she had discussed developments in the international banking scene at some length with Mr. Leutwiler, Head of the Swiss National Bank, during her visit to Switzerland in August. Earlier, at the end of July, she had had a discussion of these matters with the Governor of the Bank of England. But she had been concerned at the rapidity with which the Mexican crisis had arisen. She wondered whether the seriousness of the present situation was properly understood internationally. It was her impression that although the international financial community recognised that high interest rates and continuing recession were producing serious effects, they hoped to muddle through without any clear idea of the action necessary to preserve the integrity of the international financial system. It was regrettable that the recent group of high level international meetings, in particular the Versailles Summit, had taken place when it did, rather than in the coming weeks, since she believed that the meetings would have been put to better use if they had been aimed specifically at an appreciation of the situation in the wake of Mexico. The Prime Minister said that she would like to develop positive UK proposals, and to put them forward internationally. But as a first step she would be grateful for a comprehensive schedule of Mexico's due debt repayments (Mr. Loehnis interposed that only the Mexicans at this stage had the information necessary for producing such a schedule); and a breakdown of UK exposure to Mexico with a maturity analysis. She also wished to discuss the issue of liquidity in particular in relation to our own banks; and the extent to which successive rescheduling operations had produced a number of banks in different countries with unsound balance sheets. The recent developments had persuaded her that we needed to look again at the criteria for extending official credit, for trade promotion purposes, to countries which were of doubtful creditworthiness. The Prime Minister recalled that she had already advanced a proposition on these lines at Versailles in relation to the Eastern bloc countries, but that although she had US agreement, no German support had been forthcoming.

~~CONFIDENTIAL~~ SECRET

/ In discussion

In discussion, it was pointed out that the crisis in Mexico had arisen partly because of the efforts made by the new financial team there to tackle their problems before large payment arrears accumulated. The collapse of confidence had subsequently brought about a flight of capital. The Prime Minister enquired about UK banks' exposure to Mexico. Sir Kenneth Couzens said that this exposure, at $6 billion, had to be seen against the total exposure of US banks and their subsidiaries of around $22 billion, and of Japanese banks of $8 billion (or $10 billion on a consolidated basis). The Governor said that when a borrower failed to make payments on the debts due, the remedy which banks had usually applied had been to stretch out the payment schedule. Of course banks recognised that in some cases even these revised schedules would not be met; but in other cases they would be. The net effect was to lengthen the maturity structure of the banks' loan portfolios. The Chancellor said that for some years the UK had been amongst those urging more cautious borrowing policies. The Mexican crisis had underlined the importance of this, and had also demonstrated the futility of oil producers basing their development plans on the belief that the oil price would always rise. There could be no doubt that the international financial system was under very great strain. But the market mechanism was beginning to turn: it was noteworthy that the recent reduction in US dollar interest rates offered relief to Mexico on a major scale - around $4 billion, i.e. about the total of the IMF facilities which the Mexicans were applying for.

The Prime Minister said that she feared that the international community was being too complacent. The indebtedness which developing countries, particularly Latin American countries, had accumulated since 1979 had been piled on top of their post-1973 indebtedness. Banks' exposure to these countries was now at a high level. Furthermore, real interest rates were now much higher than in the post 1973 period. The Governor said that it was sometimes necessary for the international community, in order to maintain confidence, to speak in a way which might appear complacent. But there was no complacency: indeed, the difficulties of the present situation had been foreseen. After the first oil price increases deposits with the banking system which arose from the large OPEC surpluses had been on-lent in the large majority of cases to countries which were at the time good risks. But with the growing indebtedness of those countries, in particular following the second round of oil price increases, a number of those countries had become poor risks. The international financial institutions had played an important part in the recycling process. But their role needed to be developed further. He hoped that progress would be made in this direction in the forthcoming meetings at Toronto. There was no doubt that high interest rates, the accumulation of debt, and the depth and extent of the world recession had exacerbated the problems. It had to be recognised too, that many banks were coping with the effects of the world recession at home as well as overseas, nursing domestic customers affected by the recession. There had been a contraction in international confidence before Mexico's difficulties came to the fore. Mr. Loehnis observed that the Mexicans had been pursuing policies of accelerated external borrowing together with a large and growing

/ budget

budget deficit - which had inexorably led to currency depreciation, a flight of capital, and an inability to borrow further. They now faced retrenchment and financial reconstruction, with the help of the international community. Mr. Walters said that a restoration of confidence in Mexico would come about if the new Mexican Government implemented a suitable reform package. But would they have the political will and the administrative capacity to do so? The Governor and the Chancellor listed examples of countries which had reached, through pursuing unsound policies, the position in which the Mexicans now found themselves; and the effect of changed policies in restoring confidence. The Prime Minister enquired whether the right policy for creditors would be to lend no new money to Mexico. Mr. Loehnis said that some projects, notably in the development of natural resources, should certainly continue to go ahead, given that they would help with the adjustment process. The Prime Minister commented that we should re-assess the criteria we applied in extending official credit to countries of doubtful creditworthiness.

The Prime Minister asked what general prescription should be enjoined upon the financial community to strengthen the international financial system. Sir Kenneth Couzens said that the British Government had been enunciating for a number of years the general principles which needed to be followed case by case. The co-operative international arrangements built up since 1974 by central banks and banking supervisory bodies, designed to improve both the supervision of international banking business and for dealing with any problems that arose, needed further improvement. The Ambrosiano case demonstrated this. But the way forward was clear. There was, too, the principle of not precipitating a default - as the Prime Minister herself (in the case of Poland) had recently argued with the United States Administration. There was, further, the need to increase the resources of the international financial institutions to an appropriate level; to ensure that they conducted their affairs rigorously; and to protect them from North-South politicisation. Finally, there was the need for countries to adjust to changed economic circumstances.

The Prime Minister enquired about the measures available to central banks in a liquidity crisis. The Governor said that if there were to be turbulence in international markets the first effect on the principal UK banks would be to strengthen their liquidity, since deposits would tend to move to the strongest institutions. As in the UK's secondary banking crisis in 1974 the first remedy for central banks to apply if there were liquidity problems would be to attempt to recycle funds; if that proved impossible it would sometimes be necessary to supply liquidity. The Prime Minister enquired about banks' tax positions in relation to their specific and general provisions against bad debts. The Governor explained the position, and referred to the discussions which the Bank were having with the Inland Revenue. The Prime Minister invited the Governor to raise this matter with her if these discussions ran into difficulty.

/ There

There followed a brief discussion of US monetary policy. The Prime Minister enquired about the extent to which the recent relaxation in US policy was motivated by a concern about the soundness of their banking system. The Governor said that the Fed had modified their practice in relation to the time-scale over which they were aiming to meet their targets; they had also slightly relaxed their general policy, being ready to tolerate an outcome nearer the top of their target range; and in individual cases when required they had been ready to supply liquidity to individual institutions. The worry was that, as the US economy came out of recession, interest rates would go up again. If so we should see a further reduction in the already very low growth rates which OECD countries were forecasting.

The Prime Minister enquired what the next step should be in strengthening the international financial system. The Chancellor said that we would be seeking to reach agreement at the end of this week with the United States, Germany, France and Japan about the size of the IMF quota increase. He expected considerable difficulty, particularly with the Americans, about reaching agreement. The Governor said that, as the Ambrosiano affair had illustrated, there was still much to be done in improving the supervisory arrangements for banks. Inspite of all our efforts much remained to be done: even the Germans had only a gentlemen's agreement that their banks would consolidate the balance sheets to take account of their offshore operations.

Summing up, the Prime Minister said that she would wish to monitor developments in the international banking scene carefully. She would be grateful to be kept closely in touch with these matters, in particular with the outcome of the forthcoming international meetings. The Treasury should let her have a note on how to limit the growth of subsidised export credit and the escalation of competitive export subsidies, with a view to tightening up the criteria for lending to countries of doubtful creditworthiness. She would be grateful if the Bank could provide the schedules of exposure and indebtedness she had mentioned at the beginning of the discussion.

MCG 8.9.82

I am sending copies of this letter to Brian Fall (Foreign and Commonwealth Office), John Rhodes (Department of Trade) and Tim Allen (Bank of England), Cabinet Office

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
H.M. Treasury.

PRIME MINISTER

Enclosed in this folder for your meeting with Professor Walters are:

A. Paper prepared by the Treasury for the Seminar on the International Banking Scene.

B. Chancellor of the Exchequer's minute of 24 August on Mexico.

C. Lord Lever's paper on 'Deficit Finance - Bankers and Governments'.

Duty Clerk
27. 8. 82

Prime Minister

Meeting on the International Banking Scene on Wednesday 1st September at 9 a.m.

Those attending will be :-

Chancellor of the Exchequer
Sir K. Couzens (Mr. Middleton is on holiday)

The Governor
Mr. Loehnis (Executive Director in charge of the international side of the Bank)

Mr. Walters

I have found that Harold Lever sent a copy of his paper to the Chancellor and to Ken Couzens, and also to the Governor. So all those attending will have already seen it.

F.E.R.B.
27. 8.

Prime Minister's
Duty Clerk 27/8

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

27 August 1982

F.E.R. Butler, Esq.,
No.10 Downing Street

Dear Robin,

SEMINAR ON THE INTERNATIONAL BANKING SCENE

As agreed, I am attaching three background papers in ... advance of the Prime Minister's seminar on Wednesday.

The first is a paper prepared by the Bank of England, in response to the Prime Minister's request for an assessment of the financial standing of various Latin American countries and the implications for the banking system. We had been intending to process this further, but given next week's meeting it seemed sensible to send it to you now, particularly as the four largest LDC borrowers from BIS banks are Latin American countries. The section on pages 4-6 deals with the implications for the international banking community, and British owned banks in particular. Short assessments follow of prospects for each of the main Latin American borrowers.

The second paper is a compilation of available statistics on the world-wide exposure of the international banking system and of British banks. This is of course only part of the picture, since international business accounts for less than 15 per cent of the world banking system's assets. But there are no available statistics on international banks' aggregate domestic exposure, for example to particular problem industries or corporations.

This note also describes the two most important aspects of the co-operative international arrangements built up since the banking failures in 1974 by the central banks and banking supervisory bodies of G10 countries and Switzerland - both for improving the supervision of international banking business, and for dealing with any problems that arise.

/The third

The third paper shows our exposure to "problem" countries on official (ECGD covered) debt. These figures are on a different basis from the banking statistics; there is also some overlap between the two since bank lending covered by official export credit agencies is also included in the banking figures.

I am copying this letter and its enclosures to the Private Secretary to the Governor, and to Alan Walters.

Yours ever,

John Kerr.

J.O. KERR

LATIN AMERICA: AN ASSESSMENT OF THE FINANCIAL STANDING OF COUNTRIES IN THE REGION AND THE IMPLICATIONS FOR THE BANKING SYSTEM

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GENERAL ASSESSMENT

A PROBLEMS OF MAJOR LATIN AMERICAN BORROWING COUNTRIES

The focus of this paper is on Mexico, Brazil, Argentina, Venezuela and Chile, which together account for some four-fifths of the external debt of Latin America and the Caribbean which is estimated to be approaching US$300 bn. ? In doing this, it is not the intention to underrate the serious difficulties in which a number of other countries in the region find themselves; Bolivia, Costa Rica, Guyana and Honduras are all currently involved in debt rescheduling exercises, but in those cases the magnitudes are not such as to offer a threat to the fabric of the international financial system, nor are they likely of themselves to give rise to a serious knock-on effect on other countries in Latin America, although in present circumstances the psychological impact of any further failure needs careful watching.

Attached to this general assessment are individual pieces on the five major borrowing countries referred to above together with three statistical tables. While the high external debt borne by each country shares some common origins with the others (notably the ability and need to raise readily available - if sometimes expensive - credits on the international market for development purposes) and some common characteristics (notably the recent growth both of private sector and short-term debt), it would also be true to say that each country has arrived at the difficult position it now finds itself in by significantly different routes. A distinction can be made, for example, between those of the five which are oil producers - Mexico, Venezuela and Argentina - and Brazil and Chile, which are net importers of oil. This contrast is at its sharpest between Mexico and Venezuela, which have failed, or at least have not yet succeeded in turning their substantial oil wealth to their long-term economic advantage, and Brazil, which has developed a highly diversified productive and exporting capacity while oil constitutes a major part of its import bill. Despite these fundamental differences, all have built up substantial indebtedness on the international market. The level of this external debt can be said to be sustainable only so long as economic policies remain reasonably consistent and respond sufficiently quickly to changes in circumstances both at home and abroad.

The view over the next twelve months indicates that of the five countries under review, only Venezuela (by dint of its cushion of foreign exchange reserves) and, with a lesser degree of confidence, Chile (by virtue of strict policies allied to current negotiations on an IMF programme) can be said to be likely to avoid trouble, but policies conducted in both countries have not been entirely risk free. The size of Venezuela's debt has been contributed to by uncontrolled short-term borrowings in recent years by public sector agencies. The foreign exchange difficulties of Chile are a reflection of a stubborn refusal between 1979 and June of this year to abandon a fixed exchange rate policy which left the peso seriously overvalued. Argentina's wounds are almost habitually self-inflicted. With near self-sufficiency in oil, exportable surpluses of basic foodstuffs and low population growth, Argentina's economy has possibly the soundest potential of any country in Latin America. But the size of the public sector, much of it under the control of the freely spending armed forces, and the volatile nature of the people reduce the opportunities for coherent and effective policy-making. Since before the Falklands invasion it was clear that Argentina would have to enter into some form of rescheduling exercise with its creditors and this is even more necessary now. The volatility of the political situation there makes that country the most likely one of the five which might risk repudiating its external debt, but this still must be considered to be unlikely provided negotiations on a debt restructuring can get under way soon with the banks. Brazil's efforts, especially since end-1980, to cope with its huge external debt service have been impressive. Economic policy is in firm hands and the authorities have shown themselves willing to pay the margins necessary to raise the money needed in the international market. This year, however, Brazil's debt service obligations may be more difficult to meet, reflecting both the impact on the country's export earnings potential of the prolonged world recession and the premature relaxation of economic policy during an important election year for the military government.

For Mexico the crisis has already broken and an international rescue operation, involving central bank assistance to help the country meet its immediate obligations, is currently under negotiation. It is the speed with which Mexico's difficulties have developed which provide the major lesson to be learnt by both the Mexican authorities and her international creditors. In June 1981 the thought of Mexico finding itself within the next 14 months to be unable to generate the necessary finance to meet its obligations was inconceivable. Serious economic mismanagement, constrained by political considerations and characterised by a reluctance to recognise and face up to the realities of a fast deteriorating set of circumstances has been revealed by policy measures over the past (election) year, which have been inadequate, inconsistent, and taken too late. Even the new, highly respected, economic team has recently been forced to adopt measures to protect the reserves (including a three-tier exchange rate and exchange controls) which can hardly be expected to restore confidence either within Mexico or abroad.

A question which has to be addressed is to what extent the crisis in which, for example, Mexico finds itself is likely to have a 'knock-on' effect on any of the other countries under review, say Brazil. The answer to which this paper lends support is that such an effect is unlikely to be so specific, although it is inevitable that attention to a bloc of countries is likely to be drawn by difficulties in one of them. Looking back to 1980, worries about Brazil showed signs of affecting sentiment towards the area as a whole, but this concern gradually ebbed as Brazil's fortunes improved and attention moved towards developments in Eastern Europe. However, by the beginning of this year again, mounting economic difficulties in Latin America had led to an awareness in the banking community of the need to re-assess both its willingness to lend to much of the region and the terms attached to new borrowings. The Falklands crisis sharpened this focus, but it would be wrong to see any causative link between that and the circumstances of Mexico today, the origins of which were already well in train by the end of 1981. Together, however, the two events have reinforced what was already becoming a cautious attitude toward lending to Latin America on the part of the commercial banks.

B IMPLICATIONS FOR THE BANKING SYSTEM

Total lending by the international banking community to the non-OPEC developing countries, which includes Mexico, represents just over 5% of its total assets which is substantial and larger than its own total capital but relatively modest by comparison with its total loans. Loans to Brazil and Mexico each represent about 1% of total assets. Experience to date suggests that the banks have managed restructuring of debts in a fairly orderly way so that debt service difficulties by some of the largest developing country borrowers need not of themselves pose a major threat to the international banking system. The banks are better supervised than they were 10 years ago and risks are more diversified among more participants. However, there is no doubt that the size and structure of debt built up by some countries since the first oil shock is causing considerable concern in the credit markets and tending to make lending banks much more conservative. Some of the big borrowers are finding it hard - perhaps impossible - to maintain the flow of new capital. If Mexico and then Brazil are forced by a cash flow crisis to reschedule - assuming that Argentina cannot avoid it - the volume of questionable debt will reach well over $200 bn - although not all of it is to banks. This is several times larger than experience to date, but provided that some debt service is maintained - especially of interest - on the rescheduled amounts, orders of this magnitude might be manageable. It would admittedly be painful: the quality of some of the banks' assets would be impaired; their earnings might be quite severely affected in the short run if arrears on interest and capital began to build up; confidence in those banks believed by the market to be heavily exposed to problem countries could be affected.

There is, however, a risk of second order effects if the lending banks decide that the creditworthiness of all developing countries, including those outside Latin America, is no longer high enough to justify further lending. This would extend the cash flow problem to other countries and so enlarge the proportion of debts that had to be rescheduled. Of course a significant proportion of all of the debts in question would have official guarantees from bodies like ECGD, and rescheduling of official loans would therefore also be entailed. The consequences for the borrowers would be severe enforced adjustment.

It is possible that a few of them would prefer the odium of outright repudiation of debt to the domestic and political cost of the adjustment needed to maintain the debt service. This would lead to outright losses by the banks. However, most borrowers are probably fully aware that the long-term cost to their creditworthiness of such drastic action would outweigh the short run gain; many of the larger borrowers are also creditors themselves having developed export credit facilities to support their own newly emerging industries.

Even if the debt service difficulties of the developing countries did lead to major outright losses, these too could probably be absorbed in most cases by the banks, albeit with a nasty jolt, although the seriousness of the impact would depend also on the banks' loss experience with their domestic loan portfolio. Although exposure is better diversified than it used to be its distribution is still uneven. The banks with the largest exposure to Latin America are the big American international banks who are similarly at risk in relation to some large US corporations. There is thus a possibility that a combination of unfavourable events in Latin America and in the US domestic market could in the worst case threaten the solvency of some of them. There would then be a serious danger of a crisis of confidence from which the London market would not be immune and which could only be averted by official intervention. The resumption of lending by the private markets to Hungary has already shown that leadership from the authorities can help to restore financing flows.

Total lending by British owned banks to Latin America amounts to some $17 bn. All the major British banks have substantial exposure to the region. The scale of this exposure and its potential seriousness if some of it were to crystallise as bad debts is illustrated by the fact that for three important banks their theoretical exposure exceeds their capital. There is no reason to suppose that British banks are more at risk than their counterparts in other countries. Compared with some foreign banks, the general quality of the major British banks' assets is high. In addition the relative strength of their earnings and capital position is such that they should be better placed to withstand losses and to retain the confidence of depositors. Nevertheless, some of the smaller banks in London, particularly those which have tended to specialise in

Latin American lending may be more vulnerable both to actual losses and to pressure on their liquidity.

In conclusion, the most probable outcome, of debt service difficulties in Latin America would be some impairment of the profitability of international banks, some slowing down of the rate of new credit to other developing country borrowers and greater discrimination between different credit risks both by price and amount. This might in itself be no bad thing and by making the banks more choosy help reinforce the role of the IMF in assisting adjustment by providing conditional liquidity to borrowers. Their creditworthiness would also be enhanced by a sustained reduction in US interest rates which would not only reduce their debt service burden, but also contribute to economic recovery in the global economy.

ARGENTINA

		1981	Forecast 1982
1	Total Debt ($bn):	35.7	37.3
2	O/w Public Sector:	20.2	21.1
3	British Banks' consolidated claims ($bn):	2.7	
4	Debt Service Ratio (%):	58.1	82.1
5	Financing Requirement ($bn) (= Current account + medium & long-term debt amortization)	7.4	7.2

The significant increase in external debt from $8¼ bn in 1976 to $35¾ bn (56% of which owed by the public sector) at end-1981 was facilitated by relative economic and political stability in Argentina over most of the period. In latter years, however, growing uncertainties on both these fronts have progressively reduced the country's ability to increase its debt and forced both public and private sectors to rely heavily on short-term borrowings, which accounted for nearly 30% of debt at the end of last year. Following the Falklands crisis the growth in external debt has come virtually to a standstill.

The country's total debt servicing burden (including short-term maturities) in the second half of this year is officially put at $15 b compared with an original unofficial estimate of $19 bn due in the whole of 1982. The bunching of repayments reflects additional maturities of rolled over short-term credits - effectively the only type of financing available since the imposition of the UK asset freeze in April. There is a strong likelihood that the Argentines may not be able to meet a sizeable portion of these commitments as the expected trade surplus in the second half of the year (after peak seasonal grain exports have finished) will be insignificant by comparison and only a fraction of international reserves are reported to be quickly available. Already, by end-June, $2¼ bn in capital repayments were overdue and interest payments reportedly running up to a month late.

Despite the precariousness of the country's external financial positio the new Bignone regime has been forced, in the interests of political stability, to substitute reflationary policies for the strict monetary orthodoxy espoused by former Finance Minister Alemann. Measures, which include a large devaluation of the peso, general wage increases of 20-30% and interest rate ceilings, have led to apprehension that a wage/price spiral reminiscent of the Peronist period in the mid-1970s will develop. According to unofficial forecasts, year-on-year inflation could accelerate to over 200% by the end of the year from around 140% now.

At the same time, the Argentines, who sent a mission to New York early in August for preliminary discussions with commercial bank creditors, are seeking fresh funds and a renegotiation of existing debt in a way that falls short of a formal rescheduling. However, international banks are unlikely to be accommodating while UK/Argenti[na] sanctions remain in force; and even once these are lifted, a major rescheduling appears inevitable in view of the rapid deterioration in Argentina's creditworthiness, which has been exacerbated by concern over the country's uncertain political situation and the new economic policies. Meanwhile the markets are concerned over reports of a growing lobby in Argentina favouring debt repudiation.

BRAZIL

		1981	1982
1	Total Debt ($bn).	69.4	81.0
2	O/w Public Sector:	47.2(est)	53.5
3	British Banks' consolidated claims ($bn):	4.3	
4	Debt Service Ratio (%):	66.9	73.2
5	Financing Requirement ($bn): (= Current account + medium & long-term debt amortisation)	19.4	20.4

Dependence on imported petroleum and a policy of deferred adjustment in the years following the first oil shock lie behind the rapid accumulation of foreign debt, which rose from under $13 bn in 1973 to around $70 bn at end-1981. Of this over 65% is accounted for by the public sector, although its share has tended to diminish in recent years as the authorities have encouraged private sector borrowing by, for example, exempting foreign currency financed bank lending from credit ceilings. In contrast with other large borrowers in the region, Brazil has successfully limited the increase in short-term debt which represents only around 12% of the total.

Steep rises in the cost of servicing the external debt have become an increasing constraint which the authorities have sought to alleviate by boosting exports and continued large scale borrowing. This year, however, Brazil may experience difficulty in covering debt service commitments* of some $18½ bn given the government's apparent inability to consolidate last year's progress in reducing inflation and the current account deficit, and the negative impact this is beginning to have on market sentiment.

With national elections due in November, the authorities have sought a premature relaxation of the tight economic policy pursued since late 1980, in order to lead the country out of its worst recession in recent history. However, many of the prospective benefits to the business community have been slow to materialise. The reason lies mainly in the failure to control public expenditure which has necessitated increased taxes, successive rises in administered prices and higher interest rates. Reflecting these developments,

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* ie payments of interest and principal on medium and long-term debt and of interest on short-term debt.

year-on-year inflation, after falling steadily from a peak of over 120% in April 1981 to 91% in May 1982, has reaccelerated to almost 100% in July.

Contrary to orginal official projections for a further improvement in the current account deficit this year to around $10½ bn, from almost $13 bn in 1981, a deterioration to over $13 bn appears probable in the light of poor export earnings, which could fall by up to 10% this year. This not only reflects the impact of world recession, which has led to weak commodity prices and a sharp contraction in Brazil's most important markets for manufactured exports, but also worsening competitiveness as the authorities have resorted to an over-valued exchange rate in an attempt to limit inflationary pressures. The government has recently revised down the expected trade surplus for the year from $3 bn to $1½ bn, similar to last year's outturn. Inthe absence of a trade improvement, the projected current account deterioration is largely attributable to higher net interest payments.

There is concern in the markets that, with banks approaching their country limits for Brazil in addition to exercising more caution in lending to Latin America generally, the country may experience difficulty in raising the higher than expected balance of funds (some $4-5 bn) needed to complete this year's borrowing programme. Already there are indications that spreads on medium term credits, having remained steady for a year now at around 2⅛%, may be coming under pressure. Present uncertainty over Brazil's prospects is reinforced by rumours of a growing lobby for the replacement of Planning Minister Delfim Neto - a key figure behind the country's economic progress in recent years and held in high regard by the international banking community. A consistent opponent to calls at home for a rescheduling of the external debt, his replacement could spark a major crisis.

CHILE

		1981	1982 (FORECAST)
1	Total Debt ($bn):	14.5	17.5
2	O/w Public Sector:	4.5	6.0
3	British Banks' consolidated claims ($bn):	0.9	
4	Debt Service Ratio (%):	41.0	50.0
5	Financing Requirement ($bn): (= Current account + medium & long-term debt amortization)	5.9	4.0

Post-Allende economic policies have stressed the pre-eminence of the private sector in the economy. Since public sector finances have been in balance and monetary policy was effectively neutral, the bulk of financing the widening current account deficit has fallen on the private sector. As a result private sector debt has increased from $0.4 bn out of a total debt of $3.3 bn in 1973 to $10.0 bn in 1981. Not surprisingly given the increase in private sector debt, two thirds of total debt is owed to international banks. Whereas public debt service (interest and amortization) has changed little in recent years ($0.9 bn in 1981 compared to $0.8 bn in 1977), private sector debt servicing has risen to $1.6 bn in 1981 from $1.1 bn in 1977 and, on existing debt, is likely to average about $2.0 bn pa until the mid-1980s.

The most notable success of Chilean policy has been in the battle against inflation. However, with its open economy characterised by low tariffs and an overvalued currency, Chile has not escaped the full brunt of recession over the last year or so. This has resulted in a record number of bankruptcies which threaten the stability of the financial system. Chilean banks' heavy exposure to the international financial system has forced the authorities to react quickly to maintain confidence by closing down a number of (small) unviable institutions as well as to take measures to alleviate the effects of banks' large overdue loan portfolios. Finally, the authorities were also forced to devalue the peso in June after maintaining a fixed parity for 3 years.

The recession will, however, lead to a narrowing of the current accoun deficit during 1982, thus substantially reducing the country's financi requirement and slowing down the increase in the stock of external deb

There has, nevertheless, been some market resistance to Chilean borrowers in recent months (also affected by the Falklands crisis) with spreads on public sector borrowings reaching LIBOR + 1¼/1⅜% compared with +⅞/1% at the beginning of the year. Private sector borrowings have been raised at +1⅛% earlier in the year but have been scarce of late. However, the general record of good economic management, the high level of reserves ($2.8 bn at end-June), and expected backing from the IMF to the tune of SDR 0.7 bn over the next year and a half should help to alleviate problems in the short-term.

outflows remained unchecked despite a substantial depreciation of the peso from February of this year. The emergence of debt servicing difficulties in the private sector and in particular those of the large industrial conglomerate, Grupo Alfa, which came to the fore this year, were a further blow to international confidence. At a market level, therefore, the deterioration in credit worthiness led to an appreciable rise in spreads. A $2½ bn jumbo loan in June earned margins of 1% and 1½% over LIBOR (or ¾% and 1⅛% over the US prime rate) whilst a euro-dollar note issue last month carried a record interest rate of 18½%.

MEXICO

		1981	Forecast 1982
1	Total Debt ($bn):	72.0	88.0
2	O/w Public Sector:	53.0	64.0
3	British Banks' consolidated claims ($bn):	5.7	
4	Debt Service Ratio (%):	50.0	66.0
5	Financing Requirement ($bn): (= Current Account + medium & long-term debt amortization)	19.7	18.9

Mexico's acute socio-economic pressures and the low level of domestic savings have led to a rapid build-up in external indebtedness to finance the government's ambitious development plans. The stock of medium and long-term public external debt rose from $3.5 bn at the beginning of 1972 to $42.2 bn in 1981. Public debt servicing rose from less than $1.0 bn in 1972 to over $9.5 bn last year. Moreover, the stock of private debt also increased rapidly, to some $20 bn at end-1981. International banks account for nearly 90% of Mexico's total debt.

The accumulation of the largest LDC debt and the particularly large public sector external borrowing requirement ($27 - 28 bn gross; $11 bn net in 1982) in themselves have presented formidable constraints. These were exacerbated by the emergence of the world oil surplus during 1981, and excess demand pressures in the economy which presented serious threats to the Mexican authorities' oil-led growth strategy. In order to finance the substantial increase in the deficits on current account and in public sector finances, the authorities also found it increasingly necessary to resort to short-term funding with the result that public short-term debt rose from $1.5 bn in 1980 to $10.8 bn in 1981.

Confidence in the authorities' ability to deal effectively with these problems was further undermined by the virtual interregnum which exists in an election year making consistent policy-making difficult. Speculation against the peso grew and heavy capital

VENEZUELA

		1981	Forecast 1982
1	Total Debt ($bn):	26.0	28.0
2	O/w Public Sector:	18.9	20.0
3	British Banks' consolidated claims ($bn)	2.5	
4	Debt Service Ratio (%):	18.0	27.0
5	Financing Requirement ($bn): (= Current account + medium & long-term debt amortization)	-1.4	4.0

The oil price increases in 1973-74 enabled the authorities to embark on an ambitious investment programme to diversify the productive base of the economy away from oil. However, this expansion was not well managed and was marked by public sector profligacy and waste. A number of large scale unproductive projects were embarked upon while agricultural self sufficiency was eroded. Thus, while the total stock of medium and long-term public debt had risen only very slowly up to the mid-1970s, the government spending programme led the authorities to make significant recourse to the euromarkets for finance from 1975 onwards.

Given Venezuela's oil wealth, the debt service ratio of about 11% on public medium and long-term debt during the second half of the 1970s was quite acceptable. However, increasingly during this period, decentralised agencies and state enterprises circumvented external debt regulations as well as their own budgetary constraints by borrowing short-term. Thus, the public sector's short-term external debt rose rapidly and exceeded $10 bn at end-1980. During the second half of 1981 and throughout this year, the authorities have attempted to rationalise and restructure short-term public debt. This met with some success during 1981 when end-year public short-term debt fell below $9½ bn. However, restructuring plans during this year have been hampered by the Venezuelans' refusal to pay higher spreads (ie more than LIBOR + ¾% for 8-year money) on their euro-borrowings, leading notably to the cancellation of an intended $2 bn credit. The Venezuelans were quick to accuse HMG and the Bank of England of sabotaging the loan (as negotiations with banks occurred during the Falklands dispute in which Venezuela strongly supported the Argentines).

In truth, however, the US and Japanese banks (there were no UK banks involved) were justified in seeking higher margins in view of a perceived greater credit risk brought about by the loss in oil revenues which could amount to some $5-6 bn this year.

The Venezuelan debt situation can thus be characterised as messy rather than a serious constraint on the balance of payments - which has been running a substantial surplus on current account in the last two years and which has enabled the authorities to accumulate foreign exchange (including Central Bank) reserves of some $18 bn at end-1981. However, the economy is susceptible to capital outflows (Central Bank reserves fell by $1.4 bn in the first quarter of this year during a period of speculation against the Bolivar) and to the world price of oil. Venezuela's total (all maturities) end-1981 debt of about $26 bn ($19 bn public, $7 bn private) is not large in absolute terms by other Latin American standards (though it represents some 38% of GDP) but it could well emerge as a constraint if excess demand pressures are allowed to appear during the run-up to elections next year or if oil revenues remain depressed beyond the short-term.

CONFIDENTIAL

NKING CLAIMS ON LATIN AMERICAN AND CARIBBEAN COUNTRIES AT END-DECEMBER 1981

billions)

	BIS reporting area banks' claims	UK banks' £ and fc claims	UK-registered banks' consolidated claims		British banks' consolidated claims		American banks' consolidated claims (end-June 1981)	West German banks' consolidated claims
			Total	Total net of outward risk transfer	Total	Total net of outward risk transfer		
entina	22.9	6.0	3.6	3.3	2.7	2.3	7.5	1.3
bados	0.1	0.05	0.03	0.02	0.03	0.02	-	-
ivia	0.9	0.2	0.2	0.2	0.1	0.08	0.5	0.1
zil	49.7	11.2	6.7	5.8	4.3	3.5	15.2	2.8
le	9.6	2.0	1.6	1.5	0.9	0.9	4.7	0.5
ombia	4.9	0.8	0.6	0.5	0.4	0.3	2.6	0.2
ta Rica	0.8	0.2	0.2	0.2	0.1	0.1	0.6	-
a	1.4	0.3	0.2	0.2	0.08	0.06	-	-
inican Republic	0.5	0.1	0.05	0.05	-	-	0.5	-
ador	4.1	0.8	0.7	0.7	0.5	0.5	1.9	0.8
Salvador	0.2	0.02	0.01	0.01	-	-	0.1	-
nada	-	-	-	-	-	-	-	-
temala	0.4	0.06	0.05	0.05	0.01	0.01	0.2	-
ana	0.1	0.07	0.03	-	0.03	0.01	-	-
ti	0.04	-	-	-	-	-	-	-
duras	0.4	0.07	0.1	0.1	0.1	0.1	0.2	-
ica	0.5	0.08	0.1	0.03	0.03	0.02	0.2	-
co	55.3	13.1	8.1	7.2	5.7	5.2	18.1	1.6
ragua	0.5	0.05	0.09	0.08	0.06	0.05	0.4	-
ma	25.6	6.0	2.4	1.2	1.9	0.8	5.1	0.8
guay	0.4	0.1	0.04	0.04	0.04	0.04	0.2	0.08
	4.3	0.8	0.7	0.6	0.4	0.3	1.8	0.08
name	0.08	0.06	-	-	-	-	-	-
idad & Tobago	0.6	0.2	0.1	0.1	0.08	0.07	0.1	-
uay	0.9	0.3	0.3	0.3	0.2	0.2	0.4	0.03
zuela	22.3	5.1	3.2	3.1	2.5	2.4	10.0	1.6

[illegible]AL (PUBLIC AND PRIVATE) DISBURSED DEBT AT END-DECEMBER 19[illegible], 1981 AND FORECAST FOR 19[illegible]

$ billions

		DISBURSED DEBT		
		1980	1981	Forecast 1982
MEXICO	medium/long-term	n/a	49.2	66.0
	short-term	n/a	22.8	22.0
	Total	46.8	72.0	88.0
BRAZIL	medium/long-term	53.8	61.4	72.0
	short-term	7.0	8.0	9.0
	Total	60.8	69.4	81.0
ARGENTINA	medium/long-term*	16.8	26.0	
	short-term*	10.4	9.7	
	Total	27.2	35.7	37.3
VENEZUELA	medium/long-term*	13.0	15.0	18.0
	short-term*	12.0	11.0	10.0
	Total	25.0	26.0	28.0
CHILE	medium/long-term*	9.5	12.5	15.0
	short-term*	1.2	2.0	2.5
	Total	10.7	14.5	17.5
		170.5	217.6	251.8

*These maturity breakdowns are partially estimated.

...RVICE, DEBT PATIOS AND FINANCING REQUIREMENTS

	Debt Service* $ billions			Debt Ratios: Debt Service Ratio ≠			Debt service as a % of GDP			Disbursed debt as a % of exports of goods & services			Disbursed debt as a % of GDP			Financing Requirements ($bi...) = current a/c deficit + amortisation of medium/long-term debt		
	1980	1981	Forecast 1982	1980	1981	Forecast 1982	1980	1981	Forecast 1982	1980	1981	Forecast 1982	1980	1981	Forecast 1982	1980	1981	Forecast 1982
...XICO	10.1	15.0	20.0	41.0	50.0	66.0	5.0	13.0	11.0	189.0	239.0	293.0	25.0	34.0	48.0	12.2	19.7	18.9
...AZIL	14.2	18.0	18.3	61.2	66.9	73.2	5.7	6.3	5.8	262.1	258.0	324.0	24.4	24.4	25.8	19.5	19.4	20.4
...GENTINA	5.5	6.8	9.2	49.1	58.1	82.1	3.6	5.4	11.1	242.9	305.1	333.0	17.7	28.1	44.8	8.1	7.4	7.2
...NEZUELA	3.5	4.5	5.1	16.0	18.0	27.0	6.0	7.0	7.0	112.0	106.0	147.0	42.0	38.0	38.0	- 1.5	- 1.4	- 4.0
...HILE	2.1	2.5	3.0	34.0	41.0	50.0	8.0	8.0	12.0	170.0	238.0	292.0	39.0	44.0	68.0	3.2	5.9	4.0

* Gross interest and medium/long-term amortisation. In normal circumstances it is assumed that countries' short-term debt is rolled over as a matter of course and therefore maturities of such debt are excluded from the calculation of debt servicing commitments.

≠ Debt service as a % of exports of goods and services.

ATTACHMENT 2

THE INTERNATIONAL BANKING SYSTEM

A: THE WORLD SYSTEM

Agreegate international lending

International business - that is overseas lending - represents a still small (but growing) proportion of the world banking system's total assets.

Table 1: Share of international lending in total bank assets (%)

1974	1976	1978	1980	1981
9.8	12.0	12.6	15.6	17.4

Loans to the two countries that are the largest developing country borrowers - Mexico and Brazil - amount in each case to about 1% of total bank assets.

2. So banks' international exposure is still small in relation to their domestic exposure, despite the rapid acceleration in the 1970s. A complete assessment of the world banking system's exposure should also include banks' domestic exposure - for example to particular problem sectors or companies. But no aggregate figures of this kind are available.

3. International lending mushroomed in 1973/4 (temporarily growing at over 50% per year) as oil surpluses were recycled. Since 1974 the growth of lending has been fast, but fairly steady, at around 20-25% a year; the pace accelerated slightly in 1978/9 as countries first rebuilt their liquidity in the easier market conditions of 1978 and then were forced into further borrowing by the oil price rise of 1979, but has been gradually slackening subsequently to slightly under 20%.

Table 2: International claims of banks in the BIS area (excluding claims on other BIS area banks).

$ billion, end year

1973	1974	1975	1976	1977	1978	1979	1980	1981
175	245	285	355	430	535	665	810	940

Of course, part of this growth is a reflection of inflation - the US price level doubled in this period.

4. The rate of growth has slowed recently. New lending in the first quarter of 1982 is estimated at $20 billion; compared with $30 billion in Q1 1981. It has probably slowed further since March but, complete figures are not yet available.

Geographical Exposure

Table 3: Distribution of international claims of BIS banks (excluding claims on other BIS area banks) end 1981 ($bn)

BIS countries and off-shore centres	Other industrial countries	Eastern Europe	Oil Exporters	Other developing countries: Latin America	Other developing countries: Others
478	99	61	72	159	71

Table 4: Of which: credit to the top ten developing country borrowers from banks:

	Debt to BIS banks, December 1981, $ billions	
Mexico	55	(88)*
Brazil	50	(81)*
Venezuela	22	(28)*
Argentina	23	(37)*
Korea	17	(33)*
Yugoslavia	10	(18)*
Philippines	7	(17)*
Chile	10	(17)*
Greece	9	n.a
Algeria	7	(16)*

*Estimated total external debt in 1982 (including debts to Governments, non-banks everywhere and banks outside the BIS area).

5. At end 1981 these top ten borrowers, within which Latin American countries predominate, accounted for around 58% of all borrowing by developing countries(ie Ldc's + OPEC and Eastern Europe).

Table 5: Other major borrowers from BIS banks (Dec 1981 $ billion)

Spain	27	na
GDR	10	(15)*
Poland	15	(30)*
USSR	16	(20)*

*see note on Table 4

It might also be helpful to look at the debt of the developing countries as a whole.

Table 6: Developing countries (a) gross long term external debt

$ bns

	1973	1978	1981
Total	97.3	272.7	425.2
(as % of GNP)	(15.3)	(19.5)	(22.0)
By type of creditor:			
official	49.1	117.8	180.0
private	48.3	154.9	245.3
By type of borrower:			
net oil exporters	15.6	61.5	86.6
net oil importers:			
major exporters of manufactures	38.9	107.9	162.7
low income countries	21.6	46.2	69.3
other net oil importers	21.2	57.1	106.6

Source: World Bank

(a) includes Greece, Portugal, Turkey, Yugoslavia, Oman and the OPEC high absorbers.

Adjustment for inflation is difficult to interpret because relevant inflation rates vary so much from borrower to borrower. However, the following table gives some impression.

Table 7: Nominal and real external debt of the developing countries

$ bns

	1973	1974	1975	1976	1977	1978	1979	1980	1981	% of 1973
Nominal	97.3	120.6	147.1	176.5	216.7	272.7	322.8	370.1	425.2	(437)
at end 1981 trade prices	238.4	217.8	265.6	297.0	336.6	378.5	348.5	360.0	425.2	(178)

[Source of debt data: IMF Task Force on Non-Concessional Flows]
The 1981 level is expressed as a percentage of 1973 as a guide.

Capital Adequacy

6. Banking capital ratios have remained steady or in some cases declined a little in recent years, but the figures show no sharp deterioration. Because of rising credit risks banks may be slowing the pace of new lending and supervisors in the G10 countries have concluded that further erosion in banks' capital ratios should be resisted.

B: BRITISH BANKS' OVERSEAS EXPOSURE

7. The aggregate statistics for international exposure are, of course, much lower than those for the major banks traditionally most involved in international lending. For the latter, a proportion of about 50% would not be unusual. Much of this will be to other industrialised countries, but in many cases their exposure to the developing countries as a group would exceed their own capital.

The position of London as the world's major international banking centre is reflected by the fact that British owned banks*too are proportionately much more exposed overseas than is the world banking system as a whole. Foreign lending out of London accounts for around 25% of total assets.

Some of the major US banks have more than half their business in international lending (Citicorp 62%; Chase and Morgan Guaranty 58%; Manufacturers Hanover 51%; Bank of America 42%). The proportion of French bank claims on foreign countries is 33%. Statistics for most other countries are generally not consolidated and therefore similar comparisons are not possible.

*ie, excluding the UK subsidiaries of foreign owned banks, and consortium banks.

in the wake of the Herstatt affair that they were satisfied that means were available for the provision of temporary liquidity to the euromarkets and would be used if and when necessary.

That statement still stands. As was also said in 1974, however, it would not be practicable or advisable to lay down in advance detailed rules and procedures for the provision of such liquidity. In particular, if such provision were to be in any sense automatic or if the factors or criteria which determined it were precisely specified, there would be a danger that the disciplines of the market would be overriden - if the arrangements looked too restrictive - or undermined, if they looked too lax."

Cooperation between supervisory authorities: the Concordat

11. Perhaps the most important single element of cooperation between supervisory authorities is what has come to be known as the "Concordat" on division of supervisory responsibility between national authorities for different banks and their branches and overseas subsidiaries. The basic principle is that no foreign banking establishment should escape supervision. A distinction is made between branches, which are an integral part of the bank, and locally incorporated subsidiaries and the division of responsibility is described below. The Concordat is supplemented by the principle of consolidated supervision so that a bank's capital adequacy and risk exposure can be assessed on the basis of the totality of its world-wide business, including its foreign branches, subsidiaries and affiliates.

12. The Concordat was described in more detail by the Bank of England in 1981 as follows :

"It sets out guidelines covering the responsibilities of different supervisory authorities for the ongoing supervision of banks where those banks operate in more than one national jurisdiction. It is not, and was never intended to be, an agreement about responsibilities for the provision of lender of last resort facilities to the international banking system, and there should not necessarily be considered to be any automatic link between acceptance of responsibility for ongoing supervision and the assumption of a lender of last resort role. The aim of the Concordat is to sustain as far as possible by effective supervision the health and safety of the existing structure. It does not set out to rule on the way in which the pieces of that structure should be picked up if it is broken. The Concordat encompasses the following principal guidelines and recommendations :

- The supervision of foreign banking establishments should be the joint responsibility of host and parent authorities.

- No foreign banking establishment should escape supervision, each country should ensure that foreign banking establishments are supervised, and supervision should be adequate as judged by both host and parent authorities.

- The supervision of liquidity should be the primary responsibility of host authorities since foreign establishments generally have to conform to local practices for their liquidity management and must comply with local regulations.

- The supervision of solvency of foreign branches should be essentially a matter for the parent authority. In the case of subsidiaries, while primary responsibility lies with the host authority, parent authorities should take account of the exposure of their domestic banks' foreign subsidiaries and joint ventures because of the parent banks' moral commitment in this regard.

- Practical cooperation would be facilitated by transfers of information between host and parent authorities and by the granting of permission for inspections by or on behalf of parent authorities on the territory of the host authority. Every effort should be made to remove any legal restraints (particularly in the field of professional secrecy or national sovereignty) which might hinder these forms of cooperation."

H M TREASURY

ANNEX

BANK FOR INTERNATIONAL SETTLEMENTS

15th April 1980

PRESS COMMUNIQUE

1. At their meetings in Basle on 10th March and 14th April the central-bank Governors of the Group of Ten countries and Switzerland exchanged views on the evolution during recent years, and the future prospects, of the international banking system in general, and the Euro-currency market in particular.

2. The Governors recognise the important part played by the banks in recycling large surpluses which have arisen during the last few years. They noted that international bank lending aggregates have been expanding at an annual rate of some 25 per cent. Moreover, the contribution of the international banking system to recycling the large OPEC surpluses that have re-emerged will lead to further substantial growth of these aggregates.

3. In view of the present volume of international bank lending and of its prospective future rôle the Governors are agreed on the importance of maintaining the soundness and stability of the international banking system and of seeking to avoid any undesirable effects either worldwide or on the conduct of policy in particular countries.

4. With these considerations in mind, the Governors have decided to strengthen regular and systematic monitoring of international banking developments, with a view to assessing their significance for the world economy, for the economies of individual countries, including particularly the operation of their domestic monetary policies, and for the soundness of the international banking system as a whole. A Standing Committee on Euro-markets will consider the international banking statistics compiled by the BIS and other relevant information and report to the Governors at least twice a year, and more frequently if developments call for it. These arrangements for closer surveillance could provide a framework for intensifying, if appropriate, co-operation on monetary policies between the countries concerned.

5. Recognising that individual banks, or the international banking system as a whole, could in future be exposed to greater risks than in the past, the Governors re-affirm the cardinal importance which they attach to the maintenance of sound banking standards - particularly with regard to capital adequacy, liquidity and concentration of risks. To this end they place high priority on bringing into full effect the initiatives already taken by the Committee on Banking Regulations and Supervisory Practices with regard to the supervision of banks' international business on a consolidated basis, improved assessment of country risk exposure, and the development of more comprehensive and consistent data for monitoring the extent of banks' maturity transformation.

6. The Governors note that differences in competitive conditions between domestic and international banking that arise out of official regulations and policies stimulate growth of international bank lending in general; and that transactions channelled through the Euro-currency market can pose problems for the effectiveness of domestic monetary policy in those countries where such differences are particularly significant. The Governors will continue efforts already being made to reduce the differences of competitive conditions, fully recognising the difficulties arising from differences in the national structure and traditions of banking systems.

Attachment 3.

DEBT STATISTICS

OFFICIAL CREDIT INSURERS' COMMITMENTS AT MARCH 1982 (including short term)

	Total Commitments* at 31 March 1982 $m	of which ECGD's $m	(as a percentage share)
1. EASTERN EUROPE			
Yugoslavia	5,147.8	1,273.5	24.7%
Bulgaria	760.4	22.7	3.0%
Czechoslovakia	1,477.2	104.9	7.1%
GDR	4,218.7	185.4	4.4%
Hungary	692.2	80.1	11.6%
Poland	9,731.2	1,856.1	19.1%
Romania	3,317.9	738.9	22.3%
USSR	17,350.3	1,423.1	8.2%
2. LATIN AMERICA			
Mexico	8,343.6	1,054.9	12.6%
Brazil	14,504.9	1,668.7	11.5%
Argentina	8,267.9	521.4	6.3%

*excluding COFACE (French Credit Insurance Agency) ; but including undisbursed commitments file

MR WALTERS cc Miss Stephens

The attached letter is self-explanatory. The Prime Minister would like a prefatory chat with you about this subject on Tuesday. I have asked Miss Stephens to arrange a time.

I am sorry to confront you with this on your first day back from holiday and before we have even met each other.

F.E.R.B.

25 August 1982

10 DOWNING STREET

From the Principal Private Secretary

25 August 1982

Pile AH
cc Bank
Alan Walters
Caroline

Dear John,

This confirms the arrangements we have made for a seminar starting at 9.00 am on Wednesday 1 September at 10 Downing Street about the international banking scene. Following the Mexican episode and the Prime Minister's talks with bankers in Switzerland, she feels that it would be useful to have a tour d'horizon on this subject covering the scale and development of international indebtedness and the United Kingdom's exposure, public and private, relative to that of other developed countries. She would like to discuss whether there are any policy initiatives we should now be preparing in either the international or the national context.

BF meeting 1 Sept 82

You kindly said that the Treasury would try to provide some scene setting material in advance of the meeting, in addition to the note on Mexico which I understand that you are sending over.

In addition to the Chancellor and anyone he wants to bring from the Treasury, I have invited the Governor of the Bank of England, and I am also arranging for Mr Walters to attend. I should be grateful if you would let me know in due course who from the Treasury will be accompanying the Chancellor; and I should be similarly grateful if Tim Allen (to whom I am copying this letter) would let me know if the Governor is bringing anyone from the Bank.

Yours ever,

Robin Butler

John Kerr Esq.,
H M Treasury.

A18

Econ Pol August '82

FILE SW

10 DOWNING STREET

From the Private Secretary

25 August, 1982

Mexico

The Prime Minister was grateful for the Chancellor of the Exchequer's minute of 24 August, which she has noted without comment.

W. F. S. RICKETT

Peter Jenkins, Esq.,
H.M. Treasury

EcoN POL. Aug 82

Prime Minister 2

WR 25/8

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

PRIME MINISTER

MEXICO

I understand you received some briefing from the Bank on Mexico while you were abroad. But you may like to be brought up to date, particularly on UK participation in the BIS loan to Mexico.

2. The Mexican experience has been the classic one of over-rapid expansion leading to growing inflation and an external collapse. The Portillo administration, relying too heavily on Mexico's oil wealth, sought very fast growth and development. The budget deficit grew rapidly as a proportion of GNP (it has reached 14 per cent), inflation increased and external borrowing accelerated. As has happened with industrial as well as developing countries, the process has ended with depreciation, a flight of capital and inability to borrow further. Mexico now faces retrenchment and financial reconstruction with the help of the international community.

3. Action to deal with the Mexican financial crisis is proceeding by four main routes:-

(i) Direct help from the United States
This has provided Mexico with the most immediate assistance. We know of 4 forms of help totalling nearly $3\frac{1}{2}$ billion. The Mexican central bank exhausted a swop facility of $700 million with the Fed more than a week ago. The United States are advancing $1 billion to Mexico against future deliveries of Mexican oil for the US strategic

stockpile: and a further $1 billion by way of credit to enable the Mexicans to buy US grain. In addition, the Fed is likely to provide a short term loan of another $750 million in parallel with the BIS loan from other central banks.

(ii) The IMF application

After some hesitation on political grounds, the Mexicans have announced that they have applied to the IMF for facilities totalling nearly $4 billion over 3 years. $800 million is likely to be available quite quickly as a Compensatory Financing Facility related to the loss of export earnings from the fall in the price obtained for Mexican oil and other primary exports. The remainder will be a normal drawing related to Mexico's IMF quota and spread over 3 years. Provided a satisfactory adjustment programme can be speedily negotiated with the IMF, the announcement effect of this application on Mexico's credit standing is likely to be at least as valuable as the money itself.

(iii) Rescheduling of private debts

The Mexicans are asking the private banks to which $60 billion is owed to defer requirements for capital repayments during the coming months. There will be practical difficulties in obtaining an agreement with the very large number of banks involved, some of them quite small, but it is in the interests of the banks to obtain a rescheduling which secures continued payment of interest, even at the cost of deferment of capital repayments for the present. The total exposure of US banks and their subsidiaries is about $22 billion, of Japanese banks $8 billion, of British banks $6 billion and French banks $4-5 billion. The figure of $8 billion is sometimes quoted for UK

3

banking exposure, but this relates to banks registered in London, including American-owned subsidiaries. The $6 billion figure relates to banks in British ownership or control, wherever registered.

(iv) A BIS loan of $$\frac{3}{4}$ billion for 3 months renewable up to a maximum of one year. This will be linked with a direct loan by the Fed of the same amount to make a total loan from the central banks of 11 countries of 1\frac{1}{2}$ billion. The Americans do not belong to the BIS.

4. The UK participation in the central bank short term loan operation will be a commitment by the Bank of England to provide $140 million to the BIS if the BIS were to fail to obtain repayment. In a total short term loan of 1\frac{1}{2}$ billion, of which half is carried by the United States, $140 million is not an unreasonable UK share, given the extent of our banking exposure. Since the risk is too large for the Bank to carry it on its own resources, as it has done so far on a much smaller scale in the case of Hungary, we are giving the Bank a Treasury guarantee in respect of this commitment. This gives rise to no public expenditure problem unless and until it is called. The BIS will seek assurances of a "take out" from the proceeds of the Mexican application to the IMF, if necessary. There is no specific statutory authority under which the Treasury can extend this guarantee and in accordance with PAC requirements we shall therefore be laying a Minute before Parliament. There is a clear justification for the action we are taking in the urgency of the situation and the international character of the rescue in which we are participating.

5. We think it very possible that Mexico will seek a rescheduling of official as well as private banking debt. This would be likely, as a minimum, to produce deferment of capital

repayments to ECGD during the coming months, with a corresponding addition to the PSBR in the year of deferment. The amount involved could be of the order of £100 million or more. Total ECGD exposure to Mexico is about $2 billion.

6. A striking feature has been the speed with which this international rescue operation has been set in motion. The American authorities have recognised the urgency of the requirement and the extent to which their own interests were at stake, both in the economic stability of their neighbour and in the exposure of their banking system. The IMF and BIS have also reacted very speedily. The Mexican authorities for their part have tackled the situation with urgency and determination once the actual extremity was upon them. The pace is bound to be slower now. Agreeing an IMF programme will take some time. So will the negotiations with the banks. But at least the international financial community has so far avoided an impression in the markets that the Mexican situation was going out of control. What is now needed as much or more than the plugging of a particular financial gap is a progressive restoration of confidence in Mexican credit.

7. Copies of this minute go to the Foreign and Commonwealth Secretary, the Secretary for Trade, the Governor of the Bank of England, and Sir Robert Armstrong.

G.H.

24 August 1982

86 Eaton Square, London SW1

<u>PERSONAL</u> 4th August, 1982.

Dear Prime Minister,

Before the last Summit I was asked, by a friend connected with the State Department, to prepare a note for Alexander Haig on the international monetary situation. I sent your people a copy of this. I was very glad to see that the Summit set up Study Groups but the area of study ought, in my view, urgently to be enlarged to include the growing banking crisis. I have now been asked to prepare a note on this, too, for George Shultz.

I hesitate to add to your many burdens but if you would read this note you will see why I regard this matter as being so centrally important and a threat to all our hopes of economic recovery. I have been raising this issue continually for the last 7 years with our government and with others and with the bankers. Many of the last are now, in private, belatedly agreeing with me, but they seem to have passed from complacency to defeatism. There are no grounds for either. I believe that if you felt able to lend your weight to the principle of urgent and <u>systematic</u> action, you will have a wide response.

Yours,

Harold

Encl.

DEFICIT FINANCE - BANKERS AND GOVERNMENTS

DIAGNOSIS

This note focuses on the failure of the Western nations to respond adequately to the financial and banking implications of the OPEC cartel.

The artificially high price of oil after 1973 produced enormous current account surpluses for many of the OPEC countries. These surpluses had their mirror image in the deficits of the oil consuming countries, many of the weaker of whom seem likely to remain in chronic or semi-chronic deficit because of their difficulties in raising the relative price or volume of their exports. The governments of the leading countries, motivated by economic, political and moral considerations, recognised that finance would have to be found for these weaker countries for an extended period. But it was not possible, within the existing philosophy and budgetary mechanics, for these governments to provide directly anything like the amount of finance needed. They turned instead to the softer option of encouraging their private bankers to recycle to the weaker countries the vast deposits from the OPEC surplus. The private bankers were not slow to respond.

It would have been virtually impossible for the banks to undertake this novel, enormous and continuing recycling operation within the constraints of the domestic banking regulations of their respective countries. There was, however, an agency ready to hand - the Eurodollar market. This had come into being mainly to escape tax complications and such regulations on bank lending as existed prior to OPEC. Thus, a vast recycling operation proceeded apace after 1974 and in large part through the Eurodollar market. All the great banks of all the great countries were drawn in. Funds flowed plentifully to virtually all the State borrowers in South America, Africa, Asia and even to the Soviet Bloc. Many of the countries who drank from this pool did so not merely to finance their deficits but also to add to their reserves.

A "solution" having been found to the problem of deficit financing, the leaders of the West appeared to feel that they were largely exempt from the need for any further action; they preferred to ignore the fundamental weaknesses of these arrangements. These may be summarised:-

1. The lending effectively under-wrote OPEC's monopoly price and provided the means whereby many of the poorer customers of OPEC could continue to pay whatever price OPEC felt able to exact.

2. There was no decision by governments or central banks on the volume or direction of the recycling, which were left to the reflexes of the private banking system. As a result, no decision was taken as to the total amount of resources that should be channelled through the Western banking system, nor as to how that vast sum should be apportioned between the borrowing countries. Neither was there any real attempt to impose on the lending any conditions which would reflect the legitimate political and economic

interests of the governments of the West. The irony is that as borrowers have successively come under pressure to meet their obligations, the West has falsely been charged with neo-imperialism whereas in fact, a vast, unprotected and largely unconditional transfer of resources has taken place.

3. The economies of many of the borrowing countries were such that only by further borrowing for an indefinite period could they meet their interest and repayment obligations. Neither the leading governments nor the private bankers seriously considered whether the borrowing by these largely impoverished nations could be treated as a purely commercial operation. The inevitable ballooning of the debt, from each year's deficits and accrued interest, was, during the early years, somewhat mitigated by the fact that interest rates were low or even negative in real terms. But the problem has more recently been sharply aggravated by the move into very high real interest rates.

These factors produced a dynamic of increasing incredibility built into the system - a built-in self-destruction of vulnerable arrangements which must ultimately threaten the flow of funds, the demand in world trade which they finance, the political and economic stability of the fragile borrowers and the banking system itself.

There are two further points to note. First, this massive use of the Eurodollar markets by sovereign borrowers developed at a time when corporate borrowers were also very greatly extending their use of them.

Broadly, the multinationals have borrowed on a scale roughly comparable to that of the sovereign borrowers. The over-optimism that infected the market with respect to the latter seems also to have spilled over to the former. The result is that many of the loans to large corporate borrowers are as shaky as those to the sovereign borrowers, and the banks now have two major classes of non-performing assets. Secondly, to make matters worse, the combination of recession, high interest rates and a long period of inflation has driven business and industry within the advanced countries themselves to rely ever more heavily on their domestic banking systems for finance. The banking system as a whole, therefore, is at all points heavily exposed to a unique degree.

We must note, too, that the growth in the Eurodollar market has serious financial implications for the economies of all countries and for their parities. The prudential control and regulation of this enormous market has, by normal banking standards, always been inadequate. The market has been fed by OPEC surpluses but has also attracted surplus cash from the banks in the advanced countries themselves; in addition, the liquidity resources of many multinationals and even of some central banks were added to the total. We have thus allowed to develop a vast and unregulated cash mountain, restlessly moving between currencies to become a major source of parity instability. Moreover, these fund movements jeopardise any attempt within any one country to maintain monetary control.

THE PRESENT FRAGILITY

We have in being a system of deficit financing extremely vulnerable to economic and political spasms and dependent on a high level of technical financial expertise in countries where neither that nor political stability is usual. Criticisms of the fundamental long-term incredibility of this system of lending were, for a number of years, brushed aside by the governments and the bankers themselves. But reality is brutally breaking through. The ballooning debt of countries with only a fragile prospect of ever making repayment has now reached hundreds of billions of dollars. Numerous small defaults have been followed by larger ones, and others, even larger, threaten. Nearly all of the great banks in the Western banking system are heavily overexposed. The assets against which they have lent their depositors' money are increasingly called into question. Actual default has so far largely been covered over, and formal default avoided, since the latter would have manifestly devalued the bankers' assets in their balance sheets. "Rescheduling" amounts to little more than exchanging a basically incredible promise to pay which has in fact been defaulted for another basically incredible promise to pay at a later date. This process is breaking down. The sheer mechanical problems, complex in the extreme, of hundreds of banks agreeing to roll over past obligations are becoming overwhelming. More important, the larger the scale of these operations the less their effectiveness and credibility. The distinction between actual and formal default is increasingly losing its value in the eyes of auditors and depositors. Moreover, the inducement to the bankrupt borrowers to co-operate is the prospect of new money - this is increasingly difficult to achieve, even under government pressure. The banking system has become hostage to its impoverished debtors.

We now seem to be at the beginning of a period of maximum anxiety for the banks, and individual banks are already experiencing considerable pressure. First, interest payments and repayments of principal have been missed on a substantial scale, leading to a growing cash flow problem for the banks. Secondly, the nervousness of certain depositors is already in evidence. Central banks, who should never have been depositors in the first place, and some multinationals and other investors are withdrawing their deposits on a big scale. Thirdly, the pattern of balance of payments surpluses and deficits is beginning to shift. OPEC surpluses have recently been eroded and some OPEC countries are drawing down deposits to finance their deficits. Unhappily, there is no assurance that the recipients of these funds are depositing them in the same way as these OPEC countries did. Of course, the funds remain somewhere in the banking or central banking system; but a serious problem of mismatch is sure to develop. The banks are thus imminently facing a highly dangerous combination of deposit withdrawals and non-performing assets. The credit markets' reaction is clearly illustrated in the loss by all the major US banks (save Morgan Guaranty) of their triple-A bond rating - a sensational development which has not received the attention it deserves.

AN OUTLINE OF THE REMEDIES

The twin central problems which now face us are

(1) How to cope with the threat that the past lending represents to the financial stability of our banks and of the borrowers?

(2) How to ensure a sustained flow of lending in the future? If this is not achieved, a considerable percentage of the advanced countries' exports would vanish as the finance for them is reduced. This is to say nothing of the damage caused to the politics and economics of the borrowers and ultimately the danger to the banking system itself with multiplier effects throughout the world's economy. The political consequences for the advanced countries need no emphasis.

The governments of the world must now accept some responsibility for past lending and must undertake the necessary supportive action to ensure an adequate future flow. They encouraged the banking system to undertake this lending while guaranteeing only a small proportion of it. Indeed, they often brought pressure on the banks in pursuit of what were basically the political and economic purposes of governments. They must now accept some responsibility in order to protect both these purposes and the banking system.

Ideally, the governments of the leading countries would agree on joint action to protect the world's banking system by setting up an International

Bank both to regulate international finance and to act as lender of last resort. However, we cannot wait for this highly desirable development in order to handle the present dangers. We must at once move to ensure that each central bank acts to support its own private banks by protecting their liquidity situation in the event of defaults or postponements in payment by sovereign borrowers on existing debts. This can be done in a variety of ways. Where such lending has been normal and broadly prudent (so far as that term can be justly used in relation to a wildly imprudent system) each central bank could, for example, offer to discount where necessary the paper of the lending banks and to roll-over interest and repayment to match any defaults or delays by the borrowers. Alternatively, the central bank could buy assets guaranteed by the private banks. The central bank in question would accept delays of interest and repayments subject to a commitment whereby the banks wrote down, as required out of their profits and over a long period, the loans on which there had been default or where payment had been delayed. The banks would be making continuous repayment to the central banks out of their profits as well as out of any funds accruing from their defaulting debtors. Some such arrangement would protect the banking system while exculpating governments from the charge that they were themselves meeting the costs of the banks' misjudgements. It would, in effect, sustain our banks by enabling them to extend the period required to write down their questionable loans without calling their liquidity or solvency into question. The alternative of an enforced abrupt write down would have calamitous consequences. It is in our interests as well as those of the banks to make arrangements which give them time to pay for their own errors and avoid the backlash on us all.

It would be quite inadequate for some arrangement like the above to be carried out by individual central banks acting in isolation from one another. When the difficulties materialise, the central banks must be acting in harmony and be clearly seen to be so acting. There are two reasons for this. First, if the private banks of one or two countries are called into question there are very likely to be massive movements across the foreign exchanges as depositors seek areas of greater safety. This process has already started and parities have already been distorted. Collective arrangements for avoiding further gyrations and distortions in parities must be achieved before the process gets out of hand. This work should be co-ordinated with the Study Groups set up at the last Summit. Secondly, and even more importantly, we must at all costs head off any further widespread withdrawal of funds from the banking system in favour of government obligations, which will certainly take place if bank defaults start and if joint action by governments is not visible. Though individual central banks are to retain responsibility for the banks in their own countries, that responsibility should be in relation to a wider collective plan.

So far as future lending is concerned, governments and central banks must bring into being a systematic and sustainable system. A bare outline of how this might be done is as follows. A committee of central banks, in collaboration with their governments could prepare a periodic outline of the total volume of liquidity recycling or bank lending which is likely to be needed. This overall sum would then have to be apportioned between the prospective borrowing countries. Lending banks would be required to register their proposed loans with the committee, and if there is delay or default by the borrower, the central banks would stand ready to cover the liquidity and solvency problems of the banks broadly on the lines I have outlined in respect of past lending. The lending banks would, as part of their relationship with the central banks committee, be required to submit consolidated balance sheets so as to bring the overall Eurodollar lending under central bank supervision. These arrangements would, of course, have to be operated flexibly. But if international lending is to continue on an appropriate scale, other action will be required by governments. For example, it will be necessary for the IMF and other international institutions to develop a more prominent, coherent and predictable supportive role.

This is a bare outline of my proposals and I will be happy to discuss them more fully if required. In the past, the world's leaders, their finance ministers and the central banks have reacted only to crisis, without even an outline strategy to guide them. To do the same on this occasion would be to make a grievous error. The damage from existing arrangements is already accruing and the costs of delay are rising rapidly. It is imperative that we now organise this outline strategy and find effective agencies for implementing it. In my view the alternative will be a series of crises of the gravest kind.

SUMMARY

The banking system of the western world is now heavily and dangerously overextended. If its lending abruptly contracts there will be an avalanche of large-scale defaults world-wide which will inflict extreme damage on world trade and on the political and economic stability of the borrowing and lending countries. It was broadly right and necessary for the Western countries to mobilise their private banks in support of global political and economic interests. It was in the highest degree dangerous that governments failed collectively to accept the commitments and responsibilities which would have both supported and disciplined the activities of the banks.

The problems I have discussed are an important part of our central problem, namely, that in a world which has become increasingly interdependent we lack agencies capable of thinking about the system as a whole and of organising collective action to defend our global interests.

Harold Lever

3rd August, 1982.

Briefing by Bank of England.

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NEXICO FACES ACUTE LIQUIDITY CRISIS ESPQCIALLY OVR NEXT
~~TEXXNATBEXHENYTHEYEMEETMAKE~~ NEX 10 DAYS WHEN THEY MAY HAVE TO MAKE
PAYMENTS OF SOME DOLLARS ONE AND A HALF BILLION
THEY HAVE VIRUALLY NO RESERVES AT ALL THE POTENTIAL
PROBLEMS FOR THE INERNATIONAL BANKING SYSTEM ARE VERY
SERIOUS

MEXICAN AUTHORITIES HAVE BEEN IN WASHINGTON ALL WEEKEND
NEGOTIATING TO ~~SU~~ SOLVE IMMEDIATE AND LONGER TERM PROBLEMS
THEY ARE SAID BY THE AMERICANS TO ~~W~~ BE DETERMINED NOT TO
DEFAULT OR EVEN RESCHEDULE IF POSSIBLE THEY ARE IN
NEGOTIATIONS WITH THE IMF, AND HAVE AGREED TO ANNOUNCE
THIS FACT SHORTLY (PROBABLY TODAY) THEY AND THE IMF
HOPE IT MAY BE POSSIBLE TO AGREE A PACKAGE OF MEASURES
BY MID SEPTEMBER, AND TO GET AUTHORITSATION FOR ~~M~~ THEIR
MAXIMUM DRAWING POSSIBILITIES (PERHAPS NEARLY DOLLARS
FOUR BILLION BUT ONLY DRAWABLE IN INSTALLMENTS OVER
18 MONTHS)

AGAINST THIS BACKGROUND THE AMERICANS ARE SEEKING WAYS OF
BRIDGING THEIR SHORT TERM DIFFICULTIES THDEY HAVE ALREADY
BORROWED DOLLARS ~~SEE~~ SEVEN HUNDRED MILLION FROM THE FEDERAL
RESERVES THE US ADMINISTRAION ARE ARRANGING TO MAKE PRE-
PAYMENTS FOR OIL OF DOLLARS ONE BILLION FOR THIS WEEK,
BUT THERE WILL BE ANEED FOR AT LEAST ANOTHER DOLLARS ONE
AND A HALF TO TWO BILLION OVER THE NEXT FEW WEEKS BEFORE
THE IMF DRAWING CAN BE IN ~~PLC~~ PLACE

THE AMERICANS ARE ASKING OTHER MAJOR COUNTRIES TO GIVE SHORT
TERM SUPPORT THERE HAVE BEEN CONVERSATIONS WITH THE SWISS
GERMANS FRENCH CANDADIAN JAPANESE ~~CENA~~ CENTRAL BANKS ALL OF
WHOM HAVE REACTED REASONABLY FAVOURABLY TO THE POSSIBILITY
OF SUPPORT HERHAPS OF THE ORDER OF DOLLARS ONE HUNDRED AND
FIFTY TO TWO HUNDRED MILLION BANK OF ENGLAND AND ~~R~~ TREASURY
~~HAE~~ HAVE ALREADY BEEN APPROACHED, AND HAVE EXPRESSED SYMPATHY
IN PRINCIPLE H THERE WILL BE A MEETING IN BASLE ON
WEDNESDAY TO SEE WHAT IS POSSIBLE

THERE WILLBE A MEETING WITH THE MAIN COMMERCIAL BANK CREDITORS
LATER THIS WEEK (BRITISH BANKS EXPOSURE IS ABOUT DOLLARS SIX
BILLION OUT OF DOLLARS SIXTY BILLION) IT IS REAGARDED AS
ESSENTIAL THAT THEY BE HELD TO SOME ~~FOMTFOM~~ FORM OF STANDSTILL
FOR THE NEXT SIX WEEKS THERE IS IN ANY CASE DANGER THAT IF
THE MAJOR BANKS HOLD MANY OTHER BANKS WILL PULL OUT BUT IT
IS IMPORTANT TO DEMONSTRATE MAXIMU M CENTRAL BANK CONFIDENCE
IN MEXICO

THERE IS GENERAL CONCERN ABOUT BACK WASH EFFECTS ELSEWHERE IN
THE ECONOMY THE GERMANS ARE WORRIED THAT UEO IS FAR FROM OUT
OF THE WOOD THE AMERICANS ARE WORRIED ABOUT CONTAGIOUS
EFFECTS ON BRAZIL, CHILE, AND ESPECIALLY ARGENTINA IN
PARTICULAR VOLCKER AND LEUTVEILER HAVE REPRESENETED TO THE
BANK OF ENGLAND HOW HELPFUO IT WOULD E BE IF FINANCIAL
RESTRICTIONS WITH ARGENTINA COULD BE RECIPROCALLY LIFTED
THE AMERICANS ALSO REOPORT THAT PROGRES[illegible]R SERVICES
APPEARS POLITICALLY VERY DIFFICULT IN [illegible] BANK OF
ENGLAND FEELS STRONGLY THAT IT WOUL[illegible] SYSTEM
IF WE COULD PROCEED IMMEDIATELY TO [illegible]

MESSAGE ENDS

File copy on Foreign Policy: Relations with Latin America Aug '82

cc Econ Policy: Indebtedness of the Western Banks Aug '82

file

10 DOWNING STREET

From the Private Secretary

2 August 1982

Dear Francis,

Relations with Latin America

The Prime Minister saw over the weekend the minute of 30 July by the Foreign and Commonwealth Secretary on the above subject.

Mrs. Thatcher has commented that she is very chary of the tactics proposed. We have already pursued them since 1979 without very much success.

Mrs. Thatcher believes that, given the Latin character, if we pursue Latin American Governments too hard they may take it as a sign of weakness.

She finds the idea (paragraph 6 of Mr. Pym's minute) that we need to cultivate the military aspects of these regimes unattractive.

The Prime Minister points out further that the financial position of many of the regimes is weak and that more subsidised trade could contribute to the disturbing banking situation which is already developing in the Western world. On this point, she would be grateful if the Treasury, in conjunction with the Bank of England, could produce a highly confidential assessment of the financial standing of the various Latin American countries and the implications of this for the banking system. You and the other recipients of this letter will wish to know that the Prime Minister has expressed particular concern about Mexico, of whose over-stretched financial situation she became aware recently.

BF

On the question of visits by Ministers, the Prime Minister has pointed out that these tend to be occasions when more aid is asked for and given; and indeed that the recipient countries judge the "impact" of Ministerial visits by their aid content. If the effect of Ministerial visits was indeed lasting, Mrs. Thatcher considers that we ought now to be in a highly favourable situation following the visit to Latin America by Lord Carrington. The Prime Minister would be grateful for a list of all Ministerial visits to and from Latin American countries since May, 1979.

BF

The Prime Minister's overall comment is that she very much doubts the wisdom of the tactical approach proposed. She fears

/that

CONFIDENTIAL

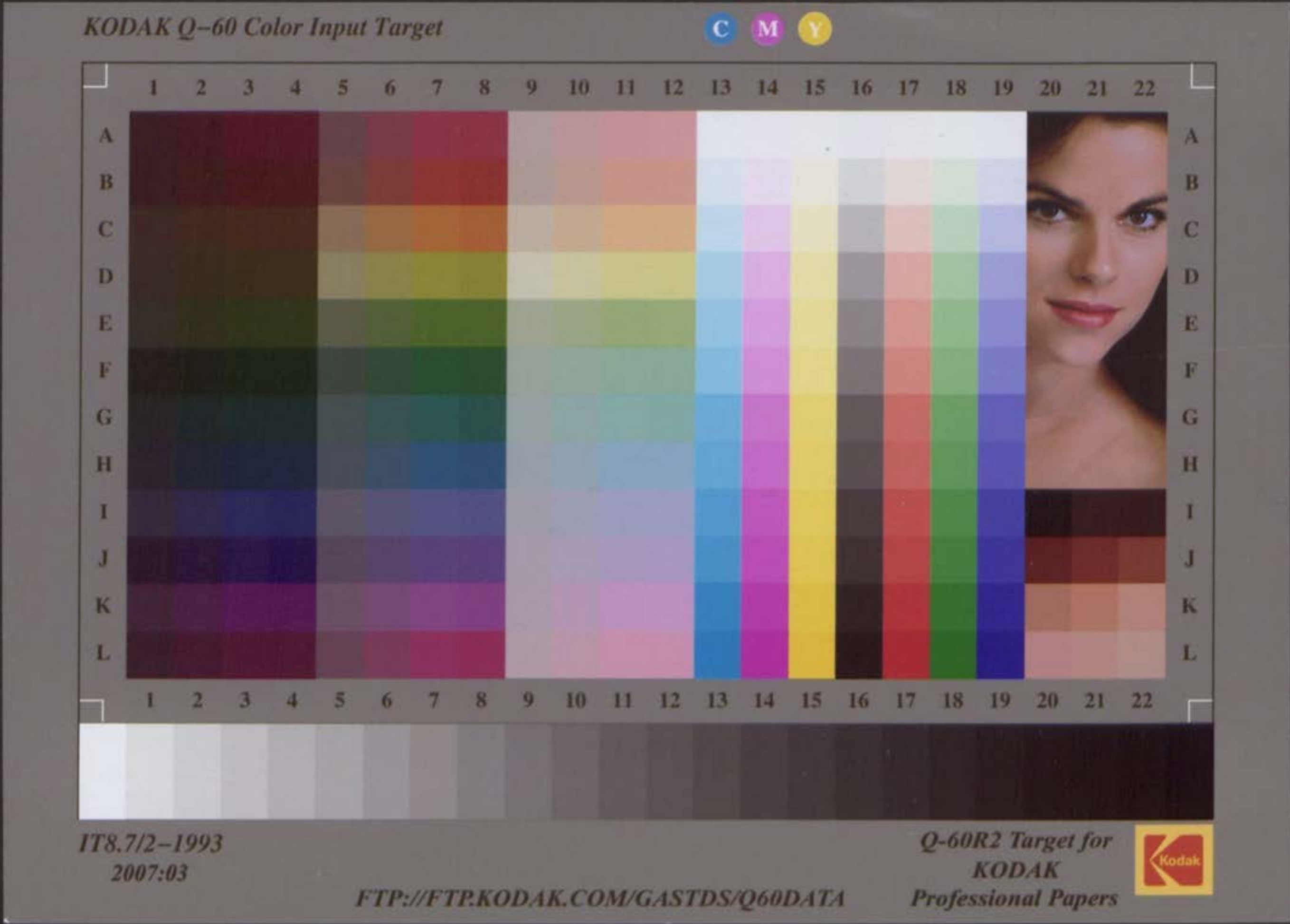
that we may be moving too quickly and too soon and without having fully considered the financial and banking situation of the countries concerned.

I am sending copies of this letter to the Private Secretaries to all members of OD and to Tim Allen (Office of the Governor of the Bank of England).

Yours ever

John Coles.

Francis Richards, Esq.,
Foreign and Commonwealth Office.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