Dup^e

CONFIDENTIAL 19. 4.82

THE GOVERNOR

Copies to Mr Loehnis
Mr George
Mr Walker
Mr Fforde
Mr Dow
Mr Balfour
Mr Holland
Mr Goodhart
Mr Flemming
Mr Sangster

G30 MEETING: WORLD OUTLOOK

The world macro-economic prospects naturally dominated our meetings in Budapest. We spent a half day on the subject formally but it came up in various guises in other sessions notably on international banking risk. The general tone was of gloom and frustration. Gloom in that everybody I think stressed the powerful deflationary forces now at work all over the world but frustration because it was also generally recognised that even though progress against inflation was likely to be better than earlier expected, anything like price stability was still a long way away.

Marris made a long and very cogent intervention on the theme that major mistakes in policy were now being made in most, if not all, of the seven major countries - especially, of course, in the US ("the worst policy mistakes since Vietnam") and Japan. I found a good deal of agreement for two propositions:

(a) that if the world recovery proved significantly weaker than the OECD was forecasting (ie 3% in 1983), governments and central banks were now so much the prisoners of their own proclaimed "credibility by inflexibility" that it might prove very difficult to secure quite moderate and pragmatic policy adjustments without having them nullified by the markets; and

(b) that in all the discussion of the need to avoid defaults in individual country cases we were in danger of losing sight of the potential impossibility that these deficits could be worked off. Now that real interest rates were so high everywhere (a fact stressed by almost everybody) and prospects for activity and commodity prices so weak we were perhaps facing a situation comparable to that on reparations about which Keynes wrote in "The Economic Consequences of the Peace".

Witteveen was particularly gloomy about the likelihood that activity would be worse than was generally expected and that it would be hard to do anything about it.

John Heimann and Geoffrey Bell both spoke in a way that I found alarming about "international bank lending going into reverse". They made great play of the fact that there was now a sharp change in sentiment in many banks. Whereas before promotion and prestige had depended on building up the loan book, now the dominant motive was not to be caught out lending to the wrong country. I thought they were genuinely worried about the problems of financial crunch.

But perhaps the most striking contribution came from Tony Solomon. On the fiscal/monetary policy imbalance he said he thought the markets had not yet significantly understood the seriousness of the predicament. In his view if nothing is done the 1983 deficit is now likely to amount to around $180 bn (with another $20 bn of off-budget deficit). If it proved possible to reduce the deficit "by enough significantly to affect financial markets" he thought you could get, say, a 3% fall in short rates and a 1% fall in long rates. But this would mean very severe fiscal action - ?bringing the deficit nearer $100 bn - and although it would clearly be better in the longer run for growth, in the short run it would undoubtedly be contractionary.

He then addressed himself to the question what would be a proper recommendation for the Versailles Summit. He started by saying that given the "Reagan ideology" and the general view (he believed mistaken) that the Bonn Summit had been an error, he thought that it would be a waste of breath to try to influence the Summit of which nothing would come. If, however, one could imagine (in his view) more realistic policy makers, he thought a helpful package could be devised along the following lines. The US would make a major attack on the budget including (and here he thought they could be joined by the Europeans) an increase in energy taxes. This could be followed (he was vague on the time scale) by some general relaxation of monetary policy. On the other hand, Japan should ease fiscal policy and "do something about the yen" either by tightening monetary policy or by a temporary export surcharge. Germany, on the assumption (which the OECD makes) that they would have a current account surplus this year (Emminger hotly disputed this) should ease fiscal policy.

He stressed, of course, that he was talking in a personal capacity but his candour and its very gloomy implications were indeed striking.

CWM

19 April 1982

Dupe

CONFIDENTIAL

19.4.82

NOTE FOR RECORD

Copies to The Governor o/r
Mr Blunden
Mr Loehnis o/r
Mr George
Mr Walker
Mr Balfour
Mr Holland
Mr Bull

HUNGARY

I was in Budapest for the G.30 meeting from Wednesday, 14 to Sunday, 18 April. Much trouble was taken by the Hungarian authorities to emphasise the seriousness both of their predicament and of their determination to pull themselves out of it.

We learnt as soon as we convened on Saturday morning that Kadar wished to see the whole Group in the Houses of Parliament at 11.00 am the following morning. I gathered (and our Ambassador later confirmed) that Kadar is normally very choosy about whom he sees and that this was a striking gesture. Kadar shook hands with each of us both at the beginning and at the end. Witteveen made an opening statement about the background and purpose of the Group of 30 and invited short contributions from Roosa and Emminger which contained nothing of substance. Kadar addressed us for a full hour in what was unanimously agreed afterwards to be a very impressive manner. He kept a good balance between domestic Hungarian preoccupations and the world scene and dealt both in political and economic terms. The centre-piece was of course an account of the success of the Hungarian experiment arousing the interest of each of the other COMECON countries including the USSR and, most recently, China.

He went out of his way not to duck the immediate problems saying that we had been too polite not to refer to them but we all knew that Hungary was in difficulty on the international monetary markets. He emphasised very seriously their determination (backed up by their past record) to pay all bills precisely on time. He also said that though they were of course in close continuous contact with their Soviet friends they were independent in their economic policy and management.

He spoke of the IMF application saying in terms that Fekete would have liked it three years ago and implying rather handsomely that this would have been better - "but there were other considerations". He ended by tackling the thesis that the Soviet Union could be attacked through the pressure on the East European countries. He said it might be possible to liquidate the Soviet satellites ("and perhaps Western Europe") but the USSR would remain. From a distance he said the Soviet structure may look like a somewhat rickety house with peeling walls but its fundamental structure was far stronger than it might look. People were used to hardship and would accept more if it proved necessary.

I had of course a number of talks with Fekete himself and he delivered to the Group a characteristically lively and persuasive account of the Hungarian position, their recent measures and their determination. He also circulated a paper to the Group which is available to anyone who wishes to see it. It is a bit slap-dash in style and not fully revised but contains much of interest including a handsome tribute to the Governor's Bonn speech. The main points Fekete made were as follows. The measures being taken were serious. Many forms of subsidy and non-export oriented investment were being cut back and the standard of living would have to fall (Lamfalussy told me that he saw these points being put across very unambiguously on Hungarian television and that from his own private contacts with Hungarians in no way connected with finance and economics he believed that the necessity for these measures was being accepted).

Fekete's second point was that he had the total backing of Kadar to do everything necessary to pay all bills as they became due. In particular they were "mobilising their non-monetary reserves". For example, they were now selling on a substantial scale their reserves of wheat which were higher than needed especially in the light of the expected good crop.

As regards the sources of the drain on the national banks' reserves so far this year Fekete told me and Lamfalussy (having been shown - though not allowed to take away - the detailed figures) confirmed that the Soviet Bloc reduction amounted to about $200 mn. As regards the commercial banks Fekete said that while there had been an initial ripple of panic this now he believed was past. The Swiss banks after discussion with Leutwiler had restored their position to what it had previously been. Elsewhere most banks had remained fairly calm. (Lamfalussy told me that from the figures he was shown the only significant withdrawals were by Commerzbank in Germany, Credit Lyonnais in France and NatWest here. American banks seemed to have been steady.)

Lamfalussy told me that on the basis of the figures and policy measures provided by the Hungarians to the BIS, and his own further information gathered in Budapest, he believed that it was a fair forecast that the current account will be brought to balance by the end of the year. He said that the presentation he would make in Basle was that there was a perfectly good economic case for interim financial support to Hungary to cope with what could properly be described as a liquidity problem. What the central banks and governments would have to assess was much more the political rather than the economic risk (ie would the Americans be difficult over an IMF drawing late this year?).

Much importance was being attached by the whole Hungarian government to today's meeting in Basle. Separately from my talks with Fekete I was deliberately taken aside at receptions first by Timar and then by the Deputy Prime Minister, who is due to go to Washington at the end of the month, to plead for our help. I said on each occasion that though we at the Bank were very sympathetic to their position and that we fully understood the case on the widest possible grounds for not allowing their developments to be frustrated, nevertheless they must understand there were difficulties. They should certainly not expect a decision today or tomorrow. We would however consider their case and discuss with our government as sympathetically as we could.

Finally, Lamfalussy told me that he thought that the most important thing was that we put up something out of a second $100 mn. In particular, the French would be very influenced by what we did. The BIS were however aiming to involve rather more countries this time including Italy and the Swiss themselves. I would take from this the view that we need to have in terms of not more than $15 mn and perhaps of only $10 mn. I am even more convinced than ever however that we should be prepared to participate to some extent.

I kept our Ambassador Bryan Cartledge in touch with what was going on and had a very useful discussion over lunch with him on Friday.

CWM

I.C.

19 April 1982