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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.

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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

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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.

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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 off-shore 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.

MCM 8982

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.