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New York,

BRIEFING FOR ANGLO-GERMAN SUMMIT

The Chancellor has asked me to supplement the briefing on International Debt Problems (PMVX(82)12b), by picking up, in this letter, some points which he made at this afternoon's briefing meeting, and which show how current debt and banking problems might be set in the context of economic policy.

2. As the brief suggests, the Chancellor does see these debt and banking problems as part of the pain of transition from a high inflation to a lower inflation world economy. Both nationally for firms and internationally for borrowing countries, a period in which the rate of inflation is being quite sharply reduced is likely to put those who are over-borrowed into difficulty. Borrowing countries, like borrowing firms, can no longer rely on inflation and negative interest rates constantly to ease the weight of their debt. There is a sense in which forced transfers from international lenders to international debtors, like forced transfers between domestic savers and domestic borrowers, have come to an end.

3. The main part of this problem, nationally and internationally, has to be solved by adjustment. Trying to solve it by general reflation is not the answer; that would not produce soundly based growth and would be tantamount to abandoning the fight against inflation. But in this as in other fields of the transition, every effort should be made to manage the transition so as to minimise its costs. That means making every effort to maintain confidence and to avoid precipitating action, either by the banks or by governments, which would impair confidence or make the problem worse. It makes highly desirable the kind of confidence-building activity we are envisaging in the IMF and between central banks; and which is described in paragraphs 3 and 4 of the Background part of the brief.

4. It is also crucial to minimising transition costs that as much as possible should be done to give time for the necessary adjustments. It is better that adjustment should be sustained than that it should happen at too fast a pace. Thus, the banks can cope much more readily with deferments of repayments, or even with write-offs, if country problems, like company problems, are spaced out and can be absorbed in the profits of 2, 3 or more years rather than 1. The function of the IMF is to give reasonable



(but not excessive) time for adjustment. The effects of the debt problem may be with us for a long time. There will be continuing problems of particular countries when, hopefully, the risk of a dangerously rapid succession of failures is no longer acute.

5. So the task is to achieve the right balance of adjustment and of action to maintain confidence. We have to apply much time and care to every individual case, and to secure as much spacing out of the problems as possible. The Chancellor is confident that this is the right basic approach.

6. We may hope for an easing of the situation as the benefits of a lower level of inflation come through. Obviously the lower level of interest rates is easing the burdens of both national and international debtors. If moderate growth resumes in 1983, in the United States and in the world economy generally, that will improve the export opportunities of LDCs and buttress the prices of their commodity exports. The debt and banking problems are more likely to remain acute if there is another year without growth. What happens in the United States is likely to be critical. In particular any reverse to very high interest rates would be enormously damaging: hence the importance, which Chancellor Kohl should recognise without difficulty, of the Americans taking the effective action to control their deficit at which they have so far jibbed. The hope must be that after next week's mid-term election they will be prepared to be more resolute over the control of borrowing: anything that Chancellor Kohl could do on his US visit to emphasise the need for this would, in the Chancellor's view, be helpful.

7. I attach notes on developments on international debts since the brief PMVX(82)12b was prepared.

8. Copies of this letter to go Brian Fall at the FCO and Richard Hadfield in the Cabinet Office.

Yours ever,

J. O. Kerr

J O KERR

Argentina

We now know that they are negotiating a 15 month standby rather than the 3 year standby referred to in the Annex in the brief.

Mexico

An important problem in Mexico's negotiations with the IMF is difficulties between the outgoing Portillo administration and the incoming one of President-elect de la Madrid. The Mexicans are not yet talking to the banks about rescheduling and we cannot yet be sure whether they will present a proposal to the banks by the end of the present moratorium on 23 November.

Yugoslavia

The BIS has rejected the idea of a 3 year standby for Yugoslavia. They feel they cannot engage in medium term lending. Since the brief was written the Yugoslavs have devalued the dinar by 20%.

Poland

The latest political developments in Poland have made it more difficult to get general agreement on discussing with the Poles rescheduling of 1982 official debt payments.