SUBJECT
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10 DOWNING STREET

From the Principal Private Secretary

4 February 1986

Dear Philip,

PRIME MINISTER'S MEETING WITH THE MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND

The Prime Minister had almost an hour's discussion with Monsieur de Larosiere, Managing Director of the IMF, on 3 February about the development of the world economy.

Larosiere said that management of the international debt situation had become more difficult, especially following the recent fall in oil prices. If the oil price fell below $18-19 a barrel, the international debt situation would, in his view, be very difficult to handle. The situation was as dangerous as in 1982. But now the IMF could not pump new money into the system; indeed, the Fund would, over the next few years, receive funds from its members. To that extent the system had lost its buffer. He agreed with Secretary Baker that the World Bank had to be given a greater role. But the Bank must not lower the quality of its lending. In any event, the World Bank finance would be relatively small. He concluded therefore that the commercial banks should make more finance available, for example increasing their nominal exposures to 3 per cent a year compared to the 14 per cent prospective increase in their capital base. Even this increased exposure might not suffice to safeguard the system if oil prices fell to an even lower level.

The Prime Minister commented that commercial banks would want to see the backing for their new loans. If they came to Government for support, the banks would be told that they were on their own. Larosiere commented that he was not suggesting that bank loans should be guaranteed by Governments. But imaginative action needed to be taken to prevent Mexico initiating a domino reaction from other debtor countries.

Larosiere noted a growing political fatigue in some debtor countries. Critics of the existing strategy were increasingly arguing that it was wrong for the developing countries to run trade surpluses and so effectively to transfer resources to the developed world. The Prime Minister agreed that it was distressing for debtor countries, even after taking firm economic action, to see

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the level of their debt increase because of increases in interest rates or falls in the oil price.

Larosiere said that the position of Mexico was crucial. The authorities there had assumed an oil price of $23 in setting their budgetary targets, but now the price has fallen to below $19. Mexico's problems were still probably manageable even with a $19 oil price, though the commercial banks would need to make more new money available. He feared that there were forces in Mexico pushing the country towards a Peruvian reaction. Everything should be done to encourage the goodwill of the Mexican Government.

Larosiere commented that in Brazil the problem was high inflation, stimulated largely by an uncontrolled fiscal position which was pre-empting resources into the public sector. Brazil had been able to sustain this fiscal expansion while resources remained unused as a result of the recession. But soon capacity constraints would make inflation even worse. Argentina had some success in reducing its inflation rate, though unfortunately this was now edging up. Again, the Fund was trying to persuade that country to restrain fiscal policy, with the aim of limiting the fiscal deficit to some 3 per cent of GDP.

The Prime Minister commented on Nigeria that her feeling was that the country still had not taken sufficiently strong measures. Larosiere replied that the Fund had not yet studied the recent budget, but his impression was that more needed to be done on the external side.

Larosiere said that the course of interest rates was crucial for the prospects of the large debtors and interest rates depended on the policy mix in the United States. The Prime Minister said that she believed that confidence in the dollar would remain. The United States was fundamentally a vigorous economy, with a long tradition of self-reliance and no prospect of a Socialist Government. And unlike Europe, it did not have enemies on its border. Larosiere emphasised that the United States had to introduce the proper domestic policies to deal with its internal and external deficit. The Prime Minister expressed her confidence in President Reagan's determination, though she accepted that the real test of the Gramm-Rudman Act would come in its second year of operation.

Concluding the discussion on the international economy, Larosiere said that if there were the right macro policies in the United States, the oil price was stabilised in some way, for example by moderation of production to prevent a slump in the oil price, banks were reasonably co-operative and export credit agencies did not cut back exposure, then the international debt problem would continue to be manageable. But if these conditions were not forthcoming, imaginative solutions would need to be sought, including the conversion of bank debt into equity, greater readiness by developing countries to accept foreign investment, and sales by the banks of debt at a discount.

Larosiere then asked for the Prime Minister's views on the possibility of "an understanding" with OPEC on oil prices. The Prime Minister emphasised that she was firmly against such an approach. The UK was a free economy and it was for the oil companies themselves to decide levels of output. There would need to be a "devastating" situation before the British Government could conceive of restrictions in oil production. Larosiere commented that he was not necessarily opposed to low oil prices, but disliked the speed of change in prices. The Prime Minister agreed, fearing a substantial increase in oil prices in, say, three years' time.

Commenting on the UK economy, Larosiere said that a fall in the oil price would reduce the scope for tax reductions. The UK fiscal position therefore had to be very restricted. The Prime Minister noted the difficulties in judging the tightness of monetary policy. Larosiere agreed that it was necessary to pay attention to many indicators in judging monetary conditions.

I am sending a copy of this letter to Colin Budd (Foreign and Commonwealth Office) and Michael Stark (Cabinet Office).

Yours sincerely

Nigel Wicks

N. L. Wicks

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