

Prime Minister

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17 January 1983

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Econ.
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PRIME MINISTER

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CHILE

The problem of lack of confidence in the currency has resulted in a disintegration of the financial system in Chile. A flight of capital and the resulting strain on liquidity has resulted in three major banks being liquidated. And in the case of the five major banks in Chile, covering about 65% of the banking system, the government has appointed a man who they call a manager. They will remain in business under government direction. The government has not guaranteed the debts of these banks. But it has said it will meet their liquidity needs.

In particular, the government takes the view that liquidated banks may default on their foreign debt. This, it is said, will teach the lenders a lesson to be more discriminating in their lending practices. One would think that it is a bit late in the day to do that.

The government are putting some pressure on private creditors to establish rescheduling of debts with creditors. This again is a complete reversal of policy since, when I was there, there was a policy of "no rescheduling". I expressed by scepticism about such a policy, but it was reversed even quicker than I thought it would.

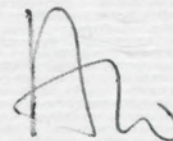
These reversals and confusions of policy will undoubtedly lead to another great capital outflow. I suspect that the authorities will be unable to hold the peso at the "crawling peg" rate of about 73 pesos to the dollar. The result will be dreadful turmoil and confusion in the foreign exchange markets.

I am very worried about the effects of Chile on the international financial system. It is a small country and it does not have the priority that Mexico, Brazil and Argentina enjoy in the international banking system. I suspect it hardly figures in Paul Volckers's "drip feeding" arrangements. It could just spark off a major crisis. I do not know the distribution of their creditors, although they are clearly for the most part American banks. I have tried to check with my contacts in the United States, but they seem to know very little about the risks involved. While it is mainly

/the Fed's

the Fed's responsibility to bail out American banks, I am not
entirely certain that they are apprised of the dangers.

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