



10 DOWNING STREET

*From the Private Secretary*

30 May 1984

VISIT TO THE WEST COAST OF THE UNITED STATES

The Prime Minister read with interest your Secretary of State's minute of 25 May reporting on his recent visit to the United States.

A. J. COLES

Callum McCarthy, Esq.,  
Department of Trade and Industry.

CONFIDENTIAL

②  
PRIME MINISTER

87 31/5

29 May 1984

STATE OF THE ECONOMY

The United States of America

At the end of 1983, I wrote explaining why the dollar was not then falling as many predicted. The dollar has again powered ahead based on:

- a. The higher interest rates caused by the monetary and deficit troubles.
- b. A renewed reluctance by US banks to lend more money overseas to shore up the debtor nations.
- c. The growing international tension, particularly in the Gulf, which makes international depositors more enthusiastic about placing money in the States than in less secure countries, or even in countries short of oil like Japan.
- d. The industrial troubles in Germany and the UK.

Interest Rates

Both short- and long-term interest rates in the States have been rising sharply. Long bonds in the US now offer a yield

CONFIDENTIAL

of 13.4 per cent, compared with 10.7 per cent a year ago. Short rates (Primes) are now 12.5 per cent.

The combined public and private sector demand for credit is enormous compared with available US savings. The US can continue to run its large budget deficit only if it succeeds in deterring private sector borrowing by high interest rates and/or if it succeeds in attracting more savings, also by higher interest rates. The other possible course - that of printing the money - would work in the short-term, but is still an unattractive option to the Fed., who remain concerned about rekindling inflation.

The table below sets out the total US requirement for credit:

|                        | 1981 | 1982 | 1983 | 1984(est.) |
|------------------------|------|------|------|------------|
|                        | \$bn | \$bn | \$bn | \$bn       |
| <u>Total borrowing</u> | 490  | 480  | 618  | 710        |
| Public Sector          | 155  | 275  | 300  | 290        |
| Private Sector         | 335  | 205  | 318  | 420        |

In 1980 and 1981, US private savings were double and then treble the Federal deficit. They were equal to the deficit in 1983, and may be less than the deficit in 1985. Thus the only way of financing the growing demand of the private sector for credit, and of paying for the yawning gap in the balance of trade, is with money from overseas. This assumes that more rapid inflation and money growth are ruled out.

Bond and Equity Markets

Both the bond and the equity markets are showing the tensions early. The equity market keeps on hitting new lows this year, and even the satisfactory profits figures and good real growth in the economy cannot produce any smiles on the face of the Wall Street investor. We are living through that period in the US when industrialists and some outside commentators express surprise at how well profits and activity are doing, and ask why it is that the stock market is so perverse. This is the usual position towards the top of an economic cycle, where the pressures on credit markets are already severe, throttling off the money for securities markets, and sending them into a spin with the higher interest rates that result. Similarly, the bond market is showing the paranoia you would expect when asked to finance too large a Government deficit for the amount of cash available.

What Happens Next?

In the short-term, there is an unholy tension between the fears generated in the wake of the Continental Illinois collapse on the one hand, and the need for higher interest rates to restrain credit demand on the other. The US economy is a particularly cumbersome one to manage when trying to cut private sector borrowing, because most interest on loans is tax-deductible. The quickest way to

CONFIDENTIAL

reduce the budget deficit and to cut credit demands, would be to cancel the tax-deductibility of all interest charges: this could, however, bring a number of the borrowers into severe difficulties, and would therefore curb credit in a painful way.

This tension is likely to be resolved by:

1. a trend towards higher interest rates unless and until the credit demands are abated; but
2. some temporary recourse to printing money (lower interest rates and more inflation) whenever a major bank seems to be in difficulties.

The only long-term way out is by cutting the budget deficit. Perhaps the events of the last few weeks have brought nearer the point when the President feels he can present proposals that come to grips with the deficit this year rather than at some future date. Once he did so, the bond market in particular would leap upwards and interest rates could then start to fall.

The banking tensions are serious. The LDCs do need lower interest rates in order to preserve the fig leaf of honesty about repayment of capital, and even about the payment of interest. On the other hand, as the risks of the international banking system are perceived to grow, and as the countries themselves start discussing the possibility of

CONFIDENTIAL

CONFIDENTIAL

non-payment, the risk premium in rates charged to LDCs will tend to rise. There is a lot to be said for Alan Walters' suggestion that a market should be created in LDC debt so that banks can (a) quantify their losses; (b) sell on some of the worst risks if they are over-extended, in order to gain liquidity which they desperately need.

It should be remembered that banks are always technically bankrupt, as they lend long and borrow short to a greater or lesser extent. A bank collapses normally not because it is insolvent, but because it is illiquid. As soon as depositors lose confidence, a run develops and the bank runs out of till money. The FDIC reassured the system by underwriting Continental Illinois, and by pledging further support. US markets will now believe that if a bank is large enough, and its loan book bad enough, the FDIC will stand behind it; and this goes a long way to averting the fear of a financial Armageddon.

#### United Kingdom

The United Kingdom economy, which has been recovering nicely for 1 years, now has to weather these major international shocks. Sterling has suffered along with other major currencies against the rise of the dollar. Interest rates here have been dragged up. The only way to prevent our recovery being more badly affected, and our interest rates being forced up too far, is by the continuation of sound policies - particularly on public borrowing. Any country

CONFIDENTIAL

CONFIDENTIAL

which is running too large a government deficit against the background of US monetary turbulence is running great risks. Any country which itself develops some of the bad American habits could find the backwash from the US banking crisis that much more difficult.

Our problem is going to be a political one. The result of American action, and more especially of American inaction over the budget deficit, is going to be a slowing of US economic growth, which in its turn will slow down the recovery in the rest of the world. As our unemployment hasn't even begun to fall yet, it is difficult to explain that the US recovery is under pressure and that we have to persevere with a fairly restrictive stance so that the international turbulence does not worsen our position. The good news is that the combination of banking crisis and plunging markets in the States will bring home, in a visible way, damage caused and perpetrated by the high American deficits and high American interest rates.

#### The Oil Crisis

Oil and financial markets have been relatively sanguine so far about the condition in the Gulf. It may be wrong to be too relaxed. Some 11 million barrels of oil are produced by the Gulf States in normal conditions. Half of this could be replaced quite easily by increases in production elsewhere or sent by different routes. Whilst it is true that the

CONFIDENTIAL

CONFIDENTIAL

Saudis have large stocks, and that international stocks are higher than they were in 1974 and 1979, the amount of oil which could be withdrawn from the system is actually larger this time than the amount withdrawn at the time of the Iranian crisis in 1979.

If the Gulf is made dangerous for shipping, we must assume that the oil price will rise, and could rise quite dramatically. Even with Saudi-American co-operation in providing air cover for tanker convoys, oil movements in the Gulf could be reduced substantially. Iraq is likely to carry on with its attacks on ships bound towards Kharg Island.

The miners' strike will be more difficult to continue if oil markets take off. It would be important to have bought as much fuel oil forward as possible to secure the supplies needed to continue with maximum oil burn, which is a vital part of our endurance. Our own position as a net exporter of oil gives us some advantages as, in extremis, the Government does have powers to organise contracts to help our own refineries. In the meantime, the policy of wait-and-see and keep the markets calm may break down: the IEA proposals should then be implemented swiftly.

#### Conclusions

1. The US over-borrowing and financial tensions are coming to a

CONFIDENTIAL



CONFIDENTIAL

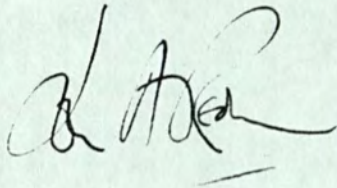
head. In the short-term, pledges to bail out the banks might mean some monetary easing, and therefore more inflation. Until the budget deficit is cut, however, we should expect the trend in US interest rates to be upwards, and for growth to start to slow down by next year.

2. The best stance for the UK to follow remains that of caution. Against a background of an international banking crisis, and a nascent oil crisis, any country which is borrowing too much, or has an unsound balance of payments, is that much more vulnerable.
3. The Economic Summit will have to say something more about the international debt crisis. Could it not reconsider the marketable debt solution, so that we can quantify the damage and start talking about the truth of the position rather than papering over the cracks in the major international banks? Marketable debt will erase the worst fears about bank insolvency and enable banks to sell debt to raise cash when they need it.
4. The safety of shipping in the Gulf cannot be guaranteed. Shipping is already slowing, and if this continues for any length of time, we must assume that the oil price will rise, and could rise sharply. Even with positive Saudi action, oil shipments could decline. This will help sterling, and will help UK Government revenues, but it will hinder recovery world-wide.

CONFIDENTIAL

CONFIDENTIAL

5. We should make sure our contingency plans concerning oil for power stations and refineries are in good shape.

A handwritten signature in dark ink, appearing to read "John Redwood", written in a cursive style.

JOHN REDWOOD

CONFIDENTIAL