SECRET

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PRIME MINISTER

INTERNATIONAL DEBT CRISIS

There are many solutions on offer:

1. Solutions giving or lending more money to the debtor countries

Reducing interest rates for them.

Offering national loans or loans through international bodies.

Stepping up grants and aid.

Writing off a portion of the debts to ease interest and capital repayments.

In each of these cases, he who makes a bold initiative may end up writing out the first large cheque. These "solutions" do not solve the problem, they merely postpone the day of reckoning. It does not help a drug addict to give him more drugs to keep him going, although it is painful to face up to the need to withdraw from the drug on which he is hooked.

Encouraging payment of interest and repayment of capital is a poker game. If the West look as if they are softening, they could bring on the very crisis of non-payment they dread.

Some modest strengthening of the IMF/World Bank resources has been and may be necessary, however, if their new lending or replacement lending is firmly linked to policies which encourage adjustment within the borrowing countries.

2. <u>Schemes which encourage adjustment within the debtor countries themselves</u>

Forcing or encouraging domestic austerity in debtor countries, to divert their resources to exporting.

Encouraging more equity financing of new projects within debtor countries from overseas, and encouraging asset sales by debtor countries.

Discouraging Western protectionism against Third World exports, so they can trade their way back to honesty.

These schemes have more to recommend them. Austerity alone can bring political problems in the debtor countries, and limits world economic recovery. More emphasis needs to be placed on encouraging trade and equity investment. Mexico's oil is a saleable capital asset (the UK was happy enough to encourage foreign equity capital to finance part of its North Sea development). Brazil's agricultural and lumber resources are also saleable.

3. Policies which encourage adjustments by the Western banks

Creating a market in debt would enable banks, depositors and regulators to determine how serious the problem is. The lack of any precise quantification of bad debts allows rumours to thrive and to threaten the solvency of banks. Quantification would prevent the more silly rumours from running, whilst the market would enable exposed banks to begin selling on some of the debt on their balance sheets to other investors, thereby reducing the bank's risk and raising its liquidity. Syndicated loans could be converted into tradeable bonds, without altering the obligations on the debtors. This can be done gradually, country by country, whilst watching the resulting solvency of the banks. We will then see if the provisions are adequate and banks can come to a better view of what additional capital write-offs they need to make.

What is not to be encouraged is a general move to guarantee all wobbly bank deposits: this can become code for inflating Western money supplies, bringing interest rates down temporarily only to recommence the inflationary process.

Continential Illinois and other banks now need propping up because the more fundamental issues have been ducked.

The only safe way to bring US interest rates down - and therefore alleviate the problem - is by cutting the US deficit, not by swamping the system with more dollar cash. Of course we could temporarily inflate our way out of the difficulties, but then so much of the anguish of adjustment policies against inflation over recent years would have been lost, and a well-based recovery would be that much more distant a prospect.

Conclusion

Beware solutions which encourage a grand plan for the west to pay off or subsidise debt.

Encourage equity finance of LDCs, asset sales by debtor countries, and a market in debt.

Discourage perpetuation of easy money and deposit guarantees.

Strive for proper adjustment of interest rates in the US by tackling the budget deficit and the tax deductibility of interest for private borrowers.

Make the bank shareholders carry their burden manfully.

JOHN REDWOOD

The first oil price rise at the end of 1973 led the less developed countries of the world to begin borrowing very heavily from the governments, the private markets and the banks of the West. They now probably owe around $800 bn., something under half of it to private banks. The bankers gave little serious consideration to the LDCs' inability to service the debt. The LDCs were sovereign borrowers, and for the bankers this default was unthinkable and new credit would therefore always be available. But this ~~was not the case and~~ the process of snowballing debt had a built-in dynamic of incredibility.

For some time now most of the LDCs have been unable to raise the money on the private markets to meet their debts to the private banks: they have been obliged to renegotiate them, usually on consideration of agreeing to alter their economic policies. This process known as "rescheduling" is simply an agreement on the terms for deferring capital repayment obligations and interest payments.

All of this has been done on a "pragmatic" case by case basis, which means that each debtor country's situation has been dealt with separately. Where you are dealing with the difficulties of an individual debtor this response is all that is required to provide the necessary breathing space within which resumed payment can be organised. But where most of the debtors cannot meet their obligations punctually there is a generalised international debt problem, and a more fundamental analysis is required to discover what has gone wrong and how to put it right. Unfortunately no such analysis, or outline strategy derived from it, has been attempted by the leading governments concerned.

The central question which must now belatedly and explicitly be asked is whether a system of large-scale, purely commercial lending by the private banks to poor countries is sustainable. Commercial lending is based on the assumption that the transfer of resources which it makes possible will strengthen the wealth-creating ability of the borrower sufficiently to allow him to pay interest on his loan and ultimately repay the capital; the lender would correspondingly come to enjoy a rentier income until the repayment occurs.

When the lending is across frontiers, the borrowing country starts off with a trading deficit, reflecting the inflow of imports obtained on credit. If the debt involved is to be serviced, the borrower must at some future time achieve a trading surplus. For the present rescheduling operations could only to provide a solution, if we therefore, we must believe that the debtor countries will at some point start to run large and continuing trading surpluses with the developed world.

But the sums to be serviced are already gigantic, and the rolling over up (rescheduling) of interest payments adds to them enormously. In addition, many of the borrowers may need fresh capital on top in order to resume development. No one has so far been bold enough to estimate

it would be reasonable to expect these debtors

the date when most of these debtors might reasonably expect to achieve the export surpluses required to meet their ever increasing interest payments, let alone repayment of the debt. This is no surprise, because the size and duration of the surpluses required are historically unprecedented and the countries involved are exactly those who have the least chance of generating them.

Achieving a trading surplus is a much more complicated and costly process than neatly depriving your citizens of an equivalent amount of consumption. The whole economy has to be bludgeoned, and even the best-run societies suffer a loss in wealth production that is far greater than the surplus required, witness France at the present time or the UK in the 1960's and 1970's. The LDCs are not among the best administered societies and the degree of real control that governments have there is tenuous. The notion that they could generate the surpluses required to service existing debt is, in my view, in the highest degree improbable. The performance will vary from country to country, but the result for most can be in little doubt.

There is a second problem. However vigorously their economies may grow, the debtor countries will in the foreseeable future always have an income per head very much less than that of their creditors. Will it be politically feasible for the governments of the debtor countries on a sustained basis to enforce the measures that would be required to achieve even the payment of interest? To say, as some do, that there is no need for the capital to be repaid is no comfort because that would mean paying interest on the debt to all eternity. Can it be seriously expected that hundreds of millions of the world's poorest populations would be content for long to toil away in order to transfer resources to their rich rentier creditors?

But let us make the assumptions that the debtor countries will at some distant date be able to pay, and that their people will over a lengthy period assent to the exactions required. There is still a third difficulty. Can the lending countries themselves deal with the problems of becoming rentiers on this scale? The required trading surplus of the debtors could be obtained only by a major reduction in their manufacturing imports and by a vast increase in their manufacturing exports. This would create adjustment problems for the developed world much larger even than those raised by the present Japanese export surplus. The structural changes which would be required inside the advanced countries to accept a continued export surplus in manufactures from their debtors would be very great indeed. A number of European countries, the UK, Norway and Holland, have some recent experience of rentier status through the development of North Sea oil and gas. We have found, to our cost, that the practical consequences are by no means all good, whatever the textbooks

These are not fantasy problems of the future. Even now, the relatively modest attempts by the LDCs to eliminate their current account deficits have raised very great difficulties for them and for us. They have suffered a fall, in some cases a sharp fall, in living standards. For countries like Brazil and Mexico real living standards have dropped by 15% in the last 3 years and in other countries it is much worse. We have felt acute pressures in some industries and have seen a rapid increase in protectionist sentiment. Any movement towards protectionism would, of course, make the ability of the LDCs to achieve a trading surplus even more hopeless. But what we have seen so far is as nothing compared with what would be needed by both of us to adapt to the trade performances required to service these debts in the future. Anyone who has studied the experience of recent years will not find credible the proposition that either party can make the necessary adjustments without enormous mutual injury.

To sum up. I judge that the great majority of the debtor countries will be unable to pay back most of the lending and that, even if they could, their people would not allow them to make the payments. Further, I do not believe that even if these countries could, should and would be able to pay in real terms that we have the ability to cope with the role of rentier on the scale that would be involved. For the most part The reality is can't pay, won't pay and couldn't be accomodated. In short, the modern world's

None of this means that the transfer of resources to the LDCs should not have taken place. Nor is to deny that the best, and perhaps the necessary, way of doing so was through commercial agencies, but only with active and direct government involvement. What it does mean is that our authorities should belatedly recognise that the bank lending which they encouraged and permitted must now be supported funded by them, after the event, in order to preserve the proper functioning of their banking system, to avoid serious disruption of world trade and to play a supportive role in the political and economic development of the LDCs

The first of these, the proper functioning of the banking system, is now urgently coming under question. To some this merely reflects the current high levels of interest rates. In my view the problem is more structural, more fundamental. The 9 biggest banks in America have lent to Mexico, Brazil and Argentina sums equivalent to 250% of their capital and reserves resources. If only less than half this money were to prove irrecoverable they would be without any capital at all. But even if a very much smaller percentage were suddenly lost, the impact could endanger their be very dangerous for stability and ultimately that their existence and for the stability of the whole American banking system. The position is to a lesser extent applicable to all the great banks of the world. We are not dealing with the isolated misjudgments of a few banks but with the worldwide overcommitment of an interlocking banking system. Moreover, the banks did not act in isolation. Their decisions were approved and encouraged by the authorities. The governments and banks were in this system of lending together, and only together can they come out of it without major damage to the financial and economic system.

A number of proposals to relieve the situation have been made, in many cases by people of considerable experience. These range from rather vaguely formulated international guarantees of existing debt to transfers at a discount of some or all of the bank debts to an international institution. This is not the place for a detailed critique of these proposals, but few of them envisage a sufficient release for the banks from the deadweight of existing non-performing debt and most assume unrealistic demands on the LDCs. In my view, the minimum required to preserve the effective functioning of our banking system is that the leading governments should create the machinery, and provide the funds, whereby current interest on the debts can be paid by the debtors to the banks. Given a guaranteed flow of interest for a sufficient number in the years immediately of years ahead, the banks could cope with ~~begin~~ the necessary write-down of bad debts. Precisely how much it will be necessary for them to write-down is not yet clear but it follows from the foregoing that I would judge it to be a very considerable proportion of the whole. However, if the banks are given sufficient time and are guaranteed their interest due, the write-down is feasible. In my view, a realistic write-down over an extended period of time is the maximum burden that can be safely imposed on the banks. What they cannot sustain is a loss of interest payments combined with a

This operation should not be conceived as bailing out the banks. Rather, it is an attempt to protect the basic financial and economic structures of the developed world and of their debtors from the consequences of the imperfect emergency measures taken to deal with the oil price rises. Without bank lending there would have been a world crisis long ago, which is why the lending was approved by the creditor governments in the first place. Though a purely bank intermediation of the OPEC surplus was by no means ideal, no other method was available at that time.

In addition to securing the soundness of the banking system, the authorities must also decide what genuinely new funds should be provided to the developing countries to enable them to resume some economic growth. I am not here attempting to assess what is required but I am urging that, for the first time, the political leaders at the Summit come at least to outline decisions on (1) whether there should be new funds provided, (2) if so, how much, on what terms and how they should be apportioned, and (3) what the mechanics are available to achieve such transfers? In my view, there ought to be such transfers but on a much smaller scale than that of the last ten years. Further, it should be made available not on conditions designed to secure early repayment but exclusively conditioned on productive usefulness to strengthen the economies of the recipient countries. I believe that these terms could be acceptable to the borrowers, would be in the interest of both lenders and borrowers and has had up to now.

Many still live with the comforting assumption that the present we have achieved piecemeal actions are enough ~~the broad outlines required~~ to deal with the threats to the financial systems of the creditors and debtors. I believe this proposition to be manifestly unsustainable. We have built up a vast debt time bomb because we too readily accepted the false assumption that sovereign risk was no risk and that indefinite refinancing in monetary terms would be available to the debtors. We are now living with the illusion that emergency patch-work measures will prove adequate to sustain a dangerously ~~basically~~ unsound edifice. So long as we leave ~~Having left~~ the central issue untackled, far from solving the problem we are deferring it and allowing it to grow ~~making it bigger~~ as the debt mounts.

Unfortunately, the difficulties which deterred the governments from strategic analysis in 1974 exist with even greater force now that they have problem ~~is~~ to deal with the huge past debt as well as the future investment needs of the LDCs. Moreover, the problems can only be solved by ~~operation would need to be a~~ co-operative and collective action ~~concerted one~~ by the OECD governments. This is wholly ~~so much~~ at variance with the authorities preferred role of case by case crisis managers. Only a radically changed posture by them will offer protection from the very grave dangers which threaten us. ~~that it is difficult to be optimistic that proper decisions will be taken before financial panic begins.~~

If we are told that there is insufficient political will available to move to an intelligent, coherent and sustainable solution to our problems, then for my part I must warn that this is equivalent to there being insufficient political will to avoid an impending series of the most dangerous and escalating financial, economic and political crises.

HAROLD LEVER