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PRIME MINISTER

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The continuing surge of the dollar reflects the powerful financial pressures at work, channelling massive funds into the US to pay for the large balance of payments deficit on current account. US interest rates remain at penally high levels, with US prime of 13 per cent, compared with a latest US inflation figure of 2.9 per cent. US domestic borrowers are still shielded from the worst impact of this by the substantial tax breaks they enjoy. The run-up to the quarter end naturally increases world demand for dollars, as international borrowers have to buy the US currency to pay their interest charges.

The pattern is as it has been for more than a year. The US banks, short of capital and short of liquidity, are not increasing their debt exposure overseas. Capital exports from the US have effectively stopped. At the same time, the US banks have to bid for funds, and the high resulting interest rates are very attractive to depositors from around the world.

The latest Mexican rescheduling will contain an option for non-US banks to convert half their dollar loans into domestic currencies. Such conversions are another factor in reducing the world supply of dollars, while increasing the supply of other currencies through liquidation of dollar debt. The abolition of withholding tax on US treasuries for foreign buyers is a further inducement to channel money into the US: at the same time it makes Eurodollar investment less attractive. The debt crisis therefore imposes a perpetual vicious circle, stopping more American dollar lending and converting existing dollar debt into other currencies.

Banks are still under pressure. By 1983, capital represented some 3.73 per cent of the total asset base of the 34 largest US, Canadian, UK and Japanese banks, dominated by the US ones. In 1970, the ratio was more than 5 per cent. The renewed fears about the quality of lending, not only internationally but also domestically in the US (particularly to the energy sector) serves to accelerate dollar strength and the contraction of the credit base.

The latest US estimates show both growth and inflation falling. The second quarter real growth figure has been revised downwards to 7.1 per cent, and the "flash" estimate for the third quarter shows the real growth rate dropping off to an annual 3.6 per cent. Inflation has slackened off to 2.9 per cent from 3.3 per cent. (Our 5.0 per cent no longer looks satisfactory). AS

The falling trend of housing starts, the high level of real interest rates, the flash figure, and anecdotal evidence about the US economy, all point to a sharp slowing in the phenomenal growth rate the economy was recording 6 months to a year earlier.

The US remains locked into the battle of the two deficits. The substantial balance of payments deficit is still being added to by the growing strength of the dollar. It has been estimated that a 1 per cent real increase in the dollar leads to an additional $2 billion of trade deficit after a 2-year gap, assuming other factors are equal. The latest surge in the dollar will exacerbate the problem.

It still requires some combination of slower economic growth, lower US interest rates, a change of sentiment, and perhaps some resumption of additional dollar lending overseas, as part of the rescheduling and repackaging of international debt to bring the dollar down significantly.

The international debt problem

I checked with the Bank of England. They deny heaping praise on Sir Walter's scheme. AT

I telephoned Alan Walters and discussed the Salomon proposals with him. He responded as we had done, welcoming the movement towards a market in debt - as he always has - but expressing considerable scepticism about the international body designed to weed out the bad debt and judge the solvency of banks. Nonetheless, he readily agreed to give the pamphlet a favourable wind for publication, and to see if he could help Walter Salomon with Paul Volcker. His view was that the US economy is slowing down quite quickly now, and this might feed through to lower interest rates and a more stable dollar.

John Redwood

JOHN REDWOOD

High US rates
long + Short term.

U.K. - U.S. YIELD COMPARISONS