

SH/11

Re Governor

SECRET

You see the Prime Minister at 3:00  
tomorrow - for 1/2 hour. <sup>mentioned that you</sup>  
Subjects that you intend to cover include  
the following:

Hungary

Yugoslavia + you will have

Argentina - <sup>incl. latest position on</sup>  
the veedores

Mexico - <sup>you have read depositions</sup>

Brazil

Germany - ASG

Canada - Dome

USA

Italy - Ambrosiano.

P.M. Seminar write-up. - doss.

Basle - Capital Adequacy

Provisions

Concordat

ATM's write up.

Also: Hong Kong - the latest position  
and (from the P.M.) run down on her trip to the Far East  
I also enclose a few papers on the Geneva Group, the latest  
money talks on Howard + Birtel

all papers  
on T/S

...

+

SALL  
Sub top.

CR 1/10.

THE GOVERNOR

Some possible points for your talk this afternoon.

1 The most serious aspect of the world scene is not so much the depth of the recession but the extent to which it has been and is likely to go on being prolonged, continually disappointing expectations, and cumulatively weakening confidence. Moreover it means that bank finance has been extended to companies and countries on a "false prospectus". Thus both lenders and borrowers' balance sheets are weakening.

2 <sup>Whatever</sup> ~~Whether~~ blame may be attached to past behaviour - enthusiastic banks, improvident governments, badly-managed companies etc, the point now is to look forward and understand the inter-relationship between the real and the financial economies domestically and internationally. From now on the accumulated debt and the need to ensure "adjustment" by the borrowers will be exercising an extra deflationary force on top of the generally depressed "animal spirits". If there are defaults or repudiations the process will be worsened by decreased confidence in the financial system.

3 It was a premise of policies adopted by HMT and other governments that reducing the claims of the public sector and improving inflationary expectations would produce a spontaneous and sustainable increase in private sector activity. In practice, for doubtless many reasons, it must now be admitted that this is not happening and not likely to happen on a scale necessary to overcome cumulative downward pressures. <sup>Some special action is therefore necessary. Only a</sup> A limited amount can be done quickly even on a world scale and the limitations are greater on the UK alone. But some things are possible.

4 There must be no going back on the fight against inflation and no move to substantial reflation. What is necessary, however, is to

persist in the fight against inflation but perhaps not only by narrowly construed meanings. And to persist in the fight against current public expenditure (especially transfers) <sup>But</sup> in the extremely abnormal circumstances now developed to be prepared to look again at public investment and <sup>not to be enslaved or mesmerized by</sup> at mechanical numerical views of public deficits. The PM outstandingly but perhaps governments and central banks rather generally have since the second oil shock established real credibility in their anti-inflationary determination. They should be able to draw on that credibility bank rather than continue to depend on the achievement of numerical targets to keep markets calm.

- 5 Even alone the UK can make some moves in this direction and it would be wise not to wait until April. Because the exchange rate is so vulnerable (adverse balance in manufactures running at £1½ bn pa over the last six months) any help given should be competitiveness improving (reductions in NIS, indirect taxes etc) or non-import generating (infrastructure investment projects). What would sound at first like big numbers in terms of billions of pounds could be necessary not to reflate but <sup>just</sup> to prevent <sup>improvement</sup> ~~improvement~~ continuing to rise rapidly.
- 6 Further interest rate reductions may have a part to play, but unless they are matched externally <sup>can</sup> again lead quickly to dangers <sup>of falling exchange rate</sup> (though some fall could well be accepted if it were orderly). They could also lead to rather obvious overshooting of the money markets. <sup>And</sup> they will have to be seen in the context of fiscal policy.
7. Over and above what the UK can do, international co-ordination is really necessary. Versailles was a waste <sup>of</sup> opportunity. None of the other western leaders has anything near the credibility of the Prime Minister especially now that Schmidt has presumably gone. Perhaps she could <sup>set up</sup> ~~think~~ of an initiative to her colleagues which would at the minimum state concern and determine <sup>action</sup> to hold the West together, <sup>and</sup> at the maximum explore possible joint actions to arrest the present alarming tendencies. Of course this would need a lot of thought because everybody's circumstances <sup>often</sup> matter.

8 All this may be resisted ~~and~~ *as stony eyed on U-trans.*  
Certainly it carries risks of failure and of alarming markets.  
But the risks in the other direction are now very serious indeed.  
Another year of world stagnation could put intolerable strains on  
the financial system and bring a surge of protectionism and dirigism  
that might not be reversed for a generation.

*Cwm*

1 October 1982

Subst  
S411

SECRET

1.10.82

THE GOVERNOR

*Saw an advance version  
4/10*

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persist in the fight against inflation but perhaps not only by narrowly construed means. And to persist in the fight against current public expenditure (especially transfers). But in the extremely abnormal circumstances now developed to be prepared to look again at public investment and at mechanical numerical views of public deficits. The PM outstandingly but perhaps governments and central banks rather generally have since the second oil shock established real credibility in their anti-inflationary determination. They should be able to draw on that credibility bank rather than continue to depend on the achievement of numerical targets to keep markets calm.

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Cwm

1 October 1982

1.10.82

*This was most helpful.*

THE GOVERNOR

Copy to DGPS only

*OR 1/10.*CALL ON PRIME MINISTER  
SITUATION IN PROBLEM COUNTRIES

## Overall

1 On balance the situation looks somewhat more stable than in the immediate aftermath of Toronto - although in retrospect the outcome of Toronto was by no means bad. There were unresolved issues over Mexico and Argentina at the end of the Toronto week, but the hot-house juxtaposition of bankers, journalists, finance ministers and central bank governors, which might have led to a lemming-type deterioration in confidence, did not do so. Confidence - pace the journalists - was certainly no worse at the end of the week than at the beginning. And real gains were achieved in focussing attention on the size of the Fund (isolating the Americans), advancing the target date for resolution of the 8th quota review to next May and producing pledges for the 4th year of IDA 6.

2 Furthermore, while major uncertainties on Mexico and Argentina still remain, the aftermath of Toronto in both cases has been positive (see below). Similarly necessary and inevitable structural changes in the interbank market, including a contraction in its overall size and tiering (a healthy recognition that risks vary), are so far taking place in an orderly manner. But the right pace of adjustment is very hard to achieve, and it would be premature to suggest that the risk of things going wrong is not still significant and actual.

## Mexico

3 - Silva Herzog's news that President Lopez Portillo was prepared to resume IMF negotiations has been endorsed and reinforced by report of Spanish Ambassador's talk with him on 15 September.



- Separate meetings of Cranley Onslow and Rhodes (Citibank) with Tello show that he too accepts inevitability of an agreement with Fund and harsh adjustment measures this will entail. Main stumbling block is likely to be pace of reduction of public sector deficit.
- Advisory Group of banks working hard - and so far successfully - to get generality of banks lending to Mexico to behave pragmatically and responsibly. There is some haemorrhage of interbank deposits, and this could become worrying, but position is currently being held. [BIS/Fed swap of \$1,850 mn only drawn as to just over \$260 mn.]
- IMF agreement would be important boost to confidence. Encouraging that Mexicans seem to recognise need for speed.
- Bank of England in close touch with Fed on position of Mexican branches (two men over there now) and with Mexican branches in London, monitoring liquidity needs.

#### Argentina

- 4 - Despite muddle over timing of removal of restrictions, indications are that position of del Solar and Wehbe may be strengthening marginally against the military.
- Last week del Solar telephoned to say the supervisors from Interior Ministry were being removed both from banks and other UK commercial enterprises.
- Despite somewhat conflicting and confusing accounts of what the Argentinians intend to do about repaying arrears to UK banks, latest indications are that they do intend to honour the agreement - ie to repay arrears of principal and interest on medium and long-term debt, but negotiate rollover of short-term debt (as they have with other non-UK banks). Barclays and Lloyds have men in Argentina at the moment discussing this question with the Central Bank.

- Argentina is to have talks with IMF and is entering into debt-restructuring talks with banks. They have made low-key approach to BIS on normal banking facilities.

#### Brazil

- 5 - Mexican problems, size of Brazilian debt and unease before election on 15 November has meant that funding in interbank market has become more difficult for Brazilian banks.
- Brazilian authorities have introduced austerity measures despite impending election (compulsory deposits on current accounts raised from 35% to 45% and 5% reserve on time deposits imposed; public enterprise budgets cut, foreign exchange allowances constrained). After the elections they will tackle wage indexation.
- Central Bank of Brazil have sent Director to London and New York to investigate at first hand possible liquidity problems of Brazilian bank branches, and are taking sensible steps to forestall problems. Most encouraging efficiency.

#### Bolivia

- 6 - After several months of recurring foreign exchange difficulties a number of conflicting reports were received from the Central Bank and the Ministry of Finance during September concerning Bolivia's ability to meet payments due to creditors. On 28 September the authorities announced that Bolivia would cease all repayments on its external debt until the civilian government takes office on 10 October.
- The general feeling amongst banks is that the Bolivians should more realistically seek a moratorium on debt repayments until the end of the year in view of their difficulties.
- Bolivia is clearly experiencing debt difficulties and there is little reason to hope that the installation of the

civilian government will bring very much improvement. Bolivia's debt problems are much less a source of concern than those of Mexico: the external public debt totalled some \$2.5 bn at end-1981. Of this some \$1.1 bn was owed to commercial banks. The exposure of UK registered banks on a consolidated basis was \$174 mn at that date (that of British banks on the same basis was \$111 mn).

#### Hungary

- 7 - The BIS did agree additional \$300 mn standby facility, although the new money involved is only \$200 mn, since \$100 mn is reserved solely to repay maturing tranche of earlier assistance on 17 November. IMF reports good progress on negotiations, and vital for overall confidence that central banks not be seen to withdraw support at this stage. Demonstration effect for other East European countries important.

#### Yugoslavia

- 8 - A major problem because indebtedness large (\$20 bn) and structural problems intractable (Federal/Provincial balance of power).
- Makic in London at moment.
  - Rescheduling probably inevitable in due course, but they are determined to avoid it. Better for us that it be postponed till satisfactory Mexican recovery plan is seen to be in place.
  - Request to BIS for long-term help. Inappropriate. November meeting will consider what can be done short-term. Probably need government guarantee: not bankable on economic grounds.

1 October 1982

ADL

ADL

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