

CONFIDENTIAL

PRIME MINISTER

BRAZIL

You are holding a meeting tomorrow on Brazil. This arises out of the Foreign Secretary's letter, Flag A, which argued that the Brazil package was in danger of breaking down and that a further UK contribution might be needed.

Mr. Tebbit has written at Flag B, arguing for a small increase in export credit on trade grounds.

The Chancellor has written at Flag C, arguing that

- 1) FCO fears are overdone - both on IMF and commercial bank channels progress is being made;
- 2) pressure for further UK Government involvement is being successfully resisted;
- 3) the trade case for more export credits is weak.

Also relevant is the background note at Flag D.

Attendance will be:

Chancellor
Mr. Middleton
Mr. Unwin

Secretary of State for Trade
and Industry
Mr. Titchener

Foreign Secretary
Mr. Appleyard

Governor
Mr. Blunden

AT

15 November 1983

International debt file

WHY THE U.S. SHOULDN'T FILL THE IMF'S TILL

■ Legislation increasing the U.S. contribution to the International Monetary Fund has stalled in Congress. Even if the Reagan Administration starts pushing it enthusiastically, the measure's opponents may win, and get a chance to test their contention that subsidizing the Third World is not necessary to avoid global calamity.

The task the IMF is now offering to perform is completely different from the one for which it was created. The Fund was set up at the Bretton Woods conference in 1944 for a world of fixed exchange rates, and its purpose was to lend short-term funds to countries in temporary difficulty so that they could stabilize their currencies. When fixed rates were replaced by floating rates in the early 1970s, the IMF was deprived of its essential function.

But as Milton Friedman observed in a statement to Congress opposing the bill, "International bureaucratic organizations neither die nor fade away." The IMF went marching on, partly as a foreign aid agency offering three- to five-year loans, and partly as a sort of incipient world central bank, involving itself in international unpleasantnesses caused by countries unable or unwilling to pay off their debts. Its new role

has been a source of comfort to commercial bankers on the hook for loans to those countries. In the process, the IMF has grown steadily. Its lending has increased 35% more than world exports have between 1970 and 1982. IMF officials have constantly pressed for more

money. In the current round of requests for capital contributions from member states, the U.S. is to kick in about 20% of the total, some 6% of it in cash and the remainder as a letter of credit.

CONGRESS HAS LONG been underwhelmed by the idea of giving what works out at around \$8.4 billion to an international agency when the U.S. was running huge budget deficits. But it got downright balky when the grass roots came alive with last-minute protest activated by an unlikely but effective coalition of pressure groups, spanning the spectrum from goldbugs to environmentalists. In the end, authorization was approved by both Senate and House (narrowly). But the two versions of the bill differed radically, and no effort has yet been made to reconcile them. And new complications have appeared, including a proliferation of amendments mostly promoting political causes or harassing the banks. One unkindly directs that the salaries of the IMF's 1,500 Washington employees be limited to \$67,200, which about a fifth of them currently exceed.

The Reagan Administration was initially cool to an IMF quota increase. But the threatened Mexican default last year and subsequent alarms about the "debt bomb" apparently changed its mind. The numbers looked

impressive. In mid-1982 the total capital of U.S. banks was an estimated \$66.2 billion. Their loans to non-OPEC developing countries, including the Eastern bloc, were \$108 billion. The nine largest U.S. banks were disproportionately represented: their exposure amounted to 235% of their capital. Only a beefed-up IMF, its supporters argued, could extend cheap emergency credit, coordinate international action, and generally guard against a country's default blowing a hole in the banking system and precipitating a 1930s-type collapse of international trade.

"It's been labeled a bank bailout bill," American Express Chairman James D. Robinson III says. "The small town politician or bank in Maine says, 'It serves those bastards right.' I'd like to ask how many able-bodied men between the ages of 18 and 24 they have in their community and what size boots they wear. I'd tell them to get ready to go to Latin America, because you let some of those governments go populist and you're going to have national security problems."

It is hard to shrug off what might happen if debtors defaulted on loans that represented a substantial portion of the lending institutions' capital. But opponents of the IMF quota increase point out that not much attention has been paid to the many possible solutions that lie between unequivocal sup-



PH. TAYLOR

port for the IMF and world financial collapse.

For one thing, it's by no means clear that the IMF needs the U.S. contribution. Its unique role in dealing with troubled debtor nations is to serve as the "bad cop," imposing strict economic policy conditions that will reassure other lenders that the borrower will behave responsibly in the future. This imprimatur could be backed with a token loan or, conceivably, nothing at all. What the borrowers want is the IMF seal of approval that will reopen their lines of credit with the commercial banks. And that's where the major lending role belongs.

But the IMF may not be needed to stave off financial crisis at all. One articulate advocate of this thesis is Sir Alan Walters, an academic economist and adviser to British Prime Minister Margaret Thatcher (who like Reagan is officially committed to the quota increase). Walters, now Resident Scholar at the American Enterprise Institute in Washington, D.C., insists he's in fa-

vor of U.S. support for the current bill—as Thatcher's economic adviser, he could hardly do otherwise. Radical changes, he says, should come slowly so as not to unsettle financial markets.

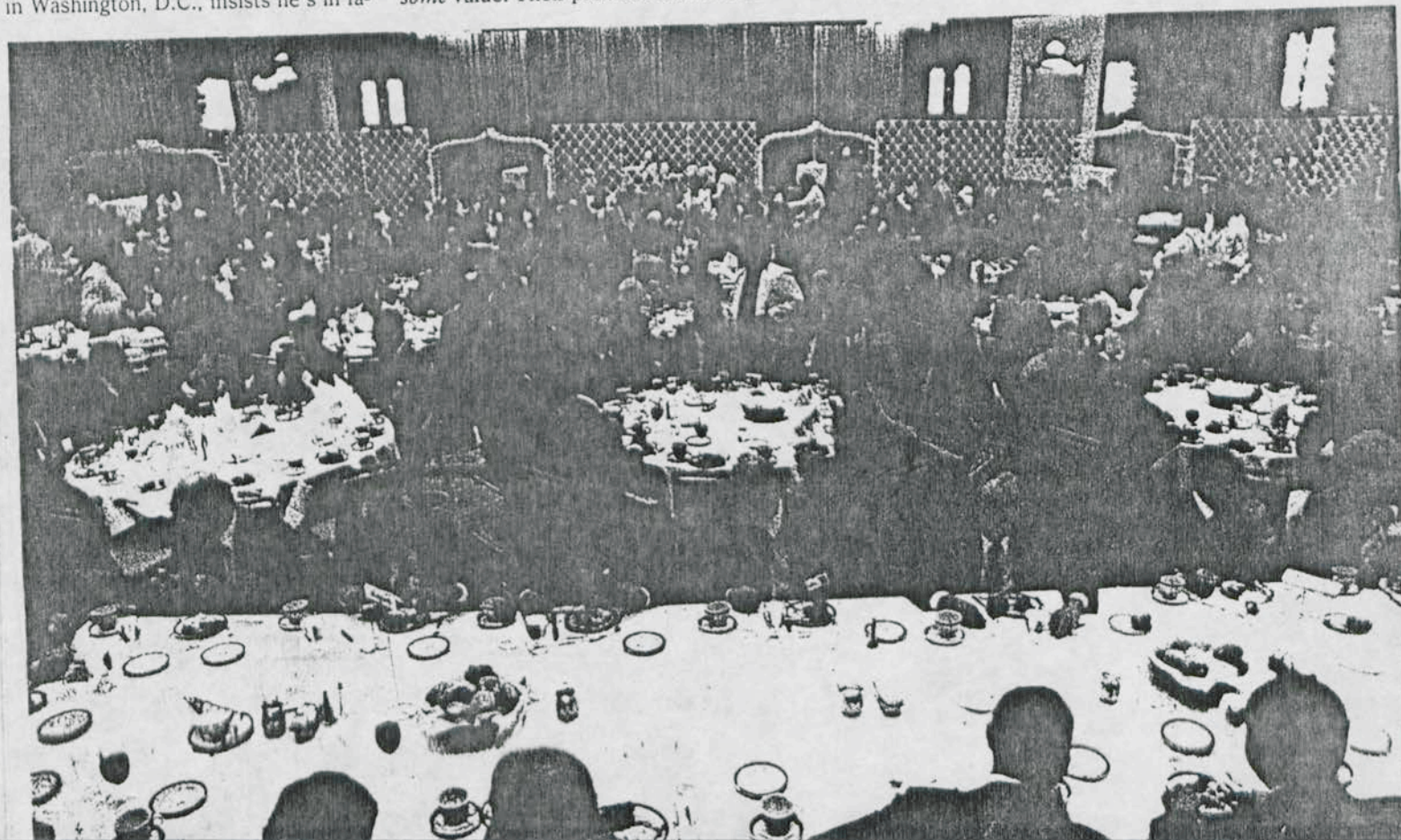
Nonetheless, he believes that if the IMF doesn't get its funding, the commercial banks can handle the problem loans largely on their own—with some pain, to be sure, but without critical damage to the financial system. The banks can begin, as he puts it, by "telling the truth" and writing down their problem loans to their true economic value, as normal banking practice would dictate.

WHAT MAKES THIS possible, Walters says, is that the write-downs would not be anywhere near as large as IMF supporters think. Much of the Third World's debt, he points out, is quite solid. Countries like Malaysia are perfectly sound. Even loans to notorious basket cases have some value. Their problem is almost al-

ways illiquidity, a shortage of cash, rather than bankruptcy. Mexico, for example, could easily pay off its borrowings by selling or leasing its natural resources to foreigners, and would benefit from more efficient production into the bargain. While Mexican political leaders will doubtless resist submitting to this indignity, the financial markets' view of the country's situation appears surprisingly calm. Mexican government bonds with a 16½% coupon recently traded in London at 96½% of face value. The discount on them has narrowed appreciably, and even at the height of the crisis it was never more than 20%.

Other signs support Walters' non-explosive view of the debt bomb. A secondary market in foreign bank loans has been quietly operating for some time in London—Walters calls it a "covert market." It has now grown to the point where the need for a Reuters screen displaying prices is being seriously debated, a sure sign of a market both maturing and coming out of

Debtor nations wined and dined bankers and IMF officials at the agency's annual meeting in September. This lunch was sponsored by Brasilinvest, a large Brazilian bank.



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the closet. Latin American loans now trade at 75% to 87% of face value.

The secondary market would provide an outlet for written-down loans, says Walters, and it should be developed accordingly. By selling the loans off at whatever discount was necessary, the banks would recover at least some of their money. Those new owners, in turn, could take a lot lower payout from the borrowing countries and still make a profit.

Walters does not think the costs to the banks would be unbearable. For example, the nine largest U.S. banks have shareholders' equity of \$24.5 billion and loans of \$31.4 billion to Mexico, Brazil, and Argentina. They might have to write those loans down some 25%, which would be equivalent to a loss of \$7.9 billion. That wouldn't do much for their shareholders, of course, but the resources are there to pay if the writeoffs are taken over time: their dividends last year came to more than \$1 billion.

ONE PROBLEM IS THAT THE Internal Revenue Service recently reduced the percentage of loan loss reserves that are tax deductible. In West Germany, by contrast, banks have been actively building up reserves against their bad loans to Eastern Europe, and the government has recently encouraged them by granting tax-deductible status to their reserves against loans to Poland, one of their biggest debtors. (Previously, such loans to sovereign states weren't deductible.)

If any bank was particularly hard hit, it could be merged with another. If a country abruptly defaulted, the whole panoply of provisions against panic would come into effect as with any domestic bank failure, including deposit insurance and the ability of the Federal Reserve to pump liquidity into the system. The existence of national central banks precludes the need for an international one.

Advocates of the increased IMF contribution have argued that its cost will only be \$200 million a year, the estimated average annual cost to the Treasury of the difference between its cost of borrowing and the interest it will get from the IMF. Opponents counter that these interest costs are only the tip of the iceberg; the true economic impact is the appropriation of some \$8.4 million worth of re-

sources from the U.S. economy. Beyond this, the economic consequences of both plans depend on events and are hard to quantify.

On the whole, the world might be better off without the IMF. As of now, argues Carnegie-Mellon University economist Allan Meltzer, the agency is the perpetrator of an "international Ponzi scheme" whereby U.S. banks keep bad loans on their books at face value, lend more money so that their debtors can meet interest payments, rely on the IMF's injecting funds into debtors to assist the process, and paradoxically end up showing increased earnings despite the deteriorating quality of their loan portfolios. Indeed, the critics maintain that by encouraging the banks' belief in ultimate bailout, the IMF inspired reckless loan policies in the first place.

Even the bankers who so ardently support the IMF and the quota increase should be having second thoughts; their cozy relationship with it may be entering a less cozy phase. The IMF has begun to assume the power, for example in this year's Brazil bailout, to direct the creditor banks to lend yet more money as part of any settlement—"bailing the banks in deeper," as Administration defenders of the quota increase have been proclaiming. Says former Reagan Treasury official Paul Craig Roberts, now at Georgetown University's Center for Strategic and International Studies: "This amounts to the political allocation of credit." He argues that the IMF itself is going to lose control to politicians in the debtor nations, who will realize its decisions are political rather than economic and can be affected by the specter of default. "The banks' friends," says Roberts, "are putting them over a barrel." Brazil's refusal in late October to accept the IMF's wage-limiting proposal suggests the shift of power has already begun.

■ The fundamental assumption underlying the IMF is that free markets can be improved by enlightened intervention. At the time of Bretton Woods this assumption dominated virtually every aspect of economic policy. Now international economics is one of its few unchallenged refuges. Yet relatively more money was lent and invested across borders before 1914 than today. With no IMF to save it, the system absorbed defaults regularly. □