Prime Minister (2)
To be aware of these developments
AT 10/5

CHANCELLOR

FROM: J.G.LITTLER
DATE: 10 MAY, 1984

cc Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr.Unwin
Mr.Battishill
Mr.Lavelle
Mr.Mountfield
Mr.Bottrill
Mr.Kelly

NEW YORK MEETING OF BANKERS

There has been a good deal of (mainly misleading) publicity of a meeting held during the last few days by the New York FED, which was attended by a number of central bank representatives (including the Deputy Governor, Mr.Loehnis and Mr. Cooke from the Bank of England), by representatives of a couple of major United States commercial banks and, for part of the time, by the IMF Managing Director and an IBRD representative.

2. Mr.Loehnis has promised me a fuller account by tomorrow, but has given me orally the following summary.

3. From the outset the meeting was designed, and was carried through, on the basis of general talk about current problems, and not on the basis of seeking early decisions. No Finance Ministry representatives were involved, and the meeting was not discussing ways of bringing in Government support.

4. Discussion focussed heavily on problems of management of the maturities and interest costs of commercial debt. Two ideas or families of ideas were particularly favoured:-

(a) Rescheduling: there was a broad measure of agreement that very short-term rescheduling could not go on and that efforts should be made to induce commercial banks to think in terms of multi-year rescheduling to achieve better overall maturity profiles.

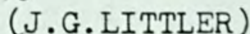
(b) Interest rates: everybody was expressing concern about already high, and possibly even higher dollar interest rates, and there was a widespread disposition to look for ways of "capping". Outright capitalisation of interest was unpopular, but there was much discussion of varieties of schemes to defer some "top slice" or "excess element" - however defined - in the total nominal interest rate. One idea which attracted

a good deal of interest was something akin to the British mortgage arrangements under which standard payments are made by the debtor, with the proportion of capital and interest varying in response to interest rate changes.

5. No specific follow-up action has been agreed. The participants will continue to think over these ideas, and individual central banks are likely to discuss them with their own commercial banks. Mr. Loehnis believes - and thinks that others take the same view - that what is needed is an initiative arising from the commercial banks themselves. But encouragement may be needed from central banks and - as we have seen elsewhere - American supervision requirements have a rigidity which could stand in the way of some sensible ideas and action on the part of the US authorities on this front might be needed.

6. On the face of it, I think this sounds to have been a sensible discussion. I had the opportunity of a talk yesterday with Sir Alan Walters to go over some possibilities in this field. We agreed that moves by commercial banks themselves to limit or ease the burdens of excessively high interest rates could be welcomed (a step on the road to recognition by the banks that they cannot go on expecting full value on all parts of their balance-sheets). But he agreed strongly with my view that we should resist any proposals by commercial banks to seek compensation or guarantees from central banks, governments, or international institutions.

7. In view of the publicity which the meeting aroused, it is possible you might face a question in Parliament this afternoon. I attach a short note.



(J.G.LITTLER)

Q. Recent meeting of bankers in New York.

A. Understand this was a private meeting of bankers, mainly central bank representatives, to exchange ideas about international commercial debt problems.

I welcome such discussions, which understandably focussed on the unwelcome impact on these problems of rising dollar interest rates.

Notes for Supplementaries

1. Governments were not represented at the meeting.

2. Governments are playing a full part in tackling the management of international debt problems - through the International Monetary Fund and through rescheduling of official and officially-guaranteed debt.

3. I see no case for Government financial support to relieve commercial banking debt.

u.s. file

Fact and Comment II

By M.S. Forbes Jr., Deputy Editor-in-Chief

THE NEW ECONOMIC MIRACLE?

LONDON—No one could have conceived of this question a few years ago: Is Britain becoming the economic powerhouse of Western Europe, if not of the industrial world?

Last year the United Kingdom's growth rate exceeded everyone else's. When adjustments and revisions are made, Britain will have outperformed not only our European partners, but the U.S. and Japan as well. Since the late 1970s, Britain's income per capita growth has topped the industrial rankings. Productivity has grown phenomenally. Inflation remains low. New business starts are at a record.

The brilliant new Chancellor of the Exchequer, Nigel Lawson, could, with a bit of courage and imagination, become the 20th-century Gladstone. His first budget was bold, at least by British standards. Recognizing the importance of services, he is phasing out the overly generous incentives to buy new plant and equipment, and instead is cutting the corporate income tax from 52% to 35% over a four-year period. He removed a 15% surcharge on investment income, reduced capital transfer taxes and eliminated a payroll tax surcharge, which was a job destroyer.

The reaction to the Chancellor's budget: The stock market boomed and interest rates fell. For the first time in decades, long-term U.K. interest rates in 1983 fell below those of the U.S. The gap is widening in 1984.

Not that all is milk and honey. Unemployment remains appallingly high (over 12%), though it is better than that of most Western European countries. Britain's performance is relative. Fifteen years ago the U.K.'s current growth rate would have been regarded as pitiful. Thanks to the recession, government spending as a percentage of GNP has grown sharply. Many government bureaucracies, especially health services, remain bloated.

Much remains to be done. Nigel Lawson must make the major moves. He should significantly reduce the rates of Britain's personal income tax, which are far too high. The capital gains tax, currently 30%, must also be cut substantially.

With changes like that, Britain's performance will truly be outstanding.

THERE'S A WAY

for the U.S. to save several billion dollars a year in servicing the national debt. Current outlays for interest now come to more than $120 billion a year. The method: indexing government bonds, both for principal and interest.

The British under Mrs. Thatcher have done this for three years, and the system has worked well. Most new government bonds issued in the sceptered isle are indexed.

Historically, the "real" interest rate on government debt has been 2 1/2% to 4%. Thanks to investor uncertainty about inflation, real long-term interest rates are abnormally high, both here and in the U.K.

For instance, though inflation is rising at a 3%-to-5% rate (depending upon which measure one uses), the U.S. Treasury's new 20-year bond issue has a coupon of 12⅜%.

These high rates cost Washington plenty. Wouldn't it be nice if the interest coupon could be, say, 3%? In Britain, that's what the government pays on new bond issues.

With indexing, investors know their income and principal are protected. They don't need a stiff premium in interest rates to cover fears about inflation. (In the U.K. the extra income is taxed; the additional principal is not).

Even though the bond's principal is indexed to keep up with deflation, the government could save a bundle if it holds inflation down. Alan Walters, formerly Prime Minister Thatcher's economic adviser and now a professor of economics at Johns Hopkins University, points out in a paper for the American Free Enterprise Institute that a five-year indexed debt instrument could save the government more than $200 in overall outlays for each $1,000 bond. Longer term, the savings could be even greater.

The arguments against indexing government bonds—such as hurting the market for securities from the private sector—have been refuted by Britain's experience.

The U.K. has shown the way on this. Too bad we don't have a Treasury Secretary strong enough to do the same thing on this side of the Atlantic.