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4 June 1984

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C.M.O.
+ to Man
Policy

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.

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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. Schemes which encourage adjustment within the debtor countries themselves

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

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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.

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Continental 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.

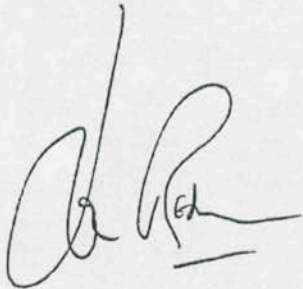
Encourage equity finance of LDCs, asset sales by debtor countries, and a market in debt.

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.

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Make the bank shareholders carry their burden manfully.

A handwritten signature in dark ink, appearing to be 'J. Redwood', with a horizontal line underneath the name.

JOHN REDWOOD

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