

PRIME MINISTER

② Agree to raise with Chancellor at next bilateral?

AT
27/11

A BANKING CRISIS IN THE UNITED STATES

The balance sheets of US banks, particularly the Money Centre Banks, are in a parlous state and cannot be quickly recapitalised (especially at P/E ratios of 4 to 6!). If I am correct in the judgement that the United States is entering a slowdown to stagnation or worse in 1985, then the loan portfolios will deteriorate markedly. (Recall that Continental Illinois went bust in one of the most vigorous expansions in post war history!)

e/

It would be wise for the Bank to prepare contingency plans for the event of perhaps three or four big (MCB) failures and the consequential Fed-FDIC reaction. One needs to know the amount of exposure of our banks and corporations, the effects of the Fed selling Treasuries to finance deposit-support, the likely widening of spreads in the "flight to quality" and so on.

The Bank may protest that such a scenario is quite "unthinkable". But that is why we must think it out and take whatever preventative measures seem prudent. I have already spoken to Sir Peter Middleton about my fears and have made similar suggestions. I think it would be best to make it clear to the Chancellor that such failures should be viewed as alarming but by no means impossible contingencies, and that we should do what we can to avoid the fallout.

I must have more
time with Alan to discuss
this.

not

AW

ALAN WALTERS
27 November 1984

US file.

Extract for L A Walter Book

-35-

almost 80% from 1981.1 to 1983.4, in gross trading profits for non-North-Sea corporations - a real increase of around 50 percent. And in March 1984 corporate profits had increased 25 percent over March 1983.^{1/} The CBI 1984 forecast was for a net pretax rate of return of non North Sea industrial and commercial corporations of 8.5 percent compared with less than 4 percent in 1981. These data are evidence of a strong increase in aggregate demand from 1981 to 1983. It was increasingly profitable to produce more goods and services - but, alas, not to employ more labour. The number of jobs fell, from 1981 to 1984, and the rate of unemployment increased and remained high and is widely expected to stay at around 3 million for some time.^{2/}

Additional plausibility for this wage-cost explanation of high

^{1/} See Hansard 12th July 1984 Chancellor's Question Time.

^{2/} This is a stark contrast to the United States where, from the end of 1982 onwards there has been a sharp recovery of profits, similar to that in the UK, but also a very large reduction in the rate of unemployment. Many observers of a Keynesian persuasion have attributed this recovery to the striking increases in the federal deficit. But these increases in the deficit began in mid 1979 to mid 1980 - over which the deficit increased about \$70 bn - and again another increase in almost \$60 bn at the end of 1980 through to 1982.2. The increase in the deficit from 1979 to mid 1981 was about \$100 bn. Yet there was a sharp contraction in 1981-2 - gross investment fell precipitously from mid 1981 to the end of 1982 and unemployment rose to nearly 11 percent. The addition to the deficit of another \$70 to \$80 m in the last half of 1982 was thought by Keynesians to be the cause of the great recovery from December 1982 or January 1983 onward. If the 1982 increase in the deficit were the stimulant of the economy in 1983 why did the \$100 bn not work its wonders in 1981-2 rather than lead to the down turn to one of the deepest slumps of the post war years? On the other hand, monetarists such as Professor Karl Brunner correctly predicted the recovery on the basis of the sharp expansion in M_1 and M_0 which began in mid 1982 and persisted through the middle of 1983.