86 Eaton Square, London SW1

PERSONAL

4th August, 1982.

Dear Prime Minister,

Before the last Summit I was asked, by a friend connected with the State Department, to prepare a note for Alexander Haig on the international monetary situation. I sent your people a copy of this. I was very glad to see that the Summit set up Study Groups but the area of study ought, in my view, urgently to be enlarged to include the growing banking crisis. I have now been asked to prepare a note on this, too, for George Shultz.

I hesitate to add to your many burdens but if you would read this note you will see why I regard this matter as being so centrally important and a threat to all our hopes of economic recovery. I have been raising this issue continually for the last 7 years with our government and with others and with the bankers. Many of the last are now, in private, belatedly agreeing with me, but they seem to have passed from complacency to defeatism. There are no grounds for either. I believe that if you felt able to lend your weight to the principle of urgent and systematic action, you will have a wide response.

Yours,

Harold

Encl.

DEFICIT FINANCE - BANKERS AND GOVERNMENTS

DIAGNOSIS

This note focuses on the failure of the Western nations to respond adequately to the financial and banking implications of the OPEC cartel.

The artificially high price of oil after 1973 produced enormous current account surpluses for many of the OPEC countries. These surpluses had their mirror image in the deficits of the oil consuming countries, many of the weaker of whom seem likely to remain in chronic or semi-chronic deficit because of their difficulties in raising the relative price or volume of their exports. The governments of the leading countries, motivated by economic, political and moral considerations, recognised that finance would have to be found for these weaker countries for an extended period. But it was not possible, within the existing philosophy and budgetary mechanics, for these governments to provide directly anything like the amount of finance needed. They turned instead to the softer option of encouraging their private bankers to recycle to the weaker countries the vast deposits from the OPEC surplus. The private bankers were not slow to respond.

It would have been virtually impossible for the banks to undertake this novel, enormous and continuing recycling operation within the constraints of the domestic banking regulations of their respective countries. There was, however, an agency ready to hand - the Eurodollar market. This had come into being mainly to escape tax complications and such regulations on bank lending as existed prior to OPEC. Thus, a vast recycling operation proceeded apace after 1974 and in large part through the Eurodollar market. All the great banks of all the great countries were drawn in. Funds flowed plentifully to virtually all the State borrowers in South America, Africa, Asia and even to the Soviet Bloc. Many of the countries who drank from this pool did so not merely to finance their deficits but also to add to their reserves.

A "solution" having been found to the problem of deficit financing, the leaders of the West appeared to feel that they were largely exempt from the need for any further action; they preferred to ignore the fundamental weaknesses of these arrangements. These may be summarised:-

1. The lending effectively under-wrote OPEC's monopoly price and provided the means whereby many of the poorer customers of OPEC could continue to pay whatever price OPEC felt able to exact.

2. There was no decision by governments or central banks on the volume or direction of the recycling, which were left to the reflexes of the private banking system. As a result, no decision was taken as to the total amount of resources that should be channelled through the Western banking system, nor as to how that vast sum should be apportioned between the borrowing countries. Neither was there any real attempt to impose on the lending any conditions which would reflect the legitimate political and economic

interests of the governments of the West. The irony is that as borrowers have successively come under pressure to meet their obligations, the West has falsely been charged with neo-imperialism whereas in fact, a vast, unprotected and largely unconditional transfer of resources has taken place.

3. The economies of many of the borrowing countries were such that only by further borrowing for an indefinite period could they meet their interest and repayment obligations. Neither the leading governments nor the private bankers seriously considered whether the borrowing by these largely impoverished nations could be treated as a purely commercial operation. The inevitable ballooning of the debt, from each year's deficits and accrued interest, was, during the early years, somewhat mitigated by the fact that interest rates were low or even negative in real terms. But the problem has more recently been sharply aggravated by the move into very high real interest rates.

These factors produced a dynamic of increasing incredibility built into the system - a built-in self-destruction of vulnerable arrangements which must ultimately threaten the flow of funds, the demand in world trade which they finance, the political and economic stability of the fragile borrowers and the banking system itself.

There are two further points to note. First, this massive use of the Eurodollar markets by sovereign borrowers developed at a time when corporate borrowers were also very greatly extending their use of them.

Broadly, the multinationals have borrowed on a scale roughly comparable to that of the sovereign borrowers. The over-optimism that infected the market with respect to the latter seems also to have spilled over to the former. The result is that many of the loans to large corporate borrowers are as shaky as those to the sovereign borrowers, and the banks now have two major classes of non-performing assets. Secondly, to make matters worse, the combination of recession, high interest rates and a long period of inflation has driven business and industry within the advanced countries themselves to rely ever more heavily on their domestic banking systems for finance. The banking system as a whole, therefore, is at all points heavily exposed to a unique degree.

We must note, too, that the growth in the Eurodollar market has serious financial implications for the economies of all countries and for their parities. The prudential control and regulation of this enormous market has, by normal banking standards, always been inadequate. The market has been fed by OPEC surpluses but has also attracted surplus cash from the banks in the advanced countries themselves; in addition, the liquidity resources of many multinationals and even of some central banks were added to the total. We have thus allowed to develop a vast and unregulated cash mountain, restlessly moving between currencies to become a major source of parity instability. Moreover, these fund movements jeopardise any attempt within any one country to maintain monetary control.

THE PRESENT FRAGILITY

We have in being a system of deficit financing extremely vulnerable to economic and political spasms and dependent on a high level of technical financial expertise in countries where neither that nor political stability is usual. Criticisms of the fundamental long-term incredibility of this system of lending were, for a number of years, brushed aside by the governments and the bankers themselves. But reality is brutally breaking through. The ballooning debt of countries with only a fragile prospect of ever making repayment has now reached hundreds of billions of dollars. Numerous small defaults have been followed by larger ones, and others, even larger, threaten. Nearly all of the great banks in the Western banking system are heavily over-exposed. The assets against which they have lent their depositors' money are increasingly called into question. Actual default has so far largely been covered over, and formal default avoided, since the latter would have manifestly devalued the bankers' assets in their balance sheets. "Rescheduling" amounts to little more than exchanging a basically incredible promise to pay which has in fact been defaulted for another basically incredible promise to pay at a later date. This process is breaking down. The sheer mechanical problems, complex in the extreme, of hundreds of banks agreeing to roll over past obligations are becoming overwhelming. More important, the larger the scale of these operations the less their effectiveness and credibility. The distinction between actual and formal default is increasingly losing its value in the eyes of auditors and depositors. Moreover, the inducement to the bankrupt borrowers to co-operate is the prospect of new money - this is increasingly difficult to achieve, even under government pressure. The banking system has become hostage to its impoverished debtors.

We now seem to be at the beginning of a period of maximum anxiety for the banks, and individual banks are already experiencing considerable pressure. First, interest payments and repayments of principal have been missed on a substantial scale, leading to a growing cash flow problem for the banks. Secondly, the nervousness of certain depositors is already in evidence. Central banks, who should never have been depositors in the first place, and some multinationals and other investors are withdrawing their deposits on a big scale. Thirdly, the pattern of balance of payments surpluses and deficits is beginning to shift. OPEC surpluses have recently been eroded and some OPEC countries are drawing down deposits to finance their deficits. Unhappily, there is no assurance that the recipients of these funds are depositing them in the same way as these OPEC countries did. Of course, the funds remain somewhere in the banking or central banking system; but a serious problem of mismatch is sure to develop. The banks are thus imminently facing a highly dangerous combination of deposit withdrawals and non-performing assets. The credit markets' reaction is clearly illustrated in the loss by all the major US banks (save Morgan Guaranty) of their triple-A bond rating - a sensational development which has not received the attention it deserves.

AN OUTLINE OF THE REMEDIES

The twin central problems which now face us are

(1) How to cope with the threat that the past lending represents to the financial stability of our banks and of the borrowers?

(2) How to ensure a sustained flow of lending in the future? If this is not achieved, a considerable percentage of the advanced countries' exports would vanish as the finance for them is reduced. This is to say nothing of the damage caused to the politics and economics of the borrowers and ultimately the danger to the banking system itself with multiplier effects throughout the world's economy. The political consequences for the advanced countries need no emphasis.

The governments of the world must now accept some responsibility for past lending and must undertake the necessary supportive action to ensure an adequate future flow. They encouraged the banking system to undertake this lending while guaranteeing only a small proportion of it. Indeed, they often brought pressure on the banks in pursuit of what were basically the political and economic purposes of governments. They must now accept some responsibility in order to protect both these purposes and the banking system.

Ideally, the governments of the leading countries would agree on joint action to protect the world's banking system by setting up an International

Bank both to regulate international finance and to act as lender of last resort. However, we cannot wait for this highly desirable development in order to handle the present dangers. We must at once move to ensure that each central bank acts to support its own private banks by protecting their liquidity situation in the event of defaults or postponements in payment by sovereign borrowers on existing debts. This can be done in a variety of ways. Where such lending has been normal and broadly prudent (so far as that term can be justly used in relation to a wildly imprudent system) each central bank could, for example, offer to discount where necessary the paper of the lending banks and to roll-over interest and repayment to match any defaults or delays by the borrowers. Alternatively, the central bank could buy assets guaranteed by the private banks. The central bank in question would accept delays of interest and repayments subject to a commitment whereby the banks wrote down, as required out of their profits and over a long period, the loans on which there had been default or where payment had been delayed. The banks would be making continuous repayment to the central banks out of their profits as well as out of any funds accruing from their defaulting debtors. Some such arrangement would protect the banking system while exculpating governments from the charge that they were themselves meeting the costs of the banks' misjudgements. It would, in effect, sustain our banks by enabling them to extend the period required to write down their questionable loans without calling their liquidity or solvency into question. The alternative of an enforced abrupt write down would have calamitous consequences. It is in our interests as well as those of the banks to make arrangements which give them time to pay for their own errors and avoid the backlash on us all.

It would be quite inadequate for some arrangement like the above to be carried out by individual central banks acting in isolation from one another. When the difficulties materialise, the central banks must be acting in harmony and be clearly seen to be so acting. There are two reasons for this. First, if the private banks of one or two countries are called into question there are very likely to be massive movements across the foreign exchanges as depositors seek areas of greater safety. This process has already started and parities have already been distorted. Collective arrangements for avoiding further gyrations and distortions in parities must be achieved before the process gets out of hand. This work should be co-ordinated with the Study Groups set up at the last Summit. Secondly, and even more importantly, we must at all costs head off any further widespread withdrawal of funds from the banking system in favour of government obligations, which will certainly take place if bank defaults start and if joint action by governments is not visible. Though individual central banks are to retain responsibility for the banks in their own countries, that responsibility should be in relation to a wider collective plan.

So far as future lending is concerned, governments and central banks must bring into being a systematic and sustainable system. A bare outline of how this might be done is as follows. A committee of central banks, in collaboration with their governments could prepare a periodic outline of the total volume of liquidity recycling or bank lending which is likely to be needed. This overall sum would then have to be apportioned between the prospective borrowing countries. Lending banks would be required to register their proposed loans with the committee, and if there is delay or default by the borrower, the central banks would stand ready to cover the liquidity and solvency problems of the banks broadly on the lines I have outlined in respect of past lending. The lending banks would, as part of their relationship with the central banks committee, be required to submit consolidated balance sheets so as to bring the overall Eurodollar lending under central bank supervision. These arrangements would, of course, have to be operated flexibly. But if international lending is to continue on an appropriate scale, other action will be required by governments. For example, it will be necessary for the IMF and other international institutions to develop a more prominent, coherent and predictable supportive role.

This is a bare outline of my proposals and I will be happy to discuss them more fully if required. In the past, the world's leaders, their finance ministers and the central banks have reacted only to crisis, without even an outline strategy to guide them. To do the same on this occasion would be to make a grievous error. The damage from existing arrangements is already accruing and the costs of delay are rising rapidly. It is imperative that we now organise this outline strategy and find effective agencies for implementing it. In my view the alternative will be a series of crises of the gravest kind.

SUMMARY

The banking system of the western world is now heavily and dangerously overextended. If its lending abruptly contracts there will be an avalanche of large-scale defaults world-wide which will inflict extreme damage on world trade and on the political and economic stability of the borrowing and lending countries. It was broadly right and necessary for the Western countries to mobilise their private banks in support of global political and economic interests. It was in the highest degree dangerous that governments failed collectively to accept the commitments and responsibilities which would have both supported and disciplined the activities of the banks.

The problems I have discussed are an important part of our central problem, namely, that in a world which has become increasingly interdependent we lack agencies capable of thinking about the system as a whole and of organising collective action to defend our global interests.

Harold Lever

3rd August, 1982.