Mr. Scholar PA 2
Econ Pol

LORD ROTHSCHILD

Telephone: 01-626 4356

Telex: 888031

N.M.Rothschild & Sons Ltd.
New Court
St. Swithin's Lane
London EC4P 4DU

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Dear ~~John~~ Robin,

(1) When the Prime Minister saw me a little while ago, she asked me some questions about the international banking scene and made some comments on it.

(2) I feel sure that the Prime Minister has seen Harold Lever's memorandum on this subject. I showed it to two people here whom I think have top class brains, both in general and at finance in particular. It occurred to me that the Prime Minister might like to see their reactions to Harold Lever's memorandum - neither of them knew he was the author but one correctly guessed he was - and their views are enclosed. You may not think them of sufficient interest for the Prime Minister to see and, if that is your view, just put them in the wastepaper basket.

Yours
Victor

ECONOMIC POLICY : INDEBTEDNESS.

Deficit Finance - Bankers and Governments

In general I agree that the present state of international banks and their exposure to bad risks gives considerable cause for concern and the paper communicates this lucidly.

My reservations centre upon the analysis of the origins of the problem and to a lesser extent on the proposed solution.

The paper attributes the blame mainly to the OPEC surpluses and recycling to poorer countries unable to pay for their oil imports without recourse to the Euromarkets. This does not, however, explain why Mexico & Nigeria are two of the larger and more worrying problem territories whose debts have grown mainly because they are oil exporters whose credit was thought to be good. Nor does the argument that the oil recycling spilled over into lending to larger corporations which are now suspect take us that far.

I would suggest that the problem has some of its origins in the aggressive loan marketing policies of a variety of private sector banks, often led by or influenced by American business policies. These bankers built their operations around highly paid sales teams whose task was to lend more money. In their search for suitable borrowers large corporations, energy projectors and rapidly expanding highly populated oil producing states all seemed reasonable collateral and all needed substantial funds.

The 1981- recession has changed the bankers' perceptions of the security afforded by many of these large companies and energy projects. The weak oil price has made many energy projects approved in the inflationary days of 1980 look unwise. The lower level of world demand has highlighted both the massive structural changes underway in the industrial economy and the competitive inventiveness of the peoples of the Far East basin. This has weakened many large western corporations. Finally it has exposed the dangers of the Nigerian and Mexican dash for growth. All this has coincided with major production difficulties within the Comecon bloc which has borrowed heavily from the west and with the difficulties amongst Ldcs mentioned in the paper.

If you accept this somewhat broader perspective of the crisis the remedies needed are also complex. The problem is in part one of confidence. Most banks are technically bankrupt all the time. This normally does not matter as the bulk of depositors have confidence or new depositors replace those withdrawing funds. We are now approaching a position where banks could experience damaging withdrawals of funds.

To ward this off I agree it may be necessary not only for each Central Bank to act as lender of last resort and to provide the essential short term liquidity, but also for there to be a risk exposure plan for each bank to gradually reduce its involvement with dangerous types of lending. Sovereign risk in many ways seems the easiest to handle. Rescheduling has to take place on terms which entail the IMF dealing with the problem on behalf of the lenders. For those companies badly affected by structural change each central bank will have to conduct its own lifeboat operation making a judicious use of asset sales, capacity reductions and bankruptcies. The U.K. clearers are currently doing this well with our major industrial casualties.

The problem will be exacerbated if the pressures on trading nations leads to a substantial tariff war and a further decline in international trade and activity through protectionism. It will be important to avoid such a trend by renewing efforts in GATT talks.

International agreement would help and I believe work has already been done to achieve it, including plans for dealing with a Euromarket led collapse. Further pressure behind the scenes for such action cannot hurt. Further public discussion could of course adversely affect confidence to the detriment of the system.

Subject Deficit Finance - Bankers and Governments

Thank you for the paper on the above. It is particularly clearly (almost glibly) written. It looks like one of Harold Lever's pieces.

You asked if I saw anything wrong in it. There are a number of minor flaws which I won't comment on. However, the two main flaws are, in my view:-

1) The author is essentially suggesting that the major central banks (i.e. governments, the tax payer) lend money to the private sector banks. This is either to replace deposits which they are losing or to replace liquidity (funds) which they have lost because three month loans e.g. to Mexico have (will) become ten year loans.

   Where will the governments get that money from? They will borrow it. The flaw is that the author does not relate the banking crisis, and his solution, to the inflationary impact of his solution on the world.

2) In the past it has rarely been possible to restore lenders' confidence in a bank or in a country once that confidence has gone (e.g. 1974 fringe bank problems in the UK). As the author

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points out, borrowing by countries and companies has reached an insupportable level. It is, therefore, almost impossible for Mexico or International Harvester or British Steel (as examples) to support the debt they have incurred. My point here, and this is the second possible flaw, is that it might in the long run be preferable to encourage defaults now. If countries and companies are allowed to painfully exist, if the debt is insupportable, then they will eventually have to default in any case.

It has taken approximately fifty years for bankers to have forgotten the damage caused by excessive lending in the 1920's and 1930's; a fair dose of pain is probably necessary now to prevent a too premature re-occurrence of the disease.