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FILE

SUBJECT

G. M. de Larosiere



10 DOWNING STREET

From the Private Secretary

22 November 1982

Dear John,

Call by Mr de Larosiere

Mr. de Larosiere, the Managing Director of the IMF, called upon the Prime Minister this afternoon. The Chancellor of the Exchequer and Mr. Alan Walters were also present.

The Prime Minister said that she had asked Mr. de Larosiere to come in because she was concerned about the international financial scene. As she saw it, we had a difficult year ahead. Was the Fund programme for Mexico sufficiently rigorous? She had, further, noticed that the amount of Fund money which would be paid to Mexico was small in relation to the due debt, and she wondered whether the commercial banks would follow the Fund and make the sizable large financial commitments which were necessary. She was concerned, too, about the prospects for Argentina, and for Eastern Europe. The situation was full of dangers: there would be secondary effects as countries ran into difficulty, whose impact on the international financial system had not yet been fully appreciated.

Mr. de Larosiere said that time was running out. The immediate task was to sort out Mexico. He agreed that the secondary effects of default and of delayed payments were worrying. The Fund programme for Mexico could certainly not be described as mild. It provided for a reduction in the public sector deficit of 8 percentage points of GDP in one year. He believed that there had been no Fund programme for any country as tough as that before. This objective would be buttressed by a series of tough, specific, policy changes. He was not at liberty to disclose what these were, but the Mexicans had drawn up three scenarios with policy changes which, if implemented, should lead to the required reduction in the public sector deficit. It had been made clear to the Mexicans that if these decisions were not taken there would be no IMF programme. Mr. de Larosiere said that in his view the programme was very harsh indeed, and probably too demanding. For 1983 \$7 billion would, apart from the IMF loans, be needed by Mexico. Of this, some \$2 billion would come from public sources, for example from EXIM; the rest would have to

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- 2 -

from commercial banks, who would thus increase their exposure by some 8 percent. Some 1600 banks were involved. He had had discussions with the banks, and made it clear to them that, if they were to recuperate the interest of some \$12 billion which was due to them in 1983, they would have to make available this further \$5 billion. He would not put this whole package forward to the Fund Board until all these elements were in place.

The Chancellor commented that we were taking action on these international financial problems on a number of fronts: we were keeping up the pressure on the Administration to take corrective fiscal action; we were aiming to tighten up international banking supervision; and we were doing all we could to increase the Fund's resources and bring forward the operative date for the quota increase. The Prime Minister enquired about the Fund borrowing in its own name from the markets. Would this not take up funds which would otherwise be deposited with the banking system? Mr de Larosiere agreed, and said that the Fund were going slow on this at the moment; they were not themselves in the recycling business.

Argentina, Mr de Larosiere said, was a less formidable problem, if only because the sums involved were smaller: only \$3 billion was required, of which some \$2 billion would come back to the banks immediately in payment arrears. Brazil's problems seemed likely to come to the fore next.

There followed some discussion of the US scene. The Prime Minister said that she now had the firm impression that Mr Volker had relaxed monetary policy, mainly because of his worries about US banks. But US fiscal policy was in disarray. Mr de Larosiere said that the Administration would have to make up their minds: the deficit currently projected would not be absorbable without either a fresh bout of inflation, or very high interest rates. The likely 1983 deficit was around \$180 billion. This would absorb nearly 80 per cent of US savings. As he saw it, this made urgent the need for the Chancellor of the Exchequer to secure the chairmanship of the Interim Committee, because the UK was the only country which could have the desired influence on the Administration. He hoped that the Prime Minister would feel able to put these points herself to President Reagan.

The Prime Minister said that the Administration were running, in effect, a Keynesian policy, under the description of "supply-side economics". She had been sympathetic before the Versailles Summit to the case which had been put to her, through Mr Shultz, that expenditure cuts and not tax increases were what was required. But the situation had worsened since then, and she now believed that both were urgently needed. Mr de Larosiere referred to the scope that existed for increasing indirect taxes in the US. Their impact was at present not heavy, and the Administration could do much to alleviate the problems of the international financial system, if it were prepared to increase these taxes.

He reiterated his hope that the Prime Minister would herself put these concerns directly to the President.

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CONFIDENTIAL

- 3 -

I am copying this letter to Brian Fall (Foreign and Commonwealth Office) and Richard Hatfield (Cabinet Office).

You sincerely,

Michael Scholar

John Kerr, Esq.,
HM Treasury