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ALAN WALTERS
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PRIME MINISTER

VISIT OF KARL BRUNNER: 27 APRIL 1983

1. Banks and Debts

Karl's report on banking and debts to the Senate Banking Committee makes two salient points. First, it is the responsibility of central banks and governments to maintain the money supply, and secondly that it is not the job of government to bail out those who own the equity of the banks.

I agree. The real problem however is to find methods of implementing a system that will achieve these objectives.

One of the main obstacles is that banks believe that ultimately the Government (taxpayer) will bail them out. Suggestions already litter the press which amount to just that. For example, many bankers and "experts" argued that the Government should take over the sovereign non-performing debt and issue to the banks Government Bonds at 90% of the face value of the debt.

While this probability exists, bankers will be happy to string along with their present non-performing loans written up at their face value in their books. There is no incentive to recognise the reality that the value of these loans, in any open market, would be considerably less than at a 10% discount. Consequently, there is no market for such bank loans. All wait for the bail-out.

There is, however, a market for non-bank Mexican Government debt. For example, sterling denominated Mexican Bonds trade at about 20% yield on the London market. This therefore suggests that nominal debt should be written down to about two-thirds of its face value. That would then be the price it would fetch on an open market.

A similar realistic pricing of bank loans would enable us to see what banks are really worth. It is likely that some of them would be near insolvency. But they then would be ripe for a take-over as can be seen in the recent take-over of Seafirst in the United States. After all, banks that are near bankrupt usually have very profitable assets to acquire.

/I believe

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I believe it is wrong for us to continue bailing out, with additional good money chasing bad. But unfortunately we cannot avoid this since it is the policy pursued by both the Fed and the IMF. In my judgement we could not have had any effect at all on the Fed. For powerful political reasons they had to soften the blow to both Mexico and Brazil and to their own banks. The ease of rescheduling and the kid-glove treatment of the banks will induce emulation by other countries. But we cannot now rewrite this period of history. We should, however, learn the lesson for the next time such as when there is a new request for additional liquidity, through a new issue of SDRs or quota expansions for the IMF.

2. Investment Markets and their Abuse

Fritz Leutwiler has recently complained of the pressure imposed by Central Banks (particularly the Bank of England and the Fed) on commercial banks to keep open their interbank credits to banks of countries under rescheduling conditions (Mexico, but particularly Brazil and Venezuela). Leutwiler has a powerful point. Interbank lines have been grossly abused as a cheap source of roll-over credit. Western banks, thought they were lending short and found that in fact they were lending long. Such a transformation threatened the integrity of the interbank market and should not be condoned or encouraged by Central Banks in their anxiety to finance the interest payments of Mexico, Brazil etc, and maintain the fiction of the soundness of the loan portfolio. Leutwiler is implicitly arguing that, if it is a political decision, to keep drip-feeding Mexico etc, then let it be done politically as an overt act of government credit. To disguise it as normal interbank operations threatened the integrity of all such markets. I agree!

3. US Monetary Policy

I agree with Karl's interpretation of recent US monetary policy. It has been very expansionary since July and although there are signs over the last eight weeks of some reining back, the implications, as I mentioned before, are serious. The present policy is Micawberish. They are hoping that something may turn up (the world economy) or something may turn down (the price of oil) before the past monetary expansion works its wonders on the rate of inflation. Luck is essential!

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ALAN WALTERS